FAILING FIRM ANALYSIS AND THE CURRENT ECONOMIC DOWNTURN

BY KEN HEYER[1]

1 Retired from the Antitrust Division of the Department of Justice and the Federal Trade Commission. I would like to thank Dennis Carlton, Sheldon Kimmel, and Paul Godek for generously providing valuable comments and suggestions.

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I. INTRODUCTION

This is not the first time, even in recent memory, that large numbers of firms in our economy suffer from a severe economic downturn. During the Great Recession that began in 2008 a similar situation arose. At that time, many observers were calling for more lenient treatment of mergers proposed by firms in economic distress. Today, some in Congress are arguing for the exact opposite.

In a paper published in November 2009 by Competition Policy International, Sheldon Kimmel and I addressed the issue and concluded as follows:

> In recessions, we expect to see an increase in both the number and share of mergers where at least one of the parties is having difficulty independently staying afloat. This raises the importance of adopting a sound framework for analyzing merging firms in some form of financial distress. This paper concludes that, while it can be hard to evaluate a failing firm defense under the Merger Guidelines, the principles underlying the test are generally sound, even when the overall economy is going through very difficult times. The recent severe downturn may lead to more proposed mergers between financially distressed firms, but it does not imply that looser standards ought to be applied when evaluating them.[2]

That conclusion remains economically sound. The logic underlying it, and the logic's application today, are worth revisiting. In this brief note I revisit some of the issues raised by the failing — and flailing — firm defenses in times of severe economic distress, discuss certain nuances that may be specific to our current circumstances, and briefly sketch an approach that may be useful in helping competition agencies navigate these timely issues in circumstances where theory may be sound and generally agreed upon, but where information and evidence are subject to significant uncertainty.

Firms seeking to persuade competition agencies that proposed mergers should not be challenged have available to them an assortment of possible defenses, the logic and validity of which are as applicable today as they have been during more robust economic times. These include arguments that entry would be timely, likely, and sufficient; that large cognizable efficiencies would result from the merger; and that the parties are not especially close competitors. These defenses are described and discussed at some length in the Horizontal Merger Guidelines ("HMG"), and some or all of them are commonly invoked during a merger review.

2 Heyer, Ken & Kimmel, Sheldon, "Merger Review of Firms in Financial Distress," Competition Policy International, November 1, 2009.

The HMG include also a discussion of one additional defense, something that has come to be known as the "failing firm defense." It states that "a merger is not likely to enhance market power if imminent failure…of one of the merging firms would cause the assets of that firm to exit the relevant market." Demonstrating imminent failure requires the parties to prove that: (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; and (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger.

Given the current economic downturn, the failing firm defense seems likely to play an increasing role in antitrust merger reviews. Faced with rapidly declining demand for their goods and services, a large number of firms, many of whom had been highly successful, are suddenly struggling to survive. Some of these firms, perhaps as a last resort, can be expected to seek a lifeline from more solvent enterprises willing and able to acquire them. Further, it seems likely that in many cases the would-be acquirers will be firms in the same industry.

While such mergers may well generate cognizable efficiencies of one type or another, they may also be a means of obtaining market power and harming consumers. When faced with horizontal mergers in concentrated markets, the competition agencies, together with lawyers and economists working for the merging parties, customarily devote considerable time and resources to analyzing the likely net effect of these two forces. To the extent that a merger satisfies the failing firm defense, however, a rigorous analysis of likely efficiencies or increased market power, much less a careful balancing of the two, becomes unnecessary. For this reason, the failing firm defense provides a potentially quite powerful "get out of jail free" card for struggling firms and their would-be acquirers.

The failing firm defense has a compelling logic to it. Merger policy, properly applied, is forward looking. If one of the merging parties (and its assets) are not going to remain in the market in the future, why should approval of a merger be held hostage to the fact that the two firms may previously have been significant competitive constraints on one another? A merger cannot be anticompetitive if there would be no future competition to preserve. Further, there may be some benefits to permitting the owners of firms that are otherwise going out of business to earn, through merger rather than liquidation, a somewhat greater return on their initial investments.

In applying the failing firm defense to proposed mergers in our current environment, I consider below three issues. One is whether the requirements of the failing firm defense are too strict. In determining whether to clear mergers involving firms that are struggling greatly, the competition agencies should not, it is argued, ignore the fact that the struggling firm is "flailing," even if not literally failing under the demanding requirements of the defense. We consider circumstances under which a "flailing but not quite failing" firm defense should be permitted.

A second issue relates to whether the failing firm defense may be too lenient. In particular, is it robust enough to account properly for all of the relevant "but for" scenarios that might, in our current environment, disqualify a firm from successfully claiming failing status?

Third, I examine briefly the call from some in Congress that there be a complete moratorium on certain mergers. Fearing the prospect of large companies using the current crisis as an opportunity to scoop up struggling firms, one proposed piece of legislation would prohibit companies with more than $100 million in revenue, financial institutions, and most private equity partners and hedge funds, from acquiring or merging until the U.S. economy is no longer under financial stress. Is there a legitimate justification for such a moratorium, a closure of the market for corporate control; or is traditional antitrust analysis of mergers, including the failing firm defense, adequate to the task?

I conclude with a general suggestion for analyzing mergers, including those in which the failing firm defense is raised, in those many circumstances where outcomes are uncertain and the optimal decision may not be at all obvious.

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II. IS THE FAILING FIRM DEFENSE TOO STRICT?

It is well recognized that simply because a firm may be struggling financially, this alone ought not justify permitting an otherwise anticompetitive merger to take place. The "flailing" firm — a struggling firm that is not exiting the market and thus does not satisfy the demanding conditions of the failing firm defense — can often be expected to continue as an important competitive constraint on its rivals. Indeed, it may even compete for business *more* aggressively, and more effectively, than it had been doing when its very survival was not at stake. Requiring that such a firm remain independent, or otherwise sell itself to a third party whose incentives will be strong to continue competing, seems generally to be the better course unless some combination of the usual merger defenses suggest otherwise. The struggling firm's stockholders may suffer, but consumers will benefit, and it is the welfare of the latter that antitrust is properly concerned with.

That said, mergers involving firms that are "flailing but not failing" should, in certain circumstances, be afforded more relaxed antitrust treatment than were they not flailing. In particular, where the firm's financial distress can be expected to leave it significantly less competitive in the future than it had been in the past, a more lenient posture towards the merger is simply a proper application of the principle that antitrust is forward looking, not some sort of static analysis held hostage to a very different history.[3] This observation is neither new (the Supreme Court recognized it in its *General Dynamics* decision, and a District Court accepted it recently when ruling to permit T-Mobile's acquisition of Sprint), nor inconsistent with the competition agencies' appropriate focus on the "but for" world.

During a severe and prolonged economic downturn, many successful firms are facing difficult choices, and it cannot simply be assumed that as long as they manage to survive, they will come out of the crisis as anything like what they had once been. Firms in severe financial distress may present a weaker competitive force going forward for any number of reasons. Perhaps important investments will be deferred by the firm, if not abandoned permanently. Needed capital may be impossible to raise — particularly if markets "freeze up," making it virtually impossible for flailing firms to obtain funding. Costly competitive initiatives may be abandoned. Perhaps scarce and valuable employees will leave in order to take more remunerative or more secure positions elsewhere. Perhaps the firm's suppliers will lose confidence that they will be paid in a timely fashion and will be more reluctant to continue investing in a relationship with the firm. For any number of reasons, that is, it could be the case — particularly during economic crises such as the one we are currently experiencing — that the relatively low bar of "continued existence in the marketplace" is no guarantee that the distressed firm will in fact remain an effective competitive constraint going forward.[4]

Where the struggling firm will provide in the future a less significant competitive constraint in the market, the competition agency's analysis should treat it as such, and should adopt a commensurately more lenient policy towards the merger — weighing any cognizable efficiencies against the remaining risk that eliminating even a diminished competitive force could prove harmful to consumers. Of course, the flailing firm's weakened competitive position may be only short-lived, or it may not impact very materially the firm's ability to compete even in the short term, or the claim may not be supported by evidence. Nevertheless, it cannot simply be assumed that a flailing-but-not-failing firm will be as competitive going forward as it may have been in the past. That is hardly a certainty, and plausible evidence to the contrary should be examined and treated as seriously as the agencies treat other issues relevant to their overall analysis. This seems all the more important during serious economic downturns, when such outcomes may well be more plausible, and more widespread, than usual.

3 The converse is true as well. The competition agencies are certainly on firm ground in viewing with great skepticism claims that nascent competitors who have yet to turn a profit and may not yet be a strong competitive force in the marketplace are not worth preserving as independent entities. Whether or not such firms have yet recorded profits seems less relevant than whether, for example, these firm have been able to continue raising necessary capital in the marketplace. If they have been able to – and many "unprofitable" startups do seem to have very high stock market valuations – investors apparently view the firm's future prospects to be promising.

4 That having been said, to the extent that assets departing from the flailing firm would flow to the more successful rival even absent a full merger, one would want to consider whether a merger that keeps the entire bundle of assets of the flailing firm together (under the control of the acquiring entity) is more efficient than piecemeal dismemberment. If not, then the merger presents fewer, perhaps no, cognizable efficiencies and eliminating the diminished, but not exiting, rival is more likely to be of competitive concern.

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III. THE FAILING FIRM DEFENSE AND THE RELEVANT "BUT FOR" SCENARIO

In asking what would happen if a proposed merger involving a potentially failing firm is not permitted, the HMG properly asks about the likely "but for" scenario. It looks to the ability of the firm to reorganize itself under the bankruptcy laws while still remaining in business, and looks also at its ability to sell off relevant assets to a buyer likely to replace its competitive role in the market. Understandably, given the somewhat unprecedented times we find ourselves in, the HMG does not refer explicitly to the ability of an otherwise failing firm to stay afloat through other means — specifically, through loans or grants from the government. The extraordinary and virtually unprecedented role being played by the Federal Reserve and the federal government today arguably provides this additional lifeline to otherwise struggling firms, supplementing the role of ordinary capital markets in helping maintain in the market a firm that would otherwise be forced to exit.

Though fully consistent with the spirit of the HMG's failing firm requirements, this potential avenue through which otherwise failing firms might be able to survive ought to be a factor in the competition agency's assessment of its failing firm claims. Reliably predicting how successful government efforts to keep particular firms alive through the crisis is, however, no easy task. The process is difficult and uncertain, and there may be significant fixed costs of working with a government bureaucracy that, particularly for smaller firms, may not be worth incurring.

On the other hand, a struggling firm may well prefer to be bought out by a competitor (at an attractive price) than go through the process of securing support from the government. A firm may even refuse to apply for an ostensibly available government loan, or it may express to antitrust officials strong skepticism that such support will be forthcoming quickly enough, and on terms that it can live with.[5] Nevertheless, where evidence plausibly demonstrates that this lifeline would indeed maintain the firm as an independent player in the market, the competition agencies should be more reluctant to accept the failing firm defense.

IV. THE FAILING FIRM DEFENSE AND CALLS FOR A MERGER MORATORIUM

Finally, there is the question of when or whether antitrust enforcers should ever object to mergers involving bona fide failing firms — i.e. firms whose assets would literally exit the market in the absence of the proposed acquisition. Why, in particular, should a merger moratorium be employed during times of severe economic distress? A handful of reasons might be suggested, though none appear particularly compelling. One is a fear that the big and successful will, through acquisition of a failing adversary, become even bigger and more successful. This argument either ignores the fact that acquiring a failing firm does not eliminate a future competitor (which, as discussed above, is reason enough for permitting the acquisition), or treats the most likely explanation for such a merger — efficiencies — as a reason for condemning the merger rather than approving of it.

Antitrust enforcement generally assumes that there can be no anticompetitive effect when one firm wants to acquire the assets of an otherwise exiting rival. The logic of that position has prevailed over the past half century; there is no reason to abandon it now. To the extent there is a fear that firms made larger and more efficient through merger could more readily engage in anticompetitive or exclusionary practices going forward, a more reasonable response would seem to be to address those practices through antitrust interdiction when — and if — they take place, rather than adopt a blanket policy against becoming large and efficient at all.

Another possible explanation for demanding a merger moratorium might be a concern that the competition agencies cannot be expected to evaluate the failing firm defense correctly. Perhaps the agencies might inadvertently approve anticompetitive mergers on the mistaken view that the struggling to-be-acquired firm would be exiting when in fact it would not. Or perhaps the competition agencies in the current administration are not — in the view of a moratorium's supporters — sufficiently aggressive when it comes to enforcing the antitrust laws and would use the current economic environment as a pretext for being far too lenient. A moratorium would, it could be argued, hold things in place until a new, perhaps more interventionist, administration came to office.

These are, of course, possibilities. Decision makers at the competition agencies are human and — like courts and even legislators — do make mistakes from time to time. The fact that mistakes can be made, however, hardly seems a reason for abandoning analysis altogether and, in this case, simply prohibiting mergers entirely. The vast majority of mergers cannot seriously be expected to prove harmful, and a concern for

5 Also of potential concern is the risk — perhaps modest, though certainly non-zero — that a flailing firm defense might incentivize firms to become flailing in order to strengthen their chances of receiving merger clearance from the government.

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occasionally getting things wrong (or for being perhaps a bit more lenient under a Republican Administration than under a Democrat one)[6] would surely be outweighed by the benefits of permitting the marketplace — where traditional competitive concerns do not clearly arise — to reallocate assets during economically distressed times through mergers and acquisitions.[7]

V. ANTITRUST ENFORCEMENT GIVEN THAT OUTCOMES ARE UNCERTAIN

Failing and flailing firm claims, as with other defenses put forward by merging parties, clearly involve difficult questions for the competition agencies to navigate successfully. No matter how talented, dedicated, and hard working their staffs (and I can personally attest from decades of experience working in government that their staffs tend to be all of those things), one never knows with certainty whether a merger defense should be accepted or rejected, and whether a potentially anticompetitive merger truly is anticompetitive, or whether it is benign. “Predicting is hard” Yogi Berra once said, “especially about the future.”

Still, predicting the future is a good part of what antitrust analysis is all about, and difficult issues relating to would-be-failing-firms are ones that cannot be ignored. One possible approach to dealing with the high degree of uncertainty involved in trying to determine whether a merger involving a distressed firm should be cleared (indeed, a method that a number of writers have suggested be used by the agencies more generally),[8] would be to adopt more formally a decision-theoretic approach to analyzing the costs and benefits of allowing the merger, recognizing explicitly that the decision maker can never be one hundred percent certain that it is making the correct decision.

As a step in furtherance of this approach, and to give a brief flavor of how such a process might be employed, consider the agency proceeding somewhat along the following lines.

First, to get at the expected costs of mistakenly approving the merger when, in fact the firm was likely to be a significant competitive constraint going forward, the agency could ask itself:

- a1) How much harm to consumers do we think will occur if the merger is indeed anticompetitive and we incorrectly permit it by accepting the failing (or flailing) firm defense?

- a2) What is the probability that permitting the merger on failing (or flailing) firm grounds will, in fact, be a mistake?

To get at the expected costs of mistakenly blocking the merger — i.e. not crediting the failing (or flailing) firm defense when it should have been credited — the agency could ask itself:

- b1) How large are the benefits of permitting a benign merger that properly qualifies for this defense?

- b2) What do we think is the probability that the firm truly does qualify for the defense?

If the expected costs (a1 x a2) are greater than the expected benefits (b1 x b2), then blocking the merger is expected to prove beneficial. Conversely, if the expected costs are less than the expected benefits, the merger should be permitted.

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6 As an aside, based on my experiences working as an economist for more than three decades at the two federal competition agencies, I believe that the differences in merger enforcement across Republican and Democrat Administrations have been, while not zero, somewhat exaggerated. Further, I have seen virtually no difference across Administrations in how strictly or how leniently the failing firm defense has been applied in those cases where it has been asserted, and am not aware of any significant evidence suggesting otherwise.

7 Nor is it clear that the Supreme Court would tolerate the “taking without compensation” of property implied by a blanket prohibition on the buying and selling of assets.

8 See for example: Ken Heyer, A World of Uncertainty: Economics and the Globalization of Antitrust 72 Antitrust Law Journal 375 (2005) and Katz, Michael L. & Howard A. Shelanski. “MERGER ANALYSIS AND THE TREATMENT OF UNCERTAINTY: SHOULD WE EXPECT BETTER?” *Antitrust Law Journal*, vol. 74, no. 3, 2007, pp. 537–574.

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Determining these costs, benefits and probabilities with a high degree of accuracy is, of course, difficult and one should not ignore or minimize the challenges involved. Nevertheless, in the course of investigating whether or not to challenge a merger, the agencies frequently and appropriately, though rarely publicly and explicitly, ask themselves these types of questions all the time. Since outcomes are typically uncertain, the agencies may benefit from more explicitly employing a range of reasonable estimates, examining the sensitivity of the outcome to these alternative assumptions, and through this process better understanding the sets of circumstances under which the failing (or flailing) firm defense ought to be accepted or rejected.

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