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CLIENT ALERT

A Flailing Economy is Not Enough to Prove a Failing Firm

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Introduction

Despite the economic uncertainty due to the COVID-19 pandemic, Ian Conner, Director of the Bureau of Competition of the Federal Trade Commission (FTC), recently stated that the FTC will continue to be highly skeptical of the so-called "failing firm defense." Merging parties that make use of the failing firm defense argue that even if a proposed transaction is anticompetitive, it nonetheless should be allowed to proceed because the target is failing and but for the transaction, the target's assets will exit the marketplace.

In a May 27, 2020 blog post, Conner cautioned that despite the current economic uncertainty, the FTC will continue to closely scrutinize failing firm claims and that "the Bureau will not relax the stringent conditions that define a genuinely 'failing' firm." As antitrust practitioners are well aware, the FTC and the Department of Justice (DOJ, together with the FTC, the Agencies) have always applied stringent standards for merging parties to meet their burden of proving the failing firm defense. In fact, Conner noted that "the Bureau rarely finds that the facts support a failing firm argument." Conner's May 27 statement and those discussed in an earlier Winston briefing regarding the FTC's general approach to applying the antitrust laws during the COVID-19 pandemic should put to rest any notion that merging parties can expect less skepticism from the FTC when making a failing firm argument in the context of a merger investigation. At the same time, it is possible that because the COVID-19 pandemic has resulted in real-world economic distress, it could increase the likelihood that merging parties can successfully argue that a merging party is failing. Before discussing the COVID-19 pandemic's impact on the failing firm defense, it is helpful to review the elements of the defense.

Establishing a Failing Firm Defense

The elements of the failing firm defense are described in Section 11 of the 2010 Horizontal Merger Guidelines that were jointly published by the FTC and the DOJ (the Guidelines)[1]. As described in the Guidelines, the failing firm must demonstrate that it:

1. cannot meet its financial obligations in the near future;

2. is unable to reorganize successfully under Chapter 11 of the Bankruptcy Act; and
3. has been unsuccessful, despite good-faith efforts, in obtaining reasonable alternative offers that would keep its assets in the relevant market and pose a less severe danger to competition than the proposed transaction.

Courts generally use a similar three-pronged analysis.[2] Each of these three elements is discussed further below.

1. Inability to meet financial obligations in the near future

Under the Guidelines, a "failing" a firm must be at imminent risk of financial failure such that only the proposed transaction will resolve the firm's financial difficulties. Without more, decreasing profits or sales are insufficient. Factors considered by the Agencies and courts include whether the allegedly failing firm: (1) cannot meet its financial obligations, such as debts that are due, (2) has costs greater than its revenues, and (3) is unable to obtain loans or raise other new sources of capital. Merging parties that make a failing firm argument should expect close scrutiny of ordinary course documents, including financial statements, budgets, and strategic and marketing plans to verify claims of economic distress.[3]

The distinction between a firm that is merely facing current financial difficulties and one whose ability to compete is in jeopardy can be seen in past attempts to rely on the failing firm defense. For example, in *California v. Sutter Health System*, the parties successfully demonstrated that the target, Summit Medical Center, was at risk for imminent financial failure.[4] In particular, the court noted that Summit had been unable to pay its debts, had significant long-term debt, was prohibited by its credit agreements from taking on new debts, and faced substantial capital expenditures from necessary upgrades to its facilities.[5] In contrast, in *FTC v. H.J. Heinz Co.*, a court found that the parties did not establish the failing firm defense where the target's business was stagnant or declining without any realistic prospect of change and its plant was highly inefficient.[6] Notwithstanding these issues, the target was still a profitable business and therefore not at imminent risk of failure.[7]

2. Inability to reorganize successfully under Chapter 11 of the Bankruptcy Act

A failing firm defense will not be successful if the failing firm's debts can be restructured. Accordingly, it is not sufficient to demonstrate that outstanding bank loans may be called in because such loans could be restructured to keep the firm in business if its future prospects are encouraging.[8] To determine whether restructuring is possible, the Agencies may interview the firm's creditors and analyze any plan presented by the firm to its creditors for improving its financial situation.

The key question is whether bankruptcy would allow the allegedly failing firm's assets to remain in the relevant market. For example, in *Sutter Health*, the court found this element met where the parties established that the likely outcome of a bankruptcy would be the removal of the target's assets from the relevant market due to a liquidation.[9] Courts are divided on whether meeting this element is required with some courts holding that this prong does not need to be met to establish a failing firm defense.[10]

3. No reasonable alternative offer

The Agencies and courts require failing firms to demonstrate that they undertook a good-faith effort to locate an alternative buyer that would make a reasonable offer and was less detrimental to competition. In past guidance, the FTC has stated that "even the most financially challenged firm must do more than window shop the assets. ... The merging parties must show that acquiring company is the only available purchaser."[11] Examples of evidence of good-faith efforts to find alternative buyers include:

- contacting a number of prospective buyers, including investment firms or companies from related industries;
- providing sufficient information to companies expressing interest; and
- pursuing legitimate expressions of interest.

Hiring investment bankers or other consultants to manage a sale process can be evidence of a good-faith effort, but only where the banker or consultant is given proper incentives to search for an alternative buyer.[12] In *FTC v. Harbour Group Investments*, the court rejected a failing firm defense where the financial firm searching for an alternative buyer made minimal effort over a truncated time frame and the parties rejected three potential buyers identified by the FTC.[13]

The Agencies may require the parties to fully explore a possible transaction with the alternative buyer before accepting the failing firm defense if they believe that alternative buyers are available. In its investigation of Scott & White Healthcare's merger with King's Daughter hospital, the FTC determined that King's Daughter was likely to close unless it was acquired by another health system. The FTC learned that a buyer other than Scott & White had been interested in acquiring King's Daughter, but was unable to explore a transaction before the parties executed a purchase agreement. As a result, the FTC and the parties agreed that Scott & White would offer to sell King's Daughter to the alternative buyer. After conducting diligence, however, the alternative buyer decided not to acquire King's Daughter, which ultimately led the FTC to close its investigation.

Does COVID-19 Change Anything?

Even though the Agencies are likely to continue their rigorous scrutiny of failing firm claims, it seems likely that the real-world circumstances to which that scrutiny will be applied have, in fact, changed. A recent interview with Melissa Hill and Mark Seidman, the co-leaders of the FTC's Mergers IV Division, and a decade-old statement from the Deputy Assistant Attorney General for Economics Carl Shapiro during the last recession support this view.

According to Seidman, the framework for evaluating transactions during economic crises "is well laid out in the guidelines and the case law and the failing firm doctrine and related evaluations" and … "our questions [regarding the failing firm defense] would be really the same as they would be in any other situation." Even so, Hill noted that "the pandemic circumstances could lead to a short-term financial struggle or difficult situation that would nonetheless still be convincing to us if it was dire enough. I wouldn't expect that we would require the firm to have shown that they have long-term financial difficulties, but the ability to recover would be part of our inquiry." In a speech during the Great Recession in 2009, Carl Shapiro (then Deputy Assistant Attorney General for Economics for the DOJ) articulated a similar view. Like Hill and Conner, Shapiro maintained that while antitrust authorities might be more likely to see cases involving financially troubled firms, no special rules for financial distress were required to analyze whether those firms were failing during a recession.[14] At the same time, Shapiro also recognized that "financial distress at the industry or company level is certainly relevant to antitrust analysis. This point should not be controversial; it is merely an application of the general principle that antitrust enforcement should take account of real-world economic conditions."[15] Taken together, Hill and Shapiro's statements suggest that economic turmoil, this time the result of the COVID-19 pandemic, may make it easier for merging parties to demonstrate current economic distress and an inability to recover without the history of decline that the Agencies would expect absent the pandemic. One should still assume, however, that the Agencies will apply the same rigorous scrutiny to analyze the claimed distress.

Another possible effect of the COVID-19 pandemic is that there may be fewer prospective buyers for a particular target than pre-pandemic. To demonstrate that it has effectively "shopped" the assets, a seller will still be required to show evidence of the same good-faith search. Yet, the same good-faith search that might have produced multiple buyers pre-pandemic could result in only a single strategic buyer in the current economic environment. In such circumstances, the merging parties may be able to successfully avail themselves of the failing firm defense. Again, merging parties should not expect that the Agencies' stringent standards or analytic framework will have changed. Nonetheless, the real-world facts in which the parties are operating have changed and may make it easier to convince the Agencies that a good-faith search resulted in only a single reasonable offer.

Takeaway

Because the COVID-19 pandemic has led to increased economic distress, it may theoretically be easier to demonstrate that a firm is failing and unlikely to recover because of that distress. Nonetheless, Ian Conner's statement makes it clear that merging parties should expect a healthy dose of skepticism from the FTC in response to any invocation of the failing firm defense. In particular, merging parties should be wary of making unsubstantiated claims that a firm is failing, lest they risk their credibility with the Agencies.

For more information, contact the authors, or your Winston & Strawn relationship attorney.

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[1] U.S. Department of Justice and the Federal Trade Commission, *2010 Horizontal Merger Guidelines*, https://www.justice.gov/atr/horizontal-merger-guidelines-08192010.

[2] *Citizen Publishing v. United States*, 394 U.S. 131, 138–39 (1969).

[3] For example, in the health care context, the FTC has stated that it relies on evidence such as: "documents, interviews with payers, and evidence of a hospital's financial struggles such as staff layoffs, closed service lines, declining inpatient admissions and outpatient procedures, declining revenues and increased losses, compromised (or potentially compromised) quality, or downgraded credit scores from the rating agencies." *See* Deborah L. Feinstein, Dir. Bureau of Competition, Federal Trade Commission, *Antitrust Enforcement in Health Care: Proscription, not Prescription* (Jun. 19, 2014), https://www.ftc.gov/system/files/documents/public_statements/409481/140619_aco_speech.pdf.

[4] 84 F. Supp. 2d 1057, 1082 (N.D. Cal. 2000).

[5] 130 F. Supp. 2d at 1135.

[6] 246 F.3d 708 (D.C. Cir. 2001).

[7] *Id.*

[8] Contribution by the United States, *OECD Roundtable on Failing Firm Defence* at 5 (Oct. 6, 2009), https://www.ftc.gov/system/files/attachments/us-submissions-oecd-2000-2009/failingfirm.pdf.

[9] *Sutter Health*, 130 F. Supp. 2d at 1135.

[10] *Compare United States v. M.P.M., Inc.* 397 F. Supp. 78, 96–97 (D. Col. 1975) (failing company does not need to demonstrate no possibility of reorganization in bankruptcy; *with Sutter Health*, 130 F. Supp. 2d at 1135 (failing company must show prospects of reorganization in bankruptcy is slim or nonexistent).

[11] Debbie Feinstein and Alexis Gilman, Bureau of Competition, Federal Trade Commission, *Power Shopping for an Alternative Buyer* (Mar. 31, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/03/power-shopping-alternative-buyer.

[12] *OECD Roundtable on Failing Firm Defence* at 6.

[13] *Power Shopping for an Alternative Buyer, supra* note 9.

[14] Carl Shapiro, *Competition Policy in Distressed Industries* (May 13, 2009), https://www.justice.gov/atr/speech/competition-policy-distressed-industries.

[15] *Id*.

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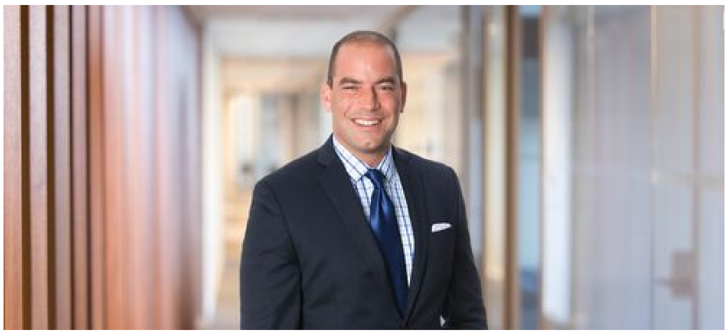

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