Before Shuttering Your Business, Consider Invoking the Failing Firm Defense in a Sale to a Competitor

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Businesses that fall on hard times are often faced with difficult choices: whether to lay off employees, close unprofitable facilities, liquidate assets, or even sell some or all of a business to a larger, more successful competitor.

When there is no feasible way to save a business besides selling it to a competitor, antitrust law offers a complete defense to mergers that might otherwise be illegal. The so-called “failing firm” defense recognizes that a merger with a close competitor — even if it leads to a more concentrated market with higher prices — may be less harmful to competition than shuttering a business altogether.

Origin of the Failing Firm Defense

The failing firm defense was first recognized by the Supreme Court in a 1930 case called *International Shoe Co. v. FTC*, 280 U.S. 291 (1930). The case involved the acquisition of a failing shoe manufacturer, W. H. McElwain, by a rival firm, International Shoe. The government sued to block the merger on the grounds that it violated Section 7 of the Clayton Act, which prohibits mergers that may “substantially” lessen competition or “tend to create a monopoly.”

The Supreme Court disagreed and allowed the merger to go forward due to the dire financial condition of the acquired company. According to the court, the target company, W. H. McElwain, was “faced with financial ruin” such that “the only alternatives presented were liquidation through a receiver or an outright sale.” In these circumstances, selling to a successful competitor avoided the “more disastrous fate” of having to sell the company’s assets through liquidation.

The logic of the Supreme Court’s opinion required that an important condition be met—namely, that there be “no other prospective purchaser” than the competitor. If another company stood ready to acquire the failing company and continue its business, or if the floundering company had other ways to save itself short of the merger, the defense was not available.

Today, antitrust regulators at the Department of Justice (DOJ) and Federal Trade Commission (FTC) recognize the "failing firm defense," and the related "failing division defense," which apply to company divisions with persistently negative cash flows. To satisfy enforcers, proponents of the defense must show that the firm or division truly is failing by virtue of its inability to meet its financial obligations. And, as in International Shoe, enforcers require that there be no viable alternative to the merger that carries a lower risk of competitive harm. Finally, agencies consider whether elimination of the company's debt through bankruptcy proceedings could correct its financial problems.

The Little Brother to the Failing Firm Defense: The "Flailing" Firm Defense

More than 40 years after the emergence of the failing firm defense, the "flailing" firm defense, also known as the "weakened competitor" defense, was born. In *United States v. General Dynamics Corp.,* 415 U.S. 486 (1974), the government sought to enjoin General Dynamics Corporation's acquisition of a fledgling strip-mining coal producer, United Electric Coal Companies, as illegal under Section 7 of the Clayton Act. The government attempted to prove the merger was anticompetitive primarily through statistical evidence that likely showed increased consolidation in the market for the production of coal as a whole and a potential significant increase in the plaintiff's market share. But, at the time, United Electric Coal was running out of coal reserves and had already committed most of its future output under long-term contracts. The company also had no experience in other methods of coal production and, therefore, was unlikely to remain a strong competitor in the market. While not an absolute defense, the company's weakened ability to compete went "to the heart of the Government's statistical prima facie case." Because United Electric Coal's competitive significance was quickly declining, the statistical evidence overstated the anticompetitive effect of the merger.

Today, the "flailing" firm defense is popularly asserted as an alternative to the failing firm defense where a company's competitive significance is likely to decline going forward, but the company may not go out of business. Unlike the failing firm defense, the "flailing" firm defense is not absolute. Government agencies have now recognized the importance of *General Dynamics* in the merger analysis and consider it a part of weighing the procompetitive benefits of a transaction against any anticompetitive harms.

While the "flailing" firm defense is not a complete defense, there are less stringent requirements for asserting it. Courts weigh a number of factors that mainly focus on an inability to meet financial obligations, such as having high fixed costs, a lack of access to capital or other vital inputs, extensive layoffs, or defaulting on debt. Courts also consider other market realities that are impeding the acquired firm's ability to compete effectively or that suggest the firm's presence in the market will decline going forward.

Increasing Your Likelihood of a Successful Defense

There are steps companies can take to improve the likelihood that the defense will be credited by enforcement agencies and, if necessary, by the courts.

First, the company should conduct a close analysis of company financials and internal documents to assess the degree to which a company's competitive significance is declining and will continue to decline, despite the best efforts of managers to turn things around. Internal records may reflect unavoidable default on debt payments, layoffs, and plans to withdraw from markets or shutter facilities. On the other hand, documents may show opportunities to turn the company around that were not taken or fully explored. The company should be prepared to explain any such potentially relevant documents to enforcers.

Second, the company should consider shopping its assets to prove no other potential buyer exists that poses less risk of harm to competition. To manage that process, the company should consider retaining a consultant or investment banking firm to ensure that assets are adequately shopped. This can help create strong documentary evidence that the assets were offered to a wide net of potential buyers, both strategic and financial. If retaining a consultant or investment banking firm is not feasible, the company should be sure to document all of its efforts at shopping the assets.

Third, if the failing company is a division or subsidiary of a healthy parent company, the analysis will be focused on that particular division or subsidiary. Thus, the company will have to take extra steps to show that the particular division will exit the market but-for the acquisition. While the DOJ and FTC have recognized that the failing firm defense may apply to a failing division, higher standards of proof will likely apply. Importantly, the division's failure cannot be a result of the creative accounting of the parent company.

Finally, companies that believe they may need to invoke either defense should consult with experienced antitrust counsel to assess available defenses, and if the time comes, to assert those defenses to antitrust enforcement agencies.

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