Note

Turning the Failing Firm Defense Into a Success: A Proposal to Revise the Horizontal Merger Guidelines

Troy Paredes

Under the failing firm doctrine, parties to a horizontal merger or acquisition can interpose the acquired company’s financial failure as an absolute defense to an otherwise anticompetitive transaction that violates section 7 of the Clayton Act. Two rationales have been offered in support of the doctrine. First, the “private interest rationale” asserts that courts should protect private interests, such as workers, shareholders, and local communities, whose welfare depends upon the survival of the failing firm. Second, the “economic rationale” asserts that mergers and acquisitions involving failing firms do not threaten competition. In this Note, the author evaluates the private interest and economic rationales and concludes that they are inconsistent with section 7’s goal of promoting competition. The author contends that competition should not be sacrificed to protect private interests and that transactions involving failing firms pose various anticompetitive risks.

The author also evaluates the predominant version of the failing firm defense, which is included in the 1992 Horizontal Merger Guidelines. The author criticizes the current defense because it is absolute and comprises rigid requirements that focus on the acquired firm’s financial condition. The author claims that this per se approach to merger enforcement undermines section 7 because it ignores market realities outside the defense’s requirements that influence a given transaction’s competitive consequences. The defense does not appreciate that the failing firm’s exit may sometimes promote competition more than its acquisition. Ultimately, the author proposes a new failing firm defense that incorporates a rule-of-reason approach. The proposed defense requires the DOJ and FTC to inquire into market realities to determine the likely competitive consequences of the acquisition in question. The acquisition should only be permitted if acquisition of the failing firm would result in a more competitive market than the firm’s financial failure and exit. The author finds support for this fact-intensive, case-by-case inquiry into market realities from other contexts in which courts, the DOJ, and the FTC employ a rule-of-reason approach to merger enforcement.

† A.B. Economics, University of California at Berkeley (1992); J.D., Yale Law School (expected 1996). I would like to thank Professor Alvin Klevorick for his comments and insights during the preparation of this Note. Any remaining errors are mine.

Copyright © 1996 by the Yale Journal on Regulation
The Yale Journal on Regulation Vol. 13:347, 1996

Introduction ................................................. 349

I. The Failing Firm Doctrine and Defense ............................ 352
   A. Overview .............................................. 352
   B. International Shoe ...................................... 355

II. Conceptual Underpinnings of the Failing Firm Doctrine ............. 357
   A. The Private Interest Rationale ........................... 358
   B. The Economic Rationale .................................. 362
      1. Market Structure ..................................... 365
      2. Market Share ........................................ 365
      3. Competition for Customers ............................ 366
      4. Exploiting Failing Firm’s Assets .................... 367
      5. Disciplinary Pricing and Predation .................. 369
      6. Piecemeal Sale ...................................... 369
      7. Excess Capacity .................................... 370

III. The Failure of the Failing Firm Defense .......................... 372

IV. A New Approach: A Proposal to Revise the Merger Guidelines ....... 377
   A. A New Approach to Failing Firms .......................... 378
      1. Chronic Excess Capacity ............................... 378
      2. Structural Deficiency ................................ 379
      3. Exit v. Merger ....................................... 382
   B. Institutional Competence and Support for the Proposal ......... 382
      1. Case Law ............................................. 383
      2. Merger Guidelines .................................... 387

Conclusion .................................................... 389
Horizontal Merger Guidelines Reform

Introduction

The more one thinks about [the failing firm doctrine], or at least the more I think about it, the less it makes sense. Indeed, it seems to me that it has become acceptable to all of us only by virtue of constant repetition and the passage of time.¹

William F. Baxter, Former Assistant Attorney General
Antitrust Division, Department of Justice

The failing firm defense fails section 7. Courts, scholars, the Department of Justice, and the Federal Trade Commission² agree that the primary goal of section 7 of the Clayton Act,³ and the antitrust laws generally,⁴ is to promote competition.⁵ A face-value reading of section 7 validates this consensus, since section 7 prohibits only those mergers and acquisitions “the effect of [which] may be substantially to lessen competition, or to tend to

---

2. Hereinafter, the Department of Justice and the Federal Trade Commission will be referred to as the “Agencies.”
3. See Brown Shoe Co. v. United States, 370 U.S. 294, 320 (1962) (“Taken as a whole, the legislative history of [section 7 of the Clayton Act] illuminates congressional concern with the protection of competition, not competitors, and its desire to restrain mergers only to the extent that such combinations tend to lessen competition.”); International Shoe Co. v. FTC, 280 U.S. 291, 297-98 (1930) (“Section 7 of the Clayton Act, as its terms and the nature of the remedy prescribed plainly suggest, was intended for the protection of the public against the evils which were supposed to flow from the undue lessening of competition.”); 1992 Horizontal Merger Guidelines, 57 Fed. Reg. 41,552, 41,554 [hereinafter 1992 Guidelines] (“The process of assessing market concentration, potential adverse competitive effects, entry, efficiency and failure is a tool that allows the Agency to answer the ultimate inquiry in merger analysis: whether the merger is likely to create or enhance market power or to facilitate its exercise.”); Donald I. Baker & William Blumenthal, The 1982 Guidelines and Preexisting Law, 71 Cal. L. Rev. 311, 315 (1983); Richard D. Friedman, Untangling the Failing Company Doctrine, 64 Tex. L. Rev. 1375, 1378 (1986) (“The preservation of competition is the principal—if not the only—goal of Section 7.”); Kevin J. Arquit, The Failing Firm Defense and Related Issues, Remarks Before the American Bar Association 4 (Apr. 12, 1991) (“A basic tenet of our merger analysis [is] that the focus of antitrust inquiry is limited to competitive effects in the relevant market . . . .”) (transcript on file with author).
create a monopoly. Given Congress' express concern for competition, section 7 enforcement should not subordinate competition to other social goals, of which the Clayton Act makes no mention. Rather, courts and the Agencies should adopt enforcement practices that best assure that competition is promoted.

Under the failing firm doctrine, upon which the failing firm defense is premised, parties to a horizontal merger or acquisition can interpose the financial failure of the acquired company, or "target," as an absolute defense to an otherwise presumptively anticompetitive transaction that violates section 7. The doctrine is principally founded upon two rationales that are inconsistent with promoting competition and that represent an overly expansive reading of International Shoe Co. v. FTC, the Supreme Court decision giving rise to the failing firm doctrine. First, the "private interest rationale" expressly invites courts and the Agencies to sacrifice competition to protect private interests, such as employees and shareholders, whose welfare depends on the failing firm's survival. Second, the "economic rationale" wrongly presumes that the acquisition of a failing competitor does not threaten to lessen competition substantially.

In demonstrating the shortcomings of the failing firm defense, this Note stresses that both the doctrine and its application are inconsistent with section 7's goal of promoting competition. Part I provides an overview of the failing firm doctrine and its origin. The discussion focuses on the unjustified expansion by courts and agencies of the Supreme Court's holding in International Shoe into a rigid and absolute failing firm defense. Part II examines the conceptual underpinnings of the failing firm doctrine, namely, the private interest and economic rationales. The analysis emphasizes that the private interest rationale expressly undermines section 7 by subordinating competition to concern for different social goals. The discussion then questions the economic rationale, noting several anticompetitive risks that the acquisition of a failing firm poses. Part III examines the practical application of the failing firm defense and concludes that, by virtue of its rigidity and absoluteness, the defense frustrates section 7; the defense not only ignores market realities that

---


7. In National Soc'y of Professional Eng'rs v. United States, the Supreme Court stated that the Sherman Act's rule of reason "does not open the field of antitrust inquiry to any argument in favor of a challenged restraint that may fall within the realm of reason. Instead, it focuses directly on the challenged restraint's impact on competitive conditions." 435 U.S. 679, 688 (1978). Professional Engineers is read to suggest that consideration of non-economic social interests at the expense of competition is not an option in antitrust enforcement. There is no principled reason why the Court would not extend its reasoning beyond the facts of Professional Engineers to include section 7. See Baxter, supra note 1, at 248, 251; Friedman, supra note 3, at 1410; Arquit, supra note 3, at 6.
bear on the likely competitive consequences of the merger, but also mistakenly relies on the target’s financial condition as a conclusive measure of its competitive consequences.

The analysis in Parts II and III explains why the current failing firm defense simply does not fit into the policy motivating section 7; the defense identifies a problem, the failure of a firm, that does not necessarily concern section 7, and proposes a solution, a presumptively anticompetitive merger, that threatens to lessen competition. Part IV then offers a more coherent approach to the failing firm doctrine by proposing revisions to the 1992 Merger Guidelines’ failing firm defense. The proposed defense’s sole objective is to promote competition. To fulfill its objective, the defense incorporates a rule-of-reason approach to section 7 enforcement. Specifically, the proposed defense replaces its predecessor’s rigidity with a flexible case-by-case inquiry into market conditions, other than the target’s financial failure, which determine the transaction’s competitive consequences. Because of its fact-intensive inquiry, the proposed approach ascertains the competitive impact of a merger better than the current defense, thereby better fulfilling the purpose of section 7. Moreover, the proposal harmonizes the failing firm defense with courts’ and agencies’ rule-of-reason approaches to other aspects of merger enforcement, especially the prima facie case. The fact that courts and the Agencies inquire into market realities in other section 7 contexts suggests both that courts and the Agencies are sufficiently competent to effectuate a rule-of-reason failing firm defense and that precedent supports the proposed fact-intensive approach.

8. Indeed, the Federal Trade Commission has recently suggested that it may be time to change the failing firm defense. Draft Agenda for FTC Hearings on Adjustments to Enforcement Policies, 69 Antitrust & Trade Reg. Rep. (BNA) 72 (July 20, 1995).

9. Before proceeding, it is important to clarify what “competition” means for purposes of this Note, especially for the economic analysis in Parts II.B, III, and IV.A. This Note posits that maximization of consumer welfare is the goal of antitrust law and its procompetitive policy. See, e.g., Reiter v. Sonotone Corp., 442 U.S. 330, 343 (1979); 1 PHILLIP AREEDA & DONALD F. TURNER, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶¶ 103-113 (1978); ROBERT BORK, THE ANTITRUST PARADOX 61-66 (1978); Baxter, supra note 1, at 619 (1983); Thomas G. Krattenmaker et al., Monopoly Power and Market Power in Antitrust Law, 76 GEO. L.J. 241, 244 (1987). Accordingly, this Note will measure the degree of competition by the level of consumer welfare attained; the higher the consumer welfare is in a market, the more competitive the market.

Ideally, courts would be asked to calculate whether consumer welfare would be higher with exit or with acquisition. Such calculations, however, are not easily performed. Therefore, this Note will use price and output as proxies to measure a market’s consumer welfare and hence its competitiveness. Specifically, as between two outcomes, the one in which price is lower and output higher is characterized as the more competitive outcome (i.e., the outcome with higher consumer welfare), and, in this Note’s terms, the “preferable” outcome. From this it follows that an “anticompetitive consequence” is one that increases price and decreases output, whereas a “procompetitive consequence” is one that decreases price and increases output. These characterizations fully classify all markets where demand does not change as a result of exit or acquisition. However, if demand should change with exit or with acquisition, a more complex...
I. The Failing Firm Doctrine and Defense

A. Overview

The failing firm doctrine permits an otherwise anticompetitive merger or acquisition if the involved parties can demonstrate that, but for the transaction, the acquired firm would fail. The failing firm defense is only considered if the prima facie case demonstrates that the transaction is presumptively anticompetitive. The leading Supreme Court cases establishing the failing firm doctrine, \textit{International Shoe Co. v. FTC} and \textit{Citizen Publishing Co. v. United States}, provided three criteria that parties must satisfy to sustain the failing firm defense: (1) the acquired firm must be in imminent danger of financial failure; (2) the failing firm must have dim or nonexistent prospects of reorganization in bankruptcy; and (3) there must be no other viable alternative purchaser of the failing firm's stock or assets.

Today, the most widely accepted version of the failing firm defense is

\begin{enumerate}
  \item Admittedly, in the full complexity of actual markets, price and output become less reliable proxies of consumer welfare. For example, when products are differentiated, it is difficult to define price and to measure output. See Thomas G. Krattenmaker & Steven C. Salop, \textit{Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price}, 96 YALE L.J. 209, 284 (1986). Further, under certain circumstances, consumer welfare can decrease when output increases. See Herbert Hovencamp, \textit{Economics and Federal Antitrust Law} \S\S 13.3-13.4 (1985) (price discrimination); F.M. Scherer, \textit{The Economics of Vertical Restraints}, 52 ANTITRUST L.J. 687, 706 (1983) (vertical integration). Despite these and other qualifications, price and output provide a good first approximation of consumer welfare and will be used as such in this Note. Indeed, this measure of consumer welfare is consistent with the economic standard other commentators have used to evaluate the failing firm defense. See Thomas J. Campbell, \textit{The Efficiency of the Failing Company Defense}, 63 TEX. L. REV. 251, 257-66, 273 (1984); Friedman, supra note 3, at 1385; Fred S. McChesney, \textit{Defending the Failing-Firm Defense}, 65 NEB. L. REV. 1, 4-18 (1986).
  \item As the elements of the failing firm defense, discussed below, suggest, failure for purposes of the defense typically means not only financial ruin, but also that the failing firm's assets will exit the market as a result of the firm's financial demise.
  \item See Arquit, \textit{supra} note 3, at 2. The prima facie case focuses solely on the combining companies' market-share statistics as evidence of the transaction's likely competitive outcome. It requires the plaintiff to establish the relevant geographic and product markets as well as the combining companies' market shares. See 1992 Guidelines, \textit{supra} note 3, at 41,554. It does not consider, however, whether the acquisition will result in synergies, whether the market is contestable, or whether one of the companies is failing. These latter factors are only considered if the prima facie case suggests that the acquisition is anticompetitive. \textit{Id.} at 41,563.
  \item 280 U.S. 291 (1930).
  \item 394 U.S. 131 (1969).
  \item See Dr. Pepper/Seven-Up Companies, Inc. v. FTC, 991 F.2d 859, 864-65 (1993).
  \item \textit{See International Shoe}, 280 U.S. at 302-03.
  \item \textit{See Citizen Publishing}, 394 U.S. at 138.
  \item \textit{See Citizen Publishing}, 394 U.S. at 138; \textit{International Shoe}, 280 U.S. at 302-03.
\end{enumerate}
Horizontal Merger Guidelines Reform

that promulgated by the Agencies in the 1992 Guidelines, though the judicial construction of the defense described above remains viable in the courts as well. Not surprisingly, the Guidelines’ version of the defense comprises rigid requirements that mirror the original judicial considerations. The 1992 Guidelines provide:

A merger is not likely to create or enhance market power or facilitate its exercise if the following circumstances are met: (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.  

Because the failing firm defense may permit an anticompetitive merger or acquisition, its requirements are strictly interpreted by courts and the Agencies, and the burden of proof falls on the parties invoking the defense. 

There has been some debate as to whether the failing firm defense is an absolute defense or merely a consideration the parties can offer to rebut the Government’s prima facie case. Today, the leading view is that the failing firm defense is absolute and, if sustained, ends the inquiry into the transaction’s likely anticompetitive effects.  


19. See Roger B. Kaplan, Note, All the King’s Horses and All the King’s Men: The Failing Company Doctrine as a Conditional Defense to Section 7 of the Clayton Act, 4 Hofstra L. Rev. 643, 645 (1976). Under the absolute-defense approach, the transaction is permitted irrespective of the threat it poses to competition. Under the more flexible approach, the target’s financial failure is only one factor considered in determining whether the merger poses a substantial anticompetitive risk.

Because mergers and acquisitions often involve targets that are financially weak and struggling, it is not surprising that the failing firm defense has become well-established in antitrust law. The defense's importance has most recently been evident in transactions in the banking, hospital, defense, and cable industries.


B. International Shoe

Courts and commentators have consistently recognized *International Shoe* as establishing the failing firm defense. Since the failing firm defense's origin and justification are rooted in *International Shoe*, it is worthwhile to consider the Court's reasoning in this case before examining how subsequent scholars and courts have justified the doctrine under section 7. McElwain, the acquired company, was facing severe financial difficulties when International Shoe, a financially strong company, acquired McElwain's capital stock in 1921. After examining McElwain's recent financial statements, which suggested that the company was "to the point of involuntary liquidation," the Court found that the "evidence establish[ed] the case of a corporation in failing circumstances, the recovery of which to a normal condition was, to say the least, in gravest doubt..." The Court's finding compelled it to hold:

In light of the case thus disclosed of a corporation with resources so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure with resulting loss to its stockholders and injury to the communities where its plants were operated, we hold that the purchase of its capital stock by a competitor (there being no other prospective purchaser), not with a purpose to lessen competition, but to facilitate the accumulated business of the purchaser and with the effect of mitigating seriously injurious consequences otherwise probable, is not in contemplation of law prejudicial to the public and does not substantially lessen competition or restrain commerce within the intent of the Clayton

---


24. *International Shoe*, 280 U.S. at 299-301. McElwain's troubles were largely the result of a general downturn in the shoe industry.

25. *Id.* at 300.

26. *Id.* at 301.
Two prominent features of the Court’s opinion emerge. First, the Court presumed that International Shoe’s stock acquisition of McElwain was not anticompetitive. The Court was convinced that International Shoe purchased McElwain’s stock not with “any desire or intention to thereby affect competition,” but to increase its plant capacity and number of employees in order to satisfy excess demand. Without the merger, International Shoe apparently could not expand quickly enough to “meet the pressing requirements of its business.” Unfortunately, the Court lacked the insights provided by modern economic analysis, which would suggest that such acquisitions may in fact threaten competition.

But even with these insights, the Court would likely have concluded that International Shoe’s acquisition of a failing company did not violate section 7. International Shoe was decided under the “old” section 7, which stressed the anticompetitive effects of an acquisition as between the acquired and acquiring companies. It is indisputable that when a company fails and exits, it no longer competes in the market. Thus, when a firm such as International Shoe acquires a failing competitor such as McElwain, the transaction does not substantially lessen competition between the two companies, since the firms would not compete in the future anyway once the failing competitor fails and exits. Although section 7 has since been amended to incorporate the fact that economists now recognize that mergers and acquisitions affect competition along dimensions outside the immediate acquirer-acquired relationship, the statutory language and judicial approach to the Clayton Act in existence in 1929 support the Court’s presumption that International Shoe’s acquisition of McElwain did not threaten competition.

The second prominent feature emerging from International Shoe is the Court’s consideration of private interests whose well-being depends upon the failing firm’s survival. The Court’s holding suggests that private interests should be considered if the transaction does not threaten competition. This holding is consistent with section 7, since section 7 does not prohibit a

---

27. Id. at 302-03. It should be noted that since the Court found that McElwain and International Shoe did not occupy the same market, the Court did not need to address the failing firm issue to resolve the case. Id. at 295-99.
28. Id. at 301.
29. Id.
30. See infra Part II.B.
32. For purposes of this Note, a firm “exits” when it shuts down and withdraws its productive capacity and other assets from the market.
34. International Shoe, 280 U.S. at 302-03.
transaction because it protects noneconomic social goals, unless it also substantially lessens competition. Although the Court indicated that concern for goals other than competition may inform section 7 enforcement, the Court did not broadly hold that competition should be subordinated to different social goals, such as the protection of shareholders, creditors, and local communities, if the acquisition in fact is anticompetitive. The Court did not permit an acquisition that it would have held violated section 7 but for its desire to protect private interests tied to McElwain. Furthermore, the Court did not invite other courts to permit anticompetitive transactions to protect private interests. Given its conclusion that the acquisition was not anticompetitive, the International Shoe Court’s concern for McElwain’s stockholders and local communities did not run afoul of section 7. Instead, the Court simply welcomed the incidental noncompetitive benefits that resulted from a procompetitive transaction.

II. Conceptual Underpinnings of the Failing Firm Doctrine

Whether the failing firm doctrine promotes section 7, and thus whether it should be recognized as a legitimate and viable doctrine under the Clayton Act, depends upon the legitimacy of the rationales supporting it. International Shoe offers two principal justifications for the failing firm doctrine: the “private interest rationale” and the “economic rationale.” For the purposes

35. See Connor, supra note 23, at 90.
36. The Court’s citation of American Press Ass’n v. United States, 245 Fed. 91 (7th Cir. 1917), indicates that it considered concern for private interests in section 7 proceedings secondary to, and contingent upon, an absence of anticompetitive threat. The American Press court stated: “[A] law designed to shield the public from injury should not be construed to compel the public to suffer an injury .... [T]he Sherman Law ... does not require the stockholders of a company ... to sustain a loss in 1917 arising with wrongdoing, if that loss can be prevented without injury to the public.” Id. at 93-94.
37. Commentators have also offered a third rationale, which asserts that the failing firm defense promotes competition by promoting entry. Specifically, barriers to exit that increase the cost of failure potentially erect barriers to entry by increasing investment risk of acquisition and de novo entry; by allowing failing companies to merge with, or otherwise be acquired by, a competitor, the failing firm defense decreases the cost of failure, thereby decreasing investment risk and promoting entry. See, e.g., 4 PHILLIP AREEDA & DONALD F. TURNER, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶ 925(c), at 105-06 (1980) (“[N]ew entry and risk-taking are encouraged the more that the costs of failure are reduced.”); Richard E. Low, The Failing Company Doctrine Revisited, 38 FORDHAM L. REV. 23, 31 (1969); Diamant, supra note 23, at 887 n. 112. Since entry promotes competition, it logically follows under this rationale that the failing firm defense furthers the policy of section 7. Although this rationale is a more persuasive justification for the failing firm doctrine than the private interest and economic rationales, it is not entirely satisfying. First, there are other more competitive ways to spur investment and entry than to permit anticompetitive mergers. For example, the Internal Revenue Code includes a variety of incentives that spur investment, such as accelerated depreciation, preferential tax treatment of capital gains, and the (now-repealed) investment tax credit. Second, to the extent that investors and new entrants are optimistic and believe that their
of antitrust law, whether the private interest and economic rationales are legitimate depends on whether the rationales are consistent with promoting competition. The following discussion concludes that they are not.

A. The Private Interest Rationale

According to the private interest rationale, courts should protect stockholders, creditors, workers, and other interests whose welfare depends upon the survival of a failing firm by allowing presumptively anticompetitive mergers that would save the firm. This rationale implicitly assumes that these private interests are of greater consequence than competition.38 The private interest rationale's proponents broadly read the International Shoe Court's expressed concern for McElwain's stockholders and communities as justification for a merger doctrine permitting a transaction that substantially threatens competition if it furthers other goals society supposedly values more.39 The private interest rationale demands an absolute failing firm defense where concern for private interests is so great as to be dispositive, thereby rendering the transaction's actual anticompetitive consequences irrelevant.40 However, to the extent that the rationale does not conclusively presume that the "anticompetitive dangers associated with the merger are outweighed by the income losses to creditors, stockholders, and communities" that would follow the firm's failure,41 it calls instead for a balancing of competition and private interests as hinted at by Justice Stewart in United
States v. General Dynamics,42 but which the Court rejected in National Society of Professional Engineers v. United States.43

Because the purpose of section 7 is to promote competition,44 the concerns motivating the private interest rationale are outside the statute's domain and should not inform section 7 enforcement. In fact, because the private interest rationale requires the evaluation of social goals other than competition, it undermines section 7. Section 7 is undermined whether concern for private interests is so great as to render irrelevant the transaction's likely competitive effect, so that any transaction involving a failing company is permitted, or whether such concern is weighed against the transaction's likely competitive effect, so that a balancing of competition against other social goals is required. In either case, the private interest rationale considers goals outside the Clayton Act at the expense of competition and thereby risks sanctioning transactions that should be prohibited based on their anticompetitive impact. Because the statutory language of section 745 does not indicate, either explicitly or implicitly, that its express goal of competition should be subordinated to, or even weighed against, other objectives, nothing in the statute supports the private interest rationale.

Given that section 7's statutory language and purpose contradict the private interest rationale, proponents of the rationale turn for legitimacy to the International Shoe Court's concern for "loss to [McElwain's] stockholders and injury to the communities where its plants were operated."46 In so doing, however, proponents of the private interest rationale effectively read out of International Shoe the linchpin of the Court's opinion, namely, its presumption that the merger did not threaten competition.47 As explained above, International Shoe, when read precisely and critically, stands for the limited proposition, wholly consistent with section 7, that concern for private interests may inform section 7 enforcement if a merger or acquisition that is not anticompetitive would protect these interests; it by no means follows from this

42. The failing-company defense presupposes that the effect on competition and the "loss to [the company's] stockholders and injury to the communities where its plants were operated," will be less if a company continues to exist even as a party to a merger than if it disappears entirely from the market. It is, in a sense, a "lesser of two evils" approach, in which the possible threat to competition resulting from an acquisition is deemed preferable to the adverse impact on competition and other losses if the company goes out of business.

United States v. General Dynamics Corp., 415 U.S. 486, 508 (1974) (citation omitted); see also Baxter, supra note 1, at 248.

43. See supra note 7.

44. See supra notes 2-6 and accompanying text.


47. See supra notes 28-30 and accompanying text.
proposition that the Court sanctioned permitting anticompetitive mergers to protect private interests. The Court never indicates that competition should be sacrificed to promote different social goals. By choosing to ignore the Court’s underlying presumption that the International Shoe-McElwain merger was not anticompetitive, advocates of the private interest rationale interpret the Court too broadly.

Some commentators have argued that a technical reading of section 7’s statutory language should not control merger enforcement if a liberal interpretation of the Clayton Act furthers social goals outside the statute’s immediate scope.

A degree of judicial discretion in this area, where concern must encompass earthy values as well as economic ones, is perhaps a fitting antidote to the confining rigor of structural analysis in merger law, an analysis which, however powerful we may deem it to be, leaves out much of what is important with regard to life as it is lived in the market place.49

Although this Note does not attempt to evaluate competing theories of judicial activism or statutory construction, or to put forth its own, this argument deserves brief attention.

Admittedly, technical statutory interpretation may not always be appropriate. For example, it is conceivable that a statute’s technical reading may sometimes undermine the policy informing the statute being enforced. Moreover, in some cases, the consideration of “earthly values” ostensibly outside a statute’s domain is actually necessary to effect the statute’s purpose. Finally, there may be cases in which generous statutory construction not only fulfills the statute’s express goal, but collaterally meets other social objectives that a literal interpretation would not meet. These three circumstances would compel that the statute be read generously, rather than strictly.

These conditions, however, differ from a case in which a liberal reading of statutory language considers interests and objectives outside the statute’s ostensible domain and leads to results that defeat the statute’s purpose. This last case demands strict fidelity to statutory language and thus technical statutory construction. Institutions responsible for statutory enforcement should not impute to legislation concerns that defeat the express legislative goal; for if a statute is read to encompass objectives that the legislature did not intend the statute to serve and that are inconsistent with it, statutory enforcement

48. See supra notes 34-36 and accompanying text.
49. LAWRENCE A. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST § 204(g), at 630 (1977).
Horizontal Merger Guidelines Reform

frustrates, rather than effects, the legislative purpose. To the extent that enforcing institutions sacrifice a statute's objective to other goals, they ultimately undermine the integrity of the legislative process.

As noted, consideration of private interests undermines section 7's goal of promoting competition. While protecting these interests is a worthy social goal, section 7 is not the proper way to achieve it. Congress was, and is, aware that interests suffer when companies fail, but it has not amended the Clayton Act to bring such harms within the scope of section 7. If Congress is concerned about protecting these interests, it should (and can) address its concern directly with legislation narrowly tailored to this end, perhaps including an amendment to section 7. It is not the responsibility of courts or the Agencies to protect private interests collaterally through liberal merger enforcement that undermines section 7.

In sum, not only is the private interest rationale mentioned nowhere in section 7, but it also misconstrues International Shoe and frustrates section 7's express purpose. These criticisms, together with the Supreme Court's admonition that interests other than competition should not inform antitrust enforcement, show that the private interest rationale does not legitimate the

50. Some commentators have suggested that Congress' reference to International Shoe during congressional debate over the 1950 amendments to the Clayton Act, see H.R. REP. No. 1191, 81st Cong., 1st Sess. 6 (1949); S. REP. No. 1775, 81st Cong., 2d Sess. 7 (1950), registers congressional support for the failing firm defense generally and for consideration of private interests during section 7 enforcement specifically, see, e.g., 4 AREEDA & TURNER, supra note 37, ¶ 925(c), at 105 (1986). However, the congressional record does not indicate that competition should be subordinated to private interests. For a thorough discussion of the congressional record, see Martin F. Connor III, Section 7 of the Clayton Act: The "Failing Company" Myth, 49 Geo. L.J. 84, 96-98 (1960).

51. Since Congress has not made a policy choice to protect every business from failure, it is especially curious that a failing firm fortunate enough to find an acquirer should be shown favor by courts and the Agencies. Failure is inherent in a dynamic and competitive economy—the type of economy that section 7 was enacted to protect—and with failure comes hardship to shareholders, creditors, workers, and communities. The private interest rationale is an attempt, at the expense of competition, to protect certain firms and interests from this reality.

52. Bolstering this conclusion is a recognition that courts and the Agencies are generally ill-equipped to balance the various interests considered under the private interest rationale. See, e.g., 4 AREEDA & TURNER, supra note 37, ¶ 925(c), at 105 ("[I]ntractable difficulties would attend any attempt to balance competitive harms against private losses on a case-by-case basis.

53. See supra note 7.
failing firm doctrine under section 7.

B. The Economic Rationale

The economic rationale expansively interprets the *International Shoe* Court’s presumption that the contested transaction at issue in that case was not anticompetitive. This rationale asserts that, since a firm that fails financially and shuts down does not compete in the future, the acquisition of such a failing competitor does not substantially lessen competition so as to violate section 7.54 To the contrary, the economic rationale asserts that, if the struggling firm’s productive capacity and other assets would exit the market if the firm suffers financial ruin, leading to higher prices and less output, permitting the transaction will actually benefit consumers by keeping such assets in the market. The economic rationale focuses exclusively on competition between the acquirer and the acquired. It demands that courts and agencies apply the failing firm doctrine as an absolute defense that only asks if the firm is failing. If a merger or acquisition involving a failing company does not threaten competition as the economic rationale asserts, then once the parties establish the company’s failure, the transaction must be permitted, since section 7 does not prohibit transactions that are not anticompetitive.

The usefulness of the economic rationale depends on the validity of the presumption that the acquisition of a failing firm does not threaten competition. Economic advances since the failing firm doctrine’s inception indicate that the acquisition of a failing company may be anticompetitive.55 The following discussion highlights many of the anticompetitive risks that may result when a healthy acquirer combines with a failing competitor.56 The discussion does not suggest that such transactions are necessarily anticompetitive or that exit


56. It is worth emphasizing that the following discussion is about risks, not certainties. These possibilities may or may not materialize. Whether they do will depend upon the particular circumstances of a given transaction.
Horizontal Merger Guidelines Reform

is necessarily the preferable outcome.\textsuperscript{57} In fact, the analysis concedes that merger sometimes promotes competition more than failure and exit.\textsuperscript{58} The discussion is simply meant to show the fundamental flaw in the economic rationale: the assumption that the acquisition of a failing firm is necessarily procompetitive and preferable to exit. The rationale mistakenly ignores anticompetitive risks that, notwithstanding an acquisition's procompetitive potentialities, disprove this underlying presumption.\textsuperscript{59}

\textsuperscript{57} Market structure and firm behavior, among other factors, influence a market's prevailing price and output. As the following discussion illustrates, exit and acquisition affect both market structure and firm behavior. To complicate matters, there may be anticompetitive and procompetitive forces simultaneously at play when a failing firm exits or is acquired. Accordingly, in the abstract, it is impossible to say whether exit or acquisition is preferable because the preferable outcome varies with the particular circumstances of each case. This Note does not undertake the task of determining under what conditions exit will be preferable to acquisition.

\textsuperscript{58} Some commentators have argued that the acquisition of a failing firm, even by a dominant firm, is preferable to allowing the firm to fail financially and exit, since acquisition keeps capacity in the market. See Campbell, supra note 9; Friedman, supra note 3; McChesney, supra note 9; William F. Shughart & Robert D. Tollison, The Welfare Basis of the "Failing Company" Doctrine, 30 ANTITRUST BULL. 357 (1985). However, these commentators ignore that the points of comparison are not a dominant firm with additional capacity versus the same firm with less capacity; rather, the alternatives are a dominant firm with additional capacity, the same firm with less capacity, a competitive market that lacks the failing firm's capacity, and a competitive market with additional capacity resulting from internal expansion and competition. While a dominant firm with additional capacity is likely to be preferable to one without such capacity, it does not follow that a market in which the same dominant firm (i.e., one with expanded capacity) exerts its market power is preferable to a competitive market with less total capacity out of which to satisfy demand or a competitive market that internally expands. When faced with all the possibilities, it is uncertain, at best, what scenario is preferable.

\textsuperscript{59} That the acquisition of a failing firm creates both anticompetitive risks and procompetitive potentialities is implicit in the premium that an acquiring firm pays for its failing competitor's assets. There are two reasons that healthy firms may pay a premium for failing companies. First, the acquirer may believe that it can capture economies by combining its assets with the failing firm's and thereby increase its market share and profits by outcompeting its remaining competitors. See, McChesney, supra note 9, at 17; Walthall, supra note 52, at 64. According to this theory, the premium embedded in the winning bid indicates that the acquirer is the most productive user of the target's assets and thus places the highest value on them; if the transaction on net is procompetitive, it does not violate section 7, even if the acquirer is the dominant firm in the market. An alternative explanation for the transaction is that the acquirer acquires the target not to increase efficiency, but with the anticompetitive intent of increasing its market power and keeping the target's assets out of its rivals' hands. See, e.g., 4 AREEDA & TURNER, supra note 37, § 930a, at 126; Friedman, supra note 3, at 1403-04. The premium over the intrinsic value of the failing firm's assets reflects the acquirer's expectation that the transaction will increase its market power; the premium in effect shows that the potential risks discussed above do in fact exist. Given these competing theories, it would be naive to attribute automatically to the acquirer a procompetitive purpose; only the acquirer knows the intent reflected in its premium.

The difficult case is one in which the premium reflects the bidder's intent to increase both its efficiency and market power. The net competitive effect of such an acquisition is uncertain. But from such uncertainty it does not follow that the transaction should be permitted without further inquiry into market realities. Indeed, to the extent that the net effect of the acquisition is procompetitive, the merger should be permitted under the efficiencies defense. See, e.g., FTC v. University Health, Inc., 938 F.2d 1206, 1222 (11th Cir. 1991); 1992 Guidelines, supra note 3, at 41,562.
The following list of possibilities, first offered by a commentator on the failing firm doctrine in 1963, is often cited as representative of the anticompetitive risks arising from the acquisition of a failing firm:

(a) [The acquisition] would enable a dominant firm to move quickly and cheaply into a new market by acquisition of a failing company where, but for the [failing firm] doctrine, the transaction would be in violation of section 7;

(b) By increasing the acquiring firm's capacity to fill orders which it would otherwise be unable to accept, the company could strengthen its position in the market and prevent competitors from handling the overflow of business that would otherwise result;

(c) By removing productive facilities from the market, a potential entrant might be forestalled from entry since he would face the increased cost of building new facilities and having these new facilities swell the total productive capacity of the market;

(d) The acquiring firm would probably obtain less of the business of the defunct company if the latter experienced total business collapse than if it effectively stepped into the shoes of the failing company and appropriated the remaining good will plus valuable customer lists, price data and other important business information;

(e) [A] large enterprise could vertically integrate by purchasing a failing company and thereby eliminate a customer of or supplier to other competitors, depending on whether the integration was backward or forward, respectively, which might result in a substantial lessening of competition in the relevant market; and

(f) Such an acquisition might give the acquiring firm an increased percentage of the market and increased market dominance, which has in itself been viewed as an undesirable result.60

The following analysis details the economics underlying some of these risks, and highlights additional risks. While not an exhaustive discussion, it establishes the principle that the economic rationale cannot legitimate the failing firm doctrine, because mergers and acquisitions involving failing firms

---

60. Sotiroff, supra note 23, at 577-78 (footnotes omitted); see also Kaplan, supra note 19, at 671 n.121.
can be anticompetitive.

1. **Market Structure**

Because an acquisition ordinarily gives an acquirer valuable assets and capacity, the transaction has the potential to change market structure. For example, a competitive market that would remain competitive if a failing firm exited may become subject to a dominant price-setting firm if a leading competitor is permitted to acquire its failing rival. In this case, the financially troubled firm's exit may be preferable to permitting the transaction, even though the transaction keeps the firm's capacity in the industry; it is not clear that the procompetitive effects of additional industry capacity will overwhelm the anticompetitive risks associated with the acquirer's newly attained dominant position and market power.61

2. **Market Share**

Even if the transaction does not change market structure, it will change the remaining competitors' relative market shares. Easterbrook and Posner provide an example:

Imagine a merger in which there are six firms. One has a 50% market share and each of the others 10%. One of the small firms goes bankrupt and the only offer that the trustee in bankruptcy receives for purchase of the firm as a going concern is from the dominant firm. The alternative of acceptance of the offer is liquidation of the business. Presumably therefore [the failing firm defense] would permit the trustee to accept the dominant firm's offer. The result is to increase that firm's market share from 50% to 60%. Now consider what would have happened had the firm been liquidated rather than acquired. Presumably its sale would have been divided up by the remaining firms in proportion to those firms' shares of the remainder of the market. The dominant firm would have picked up a little more than half of the bankrupt's sales; the rest would have been divided evenly among the remaining sellers. The result would be an increase in the dominant firm's market share to a little more than 55%—a much smaller increment than if the dominant firm is permitted to acquire the

61. See, e.g., Friedman, supra note 3, at 1387.
bankrupt . . . 62

While other examples might vary the number of firms, relative market shares, and assumptions regarding division of the failing firm's released customers with and without acquisition, the point remains that acquisition usually increases the acquirer's market share relative to its market share if the struggling firm exits. The acquiring firm will presumably gain more of the failing firm's customers if it acquires the firm than if the firm exits. 63 Acquisition, therefore, may lessen competition, especially if the acquirer is the dominant firm. 64

3. *Competition for Customers*

A firm's customers are released when it exits the market. Realizing that these customers represent potential market share and profit, remaining firms, as well as potential entrants, are likely to compete for them. 65 From this, some have reasoned that because "the acquisition of a financially weak company in effect hands over its customers to the financially strong, [the transaction] deter[s] competition by preventing others from acquiring those customers." 66

While it is unlikely that the acquisition directly hands over all of the target's customers to its acquirer, 67 it is likely that the acquiring firm "gains some advantage vis-a-vis present competitors or potential entrants" 68 that undermines competition. For example, the "failing firm's trademarks or other 'goodwill' may have a value that helps the acquirer retain the failing firm's customers;" 69 or the acquirer, by virtue of acquisition, may gain needed capacity with which it can immediately meet the target's customers' demands, whereas its rivals, lacking excess capacity or the resources to build or purchase

---

63. For more on this point, see infra Part II.B.(3).
64. If, however, a fringe firm increases its market share by acquiring the failing firm, such that the fringe firm is able to compete meaningfully with the market's dominant firm (or firms), acquisition may be preferable to exit.
65. See United States Steel Corp. v. FTC, 426 F.2d 592, 606 (6th Cir. 1970) ("[A]ssuming Certified dropped from the market place, its ready-mix business . . . would be taken up by its competitors.").
66. FTC v. University Health, 938 F.2d 1206, 1221 (11th Cir. 1991); see also FTC v. Warner Communications, Inc., 742 F.2d 1156, 1164 (9th Cir. 1984).
67. See McChesney, supra note 9, at 16 ("If a firm with some percentage of the market fails and is acquired by a healthy rival with a larger market share, how does the rival also acquire the failing firm's customers? Assets can be bought and sold, but customers or market shares cannot.").
68. 4 AREEDA & TURNER, supra note 37, ¶ 927d, at 117.
69. Id.
new capacity, may be unable to accommodate additional customers.\textsuperscript{70}

If the failing firm is not acquired but shuts down, the remaining firms will presumably compete more meaningfully and aggressively for its released customers, since they are on a more equal footing. To compete more effectively to increase (or perhaps maintain) their market shares, firms will increase quality or decrease price (or both) by, for example, expanding internally and investing in new technologies and capacity that increase productivity. Internal expansion that involves new capacity and technologies further intensifies competition because expanded capacity must win its way into the market. Such internal expansion and the competition spawning it may not be forthcoming if, because of an acquisition, the acquirer’s rivals and potential entrants do not perceive a realistic opportunity to attract the failing firm’s customers. Hence, a failing firm’s exit may be preferable to acquisition to the extent that the firm’s exit encourages its competitors to compete for its former customers.\textsuperscript{71} Granted, the competitor that would have acquired the failing firm’s customers through acquisition may ultimately acquire them through competition, but the antitrust laws do not punish a firm that increases its market share by outcompeting its rivals.\textsuperscript{72}

4. \textit{Exploiting Failing Firm’s Assets}

A failing firm may own valuable assets that profoundly impact competition when acquired and exploited by a competitor, especially a dominant leader. Assume a firm that is financially weak (for reasons other than losses stemming from excess capacity or an irreversible structural deficiency), lacks financial capital, and is unable to borrow additional funds.\textsuperscript{73} Because of its financial constraints, the firm may not be able to exploit the potential market share intrinsic in its assets. For example, the firm may own a valuable

\textsuperscript{70} See, e.g., United States Steel Corp., 74 F.T.C. 1270, 1289 (1968) (“Or consider a situation where a dominant firm purchased the assets of a dying firm thereby increasing capacity to satisfy orders which it would have been otherwise unable to accept; the acquisition thus foreclosing competing firms from handling the surplus of business that would have resulted absent the acquisition.”); 4 AREEDA & TURNER, supra note 37, ¶ 927d, at 117.

\textsuperscript{71} 4 AREEDA & TURNER, supra note 37, ¶ 925a, at 102. However, if a fringe firm acquires the failing firm and, as a result, is able to compete meaningfully with the dominant firm or firms in the market, acquisition may be preferable to exit, although there would initially be less competition for released customers than if the failing firm were permitted to fail and exit the market.

\textsuperscript{72} United States v. Aluminum Company of America, 148 F.2d 416, 430 (2d Cir. 1945) (“The successful competitor, having been urged to compete, must not be turned upon when he wins.”) (Hand, J.).

patent, trade secrets, customer lists, copyrights, or distribution and service
networks, all or some of which it is unable to take advantage of because of
inadequate funds. Moreover, assume that the acquirer has access to adequate
funds so that with a capital infusion it can, and will, fully exploit the failing
firm's assets. Under these circumstances, if the target's preacquisition
market share is 15% and the acquirer's share is 30%, it does not follow that
the postacquisition market share of the combined firm will be 45%. Rather,
because the transaction will increase the acquirer's market share by at least
the market share intrinsic in the failing firm's assets, which by assumption
exceeds 15%, the combined firm will control over 45% of the market. The
acquirer's willingness to pay a premium for its failing competitor's assets
confirms the acquirer's belief that the preacquisition market share attributable
to these assets in the target's hands underestimates the postacquisition market
share attributable to these assets in the acquirer's hands. In sum, courts and
the Agencies underestimate a transaction's likely anticompetitive effect by
focusing their analyses on the failing firm's market share and ability to
compete, while ignoring the combined firm's likely market share and power
once the acquirer fully exploits the market share intrinsic in the target's
properties.

74. A capital infusion is not the only means by which an acquirer can take full advantage
of a failing firm's assets, but it illustrates the point being made.
75. See, e.g., International Harvester, 564 F.2d at 778. When acquired by International
Harvester, Steiger, a manufacturer of tractors, was financially weak, suffering from decreasing
market share and sales. Id. at 774-76. Within two years of the acquisition, Steiger's production
increased from 1,003 units to 2,364 units, and its market share of four-wheel drive tractor
production increased from 15.9% to 22.4%. International Harvester's infusion of capital into
Steiger was a significant factor in Steiger's revitalization. Id. at 778.
76. Cf. Derek C. Bok, Section 7 of the Clayton Act and the Merging of Law and
Economics, 74 HARV. L. REV. 226, 345 (1960) ("The very fact that new men are willing to take
over the failing concern suggests that the hopelessness of its position may be open to question and
that new capital and new methods may be applied to improve the situation."); Diamant, supra note
23, at 886-87.
77. Granted, the acquisition may promote efficiency if the acquirer is the most productive
user of the target's assets and increases its market share by exploiting economies. Moreover, a
social benefit likely results from having the failing firm's valuable assets utilized; exploitation of
intellectual property, for example, not only brings new products into the market, but often
increases productivity. Nonetheless, since the firm's increased market share may enable the firm
to exert greater market power, the transaction's net effect upon efficiency remains uncertain. If,
however, the acquisition's net effect is to promote efficiency (e.g., the acquirer captures additional
market share by using the target's resources more efficiently and these efficiency gains overwhelm
any inefficiencies resulting from the increase in the acquirer's market power), the parties should
be able to sustain the efficiencies defense, in which case the failing firm defense is unnecessary.
See, e.g., FTC v. University Health, Inc., 938 F.2d 1206, 1222 (11th Cir. 1991); 1992
Guidelines, supra note 3, at 41,562.
5. Disciplinary Pricing and Predation

A company's acquisition of a failing firm increases its capacity. As a result of the acquisition, the acquirer may capture synergies that increase its efficiency or it may use its expanded capacity competitively to increase its output and keep prices down. There is a caveat, however, to these sanguine scenarios. It has been argued that a leading firm in a market may deliberately maintain excess capacity to deter potential entrants or to discipline a smaller rival that poses a competitive threat to the market leader by, for example, not following its price increases or by initiating a price decrease. Though less likely, a leading firm may also maintain excess capacity in order to drive its competitors from the market through predation. In either case, by acquiring a failing rival, a leading firm increases the amount of excess capacity under its control, thereby strengthening its dominant position in the market by warding off competitive challenges.

6. Piecemeal Sale

A failing firm may have a variety of valuable assets, including physical capacity, a recognized trademark, goodwill, patents, copyrights, customer lists, data banks, favorable long-term supply contracts, etc. Different prospective bidders, depending on their needs and corporate strategies, will value each asset differently. Moreover, while only one bidder, most likely the market's dominant firm, may have sufficient resources to acquire the failing firm in its entirety, many competitors may have the resources to acquire the strategic assets they value the most. Since the dominant firm values keeping the target's assets out of its rivals' hands, it presumably places the highest value on acquiring the failing company in its entirety; assuming it has adequate funding, this means that the dominant firm will probably acquire the target if the target is not forced into a bankruptcy sale.

If the failing firm, however, is forced to liquidate in a bankruptcy sale and sell its assets piecemeal to the highest bidder, smaller competitors might purchase and more productively use the assets, which in turn may enable them

79. See, e.g., 5 AREEDA & TURNER, supra note 78, ¶ 1136, at 219-24 (1986).
80. See, e.g., United States Steel Corp. v. FTC, 426 F.2d 592, 609 (6th Cir. 1970) ("Certified had an expanding sales organization, an aggressive reputation in marketing and long-term contract commitments. Each of these facts suggest [sic] the possibility that Certified may have been split into several going concern packages in a receivership proceeding.").
to compete away market share from the market leader. Furthermore, if the failing firm's assets are sold piecemeal in liquidation, even assuming no efficiency gains on the part of smaller rivals who acquire the assets, these rivals, as well as potential entrants, may be in a better position to compete with a dominant firm for the exiting firm's released customers. Thus, to the extent that an acquisition deprives small bidders of the opportunity to purchase the failing firm's assets, it may be preferable to allow the failing firm to fail and its assets to be more widely dispersed throughout the market.

7. **Excess Capacity**

Although an industry's chronic excess capacity is not an anticompetitive risk like those discussed above, it nonetheless undermines efficient production and resource allocation if permitted to persist. Chronic excess capacity in an industry frequently leads to intense price competition, which ultimately threatens the financial viability of relatively inefficient producers. If chronic excess capacity burdens an industry, efficiency demands that capacity be rationalized. Mergers and acquisitions involving failing firms are two possible ways to rationalize capacity and capture synergies. For example, when firms combine plants and equipment, the most efficient capacity can be retained and the least efficient shut down. However, empirical research suggests that mergers and acquisitions involving failing firms do not necessarily rationalize

---

81. If the failing firm's competitors will purchase all of its assets in the event of its liquidation, the assets will not exit the market absent acquisition and thus the combining parties will presumably be unable to sustain the failing firm defense under the 1992 Guidelines. However, it is not necessarily the case that the firm's competitors will purchase all of its assets in a bankruptcy sale. To the contrary, firms outside the failing firm's market may buy some of its assets. Under this scenario, at least some of the failing firm's assets will be lost to the market. Accordingly, the combining parties will presumably be able to meet the asset-exit requirement under the 1992 Guidelines. However, for reasons discussed below, a piecemeal sale of the firm's assets may be preferable to acquisition (even from the perspective of the failing firm's market alone), notwithstanding that some of the firm's assets will be withdrawn from the market as a result. Further, it is important to emphasize that despite the 1992 Guidelines, there remains a long line of failing firm precedent in the courts that does not include an asset-exit requirement.

82. See supra Part II.B.3.

83. See 4 AREEDA & TURNER, supra note 37, ¶ 925a, at 102. It may, however, be better for competition to permit one firm to acquire all of the failing firm's assets. For example, the assets may, when used together, produce synergies that increase efficiency to a greater extent than when the assets are divided among smaller rivals. This possibility suggests that transactions need to be considered individually and that categorical presumptions regarding competitive outcomes should be avoided.

84. For a general discussion of this phenomenon, often called "cutthroat" or "ruinous" competition, see F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 294-96 (1990). For a discussion of temporary excess capacity caused by cyclical fluctuations in the economy, see id. at 296-98.
capacity. On the contrary, mergers and acquisitions that lead to monopoly pricing may retard capacity adjustments by protecting inefficient producers and may even induce capacity expansions.

A method of capacity rationalization that can be preferable to merger is what the failing firm doctrine prevents, namely, allowing failing firms to fail financially and their assets to exit the market as a result. Although exit causes hardship for certain shareholders, creditors, workers, and local communities, it promotes efficiency and competition throughout the economy by reallocating resources to their most productive uses. Moreover, private interests tied to the industries receiving these resources benefit, as do consumers. These consumers presumably value the goods and services provided by the growing industries more than those provided by the distressed industry. Since the private interest considerations are an apparent wash, if not weighing in favor of exit, and since merger does not necessarily rationalize excess capacity, financial failure and exit should be welcomed because they facilitate the efficient reallocation of capacity throughout the economy when such firms are failing because of chronic excess capacity.

In sum, the economic rationale's fatal flaw is that, by focusing exclusively on competition between the acquirer and the failing company, it ignores anticompetitive risks outside the immediate acquirer-acquired relationship. Although the economic rationale may have been defensible under the old section 7, advanced economic thinking since International Shoe demonstrates that the acquisition of a failing firm poses anticompetitive risks. These advances, coupled with the 1950 Clayton Act amendments, establish that the economic rationale is an untenable basis for section 7 enforcement. The economic rationale does not legitimate the failing firm doctrine.

---

86. For example, firms may merge in a distressed industry to facilitate collusion, which in turn may result in higher prices. Id. at 25-26.
87. See SCHERER & ROSS, supra note 84, at 295 ("In some cases, price-fixing agreements, by permitting positive monopoly profits to be gained, have actually caused capacity to be increased in industries confronted with stagnating demand, aggravating the resource misallocation problem.").
88. See, e.g., id. at 295-96; Dooley, supra note 55, at 1442; Hale, supra note 54, at 599; Sotiroff, supra note 23, at 579-80. For a criticism of allowing firms to fail to rationalize excess capacity, see Pitofsky, supra note 55, at 236-37.
89. See, e.g., McChesney, supra note 9, at 6-7 n.20.
90. It is also worth noting that the International Shoe Court did not presume that the acquisition of a failing firm never poses an anticompetitive threat; rather, the Court concluded that in the case before it, International Shoe's particular purpose in acquiring McElwain was not anticompetitive.
91. See Baxter, supra note 1, at 250; Sotiroff, supra note 23, at 576. If, however, the acquisition of a failing firm did not threaten competition, the economic rationale would justify a per se failing firm defense.
III. The Failure of the Failing Firm Defense

Conceptually, the failing firm doctrine fails section 7. It is important, however, to consider the doctrine's practical application as the failing firm defense because whether or not antitrust enforcement ultimately promotes competition does not depend on doctrinal theories and rationales but on courts' and the Agencies' approaches to actual transactions.

Unfortunately, the application of the failing firm defense is no more successful than the doctrine supporting it.\(^\text{92}\) Consistent with the private interest and economic rationales, which are fundamentally concerned only with whether the target is failing financially, the doctrine is applied as an absolute defense comprised of rigid elements that focus on the failing firm's financial status and into which the parties must fit their facts to sustain the defense.\(^\text{93}\) As a result, the failing firm defense is prone to err by generating outcomes inconsistent with section 7.

It is impossible to determine confidently a transaction's competitive impact from the failing firm defense's narrow requirements because the defense does not inquire into factors other than financial well-being that influence whether the acquisition of a failing company is anticompetitive.\(^\text{94}\) Courts have nonetheless understood the defense's requirements to be dispositive. As a result, they have ignored market realities and have narrowed their consideration of the defense exclusively to whether the parties have met its strict requirements.\(^\text{95}\) Once the defense's requirements are met, courts have considered the defense sustained and permitted the merger;\(^\text{96}\) on the other hand, if any requirement of the defense is not met, courts have rejected the

\(^{92}\) The following criticism of the failing firm defense applies to the defense as developed in the courts, see supra notes 12-17 and accompanying text, as well as to the defense as adopted by the Agencies in the 1992 Guidelines, see supra note 18 and accompanying text.

\(^{93}\) See supra notes 12-20 and accompanying text.

\(^{94}\) A firm's financial condition, ability to reorganize in bankruptcy, and potential exit from the market do not provide adequate information upon which to determine whether a transaction involving that firm threatens competition. See supra Part II.B.


defense.\textsuperscript{97} I found no case indicating otherwise.\textsuperscript{98} By mechanically applying the failing firm defense's rigid requirements as an absolute defense that ends further inquiry into economic factors influencing the merger's likely competitive consequences,\textsuperscript{99} courts have adopted a \textit{per se} approach to section 7 enforcement. As the 1992 Guidelines demonstrate, the Agencies approach the failing firm defense with the same rigidity and absoluteness as courts.\textsuperscript{100}

The benefit of a \textit{per se} approach to section 7 is that it is relatively easy and efficient to administer, since it reduces the relevant inquiry to a few select considerations believed to predict the competitiveness of the merger at issue and thus inform the analysis. A \textit{per se} approach that focuses on a few key factors reduces the time, cost, and complexity of merger litigation and provides businesses that are contemplating mergers with relatively clear guidelines.\textsuperscript{101}

Nonetheless, strict requirements and bright-line rules under a \textit{per se} approach to merger enforcement are often undesirable, especially when they are applied as an absolute defense. Rigid, simple rules are usually based on assumptions whose validity depends upon the particular facts to which they are applied. For example, behind the failing firm defense's elements requiring financial failure and an inability to reorganize in bankruptcy,\textsuperscript{102} is the mistaken assumption that a transaction involving a failing firm does not threaten competition.\textsuperscript{103} An absolute defense to merger comprised of uncompromising requirements may not be realistic, because it ignores economic evidence outside its requirements' scope that courts and the Agencies


\textsuperscript{98} Not only was I unable to find a case in which the court held that the parties sustained the defense despite not meeting its requirements, I was also unable to find a case in which the court denied the failing firm defense despite the parties’ meeting its requirements.

\textsuperscript{99} See cases cited supra note 20.

\textsuperscript{100} For example, the 1982 and 1984 Guidelines both read: "Because the defense can immunize significantly anticompetitive mergers, the Department will construe its elements strictly." 1984 Guidelines, supra note 20, at 26,837; 1982 Guidelines, supra note 41, at 28,502. See also Arquit, supra note 3 ("[T]he requirements that must be satisfied to meet the failing firm defense are strict and the burden of proving such a defense falls, as it should, on those who seek refuge under it."). Furthermore, since the Guidelines expressly consider market factors with regard to concentration and the prima facie case, see infra Part IV.B(2), the Guidelines’ silence regarding whether market factors are considered under the failing firm defense is meaningful.


\textsuperscript{102} See supra notes 15-18 and accompanying text.

\textsuperscript{103} See supra Part II.B.
must consider to appreciate a transaction's likely competitive impact. In particular, by focusing on the firm's financial status, the failing firm defense ignores other market realities that influence the transaction's competitiveness; thus, the failing firm defense is prone to err by permitting anticompetitive transactions that would have been prohibited but for the parties' success at manipulating their facts to fit the defense. The price of the defense's simplicity is foregone competition, which section 7 was intended to promote. Because strict and absolute rules compromise accuracy, a per se approach to merger enforcement is only acceptable when the competitive consequences of particular conduct are nearly certain and unambiguous for the vast majority of cases.

An alternative to the failing firm defense's per se approach to section 7 enforcement is a case-by-case, rule-of-reason approach that inquires into market realities to ascertain the competitive consequences of a particular transaction. Although a rule-of-reason failing firm defense may prove more costly and difficult to administer than the current per se defense and may strain institutional competence by requiring courts and the Agencies to consider market realities currently outside the scope of the defense's limited requirements, a rule-of-reason defense would better ascertain the likely competitive effect of a merger or acquisition. As the discussion in Part II.B suggests, a host of factors outside the scope of the current defense's requirements influence the competitive consequences of a merger involving a failing firm. Under a fact-intensive, rule-of-reason approach, the inquiry into competitiveness is tailored to the circumstances surrounding the particular transaction at issue. Such a fact-intensive inquiry, therefore, better promotes competition than the current per se approach because it flexibly and thoroughly considers market realities instead of relying on economically unsound

104. See Diamant, supra note 23, at 890.
105. Courts and the Agencies may also err by prohibiting competitive transactions. For example, an inquiry into market realities may indicate that the acquisition of a failing target is preferable to exit. However, if the parties fail to meet one or more of the defense's requirements, this inquiry will likely never be made and the transaction will likely be prohibited unless the parties successfully sustain some other defense.
107. See, e.g., Campbell, supra note 9, at 253; Kauper, supra note 106, at 518; Piriano, supra note 101, at 711.
108. Professor Bok summarized the issue as follows: The argument in favor of considering additional factors is clear cut: There will inevitably be cases in which the apparent significance of the merger will change when a single standard . . . is supplemented by further relevant information. In at least some of these cases the change will be such as to indicate that a contrary result should be reached. Hence, the exclusion of added factors will increase the possibility of erroneous decisions. Bok, supra note 76, at 288.
assumptions about competitiveness.

It is reasonable to conclude that the benefits of increased accuracy under a rule-of-reason failing firm defense would outweigh the additional administrative costs of extending the analysis beyond whether the parties meet the current defense's immediate requirements. Whenever courts and the Agencies follow a rule-of-reason approach, they implicitly accept increased administrative costs and more complex litigation in order to promote competition. When it comes to the failing firm defense, the tradeoff seems to weigh in favor of a rule-of-reason approach.

First, the competitive consequences of a merger involving a failing firm are uncertain and ambiguous. The wide range of varying factors that influence a transaction's competitive impact suggests that the divergence between a per se and rule-of-reason failing firm defense is non-trivial and perhaps substantial.

Furthermore, as discussed below in Part IV.B, courts and the Agencies currently employ a rule-of-reason approach in other areas of merger enforcement, especially the prima facie case. Extending this approach to include the failing firm defense would require few additional resources relative to those expended during the presentation of the prima facie case and would not pose too great a strain on institutional competency.

Finally, throughout antitrust law, courts and the Agencies rely on rule-of-reason approaches when per se methods prove inadequate. There is no compelling reason why courts and the Agencies should not likewise adopt a rule-of-reason approach to the failing firm defense, especially given the current defense's conceptual and practical shortcomings.

The failing firm defense's primary, and often exclusive, reliance on the target's balance sheet and income statement to determine whether it is failing for purposes of section 7 exacerbates the risk to competition posed by the defense's rigidity. The defense's criteria do not require an inquiry into possible causes of the firm's weak financial status, and courts have consistently responded by not making one. The defense's focus on financials is

109. See supra Part II.B.
110. See infra Part IV.B.
111. For a thorough discussion of the rule-of-reason and per se approaches to antitrust enforcement, see generally 7 PHILLIP AREEDA & DONALD F. TURNER, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES & THEIR APPLICATION, ¶¶ 1507-1510 (1986); FEDERAL JUDICIAL CENTER, THE “RULE OF REASON” IN ANTITRUST ANALYSIS: GENERAL ISSUES (1981); Piriano, supra note 101.
consistent with the economic and private interest rationales. The economic rationale assumes that if the target is financially failing, the transaction is not anticompetitive; under the private interest rationale, if the target is failing, private interests are at risk. Under both rationales, all that matters is that the firm is failing. Since the firm's financials tell the courts and the Agencies all they need to know about the firm's financial condition, it would not make sense for them to ask why the firm is failing. In other words, given the rationales supporting the failing firm doctrine, the cause of the firm’s failure does not meaningfully or purposefully inform the analysis under the defense.

Weak financials, however, do not justify relaxing section 7 enforcement, because the private interest and economic rationales are untenable.\(^\text{113}\) Since the assumption underlying the economic rationale is wrong, it does not follow from financial statements indicating that the target is failing that the transaction does not substantially lessen competition. Although the firm’s financials indicate a problem for the firm and the private interests tied to it, they do not necessarily indicate a problem that concerns section 7; on the contrary, financial failure and exit may be preferable to acquisition.\(^\text{114}\) Hence, because weak financials are not by themselves conclusive indicia of the likely competitive effects of a merger or acquisition, they should not justify courts’ and the Agencies' generous treatment of presumptively anticompetitive transactions.

This does not mean that financials are never useful in section 7 enforcement. A firm’s financials are probative for purposes of section 7 if they signal a fundamental structural deficiency plaguing the firm that caused the firm’s weakness and that neither the firm nor its acquirer can remedy.\(^\text{115}\) Under such conditions, the acquisition of a failing firm would not substantially threaten competition in violation of section 7; the firm’s structural disadvantages not only undermine its ability to compete in the future, but also its acquirer’s ability to revitalize it.\(^\text{116}\) Determining whether such a deficiency exists requires courts and the Agencies to look behind the firm’s financials and inquire into the factors causing the firm’s financial weakness. Such a determination requires a rule-of-reason failing firm defense.

\(^\text{113}\) See supra Part II.
\(^\text{114}\) See supra Part II.B.
\(^\text{115}\) See infra Part IV.A.2.
\(^\text{116}\) See infra Part IV.A.2.
The current defense's reliance on financials is no more persuasive under the private interest rationale than under the economic rationale. Simply stated, the defense's focus on financials in an effort to protect private interests from a firm's failure reflects a concern outside the domain of section 7, the consideration of which frustrates the Clayton Act.\textsuperscript{117}

In sum, the practical problem with the failing firm defense is that its focus is too narrow. The inquiry should not end with the question of whether the target is financially failing. Rather, once it is determined that the target is failing, a second question should be asked: Would the failing firm's acquisition result in a more competitive market than its exit? A rigid absolute defense that focuses on financials, while perhaps answering the first question, ignores a follow-up concern. Assuming that the target is financially failing, the ensuing proposal explains how courts and agencies should answer the critical follow-up question.

IV. A New Approach: A Proposal to Revise the Merger Guidelines

The fact that the current failing firm defense frustrates section 7 does not mean that courts and the Agencies should approach transactions involving a failing company in the same way that they approach transactions in which both parties are financially healthy. Allowing a firm to fail and exit may itself have anticompetitive consequences that are not present when transactions between viable firms are prohibited. One example of such a consequence is a shrinkage in industry capacity that leads to higher prices and less output.

The foregoing discussion has identified the fundamental considerations that courts and the Agencies should take into account when developing the defense. First, a coherent approach to merger enforcement must rest on a conceptual premise consistent with section 7's purpose. Second, after recognizing that merger enforcement's sole aim is to promote competition, courts and the Agencies should acknowledge that antitrust analyses are inherently complex and cannot be reduced to a few superficial elements, especially ones based upon untenable economic assumptions. The following proposal to revise the Guidelines meets these criteria: the proposal's exclusive objective is competition, and it incorporates a rule-of-reason approach to section 7 enforcement.

The following discussion focuses on the Guidelines instead of judicial doctrine for two reasons. First, the Guidelines can be changed quickly relative to judicial doctrine. Once revised, the new Guidelines will have an immediate effect by influencing what transactions the Agencies decide to challenge.

\textsuperscript{117} See supra Part II.A.
Second, since the Guidelines inform courts' approach to merger enforcement, an immediate revision of the Guidelines would encourage courts to reevaluate their approach and incorporate the new Guidelines. By gradually applying the revisions, courts would ultimately give them the force of law.

A. A New Approach to Failing Firms

The current failing firm defense should be abolished, and a new defense premised upon the following three-pronged analysis should be incorporated into the Guidelines: (1) If the firm's financial failure is the result of chronic excess capacity in the industry, the transaction should be prohibited and the failing firm permitted to fail and exit; (2) if the firm's financial failure is caused by a fundamental structural deficiency that undermines its future ability to compete and that neither the firm nor its acquirer can overcome, the transaction should be permitted; and (3) if the firm's financial failure is not caused by such a fundamental structural deficiency or chronic excess capacity, then the investigating Agency should compare the potential competitive consequences of acquisition with those of financial failure and exit and permit the transaction only if it would result in a more competitive market than exit would. The following commentary discusses in more detail each aspect of the new approach.

1. Chronic Excess Capacity

The first question to be asked is whether the acquired firm is failing because chronic excess capacity is exerting downward pressure on prices. If the answer is no, the Agency should proceed to the second step of the analysis. Assume, however, that the answer is yes. As previously noted, mergers and

---


119. Consistent with the requirements of the current failing firm defense, especially the 1992 Guidelines' version of the defense, a firm is “failing” for purposes of the new defense only if its financial ruin causes it to exit the market. In particular, the new defense would only be implicated if the combining parties successfully establish that the failing firm’s financial failure and exit are imminent and that there is no preferable alternative to the proposed acquisition that keeps the failing firm's assets in the market.
Horizontal Merger Guidelines Reform

acquisitions may promote efficiency if the acquirer rationalizes excess capacity and captures synergies. However, if the acquirer intends to exploit potential efficiencies by rationalizing capacity and to pass these efficiency gains along to consumers, it is unnecessary to consider the failing firm defense at all. If the transaction increases efficiency to the benefit of consumers, the combining parties should be able to sustain the efficiencies defense. Thus, if the combining parties claim that their transaction is exonerated under section 7 because it rationalizes capacity, the proposed approach would require them to argue the efficiencies defense rather than the failing firm defense.

If the parties sustain the efficiencies defense, the inquiry into the transaction would end. The parties' failure to sustain the efficiencies defense would also effectively end the inquiry under the new failing firm defense. The parties' failure to sustain the efficiencies defense would mean that the combining entities did not adequately establish that they entered the transaction to capture synergies by rationalizing capacity. Accordingly, in this stage of the analysis, the new defense would presume that the parties entered the transaction for some anticompetitive purpose. Hence, if the target is failing because of cutthroat competition, the new defense would conclude that the failing firm's exit is necessary to remove excess capacity from the market; otherwise, the failing firm defense would never be considered because the transaction would presumably be permitted under the efficiencies defense in response to the parties' plans to exploit potential efficiencies by rationalizing capacity. In this case, the transaction should be prohibited under the failing firm defense, despite the resulting hardship to private interests whose well-being depends on the failing firm's existence.

2. Structural Deficiency

While the current failing firm defense is an absolute defense to the prima facie case, the proposed structural deficiency requirement is essentially a rebuttal of the prima facie case. In this step of the analysis, the combining parties challenge the predictive value of the market-share statistics underlying the initial presumption of anticompetitiveness in order to show that their

120. See supra Part II.B.7.
122. Examples of such anticompetitive purposes include: (1) the combining parties want to merge to facilitate collusion; (2) the acquirer wants to retain excess capacity under its control so that it can discipline its remaining competitors once the market's chronic excess capacity is rationalized; and (3) the acquirer wants to keep the failing firm's assets out of its competitors hands if the competitors are productive users of the assets.
merger does not threaten to lessen competition substantially. Failure under the new approach is not limited to a narrow definition that depends on the firm's financials. Rather, under the new approach, a firm is failing for purposes of section 7 only if the firm's financial failure is caused by a fundamental structural deficiency plaguing the firm that undermines its ability to compete and that neither the failing firm nor its acquirer can overcome; \(^\text{123}\) financials are meaningful only to the extent that they alert the Agency that such a deficiency may exist. As explained below, if the target is failing because of a structural deficiency, the acquisition does not threaten to lessen competition substantially, and the transaction should be permitted. If no such deficiency exists, the Agency should proceed to step three of the analysis, inquiring further into market realities in an effort to ascertain whether acquisition or financial failure and exit is more competitive. Unlike the current defense, which only asks if the failing firm could reorganize itself into a viable competitor, the structural deficiency requirement appreciates that even if the target could not reorganize successfully, a healthy acquirer may be able to exploit its assets, in which case the sum of the firms' preacquisition market shares may underestimate the merger's anticompetitive consequences. \(^\text{124}\)

If the firm is failing due to a structural deficiency that cannot be overcome, then the firm's failure is conclusive for purposes of section 7 as to the likely competitive consequences of the transaction. When caused by an insuperable structural deficiency, a firm's imminent failure is evidence that its current market share overestimates its future competitiveness. Because the failing firm is on the verge of exiting, the firm will not compete at all in the future; the failing firm's market share for purposes of the prima facie case is zero, or approaching zero.

If the acquirer, like its target, is unable to overcome the target's competitive disadvantages, the acquisition should not substantially lessen competition. The combined firm's ultimate postacquisition market share should not meaningfully exceed the acquirer's preacquisition market share, since the failing firm's future inability to compete reflects the market share intrinsic in

\(^{123}\) Structural deficiencies that would likely qualify include: inability to acquire essential inputs, such as natural resources or equipment; lack of access to essential facilities; and inability to acquire new technology (e.g., a competitor of the combining companies owns the patent). A market structure that allows only a few firms (similar to a natural-monopoly market structure) would also likely qualify. Causes of failure that would not qualify include: lack of financial capital, damaged goodwill, mismanagement, and unsuccessful advertising. Although it may seem paradoxical, a firm sometimes does acquire a competitor even when the competitor is plagued by a fundamental structural deficiency that undermines its future competitiveness. The leading example is *United States v. General Dynamics*, where the acquired firm, a coal producer, was not a viable future competitor in the market for coal because it lacked uncommitted coal reserves that were required to compete meaningfully as a coal supplier. See *United States v. General Dynamics Corp.*, 415 U.S. 486, 498-503 (1974).

\(^{124}\) See supra Part II.B.4.
its assets, regardless of who owns them. By establishing that the firm is failing because of an insurmountable structural disadvantage, the parties have successfully rebutted the prima facie case, and the transaction should be permitted. The firm’s imminent and unavoidable financial failure signals that the firm is not a viable future competitor in anybody’s hands and that, consequently, its acquisition does not substantially threaten competition.

It could be argued that even if a firm is failing because of a structural deficiency, failure and exit may still be preferable to acquisition. For example, if a firm fails, its assets may be sold off piecemeal to the most productive users. There is, however, a fundamental difference between a scenario where the transaction is presumptively anticompetitive under the prima facie case and a scenario where the combining parties have successfully rebutted the prima facie case by demonstrating a structural deficiency. Because the acquisition of a failing firm may threaten competition, a firm should not be able to interpose its financial ruin as an absolute defense to a presumptively anticompetitive transaction; the firm’s failure, in and of itself, does not negate the prima facie case of anticompetitiveness.

It does not follow, however, that a firm should be forced to exit the market whenever exit may promote competition more than merger; a merger that is not presumptively anticompetitive does not violate section 7 simply because exit may be preferable. Section 7 is not concerned with acquisitions that do not substantially lessen competition or tend to create a monopoly, nor does it require companies to conduct their business in the most competitive manner possible. Furthermore, section 7 is concerned with acquisitions that have a “reasonable probability,” not just a “mere possibility,” of substantially lessening competition. It is unlikely that the acquisition of a failing competitor suffering from insuperable structural disadvantages will endanger competition sufficiently to concern section 7.

When transactions involving failing firms are presumptively anticompetitive, it is appropriate to inquire further into market realities to determine whether exit or acquisition is preferable. However, under the proposed new approach, if an inquiry into the cause of the firm’s failure reveals a structural deficiency that rebuts the prima facie case, the transaction

125. See supra Part II.B.6.
128. Id. at 598 (emphasis omitted).
should be permitted without further inquiry into market realities under step three of the analysis. If an acquisition does not threaten to lessen competition substantially, it is indisputably outside section 7's domain.

3. **Exit v. Merger**

The Agency should consider whether financial failure and exit are preferable to merger only if the failing party’s demise is due to neither chronic excess capacity nor a structural deficiency that rebuts the prima facie case. The transaction should be permitted only if merger or acquisition would result in a more competitive market than the failing firm’s exit.

The new defense acknowledges that transactions involving failing firms may substantially lessen competition. Thus, unlike the traditional failing firm defense, which relies on an indefensible economic assumption about competition, this final step in the new approach demands a fact-intensive, case-by-case inquiry into market realities that more accurately ascertains the likely competitive effects of permitting the transaction. Moreover, since the new approach recognizes that section 7's sole aim is competition, it does not subordinate competition to other social goals. Because the market realities surrounding each transaction are unique, the proposed rule-of-reason approach better assures that merger enforcement serves section 7.

The primary virtue of the new defense is that, unlike the *per se* approach of the current failing firm defense, it incorporates a rule-of-reason approach to section 7 enforcement that focuses its inquiry on market realities in an effort to fulfill its goal of promoting competition. Although parties who could successfully sustain the new defense probably could also sustain the current failing firm defense, not all parties who could establish the current defense could establish the new defense. It is principally because of these latter cases that the Guidelines should incorporate the proposed revisions. The expansive approach of the new defense will better serve section 7 than does the current failing firm defense’s myopic inquiry into narrow considerations that insufficiently capture a transaction's competitive impact.

**B. Institutional Competence and Support for the Proposal**

A likely criticism of the proposed rule-of-reason approach to the failing firm defense is that, even if ideal in theory, it may fail in practice because it threatens to strain institutional competence. This argument is not convincing. Admittedly, a case-by-case inquiry into market realities requires more information and more sophisticated economic analyses than the current failing

129. See supra Part II.B.
Horizontal Merger Guidelines Reform

firm defense. The new failing firm defense, however, would not strain institutional competence any more than the current rule-of-reason approaches to other aspects of merger enforcement, such as the prima facie case of anticompetitiveness, under which courts and the Agencies inquire into market realities. Furthermore, besides indicating that the above approach is already operational in another setting, the fact that courts and the Agencies consider market realities outside the context of the failing firm defense suggests that the proposal is not wholly inconsistent with practice and precedent, which is important for institutional acceptance of the revisions by courts and the Agencies.

1. Case Law

Brown Shoe Co. v. United States, written by Chief Justice Warren, represents the most notable endorsement of a rule-of-reason approach to mergers and acquisitions. Not only did the Brown Shoe Court carefully consider the market realities bearing on the likely competitive consequences of the merger at issue, it also encouraged other courts to pursue a flexible case-by-case approach to section 7 enforcement that avoids rigid rules and presumptions. The Court explained:

[W]hile providing no definitive quantitative or qualitative tests by which enforcement agencies could gauge the effects of a given merger to determine whether it may “substantially” lessen competition or tend toward monopoly, Congress indicated plainly that a merger had to be functionally viewed, in the context of its particular industry.

130. For an interesting discussion on making the rule-of-reason approach easier to apply, see F.M. Scherer, Making the Rule of Reason Analysis More Manageable, 56 ANTITRUST L.J. 229 (1987).

131. 370 U.S. 294 (1962). Brown Shoe involved a merger between two producers of shoes, Kinney and Brown Shoe. Id. at 296. Although I agree with the Brown Shoe Court's adoption of a rule-of-reason approach to merger enforcement, I disagree with its overall analysis of the Brown Shoe-Kinney merger.

132. Id. at 323-46.

133. Id. at 321-22. The Court continued by listing various factors that should be considered:

That is, whether the consolidation was to take place in an industry that was fragmented rather than concentrated, that had seen a recent trend toward domination by a few leaders or had remained fairly consistent in its distribution of market shares among the participating companies, that had experienced easy access to markets by suppliers and easy access to suppliers by buyers or had witnessed foreclosure of business, that had witnessed the ready entry of new competition or the erection of barriers to prospective entrants, all were aspects, varying in importance with the merger under consideration, which would properly be taken into account.

Id. at 322. For cases where courts accepted the Brown Shoe Court's invitation to inquire into

Copyright © 1996 by the Yale Journal on Regulation
In a footnote to this paragraph, the Court continued:

[T]he courts have . . . recognized the relevance and importance of economic data that places [sic] any given merger under consideration within an industry framework almost inevitably unique in every case. Statistics reflecting the shares of the market controlled by the industry leaders and the parties to the merger are, of course, the primary index of market power; but only a further examination of the particular market—its structure, history and probable future—can provide the appropriate setting for judging the probable anticompetitive effect of the merger.134

In cases following Brown Shoe, the Court retreated from its invitation to lower courts to inquire into market realities that bear on a merger’s competitiveness. The leading case in which the Court strayed from the Brown Shoe approach was United States v. Philadelphia National Bank,135 in which the Court articulated a statistical test to determine whether a transaction is presumptively anticompetitive.136 Philadelphia National Bank represented a new judicial approach favoring easily-definable rules and simplicity over fact-intensive inquiries. However, in United States v. General Dynamics Corp.,137 decided in 1974, the Supreme Court moved away from the presumptive rigidity of Philadelphia National Bank and reembraced the Brown Shoe market-realities approach to section 7.

In General Dynamics, Material Service Corporation, a deep-mining coal producer, acquired stock in United Electric Coal Companies, a strip-mining

---


136. The Court stated:
[A] merger which produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in that market, is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive effects.

Id. at 362.

coal producer, and gained effective control of United Electric in 1959.\textsuperscript{138} Within months, Material Service itself was acquired by General Dynamics. The Government maintained that the acquisition violated section 7 because it substantially lessened competition in the coal industry. Relying on \textit{Philadelphia National Bank}, the Government presented statistics representing the companies' past sales and output to establish its prima facie case of anticompetitiveness.\textsuperscript{139} The Supreme Court looked past these market-share statistics and, quoting \textit{Brown Shoe}, stated that "only a further examination of the particular market—its structure, history and probable future—can provide the appropriate setting for judging the probable anticompetitive effect of the merger."\textsuperscript{140}

After examining a wide range of economic evidence, the Court rejected the Government's prima facie case.\textsuperscript{141} In particular, after examining the coal market, the Court concluded that "[a] more significant indicator of a [coal] company's power effectively to compete with other companies lies in the state of a company's uncommitted reserves of recoverable coal,"\textsuperscript{142} and not in its past ability to produce. Finding that United Electric's scarce uncommitted reserves indicated that its past market share overestimated its future ability to compete, the Court held that the acquisition did not substantially lessen competition.\textsuperscript{143}

The \textit{General Dynamics} Court resurrected the Supreme Court's earlier rule-of-reason approach to merger enforcement. The Court's revitalized market-realities inquiry has since remained viable and has been widely used by lower courts. Not only have these courts consistently considered economic factors that discredit the predictive value of the market-share statistics underlying the Court's presumption of anticompetitiveness,\textsuperscript{144} they have also considered market realities that influence whether a combined company, despite its presumptively anticompetitive market share, could effectively

\begin{itemize}
\item \textsuperscript{138} \textit{Id.} at 488-90.
\item \textsuperscript{139} \textit{Id.} at 494-96.
\item \textsuperscript{140} \textit{Id.} at 498 (quoting \textit{Brown Shoe Co. v. United States}, 370 U.S. 294, 322 n.38 (1962)).
\item \textsuperscript{141} \textit{Id.} at 498-501.
\item \textsuperscript{142} \textit{Id.} at 502.
\item \textsuperscript{143} \textit{Id.} at 503. The \textit{General Dynamics} Court's method of analysis is consistent with the structural deficiencies analysis in the second stage of the new proposal.
\end{itemize}
exercise market power.145 Finally, courts have begun to recognize that, even if the combined company exercises market power, efficiency gains from the merger may mean that the transaction, on net, is procompetitive.146

It is important to note that the Brown Shoe-General Dynamics market-realities approach has, on occasion; been applied in cases where financial weakness is an issue. Some courts considering a target’s financial weakness, under either the moribund financial-weakness defense147 or the traditional failing firm defense, have inquired into the cause of the firm’s financial troubles to determine whether the target was reasonably capable of


146. See, e.g., FTC v. University Health, Inc., 938 F.2d 1206, 1222 (11th Cir. 1991); United States v. Baker Hughes Inc., 908 F.2d 981, 987-89 (D.C. Cir. 1990); United States v. Syufy Enterprises, 903 F.2d 659, 664 (9th Cir. 1990); see also 4 AREEDA & TURNER, supra note 37, ¶¶ 939-944. The consideration of efficiencies by the courts is consistent with the Guidelines’ consideration of efficiencies, discussed infra Part IV.B.2.

147. The financial-weakness defense stems from a broad reading of General Dynamics. See United States v. International Harvester Co., 564 F.2d 769, 773 n.7 (7th Cir. 1977). The defense, which was first espoused in United States v. International Harvester Co., posits that financial weakness (short of failure) constitutes a deficiency that undermines a firm’s future competitiveness, thereby discrediting the Government’s market-share statistics underlying its prima facie case. Id. at 774. Today, the financial-weakness defense is moribund, if not entirely rejected. See, e.g., FTC v. Warner Communications Inc., 742 F.2d 1156, 1164 (9th Cir. 1984); Kaiser Aluminum & Chemical Corp. v. FTC, 652 F.2d 1324, 1338-39 (7th Cir. 1981); 4 AREEDA & TURNER, supra note 37, ¶ 935c, at 141; Arquit, supra note 3; Speech by Janet Steiger to ABA Section of Antitrust Law, in 62 Antitrust & Trade Reg. Rep. (BNA) No. 1560 at 490 (Apr. 9, 1992).
rehabilitating itself, or whether the acquirer reasonably could be expected to
revitalize the firm’s assets. These cases validate the proposed framework’s
structural-deficiency inquiry.

2. Merger Guidelines

Because the specific standards set forth in the Guidelines must be
applied to a broad range of possible factual circumstances,
mechanical application of those standards may provide misleading
answers to the economic questions raised under the antitrust laws.
Moreover, information is often incomplete and the picture of
competitive conditions that develops from historical evidence may
provide an incomplete answer to the forward-looking inquiry of the
Guidelines. Therefore, the Agency will apply the standards of the
Guidelines reasonably and flexibly to the particular facts and
circumstances of each proposed merger.

As the above statement in the 1992 Guidelines indicates, the Agencies,
in principle, favor a rule-of-reason approach to section 7 enforcement that
considers all relevant evidence informing the “ultimate inquiry in merger
analysis: whether the merger is likely to create or enhance market power or
to facilitate its exercise.” Other aspects of the Guidelines have also

149. 1992 Guidelines, supra note 3, at 41,553.
150. Id. at 41,553. For other evidence that the Guidelines favor a rule-of-reason approach,
see 1984 Guidelines, supra note 20, at 26,825; 1968 Merger Guidelines, Trade Reg. Rep. (CCH)
 ¶ 13,101, at 20,882 [hereinafter 1968 Guidelines]. On the contrary, while the Guidelines’ approach
to the prima facie case has focused increasingly on market realities and has become more
sophisticated and rigorous by incorporating advances in economic thinking, the failing firm defense
has become more rigid each time new Guidelines are promulgated. Compare 1968 Guidelines,
 supra, at 20,524 (requiring generally that the “resources of one of the merging firms are so
depleted and its prospects for rehabilitation so remote that the firm faces the clear probability of
a business failure”); 1982 Guidelines, supra note 41, at 20,452 (explaining that the defense’s
elements will be construed “strictly” and that a merging firm is failing for purposes of section
7 when it “probably would be unable to meet its financial obligations in the near future” and “it
probably would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act”);
1984 Guidelines, supra note 19, at 20,567 (same); 1992 Guidelines, supra note 3, at 41,562
(explaining that a merging firm is failing for purposes of section 7 when it “would be unable to
meet its financial obligations in the near future,” “it would not be able to reorganize successfully
under Chapter 11 of the Bankruptcy Act,” and its assets would exit the market absent acquisition).
Moreover, the fact that the Guidelines consistently redefine the elements constituting the failing
firm defense should be cause for concern. By changing the defense’s criteria, the drafters arguably
concede that prior versions of the failing firm defense did not adequately capture what it means
to be failing for purposes of section 7. There is no convincing reason to believe that the 1992
The Yale Journal on Regulation

Vol. 13:347, 1996

embodied the rule-of-reason approach. First, the 1992 Guidelines, recognizing that “market share and concentration data provide only the starting point for analyzing the competitive impact of a merger,” outline in considerable detail “other market factors” that the Agencies will consider with respect to the prima facie case. Although each set of Guidelines has considered other market factors, the Guidelines’ considerations and discussions have become consistently more sophisticated, analytically rigorous, and extensive. Second, the 1992 Guidelines, separate from the other market-factors analysis, consider the effect of efficiencies and ease of entry on a transaction’s likely competitive consequences; again, although predecessors to the 1992 Guidelines also considered efficiencies and entry, they did so with less analytic rigor and sophistication. Finally, the 1984 and 1992 Guidelines both incorporate General Dynamics and consider possible market changes and structural deficiencies that indicate that a party’s market share overstates or understates its future competitiveness. It is worth noting that the 1984 Guidelines’ structural-deficiency analysis, consistent with the above proposal, expressly relied on a firm’s weak financial statements to signal a more serious structural disadvantage threatening the firm’s viability; the 1992 Guidelines have finally gotten it right. The defense’s changing elements only reinforce that the defense’s rigid simplicity is an inadequate substitute for a fact-intensive, case-by-case inquiry into market realities.

151. Id. at 41,558.

152. Id. at 41,558 (“Lessening of Competition Through Coordinated Interaction”), at 41,559 (“Conditions Conducive to Reaching Terms of Coordination”), at 41,559 (“Conditions Conducive to Detecting and Punishing Deviations”), at 41,560 (“Firms Distinguished Primarily by Differentiated Products”), at 41,560 (“Closeness of the Products to the Merging Firms”), at 41,560 (“Ability of Rival Sellers to Replace Lost Competition”), at 41,560 (“Firms Distinguished Primarily by Their Capacities”).

153. For example, the 1968 Guidelines discuss only generally the importance of factors other than market share. See 1968 Guidelines, supra note 150, at 20,522. By contrast, the 1982 Guidelines not only identify more factors, but also emphasize more forcefully their importance in merger analysis. See 1982 Guidelines, supra note 41, at 20,537. Compared to the 1982 Guidelines, the 1984 Guidelines not only provide a more detailed and sophisticated discussion of market factors, but also increasingly stress their importance, stating categorically that such factors “will” be considered. See 1984 Guidelines, supra note 20, at 20,562. Finally, the 1992 Guidelines provide a more complete discussion than any preceding Guidelines. See 1992 Guidelines, supra note 3, at 41,560.


155. Id. at 41,561-62.


158. The 1984 Guidelines state:
The Department will consider the financial condition of a merging firm or any firm in the relevant market, to the extent that it is relevant to an analysis of the firm’s
Horizontal Merger Guidelines Reform

implicitly rely on a firm's financial statements as valuable signals of a fundamental deficiency that undermines the firm’s future competitive significance.\(^{159}\)

In sum, the above proposal's rule-of-reason methodology only asks courts and agencies to extend to the failing firm defense their rule-of-reason approach to the prima facie case.

Conclusion

The current failing firm defense is an anomalous enforcement practice that is inconsistent with the rule-of-reason approach generally used in section 7 enforcement. Courts’ and the Agencies’ case-by-case, fact-intensive inquiries into the prima facie case demonstrate their recognition that each merger presents an array of unique facts that influences the transaction’s competitive consequences and that therefore must be considered before prohibiting or permitting a merger. The fatal flaw of the current failing firm defense is that it limits its inquiry to a few considerations that, although consistent with the untenable private interest and economic rationales, do not sufficiently capture a merger’s competitive impact.

In the past, the Guidelines have been faithful to judicial precedent and have incorporated a *per se* failing firm defense. Past agency and judicial practice, however, should not prevent the agencies from going forward. As this Note argues, the Agencies should move away from both agency and judicial failing firm precedent by incorporating into the Guidelines a rule-of-reason failing firm defense that focuses on market realities. Given courts’ and the Agencies’ demonstrated ability to consider market realities impacting the prima facie case, there is no convincing reason why they cannot extend their inquiry to include the failing firm defense. The fact that courts and the Agencies inquire into market realities in other contexts, moreover, suggests that precedent supports this Note’s proposal, which is important to its likely future competitive significance. If the financial difficulties of a firm cannot be explained as phenomena of, for example, the business cycle but clearly reflect any underlying structural weakness of the firm, the firm’s current market share may overstate its likely future competitive significance.

1984 Guidelines, *supra* note 20, at 20,561. In a footnote, the Guidelines continued: “This factor is distinguished from the failing company doctrine, which is an affirmative defense to an otherwise unlawful merger and which . . . the Department will construe strictly.” *Id.* Together, these statements indicate that the Guidelines rejected looking into the cause of the firm’s failure under the failing firm defense. The market-realities approach to financially weak firms, as compared to the *per se* approach to financially failing firms, further indicates the rigid absoluteness of the current failing firm defense and its sole concern for whether the firm is failing without regard as to why.

159. *See, e.g.*, Arquit, *supra* note 3, at 129.
acceptance by courts and the Agencies and its ultimate incorporation into case law.