ECONOMIC ANALYSIS GROUP
DISCUSSION PAPER

Merger Review of Firms in Financial Distress

by

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EAG 09-1 March 2009

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Abstract

With the increased number of firms that are in some form of serious financial distress, once financing becomes more readily available to potential acquirers we might expect an increase in both the number and share of mergers where at least one of the parties is having difficulty staying afloat independently. This raises the importance of the policy question as to the appropriate standard to apply to such mergers. This paper shows that this standard--striking the best balance between the efficiency benefits and the potential anti-competitive effects that a merger might produce--is the same one given in the Merger Guidelines for any merger. Further, we show that requiring money-losing firms to satisfy the conditions demanded by the Guidelines "Failing Firm Defense" is appropriate even when the overall economy is going through very difficult times.

We explain also that when the conditions required by the failing firm defense are satisfied, a proposed acquisition cannot be intended to generate an anticompetitive outcome and must be expected by the acquiring firm to generate efficiencies. This inference is shown to be not only economically sound, but also to be consistent with the Supreme Court decision in which the Court introduced the failing firm defense as a variety of the efficiency defense that it accepted in that case.

I. Introduction

The current global economic recession raises serious challenges, not only for those devising and implementing macroeconomic policies, but also for those working in the field of competition policy. Increasing numbers of firms are in some form of serious financial distress, and once financing becomes more readily available to potential acquirers it is reasonable to expect an increase in both the number and share of mergers where at least one of the parties is having difficulty staying afloat independently. This raises the importance of the policy question as to the appropriate standard to apply to such mergers.

The relatively demanding conditions under which the federal competition authorities permit an otherwise anticompetitive merger under what is widely referred to as the failing firm defense are relatively clear. As stated in § 5.1 of the U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, they are as follows:

> 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; [FN. Citing the relevant statute omitted] 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.

While the language of the Guidelines itself is clear, the underlying rationale is not so widely understood and appreciated. Particularly in times when competition authorities will be faced with a disproportionately large number of proposed mergers for which some version or another of a failing firm defense may be offered, it is important to remind ourselves of the principles underlying that defense and, more broadly, the appropriate framework for analyzing merging firms in some form of financial distress.

A question also arises, or undoubtedly will arise shortly, as to whether the unusually weak state our economy's health is passing through means that merger analysis should employ a somewhat weaker, more forgiving, set of requirements for mergers proposed by firms in some significant financial distress. Our view is that, properly understood and applied, the Merger Guidelines' failing firm requirements are appropriate even in these difficult economic times. Although a weak economy may mean that more transactions will pass muster under this standard, those that do not should be blocked in troubled economic times for the same reasons they should be blocked in more "normal" times. The alternative would be a reduction in competition and harm to consumers and the economy as a whole.

II. Some Basic Merger Economics

At the outset, it is worth reviewing briefly some basic economics relevant to merger policy generally. This will help establish familiar principles relevant to our subsequent discussion of firms that are in financial distress and are flailing, but that may not be failing.

The Benefits of Competition

Competition, or more accurately the benefits generated by the process of competition, provides the central underlying rationale for antitrust law and competition policy. Competition, properly defined to include competition to obtain monopoly power by best satisfying the demands of consumers, tends to allocate society's scarce resources most efficiently. This, in turn, maximizes the value that society can squeeze out of its resources.

Eliminating competition clearly helps improve the profitability of firms seeking to eliminate competition. This is, after all, why firms often seek protection from rivalry. This enhanced profitability, however, comes at the expense of consumers. And even more importantly, it comes at the expense of the economy as a whole. As Adam Smith (*The Wealth of Nations,* vol. 1 p.278) noted back in 1776,

> "The interest of the dealers, however, in any particular branch of trade or manufacturers is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always in the interest of the dealers. To widen the market may frequently be agreeable enough to the interest of the public; but to narrow the competition must always be against it, and can serve only to enable the dealers, by raising their profits above what they would naturally be, to levy, for their own benefit, an absurd tax upon the rest of their fellow-citizens. The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is never exactly the same with the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, on many occasions both deceived and oppressed it."[1]

Although some might try to defend the wealth transfer from customers to producers that a reduction in competition causes, a reduction in competition also leads to completely indefensible economic

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[1]Smith's recommendation about regulation is worth highlighting even though this paper focuses more narrowly on the issue of failing firms. Distilling the above quote down to just its regulatory recommendation, Smith concludes that since "The interest of the dealers ... in any particular branch of trade or manufacturers is always in some respects different from ... that of the public. ... The proposal of any new law or regulation of commerce which comes from this order ... ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention."

distortions that impair the functioning of the economy. In the short run, there is the well-known "deadweight loss" generated by a monopolist's profit incentive to restrict output below the competitive level. And in the longer run, eliminating competition weakens the incentive of firms to beat out rivals for the patronage of consumers by, for example, lowering costs (i.e., leaving more of society's scarce resources for other purposes), reducing prices, and producing more desirable products.

This provides the economic basis not only for blocking mergers whose primary effect may be substantially to eliminate competitive constraints, but also for antitrust laws prohibiting cartels, and for public policy permitting firms to enter markets or expand sales in competition with one another.

Mergers and Efficiency

None of this, of course, is to say that mergers between rivals should always be prohibited. Federal antitrust authorities explicitly acknowledge that such mergers can at times be economically beneficial. Indeed, in evaluating the net consequences of proposed mergers--even ones between significant rivals--it is common practice for the agencies to analyze the extent to which the proposed merger may produce efficiencies--cut costs, improve quality, promote innovation. And, to the extent that these efficiencies are what the agencies refer to as "cognizable," the agencies will perform an integrated analysis of the merger's likely net economic effect.[2]

Cognizable efficiencies come in many forms, and can be especially difficult for competition authorities to discern and evaluate, particularly ex ante. Not only are the efficiencies themselves often difficult to evaluate, but it can be even more difficult to determine the extent to which they are truly specific to the merger--i.e., are unlikely to be achieved in the absence of the proposed merger or some other means having comparable anticompetitive effects.

In some circumstances, merger-specific efficiencies may be so large that the merger will generate net economic benefits, for example, lower prices, even after accounting for possibly greater market power by the merged firm or anticompetitive coordination by the merged firm and its remaining rivals. And in situations where the totality of the evidence indicates there is no significant risk of anticompetitive effects, mergers are generally cleared without any requirement that the firms demonstrate merger-specific efficiencies.

III. Mergers Involving Firms in Financial Distress

Traditional antitrust review applies to mergers between financially viable long-term competitors whose pre-merger independence appears to limit the exercise of market power.
This review includes, *inter alia*, an evaluation of any cognizable efficiencies, the likelihood of

[2] Cognizable efficiencies are "merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognizable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies." Section 4, Horizontal Merger Guidelines.

sufficient and timely entry and, of course, competitive effects analysis.

Where one of the merging parties is in a financially weakened state, special considerations may apply. It is frequently suggested that such mergers should be treated more leniently under the antitrust laws, however the arguments for and against such a policy are often left insufficiently explored and inadequately defended. In some circumstances treating such mergers with greater leniency may be appropriate. In other circumstances, however, it is not. Let us examine the relevant considerations a bit more carefully.

Assume we are being asked to evaluate a proposed merger between two significant competitors and that, absent the struggling financial position one happens to be in at the moment, the merger would appear to raise very serious competitive concerns. To help fix ideas, assume we are evaluating a merger of two of only three or four firms that have been competing in a relevant market, that the firms proposing to merge both have high market shares, and that sufficient entry is unlikely to be timely. In such circumstances, the competition authority may confront the following scenarios.

a. The firm will not be a constraining competitor in the future because its productivity is declining and/or because the supply of key inputs it owns is being exhausted

Particularly (though not only) where one of the merging firms is in a financially distressed condition, one needs to consider whether historical evidence of the firm's role in the market is a reasonable proxy for the role it is likely to play going forward, but for the merger. If the firm is not likely to be an effective competitor absent the merger, then the merger is unlikely to produce an adverse effect on competition.

Antitrust analysis is forward, rather than backward looking, and competition authorities should rely on historical evidence only to the extent that this helps inform us abut the future (*U.S. v. General Dynamics*, 415 U.S. 486, 501). Where it does not, we need to look elsewhere. For example, a firm may own some assets that will continue to be productive for many years, and others whose supply will be exhausted shortly. In some cases it may be clear how little life key productive assets have left in them (e.g., a once-rich coal seam may have been almost completely mined, a valuable patent may be nearing expiration, a factory may reside in a building that has been condemned and cannot economically be brought up to code). The actual or prospective loss of a firm's key assets, including the exhaustion of valuable scarce inputs, is of considerable relevance to its future competitiveness as a standalone firm and thus to the competitive implications of a merger–even one between rivals with historically very high market shares.

Other circumstances where a firm's future competitiveness cannot simply be assumed to be as great as it had been in the past might include situations where the firm is on the verge of bankruptcy. In particular,

b. The financially distressed firm is unable to meet its financial obligations because it is poorly run and/or because there is a significant exogenous decline in demand for its product

To the extent that a to-be-acquired firm is unable to meet its financial obligations (e.g., if it is about to default on its debts), a key question for competition authorities is whether, absent the merger, the firm would be able effectively to reorganize under the bankruptcy laws. The fact that the firm's creditors may be forced to take a one-time financial loss is not terribly relevant to competition analysis unless the firm's assets will be liquidated and the firm, even under the ownership of a third party, will be unable to continue competing effectively.

Importantly, even if the firm is unable to reorganize successfully under the bankruptcy laws, competition authorities properly consider what will become of the firm's assets in the event that the proposed merger does not take place. If these assets would likely be purchased by a firm that presents no (or fewer) competitive problems and would continue being employed as an independent competitive force in the market, then the mere fact of current financial distress does not imply that the proposed merger is necessarily benign.

For this reason, the failing firm defense in the Merger Guidelines requires that the relevant assets of the failing firm be shopped before competition authorities will approve a potentially anticompetitive merger. It is also why it is perhaps more accurate to refer to the failing firm defense as an "exiting assets defense." If the assets would likely remain in the market–even if in the hands of some other player–then permitting the merger may well be anticompetitive.[3]

For example, consider a manufacturer claiming to be a less effective competitor going forward because it is billions of dollars in debt due to an unanticipated fall in the demand for its product. The firm may claim that inability to service this debt, perhaps due to frozen credit markets, leaves it incapable of financing investments necessary for it to remain productive going forward. "How," it might ask, "can competition authorities reasonably object to our being acquired even by a major rival?"

In examining this situation more closely, we shall see that when financial distress does justify permitting such a merger it is because the acquisition likely generates efficiencies. We shall discuss efficiencies and their relationship to the failing firm defense in somewhat greater detail in section IV. below.

For our flailing manufacturer to be unable to meet its financial obligations and still be a desirable acquisition target by a major rival, the rival must believe that the financially distressed firm's troubles are only temporary. Otherwise, it would not want to spend good money buying a failed entity. The acquirer may hold to this belief for a number of reasons.

One is that the struggling firm will turn around even without an injection of capital from this particular acquirer. Perhaps the firm is basically sound but lost a lot of assets (e.g., due to a fire or

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[3] In the context of mergers that raise little risk of substantially harming competition, normal market forces can be relied upon to move assets to their most efficient uses. For this reason the Merger Guidelines properly refrain from imposing a requirement that the assets be transferred to whoever the government may feel is the most efficient alternative purchaser. Such a requirement is necessary and imposed only when there are substantial competitive risks.

a flood or embezzlement) and those short-term losses won't be repeated. Or, perhaps other sources would be willing to supply the firm with needed short-term credit. In such situations, the "but for" scenario is one where the financially distressed company remains a viable competitive force in the absence of the competitively suspect merger, and hence financial distress does not justify permitting the merger.

A second possible reason for the rival's interest in purchasing the firm is that the firm never will return to profitability (even as a division of the acquiring firm), but the acquirer does not know this and is making a bad bet. While this possibility can certainly not be ruled out, likely mistakes by people spending their own money seems a weak justification for departing from sound principles of competition policy. Merger here should be permitted–assuming no less anticompetitive buyer appears with an offer to purchase and continue operating the firm or use its assets to compete in the market.

Finally, the acquiring firm may correctly believe that the failing firm's failure is only temporary because it, and it alone, can nurse the target firm back to health. The rival may have superior expertise in running this type of firm, be highly knowledgeable about the future prospects of the market and/or be able to capture synergies by combining its skills with the struggling firm's assets. These may provide an economic justification for the acquirer to wish to inject needed capital into the acquired firm's enterprise.

Under such circumstances, financial distress works as a failing firm defense because there is an underlying efficiency defense; the acquirer understands and can, perhaps uniquely, help release the potential of the currently flailing firm.

IV. Efficiency Analysis and the Failing Firm Defense

While §5.1 of the Guidelines does not explicitly mention efficiencies, the failing firm defense implicitly relies upon the merger generating efficiencies. No firm would ever want to buy a competitor that meets the conditions given in §5.1 unless it believes that it can change what had been a failing firm (pre-merger) into what will be a profitable division (post-merger). Potentially that might be achieved in a number of ways, including cutting the failing firm's costs (an efficiency), or raising its revenues. One way of increasing revenues is by enhancing product quality (also an efficiency).

Revenues can, of course, also be enhanced by raising a firm's price without raising its quality or providing benefits to consumers. And, this sounds a lot like an anticompetitive effect. Recall, however, that for the failing firm defense to be satisfied, it must be determined that the firm's assets would be exiting the market "but for" the merger. If that would take place, then by definition these assets would be providing no competitive constraint in the market at all. Thus, if the conditions for the failing firm defense are satisfied, competition authorities would have no reason to object to the merger even if it were known with certainty that price is going to increase.

A failing firm defense commonly begins with the merging parties claiming that they can survive as a merged firm, but that one of them will not survive without the merger. Thus, the claim is that, one way or the other, there will be one less firm in the industry and hence the merger itself will not affect the number of firms in the industry. Therefore, the story goes, the merger is harmless.

Such a claim is not credible unless it is accompanied by an efficiencies defense. One can usefully divide the mass of failing firm stories into two types: one where the acquiring firm wants to buy the failing firm's assets because it believes it may be able to improve the performance of those assets so much that they will be worth maintaining, and one where the acquiring firm has no such hopes. We now consider those two types of stories in detail.

In the case of the efficiency story, an improvement in performance would tend to increase output above what it otherwise would have been, which is good both for the merging parties and for society as a whole. If the improvement in performance is large enough, that pro-competitive effect could justify the merger as being beneficial to consumers.

On the other hand, one can imagine a firm wanting to acquire the assets of a failing competitor even though there is no chance that this will improve the productivity of those assets.[4] While such transactions have their defenders, there are sound reasons for believing that such transactions will lead to an expected increase in price.[5]

To see this, think about what happens when the owner of a failing firm becomes the manager of these same assets as a division of the acquiring firm (for simplicity, assume that he isn't given any additional responsibilities). By the definition of failing firm, pre-merger there was nothing that this manager could have done to make those assets profitable. Post-merger, by assumption that the merger doesn't promise efficiencies, there is nothing he can do to make his costs any lower.

As for revenue enhancement, prospects for that happening aren't good either, unless price rises (a point we'll come back to). Indeed, his efforts to enhance his division's revenues are potentially going to be undermined by the managers of the firm's other divisions (who might well prefer for him to go out of business so that they could in turn sell at higher prices).

In circumstances such as these, a merger turns what had been a failing firm into what is now a failing division, *unless* prices rise post-merger. This implies that the most profitable way for its new owner to raise prices post-merger is to shut the failing division down. Of course, this is something

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[4]The "productivity" (or, more generally, the "efficient use") of the assets discussed in the text is not restricted simply to how well they can be used physically to produce, but also how well they can be used to enhance economic value. We are here considering proposed acquisitions that have no prospect of permitting either to take place.

[5] Farrell and Shapiro demonstrate formally that "If a merger generates no synergies, then it causes price to rise." See the proof of their Proposition 2 in the Appendix to Joseph Farrell and Carl Shapiro, "Horizontal Mergers: An Equilibrium Analysis," The American Economic Review March 1990.

the acquiring firm presumably knew all along, and so its motivation for buying the plant it intends to shut down must be that the acquiring firm was afraid that the acquired firm wasn't really going to shut down on its own (i.e., wasn't failing). In that case, the merger transforms a firm that wasn't doing well, but wasn't failing, into a division that is failing until it's shut down. The merger actually exacerbates the "failure" that it is supposed to solve.[6]

More on the Requirement of a Shop for the Allegedly Failing Firm's Assets

As discussed above, one key requirement of the failing firm defense is that the relevant assets be shopped to see if they would continue operating in the market in the hands of a less anticompetitive acquirer. If the financially distressed firm conducts a shop and receives a bid from another firm, however, it may not be the case that this acquirer will employ the assets in the market of concern. Assets are often fungible and have alternative uses to which they can be put. Perhaps a competing bidder even has in mind that it will liquidate them entirely. Given such uncertainty, should the competition authority be troubled by the possibility that the alternative purchaser might not continue employing the assets in its market of concern?

It should not. If the initial bidder truly were seeking to obtain the financially distressed firm's assets simply to exercise greater market power, it should be happy to see those assets exit the market via purchase by someone else instead. Therefore if, under these circumstances, the initial bidder insists on paying more than others for the relevant assets, then it is a safe bet that there are efficiencies underlying the purchase and it ought to be permitted.

A more difficult scenario is where the shop turns up an alternative bidder who bids less but does seem likely to keep the relevant assets operating in the relevant market. In this case the initial bidder may be seeking to acquire the assets for purposes of exercising greater market power *or* achieving efficiencies (or both).

Determining the net effect of permitting the troubled assets to go to the highest bidder is in principle similar to asking in the non-failing-firm context whether a merger threatening competitive harm ought to be permitted because there are sufficiently large and cognizable efficiencies. The major difference between the two cases is that in the failing firm context the "but for" scenario is that the relevant assets will be operated by some new purchaser, rather than by the current owner. The need for competition authorities to gauge the future competitiveness of the relevant assets after they are in the hands of a new owner may make prediction even more difficult and uncertain.

Another issue that may arise when shopping assets–particularly during a severe economic downturn–is that divestitures to be mandated under a Consent Decree might find no buyer willing to pay greater than liquidation value. In this context one may ask whether the failure to find any willing buyer necessarily demonstrates that the merger itself satisfies the conditions for a successful failing firm defense.

[6] The Appendix provides, in the context of a particular example, a slightly more formal demonstration of these points.

The answer is no. It may be that no third party is willing to purchase the assets for other reasons. Perhaps the package of assets being shopped is the "wrong" collection of assets and cannot be used profitably by anyone to compete profitably in the market of concern. Alternatively, it may be that although no third party would be willing to purchase and operate the divested assets (perhaps because of an inability to secure credit), both of the two merging firms would continue independently in operation. In such circumstances, the "but for" scenario would be continued rivalry between the merging firms, and a merger raising serious competitive concerns should be permitted only where cognizable efficiencies outweigh these feared harms.

V. *International Shoe v. FTC*[7]: An Early Application of Failing Firm Analysis

The failing firm defense has taken many different forms, but is hardly new. It has been around since at least 1930, when the Supreme Court issued its opinion in the *International Shoe* case and spelled out for the first time the failing firm defense it was willing to accept.

The motivation for that merger followed from a severe downturn in the orders that the failing firm had been receiving for its products. As the Court noted: "Beginning in 1920 there was a marked falling off in prices and sales of shoes, as there was in other commodities; and, because of excessive commitments which the McElwain Company had made for the purchase of hides as well as the possession of large stocks of shoes and an inability to meet its indebtedness [the company's officers] concluded that the company was faced with financial ruin, and that the only alternatives presented were liquidation through a receiver or an outright sale. New orders were not coming in."[8] International Shoe, on the other hand, "had so conducted its affairs" that its problem was its inability to fill the demand it faced for its shoes. "

Generations of scholars have apparently misread *International Shoe* [Indeed, in 2001 the DC Court of Appeals said in *FTC v. Heinz and Milnot* that "the Supreme Court has not sanctioned the use of the efficiencies defense in a section 7 case" (246 F.3d 708, 721).] Although it has been consistently overlooked, an "efficiency defense" for the parties' merger is very clearly recognized in *International Shoe*:

> During the early months of 1921, [International Shoes'] orders exceeded the ability of the company to produce, so that approximately one-third of [301] them were necessarily canceled. ... It is perfectly plain from all the evidence that the controlling purpose of the International in [buying the McElwain shoe company] was to secure additional factories, which it could not itself build with sufficient speed to meet the pressing requirements of its business.[9]

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[7] *International Shoe v. FTC*, 280 U.S. 291 (1930).

[8] P. 299

[9] pp. 300-301

Thus, the Court found that International was buying McElwain so that, post-merger, it could fill the demand for the brands that it owned with the relatively good but under-utilized plants of McElwain. This would combine their complementary strengths to generate efficiencies. The Court held specifically that the merger was legal "[i]n the light of the case thus disclosed ... the purchase of its capital stock by a competitor (there being no other prospective purchaser) ... to facilitate the accumulated business of the purchaser ... does not substantially [303] lessen competition or restrain commerce within the intent of the Clayton Act."

The key fact in *International Shoe* was the downturn in one firm's business matched with an upturn in another firm's business, allowing a merger to combine the different strengths of each firm, making the merged firm stronger than either of its components had been on their own. Moreover, by holding that the only alternative to the merger was liquidation, the Court appears also to have found that no less anticompetitive purchaser would be willing to purchase the assets and keep them operating in the market of concern–i.e., that the merger satisfied an "exiting assets" requirement.

Although the Court clearly laid out an efficiency defense, it did not actually use that precise phrase. This is hardly surprising, however, since it wasn't until 1967 that the term "efficiency defense" appeared in any Supreme Court decision.[10]

VI. Failing Firm Analysis During Tough Economic Times

Although not necessarily easy to apply, the logic of the existing failing firm defense, and the conditions it requires be met before otherwise anticompetitive mergers be approved, seems sound. Are there reasons why these conditions ought to be loosened during tough economic times (such as those we are experiencing today)?

Historically, economic downturns have often led to attempts to get new regulations or laws that restrict "unfair" or "excessive" competition (i.e., a downturn can be seen as evidence that free markets have failed, supporting moves away from free markets). One of the largest examples of that might be the National Industrial Recovery Act, which may have been an attempt to fix what the Great Depression was thought to have shown to be broken. Regardless of its motivation, what the NIRA boiled down to was allowing hundreds of industries to legally meet collusively in smoke filled rooms to limit competition as spelled out in their collusive agreements (i.e codes of "fair competition"). Available evidence suggests that its effect on the economy was very harmful.[11]

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[10] Indeed, Westlaw finds the phrase "efficiency defense" being used in only one Court decision <u>ever</u>: *FTC v. Proctor & Gamble*, 386 U.S. 568.

[11] One recent study, "New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis" (Cole and Ohanian, *Journal of Political Economy*, 2004) found that "New Deal cartelization policies are a key factor behind the weak recovery [during 1934-9], accounting for about 60 percent of the difference between actual output and trend output." The authors point not simply to the National Industrial Recovery Act (NIRA)–which was struck down in 1935 as unconstitutional–but to government failure to enforce the antitrust laws even after 1935. They write

In thinking about whether or why a departure from traditional failing firm principles might, at least in theory, be warranted, one might appeal to the fact that those applying the failing firm principles are not all-knowing and invariably make mistakes from time to time. Available information is imperfect and costly to obtain, and the future is uncertain. Talented and hard working though they may be, the staffs of competition agencies will not always get it right. And if during tough economic times the costs of wrongly finding a firm to be viable exceed the costs of wrongly finding a firm to be failing, then arguably competition authorities should bear greater risk by more readily permitting acquisitions of firms in financial distress.

At least as a theoretical matter, this possibility cannot be rejected. Absent supporting empirical evidence, however, the reverse seems as likely to be true; during times of financial distress the costs of getting it wrong might argue in favor of adopting an even tougher stance. Perhaps, that is, policy should tilt against insulating financially distressed firms from the forces of competition.

Without persuasive evidence one way or the other, an agnostic approach seems prudent. Indeed, although it may be impolitic to say so, a feature of all "bailouts"–including relaxing antitrust standards to permit anticompetitive mergers–is that they help allow inefficient management and labor agreements to stay in place instead of permitting the marketplace to force painful changes that should be made.

Clearly there is always a harm from blocking a merger that would have cut the costs of the firm that had been failing. One might also argue that such a cost is relatively high during an economic downturn because it is easier to redeploy assets in booming times than in downturns (e.g., you'll have better luck finding a job if you're the only unemployed person in a boom than you would if you were one of millions all looking for the same job in a downturn). On the other hand, one might argue that the cost of allowing a merger to create market power is greater during a downturn (since entry may be likelier during a boom). As usual, the competition authorities have to weigh all these possibilities, hoping to strike the right balance.

Another argument offered for permitting financially distressed firms to be acquired in what might be anticompetitive deals is that it is good for the economy to permit flailing firms to get the highest possible value for their assets when they are going under–even if it leads to greater market power and short-run harm to consumers. If competition authorities refuse to provide such a "safety net" there is likely to be less entry in the first place. And one might be tempted for this reason to argue in favor of relaxing the relatively demanding conditions required for a successful failing firm defense.

Such arguments are not appealing, either in good economic times or in bad ones. The amount of entry is based on potential entrants' expected profits. Truncating the amount that a firm stands to

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that "the government openly ignored collusive arrangements in industries that paid high wages" until the 1938 appointment of Assistant Attorney General Thurman Arnold. Cole and Ohanian note further that "The number of new cases brought by the DOJ rose from just 57 between 1935 and 1939 to 223 between 1940 and 1944."

lose in tough times (by allowing anticompetitive mergers) would provide an incentive for more than the optimal amount of entry–and perhaps also to entry being skewed towards markets where investors believe that a failing firm defense would be applied most leniently. Profits aren't capped when a firm does especially well (nor, we would argue, should they be). For similar reasons a floor ought not be placed under a firm's losses by providing it with an antitrust free pass when it seeks to exit via anticompetitive merger.

VII. Conclusion

Evaluating whether a proposed merger satisfies the Merger Guidelines' failing firm defense is often difficult. The principles underlying the test are, however, generally sound. Moreover, these principles remain appropriate even when the overall economy is going through very difficult times. The current severe downturn may lead to more proposed mergers between financially distressed firms, but it does not imply that looser standards ought to be applied when evaluating them.

Appendix[12]

Avoidable costs (costs that a firm can avoid by going out of business) have to be at the heart of any model used for considering the failing firm issue. To illustrate the way failing firm analysis works, this Appendix considers what may be the simplest case (the same forces apply also in more complicated cases, but it is helpful to work with this simple case since it is easier to understand). Consider a duopoly where each firm has an avoidable cost and each one's marginal cost is constant out to its capacity, although one firm is said to be failing because its marginal cost is relatively high. For the moment, consider the possibility (that will lead us to a contradiction, so that possibility will ultimately be rejected, but for the moment suppose) that both the failing firm's plant and its acquirer's plant will operate post-merger.

Since the failing firm's marginal cost is relatively high, insofar as it is possible to shift any output from the failing firm's plant to the acquirer's plant, that necessarily increases total profit. That means that if both plants operate post-merger, the acquirer's plant must be operating at full capacity (i.e., unable to accept any more orders being shifted to it). Therefore, the merger cannot improve the environment facing the failing firm's plant (i.e., post-merger its competitor will produce at full capacity which is the worst environment the acquired plant can face). Therefore the merger doesn't improve the failing firm's profitability, which is as bad (or worse) post-merger as it was pre-merger. Therefore, it will be shut down post-merger, contradicting the earlier assumption that both firms operate post-merger.

However, it makes no sense to go through the expense of a court battle to be allowed to pay good money to buy and then shut a plant that was failing on its own (i.e., if a plant is going to be shut whether it's acquired in a merger or not, it makes no sense to pay to be the one that gets to shut it). Thus, we also reject the initial assumption: if the buyer has no efficiencies to add to the acquisition, then the "failing firm" will fail only if its competitor is allowed to buy it.

[12] See also "The Supreme Court's Efficiency Defense" (Kimmel, *Supreme Court Economic Review*, 2004).