

## Paper Trail: Working Papers and Recent Scholarship

**Editor's Note:** In this edition of the Paper Trail, editor John Woodbury reviews an EAG Working Paper that looks at the antitrust agencies' merger review of firms in financial distress. Should the agencies be more willing to allow firms to take advantage of the failing-firm defense in the face of today's severe economic downturn? Send suggestions for papers to review, and your comments, to: [page@law.ufl.edu](mailto:page@law.ufl.edu) or [jwoodbury@crai.com](mailto:jwoodbury@crai.com).

—WILLIAM H. PAGE AND JOHN R. WOODBURY

### Recent Papers

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**Ken Heyer & Sheldon Kimmel, Merger Review of Firms in Financial Distress, EAG Working Paper (EAG 09-1) (Mar. 2009)**

<http://www.usdoj.gov/atr/public/eag/244098.pdf>

As Congress, policy makers, and policy wonks struggle with identifying and implementing mechanisms that will pull or push the U.S. and perhaps the world out of this Great Recession, should antitrust enforcement reflect the sudden, deep, and widespread decline in the demand for goods and services? Should the antitrust agencies be more willing today to allow merging firms to take advantage of the failing-firm defense than they might have been three to five years ago? In this EAG working paper, Justice Department economists Ken Heyer and Sheldon Kimmel argue that the current requirements satisfying the failing-firm defense are just fine, thank you.

The working paper begins with the conditions under which the agencies will rely on the failing firm defense to clear a merger that might otherwise be anticompetitive. Paraphrasing, those conditions are that the firm demonstrate its inability to meet its near term financial obligations; that it could not be successfully reorganized under Chapter 11 of the Bankruptcy Act; that it made good-faith efforts to find a competitively preferred buyer; and that absent the acquisition, the assets of the failing firm would exit the industry.

After reprising the benefits of competition and the notion that most horizontal mergers generate efficiencies (and so are never challenged), Heyer and Kimmel note that the fact of financial distress itself has no implications for antitrust enforcement policy. If the firm can be successfully reorganized under Chapter 11, then the merging parties cannot use the failing firm defense. If the firm cannot be so reorganized, then a rival firm might want to acquire the failing firm for one of two reasons—because the acquirer could choose to shut the firm down and so enable the acquiring firm to raise price (or prevent price from falling as far as it otherwise might) or because the acquiring firm “understands and can, perhaps uniquely, help release the potential of the currently [financially distressed] firm.” Viewed from that perspective, “financial distress works as a failing firm defense because there is an underlying efficiency defense.” (p.6).

Heyer and Kimmel note that if there is an alternative bidder who would purchase the assets for use in another industry but whose bid is lower than that of the incumbent firm, then the authors conclude that the incumbent's bid must be driven by efficiency since otherwise “it should be

happy to see those assets exit the market.” Yet that doesn’t seem quite right—if the assets can be redeployed at low cost, then the outside bidder’s acquisition of the assets would serve as a competitive constraint on the incumbent even if the assets were used outside of the industry. The “right” condition to satisfy the exiting asset prong of the failing-firm defense would seem to be that the exiting assets could not be easily redeployed in the market they are exiting.

The paper notes that if a lower bidder is another industry incumbent who might otherwise be competitively preferred by the agencies, then the agencies must evaluate the acquisition of the financially distressed firm by, in effect, treating the assets as being currently owned by the lower-bid firm, which would be the “but for” world. In this scenario, the agencies would evaluate the merger as if the higher-bid firm were acquiring the assets from the lower-bid firm. As the paper notes, the need to predict the competitive significance of the assets when controlled by the lower-bid firm will (or should) greatly complicate the antitrust analysis. A complete antitrust analysis requires evaluating the effect of two mergers, not one.

The authors acknowledge the possibility that in a “severe economic downturn,” there may be no alternative bidders for the assets. Curiously, the paper provides no answer as to how to proceed in these circumstances, except to observe that both firms might continue to operate. If the firm cannot be successfully reorganized under Chapter 11 and if the assets would otherwise exit the industry via liquidation and in the absence of any alternative, “competitively-preferred” bidder, it would seem to me that the financially distressed firm has satisfied the requirements for the failing firm defense.

The penultimate section of the paper (finally) addresses the issue of whether in severe economic downturns, the failing firm standards should be relaxed. The authors first point to a recent paper that finds that New Deal policies that encouraged cartel formation (or at least did not discourage that formation by enforcing the antitrust laws) weakened the recovery from the Great Depression because the cartels restricted output.<sup>1</sup>

Against that backdrop, the authors identify the criteria for relaxing the application of standards as whether “the costs of wrongly finding a firm to be viable exceed the costs of wrongly finding a firm to be failing.” (p.11). In their view, determining where the scale tilts in tough economic times is a mission impossible, and so the agencies should be agnostic. Although if anything, the authors note the New Deal experience may suggest an even tougher policy to reduce the likelihood of merger-related output restrictions.

Unfortunately, the authors spend virtually no time on what really is the 800 lb. elephant in the antitrust room: The inability to quickly redeploy the assets of the failed firm (both capital and labor) in a severe economic downturn may make the firm’s failure more costly than in “normal” periods of economic activity, when redeployment would occur more quickly. That may be the case because the Chapter 7 liquidation of one firm leads to the failure of its suppliers, which in turn has a cascading effect moving down the supply chain.

But they also note that “on the other hand . . . 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 of these possibilities.” (p.11). This conclusion may be the most important component of this too-short discussion in that it seems to acknowledge that the timing of asset redeployment is a bona fide consideration for antitrust enforcement. Thus, while the

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<sup>1</sup> See Harold Cole & Lee Ohanian, *New Deal Policies and the Persistence of the Great Depression*, 112 J. Pol. Econ. 779 (2004).

paper concludes that there is no reason for “looser standards” for meeting the efficiency defense, the paper seems to suggest one reason that in “normal” economic times we don’t consider.

To sum up, the authors note the recent evidence that the New Deal policy of at least looking the other way as cartels were being formed slowed the pace of recovery from the Great Depression. But in fact, even if true, I am unaware of anyone suggesting the adoption of such a policy—the issue here is whether we should be willing to tolerate a “bit more” risk of anticompetitive outcomes during times of severe downturn, which (if the world is linear) would have a much smaller effect on harming consumers than a cartel.

When we talk about relaxing the standards for satisfying the failing firm defense, it’s worth considering what that doesn’t mean. Suppose in normal times, the agencies tend to conclude that 1 in 20 failing firm defenses satisfy the Guidelines requirements. The authors note that more firms will “pass” simply because there are more firms that will mount that defense in economic downturns even if only 1 in 20 continue to pass the failing firm test.

But more than 1 in 20 will likely be able to successfully mount that defense and, as a result, there may be an “automatic relaxation” of the policy even if the same standard of review is maintained during the Great Recession as before. First, one would expect that the probability of reorganizing under Chapter 11 is less, perhaps considerably less, than in more stable economic periods. Second, the likelihood of finding an alternative buyer may be diminished as prospective buyers themselves are adversely affected by the economic downturn. Assuming that the firm has demonstrated its inability to satisfy its financial obligations, the final, more difficult question is whether the assets would exit the industry absent the merger. If there is little prospect that firms either inside or outside the industry would bid for the use of these assets, it must mean that the value of the assets is so low that their next best use might be scrap. As scrap, those assets would exit the industry absent the merger. In short, the likelihood that firms can satisfy the failing firm defense is greater during the Great Recession than in normal times, and that increased likelihood occurs “automatically,” i.e., without any change in the standard of review. What has changed are the facts—a widespread and substantial decline in economic activity—to which the standards are applied.

But should agencies go further by relaxing the standards themselves? Should we tolerate a “bit” more anticompetitive risk by being more permissive about the application of the failing firm standards to offset the risk of creating cascading failures because of the inability to redeploy assets quickly when there is a severe economic downturn? And, to extend the argument a bit, because the cost of redeployment is likely to be greater the greater is the “interconnectedness” of the industry in which the failing firm operates.<sup>2</sup> Right or wrong, this is a key reason for the bailout of the large banks and GM and Chrysler, i.e., that their failure would lead to “millions” of lost jobs through a cascade of failures down the supply chain and ultimately leaking into the general economy.

At the level of economic principle, there is no reason why antitrust policy could not account for a slower redeployment of assets in a time of severe economic downturn. A single failure or collection of “small” failures may generate a substantial negative externality resulting from sluggish asset redeployment, including increased unemployment. There is no reason to believe that the costs and benefits of antitrust enforcement are invariant to changes in underlying economic conditions. In effect, the risk of anticompetitive harm might increase a bit as a result of some relax-

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<sup>2</sup> It’s not at all obvious how one might operationalize the concept of “interconnectedness,” but economists have historically used tools like input-output tables to trace the economywide reverberations of changes in demand.

ation of standards, but the benefits from the looser standards would be the costs saved by what would otherwise be a slow and painful redeployment of assets of the failed firm as well as the assets of those suppliers to the failed firm.

On the other hand (and there must always be another hand), there may be an issue of whether this opens a Pandora's Box. First, having started down this path, is the direction easily reversible once economic activity returns to "normal" levels? Would the agencies have to define "normal" economic activity? There will always be some industries where the ability to redeploy assets even in "normal" times is difficult. Should this factor become a more permanent fixture of antitrust enforcement? Should the agencies consider the "disruptive effects" of a merger on small towns where asset redeployment may take a substantial amount of time?

This is obviously a slippery slope. One standard answer to whether the standards for antitrust enforcement should be broadened to encompass factors such as the timeliness of asset redeployment or small-town effects is that federal and state governments have alternative policy instruments that directly and more efficiently target these concerns. These instruments would include low-cost loans, extended unemployment benefits, and worker retraining. One can interpret the Congressional stimulus package as an effort to restore the "normal" timeliness of asset redeployment combined with policies to ease transitions during the interim. Is there a reason why the agencies should in effect go beyond what Congress has done? Don't federal and state governments have more targeted tools to address the impact of a merger on a small town or declining industries? Put differently, given both the availability and the use of these alternative policy instruments to target the timeliness of asset deployments, the marginal gain from any relaxation of the failing firm standards may be small.

In short, while the scope of antitrust enforcement can be expanded to encompass the scope of these additional objectives, it's not obvious why antitrust enforcement has a comparative advantage in addressing issues that are not directly antitrust-centric. Thus, the paper's conclusion of "no change" may be appropriate, but deserved more discussion than a reader might have expected, given the paper's title.

While the paper disappointed on addressing the implications of the Great Recession for the application of the failing firm standard, it nonetheless is an informative read on the application of the standard in more normal times. ●

—JRW