The Failing Firm Defense: Alive and Well

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The failing firm defense exempts an otherwise anticompetitive acquisition from liability under Section 7 of the Clayton Act where failure of one of the merging parties is imminent. Despite the defense's longevity, the stringent standards underlying the doctrine have limited its use over time. The defense has seldom been raised by merging parties in courts or before the Agencies and, when invoked, has rarely succeeded.[1]

This article provides an overview of the failing firm defense and highlights two recent investigations by the Federal Trade Commission and the Department of Justice, in which the defense has succeeded. Together, these cases suggest that the failing firm defense, in its current, longstanding incarnation, is alive and well. Moreover, the cases illustrate the importance of a "shop" of the allegedly failing firm's assets and the extent to which the Agencies, in the right case, may act quickly and creatively in validating the defense.

Overview of the Failing Firm Defense

Since its debut in 1930, the failing firm defense has remained remarkably consistent in its formulation.[2] The defense was first recognized in the Supreme Court's decision in *International Shoe Co. v. FTC*.[3] In that case, as a result of shrinking demand, declining revenues, excess capacity, and extensive debt, dress shoe manufacturer H.W. McElwain faced imminent, involuntary liquidation. To avoid this outcome, the company sold its voting stock to International Shoe, a capacity-constrained competitor. The FTC concluded that the transaction substantially lessened competition in the relevant market in violation of Section 7 of the Clayton Act, and the First Circuit affirmed. The Supreme Court reversed, holding that because H.W. McElwain faced a grave probability of business failure and lacked any alternative purchaser, the transaction did not substantially lessen competition.

Nearly forty years after its decision in *International Shoe*, the Supreme Court clarified the failing firm defense in *Citizen Publishing Co. v. United States*,[4] which involved a joint venture between

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1 David Scheffman, Malcolm Coate & Louis Silvia, Bureau of Economics, Fed. Trade Comm'n, 20 Years of Merger Guidelines Enforcement at the FTC: An Economic Perspective 51 (June 4, 2002) ("The FTC has successfully challenged a number of mergers where a failing firm defense was alleged."), http://www.justice.gov/atr/hmerger/12881.pdf; Debra A. Valentine, Deputy Dir., Policy Planning, Fed. Trade Comm'n, Horizontal Issues: What's Happening and What's on the Horizon (Dec. 8, 1995) (the standards of the defense "are strict . . . [and] rarely all satisfied, and, as a result, the defense is seldom invoked. In fact, the Supreme Court has not upheld its application since its 1930 *International Shoe* decision."), http://www.ftc.gov/speeches/other/dvhorizontalissues.shtm; Richard D. Friedman, *Untangling the Failing Company Doctrine*, 64 Tex. L. Rev. 1375, 1376 (1986) ("[The failing firm defense] has often been ignored or scorned, and [is] rarely invoked with success in litigation.").

2 Friedman, *supra* note 1, at 1375–76 ("Whatever else can be said about it, the failing company doctrine is a survivor. Judicially created more than half a century ago, it emerged unscathed when the Celler-Kefauver Act of 1950 tightened up Section 7 of the Clayton Act, and it even endured the antimerger jurisprudence of the 1960s.").

3 280 U.S. 291 (1930).

4 394 U.S. 131 (1969).

two competing newspapers in Tucson, Arizona. Prior to entering into the joint venture, the *Citizen* had suffered declining sales. In contrast, the *Star* recorded significant annual profits. Following the sale of the *Citizen*, the firm's new owners negotiated a joint operating agreement with the *Star* providing for (1) acquisition of *Star* stock by *Citizen* shareholders; (2) joint establishment of subscription and commercial advertising rates; (3) profit pooling between the *Star* and the *Citizen* according to an agreed-upon ratio; and (4) non-compete agreements between and among stockholders, officers, and executives for each publication. The DOJ sued, alleging, *inter alia*, that the joint operating agreement substantially lessened competition in violation of Section 7 of the Clayton Act. Finding for the government, the district court ordered the parties to submit a plan for divestiture and re-establishment of the *Star* as an independent competitor. The Supreme Court affirmed. Citing *International Shoe*, the Court explained that the failing firm defense applies only where it can be proven that (1) the target company is in imminent danger of failure; (2) the failing firm has no realistic prospect for a successful reorganization;[5] and (3) there is no viable alternative purchaser posing less anticompetitive risk.[6]

In both investigations, the dispositive issue appears to have been how thoroughly the allegedly failing firm's assets had been marketed, or "shopped," in an effort to find an alternative purchaser.

The most recent formulation of the failing firm defense can be found in the 2010 Merger Guidelines.[7] Building on the standards articulated in *International Shoe*, *Citizen Publishing*, and prior versions of the Guidelines, the 2010 Guidelines provide that a "merger is not likely to enhance market power if imminent failure . . . of one of the merging firms would cause the assets of that firm to exit the relevant market."[8] The Guidelines set forth a three-prong test that an allegedly failing firm must meet in order to qualify for the defense. The firm must: (1) be unable to meet its financial obligations in the near future; (2) be unable to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) have made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than would the proposed merger. The third prong has historically been the most difficult element to demonstrate. Under the Guidelines, reasonable offers include any offer above the liquidation value of the target's assets. The Guidelines note that the defense "is an extreme instance of the more general circumstance in which the competitive significance of one of the merging firms is declining: the projected market share and significance of the exiting firm is zero."[9]

Recent Applications of the Failing Firm Defense

Two recent merger investigations by the FTC and DOJ illustrate the continuing vitality of the failing firm defense. In both investigations, the dispositive issue appears to have been how thoroughly the allegedly failing firm's assets had been marketed, or "shopped," in an effort to find an alternative purchaser.

On April 1, 2009, Scott & White Healthcare merged with Texas-based King's Daughters Hospital in a non-reportable transaction. For over a century prior to the merger, King's Daughters had oper-

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[5] *See id.* at 138 ("[W]e know from the broad experience of the business community since 1930, the year when the *International Shoe* case was decided, that companies reorganized through receivership, or through Chapter X or Chapter XI of the Bankruptcy Act often emerged as strong competitive companies.").

[6] *See id.* at 137–38 ("The failing company doctrine plainly cannot be applied in a merger or in any other case unless it is established that the company that acquires the failing company or brings it under dominion is the only available purchaser. For if another person or group could be interested, a unit in the competitive system would be preserved and not lost to monopoly power.").

[7] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 11 (2010) [hereinafter 2010 Merger Guidelines], *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.html.

[8] *Id.*

[9] *Id.*

ated as a general acute care hospital. Through the acquisition, Scott & White planned to convert King's Daughters into a freestanding children's hospital, which would thereby eliminate Scott & White's only independent acute care competitor in Bell County, Texas.[10] The FTC began an investigation of likely competitive effects jointly with the Texas Attorney General's Office. The FTC found that King's Daughters' "poor, and deteriorating, financial condition" at the time of the transaction "would have caused the hospital to close at some point in the future if it was not acquired by another hospital or health system."[11] The investigation thus turned on the issue of whether the transaction qualified for the failing firm defense and, in particular, whether an alternative purchaser existed at the time of the transaction that might have maintained King's Daughters as a general acute care hospital in competition with Scott & White.[12]

The FTC found that the Seton Family of Hospitals had also been interested in acquiring King's Daughters, but that its opportunity to complete due diligence had been foreclosed by the agreement between King's Daughters and Scott & White.[13] As a proxy for determining whether an alternative buyer existed, the FTC required Scott & White to offer King's Daughters to Seton on terms that would require its continued operation as a general acute care hospital. These terms were embodied in an asset purchase agreement presented to Seton in October 2009.[14] After conducting additional due diligence, Seton declined to purchase King's Daughters, citing "a significant reduction in the value of the [hospital's] assets from an operational perspective" post-merger.[15] In December 2009, the FTC closed its investigation, satisfied that King's Daughters qualified for the failing firm defense based on Seton's rejection of the offer.[16]

More recently, the DOJ accepted the failing firm defense in connection with Hercules Offshore, Inc.'s $172 million acquisition of the assets of Seahawk Drilling, Inc. Founded in 2008, Houston-based Seahawk operated twenty shallow-water jackup drilling rigs, providing contract drilling services to the oil and natural gas exploration and production industry throughout the Gulf of Mexico. Since 2008, industry demand for shallow-water drilling services had declined sharply as a result of the global financial crisis and federal moratoria on offshore drilling in the aftermath of the Deepwater Horizon disaster. By October 2010, only three of Seahawk's twenty rigs were

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10 Richard Feinstein, Dir., Bureau of Competition, Fed. Trade Comm'n, Statement on the FTC's Closure of Its Investigation of Consummated Hospital Merger in Temple, Texas (Dec. 23, 2009), *available at* http://www.ftc.gov/os/closings/091223scottwhitestmt.pdf.

11 *Id.* at 1.

12 *Id.* at 2 ("This investigation was unusual, as a single issue—*did King's Daughters qualify for the failing firm defense?*—was likely dispositive as to whether the merger violated Section 7 of the Clayton Act.").

13 *Id.*

14 Press Release, Seton Family of Hospitals, Seton Family of Hospitals Must Reject Scott & White Offer to Acquire Assets of King's Daughters Hospital (Nov. 30, 2009), http://www.seton.net/about_seton/news/2009/11/30/seton_family_of_hospitals_must_reject_scott_and_white_offer_to_acquire_assets_of_kings_daughters_hospital_2.

15 *Id.*

16 *See* Feinstein, *supra* note 10, at 1.

17 Press Release, Seahawk Drilling, Inc., Seahawk Drilling, Inc. Announces Review of Strategic Alternatives (Nov. 2, 2010), http://www.seahawkdrilling.com/investor-relations/news-releases ("Seahawk's liquidity and revenue generation have been adversely affected by the dramatic slow-down in the issuing of shallow water drilling permits in the U.S. Gulf of Mexico following the Macondo well blowout, the continued low prices for natural gas, the general economic slowdown and other factors . . . ."); *see also* Seahawk Emergency Motion at ¶¶ 5–7, *In re* Seahawk Drilling, Inc., No. 11-20089 (Bankr. S.D. Tex. Feb. 12, 2011), ECF No. 9 [hereinafter Seahawk Emergency Motion] ("The decline in the United States jackup rig market since 2009 has been one of the sharpest downturns for domestic jackup rig activity over the past 30 years . . . . On April 20, 2010, the demand for offshore drilling services in the Gulf of Mexico was further negatively impacted by the Macondo well blowout . . . [as a result of which] Seahawk customers are experiencing significant delays in the issuance of drilling permits and very few new drilling permits have been issued.").

working under contract. These factors, combined with continued operating losses, exhausted Seahawk's liquidity.[17]

In November 2010, Seahawk initiated and publicly announced a formal process to explore a wide range of potential strategic alternatives to address its liquidity problem, including additional funding, recapitalization, the sale of assets, or a sale or merger of the business.[18] Seahawk retained an investment bank, which engaged in an extensive shop of the company over a three-month period, contacting more than one hundred potential merger partners, strategic acquirers, and financial investors.[19] As detailed in its bankruptcy filings, Seahawk first contacted a select group of seventeen high-graded financial investors, of which six signed confidentiality agreements and four received presentations from the company. Seahawk next contacted another group of 115 financial entities and strategic buyers, of which fifty-one received summary memoranda, thirty-seven received confidentiality agreements, and eleven received management presentations.

The Hercules and Scott & White transactions demonstrate that the failing firm defense is alive and well at the Agencies, and that the Agencies are able to move quickly (Hercules) and creatively (Scott & White) in analyzing whether the defense applies.

Ultimately, eleven companies, including Hercules—a leading global provider of offshore contract drilling, liftboat, and inland barge services for exploration and production (i.e., oil) companies[20]—submitted indications of interest or term sheets to Seahawk. With the exception of Hercules, these offers were too vague, contingent, or presented an unacceptable risk of protracted due diligence, which Seahawk was unlikely to survive. Thus, at the time of sale, Hercules was the only viable purchaser of Seahawk's assets.[21] In early February 2011, Hercules entered into an asset purchase agreement with Seahawk to acquire substantially all of Seahawk's assets through a sale under Section 363 of the Bankruptcy Code.[22] Seahawk subsequently filed for bankruptcy on February 11, 2011.

The parties filed under the Hart-Scott-Rodino Act in early March 2011, and the DOJ obtained clearance. A shortened, fifteen-day initial waiting period applied because the assets would be purchased under Section 363 of the Bankruptcy Code. In mid-March, Hercules pulled and refiled its notification to provide the DOJ with additional time to review the proposed transaction. The DOJ alleged that Hercules' acquisition of Seahawk's rigs would have resulted in a post-merger share of approximately 80 percent in drilling rigs used in soft seabeds in the Gulf of Mexico. Because of the parties' high combined market share in the Gulf of Mexico, a second request and a protracted investigation seemed possible. Given Seahawk's precarious financial condition, a lengthy investigation would have likely forced the company into liquidation and its assets out of the market. Working quickly, the DOJ, after conducting its analysis, accepted the parties' contention that Seahawk was a failing firm. The HSR waiting period was terminated prior to the end of the second fifteen-day waiting period, and the parties closed the transaction shortly thereafter. It appears that Seahawk's extensive shop of its assets and the lack of a viable alternative purchaser were critical to the DOJ's decision to close its investigation.

Conclusion

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[18] Seahawk Emergency Motion, *supra* note 17, ¶ 8.

[19] Stilley Decl. at ¶¶ 17–19, *In re* Seahawk Drilling, Inc., No. 11-20089 (Bankr. S.D. Tex. Feb. 12, 2011), ECF No. 4.

[20] Hercules' jackup rig fleet is the fourth-largest in the world and the largest in the Gulf of Mexico. In addition to barge rigs, liftboats, and marine support vessels, at the time of the Seahawk acquisition, Hercules' fleet consisted of thirty shallow-water jackup drilling rigs.

[21] Seahawk Emergency Motion, *supra* note 17, ¶ 16.

[22] Section 363(b)(1) of the Bankruptcy Code provides that, in connection with a reorganization under Chapter 11, "[a] trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1).

(Scott & White) in analyzing whether the defense applies. The transactions suggest that in evaluating the defense, the Agencies are sensitive to parties' concerns that delay could prove fatal to the allegedly failing firm. In the Hercules transaction, Seahawk's rapidly deteriorating financial condition informed the Antitrust Division's expedited review and grant of early termination. Similarly, in the Scott & White transaction, because of the exigency created by King's Daughters' financial condition, the FTC took an innovative and targeted approach in determining whether a viable alternative purchaser existed. Furthermore, the Scott & White transaction underscores the Agencies' willingness to "unring the bell" post-merger in vetting the target's search for reasonable alternative offers. Finally, both the Hercules and Scott & White transactions illustrate the critical importance of a thorough and well-documented shop to a successful assertion of the defense. ●