THE PRIVATE EQUITY (PE) INDUSTRY continues to raise, invest, and distribute money at record rates.¹ As PE M&A activity increases, so, too, has the scrutiny of the U.S. antitrust agencies. Both the Department of Justice and the Federal Trade Commission have investigated and challenged horizontal and vertical mergers involving strategic PE deals, including by filing lawsuits to enjoin anticompetitive mergers² and requiring divestitures or other remedies to resolve competitive concerns.³

On occasion, PE-backed deals involve a portfolio company wishing to avail itself of the “failing firm” defense to obtain clearance from the antitrust agencies. The acquisition of a company or division that meets this defense is not subject to liability under Section 7 of the Clayton Act.⁴ Because the PE configuration tends to alter the financial and management structure of portfolio companies in certain ways—for example, by inducing heavy reliance on debt financing or intense focus on short-term investor returns—unique questions may arise when determining whether these companies are entitled to invoke the failing firm defense. How should the antitrust authorities approach these questions, and should the unusual structures under which PE-owned companies operate change way enforcers apply the failing firm defense?

The Failing Firm Defense

The failing firm defense is based on the simple proposition that a merger is not likely to enhance market power if the assets of one of the merging firms would otherwise imminently exit the relevant market.⁵ The U.S. Supreme Court first recognized the defense in *International Shoe Co. v. FTC*.⁶ There, the FTC alleged that a merger between two shoe manufacturers violated Section 7 of the Clayton Act. While the Commission and the court of appeals agreed, the Supreme Court reversed, finding the financial state of the acquired company’s operations dispositive. The Court considered the acquired company’s excessive purchase commitments, its inability to meet the terms of its debts, and its disastrous sales history, holding:

In the light of . . . a corporation with resources so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure . . . the purchase of its capital stock by a competitor (there being no other prospective purchaser) . . . does not substantially lessen competition or restrain commerce within the intent of the Clayton Act.⁷

Nearly 40 years later, in *Citizen Publishing Co. v. United States*, the Supreme Court crystallized the failing firm standard.⁸ In affirming that a joint operating agreement between two competing newspaper publishers violated the Sherman and Clayton Acts, the Court focused on three factors. First, the proponent failed to demonstrate that the allegedly failing company was “on the brink of collapse” and would soon be liquidated.² Second, “The prospects of reorganization” under the Bankruptcy Act “would have had to be dim or nonexistent to make the failing company doctrine applicable,” as “companies reorganized through receivership, or through . . . the Bankruptcy Act often emerge[] as strong competitive companies.”¹⁰ Third, the proponent failed to show that the acquirer was the “only available purchaser” because it had made no effort to find other buyers.¹¹

The antitrust agencies’ Horizontal Merger Guidelines echo the factors discussed in *Citizen Publishing*.¹² According to the Guidelines, the antitrust agencies normally will not credit claims that the assets of one of the merging parties would imminently exit the relevant market unless all three of the following circumstances are met: (1) the company would be unable to meet its financial obligations in the near future; (2) the company would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) the company has 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 does the proposed merger.¹³
The courts and the antitrust agencies have applied the failing firm standard across a wide variety of cases and contexts and, in so doing, have clarified and explained some of its intricacies. For example, a “reasonable alternative offer” is any offer above liquidation value, even if the seller considers that offer to be unattractively low. A good-faith search for alternative offers cannot be perfunctory and must be sufficient to identify other potential buyers, allowing them an opportunity to conduct due diligence and make a binding offer. And a company cannot satisfy the failing firm defense based solely on its owners’ unhappiness with profitability or desire to exit the market.

In 2019, the FTC considered and rejected the failing firm arguments made by a manufacturer of microprocessor-equipped prosthetic knees in a Part 3 challenge to a consummated transaction. Prior to the transaction, FIH Group Holdings, LLC (Freedom), the acquired company, had been private equity-owned. Among other things, the Commission found that Freedom did not demonstrate the grave probability of business failure, pointing out that Freedom’s financial situation had been improving. The Commission rejected the argument that lenders would have liquidated the company absent the merger since “the lenders repeatedly amended [their] credit agreements rather than foreclosing.” The mere fact that Freedom had a pending debt was insufficient to demonstrate the company was insolvent, as Freedom could have refinanced or recapitalized to make loan payments. Moreover, alternatives to the challenged transaction had been available, but only “on terms that the existing shareholders did not like.” The Commission’s opinion made clear that the financial expectations of equity holders cannot be used to set an “unjustified limit on the search for offers” when seeking the protection of the failing firm defense.

**Private Equity**

The term “private equity” refers to the segment of the asset management industry that uses pooled capital to invest in the equity and, to a lesser extent, debt of companies that are not traded on a public exchange. PE firms, also known as “sponsors,” raise this equity capital through funds financed by wealthy individuals and institutional investors. Fund managers then invest that capital in companies that are perceived to have growth potential and work to increase the value of those companies, sometimes through operational control. Such companies are known as portfolio companies. After around five years, the PE firm usually will seek to “exit” the investment by taking the business public or selling it for a higher valuation, sometimes through “strategic” sales to corporate buyers looking to build scale and scope in a particular industry. Profits from the exit strategy are distributed to the fund’s investors, with the PE firm potentially earning a share of the profits or other fees.

PE investment strategies include contributing venture capital, investing growth capital, and executing leveraged buyouts (LBOs). Venture capital involves providing financial capital to early-stage companies with high growth potential, typically without gaining majority control. Growth capital usually takes the form of capital investment to fund expansion or development of a more mature company. In an LBO, the PE fund acquires a majority interest in the target company using a combination of equity and a significant amount of debt, with the debt secured by the assets of the target company and paid using the company’s future cash flows. In other words, the target company itself borrows much of the money used to pay out the former owner. The equity capital for an LBO typically comes from the PE fund, while the debt financing is obtained through banks or other lenders. This debt may come in a variety of forms, including a mixture of bank debt, secured and unsecured debt, and debt that is junior (or next-in-line) to the company’s general creditors in the event of default. An LBO leaves the portfolio company with a highly leveraged capital structure, meaning it has far more debt than equity.

After executing an LBO, PE firms typically increase the value of portfolio companies by steering them through a period of rapid performance growth. They may employ a number of methods to execute this strategy, including aligning management incentives, applying productivity improvements, and implementing aggressive cost-cutting measures. But PE firms’ focus on short-term gains and appetite for untraditional levels of debt has left PE ownership, and LBOs in particular, open to criticism. While some argue that PE ownership positively affects portfolio companies by ushering in a period of operational efficiency, others maintain that PE firms thrust speculative capital structures and outsized debt loads upon otherwise healthy firms, making them more susceptible to market forces and more likely to experience financial distress. A recent study found that approximately 20 percent of large LBOs resulted in bankruptcy for target firms within 10 years, versus a control group bankruptcy rate of two percent.

**Applying Failing Firm Analysis to Private Equity Merger Reviews**

The unique aspects of PE ownership may lend themselves to somewhat unusual failing firm arguments. For example, a portfolio company may argue it satisfies the failing firm standard because it faces imminent pressure to repay outsized debts resulting from an LBO, or because no other buyers...
PE ownership does not merit a change in the way the enforcers apply the failing firm defense.

would value the firm sufficiently to repay existing debts or net a return for investors. At the same time, PE ownership does not merit a change in the way the enforcers apply the failing firm defense. Just like any other company, a portfolio company seeking to avail itself of the defense must explain why the company should be viewed as insolvent, whether bankruptcy is a viable alternative, and what efforts the company has made to pursue alternative partners that would keep its assets in the market.

**Portfolio Companies Must Do More Than Argue That Oversized Debts Are Coming Due.** Given the high debt loads often associated with LBOs, it is not surprising that PE-owned companies sometimes take on a level of debt that becomes unsustainable. Portfolio companies in this situation may find that while they generate sufficient revenues to cover operating expenses, revenues are insufficient to make payments on those previously agreed upon debts.

Such companies may argue they meet the first prong of the failing firm test because they cannot meet their debts as they come due. But that fact is not the end of the antitrust authority’s inquiry into the firm’s financial condition. For example, the antitrust agencies may find that trends in sales or customer visits, as well as ordinary-course financial projections, indicate the firm could be in a position to repay debts in the near future. Internal cash flow models may reveal spending that the company could defer in the name of debt repayment. Ordinary-course documents may point to operational improvements that the company could make to increase the chances of solvency. The PE firm’s internal books, reports to investors, or appraisals may show that the portfolio company or its assets are worth more than liquidation value. And alternative courses of action, such as refinancing or recapitalization, may be available to help the company make future payments. All of this information is meaningful to the antitrust analysis if it demonstrates that the portfolio company could emerge from its financial distress and remain an effective competitor absent the proposed merger.

In addition, in a highly leveraged situation where the portfolio company’s assets have low liquidation value, the views and incentives of lenders can be probative, and potentially dispositive, of the availability of the failing firm defense. A lender’s assessment of the company’s health and future financial prospects is arguably more important than that of business management because it is ultimately up to the lender whether to extend the maturity date of the loan or cut its losses by accelerating the loan and forcing the company into bankruptcy or liquidation. In particular, if a lender believes the market value of the company’s assets or the amount of the debt is higher than the liquidation value of the assets, the lender is unlikely to force the company to liquidate. That is because the lender is more likely to get its money back while the company’s assets remain in the market.

Another relevant factor can be whether lenders have shown flexibility on loan repayment in the past, or whether they contemplate doing so in the future. Such flexibility may be especially likely if earnings trends or variability demonstrate that the portfolio company could repay at least some portion of its loans. If lenders are interested in offering the company less onerous debt terms that the company can actually satisfy, the company may be unlikely to fail based on its debt load alone.

In certain situations, the antitrust authorities may also examine the factors that led the portfolio company to its current financial distress. For instance, a PE owner may impose a significant debt burden on an otherwise healthy company, extracting substantial dividends even as it uses the debt burden to justify a merger with a close competitor. Under these circumstances, the financial resources of the PE owner, and the owner’s extraction of excess equity returns, may be relevant to the question of whether the portfolio company should be considered “failing” for antitrust purposes, especially if the PE owner is also capable of putting the company back on the road to financial health.

**Private Equity Ownership Does Not Necessarily Mean Bankruptcy Will Be Unsuccessful.** The second prong of the Guidelines’ failing firm test asks whether the troubled company could reorganize successfully under Chapter 11 of the Bankruptcy Act—in other words, whether easing or eliminating the company’s debt through bankruptcy could fix the company’s financial troubles. PE-owned portfolio companies cannot simply point to their complex capital structures to satisfy this element; rather, just like any other company, they must put forward proof that they would not emerge successfully from bankruptcy.

As noted above, PE-owned companies may be indebted to a variety of lenders after an LBO. These may include senior lenders, which stand first in line to be repaid, as well as junior or subordinated lenders, which are paid only after all senior debts are satisfied. Each class of stakeholders may have a different mechanism at its disposal to drive what it believes will achieve the best outcome for itself—that is, maximizing its return on investment. For instance, senior lenders may have more rights than junior lenders or equity holders, including the promise of control over the path taken in bankruptcy. Junior lenders, on the other hand, may have fewer rights to accelerate their loans and may need to wait for senior debtholders to approve material asset sales.

Although using this type of capital structure may make reaching agreement more complex, bankruptcy can still succeed. In the case of a company whose assets are worth more than liquidation value, stakeholders may still share a common goal: to ensure that the troubled portfolio company’s assets
remain in the market. If a successful plan of reorganization that keeps the company’s assets in the market will put the company in the best position to return capital to its lenders, there could be good reason for these lenders—no matter what their differences—not to get in the way. Lenders may even be able to come to an agreement to avoid bankruptcy altogether if other courses of action make repayment more likely, including raising additional capital, refinancing, and limited asset sales.

Thus, like other companies, a portfolio company seeking to avail itself of the failing firm defense should be prepared to address why bankruptcy is unlikely to succeed. For example, did the portfolio company initiate Chapter 11 bankruptcy proceedings, hire a banker to do an official review for bankruptcy, or create a plan for reorganization that the company or a court deemed infeasible? Has the portfolio company previously undergone and emerged successfully from bankruptcy? Do lenders’ actions demonstrate they are unlikely to agree to a successful reorganization plan? Does the liquidation value of the company exceed its value as an ongoing business?

In the same way, the antitrust enforcers will closely scrutinize subjective statements of PE owners when assessing whether bankruptcy is a viable option for the portfolio company. For example, if a PE owner contends that bankruptcy is likely to ruin the portfolio company’s assets, the agencies will look for concrete evidence of that fact. Whether entering into bankruptcy harms the PE owner or other stakeholders’ business interests may be irrelevant to the antitrust analysis; the failing firm standard assesses the options for the company’s assets to remain in the market absent the proposed transaction, regardless of whether those possibilities produce the optimal outcome for business owners.

A Portfolio Company Must Make Good-Faith Efforts to Elicit Reasonable Alternative Offers. An allegedly failing company also must demonstrate that it has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its assets in the market and pose a less severe danger to competition than the proposed transaction. The PE structure does not influence the search a portfolio company must conduct to satisfy this requirement.

A portfolio company may argue before the antitrust enforcers that its outsized debt loads make it an unpalatable target for potential acquirers, rendering any attempt to elicit reasonable alternative offers futile. Although excessive leverage could mean the company will have difficulty attracting buyers, that is not always true. Indeed, a company’s capital structure may not impact its value in an efficient market. Therefore, even a portfolio company burdened by excessive debts must demonstrate it attempted to shop the assets for a price above liquidation value.

Similarly, a portfolio company seeking to avail itself of the failing firm defense may argue that its proposed partner is the only available purchaser because no other potential buyers valued the company sufficiently to repay the portfolio company’s debts or net a return for investors. But the central question under the third prong of the failing firm test is whether a less anticompetitive transaction could keep the troubled company’s assets in the market, not whether the proposed transaction would be advantageous for stakeholders. Just like any other company, a portfolio company seeking the protection of the failing firm defense must show that it exhausted reasonable efforts to find a less anticompetitive alternative regardless of whether it accepted the best offer presented.

“Flailing” or Weakened Competitor Arguments Are Not a Back Door. In certain circumstances, a company’s weakened financial condition arguably indicates that it is unlikely to compete effectively in the future—for example, if depleted financial reserves will prevent capital improvements necessary for the firm to remain competitive. If a firm is unlikely to be an effective competitor but for the merger, its future competitive significance could be less than its current market shares indicate.

Portfolio companies that cannot satisfy the failing firm standard may thus still contend that their strained financial position is relevant to the antitrust analysis of a merger. But just like any other company, a PE-backed portfolio company cannot simply wave the flag of deteriorating financial health to skirt the requirements of the failing firm defense. In particular, questions relevant to the availability of the failing firm defense may still apply. Could alternative but unexplored courses of action, such as operational improvements or refinancing, turn the company’s finances around? If bankruptcy seems imminent, is reorganization likely to improve the company’s financial outlook? And what alternatives, including alternative mergers or other types of transactions, might the company pursue to save it from its downward spiral? Answers to these questions could help the antitrust authorities determine whether the company’s financial weakness in fact undermines the predictive value of current market share statistics. Counsel thus should expect these or similar questions when asserting that a portfolio company is likely to be less competitive in the future than it is today.

Conclusion

The structures of PE-owned companies do not merit a change in the way the antitrust authorities apply the failing firm defense. Rather, the availability of the defense should remain firmly grounded in the principles announced in National Shoe: a firm is “failing” for antitrust purposes only where, absent the proposed transaction, its assets face a “grave probability of business failure,” little prospect of rehabilitation, and no other reasonable alternatives. Whether owners, lenders, or other stakeholders would achieve their financial goals without the proposed transaction has no bearing on whether a merger is illegal. Instead, as in any other context, a portfolio company seeking to avail itself of the failing firm defense must prove it is financially insolvent and lacks practical alternatives to keep its assets in the relevant market.


6 Int’l Shoe Co. v. FTC, 280 U.S. 291 (1930).

7 Id. at 299–303.


9 Id. at 137–38.


12 Guidelines, supra note 5, § 11.

13 Id.

14 Id. § 11 n.16 ("Any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets will be regarded as a reason- able alternative offer. Liquidation value is the highest value the assets could command for use outside the relevant market.").

15 United States v. Energy Solutions, Inc., 265 F. Supp. 3d 415, 446 (D. Del. 2017) (rejecting failing firm claim where the purportedly failing company “clearly focused on obtaining what it perceived to be . . . fair value, not an offer above liquidation value”) (citing Guidelines, supra note 5, § 11).

16 See id. at 445 (provider of radioactive waste disposal services failed to conduct a good-faith search to elicit reasonable alternative offers where it “essentially engaged in a single bidder process and then agreed to several deal protection services that . . . made it impossible to entertain other offers”); Debbie Feinstein & Alexis Gilman, Power Shopping for an Alternative Buyer, FTC Competition Matters Blog (Mar. 31, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/03/power-shopping-alternative-buyer.

17 See United States v. Phillips Petroleum Co., 367 F. Supp. 1226, 1260 (C.D. Cal. 1973) ("The law is clear that evidence of a decline in market position and varying profits and losses cannot be elevated to the status of a ‘failing company’ by subjective statements of management intention or desire to go out of business if the acquisition had not taken place.").


19 Id. at 6.

20 Id. at 44.

21 Id. at 46.

22 Id. at 46–47.

23 Id. at 49–51.

24 Id. at 49–50; see also id. at 50–51 (‘‘Freedom’s executives and shareholders were focused on obtaining the highest possible offer, which is a different objective from searching for a reasonable alternative offer above Freedom’s liquidation value.’’) (internal citations omitted).

25 AM. BAR ASS’N, PRIVATE EQUITY ANTITRUST HANDBOOK 3 (2016).

26 Id. In the PE industry, investors are also known as limited partners. PE firms typically create a separate entity to serve as the general partner of the fund, which usually retains authority over the purchase or sale of investments. Id. at 4–5; Bain 2019 Report, supra note 1; RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 846 (11th ed. 2014).


28 Id. (3 to 7 years of ownership); Bain 2019 Report, supra note 1, at 18 (in 2018, the median period in which funds held onto portfolio companies before exiting was 4.5 years).

29 See Bain 2019 Report, supra note 1, at 19.

30 AIC Private Equity FAQs, supra note 27; BREALEY ET AL., supra note 26.


32 Id.; AIC Private Equity FAQs, supra note 27; BREALEY ET AL., supra note 26, at 846.

33 BlackRock, supra note 31; AIC Private Equity FAQs, supra note 27.

34 BREALEY ET AL., supra note 26, at 836–40.


38 See Otto Bock Commission Opinion, supra note 18, at 46; Carl Shapiro, Competition Policy in Distressed Industries, Remarks Before the ABA Antitrust Symposium: Competition as Public Policy (May 13, 2009), https://www.justice.gov/atr/speech/competition-policy-distressed-industries (stating that it is important to “distinguish between a firm ‘merely’ facing financial distress and a firm whose fundamental ability to compete effectively in the future is in doubt. . . . The fact that a firm has been losing money does not mean that it is a ‘failing firm’ in the antitrust sense.”).

39 Compare United States v. Black & Decker Mfg. Co., 430 F. Supp. 729, 778–79 (D. Md. 1976) (finding the failing company defense had been met where, among other things, the company’s retained earnings position had deteriorated significantly, its working capital had decreased precipitously, and the company was in a severe cash flow position, manifesting in its failure to pay suppliers as those payments came due) with Otto Bock Commission Opinion, supra note 18, at 45 (“At the time of the Acquisition and during the one year leading up to it, Freedom was engaged in a turnaround that had begun to show results.”).

40 Cf. United States v. Third Nat’l Bank in Nashville, 390 U.S. 171, 189 (1968) (failing bank had “backward management” that prevented it from computing operations, halting declining market share, recruiting new talent, and raising low salaries; failing firm defense was not available because the bank could have improved its bad management or sell to someone else).
See Shapiro, supra note 38 ("If the firm owns important assets whose value is greatest in their current use, these assets are unlikely to exit the market, even if the firm cannot meet its financial obligations in the near future. One signal of this situation is that investors place greater value on the firm or division as an ongoing concern than in liquidation.").

See Otto Bock Commission Opinion, supra note 18, at 46 ("Respondent does not argue that conditions in credit markets were extraordinary or unusually constrained, so as to preclude refinancing or recapitalization to help make the payments due at the conclusion of the term loan.").

See id.

See id. (To the extent the CEO attempted to assess Freedom's liquidation value, "the estimates he generated were less than the [amount] that Freedom owed the banks"); BREALEY ET AL., supra note 26, at 356 (stockholders will choose to default on debts "only if the value of the assets is less than the amount of debt").

See Otto Bock Commission Opinion, supra note 18, at 46 ("Respondent objects that Freedom's lenders would still have liquidated the company . . . because they had lost patience with Freedom and wanted to exit the loans at any cost. . . . [T]he record contains no testimony of the lenders. Moreover, the creditors' actions were consistent with a preference for an orderly sale of Freedom.").

See Otto Bock Commission Opinion, supra note 18, at 49–51.


Compare id. at 29–34 (assessing evidence that the financially troubled hospital's financial performance was improving significantly, that it had sufficient cash reserves to fund existing capital needs and meet financial obligations, and that it would not necessarily have made deep service cuts absent the transaction; in addition, finding the hospital could have addressed its financial difficulties by pursuing less anticompetitive courses of action, such as through an affiliation with an out-of-market hospital system) with Otto Bock Commission Opinion, supra note 18, at 43–51 (considering similar evidence when evaluating the availability of the failing firm defense).

See FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 154 (D.D.C. 2004) (a company's financial difficulties are "only relevant if [the company] demonstrates that this weakness undermines the predictive value of the government's market share statistics").