Surviving the Shipwreck: A Proposal to Revive the Failing Division Defense

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INTRODUCTION

The Federal Trade Commission (FTC) and the Antitrust Division of the United States Department of Justice (DOJ) evaluate the legality of certain proposed mergers by a set of self-imposed standards known as the Merger Guidelines. The Merger Guidelines outline two absolute defenses to pre-merger enforcement actions brought by the FTC and DOJ (collectively “the agencies”) based on the merging parties’ financial condition—the failing company defense and the failing division defense. The failing company and failing division defenses permit qualifying merging parties to consummate proposed mergers involving failing assets, even if the transactions are anticompetitive in violation of federal antitrust laws. A successful application of the failing company defense requires that a company (1) is “unable to meet its financial obligations in the near future,” (2) is unable “to reorganize successfully under Chapter 11 of the Bankruptcy Act,” (3) make unsuccessful good faith efforts to locate less-anticompetitive purchasers, and (4) absent the merger, the assets of the company “would exit the relevant market.” The requirements of the failing division defense are similar to those of the failing company defense,
but instead of focusing on the financial status of the entire company, the failing division defense only considers the financial status of the specific division. A division of an otherwise successful company can qualify for the failing division defense if (1) the division has negative operating cash flow, (2) the assets of the division would be sold outside the relevant market absent the acquisition, and (3) the merging parties were unable to locate a less-anticompetitive purchaser for the assets.\(^8\)

The DOJ first indicated that a failing division of an otherwise successful company could qualify for a failing division defense in the 1982 version of the Merger Guidelines.\(^9\) In 1982, commentators predicted that the failing division defense would become a staple of antitrust merger enforcement.\(^10\) The enthusiasm with which the failing division defense was originally received quickly faded.

Since the Supreme Court’s landmark decision in *International Shoe Co. v. FTC* in 1930, courts have widely applied the failing company defense to mergers involving failing companies, but have not extended the same protection to mergers involving failing divisions.\(^11\) Despite the enthusiasm with which the defense was introduced in the 1982 Merger Guidelines, no court has ever applied the failing division defense to a merger involving failing divisional assets.\(^12\) If the failing company defense is considered a survivor through seventy years of merger enforcement policy,\(^13\) the failing division defense is analogous to a shipwreck. Instead of applying the failing division defense, courts have addressed mergers involving the sale of divisional assets of an otherwise successful company in the following three ways: (1) considering the merger under the more widely accepted failing company defense, (2)

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8. Id. \S 5.2.


11. 280 U.S. 291, 301-02 (1930); see infra Part II.A.

12. See infra Part II.C.

13. See Richard D. Friedman, *Untangling the Failing Company Doctrine*, 64 TEX. L. REV. 1375, 1375-76 (1986) (noting how the failing company defense has endured despite being “often ... ignored or scorned, and rarely invoked with success in litigation” (citations omitted)).
applying the weak competitor analysis proposed in *United States v. General Dynamics Corp.*, 14 or (3) in rare cases, mentioning, but not applying the Merger Guidelines’ failing division defense. 15 These three approaches to mergers involving failing divisions harm competition, decrease certainty in an extremely complex merger review process, and do not provide the requisite flexibility to prevent the overriding social harms that may arise from blocking a merger. 16

Now is the time to reevaluate the failing division defense. In 2001, the District Court for the Northern District of California noted the existence of the failing division defense and suggested its willingness to apply the defense in appropriate cases. 17 Although the court in *Sutter Health Systems* did not have the opportunity to apply the failing division defense because the merging party was an independent legal entity, the court indicated that it would apply the failing division defense to mergers involving failing divisional assets in appropriate cases. 18 Other courts, particularly the District Court for the District of Columbia, 19 should follow the Northern District of California’s lead. Merger activity involving failing entities is skyrocketing in light of the recent wave of bankruptcies. 20 The number of mergers reported to the agencies pursuant to the Hart-Scott-Rodino Antitrust Improvements Act (HSR Act) tripled from 1999 to 2000. 21 Accordingly, the failing division defense increasingly is raised before the agencies, providing more opportunities for judicial review of the failing division defense. 22

15. *See infra* Part II.
16. *See infra* Part IV.
18. *Id.*
19. Substantially all recent federal merger enforcement actions are brought by the agencies in the District Court for the District of Columbia. *See infra* note 160 and accompanying text.
22. *See* Helene D. Jaffe, *Developments in Merger Law and Enforcement in 1990-91*, 60 *Antitrust L.J.* 667, 667 (1991) ("With the downturn in the economy, there has been a
This Note considers the approaches of federal antitrust enforcement agencies and courts with respect to the failing division defense and proposes a two-step Modified Strict Adherence approach to the review of mergers involving failing divisional assets. First, in step one, agencies must apply strictly the Merger Guidelines’ three-part failing division defense to the merger.23 In step two, if the FTC or DOJ seek a preliminary injunction in federal district court blocking a proposed acquisition, after considering the Merger Guidelines’ three-part failing division defense, the court may weigh the impact of overriding social harms resulting from blocking the merger against the acquisition’s anticompetitive impact.24 The court may consider various social harms, including harm to stockholders, employees, and the surrounding community.25

Part I of this Note begins with a brief overview of the federal merger review process and history of the failing division defense in the Merger Guidelines before considering the two approaches federal enforcement agencies have taken to address mergers involving the sale of failing divisional assets. Part II analyzes each of the three different approaches courts have taken to address mergers involving the sale of failing divisional assets. After suggesting reasons for the lack of judicial acceptance of the failing division defense in Part III, Part IV of this Note proposes and outlines the two-step Modified Strict Adherence approach to the failing division defense and explains how this approach better meets the goals of antitrust enforcement—protecting competition, increasing certainty, and avoiding inequity by allowing for flexibility—than the current treatment of the failing division defense by the agencies and courts.
I. THE FORGOTTEN DEFENSE: THE FAILING DIVISION DEFENSE IN THE MERGER GUIDELINES

A. The Merger Review Process

The primary authority for federal antitrust enforcement is Section 7 of the Clayton Act (Section 7), which provides that "[n]o person ... shall acquire the whole or any part of the assets of one or more persons [if] ... the effect of such acquisition ... may be substantially to lessen competition, or tend to create a monopoly." The FTC and DOJ are the two principal federal agencies charged with enforcing Section 7. The HSR Act generally requires merging parties to notify the FTC and DOJ prior to the consummation of all transactions valued over fifty million dollars. Mergers subject to the HSR Act must submit to a thirty-day waiting period, allowing one of the agencies to investigate the proposed merger prior to consummation. Although the agencies have overlapping jurisdiction of merger enforcement, under the HSR Act only one agency may review a proposed merger. Through a procedure known as clearance, one agency will authorize or clear the other agency to


30. See Rachel E. Barkow & Peter W. Huber, A Tale of Two Agencies: A Comparative Analysis of FCC and DOJ Review of Telecommunications Mergers, 2000 U. CHI. LEGAL F. 29, 31 (2000) (noting that "[d]ual review of the same issue by two federal bodies is rare"). For detailed discussion of the merger review process by the agencies, see The Merger Review Process, supra note 1, ch. 1. Upon receipt of the HSR filing by the merging parties, one agency must file for and receive clearance from the other agency in order to begin a preliminary investigation. Id. at 21. If the merger does not pose an anticompetitive threat, the waiting period will expire or one agency will grant early termination of the waiting period, allowing the merging parties to proceed. Id. at 8. If serious anticompetitive concerns arise during the preliminary investigation, the agencies may extend the investigation period by issuing a "Second Request." Id. at 9-10.
proceed with an investigation into the potentially anticompetitive impacts of the proposed acquisition or merger.\textsuperscript{31}

The Merger Guidelines represent the agencies' position with respect to merger enforcement, indicating what factors the agencies will consider in determining whether a proposed acquisition violates Section 7.\textsuperscript{32} The Merger Guidelines define competition in terms of market power, which is "the ability profitably to maintain prices above competitive levels for a significant period of time."\textsuperscript{33} Thus, market power is the "ultimate inquiry" for merger enforcement agencies.\textsuperscript{34} In the event that a merger is deemed anticompetitive, the investigating agency may seek to block the merger by filing for a preliminary injunction in federal district court.\textsuperscript{35} Accordingly, the HSR Act creates the potential for two stages of merger review—first by the investigating agency, and second before the district court.

B. The Failing Division Defense in the Merger Guidelines

The DOJ first alluded to the failing division defense in the 1982 Merger Guidelines by outlining the failing company defense and then noting that the same defense may apply "when the allegedly failing firm is an unincorporated part of a larger parent firm."\textsuperscript{36} The DOJ revised and reissued the Merger Guidelines in 1984.\textsuperscript{37} The

\textsuperscript{31.} See THE MERGER REVIEW PROCESS, supra note 1, at 9.
\textsuperscript{32.} Id. at 2.
\textsuperscript{33.} 1992/1997 Merger Guidelines, supra note 2, § 0.1.
\textsuperscript{34.} See id. § 0.2. The courts have taken a similar approach, defining competition in terms of market share. See United States v. Blue Bell, Inc., 395 F. Supp. 538, 547-48 (M.D. Tenn. 1975) (citing United States v. Gen. Dynamics Corp., 415 U.S. 486, 501 (1974)). If the post-acquisition firm has a combined market share of thirty percent or greater it is presumed unlawful. Id. But cf. Wesley A. Cann, Jr., Section 7 of the Clayton Act and the Pursuit of Economic "Objectivity": Is There Any Role for Social and Political Values in Merger Policy?, 60 NOTRE DAME L. REV. 273, 279 (1985) (noting that Congress considered political consequences of economic concentration and national concentrations of wealth in addition to market share when defining competition).
\textsuperscript{35.} THE MERGER REVIEW PROCESS, supra note 1, at 29-30.
\textsuperscript{36.} 1982 Merger Guidelines, supra note 9, at V.B.
\textsuperscript{37.} See 1984 Antitrust Merger Guidelines, 49 Fed. Reg. 26,823 (June 29, 1984) [hereinafter 1984 Merger Guidelines]. Since the DOJ's first attempt at Merger Guidelines in 1968, the Merger Guidelines have undergone several revisions. The current joint Merger Guidelines between the FTC and the DOJ are based on the DOJ's 1982 Merger Guidelines. See 1982 Merger Guidelines, supra note 9. The 1982 Merger Guidelines were a complete
1984 Guidelines included the first clear enumeration of a separate failing division defense. In order to qualify for this absolute defense, the 1984 Merger Guidelines required that the assets of the division would be "liquidated" if not sold, and that the acquired company had made "unsuccessful good faith efforts" to locate less anticompetitive purchasers.

The current version of the failing division defense was established in section 5.2 of the 1992 Merger Guidelines, which the DOJ and FTC jointly issued. The 1992 Merger Guidelines established a three-part test for the failing division defense: (1) "upon applying appropriate cost allocation rules, the division must have a negative cash flow on an operating basis," (2) "absent the acquisition, it must be that the assets of the division would exit the relevant market in the near future if not sold," and (3) the allegedly failing division must have "made unsuccessful good faith efforts to elicit reasonable alternative offers of acquisition ... 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."
C. Agency Application of the Merger Guidelines’ Failing Division Defense

Although merging companies raise the failing division defense with increased frequency before the agencies, limited information exists on the agencies’ treatment of the defense due to the confidential nature of HSR Act filings and investigations.\(^2\) The few cases raising the defense brought before the courts, agency press releases, and commentary on agency action in legal publications, however, provide insight into how agencies review mergers in which parties raise the failing division defense. When merging parties raise a failing division defense, the agencies take one of two opposite approaches: either strictly applying the requirements of the Merger Guidelines’ failing division defense or exercising prosecutorial discretion and not challenging the proposed merger.

1. **Strict Application of the Merger Guidelines’ Failing Division Defense**

Documentation from two investigations indicates that when the agencies consider the failing division defense they will construe strictly the Merger Guidelines’ three-part analysis. First, in 1990, the FTC investigated a joint venture between two telescope subsidiaries.\(^3\) Meade and Celestron were the two dominant players in the United States market for Schmidt-Cassegrain telescopes, primarily used for hobby viewing by amateur astronomers.\(^4\) The FTC found the joint venture prima facie anticompetitive and sought a preliminary injunction blocking the merger in the District Court for the District of Columbia.\(^5\) The district court’s discussion of the FTC’s findings regarding the “only available purchaser” prong reflects the FTC’s narrow treatment of the failing division defense.\(^6\)

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44. *Id.*
45. *Id.* at *3.
46. The merging parties actually raised the failing company defense, not the failing division defense, before the district court because the District Court for the District of
Although the parties conducted a search for alternative purchasers, the FTC found the search was inadequate, noting that the parties searched for alternative purchasers only after agreeing to the terms of the joint venture.\textsuperscript{47} In upholding the findings of the FTC and granting the agency's request for a preliminary injunction blocking the merger,\textsuperscript{48} the district court found that "[the parties'] search for an alternative [purchaser] ... was characterized by a minimal effort and designed primarily to be perfunctory."\textsuperscript{49} The FTC went one step beyond requiring the parties to make "unsuccessful good faith efforts" to locate less-anticompetitive alternative purchasers as the Merger Guidelines require, and conducted its own search for possible purchasers and alternatives to the joint venture.\textsuperscript{50} Under the FTC's narrow construction of the only available purchaser prong of the failing division defense, "unsuccessful good faith efforts" by merging parties may not be enough to meet the stringent requirements of section 5.2.

Also in 1990, the FTC authorized Commission staff to seek a preliminary injunction to block FlightSafety International's acquisition of the flight simulator assets of its competitor, Bicoastal.\textsuperscript{51} FTC staff attorneys found that even if Bicoastal's SimuFlite division had negative operating cash flow, the merging parties failed to prove both that the assets of the division would exit the market absent the acquisition and that the parties had made "unsuccessful good faith efforts" to locate alternative purchasers.\textsuperscript{52} Narrowly construing the Merger Guidelines' failing division defense, the FTC "insisted on proof not only that SimuFlite would be liquidated, but that its assets would exit the market in a

\textsuperscript{47} Id.

\textsuperscript{48} The district court's treatment of the Meade/Celestron joint venture is discussed in greater detail in Part II, infra.

\textsuperscript{49} Harbour Group, 1990 WL 198819, at *4.

\textsuperscript{50} Id. at *5.


\textsuperscript{52} See Jaffe, supra note 22, at 670 n.23.
liquidation, rather than be acquired by less-anticompetitive [acquirers].\textsuperscript{53}

2. Prosecutorial Discretion

In addition to narrowly applying the Merger Guidelines' failing division defense, the agencies also choose not to challenge many mergers in which the merging parties raise the failing division defense.\textsuperscript{54} Due to the confidential nature of the HSR filings, it is impossible to know exactly how many mergers in which parties raise the failing division defense are allowed to proceed under the exercise of the agencies' prosecutorial discretion.\textsuperscript{55} The agencies' authority to enforce Section 7 is discretionary, not mandatory.\textsuperscript{56} The use of prosecutorial discretion, however, has led to criticism of the disparity between the agencies' written policy on merger review in the Merger Guidelines and their actual practice. "Whatever the Department [of Justice] publicly says, it has long considered division failure on an ad hoc, unsystematic basis."\textsuperscript{57}

II. AN "UNSETTLED AREA OF LAW": THE FAILING DIVISION DEFENSE IN THE COURTS

The failing division defense currently does not exist outside the context of the Merger Guidelines. Although the agencies have applied the failing division defense to mergers involving the sale of failing divisional assets,\textsuperscript{58} courts have not done so. Instead, courts have approached antitrust challenges to the sale of divisional assets in three ways. First, some courts have considered the sale of failing divisional assets under the similar failing company defense.\textsuperscript{59}

\textsuperscript{53} Id.

\textsuperscript{54} See Thomas L. Greaney, Night Landings on an Aircraft Carrier: Hospital Mergers and Antitrust Law, 23 AM. J.L. & MED. 191, 198 (1997) (noting that "the agencies routinely exercise their prosecutorial discretion not to challenge many acquisitions that appear to violate the Merger Guidelines").

\textsuperscript{55} See supra note 42 and accompanying text.

\textsuperscript{56} See United States v. FCC, 652 F.2d 72, 82 (D.C. Cir. 1980); Home Box Office, Inc. v. FCC, 567 F.2d 9, 40 (D.C. Cir. 1977).

\textsuperscript{57} Kauper, The 1982 Horizontal Merger Guidelines, supra note 37, at 529.

\textsuperscript{58} See supra Part I.

\textsuperscript{59} See infra Part II.A.
Second, because the failing division defense is only applied after a prima facie showing that the merger is anticompetitive, many courts have avoided construing the failing division defense by applying the analysis in United States v. General Dynamics Corp.\textsuperscript{50} to find that the merger is not anticompetitive in the first place.\textsuperscript{61} Finally, some courts have noted the existence of a failing division defense, but declined to decide the case on the merits of such a defense.\textsuperscript{62} Discussion of these three approaches will show the courts' overall treatment of the failing division defense as an "unsettled area of law"\textsuperscript{63} despite its clear enumeration in the Merger Guidelines.

A. The Survivor: The Failing Company Defense

The failing company defense "allows a competitor to acquire a firm that is facing grave financial difficulties even if the acquisition will reduce competition."\textsuperscript{64} To qualify for the failing company defense, courts have traditionally looked to whether a company will file for bankruptcy to determine if the company faces "the grave probability of business failure."\textsuperscript{65} Despite the impossibility of a division filing for bankruptcy, the courts have applied the failing company defense to mergers involving failing divisional assets. A brief survey of the history of the failing company defense provides the background necessary for understanding the application of the failing company defense to failing divisions.

1. A Brief History of the Failing Company Defense

The Supreme Court first recognized that a company's failing status could be an absolute defense to a Section 7 enforcement

\begin{itemize}
  \item[\textsuperscript{60}] 415 U.S. 486, 506 (1974).
  \item[\textsuperscript{61}] See infra Part II.B.
  \item[\textsuperscript{62}] See infra Part II.C.
  \item[\textsuperscript{64}] Thomas J. Campbell, The Efficiency of the Failing Company Defense, 63 Tex. L. Rev. 251, 251 (1984) [hereinafter Campbell, Efficiency].
  \item[\textsuperscript{65}] Citizen Pub'l'g Co. v. United States, 394 U.S. 131, 137 (1969) (quoting Int'l Shoe Co. v. FTC, 280 U.S. 291, 302 (1930)).
\end{itemize}
action in *International Shoe Co. v. FTC*. The International Shoe Company merged with its competitor, the financially defunct W.H. McElwain Company. In recognizing what is now referred to as the failing company defense, the Supreme Court held that acquisitions involving failing companies, although anticompetitive by definition, do not always violate Section 7. The Court held that a merger of a corporation with resources so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure with resulting loss to its stockholders and injury to the communities where its plants were operated ... is not in contemplation of law prejudicial to the public and does not substantially lessen competition or restrain commerce within the intent of the Clayton Act.

The passage of the 1950 Celler-Kefauver Act, which amended sections 7 and 10 of the Clayton Act, further validated the failing company defense. Citing the above language of *International Shoe* with approval, Congress recognized that Section 7 should not apply to mergers involving failing entities and "unequivocally endorsed the defense." In 1969, almost forty years after the landmark *International Shoe* decision, the Supreme Court in *Citizen Publishing Co. v. United States* provided the modern framework for the failing company defense. *Citizen Publishing* involved a joint operating agreement between the only two daily newspapers of general circulation in Tucson, Arizona. The newspapers argued that the joint operating agreement did not violate Section 7 because *Citizen Publishing*, one of the newspaper publishers, qualified for the failing company defense. Writing for the majority, Justice Douglas set forth a three-part analysis for the failing company defense: (1)
the acquired company must be in imminent danger of failure; (2) prospects of reorganization must be dim or non-existent; and (3) the parties must make a good faith effort to determine that there are no alternative purchasers. Applying the findings of the lower court to this framework, the Court determined that Citizen Publishing did not qualify for the failing company defense because there was no evidence that (1) the owners tried to locate a less-anticompetitive purchaser or (2) the company would have shut down but for the joint operating agreement between the two publishers. With little variation, the Citizen Publishing three-part test is still used widely by many jurisdictions to make failing company determinations and it served as the basis for the failing company defense enumerated in the Merger Guidelines.

2. Application of the Failing Company Defense to the Sale of Divisional Assets

Instead of developing a separate failing division defense, some courts have applied the Citizen Publishing three-part failing company defense to the sale of failing divisional assets. In 1972, the District Court for the Central District of California applied the failing company defense to a wholly owned subsidiary in Calnetics Corp. v. Volkswagen of America, Inc. The defense was not successful because the company failed to demonstrate adequately its failing status and the unavailability of alternative purchasers under the Citizen Publishing three-part test. Even though the acquired company’s financial statements indicated a net loss immediately prior to the acquisition, the court considered the company’s retained

75. Id. at 136-38. These requirements vary slightly from the current test for failing company defense as set forth in § 5.1 of the Merger Guidelines. See 1992/1997 Merger Guidelines, supra note 2, § 5.1. The Merger Guidelines’ test additionally requires that the firm is unable to meet its financial obligations as they come due and that the failing company is unable to reorganize successfully under Chapter 11 of the Bankruptcy Act. Id.

76. Citizen Publ’g Co., 394 U.S. at 137-39.


79. Id. at 622.
earnings surplus and found that the company was not facing a “grave probability of business failure.” The court also found that the parties had not made sufficient efforts to locate alternative purchasers, noting that the company did not hire a broker to manage the sale and that the company ignored possible sales leads.

In addition to wholly owned subsidiaries, courts have also applied the failing company defense to mergers involving divisions of larger companies. In 1984, the District Court for the Northern District of Ohio considered Bass Brothers’ purchase of the carbon black assets of the Ashland Oil Company. Although citing Citizen Publishing, the court seemingly applied a different analysis. Instead of considering whether the parent company met the requirements of the Citizen Publishing test, the court looked at the profitability of the division and whether the assets of the division in question would exit the relevant market absent the acquisition. Enjoining the merger by granting the FTC’s motion for summary judgment, the court found the carbon black division was profitable immediately prior to the proposed acquisition and that Ashland’s “contingency plan [was] to try to find another buyer” not to sell the carbon black assets outside the relevant market.

In 1992, the District Court for the District of Columbia considered the application of the Citizen Publishing failing company defense to the acquisition of the Brooklyn Bottling assets of the

80. Id.
81. Id.
83. Id. at *26.
84. Id. at *18. The court also addressed the second Merger Guidelines requirement—that no alternative purchaser exists. See 1984 Merger Guidelines, supra note 37, § 5.2. The District Court for the Northern District of Ohio, like the court in Calnetics, found that Ashland’s efforts were insufficient to sustain the failing company defense because it “made no formal effort to find any buyer.... It never retained an investment banker to find a buyer.” Bass Bros. Enters., 1984 WL 355, at *18.
85. Bass Bros. Enters., 1984 WL 355, at *18 (finding not only that the carbon black division was profitable at the time of the acquisition, but also that the division was likely to remain profitable for at least another year). The analysis the Bass Bros. court used is strikingly similar to the modern Merger Guidelines’ failing division defense. See 1992/1997 Merger Guidelines, supra note 2, § 5.2.
Dr Pepper/Seven-Up Companies. Although the purchaser, Honickman, only acquired certain assets (which could have constituted a division) of the Dr Pepper/Seven-Up Companies, the court cited the language in Citizen Publishing requiring “dim or nonexistent” prospects of reorganization under the bankruptcy laws. The district court found that the merging parties did not qualify for the failing company defense because “[the purchaser] had failed to establish that he was the sole plausible acquirer of Seven-Up Brooklyn.” On appeal, the District of Columbia Circuit remanded the case to the district court after finding that the district court's granting of summary judgment blocking the merger was arbitrary and capricious. The District of Columbia Circuit, however, did not question the district court's use of the Citizen Publishing failing company defense instead of applying the failing division defense.

B. The Alternative: General Dynamics

In addition to applying the failing company defense to mergers involving failing divisional assets, courts have taken a second approach—applying the analysis in United States v. General Dynamics Corp. to find that the proposed merger is not prima facie anticompetitive. By finding the merger does not threaten market competition, the courts do not have to reach the issue of a failing division defense.

1. General Dynamics Generally

Recognizing that external market factors may impact a currently viable firm’s future ability to compete successfully in the relevant


87. Dr Pepper/Seven-Up Cos., 798 F. Supp. at 778 (citing Citizen Publg Co. v. United States, 394 U.S. 131, 138 (1969)).

88. Id. at 778.

89. Dr Pepper/Seven-Up Cos. v. FTC, 991 F.2d 859, 864-66 (D.C. Cir. 1993).

90. See id.

market, the Supreme Court in *General Dynamics* established the “weak competitor” analysis to rebut the agency’s prima facie case that a merger was anticompetitive. The *General Dynamics* Court permitted the merger of two competitive coal companies after considering recent changes in the coal market. Although United Coal was successful at the time of its acquisition by General Dynamics, the Court concluded that evidence of the company’s past performance did not accurately reflect its future ability to compete. United Coal lacked the coal reserves necessary to secure future contracts. The Court held that the acquisition did not violate Section 7, because the company was unlikely to be a significant competitor in the coal industry absent the acquisition.

*General Dynamics* represented a significant shift in the Court’s view of which mergers violated Section 7. Today, the *General Dynamics* analysis stands for the proposition that “forward-looking analysis of market conditions” can rebut an agency’s prima facie case that a proposed merger is anticompetitive. Inaccurate future market share statistics do not establish an absolute defense, but...
rather provide a means of demonstrating that the acquisition does not violate Section 7 in the first place. Although the General Dynamics approach has been described as a "cousin to the failing company defense," unlike the failing division defense, which considers internal factors, such as management decisions to liquidate failing assets, the General Dynamics analysis only considers the impact of external market factors on post-acquisition market shares.

2. General Dynamics Applied to Failing Divisions

In addition to applying the Citizen Publishing failing company defense to enforcement actions involving failing divisions, courts also have applied the General Dynamics analysis. In FTC v. Great Lakes Chemical Corp., the District Court for the Northern District of Illinois denied the FTC's request for a preliminary injunction despite the FTC's finding that Great Lakes' acquisition of Velsicol's bromine division violated Section 7. Under the General Dynamics analysis, the court considered the impact of a "constantly evolving market" on the accuracy of market share data. After noting that in the bromine market "a company's future ability to compete is reflected less in past production statistics than in the vigor of its current research and development efforts," the court held that Great Lakes had sufficiently rebutted the FTC's prima facie case.

The District Court for the Northern District of Ohio also applied the General Dynamics analysis to the sale of failing divisional assets. In FTC v. Bass Brothers Enterprises, which involved the sale of Ashland Oil's carbon black division, the merging parties argued that the acquisition was not anticompetitive under the General Dynamics analysis and, alternatively, that they were entitled to merge under the failing company defense. After finding

101. Id. at 91.
102. Id.
104. See id. at *26 (outlining the court's Conclusions of Law). For consideration of the court's decision regarding the failing company defense, see supra notes 82-85 and accompanying text.
the acquisition prima facie anticompetitive, the court considered the “structure, history, and probable future” of the carbon black market under the *General Dynamics* analysis. The court granted the FTC's request for a preliminary injunction, concluding that the FTC's statistics “accurately depict [Bass Brothers' and Ashland's] likely future competitive potential.”

In 1990, the District of Columbia Circuit applied the *General Dynamics* analysis to a merger involving two subsidiary corporations in *United States v. Baker Hughes*. Upholding the lower court's denial of a preliminary injunction, the court allowed a company's acquisition of its competitor's hardrock hydraulic underground drilling rigs (HHUDRs) division. The DOJ “present[ed] statistics showing that combining the market shares of [the two producers] would significantly increase concentration in the already highly concentrated United States HHUDR market.” The court found that “the government's statistics were misleading,” because the HHUDR market was historically characterized by few players and the parties pointed out that in a given year only twenty-two rigs were sold in the relevant market. Considering these external market factors under the *General Dynamics* analysis, the court denied the DOJ's request for a preliminary injunction and allowed the merger.

C. The Shipwreck: The Failing Division Defense

In addition to applying the failing company defense or the *General Dynamics* analysis to merger enforcement actions brought under Section 7 involving the sale of failing divisional assets, three cases—all in federal district courts—have considered applying a failing division defense. No court, however, has decided a merger case on the merits of such a defense.

106. *Id.* at *26.
108. *Id.*
109. *Id.* at 983.
110. *Id.* at 986.
111. *Id.*
112. *See, e.g.*, *California v. Sutter Health Sys.*, 130 F. Supp. 2d 1109, 1133-34 (N.D. Cal. 2001) (holding that there is a failing division defense, but that it was unnecessary to apply
In 1967, the District Court for the Western District of Oklahoma considered the possibility of a failing division defense in *United States v. Reed Roller Bit Co.* Dissatisfied with its wholly owned subsidiary, American Iron, AMF hired a broker who arranged for the subsidiary’s sale to Reed Roller. American Iron and Reed Roller were the second and third largest producers of tool joints in the relevant market. After finding the merger prima facie unlawful under Section 7, the court considered AMF’s argument that the failing company defense should apply to failing subsidiaries. The court found that, although “American Iron’s poor performance made it a most unattractive subsidiary, it was not near bankruptcy....” The existence of a failing division defense was a novel issue before this court, but the court only addressed the failing division defense in a footnote. Because the subsidiary was not failing, it would not have qualified for the failing division defense. The court, therefore, did not need to reach the issue of whether it would recognize a failing division defense.

*Reed Roller* set the stage for courts to forestall application of the failing division defense. More recently, the District Court for the District of Columbia also refused to consider whether a failing division defense existed. In *Harbour Group*, the merging parties, two telescope manufacturers, were unable “to demonstrate that the

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114. *Id.* at 576.
115. *Id.* at 579.
116. *Id.* at 583.
117. *Id.* at 584.
118. *Id.* at 584 n.1.
119. *Id.* at 584 n.1 (“Thus, it is unnecessary to decide whether the failing company doctrine extends to the sale of an unprofitable subsidiary of a prosperous parent company.”).
120. *See, e.g.*, *United States v. Blue Bell, Inc.*, 395 F. Supp. 538, 550 (M.D. Tenn. 1975). In *Blue Bell*, the parties argued that the acquisition of an industrial laundry division by a competitor did not violate Section 7, claiming protection of the failing division defense. *Id.* Although the District Court for the Middle District of Tennessee did not decide whether a failing division defense existed, it did note, however, that even if one did exist, unsatisfactory performance would not “put [a division] within the definition of a ‘failing company’ defense.” *Id.*
121. *See FTC v. Harbour Group Inv., L.P.*, No. CIV.A.90-2525, 1990 WL 198819, at *2 (D.D.C. Nov. 19, 1990). This case was decided the same year that the D.C. Circuit applied the *General Dynamics* analysis to a merger involving a failing division in *Baker Hughes*. *See supra* notes 107-11 and accompanying text.
merger [was] the 'only available’ alternative." The court found it unnecessary to decide on the failing division defense and “construe this unsettled area of law,” because even if the court recognized the failing division defense it would not have applied to the facts of this case.

The only case to acknowledge a separate failing division defense was *California v. Sutter Health Systems*. In 2001, the District Court for the Northern District of California accepted the failing division defense in dicta. Although this court recognized the failing division defense, it did not have the opportunity to apply it because, as a wholly owned subsidiary, the failing entity in question was an independent legal entity—not a division. Accordingly, the court applied the failing company defense, not the failing division defense.

### III. Why Have the Courts Failed to Accept the Failing Division Defense?

After the adoption of the 1982 Merger Guidelines, commentators predicted that the issue of the failing division defense would “be back again and again in the near future.” So why have the courts ignored and avoided applying the failing division defense? First, courts may not have had adequate opportunity to consider the failing division defense. Second, courts may fear that increased application of the defense will create incentives to manipulate company data to meet the defense’s strict evidentiary requirements. Finally, some courts may perceive that the failing division defense is unnecessary in light of the increased application of the *General Dynamics* analysis.

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123. Id. at *2 n.7.
124. 130 F. Supp. 2d 1109, 1133 (N.D. Cal. 2001).
125. Id. at 1134.
126. Id.
127. Id.
128. Sims & Blumenthal, supra note 10, at 17 (discussing the Merger Guidelines’ treatment of the failing division defense).
129. See infra notes 132-39 and accompanying text.
130. See infra notes 140-45 and accompanying text.
131. See infra notes 146-54 and accompanying text.
approach proposed in Part IV of this Note addresses each of these reasons for the non-acceptance of the failing division defense.

A. Lack of Opportunity

The District Court for the District of Columbia in FTC v. Harbour Group Investments\textsuperscript{132} noted that it would not consider the application of the failing division defense because it did not wish "to construe this unsettled area of law."\textsuperscript{133} The unwillingness of courts to consider the failing division defense may have had a circular effect: that of discouraging merging parties from raising the defense before the courts, and, because merging parties rarely raise the failing division defense, it remains "an unsettled area of law" further discouraging parties from raising the defense.\textsuperscript{134}

Although merging parties frequently raise the failing division defense in investigations before the agencies,\textsuperscript{135} it is rare for mergers involving the failing division defense to actually make it to court.\textsuperscript{136} If an agency seeks a preliminary injunction after investigating a merger, the merging parties have significant incentives to negotiate a settlement with the investigating agency if the failing division defense is the foundation of their legal case.\textsuperscript{137} As "[t]he most important factor is usually counsel's assessment of how the client would fare in court,"\textsuperscript{138} courts' non-acceptance of the failing division defense discourages counsel from pursuing judicial review of challenged mergers to which the defense might apply.\textsuperscript{139}

\textsuperscript{133} Id. at *2 n.7.
\textsuperscript{134} Id.
\textsuperscript{135} See supra note 22 and accompanying text.
\textsuperscript{136} Cf. Troy Paredes, Note, Turning the Failing Firm Defense Into a Success: A Proposal to Revise the Horizontal Merger Guidelines, 13 YALE J. ON REG. 347, 354 n.21 (1996). Discussing mergers generally, Mr. Paredes noted that "[m]ost mergers that the Agencies investigate never go to trial but are resolved at the preliminary injunction stage or in the offices of the Agencies when the combining parties make their case to them." Id.
\textsuperscript{137} See THE MERGER REVIEW PROCESS, supra note 1, at 248-49 (suggesting that when debating whether to enter into negotiations for a consent agreement, merger counsel should consider their client's likelihood of success in court, "monetary and nonmonetary costs of litigation," and the "likely terms of the consent order").
\textsuperscript{138} Id.
\textsuperscript{139} Merging parties relying solely on a failing division defense have no hope of success in most jurisdictions. See supra Part II. The exceptions to this general trend of non-
The number of cases before courts raising the failing division defense would likely increase if counsel were assured that the defense would be judicially considered and ultimately accepted. The Modified Strict Adherence approach proposed by this Note secures acceptance of the failing division defense by requiring courts to consider the Merger Guidelines' three-prong failing division defense in step two.

B. Manipulability of "Failing" Status

Another reason courts may be reluctant to accept the failing division defense is that increased application of the defense may tempt companies to allocate costs among divisions or to "manipulate the capital structure of a wholly owned subsidiary" in order to create a "failing division." In order to qualify as "failing" under the Merger Guidelines, a division "must have negative cash flow on an operating basis." Courts may fear that application of the failing division defense would allow mergers that would otherwise not be permitted under the Merger Guidelines and Section 7, "but for the parties' success at manipulating their facts to fit the defense."

Unjustifiable fear of manipulation should not preclude the application of a defense that is otherwise beneficial. Strict acceptance are the cases brought in the District Courts for the Northern District of California and the Northern District of Illinois. See California v. Sutter Health Sys., 130 F. Supp. 2d 1109, 1134 (N.D. Cal. 2001); FTC v. Great Lakes Chem. Corp., 528 F. Supp. 84, 96 (N.D. Ill. 1981). One case in each of the above jurisdictions, however, is unlikely to create a large enough incentive for merger counsel to risk inapplicability of the defense in light of the expense of complex antitrust litigation.

140. AREEDA, HOVENKAMP & SOLOW, 4 ANTITRUST LAW ¶ 953e (1998); see Kauper, The 1982 Horizontal Merger Guidelines, supra note 37, at 528-29 (discussing the difficulties of assessing the failure of a division and how "the larger entity can manipulate data and arbitrarily allocate costs"); Note, Horizontal Mergers After United States v. General Dynamics Corp., supra note 92, at 377 ("With the complex nature of modern industries, a relaxed failing firm standard would create conditions ripe for managerial manipulation of financials to produce a mirage of compliance.").


142. Paredes, supra note 136, at 374.

143. Kauper, The 1982 Horizontal Merger Guidelines, supra note 37, at 528-29 (arguing that fear of manipulation is not sufficient to completely preclude use of the failing division defense); see also AREEDA, HOVENKAMP & SOLOW, supra note 140, ¶ 953e (arguing that "the parent should be permitted to make a showing that would establish a 'failing division'"). For
adherence to the Merger Guidelines' three-prong failing division defense, as proposed in step one of the Modified Strict Adherence approach, can curb these fears through the implementation of safeguards against data manipulation. First, as an evidentiary safeguard, the Merger Guidelines require evidence of the division's failure that was produced prior to the merger negotiations. Second, the merging parties bear the burden of proving all three prongs of the Merger Guidelines' failing division defense. Accordingly, fact-finders can consider the reliability of the parties' financial evidence when deciding whether the division is actually failing, which reduces incentives for companies to manipulate financial data.

C. Is the Failing Division Defense Necessary in Light of General Dynamics?

A third reason courts have not accepted the failing division defense may be the application of the General Dynamics analysis in cases involving failing divisional assets. Courts recently have applied the General Dynamics analysis to mergers which may have otherwise qualified for the failing division defense. Merging parties that could potentially successfully defend against a Section 7 enforcement action by raising the failing division defense also argue that the merger is not prima facie anticompetitive under

additional discussion of the benefits of the failing division defense, see infra Part IV.

144. 1992/1997 Merger Guidelines, supra note 2, § 5.2. The guidelines state:

Due to the ability of the parent firm to allocate costs, revenues, and intracompany transactions among itself and its subsidiaries and divisions, the Agency will require evidence, not based solely on management plans that could be prepared solely for the purpose of demonstrating negative cash flow or the prospect of exit from the relevant market.

Id.

145. Although the Merger Guidelines do not assign burdens, the agencies defer to the judicially assigned burdens with respect to the failing defenses. 1992/1997 Merger Guidelines, supra note 2, at Statement ("The language, therefore, is intended to be burden-neutral, without altering the burdens of proof or burdens of coming forward as those standards have been established by the courts."). The burden of proof historically rests with the party asserting the failing defense. See, e.g., Citizen Publ'g Co. v. United States, 394 U.S. 131, 138-39 (1969) ("The burden of proving that the conditions of the failing company doctrine have been satisfied is on those who seek refuge under it." (citations omitted)).


147. See supra Part II.B.
the *General Dynamics* analysis, which may cause courts to consider the failing division defense unnecessary if the case can be decided under the *General Dynamics* analysis alone.

In many cases, a firm that might consider arguing a failing division defense to a merger enforcement action may also qualify to argue that the acquired firm is not a strong competitor in the relevant market under *General Dynamics*. This overlap has somewhat blurred the evidentiary distinction between the *General Dynamics* analysis and the failing division defense. The Court in *General Dynamics* focused on external market factors to determine whether current market shares of the merging firms accurately reflected the competitive impact of the proposed merger. Distinguishing this analysis from the failing company defense, the Court explained that consideration of market realities was inapposite to a finding that the merging company was failing.

Although the *General Dynamics* analysis and the failing division defense may apply in many of the same cases, they are sufficiently different to warrant the acceptance and use of both approaches to merger review. The fundamental difference between the analysis in *General Dynamics* and the failing division defense is one of form: the analysis in *General Dynamics* is used to refute the agency's prima facie finding that a merger is anticompetitive; conversely, the failing division defense is, as it is aptly called, an absolute defense applied after a finding that a merger is anticompetitive.

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148. *See, e.g.*, Kaiser Aluminum & Chem. Corp. v. FTC, 652 F.2d 1324, 1338 (7th Cir. 1981). Although the Seventh Circuit decided Kaiser under the *General Dynamics* analysis, the merging parties could have raised the failing division defense. The assets in question constituted a division of a larger company. *Id.* at 1329. In addition, the parties argued that the reason the proposed merger would not substantially lessen competition under the *General Dynamics* analysis was because "lack of financial resources adversely affected Lavino's ability to compete." *Id.* at 1338. This argument sounds more like a failing division defense argument than a *General Dynamics* one.

149. *See, e.g.*, *id.* at 1341 (explaining that "while it may be a relevant factor in some cases, [financial weakness] certainly cannot be the primary justification of a merger in resistance to a [Section] 7 proceeding"); *see also* United States v. Ivaco, Inc., 704 F. Supp. 1409, 1428-29 (W.D. Mich. 1989).


151. *See supra* note 148 and accompanying text.

152. *See Gen. Dynamics Corp.*, 415 U.S. at 507-08 (explaining the difference between its analysis and the failing company defense); *see also* Kaiser Aluminum, 652 F.2d at 1340 ("Characterization of the defense in *General Dynamics* as an 'affirmative defense' is wrong."); *Note, Horizontal Mergers After United States v. General Dynamics Corp.*, *supra* note 92, at
Court in General Dynamics clarified that its analysis proved "an entirely different point" than the analysis under a failing defense.153 Rather than showing that United would have gone out of business but for the merger with Material Service, the finding of inadequate reserves went to the heart of the Government's statistical prima facie case ...."154

The General Dynamics analysis is inadequate to address some mergers that would otherwise be approved under the failing division defense. Consider a merger of a division which otherwise meets the qualifications of the Merger Guidelines' failing division defense155 but has a large market share. Assume that this hypothetical failing division is in a market such that operating at current levels, the failing division could maintain or even increase its competitive position in the market if the parent company continued to sink money from more profitable areas of the business into this "money trap." Under the General Dynamics analysis, this merger would fail because the failing division would remain a viable competitor in the relevant market. Application of the failing division defense in this situation would allow the company to sell off this division as a discrete operating unit without the harm—financial, competitive and otherwise—of a piecemeal sale.156 Accordingly, because the General Dynamics analysis and the failing division defense address fundamentally different considerations and do not necessarily always overlap, the acceptance and use of both analyses to sales involving failing divisional assets are required.

378-79. The argument that the failing division defense and the General Dynamics analysis lead to the same outcome and, therefore, it does not matter which analysis is applied is beyond the scope of this Note. For the purposes of this discussion, it is sufficient to note that the General Dynamics approach and failing division defense are fundamentally, if not practically, different.

154. Id.
155. For instance, if the division has negative operating cash flow, the assets would otherwise exit the relevant market absent the acquisition, and the parties made unsuccessful good faith efforts to locate less anticompetitive alternative purchasers. See 1992/1997 Merger Guidelines, supra note 2, § 5.2.
156. See infra note 190 and accompanying text.
IV. THE MODIFIED STRICT ADHERENCE APPROACH TO THE FAILING DIVISION DEFENSE

Any proposal to modify the approach taken by the agencies and courts with respect to the failing division defense should protect competition, increase certainty, and provide a guarded level of flexibility in the merger review process. Current treatment both within the agencies and courts of mergers involving failing divisional assets fails to meet these three goals.

This Note proposes that the agencies adopt a two-step Modified Strict Adherence approach to the failing division defense. In step one, an agency investigating a merger in which the parties raise the failing division defense must evaluate the defense under the strict Merger Guidelines' failing division defense. Step two applies when a merger is challenged in court. In step two, the court must first apply the strict Merger Guidelines' test required in step one. If, however, overriding social harm to stockholders, employees, creditors, or the surrounding community may result if the merger is blocked, the court may weigh these harms against the anticompetitive impact of the acquisition to determine if equity warrants allowing the merger in violation of Section 7.

Before considering how the Modified Strict Adherence approach achieves the above three goals—protecting competition, certainty, and flexibility—a discussion of how the courts will apply this approach, in light of their past application of the failing company defense, is useful.

A. The Merger Guidelines' Test

The Merger Guidelines outline a three-part test to determine whether a failing division qualifies for protection against Section 7 enforcement actions: (1) "the division must have a negative cash
flow on an operating basis,” (2) “absent the acquisition, it must be that the assets of the division would exit the relevant market in the near future,” and (3) the owner must make “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.”

Consideration of how courts have applied the similar failing company defense requirements illustrates how courts may consider the Merger Guidelines’ failing division defense. This Note’s analysis focuses on the District of Columbia Circuit, where the agencies bring a substantial majority of their enforcement actions.

1. Negative Cash Flow on an Operating Basis

First, a successful application of the failing division defense requires that “the division must have a negative cash flow on an operating basis.” The agencies have defined negative cash flow in terms of generally accepted accounting principles and have carefully scrutinized the merging parties’ financial statements to determine whether this prong has been met. The District of Columbia Circuit, where the agencies bring a substantial majority of their enforcement actions, has provided guidance on this issue.

159. 1992/1997 Merger Guidelines, supra note 2, §§ 5.1, 5.2 (footnote omitted).

160. In Fiscal Year 2001, the agencies challenged nine mergers in federal district court—eight by the DOJ and one by the FTC—all of which were filed in the District Court for the District of Columbia. FEDERAL TRADE COMMISSION, FTC HSR ANNUAL REPORT TO CONGRESS FOR FISCAL YEAR 2001 14-20, available at http://www.ftc.gov (last updated Mar. 7, 2003). This report includes statistics from October 1, 2000 to September 30, 2001. Id. at 3.

161. 1992/1997 Merger Guidelines, supra note 2, § 5.2. Both the courts and agencies agree that the relevant time period for assessing the firm’s condition is at the time of the proposed acquisition. See United States v. Phillips Petroleum Co., 367 F. Supp. 1226, 1261 (C.D. Cal. 1973) (“[T]he legality of an acquisition under [Section] 7 must be determined on the basis of objective evidence of conditions as they existed at the time of suit.”); In re United States Steel Corp., 74 F.T.C. 1270, 1279-80 (1968), rev’d on other grounds sub nom. United States Steel Corp. v. FTC, 426 F.2d 592 (6th Cir. 1970) (holding that failing status depends on the financial status of the company at the time of the acquisition); LAWRENCE A. CUNNINGHAM, INTRODUCTORY ACCOUNTING AND FINANCE FOR LAWYERS 176 (3d ed. 2002). But cf. CHARLES R. WRIGHT, UNDERSTANDING AND USING FINANCIAL DATA: AN ERNST & YOUNG GUIDE FOR ATTORNEYS 133-34 (2d ed. 1996) (“[C]ash flows can increase while the company is operating at a loss .... Do not be fooled by looking at only one part of the picture.”).

162. Operating cash flow is generally reported on a company’s Statement of Cash Flows as one of three cash flow considerations: Operating, Investing, and Financial activities. CUNNINGHAM, supra note 161, at 177-78; WRIGHT, supra note 161, at 130.
Columbia Circuit is likely to consider a company’s financial statements to determine whether its division is failing, because the court already considers financial statements to determine whether the company “face[s] the grave probability of business failure” as required by the Citizen Publishing failing company defense.\textsuperscript{163} In Michigan Citizens, the District of Columbia Circuit held that a firm faces the grave probability of business failure only when “the owners of the ‘failing’ company are contemplating liquidation; indeed, the [merger] must be the ‘last straw’ at which the company can grasp.”\textsuperscript{164}

2. Assets Would Otherwise Exit

The second requirement of the Merger Guidelines’ failing division defense is that, “absent the acquisition, it must be that the assets of the division would exit the relevant market in the near future if not sold.”\textsuperscript{165} Although the District of Columbia Circuit has not addressed this prong with respect to the failing company defense, the Second Circuit has found that the assets of the failing division would otherwise “exit the relevant market”\textsuperscript{166} if the company intended to shut down the division and liquidate its assets absent the acquisition and if the company is not undertaking rehabilitative efforts.\textsuperscript{167} In order to meet this prong, the agencies have required proof that no one else would purchase the productive assets and keep them in the market.\textsuperscript{168} Additionally, rehabilitative efforts may indicate a willingness to restore the failing division absent the


\textsuperscript{164} Mich. Citizens, 868 F.2d at 1288 (quoting Citizen Publ’g Co., 394 U.S. at 137).

\textsuperscript{165} 1992/1997 Merger Guidelines, supra note 2, § 5.2.

\textsuperscript{166} Id.

\textsuperscript{167} F. & M. Schaefer Corp. v. C. Schmidt & Sons, Inc., 597 F.2d 814, 817 (2d Cir. 1979). In F. & M. Schaefer Corp., the court found that the assets of Schmidt would not exit the market absent the stock acquisition by Schaefer, considering that the company had recently implemented rehabilitation measures and “enjoy[ed] the continued support of its creditors.” Id. at 817.

acquisition, instead of an intention to shut down the division and sell the assets outside the relevant market as the Merger Guidelines required.\footnote{169}{See F. & M. Schaefer Corp., 597 F.2d at 817.}

3. Less-Anticompetitive Purchaser Prong

The third prong of the failing division defense requires that the seller undertake a good faith effort to identify alternative purchasers that present less severe anticompetitive effects.\footnote{170}{1992/1997 Merger Guidelines, \textit{supra} note 2, §§ 5.1, 5.2.} The District Court for the District of Columbia thoroughly considered the “only alternative purchaser” prong in \textit{FTC v. Harbour Group Investments}.\footnote{171}{No. CIV.A.90-2525, 1990 WL 198819, at *3 (D.D.C. Nov. 19, 1990).} The \textit{Harbour Group} court required that “the party claiming entitlement to the defense [prove] that the acquiring company is the ‘only available purchaser.’”\footnote{172}{\textit{Id.} at *3 (quoting Citizen Publ’g Co. v. United States, 394 U.S. 131, 138 (1969)).} To meet this standard, the court held that companies must broadly disseminate information about the pending sale in order to solicit potential buyers.\footnote{173}{\textit{Id.} at *5.} Although the court found that a merging party is not obligated to hire a broker, it considered the failure to do so as evidence of a lack of diligence in the search for an alternative purchaser.\footnote{174}{\textit{Id.} at *4 (noting this failure represented a “departure from the normal business operations” and was characteristic of the company’s perfunctory attempt to locate alternative purchasers).} Finally, the court considered that the search for alternative purchasers did not begin until after the acquisition deal was close to finalization, suggesting that the search was “not designed to result in serious alternatives.”\footnote{175}{\textit{Id.} at *6.}

Depending on the facts in a given case, the District of Columbia Circuit may also look to the various additional obligations imposed in other circuits on parties trying to meet this prong of the defense. Some other courts have required the parties to contact smaller
competitors, while others required the good faith evaluation of incoming offers.

B. Counterbalancing Social Harm Against Anticompetitive Effects

Step two of the Modified Strict Adherence approach allows courts to weigh overriding social harm that may result from blocking a proposed acquisition—only after the court has considered the three-prong failing division defense from the Merger Guidelines—allowing courts “to determine whether the public interest could be served by a preliminary injunction” blocking the merger.

Although consideration of social harm is necessarily fact specific, the court should consider the harm to employees, stockholders, creditors, and the surrounding community of the failing division if a preliminary injunction blocks the merger. The Supreme Court originally considered these factors in justifying the failing company defense in *International Shoe.* Courts, however, are not limited to considering only the *International Shoe* factors. Since *International Shoe,* other courts have considered the fact that the acquisition will promote both foreign trade and long-term benefits to competition, such as the promotion of new entry into the market and increase of research and development efforts in the industry.

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176. United States v. Greater Buffalo Press, Inc., 402 U.S. 549, 556 (1971) ("Moreover, only King and Greater Buffalo were considered as prospective purchasers; the numerous other smaller color comic supplement printers were never even approached.").

177. United States v. Black & Decker Mfg. Co., 430 F. Supp. 729, 781-82 (D. Md. 1976) (holding that this prong was not met when a failing company failed to solicit bids, refused negotiations with alternative purchasers, and effectively precluded consideration of any company other than the purchaser).

178. See FTC v. Great Lakes Chem. Corp., 528 F. Supp. 84, 98 (N.D. Ill. 1981) (approving the acquisition of a failing division and finding that “significant public and private equities favor consummation of the proposed acquisition").


180. See id. *International Shoe* was cited by Congress with approval in passing the 1950 Celler-Kefauver amendments to the Clayton Act, further suggesting that the Clayton Act should not apply when overriding social harm would result. See supra notes 66-71 and accompanying text.

181. For the application of these various factors, see, for example, *Great Lakes Chem. Corp.,* 528 F. Supp. at 98 (applying these factors to the sale of a failing division).
C. Benefits of the Modified Strict Adherence Approach

The agencies' and courts' current treatment of the failing division defense is inconsistent with the goals of antitrust policy—namely protecting competition, increasing certainty, and providing adequate flexibility. Often the agencies exercise prosecutorial discretion and decide not to challenge the merger. Although sometimes the agencies will consider the failing division defense, merging parties have no opportunity to argue the defense on review by the courts. The courts have either applied another defense entirely (the failing company defense), applied the General Dynamics analysis to find that the merger is not prima facie anticompetitive, or addressed the failing division defense, but decided the case on other grounds.

The Modified Strict Adherence approach provides a two-step framework in which to apply the failing division defense. Through strict application of the defense by the agencies in step one and the possible consideration of social harms by courts in step two, the Modified Strict Adherence approach better achieves the goals of antitrust policy than the various current treatments of the failing division defense. The Modified Strict Adherence approach protects competition, increases certainty in a complex area of legal practice, and provides for flexibility to prevent inequity.

1. Protection of Competition

The protection of competition is the central goal of antitrust policy. So, how can a defense which permits a merger that is, by definition, anticompetitive be reconciled with Section 7 of the Clayton Act which prohibits such acquisitions? Some commentators suggest that it cannot. The Modified Strict Adherence approach

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182. For discussion of the various treatment of mergers involving failing divisional assets, see discussion supra Parts I, II. For discussion of how the Modified Strict Adherence approach to such mergers achieves these goals, see supra Part IV.B.

183. See AM. BAR ASS'N, supra note 157, at 5 (noting that “the central objective of the antitrust laws is to protect the competitive enterprise system”) (citations omitted).

184. Detailed analysis of the economic justifications of the failing division defense, although extremely interesting and worthy of further consideration, is beyond the scope of this Note. Many commentators have written about the economic justifications, or lack thereof, of the failing division and failing company defenses. For arguments that the failing
protects competition in three ways: by allowing mergers that enhance competition, by providing a forum in which non-economic, pro-competitive factors may be considered, and by enhancing the agencies' role as the federal antitrust law enforcers.

A merger which results in increased market concentration through the acquisition of a failing firm or division is anticompetitive, by definition.¹⁸⁵ Defining competition solely in terms of post-acquisition market share, however, does not take into account the impact on market share that may occur if the merger is blocked. Thomas Campbell suggested that those who argue that the failing division defense cannot be reconciled with Section 7 “have not considered the other side of the balance—the consequence of letting a firm simply leave the industry.”¹⁸⁶

The proper measurement of the anticompetitive effect of a proposed acquisition is whether the merger is anticompetitive compared to the market after the assets of the failing division exit, because the Merger Guidelines’ failing division defense requires a finding that the assets in question would otherwise exit the market absent the acquisition.¹⁸⁷ Maintaining a failing division's productive assets as a discrete unit, even in the hands of a competitor, can

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¹⁸⁵. See supra notes 32-33 and accompanying text.

¹⁸⁶. Campbell, Efficiency, supra note 64, at 257.

significantly benefit competition. Economic theory suggests that "the acquisition of a failing firm, even by a dominant firm, is preferable to allowing the firm to fail financially and exit, since acquisition keeps capacity in the market." When the failing company analysis is applied to situations where the result, absent the acquisition, would be the exit of the productive assets from the relevant market, allowing the acquisition is a better result for competition than letting the firm fail.

Competitive impacts should not be defined solely in terms of market share. Step two of the Modified Strict Adherence approach benefits facets of competition other than market share, such as jobs and branding, by allowing the court to look beyond market share statistics and consider broader social concerns. First, allowing the sale of a division as a going concern rather than awaiting its exit preserves jobs if the acquirer maintains current division operations. Second, selling the assets as a unit minimizes damage to competition by protecting non-productive assets such as reputation and brand name. Finally, competition suffers when companies are forced to sink money into the maintenance of a failing division instead of being permitted to sell it. By allowing the sale of a division within the relevant market, the parent firm may be able to realize a higher selling price rather than allowing the division to fail and then auctioning off its remains piecemeal.

Finally, the application of the failing division defense can benefit competition by lending legitimacy to the role of the agencies as the primary federal antitrust enforcers. The FTC and the DOJ are the

188. Paredes, supra note 136, at 363 n.58.
189. Id.
190. Cf. Timothy B. Wathall, The Failing Company Defense and Corporate Collapse: Probing for a Rational Approach to Business Failure, 5 GEO. MASON L. REV. 51, 68 (1982) (pointing out that jobs are preserved if the acquiring entity is "committed to continue operation in the same locale").
191. Cf. Kurt Badenhausen, Brandwagon, FORBES, June 12, 2000, at 60 (noting that "intangibles are everything" in competition).
192. See Campbell, Efficiency, supra note 64, at 255 (noting that failure to allow mergers under the failing division defense would force companies to continue operating failing divisions at a loss).
two federal agencies primarily charged with enforcing the federal antitrust laws.\textsuperscript{194} Instead of applying the failing division defense when raised by the parties, the agencies frequently decide not to challenge the acquisition through the exercise of prosecutorial discretion.\textsuperscript{195} Although prosecutorial discretion may conserve judicial resources and maintain the confidentiality of HSR Act filings by merging parties, the current use of prosecutorial discretion in the context of failing division merger analysis is particularly harmful to the legitimacy of the enforcement agencies. First, by using prosecutorial discretion, the agencies are essentially allowing the consummation of an otherwise anticompetitive merger in violation of Section 7 without the procedural and evidentiary safeguards of the Merger Guidelines' failing division defense.\textsuperscript{196} Second, failure to apply the strict Merger Guidelines' test in favor of dismissal on prosecutorial discretion grounds creates decisions that appear arbitrary.\textsuperscript{197} Although the agencies may exercise prosecutorial discretion to prevent social harms that may result if a proposed merger is blocked, their role is the enforcement of antitrust policy, not social policy.\textsuperscript{198} The agencies subject themselves to continuing scrutiny when they are sidetracked from the protection of competition.\textsuperscript{199}

\textsuperscript{194} See supra note 27 and accompanying text.
\textsuperscript{195} See supra Part I.C.
\textsuperscript{196} See Greaney, supra note 54, at 198 n.61.
\textsuperscript{197} Joe Sims, A New Approach to the Analysis of Hospital Mergers, 64 Antitrust L.J. 633, 636 (1996) (explaining that "while the exercise of intelligent prosecutorial discretion is always welcome, from the outside the decisional standards are opaque and decisions can appear arbitrary").
\textsuperscript{198} Eleanor M. Fox, Antitrust, Competitiveness, and the World Arena: Efficiencies and Failing Firms in Perspective, 64 Antitrust L.J. 725, 733 (1996) ("Jobs problems should be dealt with by jobs policy ... competition policy should be dealt with by antitrust.").
2. Certainty

In addition to protecting competition, certainty is also crucial to effective antitrust enforcement.\textsuperscript{200} In issuing the joint 1992 Merger Guidelines, the FTC and DOJ indicated their intention to increase certainty in the merger review process by providing a roadmap for the agencies' evaluation of mergers.\textsuperscript{201} Certainty is necessary in merger review for several reasons. First, it is extremely valuable to merging parties.\textsuperscript{202} "Mergers are time-sensitive transactions, and the potential duration and uncertainty of a court battle is often enough to dissuade all but the most ardent firms from completing a deal."\textsuperscript{203} Second, strict adherence to guidelines will "substantially reduce the possibility that the agencies will challenge a proposed transaction that is unlikely to injure competition."\textsuperscript{204} Dealmakers praised the 1992 Merger Guidelines, which included the current failing division defense, as a clear and concise vehicle for enhancing competition.\textsuperscript{205}

Clear and concise Merger Guidelines alone are insufficient to lend certainty to the merger review process; strict adherence to the Merger Guidelines is necessary. The Merger Guidelines are worthless if the merging parties are unable to rely on them for guidance in the dealmaking process.\textsuperscript{206} Although there may be decreased certainty at the stage of court review as a result of

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\textsuperscript{200} Alan A. Fisher & Robert H. Lande, Efficiency Considerations in Merger Enforcement, 71 CAL. L. REV. 1582, 1695 (1983) ("[A]ny antitrust enforcement system must, above all, be as objective and predictable as possible.").
\textsuperscript{201} See 1992/1997 Merger Guidelines, supra note 2, §.0. ("By stating its policy as simply and clearly as possible, the Agency hopes to reduce the uncertainty associated with enforcement of the antitrust laws in this area."); see also Kauper, The 1982 Horizontal Merger Guidelines, supra note 37, at 500 (noting that the 1982 Merger Guidelines were born out of a "persistent quest ... for certainty").
\textsuperscript{204} Rill, supra note 202, at 53 (noting that the 1992 Merger Guidelines "will prove to be an extremely valuable resource for dealmakers").
\textsuperscript{205} See id.
\textsuperscript{206} Cf. Sims & Blumenthal, supra note 10, at 17 (noting that the increased certainty provided by the 1982 Merger Guidelines could be eroded by the use of prosecutorial discretion and judgment calls).
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court consideration of social harms, the Modified Strict Adherence approach will increase certainty overall by first applying the Merger Guidelines' failing division defense. The current treatment of the failing division defense is replete with uncertainty.207 Prior to agency review, merging parties do not know whether their merger will be subject to strict scrutiny or, conversely, whether it will not be subject to scrutiny at all if the agency exercises prosecutorial discretion and does not challenge the acquisition.208 Courts further compound the uncertainty in the merger review process because they have not accepted the failing division defense.209 Rather, courts decide merger cases based on the failing company defense or the General Dynamics analysis.210 Considering these varied approaches, the only certainty regarding the failing division defense in the current merger review process is that merging parties cannot rely on the Merger Guidelines' failing division defense. The Modified Strict Adherence approach requires both agencies and courts to consider the failing division defense as outlined by the Merger Guidelines. This approach solves the uncertainty of the current system by providing a unified analysis on which merging parties can rely for guidance in the dealmaking process.

3. Flexibility

A new approach to the failing division defense should also provide flexibility,211 because strict Merger Guidelines analysis may not reflect the true competitive impact of a proposed merger.212 Consider a merger in which a division meets only two out of the three requirements of Merger Guidelines’ test: it has negative operating cash flow and has adequately shown that its assets will exit the market if the acquisition is blocked, but did not show that

208. See supra Part I.C.2.
209. See supra Part II.
210. See supra Parts II.A-B.
211. See supra Part II.
212. See Campbell, Efficiency, supra note 64, at 256 ("[T]he confining rigor of structural analysis in merger law ... leaves out much that is important with regard to life as it is lived in the market place.") (quoting L. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST § 204(g) (1977)).
it made sufficient efforts to find a less-anticompetitive alternative purchaser. Assume that no less-anticompetitive purchaser actually exists, such that the company's sufficient efforts to locate alternative purchasers would have been futile. Strict Merger Guidelines analysis dictates blocking this merger. The Modified Strict Adherence approach provides the requisite flexibility in step two to allow the consummation of this merger if overriding social harms, such as harm to stockholders, employees, and the surrounding community, would result absent the merger.

The consideration of non-economic factors is not new to antitrust law and policy. The 1950 Celler-Kefauver Amendments to sections 7 and 10 of the Clayton Act, in quoting the language of International Shoe, endorsed the Court's view that antitrust policy should be concerned with non-quantifiable harms such as the harms to stockholders, creditors, and the surrounding community that would occur absent a proposed merger. Opponents of the failing division defense point to the statutory language of Section 7, noting that Section 7 is only concerned with mergers that substantially lessen competition, and does not mention social concerns. Prior to becoming FTC Chairman, Robert Pitofsky addressed this opposition, noting that although balancing of social considerations will mitigate the "tidy world of exclusively micro-economic analysis," failure to take into account such impacts of a proposed merger "would be unresponsive to the will of Congress."

During step two of the Modified Strict Adherence approach, a court should consider the harm to employees, stockholders, creditors, the surrounding community of the failing division, and any other social harms that may result if a preliminary injunction blocks the acquisition. Ultimately, weighing these factors against the anticompetitive impact of a proposed merger is necessary to ensure that the enforcement agencies do not cause substantial social harm simply because at the time of the merger the company

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215. See Cann, supra note 34, at 284.
216. Pitofsky, supra note 157, at 1052.
failed part of a rigid analysis. These considerations provide adequate flexibility to restore the original intention of the courts and legislature not to apply Section 7 when overriding social harm would result, and prevents harm to competition that may result from a per se approach to the Merger Guidelines' failing division defense.\footnote{218}

Because very few merger cases go to court,\footnote{219} and even fewer of those involve the failing division defense, consideration of social harm in merger cases may be rare. One reason that the failing division defense is rarely litigated in court is because attorneys are often unwilling to risk asserting a defense that the courts have historically disfavored.\footnote{220} Increasing acceptance of the failing division defense in the courts will likely result in more cases raising it as an issue in the near future, providing the litigants with an opportunity to argue that overriding social harms would result if their proposed acquisition is blocked.

Some commentators on the failing company defense have suggested incorporating social factors into the merger review analysis at the agency level.\footnote{221} Consideration of social factors by antitrust enforcement agencies is inadvisable. First, the agencies are experts in antitrust policy, not social policy.\footnote{222} Because of their lack of expertise developing social policy, agency balancing of social concerns is an inefficient use of the agencies' limited resources. Second, consideration of fluid factors, such as social harm, can create avenues for political and interest group influences and result
in the appearance, if not reality, of arbitrary antitrust enforcement
decisions. Recent events demonstrate that the FTC and DOJ are
easily swayed by outside pressure from politicians and the legal
community. For example, buckling under Congressional pressure,
in 2002, the DOJ withdrew from an agreement with the FTC
regarding clearance procedures, which divided enforcement areas
between the agencies and effectively prevented clearance disputes
over which agency would investigate a given merger.

Step two of the Modified Strict Adherence approach allows
limited consideration of social harms by the courts, while pre-
venting the harm that can arise from agency consideration. Courts
are more sheltered from political pressures than agencies and are
better equipped to make decisions of social policy. Additionally,
courts frequently balance social considerations in other contexts,
including the failing company defense, enabling them to better see
a “big picture” of merger analysis not available to agency officials
who are primarily concerned with increases in market power.

CONCLUSION

After nineteen years in the Merger Guidelines, it is time to
reconsider the failing division defense. Despite acquiescence in the
courts and disparate treatment by the antitrust enforcement
agencies, justification exists for the increased application of the
failing division defense in the context of merger review under
the Hart-Scott-Rodino Act. This Note proposes a Modified Strict
Adherence approach to the failing division defense involving two

224. For more information on the clearance process, see THE MERGER REVIEW PROCESS,
supra note 1, at 26.
225. See, e.g., Brent Shearer, Merger Clearance Accord Turns Nasty, MERGERS &
ACQUISITIONS, June 1, 2002, LEXIS, Mergers and Acquisitions Journal File; see also James
R. Weiss & Martin L. Stern, Serving Two Masters: The Dual Jurisdiction of the FCC and the
Justice Department Over Telecommunications Transactions, 6 COMM. LAW CONSC. 195,
199-200 (1998) (noting that the DOJ, although historically less susceptible to political
pressure, has recently faced increased Congressional scrutiny). But see William J. Baer &
David A. Balto, Public Choice: Do Politics Corrupt Antitrust Enforcement? The Politics of
Federal Antitrust Enforcement, 23 HARV. J.L. & PUB. POL'Y 111, 125 (1999) (claiming that
antitrust enforcement agencies are more susceptible to political pressure because their
decisions are increasingly transparent).
226. See supra note 34 and accompanying text.
steps of analysis. In step one, enforcement agencies strictly construe the Merger Guidelines' three-part failing division defense. In step two, after first applying the Merger Guidelines' failing division defense, courts may weigh social harms against the anticompetitive impact of the merger and balance the equities of the acquisition. Application of the Modified Strict Adherence approach to the failing division defense will protect competition, increase certainty in an increasingly complex area of legal practice, and provide for flexibility in fact-specific inquiries. The failing division defense is one shipwreck worthy of reclamation.

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