COVID-19 May Lower Bar For Distressed M&A Defenses

By **Colin Kass, Michael Callahan and Simon Sharpe** (October 28, 2020)

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Beyond its devastating human toll, the COVID-19 pandemic has had a historic impact on the U.S. economy, causing tens of millions of Americans to lose employment and numerous businesses to temporarily or permanently shutter.

This presents an environment ripe for distressed M&A activity. Will U.S. antitrust law stand in the way of the economic forces spurring such consolidation?

U.S. antitrust enforcers have historically viewed industry consolidation suspiciously, considering it better to let troubled businesses naturally run their course. But does that view apply in the context of a rapid economic downturn, particularly where the underlying cause is an environmental health crisis?

On one hand, the American consumer benefits from competition, no matter how fleeting it may be. On the other hand, denying consolidation prolongs excess capacity and duplicative overhead costs, which drag profits and waste resources and, potentially, the overall economic health and recovery of that industry.

There are two existing doctrines — the failing firm and flailing firm defenses — that nod in favor of, and could support, consolidation in a crisis. Still, the antitrust agencies have erected high hurdles to satisfying those defenses. They are rarely tried and even more rarely successful.

As COVID-19 has changed so much of American life, the moment demands revisiting those doctrines and asking afresh whether antitrust law should be more welcoming of distressed M&A.

An Economic Environment Ripe for Distressed M&A

Unlike prior significant economic downturns, which were primarily caused by financial market dislocations or systemic economic issues, the current downturn is driven by cratering consumer demand, first stemming from stay-at-home orders and continuing due to social distancing guidelines and a general fear of exposure to the virus.

U.S. gross domestic product for the second quarter of 2020 plummeted 32.9% on an annualized basis — the worst plunge in economic activity in history — with a large portion of that decline attributable to a sharp contraction in personal consumption.[1]

A near-term significant rebound of the broader U.S. economy seems unlikely given the uncertainty of continued or renewed federal stimuli both for businesses and individuals, consumer caution, state and local government spending cuts, and the enduring spread of the virus.[2]

While there have been some economic bright spots, the crisis has been disastrous for many sectors of the economy, notably energy, retail, travel, leisure and hospitality. The wrath of

the virus has been felt by businesses large and small. National retailers and consumer-facing businesses including Hertz Corp., CEC Entertainment Inc., Brooks Brothers Group Inc. and GNC Holdings Inc. have all filed for bankruptcy protection, and hundreds of thousands of small businesses across the country have either temporarily or permanently closed.

The U.S. House of Representatives' Small Business Committee reported that 110,000 small businesses permanently closed by mid-summer, with an estimated 7.5 million additional small businesses that could be headed down the same path.[3]

The distress that many businesses face will likely force them to pursue one of two options: (1) seek an acquirer to keep them afloat or (2) sink and exit the market. Strategic acquirers with the strongest balance sheets may look to consolidate as a defensive strategy, while businesses that face a lengthy recovery may look to divestitures or to private equity, special purpose acquisition company or other white knights acquirers for survival, whether through or as an alternative to a Chapter 11 bankruptcy process.

Antitrust Review of Failing or Flailing Firm Acquisitions

Section 7 of the Clayton Antitrust Act prohibits mergers and acquisitions that may substantially lessen competition. A merger between two of only a few strong competitors may harm consumers by depriving them of choice and the benefits of a competitive rivalry to win the hearts, minds and wallets of customers.

What happens when the hearts, minds and wallets go away? Is it better to let firms go under, potentially causing permanent economic damage, or call the game and let the struggling firm live to fight another day, albeit in altered form? A knockout might make great headlines, but referees call the match when necessary. Antitrust laws do the same. The failing and flailing firm defenses are designed to permit strong, competitive businesses to acquire failing firms rather than let those assets be torn asunder and scattered to the wind.[4]

However, these defenses are notoriously difficult to invoke.[5] Under the merger guidelines, the failing firm defense places the burden squarely on the merging parties to show that the failing firm:

- Would be unable to meet its financial obligations in the near future;
- Would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Code; and
- Has made unsuccessful good-faith efforts to elicit reasonable alternative offers.[6]

In addition, the agencies consider whether there might be a less problematic acquirer. This effectively means that the merging parties must often establish that the acquiring company is the only available purchaser.[7]

Satisfying these standards is extremely rare. Prior to the pandemic, antitrust enforcers appear to have expressly approved only two transactions based on the failing firm defense in the last several decades.[8]

Faced with daunting odds, merging parties had to get creative. If the target is not imminently failing, parties may argue that the trajectory of the business and the marketplace will surely lead it there. So why not let a strong acquirer nurse the bloodied competitor back to health?

In the 1987 U.S. v. General Dynamics Corp. case, the U.S. Supreme Court accepted this argument, giving rise to the so-called flailing firm defense.[9] That case involved a merger among coal mines, both with fairly high market shares. One of the mines was nearly depleted: its future production would not match its historical production, and so it was evident its current strength was no indication of its lack of future competitiveness.

The Supreme Court held that future competitiveness is what matters, and if a firm is not likely to impose a competitive constraint in the future, then a merger could not substantially lessen competition.

The flailing firm defense is also hard to satisfy, but it is no unicorn. Its most prominent success story may be familiar. Before the Boeing Co.-Airbus SE rivalry, there was the Boeing-McDonnell Douglas rivalry. Boeing won. While McDonnell Douglas was still building planes, it was reeling from the competition and lacked the resources to continue funding the long-term research and development costs required to develop commercial planes. Boeing seized the opportunity, declaring a merger was necessary to the make the industry strong. The Federal Trade Commission agreed.

The failing and flailing firm defenses operate as a rebuttal to a prima facie case of harm to competition based on market shares or other evidence. Courts have identified a variety of conditions that might constitute such a rebuttal, including: lack of resources required for long-term competition, financial difficulties that prevent improvement of the firm's competitive position, or poor brand image or sales performance.[10]

But many courts have deemed the flailing firm defense among the weakest of rebuttal evidence, often requiring a showing that the acquired firm's weakness (1) cannot be resolved by any competitive means and (2) would cause the firm's market share to drop to a level that would undermine a prima facie case.[11] Still, the defense is credited in the rare case,[12] including in recent blockbuster merger challenges delivered just before the outbreak of COVID-19.

Asserting the Failing Firm Defense in a Time of COVID-19: Don't Forget the Pre- and Post-COVID-19 World

As they did during the 2008 economic downturn, the agencies, at the outset of the pandemic, warned against any perception that a failing or flailing firm defense might fall on more receptive ears. The FTC said that parties should "think twice before making apocalyptic predictions of imminent failure during a merger investigation" and that the agency "will not relax the stringent conditions that define a genuinely 'failing' firm."[13]

After months of broad shutdowns, the FTC may be changing its tune. In an interview in July, Ian Conner, director of the FTC's Bureau of Competition, said:

We may be more receptive to [the failing firm defense] from the standpoint when you say

we're in dire financial straits because we've been closed for three months, we've seen drop-off in revenues. … What we think is different is that now we are looking even more diligently at [buyers' and sellers'] current financial state and their debt because of this crisis. Those are questions that we would have asked before. It's just now with Covid, there's concern with debt financing and viability that are directly resulting from the Covid crisis.

Similarly, Makan Delrahim, assistant attorney general for the U.S. Department of Justice's Antitrust Division, acknowledged that some transactions may be very necessary now to ensure continued viability of businesses.

More recently, Deputy Assistant Director of the FTC Bureau of Competition Kelly Signs said that "the idea of failing is not the same as bankruptcy or being unable to pay the bills," adding that failing means "without the merger the company would be liquidated and its assets would be sold outside the market." This may be an attempt to moderate expectations with respect to the defense and a sign that the agency sees this as a big issue on the horizon.

While the wave of failing firm transactions has yet to hit, it is likely only a matter of time. On May 1, the defense notched its first success in the time of COVID. The DOJ allowed Prairie Farms Dairy Inc. to acquire certain milk processing plants from Dean Foods Co., which had filed for bankruptcy in November 2019.

Absent the transaction, Dean Foods was otherwise likely to shut the plants down. Delrahim explained in a statement: "This is a tumultuous time for the dairy industry, with the two largest fluid milk processors …in bankruptcy ,and a pandemic causing demand for milk by schools and restaurants to collapse."[14]

The upshot? Firms should not discount the failing or flailing firm defenses just because they might be difficult. They work in the right transactions and with the right facts. Still, the agencies are likely to view crying COVID-19 as crying wolf.

A successful failing firm defense requires more than an assertion that the pandemic hurt. Almost everyone could make that argument. The winning record for the failing firm defense will include documented evidence of a sustained weakening financial condition, along with evidence of a robust effort to avail other alternatives such as bankruptcy reorganization or sale to alternative less problematic buyers.

COVID-19-related hardships should be just part of the story — the final nail in the failing firm's coffin, or the circumstance that weakened an already struggling firm past the point of future viability.

Merger analyses are, at their core, efforts to predict the future based on evidence of the past. The endeavor is by nature imbued with a certain amount of uncertainty, and transformative world events like the COVID-19 pandemic only increase that uncertainty. It can no longer be simply assumed that past performance will continue into the future along a similar trajectory. The longer the upheaval continues, the more evidence of firms' performance in the era of COVID-19 there will be.

Even if enforcers and courts are not fully convinced that the standing rules should be loosened, meeting the requirements of those rules will be available to a vastly wider range of firms than ever before. This could give rise to failing industry arguments, where firms' future success is not based solely on their own financial wherewithal, but also on the rapidly changing marketplace. Airline travel, for instance, may see a long-term decline and

contraction that does not require the capacity of an industry structured for pre-COVID-19 levels of travel.

These kinds of arguments played out in the FTC's bid to prevent a joint venture combining seven coal mines in Wyoming and Colorado. While disclaiming reliance on a failing firm defense, the companies' defense included testimony that the coal industry as a whole faced unnavigable headwinds, requiring consolidation.[15] The FTC responded that antitrust law "provides no exception for anticompetitive transactions in declining markets."[16]

In a surprise move, Attorney General William Barr publicly second-guessed the FTC's challenge to the coal merger, stating in an interview that the suit is an example of "regulators … addressing the problems of yesteryear rather than keeping up with current market trends."[17] Ultimately, the U.S. District Court for the Eastern District of Missouri, while stating it "certainly does take note of all of those circumstances," nonetheless held that it

cannot conclude … that the JV's likely benefits — which are not insubstantial, including significant efficiencies for Defendants and some mitigation of the decline of Arch and other entities in the Wyoming coal industry — will outweigh the potential harm to consumers form the lost competition.[18]

Coal may be a long-declining industry, but what about devastated industries? Industries that would otherwise have continued absent a global pandemic? There, the viability of any competition may depend on broad acquisition strategies.

For example, AMC Entertainment Holdings Inc. recently sought to modify its 2016 merger settlement with the DOJ to allow it to reacquire 10 theaters it had divested in its acquisition of Carmike Cinemas Inc. Its argument: allowing it to repurchase the theaters — which previously had presented a competition issue to the DOJ — would now serve the public interest by "providing the opportunity for theatrical exhibition to continue" when most companies were closing theaters.[19]

The DOJ did not oppose, and the court granted the relief, noting "the COVID-19 pandemic has caused extreme economic hardship in the movie theater industry, and the proposed amendments are necessary to ameliorate additional harm to the industry."[20]

Further examples may be legion. Key to any failing or flailing firm defense will be strong and detailed economic evidence, not only with respect to the firms that are party to the transaction, but with respect to the industry more broadly. This will require careful planning and thought to best position such transactions before the agency and make the available antitrust defenses obvious, compelling and inevitable.

Should dealmakers be more aggressive in entering the brave new world and putting forth transactions that the agency may have rebutted six months ago? Can they be? Yes, if the facts support it. Given current economic trajectories, in more cases than many might expect, the facts may support even the narrowest reading of the failing and flailing firm defenses.

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[1] See Jeff Cox, Second-quarter GDP plunged by worst-evet 32.9% Amid Virus-Induced Shutdown, CNBC.com (July 30, 2020), available at https://www.cnbc.com/2020/07/30/us-gdp-q2-2020-first-reading.html.

[2] See Julia Carpenter, Americans Are Saving More, but How Long Can It Last?, Wall Street J. (June 4, 2020), available at https://www.wsj.com/articles/americans-are-saving-more-but-how-long-can-it-last-11591272180.

[3] https://smallbusiness.house.gov/news/documentsingle.aspx?DocumentID=3369.

[4] United States v. Greater Buffalo Press, Inc., 402 U.S. 549,555 (1971) (to successfully assert the defense, defendants have the burden of showing that the resources of the acquired company were so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure, and that there was no other prospective purchaser).

[5] See United States v. EnergySolutions, Inc., No. 16-cv-01056 (D. Del. July 12, 2017), ECF No. 235 (The failing company doctrine cannot be applied in a merger or in any other case unless it is established that the company that acquires the failing company or brings it under dominion is the only available purchaser).

[6] Horizontal Merger Guidelines §11.

[7] See U.S. v. EnergySolutions, Inc., et al., 16-cv-01056, ECF No. 235 (D. Del. July 12, 2017) ("The failing company doctrine plainly cannot be applied in a merger or in any other case unless it is established that the company that acquires the failing company or brings it under dominion is the only available purchaser.") (quoting Citizen Pub. Co. v. United States, 394 U.S. 131, 139 (1969)).

[8] In Scott & White Healthcare / King's Daughters Hospital (FTC File No. 091-0084), the FTC closed its investigation of Scott & White Healthcare's acquisition of King's Daughters Hospital in Temple, Texas, recognizing that the "poor, and deteriorating, financial condition of King's Daughters likely would have caused the hospital to close at some point in the future if it was not acquired by another hospital or health system." A critical component of that result was the fact that there did not appear to be any other viable bidder. See Statement of Bureau of Competition Director Richard Feinstein on the FTC's Closure of Its Investigation of Consummated Hospital Merger in Temple, Texas; http://www.ftc.gov/os/closings/091223scottwhitestmt.pdf; see also, In the Matter of CentraCare Health System (FTC File No. 161-0096). In CentraCare, the FTC approved CentraCare's proposed merger with St. Cloud Medical Group ("SCMG") with conditions based on the fact that SCMG was failing financially. See Order to Suspend Enforcement of Non-Competes, https://www.ftc.gov/system/files/documents/cases/170109centracaresuspendor

der.pdf.

[9] United States v. Gen. Dynamics Corp., 415 U.S. 486 (1974).

[10] E.g., Gen. Dynamics, 415 U.S. at 501-04 (while coal company had been and was "highly profitable and efficient," its lack of and inability to acquire scarce coal reserves limited its future ability to compete); FTC v. Nat'l Tea Co., 603 F.2d 694, 699-700 (8th Cir. 1979) (crediting evidence a company had "an extremely poor image among customers" and five years of "los[ing] substantial amounts of money"); United States. v. Int'l Harvester Co., 564 F.2d 769, 774-76 (7th Cir. 1977) (discussing "precarious" financial condition of company); FTC v. Arch Coal, Inc., 329 F. Supp. 2d 109, 155-57 (D.D.C. 2004) (finding coal company with currently viable means would become "less and less of an active competitor" given its financial difficulties).

[11] See ProMedica Health Sys., Inc. v. FTC, 749 F.3d 559, 572 (6th Cir. 2014).

[12] See United States v. Baker Hughes Inc., 908 F.2d 981, 984 (D.C. Cir. 1990) (collecting cases).

[13] On "Failing" Firms — and Miraculous Recoveries, https://www.ftc.gov/news-events/blogs/competition-matters/2020/05/failing-firms-miraculous-recoveries.

[14] https://www.justice.gov/opa/pr/justice-department-requires-divestitures-dean-foods-sells-fluid-milk-processing-plants-dfa.

[15] FTC v. Arch Coal, Inc., No. 4:20-cv-00317-SEP (E.D. Mo. Sept. 29, 2020), ECF. No. 441.

[16] Commissioner Rohit Chopra echoed this sentiment in an August 5, 2020 statement noting that while "52 percent of small business believe that they are likely to fail due to the effects of COVID-19," he would support FTC action to prevent "mergers that scoop up scores of small businesses," such as roll-up acquisition strategies. https://www.ftc.gov/system/files/documents/public_statements/1578967/chopra_statement_on_oversight_of_the_ftc_hearing.pdf.

[17] https://trib.com/news/state-and-regional/attorney-general-says-he-will-look-into-stalled-wyoming-coal-venture/article_3b20f273-5d9c-5908-92da-ab2d89619f4a.html.

[18] FTC v. Arch Coal, Inc., No. 4:20-cv-00317-SEP (E.D. Mo. Sept. 29, 2020), ECF. No. 441.

[19] United States v. Carmike Cinemas, Inc., No. 16-cv-02475-RDM (Aug. 27, 2020 D.D.C.), ECF No. 16.

[20] United States v. Carmike Cinemas, Inc., No. 16-cv-02475-RDM (August 28, 2020 D.D.C.), Minute Order.