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Summary

The failing firm defence is well-established under the US Horizontal Merger Guidelines and judicatory of the US Supreme Court. This defence is applicable to the mergers that create or strengthen the dominant position of the firms on the market and therefore do not violate the competition law. Those mergers also generate efficiency gains and social benefits.

In order to apply the failing firm defence, the following requirements have to be fulfilled: the failing firm would be unable to meet its financial obligations in the near future, it would not be able to reorganise successfully under Chapter 11 of the Bankruptcy Act, there is an alternative purchaser that would pose less severe danger to competition and in the absence of the acquisition, the assets of the failing firm would exit the relevant market.

Under the US approach, the appraisal whether the proposed merger would significantly increase concentration and result in a concentrated market and whether the merger, in the light of concentration, raises concern about possible harmful competitive effect, is based on the substantial lessening of competition test and the Herfindahl-Hirschman Index. Thus, the effect of this merger within the relevant market must be examined.

The EU law concerning mergers does not contain *explicite* reference to the failing firm defence as a foundation for approval of a merger that would create or strengthen a dominant position. Despite the lack of the statutory provision governing the failing firm defence, the Commission in its decisions and the ECJ in its case-law have developed the concept of the failing firm defence also known as the rescue merger.

The *sine qua non* conditions for the application of the failing firm defence under EU *acquis communitaire* are as follow: the undertaking to be acquired must be failing, the market share of the acquired undertaking would, in any event, be taken over by the acquiring undertaking, there is no less anti-competitive alternative buyer.

Nowadays, there is an ongoing reform of the EU merger law. The failing firm defence constitutes an integral part of the proposed draft notice on the appraisal of the horizontal mergers and is one of the factors taking into account while scrutinising the horizontal mergers. The reform includes also the HHI Index and the SLC test for the assessment of the merger.

Abbreviations

BASF	BASF Aktiengesellschaft
DAC	Douglas Aircraft Company
DOJ	Department of Justice
EC	European Community
ECJ	European Court of Justice
EMC	Enterprise Minière et Chimique
FTC	Federal Trade Commission
HHI	Herfindahl-Hirschman Index
MDC	McDonnell Douglas Corporation
MdK	Mitteldeutsche Kali AG
OJ	Official Journal
SCPA	Société Commerciale des Potasses et de l'Azote
SLC	Substantial lessening of competition test

1 Introduction

The concentration with the Community dimension, which creates or strengthens a position as a result of which effective competition in the common market or in a substantial part of it is significantly impeded, is to be declared, in principle, incompatible with the common market. A merger that would be blocked due to its harmful effect on competition is allowed when the acquired firm is a failing firm under the failing firm defence.

The failing firm defence, also known as the failing firm doctrine or the rescue merger, is well-established in the US case-law concerning horizontal mergers and included in US Horizontal Merger Guidelines. Under EU law, neither the Merger Regulation nor any other provision concerning mergers contains *explicite* reference to the failing firm defence as a foundation for approval for a merger that would create or strengthen a dominant position, thereby distort competition.

The European Commission discussed the concept of the failing firm defence at length in two cases: *Kali and Salz* and *BASF/Eurodiol/Pantochim*. The European Court of Justice confirmed the application of this defence in the case of *French Republic v Commission*.

1.1 Purpose

The purpose of this thesis is to investigate how the failing firm defence is defined, how it applies to the horizontal mergers under EU law, why, so far, the concept of it has been applied rarely and whether the failing firm defence will constitute a part of EU merger legislation after the reforms – so called modernisation of the EU Merger Regulation. The thesis deals with the following questions of importance:

What is the failing firm defence?

What are the conditions *sine qua non* for applying the failing firm defence?

When is the firm failing?

The 1st of May 2004 is the historical date when the Community will enlarge with ten countries from Central and Eastern Europe, but also is the date when the reform package of EU merger law comes into force. In the proposed draft notice on the appraisal of horizontal mergers the failing firm defence is included as one of the factors taken into account while appraising the merger. The questions arise whether the Community “dimension” of the failing firm defence will be originated as “a whole” from the US antitrust legislation or the failing firm defence will be based on the own Community concept.

1.2 Method

The method used in order to achieve the purpose of this thesis is a descriptive and analytical judicial method. For locating the relevant sources, the traditional library searching has been used. Due to the limited sources concerning the failing firm defence and litigated court cases relevant for the aforementioned purpose, *Westlaw* database and on-line search were of the great importance. Nevertheless, the EU web site and *Celex* constituted the support for achieving the purpose

In order to present the necessary economic considerations of the failing firm defence, the relevant opinions of well-known specialists have been quoted and expressed. Nevertheless, the thesis primarily focuses on decisions and judgements while obtaining the required facts.

1.3 Delimitation

The interesting meetings with Anders Forkman from Vinge have given the inspiration for the subject of this thesis.

In order to understand the concept and definition of the failing firm defence, the US approach concerning this defence and American *modus operandi* of the application need to be scrutinised.

The failing firm defence is rather new and at the stage of development within the merger aspects under EU law, therefore it was hard to find essays and reports concerning this subject. The thesis has been written from the competition law perspective dealing only with horizontal mergers. In addition to horizontal mergers relevant economic aspects of the failing firm defence have been used as supporting argumentation.

This thesis focuses mainly on horizontal mergers as one concept, and does not investigate every area of this concept separately. The aforementioned areas, like R&D, JV and Full Function JV, were left aside by choice, due to the fact that splitting up the concept would make the thesis too wide-ranging.

1.4 Disposition

This thesis consists of three parts: theoretical, practical and analysing. Before focusing on the concept of the failing firm defence, the background information is required in order to give the reader a better starting point. Thereafter, the US approach concerning the failing firm defence is presented. The economic analysis of the failing firm defence with four scenarios is also introduced. Then, the failing firm defence is discussed from the EU law perspective. Finally, the case concerning a merger with the

failing firm defence argument, notified to the US Federal Trade Commission and the European Commission is analysed. The thesis is completed with author's own analysis and concluding remarks.

2 Failing firm defence - US approach

"For it ought to obey him by whom it is preserved; because preservation of life being the end, for which one man becomes subject to another, every man is supposed to promise obedience, to him, in whose power it is to save, or destroy him"

(Thomas Hobbes¹)

Failing firm defence is a way of protecting the weak – failing firms by allowing them fall under the *dominium* of the powerful companies.

Mergers creating or strengthening the dominant positions of the undertakings on the market are illegal in accordance with the competition law in most developed countries. A merger that would be blocked due to its adverse effect on competition is permitted when the firm to be acquired is a failing firm and less detrimental merger is unavailable. Blocking the merger will cause the loss of jobs and assets from the market and will cease the possible economic and social benefits. Therefore, the merger with the failing firm leading to high concentration may be accepted under the failing firm defence.

2.1 Background of the failing firm defence

The failing firm defence was created by the case law rather than by statute. The Supreme Court first recognised this defence in 1930 in the leading case *International Shoe Co. v Federal Trade Commission*². The Court allowed the merger of two the largest shoe manufactures, one of which was facing grave financial difficulties. The Court also stated:

"In the light of the case thus disclosed of a corporation with resources so depleted and the prospect of the 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, we hold that the purchase of its capital stock by a competitor (there being no other prospective purchaser), not with a purpose to lessen competition, but to facilitate the accumulated business of the purchaser and with the effect of mitigating seriously injurious consequences otherwise probable, 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".³

This judgement has laid down the cornerstone for the failing company defence. Nevertheless, the Court did not say it was creating the "defence". It aimed at a broad analysis of the competitive and the anti-competitive effect of the acquisition of the company on the edge of the bankruptcy.

¹ Hobbes, T., *Leviathan* [1651], Cambridge University Press, 1996, p. 140

² 280 U.S. 291 (1930)

³ *Ibidem* § 6

The principle was developed further in the *Citizen Publishing Co.* case, where the Supreme Court set out the conditions under which the defence would be accepted. Finally, in the case of *General Dynamics* the possibility of the failing firm defence was justified on the ground that one of the firms is at least in a position of financial weakness.

The legislative history of revision of the Clayton Act by the Celler-Kefauver Act of 1950 eliminated any doubts concerning the validity of the failing firm defence. The *International Shoe* case was the base for the abovementioned amendment. Although, it is difficult to determine the precise basis for the congressional acceptance of the failing firm defence, the House and Senate Judiciary Committees reports unequivocally endorsed the defence. The Supreme Court subsequently reaffirmed the validity of the defence in the case law. Thus, the failing firm defence constitutes an integral part of the US merger law.⁴

2.2 What is the failing firm defence?

Section 7 of the Clayton Act provides:

"No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create monopoly".⁵

This section constitutes the principal provision governing the mergers. It prohibits any kind of business activities that may substantially lessen competition. Under the wording of this section, it is not necessary to prove that the competition has been restrained. It is enough that it "may" tend to substantially lessening of competition. Therefore the competitive effect of mergers is of a great importance and has to be scrutinised. The only exemption for the violation of the Section 7 is the failing firm defence.

The Department of Justice and Federal Trade Commission US 1992 Horizontal Merger Guidelines identify the conditions *sine qua non* of the failing firm defence. It states as follow:

- “ 1) The allegedly failing firm would be unable to meet its financial obligations in the near future,
- 2) it would not be able to recognise successfully under Chapter 11 of the Bankruptcy Act⁶,

⁴ Campbell, T. J., *The efficiency of the failing company defence*, 63 Texas Law Review, 1984, p. 254

⁵ 15 U.S.C.A. § 18

⁶ 11 U.S.C. §§ 1101-1174 (1988)

- 3) it has made 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, and
- 4) absent the acquisition, the assets of the failing firm would exit the relevant market"⁷

A merger is not deemed to create or enhance market power or facilitate its exercise if imminent failure of one of the merging firms would cause the assets of that firm to exit the relevant market. The rejection of the proposed merger when the target is failing might lead to the liquidation of the productive assets. In the absence of the benefits such as avoiding exit cost or social benefits, this kind of mergers should not be allowed if it increases the market power.⁸

2.2.1 The requirement of failure

In order to invoke the failing firm defence, the failing company should be genuinely failing. This means that the company must be insolvent, on the verge of insolvency, or in imminent danger of financial collapse. The Courts have applied this requirement very strictly. The factors that the company's hopes for recovery are dim or non-existent have to be proved. The failing company should not receive a significant share of the gains from merger - if it does, this is the indication that the firm is not failing.⁹

The failing firm defence might also be applied when only a part of the company is failing. Refusal of such defence would force the parent company either to end a subsidiary or to keep it going at a loss.¹⁰

This requirement was widely discussed by the Supreme Court in the case of *International Shoe Co. v Federal Trade Commission*.

2.2.1.1 *International Shoe Co. v Federal Trade Commission*¹¹

International Shoe Company - the manufacturer of shoes, acquired all of the capital stock of the W. H. McElwain Company, which also made shoes. Both companies were engaged in commerce and in competition with each other. International Shoe Co. owned and controlled the McElwain Co. According to the FTC the effect of such acquisition was to substantially lessen competition between the two companies, to restrain commerce in the shoe business and to tend to create monopoly.

The Supreme Court did not consider the FTC arguments. The Court stated that there never was substantial competition between the two companies and

⁷ 1992 Horizontal Merger Guidelines § 5.1

⁸ Mason, R., Weeds, H., *The Failing Firm Defence: Merger Policy and Entry*, 2003, p.1

⁹ *Supra* note 4, p.255

¹⁰ *Ibidem*

¹¹ 280 U.S. 291 (1930)

therefore no foundation for the charge of substantial lessening of competition can be found. At the time of acquisition the financial condition of the McElwain Company was such as to necessitate liquidation or sale, thus the prospect for future competition or restraint was entirely eliminated.

The Court also upheld that acquired company was faced with financial ruin and that the only alternative presented was liquidation. The company had reached the point where it could no longer pay its debts as they became due. In this case the requirement of failure of the failing firm defence was defined. In order to rely on this defence the failing firm must face the grave probability of a business failure and the recovery to the normal condition must be in gravest doubt.

2.2.2 No possibility of reorganisation

The company, if allowed to fail, can act in accordance with Chapter 11 of the Bankruptcy Act and still be present in the market. The reorganisation process is not costless and shareholders and creditors suffer losses. The companies can be reorganised and fail, closing the capacity and liquidating the assets. Thus, causing the competitive loss based on the output measure and loss of jobs.¹²

Hence, the second element of the failing firm defence requires the firm to prove that "it would not be able to reorganise successfully".¹³ This ensures that the firm does not only have the short-term difficulties, but is also not viable in the long-term.

2.2.3 The alternative purchaser

In order to accept the failing firm defence argument there must be no other prospective purchaser. In other words, this condition refers to an alternative buyer that would pose less severe danger to competition. Furthermore, this buyer must make a reasonable offer. This offer is defined as "any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets - the highest valued use outside the relevant market or equivalent offer to purchase the stock of the failing firm - will be regarded as a reasonable alternative offer"¹⁴. Thus, the alternative buyer needs only offer more than the liquidation value and be able to keep the assets operating in the markets, even though the alternative purchaser may have less to offer in the way of improving the efficiency of the failing firm than the prospective competitor purchaser.¹⁵

¹² Correia, E. O., *Re-examining the Failing Company Defence*, 64 *Antitrust Law Journal* 1996, p. 691-692

¹³ *Supra* note 7, § 5.1 (2)

¹⁴ *Ibidem*

¹⁵ Persson, L., *The Auctioning of a Failing Firm*, The Research Institute of Industrial Economics, 1998, p. 9

The question arises why the competitor is willing to pay substantially more than the out-of-market firm. An acquiring competitor's offer is higher due to the fact that it includes a market power premium - a payment for expected increase in the market power. The reason for purchasing an unprofitable firm is the possibility of profits from increased concentration through oligopolistic interdependence. By making an unprofitable company a good investment, the acquiring company believes that it can reduce its costs and/or improve product lines.¹⁶

The lack of an alternative purchaser must be established by good faith efforts to find another purchaser. It is required that the failing firm has made a good faith effort to obtain offers from other firms that would keep the failing firm on the market while making a less serious threat to competition. Thus, the failing firm must explore the alternative merger possibilities and seek out the *bona fide* offers.¹⁷

The Supreme Court interpretation of the alternative buyer condition was presented in the case of *Citizen Publishing Co. v. United States*.

2.2.3.1 *Citizen Publishing Company v United States*¹⁸

In Tucson, Arizona there were only two daily newspaper, the Star and the Citizen. The Citizen was the oldest, an evening paper published six times a week. The Star, slightly younger than the Citizen, had a Sunday as well as a daily issue. Prior to 1940 the two newspapers competed with each other. While their circulation was about equal, the Star was more profitable selling 50 % more advertising space than Citizen sustaining the losses. In 1936 Small and Johnson purchased the stock of the Citizen. Small increased his investment in the Citizen and was prepared to finance the Citizen's losses from his own resources.

It did not appear that Small and Johnson sought to sell the Citizen, nor the newspaper was about to go out of business. Nevertheless, the owners negotiated a joint operating agreement between the two newspapers for the period of 25 years from March 1940 that was extended in 1953 until 1990. By its terms the agreement may be terminated only by mutual consent of the parties.

The agreement provided, amongst others, for the formation of Tucson Newspapers, Inc. owned in equal shares by the Star and the Citizen. The purpose of that agreement was to cease any business or commercial competition between the two newspapers and three types of control were imposed - the price fixing, profit pooling and a market control. It was agreed that neither the Star nor the Citizen nor any of their stockholders and

¹⁶ *Supra* note 12, p. 694-695

¹⁷ *Supra* note 4, p. 256

¹⁸ 394 U.S. 131 (1969)

executives would engage in any other business in conflict with the agreement. Therefore competing publishing operations were foreclosed.

The only real defence of the appellants was the failing firm defence. The Court rejected this argument and set up the strict conditions under which the defence would be accepted:

"the failing [firm] doctrine plainly can not be applied in a merger or in any other case unless it is established that the company that acquires the failing firm or brings it under dominion is the only available purchaser. For if another person or group could be interested, a unit in the competitive system would be preserved and not lost to monopoly power".

The Court also stated that even under the assumption that in 1940 the owners of the Citizen could not long keep the enterprise in business, no effort was made to sell the newspaper. Its properties and franchise were not put in the hands of broker and the record is silent what the market, if any, for the Citizen might have been.

The Court added that the burden of proving that the conditions of the failing firm defence have been satisfied is on those who seek protection under it. That burden has not been satisfied in this case.

In the *Citizen Publishing Co.* case the only available purchaser requirement of the failing firm defence was defined. The failing firm defence can not be applied in a merger or in any other case as a defence to antitrust violation charge unless it is established that company, which acquires allegedly the failing firm, is the only available buyer.

2.2.4 Increased concentration v loss of assets

The possibility of merger as an alternative to failure of one of the merging firms indicates a trade-off between two consequences - loss of assets from the market and increased concentration. Thereby two scenarios: allowing the merger to proceed and blocking the merger need to be considered.

The first scenario is of a great importance if the costs of the merger are balanced against the costs of blocking this merger, where there is a probability that the failing firm will survive and remain competitive. If blocking the merger really means that the failing firm's assets will exit the market and therefore the output of this firm will be lost, the allowance of the merger seems to be the only good solution.¹⁹

Looking from the economical perspective, the capacity is a good predictor of output and lost output is a good measure of the competitive harm. In the case of a merger increasing concentration, it is very unlikely that the output will be reduced through the interdependence. More than output is reduced if

¹⁹ *Supra* note 12, p. 690

the acquired firm's assets exit the market thus the merger is the preferred possibility.²⁰

2.2.5 The "weak competitor claim"

The claim that the firm to be acquired is a weak competitor is made in order to show that the merger is less troubling than the combined market shares. The "weak competitor claim" was defined in the case of *United States v General Dynamics Corp.*²¹. The Court upheld that the recent market shares of the acquired firm overstated its long-term market shares since its non-renewable assets were relatively low to other competitors. No claim was made that the merger would strengthen the acquired firm. The only stated claim was that the future combined market shares would be smaller than the current combined market shares.²²

A "weak competitor claim" can be made in the circumstances that are difficult to evaluate. In case of *United States v International Harvester Co.*²³ the acquired company's "weak competitor claim" arose from its difficulty in borrowing the capital. The fact that the failing firm had recently made a small profit did not influence the finding of the Court that its weak financial condition placed the firm at a competitive disadvantage with competitors.²⁴

Nevertheless, a "weak competitor claim" does not circumvent the requirement of the alternative purchaser.

2.3 The evaluation of mergers

"Determination of the relevant market is a necessary predicate to a finding of a violation of the Clayton Act because ... substantiality can be determined only in terms of the market affected".²⁵

Under the Horizontal Merger Guidelines the assessment whether the planned merger would significantly increase concentration and result in a concentrated market and whether the merger, in the light of concentration, raises concern about potential harmful competitive effect, is based on the substantial lessening of competition test (SLC). Therefore the effect of mergers within a relevant market must be appraised.

²⁰ Ibidem

²¹ 415 U.S. 486 (1974)

²² Ibidem

²³ 564 F. 2d 769 (7th Cir. 1977)

²⁴ Ibidem

²⁵ *Brown Shoe Co. v United States*, 370 U.S. 294, 324 (1962); *United States v E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 593 (1957)

2.3.1 The relevant market definition

Section 7 of the Clayton Act is violated only by any activities that may substantially lessen competition "in any line of commerce"- the product market and "in any section of the country" - the geographic market. Thus, the relevant market has to be established and the effect of the merger within this market examined.²⁶

Market definition focuses on demand substitution factors, i.e. possible consumer responses and supply substitution factors - i. e. possible production responses. A relevant market is defined as a product or group of product - product market and a geographic area the product is produced or sold - geographic market.²⁷

2.3.1.1 The product market

The relevant product market will be defined with respect to each of the products of each of the merging firms. Under the Horizontal Merger Guidelines the market can be defined by looking at the ability of a hypothetical monopolist to impose at least a "small but significant and nontransitory" increase in price. If a price increase across a specified group of products would not be profitable due to the fact that enough numbers of consumers would switch to other products outside the group, then the specific group does not constitute the product market. In other words, if the price increase across a specified products group would be profitable for the hypothetical monopolist, the group constitutes the product market.²⁸

In case *Brown Shoe Co. v United States*²⁹ the Court recognised demand substitution as the leading basis for the product market definition. The reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it determine the outer boundaries of a product market.³⁰ Products that are "reasonably interchangeable by consumers for the same purposes" are in the same market.

Within this broad market, well-defined submarkets may exist, which constitute product markets for antitrust purposes. The boundaries of such a submarket may be determined by examining such practical factors as industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialised sellers. Therefore it is necessary to examine the effects of a

²⁶ Blumenthal, W., *Merger analysis under the U.S. antitrust law*, Practising Law Institute, 1997, p.359

²⁷ *Supra* note 7, § 1.0

²⁸ *Ibidem* § 1.11; *Supra* note 26, p. 360

²⁹ 370 U.S. 294 (1962)

³⁰ *Ibidem*, p. 325

merger in each such economically significant submarket to determine whether there is a reasonable probability that the merger will substantially lessen competition.³¹

2.3.1.1.1 Demand substitution

Demand substitution is measured by the cross-elasticity test that compares the change in the quantity demanded of one product given a price change of another product. If a price change of one product causes a large change in the demand of another product, the two products have a high cross-elasticity of demand and are treated as being in the same product market.³²

2.3.1.1.2 Supply substitution

Although demand substitution is a fundamental consideration while defining the product market, there is ongoing debate whether supply substitution should also be a defining factor.

According to one legal scholar the relevant product market should be defined by reference to both supply-side and demand-side criteria. Looking from the DOJ and the FTC perspective, the relevant market should be defined solely by reference to demand-side criteria, but taking into consideration supply substitution while identifying the market participants and measuring the market. Finally, the market should be defined solely by reference to demand substitution.³³

These three approaches can lead to substantial differences in measured market concentration. However, in case of *Brown Shoe* the Court stated that "cross-elasticity of production facilities may also be an important factor in defining a product market"³⁴

2.3.1.2 The geographic market

The geographic market in which the merging firms produce or sell will be determined. In defining this market a given geographic area for a specific group of products will be considered. Under the Elzinga-Hogarty test the geographic market is measured by determining the inflows of products - where the consumed product within the area are produced - and the outflows of products - where products produced within the area are consumed. A geographic market is properly defined when little of the specified group of products flows in or out of the specified geographic area.³⁵

³¹ *Ibidem*

³² *Supra* note 26, p. 360

³³ *Horizontal Mergers: Law and Policy*, ABA Antitrust Section, Monograph No 12, 1986, p. 110-116

³⁴ *Supra* note 29

³⁵ *Supra* note 26, p. 360

A geographic market can also be defined as a group of products and corresponding geographic area within which prices tend towards equality. The evidence that products or geographic markets are in the same market is close price relationships.³⁶

According to the Horizontal Merger Guidelines, the geographic market constitutes a region in which a hypothetical monopolist would profitably impose at least a "small but significant and nontransitory" increase in price.

2.3.2 Market shares and concentration

Market shares will be calculated for all firms identified as market participants. This calculation is based on the total sales or capacity currently devoted to the relevant market together with that which likely would be devoted to the relevant market in response to a "small but significant and nontransitory" price increase. Market shares will be calculated using the best indicator of firm's future competitive significance and can be expressed in dollar terms through measurement of sales, shipments or production, or in physical terms through measurement of sales, shipments, production, capacity or reserves.³⁷

While the market participants and market shares have been determined, market concentration need to be measured in order to appraise whether a merger leads to a substantial lessening of competition.

Market concentration is a function of the number of firms in a market and their respective market shares. The Herfindahl-Hirschman Index is used for the calculation of market concentration. The HHI is calculated by summing the squares of the individual market shares of all the participants³⁸. Thus, a market with only one participant (a pure monopoly) will have the HHI of 10 000 while a market with ten equal participants will have the HHI of 1 000. Under the Guideline the market, after the merger, can be distinguished as unconcentrated – the HHI below 1000, moderately concentrated - between 1000 and 1800, and highly concentrated – the HHI above 1800.³⁹

In the evaluation of a horizontal merger the post-merger concentration and the increase in concentration resulting from the merger have to be taken into account. The general standards for horizontal mergers are as follow:

- a) Post-merger HHI below 1 000 - the market in this region is considered as unconcentrated and does not require further analysis of competitive effects.

³⁶ Ibidem

³⁷ *Supra* note 7, § 1.4.1

³⁸ For instant, the market consists of four firms with market shares of 20%, 20%, 25%, 30%. The HHI is 2325 ($20^2 + 20^2 + 25^2 + 30^2 = 2325$).

³⁹ *Supra* note 7, § 1.5

- b) Post-merger HHI between 1000 and 1800 - the market in this region is regarded as moderately concentrated. The mergers causing the increase in the HHI of 100 points or more raise significant competitive concerns, requiring further analysis.
- c) Post-merger HHI above 1800 - the market is regarded as highly concentrated and an increase of 50 points gives significant competitive concerns. The merger producing an increase in HHI of more than 100 points is considered to create or enhance market power or facilitate its exercise.⁴⁰

The post-merger level of market concentration and the change in concentration resulting from a merger affect the degree to which the merger raises competitive concerns. The increase in concentration as measured by the HHI can be calculated independently of the overall market concentration by doubling the product of the market shares of merging firms. For instance, the merger of firms with shares of 5 % and 10 % of the market would increase the HHI by 100 ($5 \times 10 \times 2$). Due to the calculation of the HHI before the merger, the market shares of the merging firms are squared individually: $(a)^2 + (b)^2$. After the merger, the sum of those shares would be squared: $(a + b)^2$, which equals $a^2 + 2ab + b^2$. Therefore, the increase of the HHI is represented by $2ab$.

The market concentration measures are helpful in the assessment of the extent of likely competitive effect from a unilateral price increase by the merged firm notwithstanding the fact that the affected products are differentiated. If the threshold of combined market share of the merging firm is at least 35 per cent, the competition authorities presume that a significant share of sale in the market are accounted for by the consumers who regard the products of the merging firms as their first and second choice. In other words, if the threshold is at least 35 per cent, there is presumption of the adverse competitive effect of the merger and that the merger would adversely affect the consumers.⁴¹

2.3.3 The analysis of entry

A merger does not create or enhance market power or does not facilitate its exercise if entry into the market is so easy that market participants, after the merger, could not profitably maintain the price increase above pre-merger level. If the market entry passes the test of timeliness, likelihood and sufficiency, the merger raises no antitrust concern and does not require further analysis.⁴²

⁴⁰ *Ibidem*, § 1.5.1

⁴¹ *Supra* note 7, § 2.2.1.1

⁴² *Supra* note 7, § 3

The committed entry is defined as a new competition that requires significant sunk costs⁴³ of entry and exit. The competition authorities apply a three-step test in order to appraise whether committed entry would deter or counteract a competitive effect of concern.

The first step assesses whether entry can achieve significant market impact within a timely period of two years from initial planning of this impact. If significant market impact would require a longer period, entry will not deter or counteract the competitive effect of concern. The second step appraises whether committed entry would be profitable at pre-merger prices and if such prices could be secured by the entrant. If so, the committed entry is likely. The third step assesses whether timely and likely entry would be sufficient to return market prices to their pre-merger levels.⁴⁴

2.4 The auction of the failing firm

Under the failing firm defence, the allocation of the failing firm's assets is dependent on the firms' bids and is sold at the auction. The less severe danger to competition conditions need to be taken into account. The Federal Trade Commission and Department of Justice require that there must be no alternative buyer who might cause less harm to competition.

Hence, the failing firm defence can be interpreted as an auction where the firms post bids and the competition authority decides who obtains the assets, given the posted bids. The winning buyer pays an amount equal to his bid. The price has to be above the liquidation value and regarded as a reasonable alternative offer. The collection of bids is secret. Thus, the buyers do not seem to know each other's bids while bidding and the bids are assumed to be made simultaneously.⁴⁵

2.5 Application to particular industries

The failing firm defence is applicable to the banking sector, brewing beer industry, food processing, manufacturing, oil refining, publishing sector, hospitals and other industries.

The failing company defence in the banking sector was mentioned in the case of *United States v Philadelphia National Bank*.⁴⁶ The case involved a horizontal merger of commercial banks in the Philadelphia metropolitan area. The Supreme Court upheld that the failing company doctrine applied to the banking sector due to the greater public impact of a bank failure

⁴³ In economics, a sunk cost is a cost that has already been incurred and therefore can not be avoided by any strategy going forward.

⁴⁴ *Supra* note 7, § 3

⁴⁵ *Supra* note 15, p. 9

⁴⁶ 374 U.S. 321 (1963)

compared with ordinary business failure. The doctrine was successful in a bank merger in the case of *Granader v Public Bank*.⁴⁷

In the brewing beer industry the failing firm defence was applicable under the condition that all requirements are fulfilled. The defence was invoked in several cases, *inter alia* in the case of *United States v Pabst Brewing Co.*⁴⁸. The Court rejected the Pabst's failing company defence due to the fact that the party failed to prove the elements of this defence.⁴⁹

In the food processing industry the failing firm doctrine argument was successfully applied in the *United States v Maryland & Virginia Milk Producers Asso.*⁵⁰ case, in which an agricultural co-operative association, having almost 2 000 dairy farmers as its members, acquired the capital stock of two dairies - Richfield and Wakefield. At the time of the acquisition, Richfield was out of business, but owned and controlled the stock of a corporation, which controlled the Wakefield Dairy. Both companies were deeply in debts and gravely insolvent. The Wakefield Dairy was on the edge of bankruptcy. The Court stated that the acquisition of the capital stock or assets of a failing firm did not fall under the prohibition of Section 7 of the Clayton Act since the acquisition of a failing corporation, which is on the verge of going out of business, can not result in lessening competition or in creating a monopoly.⁵¹

The failing firm doctrine was first applied in the abovementioned case *International Shoe Co. v FTC* in the manufacturing sector. In the case of *United States v Pennzoil Co.*⁵² the failing firm defence argumentation was invoked in oil refining industry.

The failing firm doctrine can be applied in every sector under the condition that the party will prove the *sine qua non* requirements.

⁴⁷ Ludington, J. P. "Failing Company" Defence to action for violation of § 7 of Clayton Act, 11 American Law Reports 858, 1972, p. 12

⁴⁸ 296 F Supp 994 (1969)

⁴⁹ Ludington, p. 13

⁵⁰ 167 F Supp 799 (1958)

⁵¹ *Ibidem*

⁵² 252 F Supp 962 (1965)

3 Economic analysis of the Failing Firm Defence

A failing firm can exit from the market either by liquidation of its assets or by commencing operations in a different market. The another possibility for the failing company is selling out to another firm in its present market. If the acquisition would violate the antitrust provisions under normal circumstances, the failing firm defence is relevant. The defence would legitimise the acquisition. In order to evaluate the failing firm defence, it is necessary to compare the economic effect of exiting the market, the result in the absence of the defence, with the economic effect of acquisition by a dominant firm.⁵³

In case where the dominant firm exhibits market power then it produces fewer goods at a higher price than a similar firm in a competitive market. Allowing the dominant firm to increase its market shares and the total capacity of the industry by acquiring the failing firm will result in less total output and a higher price than in case when the acquired firm was an independent competitor.⁵⁴

On the other hand, the consequences of letting a firm exit the market and the industry need to be considered. When the failing firm disappears from the market, the employment resources of this firm, in the best case, are devoted to manufacture a completely different product or provide totally different services. This solution causes an economic loss due to the fact that the resources have less value both to the consumers and to the firm in their new use than they had in their former use.⁵⁵

Nevertheless, looking from the economic standpoint, mergers have the potential to create significant efficiencies by permitting a better usage of existing assets, allowing to achieve lower production cost of given quantity and quality than each of the firm could have achieved without the merger. This constitutes so-called the efficiency defence.

3.1 Efficiency of mergers with failing firm

The efficiency defence in US antitrust law is an "argument available for parties to a merger seeking the clearance of their transaction notwithstanding the fact that the merger may create a significant increase of concentration in the relevant market, by demonstrating that the merger will

⁵³ *Supra* note 4, p. 257

⁵⁴ *Ibidem*

⁵⁵ *Ibidem*

generate efficiency".⁵⁶ Thus, if a merger facilitates cost-saving and confers market power to the resulting firm, then the cost-saving is beneficial and the market power can lead to a price increase. Those mergers where the efficiency exceeds the inefficiency should be allowed and those that impose greater cost than benefits should be prohibited. If it can be shown that all mergers with a failing firm create efficiency, then these mergers should be allowed.⁵⁷

Under the Horizontal Merger Guidelines the merging firms are obliged to prove that the merger is the only method in order to obtain the efficiency and that this efficiency will benefit the consumer. This efficiency defence is used in order to balance pro-competitive and anti-competitive effects of merger. Cognisable efficiency is compared with three potential anti-competitive effects of a merger: the increase in concentration, potential anti-competitive effects and the likelihood of a new entry in the market. The greater anti-competitive risk the greater efficiency required.⁵⁸

3.1.1 Analysis of the efficiency of a merger with a failing firm

"Acquisition of a failing firm is always efficient"⁵⁹

According to Professor McChesney⁶⁰, the merger with the failing firm always generates efficiency. This argument will be analysed through the following scenarios.

Scenario 1: failing firm exits the market due to the merger is blocked

The exit of the failing firm makes the prior change in the market, e.g. higher costs of production or a decrease in demand. In this scenario, there are no welfare implication, but it can not be suggested that there are never any welfare losses. First, the assets of the failing firm have to be sold off, separately, if possible and this may not be their best use. Furthermore, any technical or productive achievements of the failing firm will be lost. Hence, acquisition may be welfare enhancing. There will be effects for those firms in the market that have to adjust to meet an increase in demand as a result of which production costs and prices will rise. Therefore, allowing the firm to fail risks imposing the kind of costs which competition law seeks to minimise. These will not be present if the firm is failing due to the natural

⁵⁶ Noel, P., *Efficiency Consideration in the Assessment of Horizontal Mergers under European Law and US Antitrust Law*, 8 European Competition Law Review 1997, p. 498

⁵⁷ Monti, G, Rousseva E, *Failing Firms in the Framework of the E.C. Merger Control Regulation*, 24 European Law Review, 1999, p. 43

⁵⁸ *Ibidem*, p. 44

⁵⁹ McChesney, F. S., *Defending the Failing Firm Defence*, 65 Nebraska Law Review 1986, p. 1

⁶⁰ Fred S. McChesney is a Professor of Law at Northwestern University, and Professor in the Department of Management and Strategy in the Kellogg School of Management, specializing at law and economics.

selection and the firm is the least competitive in a shrinking market. In case of the failure of firm caused by managerial incompetence or an external condition specific to it, the possibility of welfare losses materialises. A merger seems to be the solution preventing them.

Scenario 2: failing firm is acquired by monopolist

In this situation, the monopolist merely obtains added capacity, but does not gain in market power because the acquisition with the failing firm is not the cause of the monopoly. A merger between a monopolist and a failing firm does not change the (non-) competitive structure or performance of the industry. For a firm to be a monopolist there must be barriers to entry and there is probably no alternative buyer. The monopolist is already able to exploit the market power and the only interest that the monopolist has in acquisition of the failing firm will be to lower the production costs and thereby lowering the price and the consumers benefit.

Scenario 3: failing firm is acquired by dominant firm

The acquisition in this case does not increase dominance significantly because acquiring the assets does not mean attracting consumers. The dominant firm will obtain new customers whether or not it acquires the assets of a failing firm. The increase of market shares and the realignments in demand are caused by the exit of the failing firm, not by its acquisition.⁶¹

According to Campbell⁶² the marginal cost⁶³ of production is likely to decrease as a result of the acquisition, allowing an increase in supply and lowering the prices and thereby generating a larger economic surplus than would the existence of the failing firm. This is due to the fact that the acquiring firm will obtain the assets that allow an increase in productivity and may obtain know-how, which enhances its competitive position. Thus, the "merger option" is economically superior to the "exit option".⁶⁴

Scenario 4: non-dominant firm acquires failing firm and thereby becomes dominant

According to Professor McChesney this scenario is not realistic due to the fact that it is constructed by confusing cause and effect. The effect - dominance - will occur even without the acquisition of the failing firm by the realignment of the market. An acquisition of assets only affects the cost

⁶¹ *Supra* note 56, p. 1-3

⁶² Thomas J. Campbell is an Associate Professor of Law at Stanford University. J.D. 1976, Harvard University; Ph.D. 1980, University of Chicago

⁶³ Marginal cost is the incremental increase in cost due to the production of one more unit. For instance, if the production of 50 units costs \$100, but to produce 51 units costs only \$101, then the marginal cost is \$1. Neville, J, *Antitrust Legalines*, Harcourt Brace Legal and Professional Publication, INC., 5th ed., 1998, p. 4

⁶⁴ *Supra* note 4, p. 258-263

of production not the market shares. Due to the fact that acquisition lowers the costs of production, the merger is economically efficient.⁶⁵

Nevertheless, the market can be different without the merger from the way the market would look after the merger. Thus, a merger affecting the cost of production can create market power. Therefore, the analysis of the trade-off between an increase in productive capacity and the likelihood of anti-competitive behaviour seems to be necessary if the merger increases market power. However, according to Professor Williamson⁶⁶ "a merger, which yields non-trivial real economies must produce substantial market power and result in relatively large price increase for the net allocative effects to be negative", but the costs and benefits need to be calculated.⁶⁷

If one firm is already more powerful than another, there is a high probability that the former market power will increase once the failing firm exits the market and the strongest firm will tend to obtain more consumers. Thus, the difference between allowing the merger or blocking it from the perspective of trying to prevent a dominant position, is not that great. The merged firm will gain but not so much that it would gain without the merger. Thus, a consideration of the possible social benefits that the merger can create needs to be taken into account.⁶⁸

3.2 Public policy interest

The US Supreme Court in the case *United States v General Dynamics Corp.*⁶⁹ upheld that three groups of private parties benefit from the merger of a failing firm: shareholders, creditors and employees.

The shareholders will not lose the investment and will gain in case where the merger is profitable. The creditors will benefit because they will retain their rights against the debtor and will be paid back. Whereas in insolvency proceeding they would hardly be completely reimbursed. Employees also benefit because skilled and trained staff is attractive for the merged firm, especially where the failing firm has know-how or is active in a field of highly developed technology. The exit of the failing firm also affects the community where the firm operates, destroying the economic stability of the locality.⁷⁰

⁶⁵ *Supra* note 56, p. 16

⁶⁶ Oliver E. Williamson is Edgar F. Kaiser Professor of Business Administration, of Economics and of Law, University of California, Berkley. O.E. Williamson was Special Economic Assistant to the Head of the Antitrust Division of the U.S. Department of Justice in 1966-67

⁶⁷ *Supra* note 4, p. 49

⁶⁸ *Ibidem*

⁶⁹ *Supra* note 21

⁷⁰ *Supra* note 4, p. 51

The economic and/or social benefits, if present, should be of a great legal relevance while challenging the merger and should be expressed in a merger decision. The scope and application of the failing firm defence under US antitrust regime aid to make more understandable the importance of non-competitive factors.

According to Posner⁷¹ the failing firm defence is "one of the clearest examples in antitrust law of a desire to subordinate competition to other values"⁷². The merger with the failing firm is allowed only under the condition that the result of it offers some benefits to the consumer. Thus, the social policy benefits have to be appraised in line with the competition objectives. The social policy consideration works alongside the competition interests.

The relevant public policy consideration constitutes the protection of private parties whose future depend on the existence of the failing firm as well as the general welfare of the region where the industry is situated. Public policy interest together with the impact of the merger on competition makes the possibility of the assessment of the overall value of the failing firm through the merger.

⁷¹ Richard Posner is Senior Lecturer of law at University of Chicago Law School, Professor of Law, was an assistant to the Federal Trade Commission, assistant to the solicitor general of the United States, in 1981 appointed as a judge of the U.S. Court of Appeals for the Seventh Circuit. He was the chief judge of the court from 1993 to 2000.

⁷² Posner, R. A, *Antitrust: cases, economic notes and other materials*, West Publishing, 2nd ed., 1981, p. 472

4 Failing firm defence from the EU law perspective

Under the EU law, neither Article 2 of the Merger Regulation⁷³ nor any other provision of the Community legislation concerning mergers contain *explicite* reference to the "failing firm defence" as a base for approval of a merger (concentration⁷⁴) that would create or strengthen a dominant position. According to the Regulation the European Commission is entitled to examine all mergers and acquisitions with a Community dimension from the standpoint of their effect on the structure of competition.

In order to appraise the impact of a merger on the structure of competition, the Commission will take into account *inter alia* the following factors: the need to maintain and develop effective competition within the common market in view of the structure of all the markets concerned and the actual or potential competition, the market position of the merging undertakings and their economic and financial power, demand and supply trends for the relevant goods and services, barriers to entry and the buying power and interest of the consumers.⁷⁵

Despite the lack of statutory provision governing the failing firm defence, the Commission in its decisions and the ECJ in its case-law have developed the concept of the failing firm defence known as the rescue merger.

4.1 The concept of the rescue merger

Article 2 (3) of the Merger Regulation provides:

"A concentration [merger] which creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared incompatible with the common market".

A merger must be prohibited if it results in the creation of a dominant position or the strengthening of pre-existing dominance. Thus, there must be a causal link between the merger and the creation or strengthening of dominance.

The concept of the rescue merger, also referred to as the failing firm defence, enables the Commission to clear a merger even though a dominant position is created or strengthened in its aftermath, provided that there is no causal link between the merger and the dominant position. In other words,

⁷³ Council Regulation EEC No 4064/89 of 21 December 1989 on the control of concentrations between undertakings, OJ L 395, 30.12.1989

⁷⁴ Concentration defined in accordance with Article 3 of the Merger Regulation

⁷⁵ Article 2 (1) of the Merger Regulation

the merger does not lead to a deterioration of the competitive structure of the market.⁷⁶

The concept and the condition of the rescue merger have been discussed at length in the Commission's decision in case of *Kali and Salz/Mitteldeutsche Kali AG (MdK)/Treuhand*⁷⁷.

4.1.1 Kali and Salz/MdK/Treuhand case

The case concerned the joint venture between Kali and Salz and Treuhand and the concentration of the rock-salt and potash activities of Kali and Salz, a subsidiary of the German chemical company BASF and MdK, a State-owned company of the former German Democratic Republic. After the unification of German Republic, the MdK's shares have been transferred to the Treuhand, an institution incorporated under public law, responsible for restructuring and privatisation of the former German Democratic Republic state-owned undertakings and for making them competitive. This specific concentration would occur by means of the transfer of the activities to a new company jointly controlled by Kali and Salz and the Treuhand.⁷⁸

The German market for potash used for agricultural purposes was affected by the concentration. The pre-existing dominant position of Kali and Salz on the German market would be strengthened by the acquisition of the other competitor on the market – MdK. High barriers to entry, including local demand for a specific type of potash that was only produced in Germany, the long-established links between German suppliers and German agricultural co-operatives, lower transport costs and logistic advantages from the proximity of the German mines to the main distributor points made that the new entry was effectively unlikely.⁷⁹

The abovementioned concentration would create a monopoly on the market. On the other hand looking from MdK standpoint, the economic situation of this undertaking was critical and the firm was on the verge of bankruptcy without the future possibility of survival. Hence, MdK was a failing firm and the Commission in its appraisal of the notified proposal of merger examined whether the requirements of the failing firm defence were met.

4.1.1.1 The requirements of the rescue merger

⁷⁶ *Glossary of terms used in EU competition policy, Antitrust and control of concentration*, Directorate-General for Competition, Brussels, July 2002, p. 40

⁷⁷ Commission decision of 14 December 1993 No IV/M.302, OJ L 186, 21.07.1994

⁷⁸ The report of the Organisation for Economic Co-operation and Development, *Failing Firm Defence*, OCDE/GD (96)23, Paris 1996, p. 92

⁷⁹ *Ibidem*, *Supra* note 77

The parties have argued that without the merger MdK would soon be forced out of the market and the market shares of it becoming available would be obtained by Kali and Salz. The Commission stated that a merger which should normally be considered to lead to the creation or reinforcement of a dominant position on the part of the acquiring firm can be regarded as not causing such position on the market if, even in the event of merger being prohibited, the following requirements are met:

- 1) the undertaking to be acquired must be failing, in other words this undertaking would in the near future be forced out of the market if not taken over by another undertaking,
- 2) the market share of the acquired undertaking would, in any event, be taken over by the acquiring undertaking, or its assets would inevitably exit the market if not taken over by another undertaking,
- 3) there is no less anti-competitive alternative buyer.⁸⁰

4.1.1.1.1 MdK as a failing firm requirement

In the Commission's view, the lack of causality means that the failing company would disappear from the market and this would be unavoidable even if the concentration has been prohibited. The concentration itself does not create or strengthen the dominant position. Finally, the burden of proof for a missing link of causality is upon the merging undertakings.⁸¹

In this case, MdK was a failing firm of the public sector, held by Treuhand, which had covered all its losses. The Commission considered that even in case where the Treuhand would continue to provide financial aid in the future, MdK was not competitive and constituted a failing firm. The continuation of financial support by the Treuhand without the realistic perspective for re-organisation would be contrary to the EU State aid rules thereby contrary to the EC Treaty. It was also likely that MdK on a stand-alone basis would continue to make losses, even if it were given the same amount of financial support for restructuring by the Treuhand that was made available for the proposed concentration. Therefore without the acquisition by the private party, MdK would withdraw from the market.⁸²

4.1.1.1.2 The market share requirement

Due to the fact that the structural factors of the German potash market has isolated it from competitors from other countries, Kali and Salz could increase its potash production without any further expenditure and become the sole supplier on the German market and would obtain the market shares of MdK if MdK had to withdraw from the market.⁸³

4.1.1.1.3 The requirement of alternative purchaser

⁸⁰ *Supra* note 77, p. 24-25

⁸¹ *Ibidem*

⁸² *Supra* note 78, p. 92, *supra* note 77, p. 26

⁸³ *Supra* note 77, p. 27

As a part of the process of privatisation of MdK, Goldman Sachs International Limited has been responsible for tender's procedure and inviting tenders. As a result, 48 firms were approached and 19 of them expressed an interest but the intensive talks were held with only three interested parties: Kali and Salz, Potash Corporation of Saskatchewan and French group Enterprise Minière et Chimique (EMC). Nevertheless, Goldman Sachs did not succeed in obtaining an offer from any other firm than Kali and Salz. The undertakings that at the beginning of the privatisation process declared a certain interest in acquiring MdK or the part of it distanced themselves from further negotiations. None of these companies was prepared to acquire MdK concerning its present conditions, even with the substantial financial aid from the Treuhand.⁸⁴

According to the Commission, this negative response was objectively justified by a number of factors, i. e. the operating structure of MdK, the existence of over-capacities, the generally depressed state of the potash market and the absence of significant synergies as a result of the acquisition. Only Kali and Salz's geographical location and product variety made such synergies possible. Concerning the circumstances, the Commission was of the opinion that "there was a sufficient evidence to suggest that an acquisition of all or substantial part of MdK by any undertaking other than Kali and Salz can be ruled out. In view of the results of the first privatisation procedure and the Commission's findings in the course of the merger, the possibility that, in the event of a further call for offers, there might be a serious alternative buyer with a viable business plan appears to be practically excluded".⁸⁵

According to the Commission's considerations concerning the concept and the application of the rescue merger, the causality link needs to be born in mind. A merger leading to the creation or reinforcement of a dominant position can be allowed under the condition that it would cause the least possible damage to competition. In other words, any alternative partial disposal of the company, which would reduce the deterioration of the competitive structure, must as a rule be carried out if the rest of the merger is to be accepted under the merger law.

4.1.1.1.4 Additional factors

The abovementioned requirements constitute conditions *sine qua non* for the application of the failing firm defence under EU law. Other factors like employment, regional development, technical progress, are not relevant while appraising the conditions for the application of the rescue merger, nevertheless these factors are the general criteria for assessing dominance.

⁸⁴ *Supra* note 77, p. 28

⁸⁵ *Ibidem*, p. 29-30

According to Recital 13 of the Merger Regulation⁸⁶ the Commission must take into account the objective of strengthening the Community's economic and social cohesion while appraising the merger. In the Kali and Salz/MdK/Treuhand decision, after application of the concept of the rescue merger, the Commission stated that the severe structural weakness of the region in East Germany was affected by the merger and the likelihood of serious consequences of the exit of market by MdK would also be in accordance with the objective mentioned in Recital 13. Nevertheless, these considerations constitute additional factors while appraising the scope and application of the failing firm defence.⁸⁷

In the Kali and Salz/MdK/Treuhand decision, the Commission declared the acquisition of the failing firm and proposed concentration compatible with the common market. However, this decision has been appealed by the French Government and Société Commerciale des Potasses et de l'Azote (SCPA), subsidiary of EMC and by EMC in case *French Republic v Commission*⁸⁸.

4.2 The ECJ interpretation of the failing firm defence

The French Government, SCPA and EMC applied for the annulment of the Commission's decision to the ECJ on the grounds that it is incompatible with the common market, the way the Commission examined the merger in highly concentrated markets, that the Merger Regulation has been applied incorrectly and also the concept of the failing company defence was used incorrectly.

The Commission concluded that the new entity Kali and Salz/MdK and their competitor – the French state – owned company SCPA would enjoy a collective dominant position in the market for potash products in all Community countries except from Germany that was considered as a separate geographic market. There would be no effective competition between them due to their long-standing commercial links.⁸⁹

⁸⁶ *Supra* note 73, Recital 13: whereas it is necessary to establish whether concentrations with a Community dimension are compatible or not with the common market from the point of view of the need to preserve and develop effective competition in the common market, whereas, in so doing, the Commission must place its appraisal within the general framework of the achievement of the fundamental objectives referred to in Article 2 of the Treaty, including that strengthening Community's economic and social cohesion, referred to in Article 130a

⁸⁷ *Supra* note 78, p. 93

⁸⁸ Joined cases C-68/94 and C-30/95; [1998] ECR I-1375

⁸⁹ Ysewyn J, Caffarra C., *Two's company, Three's a crowd: the future of collective dominance after the Kali & Salz judgement*, 19 European Competition Law Review, 1998, p. 468

The French Government stated that the Commission had wrongly applied the failing firm defence, without taking into account all the requirements used in US antitrust law. Whereas only a full application of US conditions ensures that the derogation mechanism is established and the application of it does not have the effect of aggravating a competitive situation already in decline. Additionally, the French Government submitted that the Commission did not show that the adopted criteria concerning the undertaking's elimination from the market and the absence of a less anti – competitive alternative were satisfied in this case.⁹⁰

Finally, the French Government considered that the Commission did not show that there was no other way of conducting the acquisition, which was less harmful to competition.⁹¹

The Commission stated that in the contested decision did not adopt the American failing firm defence in its entirety. Nevertheless, it is hard to see how that could have affected the lawfulness of Commission's decision. Moreover, the Commission considered that it had shown to the necessary legal standard that the conditions for the application of the failing firm defence were indeed satisfied in the present case.⁹²

The ECJ confirmed that the failing firm defence is relevant for the assessment of whether the concentration is compatible with the common market. The conditions regarding the scope and application of the failing firm defence, set by the Commission for the conclusion that there was no causal link between the concentration and the deterioration of the competitive structure did not entirely coincide with the requirements of the failing firm defence under US antitrust law and this did not in itself constitute the ground of invalidity of the contested decision.⁹³

According to the Court, the Commission proved that “MdK was highly likely to close down in the near future if not taken over by a private undertaking” and the failing firm defence was applied correctly. Whereas, the absence of a causal link between the concentration and the deterioration of the competitive structure of the German market had not been “effectively called into question”. Therefore the concentration was compatible with the common market and satisfied the criteria referred to in Article 2 (2) of the Merger Regulation.⁹⁴

The approach taken by the Court of Justice is wider than the conditions set out in Commission's Kali and Salz decision. In the Court's view, the merger can be regarded as a rescue merger if “the competitive structure resulting

⁹⁰ *Supra* note 88, §92, 95

⁹¹ *Ibidem*

⁹² *Ibidem*, §100-101

⁹³ Venit, J. S., *Two steps forward and no step back: economic analysis and oligopolistic dominance after Kali & Salz*, 5 *Common Market Law Review*, 1998, p. 1107; *Supra* note 88, §112

⁹⁴ *Supra* note 88, §120-124

from the concentration would deteriorate in a similar fashion even if the concentration did not proceed”⁹⁵. In other words, even if the concentration is prohibited. The concept of the rescue merger second time was applied in the Commission’s decision concerning BASF/Eurodiol and Pantochim case.⁹⁶

4.3 The failing firm defence in BASF /Eurodiol /Pantochim case

In the present case, the Commission received the notification concerning a proposed concentration by which the undertaking BASF Aktiengesellschaft (BASF) would acquire control of Pantochim SA, Eurodiol SA and Provirofital NV by assets purchase from SISAS – Italian – based company.⁹⁷ The Commission’s investigation concentrated on the merger’s impact on the chemical market for BDO – related products. Although BASF – the post – merger firm would have the market share of 45 percent, the Commission accepted the concentration on the ground that acquiring companies were in financial difficulties and in accordance with the failing firm defence the merger would have less harmful impact on the market than if the undertakings exited the market.⁹⁸

4.3.1 Eurodiol and Pantochim – failing undertakings

In order to invoke the failing firm defence, the burden of proof is for the parties to present that all *sine qua non* requirements are met. BASF stated that Eurodiol and Pantochim would have been forced out of the market if they had not been acquired. These companies were on the verge of bankruptcy like their parent company SISAS, subject to a pre-bankruptcy regime under the Belgian law and administrated by four Court Commissioners (*Commissaires au sursis*). During the observation period under this pre – bankruptcy regime, the Court of Commerce ordered the provisional postponement of debts. In other words, the rights of the creditors were preliminarily suspended. Due to the lack of liquidity and the great amount of the companies’ debts the restructuring plan was not proposed. The Court of Commerce confirmed that both undertakings would have to be declared bankrupt if a buyer for them were not approved.

⁹⁵ *Supra* note 88, §115

⁹⁶ The decision of the Commission of 11 July 2001 No COMP/M.2314, the case of BASF/Eurodiol/Pantochim, OJ L 132, 17.05.2002

⁹⁷ The business activities of undertaking concerned: BASF – production, distribution and sale of chemicals, health and nutrition products, oil and gas; Pantochim: production of phthalic anhydride (PA), maleic anhydride (MA), fumaric acid (FA), butanediol (BDO), BDO derivatives and biodiesel; Eurodiol: production of butanediol (BDO), BDO derivatives and maleic anhydride (MA); Provirofital: production of phthalates.

⁹⁸ *Commission clears BASF’s take over of Eurodiol and Pantochim*, Commission Press Room, DN: IP/01/984, 11.07.2001, www.europa.eu.int/rapid/start/cgi, 31.01.2003

Therefore, once BASF terminated the financial support, Eurodiol and Pantochim would have inevitably exited the market.⁹⁹

Thus, the first requirement of the application of the rescue merger was proved.

4.3.2 Inevitable exit of the assets from the market

According to BASF, in order to fulfil the second condition of the failing company defence, it is sufficient that only a part of the market shares is accrued to the acquiring company. In accordance with the Commission's approach the establishment whether the acquiring undertaking would take over the market shares of the acquired undertaking once it was forced out of the market constitutes "the most obvious method to prove the concept of the rescue merger could be applied".¹⁰⁰

Looking from the Commission's standpoint, the assets of the failing firm would definitely exit the market in the present case. This would lead to a considerable deterioration of the market and disadvantage of the consumers. Thereby, these factors are equally relevant for the application of the failing firm defence. An immediate take-over of the failing undertakings after bankruptcy by a third party seemed to be unlikely. In the activities of these undertakings not only high costs, but also considerable environmental risk were involved resulting from the sensitive production process. Finally, the availability of the highly qualified workforce was also of a great importance for the operation of chemical activities of these companies. "As parts of the qualified workforce have already left and others will certainly do so after bankruptcy is declared, the incentives for any investor to take up business after the bankruptcy are fairly low".¹⁰¹

On the basis of the abovementioned considerations, it is very likely that the assets of Eurodiol and Pantochim would inevitably exit the market.

4.3.3 No less anti-competitive alternative buyer requirement

In BASF's point of view, there was no alternative buyer for these companies since the Court of Commerce had excluded the restructuring plan as a realistic option. Although, a number of competitors were contacted. After a close look at the business activities of the failing undertakings, including due diligence¹⁰², no other firm apart from BASF was interested in submitting the offer.¹⁰³

⁹⁹ *Supra* note 96, p. 27

¹⁰⁰ *Ibidem*, p. 28

¹⁰¹ *Ibidem*

¹⁰² Due diligence is an essential part of any corporate transaction, its objective is to find out as much information as possible about the target company, in particular what liabilities it may have, and to factor these into the terms of the offer. This investigation will include not only examination of any competition law issues faced by the target, but also the terms on

Nevertheless, in order to exclude any doubts concerning the existence of an alternative buyer, the Commission decided to conduct further inquiry regarding this matter. The South African Company Sasol Chemical Industries, at the beginning, showed the interest in acquiring Eurodiol and Pantochim. However, after the full due diligence procedure, the company decided not to buy these failing firms due to fact that the amount of the financial investment to be needed went beyond the limits of the company's international strategy. Thus, no less anti-competitive alternative buyer was available.¹⁰⁴

The Commission in its decision stated that the exit of assets and the production capacities of the failing companies would cause "a significant capacity shortage for products, which were already offered on the market under very tight capacity constraints". The market condition would be more favourable for the consumers after the merger and the exit of the failing firm from the market would be the worst scenario for them.¹⁰⁵

Concerning the imminent bankruptcy of the failing firms in the absence of the merger, the inevitable exit of the assets to be acquired from the market, combined with tight capacity constraints in the chemical industry and demand in elasticity, the Commission approved the proposed concentration, declaring that the failing firm defence was applicable and the deterioration of the competitive structure resulting from the notified merger would be less significant than in the absence of this merger.

The conditions, the scope and the application of the failing firm defence were set by the Commission in its abovementioned decisions and were confirmed by the Court of Justice. Even the ECJ accepted the use of the failing firm defence under EU law, it seems that legislature provision or interpretative guidelines regarding this matter are of a great importance.

4.4 Horizontal mergers guideline

The Commission has adopted a "Christmas Package" – a proposal to amend EC Merger Regulation and a draft notice on the appraisal of horizontal mergers.¹⁰⁶ The draft contains *inter alia* the conditions and scope for application of the failing firm defence. The questions arise whether the Commission will use current conditions *sine qua non*, established in the Kali and Salz decision and the current test of dominance for assessing the

which the target does business, its strategy, relationships with customers and suppliers and so forth., Tyler, J., *Pre-merger collaboration, The perils of sharing information: "gun jumping" in corporate transaction*, Competition Law Insight, February 2003, p. 9

¹⁰³ *Supra* note 96, p. 28

¹⁰⁴ *Ibidem*

¹⁰⁵ *Ibidem*

¹⁰⁶ Draft Commission notice on the appraisal of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, OJ C 331, 31.12.2002

merger or it is preferable to use US requirements and substantial lessening of competition test. Also to what extent economic efficiency should be taken into account in assessing the costs and the benefits of “problematic” mergers.

The aim of the draft notice on horizontal mergers is to provide the guidance how the Commission makes the appraisal of concentrations where the undertakings concerned are active on the same relevant market or potential competitors on that market and especially if one of them is a failing firm. The guideline also focuses on how the removal of an actual or potential competitor may affect competition in the relevant market.

In order to appraise the impact of the mergers, the Commission will define the relevant product and geographic market as well as scrutinise the competitive effect of the mergers. The main purpose of the market definition is to identify the competitive constraints that the merging firms face and those actual competitors of the undertakings involved that are capable of constraining their behaviour and of preventing them from behaving independently of an effective competitive pressure.¹⁰⁷

4.4.1 The conditions *sine qua non* of failing firm defence

According to the proposed guideline a merger that creates or strengthens a dominant position is declared to be compatible with the common market if one of the undertakings is a failing firm being acquired by another undertaking. The main requirement is that this merger does not cause the deterioration of the competitive structure that follows the merger. In other words, there is no causal link between the concentration and the deterioration of the competitive structure.¹⁰⁸

The Commission in its guideline, in order to declare the abovementioned concentration compatible with the common market under the failing firm defence, sets up the following conditions *sine qua non* relevant for the application of the failing firm defence:

- 1) “the acquired undertaking would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking,
- 2) there is no less anti-competitive alternative purchaser than the notified concentration,
- 3) absent a concentration the assets of the failing firm would inevitably exit the market.¹⁰⁹

Once the conditions for the application of the failing firm defence are fulfilled the merger would not be considered to cause the creation or strengthening of a dominant position as a result of which effective competition would be significantly impeded in the common market. The

¹⁰⁷ Ibidem, p. 2

¹⁰⁸ Ibidem, p. 17

¹⁰⁹ Ibidem

burdens of proof that the requirements of the failing firm defence are fulfilled and that there is no causal link between the merger and the deterioration of the competitive structure is upon the parties.

The Commission in the proposed guideline concerning the appraisal of horizontal mergers legislated the conditions and criteria for the application of failing firm defence that were introduced in its case Kali and Salz and approved by the ECJ. In order to scrutinise the possible anti-competitive effects of horizontal mergers, especially with the failing firm, the Commission introduced the substantial lessening of competition test.

4.4.2 Substantial lessening of competition v. dominance

In assessing the possible anti-competitive effects of the merger, a number of the key factors regarding the markets such as market shares, concentration levels need to be considered. The market shares often provide the first indication of the competitive importance of both the merging firms and their competitors. Nevertheless, the current market shares may be less important if there are indications that the competitive conditions may change in the near future, for instance in the light of exit or entry.¹¹⁰

According to Mario Monti¹¹¹ “the dominance test, if properly interpreted, is capable of dealing with the full range of anti-competitive scenarios that mergers may engender. However, in view to eliminate any *potential* “gap” the Commission is proposing to clarify the current substantial test so as to make clear that the test applies where the merger result in “unilateral effects” in situation of non-collusive oligopoly”.¹¹² Therefore, the substantial lessening of competition test needs to be applied.

The overall concentration in a market also provides useful information regarding the competitive situation in a market. In order to indicate the competitive pressure in the post-merger market, the Commission will apply the Herfindhal-Hirschman Index. The HHI is calculated by summing the squares of the individual market shares of all the firms in the market.¹¹³ The HHI ranges from close to zero to 10 000 (in case of pure monopoly). Although it is desirable to include all firms in the calculation, the lack of information about the small firms is not critical due to the fact that such firms do not affect the HHI significantly. The HHI gives the proportionately

¹¹⁰ Ibidem, p. 3-4

¹¹¹ Prof. Mario Monti is the European Commissioner in charge of Competition Policy and Competition enforcement reforms in the EU,

¹¹² Speech of Mario Monti, *Competition enforcement reforms in the EU: some comments by the Reformer*, given at Georgetown University, Washington, 04.04.2003, DN: SPEECH/03/02, www.europa.eu.int/rapid/start/cgi, 10.05.2003

¹¹³ For instance, the market containing five firms with market shares of 40 %, 20 %, 15 %, 15 % and 10 %, has an HHI of 2550 (40² + 20² + 15² + 15² + 10² = 2550).

greater weight to the market shares of the larger firms in accordance with their relative importance in the competitive process.¹¹⁴

The Commission is unlikely to investigate cases where the post-merger HHI is below 1000. A merger is likely to raise serious doubts if the HHI is of 2000 or more and an increase in the HHI of 150 or more. An increase in concentration measured by the HHI can be calculated by doubling the product of the market shares of the merging firms. For instance, the merger of firms with market shares of 30 % and 15 % of the market would increase the HHI by 900 (30 x 15 x 2). Due to the calculation of the HHI before the merger, the market shares of the merging firms are squared individually: $(a)^2 + (b)^2$. After the merger, the sum of those shares would be squared: $(a + b)^2$, which equals $a^2 + 2ab + b^2$. Therefore, $2ab$ represent the increase of the HHI.¹¹⁵

4.4.3 The analysis of entry

In a dynamic competitive environment the number and identity of firms can vary in response to changing conditions in the market. If the profit level in the industry is high due to the lack of competitive pressure, it can be expected that new undertaking will seek to obtain a part of that profit by entering the market. When entry of the market is easy, the mere treat of potential entry may be sufficient to prevent the merging firms from exercising market power. Thus, any price increase may encourage a new entry.¹¹⁶

In appraising whether a new entry can constitute sufficient competitive constraint on the merging parties, entry must be likely, timely and sufficient in order to prevent the potential anti-competitive effects of the concentration.

As far as the likelihood of a new entry is concerned, the Commission will scrutinise whether there is a high probability that a new entry can be expected after the concentration. The existence of barriers¹¹⁷ to entry into relevant market will be taken into account. When barriers to entry are high the merging undertakings can be expected to exercise their market power and raise the prices.¹¹⁸

In assessing whether a new entry would be timely, the Commission will examine whether this new entry will be sufficiently quick and persistent to prevent the exercise of market power within the timely period. The

¹¹⁴ *Supra* note 106, p. 4,19

¹¹⁵ *Ibidem*, p. 6, 20

¹¹⁶ *Ibidem*, p. 14

¹¹⁷ The existence of barriers to entry to the relevant market – the specific features of the market, which can give incumbent firms a decisive advantage over potential competitors. Barriers can be in form of legal, technical or strategic advantages. *Supra* note 105, p. 15

¹¹⁸ *Supra* note 106, p. 15

appropriate time period should depend on the characteristics of the market and on specific capabilities of potential entrants. Insufficient entry can not deter the anti-competitive effects of the merger.¹¹⁹

4.5 Efficiency considerations

Looking from the economic standpoint, the rescue merger can generate beneficial effects, e. g. economic efficiency and prohibition of this merger would add new detrimental economic and social effects to the merger's effect on competition. Hence, under the draft notice on the appraisal of horizontal mergers, while assessing the merger, especially with the failing firm, the Commission will take into consideration the efficiency claim and the development of technical and economic progress provided that it is for the consumers' benefit and does not constitute an obstacle for competition.

As a consequence of the efficiency claim, the merger does not create or strengthen the dominant position under the condition that a sufficient evidence that the efficiency generated by the merger is likely to enhance the post-merged undertaking to act pro-competitively for the consumers' benefit, by counteracting the effects of merger on competition.¹²⁰

According to Mario Monti, the efficiency defence can mitigate a finding of dominance. The fact that merger creates a more efficient company, does not, *per se*, constitute the reason to consider it as anti-competitive. Nevertheless, the Commission will not take into account the fact that efficiency resulting from a merger is likely to have the effect of reducing or eliminating the competition in the relevant market, for instance by enabling lower prices, as a ground for opposing a proposed concentration.¹²¹

In order to invoke the efficiency claim, the efficiency concerned has to be a direct consequence of the merger. Therefore, the Commission in its appraisal considers established industry practices, the respective capabilities of the merging firms and direct benefit of consumers in the relevant market. The merging firms have the obligation to provide the necessary evidence in order to prove that efficiency will counteract any adverse effects on competitive structure that may otherwise result from the merger. Therefore, the consumers will benefit directly from the efficiency and the concentration.¹²²

¹¹⁹ *Ibidem*, p. 16

¹²⁰ *Ibidem*

¹²¹ Speech by Prof. Mario Monti, *Review of the EU Merger Regulation – Roadmap for the reform project*, given at the Conference on Reform of European Merger Control, British Chamber of Commerce, Brussels, 04.06.2002, DN: SPEECH/02/252
www.europa.eu.int/rapid/start/cgi, 10.05.2003

¹²² *Supra* note 106, p. 17

5 Boeing/McDonnell Douglas case

The Boeing/McDonnell Douglas case illustrates the merger between two US corporations, that has an impact on US antitrust law and the Community dimension, therefore influences the EU competition structure. The parties invoked the failing firm defence in order to have the merger approved by the US Federal Trade Commission and the EU Commission.

5.1 Background

Boeing is a United States corporation whose shares are publicly traded. It operates in two principal areas: commercial aircraft and defence and space. Commercial aircraft operations involve development, production and marketing of commercial jet aircraft and providing related support services to the commercial airline industry worldwide. Defence and space operations involve research, development, production, modification and support of military aircraft and helicopters as well as related systems, space systems and missile systems, rocket engines and information services.¹²³

McDonnell Douglas (MDC) is a US corporation whose shares are publicly traded. The corporation operates in four principal areas: military aircraft, missiles, space and electronic systems, commercial aircraft and financial services. Operations in the first two areas involve the design, development, production and support of the following major products: military transport aircraft, combat aircraft and training systems, commercial and military helicopters and ordnance, missiles, satellites, launching vehicles and space station components and systems, lasers, sensors and command, control, communications and intelligence systems. In the commercial aircraft area MDC designs, develops, produces, modifies and sells commercial jet aircraft and related spare parts. The company is also engaged in aircraft financing and commercial equipment leasing and in the commercial real estate market.¹²⁴

On 14 December 1996, Boeing and McDonnell Douglas entered into agreement by which the corporation would merge and MDC would become a wholly owned subsidiary of Boeing. According to the Federal Trade Commission, in the present case, the relevant market consisted of three competitors: Boeing, McDonnell Douglas and Airbus Industrie. At the pre-merger stage, Boeing held approximately 65 % of global sales, while MDC – 5 % and Airbus 30 %. Therefore, the proposed merger would enhance

¹²³ Commission Decision of 30 July 1997 declaring a concentration compatible with the common market and the functioning of the EEA Agreement, Case No IV/M.877 – Boeing/McDonnell Douglas, OJ L 366, 08.12.1997, p. 1

¹²⁴ Ibidem

Boeing's market shares to 70 % and eliminate one of two competitors, thereby create monopoly.¹²⁵

According to the Commission, the merger between Boeing and McDonnell Douglas constituted a concentration with the Community dimension within the meaning of Article 3 of the Merger Regulation since Boeing aimed at acquiring the control of the whole MDC.

5.2 Failing firm defence argument

According to Boeing, McDonnell Douglas was a failing firm, regarding its civil section – Douglas Aircraft Corporation. Failure of competitive recovery research and development program – MDXX – and threefold fall of its market shares as well as only one obtained contract from the company whose ability to honour its purchasing obligation was uncertain caused the company's weakness. Boeing also claimed that no one would ever buy MDC products again.¹²⁶

Due to the fact that at the time of the merger notification, McDonnell Douglas held of 6 % of the global large civil aircraft orders, this production and revenues from its aircraft servicing operation kept Douglas Aircraft Corporation profitable. This profitability clearly precluded the application of the failing firm defence. None of the requirements *sine qua non* was fulfilled.¹²⁷

According to the Federal Trade Commissioner Mary Azcuenega, “the MDXX cancellation was merely an executive manipulation in order to facilitate approval of the merger”.¹²⁸

5.3 Evaluation of the merger

5.3.1 The Federal Trade Commission evaluation of the merger

The FTC, taking into account the consumer welfare evaluation, approved the merger. In its view, the decision prohibiting the proposed merger could harm important US defence interests. “Divestiture of Douglas Aircraft Company (DAC) would be likely to be unsuccessful in preserving the company as a stand-alone manufacturer of new aircraft, resulting in an

¹²⁵ King, J., *Boeing – McDonnell Douglas revisited: recommendations for a unitary merger defence*, 11 Kansas Law Review 2002, p. 379 – 380

¹²⁶ *Ibidem*, p. 380

¹²⁷ *Ibidem*

¹²⁸ *Ibidem*

inefficient disposition of whatever of company's new aircraft manufacturing operations that potentially could be saved by Boeing".¹²⁹

The Federal Trade Commission upheld that the merger would prevent the loss of jobs in the United States and any divestiture of DAC to a third party that would not operate Douglas Aircraft Company as a manufacturer of a new aircraft would be anti-competitive. As far as US defence interests are concerned, the FTC did not establish that a dominant position has been created or strengthened in the defence sector as a result of the proposed merger.¹³⁰

According to the FTC "McDonnell Douglas no longer constitutes a meaningful competitive force and the acquisition will not substantially lessen competition or tend to create monopoly in the markets for defence and commercial aircraft".¹³¹

5.3.2 The EU Commission evaluation of the merger

The Commission established that concentration of Boeing and McDonnell Douglas had a Community dimension therefore, the proposed acquisition need to be scrutinised in accordance with EU Merger Regulation. In Commission's view, the concentration would affect the product market for large commercial jet aircraft that are sold and operated throughout the world under similar condition of competition. Thus, the geographic market to be taken into account is a world market.¹³²

The proposed concentration would strengthen a dominant position of Boeing in the relevant product market through the addition of McDonnell Douglas competitive potential in large commercial aircraft. It would also cause a large increase in Boeing's overall resources and in its defence and space business, which has a significant spill-over effect on Boeing's position in large commercial aircraft market. The market shares of Boeing in the relevant product market would increase from 64 % to 70 %.¹³³

By acquiring McDonnell Douglas, Boeing would be faced with only one competitor in the relevant market and its capacity in commercial aircraft, particularly the skilled work force, would also be increased. The notified

¹²⁹ *Supra* note 125, p.383 – 386, *Supra* note 123, p. 2

¹³⁰ *Ibidem*

¹³¹ Quoted from Stevens, S., *The increased aggression of the EC Commission in extraterritorial enforcement of the Merger Regulation and its impact on transatlantic co-operation in antitrust*, 29 *Syracuse Journal of International Law and Commerce*, 2002, p. 266-267

¹³² *Supra* note 123, p. 3

¹³³ *Ibidem*, p. 8

merger would also strengthen the ability of Boeing to induce airlines from entering into exclusivity deals¹³⁴, thereby further foreclosing the market.

At this stage of the evaluation, the Commission concluded that Boeing already enjoyed a dominant position on the overall market for large commercial aircraft. The proposed concentration would lead to the strengthening of this dominant position through which effective competition would be significantly impeded in the common market.

In order to obtain the approval of the merger from the Commission, Boeing obliged itself to provide, *inter alia*, the following structural remedy:

for a period of 10 years Boeing will maintain Douglas Aircraft Company in a separate legal entity,
will provide for the Commission a report certified by an independent auditor, which describes its business performance,
Boeing will not withhold or threaten to withhold support for DAC aircraft, including spare parts,
Boeing will not use its privileged access to the existing fleet in service of DAC aircraft, in particular will not provide spare parts and product support on more favourable terms to some DAC operators,
Boeing will not enter into any additional exclusive agreements until 1 August 2007.¹³⁵

In those specific circumstances, and in manifest absence of any possible buyer for DAC, the Commission, taking into consideration the important interests of the United States, accepted the Boeing's obligations and considered that they adequately removed the concerns about a strengthening of Boeing's dominant position in the market for large commercial aircraft. The Commission will monitor the compliance of Boeing's obligations. Thus, proposed concentration will not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or in substantial part of it.¹³⁶

Due to the fact that Boeing failed to prove that the requirements of the failing firm defence are met while notifying the merger to the Federal Trade Commission, the failing firm defence argument was not invoked in the EU Commission's appraisal.

The appraisal of the merger between Boeing and McDonnell Douglas by the FTC and the European Commission was based on the Agreement between the European Communities and the Government of the United States of America regarding the application of their competition law. The Agreement

¹³⁴ Exclusivity deals – are agreements for the supply of large commercial jet aircraft to American Airlines, Delta Airlines and Continental Airlines. The parties agreed on a long-term partnership that will make Boeing the exclusive supplier of jet aircraft.

¹³⁵ *Supra* note 123, p.20

¹³⁶ *Ibidem*, p. 23

and relationship between the FTC and the European Commission seems to be a good subject for the Master thesis.

6 Concluding remarks

The failing firm defence is well-established under US regime and applies in everyday life situation concerning horizontal mergers. Nowadays, the Horizontal Merger Guidelines provide the *sine qua non* conditions of the application of the failing firm defence, which were primarily originated from the case-law of the US Supreme Court.

Mergers creating or strengthening the dominant positions of the undertakings on the market are permitted under the failing firm defence. Nevertheless, in order to invoke the failing firm defence, the failing firm should be genuinely failing. In other words, the firm must be insolvent, on the verge of insolvency or in imminent danger of financial collapse without any possibility for reorganisation. It means that the failing firm must face the grave probability of a business failure and the recovery to the normal condition must be in the gravest doubt. Thereafter, the only alternative buyer causing less severe danger to competition must be established by an auction of the assets of the failing firm. Finally, the merger must be the only option for keeping the failing firm on the market. The impact of the merger on the relevant market and competition is measured by the HHI Index and substantial lessening of competition test.

The failing firm defence is applicable to all industrial sectors, where the horizontal mergers can be conducted, especially where the public interest is involved. However, considering the merger with the failing firm, the economic aspects of this merger and of disapproval of it, like the loss of jobs, benefit to consumers, price maintenance, should also be born in mind.

The EU approach concerning the failing firm defence seems to be similar to the US regime. The defence was applied twice, so far in the *Kali and Salz* and the *BASF/Eurodiol/Pantochim* cases. The conditions of the application of the failing firm defence are alike the US requirements. The failing firm in the near future would be forced out of the market, its market shares would in any event be taken over by acquiring undertaking and the less anti-competitive alternative buyer can not be established. Thus, if there is no causal link between the merger and the deterioration of competitive structure, the merger with the failing firm under the failing firm defence can be accepted.

The ECJ confirmed the conditions and the application of the failing firm defence in the case of *French Republic v Commission*. Nevertheless, the Commission is rather sceptical while concerning the application of the failing firm defence, even though it has been approved by the ECJ. The question arises why the concept of the failing firm defence was applied rarely so far. According to Leo Flynn¹³⁷ from the Legal Service of the

¹³⁷ Email received from Leo Flynn 17.02.2003

Commission, the merger with the failing firm is rather an extreme situation and therefore is not included in the current Merger Regulation.

Nevertheless, under the proposed draft notice on the appraisal of horizontal mergers, the failing firm defence constitutes an integral part and is one of the factors taking into account while examining the horizontal concentration. The reform introduces also the HHI Index and the SLC test for the assessment of the merger. The economic aspects of it will also be considered. One can wonder why the US merger legislation is used as a standard for the EU merger reforms. The main reason is that the current US antitrust legislation seems to work in reality and is verified by the practice in a positive way.

By using the similar instruments for appraising the mergers, the divergences between the assessment of the FTC and the European Commission can be avoided. Good example is the merger between Boeing and McDonnell Douglas, where the decision of the FCT differed from the decision of the Commission and merger under EU competition law was accepted under the condition that Boeing fulfils imposed obligation.

It seems that the failing firm defence is of a greater importance for the EU merger law than it used to be. The new Union, after the enlargement, will bring the new markets where the public policy interest is involved and new possibilities for mergers, especially with the failing firms. However, this can create the situations, where the major and “influential” Western European undertakings or even US companies might like to abuse the failing firm defence in order to achieve the dominance on the market or to become the main competitors. The abuse will also have the spill-over effect on the price stability, company law, labour law, state aid and etc. This will remain the opening of the Pandora box. Therefore the Commission will have to appraise every case with failing firm defence in detailed, due to the fact that the application of the failing firm defence may be used in a different agenda.

Supplement A

Section 7 of the Clayton Act

No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create monopoly.

Supplement B

Article 2 of the EC Merger Regulation

Appraisal of concentration

1. Concentrations within the scope of this Regulation shall be appraised in accordance with the following provisions with a view to establishing whether or not they are compatible with the common market. In making this appraisal, the Commission shall take into account:
 - (a) the need to preserve and develop effective competition within the common market in view of, among other things, the structure of all the markets concerned and the actual or potential competition from undertakings located either within or without the Community;
 - (b) the market position of the undertakings concerned and their economic and financial power, the opportunities available to suppliers and users, their access to supplies or markets, any legal or other barriers to entry, supply and demand trends for the relevant goods and services, the interests of the intermediate and ultimate consumers, and the development of technical and economic progress provided that it is to consumers' advantage and does not form an obstacle to competition.
2. A concentration which does not create or strengthen a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared compatible with the common market.
3. A concentration which creates or strengthens a dominant position as a result of which effective competition would be significantly impeded in the common market or in a substantial part of it shall be declared incompatible with the common market.

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