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Failing firm doctrine an exemption not a rule in Merger Control legislation

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Summary

This paper provides a comparative analysis of the interpretation of the failing firm doctrine (FFD) given by the courts in United States and in Europe. It analyzes some cases founder of the theory and examples of arguments exchanged in the context of its application. Finally, it examines if it has been any adjustment of application of the FFD during the financial crisis period. I start by presenting the U.S. legislation in this field of law and the European counterparts and compare them. I also present the effects and the substantive assessment in both legislations. Then I try to identify possible trends in the application of this theory.

The failing firm doctrine has been firstly enounced 1921 in case International Shoe Co v FTC. The key case in EU is Kali where the Commission has discussed the concept of FFD in depth. The Commission has established that FFD is not the rule but the exception from the rule that horizontal mergers are harmful for the competition. The binding Acts in the field of Merger Control are EU Regulation (EC) No 139/2004 corresponds to chapter 7 of the US Clayton Act- (15 USC § 18).

The question that maybe asked is whether the unilateral effects analysis brings American law closer to the dominance analysis of the EU. In some respects it does. Different substantive tests in EU and US examine the anticompetitive effects but the purposes in both jurisdictions are the same. In US, the focus is on the probable price evolution, so to say a test that analyzes the conduct. In the EU before 2004, the test used was a dominance type of assessment, but now the new test, SIEC, comprises both dominance and conduct. The EU authorities and the US counterparties collaborate regarding the application of their competition laws. In assessing the competitive effects of a merger, the authorities compare the competitive conditions that would result from the notified merger with the conditions that would have prevailed without the merger. In most cases the competitive conditions existing at the time of the merger constitute the relevant comparison for evaluating the effects of a merger. However, in some circumstances, they may take into account future changes to the market that can reasonably be predicted.

No FFD cases have so far, been introduced to the Commission in which the defense was based on the current difficult economic environment. Instead governments have been using various policy instruments for example state aid to save failing businesses during the financial crisis. The financial sectors and important industries receive large amounts of state aid by Member states. The Commission has thus indicated that even though the current merger regulations including the practice of FFD are and will stay unreformed.

Preface

I would like to start by thanking my fellow students for an unforgettable time together. It will represent a new and an important chapter in my life. I appreciate all the fun we had together, all the support and experience sharing. I sincerely hope that we keep in touch in the future. We all know the importance of networking.

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I also want to thank my beloved children Filip and Amina to whom I dedicate this work. Your inexhaustible love is my inspiration and source of power.

Abbreviations

FFD	failing firm doctrine
OFT	Office of Faire Trading
CJEU	Court of Justice of the European Union
FTC	Federal Trade Commission
SLC	substantially lessening competition
SIEC	significantly impede effective competition
HHI	Herfindahl–Hirschman Index
OECD	Organization for Economic Co-operation and Development

Introduction

This paper provides a comparative analysis of the interpretation of the failing firm doctrine (FFD) given by the courts in United States and in Europe. It will analyze some cases founder of the theory and examples of arguments exchanged in the context of its application. Finally, it will examine whether it has been any adjustment of application of the FFD during the crisis.

In the current financial crisis, the theory of the failing firm could find a new significance. This paper in the first hand revisits the case founders of this theory in the U.S. and Europe and further on it analyzes the desirability of its renewal deal with the rapidly worsening situation in the real economy.

Since the outbreak of the financial crisis in the summer of 2007, the economies in the world are experiencing unprecedented recession since World War II. In this unstable economic environment, operations concentration in which one party or both are on the verge of bankruptcy will necessarily increase[1]. This situation has brought up issues related to the objectives of the economic and social policy in the regulation of competition and in particular the theory of the failing firm (FFD) as part of merger control. FFD also known in Europe under the name of rescue merger is a concept that has long been applied in different ways by a large majority of competition authorities around the world.

The FFD is usually invoked by the notifying party as the target is on the verge of bankruptcy and is in a situation as it may disappear from the market if the transaction proposed does not take place. In such cases, the doctrine of FFD is that the competition authority competent to decide to authorize the concentration, even though it create or strengthen a dominant position likely to deteriorate the competitive market structure, due to the absence of a causal link between the concentration and the potential adverse effect on competition.

[1]Remarks of Carl Shapiro, as Prepared For Delivery to ABA Antitrust Symposium: Competition as Public Policy "Competition Policy in Distressed Industries," May 13, 2009 ("Shapiro Remarks"), at 9, available at http:// www.justice.gov/atr/public/speeches/245857.htm.

The idea is that even if the merger did not take place, the situation competition would be degraded as the target and its assets inevitably come out short-term market and the acquiring firm would recover in any event most of the market shares of the defaulting company. In such cases, the potential loss of market competitiveness due to the failure of the target is equivalent to that which would result the completion of the merger. The parties usually claim that there is no causal link between the concentration and the deterioration the competitive market structure. We see how this type of justification is both an analysis of the conditions of competition prevailing historically the relevant market, as the analysis of the plausibility on possible future scenarios, or even a kind competitive classification of possible outcomes, depending on whether the operation takes place or not.

The burden of proof of the absence of causation is typically carried by the parties to the transaction but the role of the regulatory authority is clearly difficult in evaluation of alternative scenarios (the Counterfactuals)**.** Given the highly speculative exercise and knowing that in any case - the regulatory authority is called upon to decide between the creation of a dominant position and the complete disappearance of a competitor- it is not surprising that, despite a long-standing existence, the FFD was applied only on rare occasions.

It is not surprising that the implementation of FFD typically surrounded stringent precautions. However, will the current economic recession, which causes significant increase of occasions on which The FFD will be invoked, necessarily get the competition authorities to "revisit" their application concentrations control? The theory of the failing firm been invoked in the case of the concentration of the German department store chain Karstadt Kaufhof with its competitor, announced May 18, 2009[2], as well as in the case concerning the acquisition of Preston Bus Limited by rival Stagecoach Bus Holdings Limited - Case referred to the Competition Commission by the OFT May 28, 2009.[3] Similarly, it is not impossible that, in some markets, for example the bankruptcy of major automakers in North America and Europe leads discussions of the same kind.

[2]Http://www.globalcompetitionreview.com/news/article/15406/german-department-stores-consider-2-1-merger

[3] <http://www.oft.gov.uk/news/press/2009/62-09>

Purpose

The pursuit of this thesis is to answer the following question. Has the financial crisis had an impact on the interpretation and application of the concept of FFD in the US and EU?
I am going to investigate whether the financial crisis had any impact on the interpretation of the failing firm doctrine and its application by the U.S. and European competent courts. In order to answer this question, I will first present the U.S. legislation in this field of law and the European counterparts and compare them. I will try to identify similarities and dissimilarities and possible trends in the application of this theory.

Since the outbreak of the financial crisis in the summer of 2007, the economies in the world are experiencing unprecedented recession since World War II. In this unstable economic environment, operations concentration in which one party or both are on the verge of bankruptcy will necessarily increase. My hypothesis is that the application of the FFD has been more tolerant during the crisis as states might be willing to save their banks and industries champions.

I am aware of the fact that competition law is very political. It is designed for political, economic and social goals depending on situation in different countries. It is thus a product that grows out of its context. I keep in mind that the U.S. and European economic actors are rivals on the global market and that their interests consequently can be competitive in this respect. The existing differences in the legal culture should also be kept in mind. These jurisdictions have different regulatory mechanisms such as substantive tests, enforcement mechanism and bankruptcy laws, just to name a few. Do these differences have an impact on the outcome of merger control generally and the application of the FFD particularly?

Delimitations

In this paper I will deal exclusively with horizontal mergers, mergers and acquisitions involving actual or potential competitors. The subject is vast and fascinating. It deserves a major research project. I am tempted all the time to explore other aspects but I choose to ensure high quality in a well-defined area.

Method and material

Competition law makes integral part of the administrative law of the EU and its principal role is to serve as a policy instrument used to combat distortions of competition in the internal market. The merger control is par excellence concerned with the maintenance of a competitive market structure that can influence the behaviour of the market participants in a positive way. The structural analysis of the market is based on economics theories and therefore the relation between law and economics is indissoluble in this legal field. The method used in this thesis follows the same approach, the legal analysis being based not only on the case law and relevant legislation but also on purely economic reasons for why a different outcome is possible to be expected taking into consideration different parameters of the relevant market and the economic context at large. The method adopted is legal analysis with a comparative approach. The U.S. application of the relevant doctrines will be scrutinized in order to distinguish possible differences in either aims or outcomes of the control of mergers in the two jurisdictions under review.

Traditional legal dogmatic method refers to the systematic survey of legislation, case law, preparatory works and doctrines and implies furthermore, that legal science may need to concentrate more on developing domain-specific knowledge of a more fundamental kind.[4]
Comparative law is according to some scientists just another term for sophisticated legal analysis.[5] Comparative law fills the gaps in the internal structure of legal knowledge by transplanting doctrinal analysis from a range of different legal systems.[6] Comparative law as independent subject is intertwined with legal theory and jurisprudence. In this paper, the comparative law is used as a helping hand to legal theory; it is used to test a theory, not to construct a new one. The theory that I am going to test in the present study is the failing firm, which provides derogation from the general prohibition against horizontal mergers.

[4] http://www.scandinavianlaw.se/pdf/40-20.pdf, pages 520-521

[5] Kozolchyk, Boris: Trends in Comparative Legal Research, 14 Am. J. Comp. Law 100, 1976

[6] Samuel, Geoffrey, Law of Obligations and Legal Remedies, Cavendish 2001

Union law as such relies on the "*intellectual imperialism*" of law and economics movement.[7] The preconditions of achieving harmony are not necessarily uniformity and similarity, but difference and diversity. According to this approach and the competition of legal rules, this might lead to the emergence of best rules. This approach is useful in order to identify a possible "*winner*": which are the most efficient rules, the ones employed by the U.S. or by the EU regime of mergers and acquisitions?

In this paper I will essentially use case law from CJEU and U.S. appeals from the district courts and reviews of judgments from the circuit court of appeals Federal Commission cases, Guidelines from the European Commission and Guidelines from the Federal Trade Commission, U.S. Clayton Act, EU Regulation on control of mergers and doctrines**.**

Outline

The structure of the paper is as follows. Chapter one gives an introduction and explains the methodology used in this paper. Chapter two treats the financial crisis and discusses the rescues strategies, including the failing firm. Chapter three introduces the purpose and rationale of the regulatory framework for the Merger Control in the U.S. and chapter four in the EU. Chapter five presents the effects and the substantive assessment in both legislations. Furthermore in the same chapter, the financial crisis and its impact on the global economy and on Merger Control in particular the FFD will be analyzed. In chapter six I draw my conclusions.

[7] Harding, Andrew & Örücü, Esin: Comparative Law in the 21st Century, Kluwer Law International 2002

2. Rescue strategies during the financial crisis

2.1 Current financial crisis

The financial crisis began in July 2007, when investors lost confidence in the value of mortgages in the U.S. which resulted in a liquidity crisis that has been stretched over to the real economy. This has caused very significant capital injections into financial markets in Europe and the United States, a trend that has been extended to other sectors of the economy. The general trend showed that the global economy was close to a systemic failure of the banking system, which justified the emergency rescue of the institutions in question. These rescue operations and reconstructions have led to massive investment of public capital, but relatively few questions have been asked, with some exceptions, in regard to the rules of competition and the concentration of financial markets.

As the crisis has led to a sharp increase in unemployment and weakening of the national industrial champions, the question which necessarily arises is to what extent competition regulators should change their policy. It is therefore likely that after a period of coma, where the number of operations of nonfinancial mergers and acquisitions remained very low, an increasing number of the notifying parties or governments will try to invoke some form of FFD. Some signs of that were Lloyds TSB / HBOS, the acquisition of UK's Halifax Bank of Scotland by Lloyds TSB in October 2008, Alitalia / Air One, the concentration of two Italian airlines in December 2008, Mariahilf / Asklepios the concentration of two German hospitals in February 2009 and PPC / Kooperativa the concentration in the Czech market of insurance in March 2009.

The consequences of the crisis for competition can be identified mainly in the financial sector, where the governments interfered to shore up failing institutions through capital injections, state guarantees and asset support.[8] The state interventions may have saved some banks from liquidation, but can be harmful to competition in several ways and are not entirely unproblematic.

[8] ECB, 2009, pp. 88-9

Furthermore besides the increasing public debts, government interventions have the effect of adversely distressing competition on the concerned markets. The effective competition is a process, in which more efficient and innovative companies can expand their market share and profitability at the expense of the less efficient ones. The latter are compelled to either become more efficient in order to adapt to the market challenges or to successively lose their market positions and exit the markets.[9] Consumers benefit from this process such as low prices, high-quality products, a more diverse choice of goods and services and innovation.[10]

State interventions through brokering mergers between banks, such as the merger between Lloyd's and HBOS which had been accomplished under pressure and financial support by the English Government in 2008,[11] increased further the market concentration and consequently the collusion risks in an industry already characterized by reduced competition. The application of the paradigm structure-conduct-performance, which highlights that increased concentration facilitates collusion, therefore escalating the probability of collusion in the industry, is not appropriate for the banking sector[12] and that the higher profitability and market share of certain banks cannot be accredited to the use of market power but to more efficient management.[13]

On the other hand, a study arranged by the European Commission to examine the sector of retailing banking in the EU in 2007 reached the conclusion that even if efficiency-driven profitability cannot be ruled out in certain markets, "*the conjunction of sustained high profitability, high market concentration and evidence of entry barriers raises concerns about banks' ability to exploit market power over consumers and small firms*".[14]

[9] Office of Fair Trade (OFT, 2009, para. 4.3)
[10] Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings Official Journal C 31, 5 February 2004, pp. 5-18, para. 8; OFT, 2009, para. 4.2
[11] Pouncey and Bukovics, 2009
[12] Beck, 2008, Section 5; Ahrend et al., 2009, p. 20
[13] Goddard et al., 2007, pp. 1920-4
[14] COM(2007)33

2.2 Failing Firm Doctrine

The Horizontal Merger Guidelines issued by the European Commission and Federal Commission in the U.S. both refer among others to the use of FFD. Such a defense is available to the merging parties to defend a merger that involves a failing firm, that is, a firm which due to financial difficulties will be forced to exit the market without the merger. Admitting that there is no less-anticompetitive alternative than the notified merger and if the asset of the failing firm will unavoidably exit the market without the merger, the authorities may allow the merger.

Notwithstanding the substantive test used, a merger is not likely to enhance market power, if imminent failure, as defined below, of one of the merging firms would cause the assets of that firm to exit the relevant market. This is an extreme instance of the more general circumstances in which the competitive significance of one of the merging firms is declining: the projected market share and significance of the exiting firm is zero. If the relevant assets would otherwise exit the market, customers are not worse off after the merger than they would have been had the merger been implemented.

The authorities do not normally credit claims that the assets of the failing firm would exit the relevant market unless all of the following circumstances are met: (1) the allegedly failing firm would be unable to meet its financial obligations in the near future; (2) it would not be able to reorganize successfully; and (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger.

Advantages brought by the FFD could be as the following:

- Bankruptcy avoidance
- Positive impact on the entry on the market
- Potential dynamic and innovative efficiencies

The nature of the favorable consequences can be:

- Social: enhance the general welfare, avoid unemployment, increasing the efficiency of an already existing capacity by merging resources in a common pool, synergy effect and
- Economic: enhance the consumer welfare, economies of scale and scope

The lack of causality means that the potential negative consequences on the market post-merger conditions would not be in fact related to the merger operation, since the failing firm was to leave the market anyway and the merger would not be accountable for impeding the effective competition.

3. The US Merger Control legislation and jurisprudence

3.1. Purpose and rationale of the Merger Control legislation

3.1.1. The relevant law

Section 7 of the Clayton Act 15 USC § 18 is the relevant law on the matter of acquisitions. No person engaged in 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 a monopoly.

Such acquisitions, of stocks or assets, or of the use of such stock by the voting or granting of proxies or otherwise which can substantially lessen competition or tend to create a monopoly are prohibited.

The ultimate purpose of the Clayton Act is to secure the protection of the public against the evils that are supposed to result from a lessening of competition.[15] The Clayton Act aims to protect the competition and not the competitors.[16]

[15] International Shoe Co. v. Federal Trade Commission, 280 U.S. 291, 50 S. Ct. 89, 74 L. Ed. 431 (1930)
[16] Continental Airlines, Inc. v. United Air Lines, Inc., 120 F. Supp. 2d 556 (E.D. Va. 2000)

The provisions of the Clayton Act concerning acquisitions intend primarily to capture the destructive consequences of the intercorporate relationships before those relationships could work their evil.[17] For the purposes of establishing a violation of Section 7 of the Clayton Act prohibiting a merger between two companies which might result in a substantial lessening of the competition, or tend to create a monopoly. Analysis of the likely competitive effects of a merger requires determinations of the following:

(1) The relevant product market in which to assess the transaction
(2) The geographic market in which to assess the transaction and
(3) The probable effects of the transaction on competition in the relevant product and geographic market[18]

The objective is to prevent accumulation of power being individually too small as it would not be possible to use the Sherman test against them.[19] One assumption of the provision is that corporate growth by internal expansion is socially preferable to growth by acquisition.[20] The Congress acted on the premise that mergers tend to accelerate concentration in an industry.[21]

3.1.2. When the notification is required in U.S.

The filing requirement is triggered only if the value of the transaction and in some cases the size of the parties exceed certain dollar thresholds which are adjusted periodically under the Clayton Act. For the purpose of determining the dimension of the merger, it must be assessed what are the sizes of the party's ultimate parent entity and all subsidiaries of that entity. The general rule is that a notification is required if three criteria are met:

(1) The transaction affects U.S. trade

(2) Either:

[17] Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477, 97 S. Ct. 690, 50 L. Ed. 2d 701 (1977)
[18] F.T.C. v. Arch Coal, Inc., 329 F. Supp. 2d 109 (D.D.C. 2004), case dismissed, 2004 WL 2066879 (D.C. Cir. 2004); F.T.C. v. Libbey, Inc., 211 F. Supp. 2d 34 (D.D.C. 2002)
[19] U.S. v. Aluminum Co. of America, 377 U.S. 271, 84 S. Ct. 1283, 12 L. Ed. 2d 314 (1964)
[20] U.S. v. Philadelphia Nat. Bank, 374 U.S. 321, 83 S. Ct. 1715, 10 L. Ed. 2d 915 (1963); Brown Shoe Co. v. U.S., 370 U.S. 294, 82 S. Ct. 1502, 8 L. Ed. 2d 510 (1962)
[21] U. S. v. Pabst Brewing Co., 384 U.S. 546, 86 S. Ct. 1665, 16 L. Ed. 2d 765 (1966)

a. One of the parties has annual sales or total assets of $136.4 million or more and the other party has sales or assets of $13.6 million or more. Where an acquired legal person is not engaged in manufacturing only its total assets not its sales are counted unless its sales are over $136.4 million.
b. The amount of stock the acquiring firm has is valued at $272.8 million or more.

(3) The value of the securities or assets of the other party held by the acquiring firm after the transaction is $68.2 million or more. There is also a rule prohibiting interlocking directorates, which means it prohibits a person from serving on the board of directors of competing companies valued at over a certain size, $27.7 million in 2012. This rule does not apply if the two companies have annual sales in competition with each other of less than $2.7 million.

The rules are to some extent overlapping, but all transactions where the acquiring person will hold an aggregate amount of securities and/or assets of $272.8 million or more as of 2012 require notification. Also, all transactions worth more than $68.2 million must be notified, if one of the parties is worth at least $13.6 million, the other is worth at least $136.4 million and the total amount of assets now owned by the acquiring firm reaches $272.8 million. If an entity does not know whether the notification requirements apply to it, it can make a request of the Justice Department to determine that. Some assets are not counted, generally assets that do not produce income.

In transactions where either the FTC or the Antitrust Division believes that there may be significant anticompetitive consequences, either agency may require that the parties put forward additional information by means of the second request process.

3.2. US jurisprudence

3.2.1. International Shoe Case

The failing firm doctrine has been firstly enounced in case International Shoe Co v FTC though it has been accepted as a valid defense against Section 7 of the Clayton Act only in Brown Shoe. The merging companies in this case are McElwain & International Shoe. The McElwain Company, a Massachusetts corporation with its principal office in Boston, also manufactured shoes and sold and distributed them in several states of the Union. Mainly, it made and sold dress shoes for men and boys. This case is a proceeding initiated by complaint of the Federal Trade Commission and the relevant law was Section 7 of the Clayton Act which provides:

> "*No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce*."

The complaint asserts that in May, 1921, while the applicant and the W. H. McElwain Company were engaged in commerce in competition with each other, the applicant acquired all, or substantially all, of the capital stock of the McElwain Company and still owns and controls the same. To that effect the Federal Commission established that:

a. the capital stock of the McElwain Company had been acquired by the applicant at the time charged in the complaint;

b. the two companies were at the time in substantial competition with one another; and

c. the effect of the acquisition was to substantially lessen competition between them and to restrain commerce.

Thereupon the Commission issued an order instructing the applicant to divest itself of all capital stock of the McElwain Company then held or owned, directly or indirectly, by applicant, and stop from the ownership, operation, management, and control of all assets acquired from the McElwain Company subsequent to the acquisition of the capital stock. Upon appeal by applicant to the court below, the decision of the Federal Commission was confirmed.

The principal grounds upon which the present decision has been contested are that:

a. there never was substantial competition between the two corporations, and therefore no foundation for the charge of substantial lessening of competition;

b. at the time of the acquisition, the financial situation of the McElwain Company was such as to necessitate liquidation or sale, and therefore the prospect for future competition or restraint was entirely eliminated.

The grounds as enounced above were conclusive, according to the Court, who found it unnecessary to consider the challenge to the sufficiency of the complaint and other arguments. The definitions of the geographic and product market have been disputed in this context.

Geographic Market; Prior to the acquisition of the capital stock in question, the International Shoe Company was engaged in manufacturing a variety of leather shoes. It had a large number of tanneries and factories and sales houses located in several states. Its business was widespread, and its products were shipped and sold to purchasers almost throughout the United States.

Relevant Product Market*;* The International made and sold a line of men's dress shoes of various styles, which, although comparable in price, and to some degree in quality, with the men's dress shoes produced by the McElwain Company, were different from them in important details. Such competition as there was between the two companies related only to men's dress shoes.

Close to insolvency; An investigation of its balance sheets and statements, and the testimony of its officers and others acquainted with the situation, clearly shows that the company had reached the point where it could no longer pay its debts as they became due. In the face of these adverse circumstances, it became necessary, under the laws of Massachusetts, to make up its annual financial statement, which, when filed, would disclose a condition of insolvency, as that term is defined by the statute and decisions of the state[22], and thus bring the company to the point of involuntary liquidation. In this situation, dividends were discontinued, and the first preferred stockholders were notified that the company was confronted with the necessity of discontinuing dividends on that class of stock as well.

The condition of the International Shoe Company, on the contrary, notwithstanding these adverse conditions in the shoe trade generally, was excellent. That company had so conducted its affairs that its surplus stock was not excessive, and it was able to reduce prices. Instead of a decrease, it had an increase of business of about 25 % in the number of shoes made and sold. During the early months of 1921, orders exceeded the ability of the company to produce, so that approximately one-third of them were necessarily cancelled.

In this situation, with demands for its products so much in excess of its ability to deliver, the International Shoe Company was approached by officers of the McElwain Company with a view to a sale of its property. After some negotiation, the purchase was agreed upon. The transaction took the form of a sale of the stock instead of the assets. The reason for that was not to distort competition, but because by that means the personnel and organization of the McElwain factories could be retained, which, for reasons that seem satisfactory, was regarded as vitally important. It is perfectly clear from all the evidence that the controlling purpose of the International Shoe Company, in making the purchase in question was to secure additional factories, which it could not itself build with sufficient speed to meet the pressing requirements of its business.

[22] General Laws 1921, c. 106, s 65(3); Holbrook v. **International** Trust Co., 220 Mass. 150, 155, 107 N. E. 665; Steele v. Commissioner of Banks, 240 Mass. 394, 397, 134 N. E. 401, 20 A. L. R. 1203

Shortly stated, the evidence establishes the case of a corporation in failing circumstances, the recovery of which to a normal condition was, to say the least, in most serious doubt, selling its capital to the only available purchaser in order to avoid what its officers fairly concluded was a more disastrous fate. It was suggested by the court that instead of an outright sale, any one of several alternatives might have been adopted which would have saved the property and preserved competition; but all of these arguments may be dismissed as pure speculations. The company might, as suggested, have obtained further financial help from the banks, with a resulting increased load of indebtedness which the company might have carried and finally paid, or, on the other hand, by the addition of which, it might more certainly have been packed down. It can be argued that no one is wise enough to predict with any degree of certainty whether such a course would have meant ultimate recovery or final and complete collapse. If it had been possible to proceed with recovery, under the Bankruptcy Act (11 USCA), holders of the preferred stock might have paid or assumed the debts and gone forward with the business; or they might have considered it more prudent to accept whatever could be saved from the wreck and abandon the enterprise as a bad risk.

Risk for failing In the light of the case thus disclosed of a corporation with resources so exhausted and the prospect of recovery so remote that it faced the grave probability of a business failure with resulting loss to its stockholders and harm to public interest where its plants were operated. It is reasonable to assume that the purchase of its capital stock by a competitor, there being no other prospective purchaser is not in scrutiny of law prejudicial to the public and does not substantially lessen competition or restrain commerce within the intent of the Clayton Act. To regard such a transaction as a violation of law, as this court suggested in United States v. U. S. Steel Corp, would seem a distempered view of purchase and result.[23]

[23] See also American Press Ass'n v. United States (C. C. A.) 245 F. 91, 93. 94

Are there any viable alternatives? By comparing all the other alternatives with the alternative of a sale such as was made, the officers, stockholders, and creditors, comprehensively familiar with the factors of a critical situation and more able than the Federal Commission or Court to foresee future contingencies, after much deliberation, was forced to choose the latter alternative. There is no reason to doubt that in so doing they exercised a judgment, which was both honest and well informed; and if aid be needed to strengthen their conclusion, it may be found in the familiar presumption of rightfulness which attaches to human conduct in general[24]. Besides these considerations, the reliability of the conclusion which they reached finds ample confirmation in the facts already discussed and others disclosed by the record.

The findings of the Federal Commission that this competition between the two companies was substantial and, by the acquisition of the stock of the McElwain Company, had been substantially lessened, the Court of Appeals affirmed, holding that they were fully supported by the evidence. Upon a careful review of the record we believe the evidence leads to an opposite conclusion. For the reasons appearing under each of the two foregoing heads of this opinion, the judgment must be reversed.

3.2.2. General Dynamics Case

A coal producer and its successor, appellee General Dynamics Corp., acquired, through stock purchases, control of appellee United Electric Coal Companies, a strip-mining coal producer. The Government brought suit alleging that this acquisition violated Section 7 of the Clayton Act. [25] The District Court found no violation on the ground, inter alia, that the Government's evidence did not support the Government's contention that the acquisition substantially lessened competition in the production and sale of coal in either or both of two specified geographic markets.

[24] Bank of U. S. v. Dandridge, 12 Wheat. 64, 69, 6 L. Ed. 552
[25] APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS No. 72-402. Argued December 5, 1973-Decided March 1, 1974

This evidence relied principally on past production statistics showing that within certain geographic markets the coal industry was concentrated among a small number of large producers, that this concentration was increasing and that the present acquisition would materially enlarge the acquiring company's market share and thereby contribute to the concentration trend. This conclusion was primarily based on a determination that United Electric's coal reserves were so low that it’s potential to compete with other producers was eliminated. The future potential was far weaker than the aggregate production statistics relied on by the Government might otherwise have indicated, virtually all of United Electric's proved reserves being either depleted or already committed by long-term contracts with large customers so that its power to affect the price of coal was severely limited and steadily diminishing.

While the Government's statistical showing might have been sufficient to support a finding, of "undue concentration" in the absence of other considerations, the District Court was justified in finding that other pertinent factors affecting the coal industry and appellees' business mandated a conclusion that no substantial lessening of competition occurred or was threatened by the acquisition. Ample evidence showed that United Electric does not have sufficient reserves, which are a key factor in measuring a coal producer's market strength, to make it a significant competitive force. Thus in terms of probable future ability to compete, rather than in terms of past production on which the Government relied, the court was warranted in concluding that the merger did not violate Section 7 of the Act.

The District Court was justified in considering post acquisition evidence relating to changes in the patterns and structure of the coal industry and in United Electric's reserve situation, but no evidence showing that lessening of competition has yet occurred. The demonstration of weak coal resources necessarily implied that United Electric was not merely disinclined but unable to compete effectively for future contracts, such evidence going directly to the question whether future lessening of competition was probable. United Electric's weak reserves position, rather than establishing a failing firm defense by showing that the company would have gone out of business but for the merger the District Court's conclusion that United Electric, even if it remained in the market, did not have sufficient reserves to compete effectively for long-term contracts, and therefore appellees' failure to meet the prerequisites of a failing firm defense did not detract from the validity of the District Court's analysis.

3.2.3. Citizen Publishing Company Case

This case has enabled the Supreme Court to develop the doctrine of the FFD. The Court rejected the defense of the parties of the merger in question and adopted a strict test for the application the FFD. The test applied by the Court in this case is similar to the test ultimately adopted in the guidelines.[26]

The only two daily newspapers of the city of Tucson and Arizona, The Citizen and The Star, in 1940 had negotiated a common agreement by which the general activities of the two companies should be merged. They agreed also on three types of controls will be imposed (i) pricing, (ii) consolidation of profit and (iii) control of the market.

The U.S. federal government accused the party of abusing their market power and violation of Section 2 of the Sherman Act, whereas the objective of the merger was to eliminate any competition between the two newspapers. The District Court, before which the parties had brought the case, had upheld the decision. The parties were then called to the Supreme Court, arguing that Citizen was on the verge of bankruptcy and that the FFD should be applied. The Supreme Court clarified that before parties could rely on the FFD, they must demonstrate (i) that the target was in imminent danger of going bankrupt, (ii) that there was no realistic prospect of effective reorganization and (iii) that the failing firm had undertaken in good faith and reasonably looking for a buyer who would alternate less risk in terms of competition.

In this case, the Court held that, when Citizen and Star had concluded the agreement, Citizen was not on the verge of bankruptcy and that there was no serious likelihood that Citizen to cease its activities and liquid assets if the merger did not take place. In fact, at that time, Citizen was still a competitive threat to Star and would have continued even through bankruptcy proceedings. The Court also stated that no effort had been made to sell the newspaper therefore; the third element of the test was not met.

[26] Citizen Publishing Co. v.. United States, 394 U.S. 131 (1969), available at <http://supreme.justia.com/us/394/131/case.html>

3.3. Application of the Failing Firm Doctrine in the U.S

3.3.1. The legal interpretation of the Failing Firm

Although the Court declined to apply the FFD, it nevertheless cleared the concentration, because it would not have undermined the competitive market structure. The Guidelines later incorporated the spirit of the General Dynamics decision "Changing Market Conditions" which states that, although market concentration and the market share data are based on historical evidence, the Court must sometimes consider the conditions in its analysis of market dynamics and competitiveness of the company resulting from the transaction, particularly where recent or ongoing changes indicate that the current market shares of a particular firm underestimate or overestimate the importance of its future competitiveness.[27] The judgment in General Dynamics has played an important role in the assessment of strategic mergers in the United States such as the merger between Boeing and McDonnell Douglas[28].

3.3.2. Failing division in the U.S.

The first time the theory of the failing division was mentioned by the US Department of Justice goes back to the Horizontal Merger Guidelines 1992, which described the FFD and specified that this same theory was applicable when the failing firm was not part of a fully integrated larger parent company. The current version of the guidelines explicitly recognizes the theory of the failing division to apply in groups of viable companies.

[27] Section 1521 of the Bankruptcy Act

[28] United States v. General Dynamics Corp., 415 U.S. 486, 501, available at <http://supreme.justia.com/us/415/486/case.html>

The parties in a merger involving the acquisition of a failing division may, in exceptional circumstances, invoke a variant of the FFD. A merger is unlikely to cause competitive harm if the risks to competition arise from the acquisition of a failing division. The Agencies do not normally credit claims that the assets of a division would exit the relevant market in the near future unless both of the following conditions are met: (1) applying cost allocation rules that reflect true economic costs, the division has a persistently negative cash flow on an operating basis, and such negative cash flow is not economically justified for the firm by benefits such as added sales in complementary markets or enhanced customer goodwill; and (2) the owner of the failing division has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed acquisition.

A similar defense argument can be made for failing divisions as for failing firms.[29] First, upon applying appropriate cost allocation rules, the division must have a negative cash flow on an operating basis. Second, absent the acquisition, it must be that the assets of the division would exit the relevant market in the near future if not sold. Due to the ability of the parent firm to allocate costs, revenues, and intercompany transactions in relation to its subsidiaries and divisions, the Agency will require evidence, not based solely on management plans that could be prepared solely for the purpose of demonstrating negative cash flow or the prospect of exit from the relevant market. Third, the owner of the failing division also must have complied with the competitively-preferable purchaser requirement of Section 5.1 of the Horizontal Merger Guidelines.

[29] U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, Section 5.2

Although it was clearly formulated for the first time in 1982 and although this theory has generated an important expectation, it has never been applied by the Federal Courts. Several reasons for this situation have been suggested[30]. (i) U.S. courts have not had the opportunity to apply this theory: the refusal to consider this theory in cases such as FTC v. Harbour Group Investment, in which jurisdiction did not want to answer that question, was able to discourage companies to invoke this theory, (ii) U.S. courts was concerned that an application of this theory would lead to manipulation of business data to meet the strict terms of proof, and (iii) some U.S. courts have considered the theory of the failing division was unnecessary due to the increased application of the analysis "General Dynamics" in cases involving the assets of a failing division.

4. The EU Merger Control legislation and jurisprudence

4.1. Purpose and rationale of the Merger Control legislation

The Commission may decide that an otherwise problematic merger is nevertheless compatible with the common market if one of the merging parties is a failing firm. The basic requirement is that the deterioration of the competitive structure that follows the merger cannot be said to be caused by the merger. This will arise where the competitive structure of the market would deteriorate to at least the same extent in the absence of the merger. The Commission considers the following three criteria to be especially relevant for the application of a failing firm defense. First, the allegedly failing firm would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking. Second, there is no less anti-competitive alternative purchase than the notified merger. Third, in the absence of a merger, the assets of the failing firm would inevitably exit the market. It is for the notifying parties to provide in due time all the relevant necessary information to demonstrate that the deterioration of the competitive structure that follows the merger is not caused by the merger.

[30] Wait A. L., Surviving the shipwreck : a proposal to revive the failing division defense, William and Mary Law Review, Oct. 2003, vol. 45 : 429, pp. 429-468

4.2. EU jurisprudence

4.2.1. Kali und Salz Case

The key case is Kali und Salz[31] where the Commission has discussed the concept of FFD in depth. The Commission has established that FFD is not the rule but the exception from the rule that horizontal mergers are harmful for the competition. Kali und Salz was the subsidiary of BASF & MdK, a state-owned company of the former DDR. The decision concerns the joint-venture between Kali und Salz and Treuhand. MdK was on the verge of bankruptcy due to the post-communism crisis in the Eastern Europe. The criteria for lack of causality according to this decision are:

- the acquired undertaking would in the near future be forced out of the market if not taken over by another undertaking;
- the acquiring undertaking would take over the market share of the acquired undertaking if it were forced out of the market,
- there is no less-anti-competitive alternative purchase

As one can see, the first criterion refers to the capacity of the failing firm to continue to compete on the market, the second to the acquiring firm capacity to take over the market shares of the failing one and the third criterion refers a third person, another potential acquirer. The burden of proof is on the merging undertakings.

The Commission decision has been contested.[32] The French government alleged that the Commission has not followed the criteria established by the U.S. Antitrust law, referring especially to the second criterion in the Commission test of causality. CJEU found that the criterion was nevertheless consistent with Article 2(2) of the Merger Regulation.

[31] Case IV/M.308 Kali und Salz/MdK/Treuhand [1994] O.J. L186/30; on appeal Joined Cases C-68/94 and 30/95 France v Commission, Societe Commerciale es Potasses et de l'Azore (SCPA) v Commission [1998] E.C.R. I-1375

[32] Joined Cases C-68/94 and 30/95 France v Commission, Societe Commerciale es Potasses et de l'Azore (SCPA) v Commission [1998] E.C.R. I-1375

The Commission has first ever based a merger decision on the concept of the rescue merger, commonly referred to as "failing firm defense". In fact, in its decision in Kali und Salz/MDK/Treuhand, the Commission settled that the creation of a dominant position was not the consequence of the merger since the acquiring undertaking would gain a dominant position even in the absence of the merger. The lack of causality between the merger and the creation of a dominant position signifies that the latter would stem from the exit of the failing company, which would be inevitable in case the concentration is to be prohibited.

The concept of the rescue merger has been assessed on the basis of the following three criteria[33]:

a. the acquired undertaking would in the near future have been forced out of the market if not taken over by another undertaking;
b. there was no less anti-competitive alternative purchase; and
c. the acquiring undertaking would have taken over the market share of the acquired undertaking, if it had been forced out of the market.

The CJEU confirmed the Commission's approach concerning the rescue merger concept in its judgment delivered on the 31 March 1998. The view taken by the CJEU is nevertheless broader than the criteria set out in the Commission's decision in Kali und Salz. A merger can be considered as a rescue merger if the competitive structure resulting from the concentration would worsen likewise even if the concentration did not proceed, as it were, even if the concentration was disallowed.

Generally speaking, the concept of the rescue merger entails that the undertakings to be acquired can be qualified as "failing firms" and that the merger is not the reason of the weakening of the competitive structure. Therefore, for the application of the rescue merger, two conditions must be fulfilled:

a. the acquired undertaking would in the near future be forced out of the market if not taken over by another undertaking; and
b. there is no less anti-competitive alternative purchase.

It must be established, in addition to the above mentioned criteria that the assets in question would inevitably run off the market in the absence of the merger.

[33] Recital 71 in Kali+Salz

Consequently, the Commission regards the following criteria as relevant for the application of the concept of the rescue merger:

a. the acquired undertaking would in the near future be forced out of the market if not taken over by another undertaking;
b. there is no less anti-competitive alternative purchase; and
c. the assets to be acquired would inevitably exit the market if not taken over by another undertaking.

The application of the concept of the rescue merger requires that the deterioration of the competitive structure through the merger is at least no worse than in the absence of the merger.

4.2.2. BASF/Eurodiol/Pantochim Case

Would Eurodiol and Pantochim have been compelled to leave the market if not taken over by another undertaking? BASF argues Eurodiol and Pantochim would be compelled to leave the market if they were not acquired by it. These companies and their Italian parent company SISAS SPA, Milano were seriously indebted and in the first phase of bankruptcy proceedings. The observation period under pre-bankruptcy regime during which the Court of Commerce (Tribunal de commerce) ordered the provisional postponement of debts as it were a preliminary suspension of the rights of the creditors, ended on 16 June 2001.

Considering the lack of liquidity and the significant amount of the companies' debts, a restructuring plan was not anticipated in this case. Thus, the risk of bankruptcy of both Eurodiol and Pantochim was obvious. The Tribunal de commerce of Charleroi, responsible for the pre-bankruptcy proceedings, has informed the Commission that both undertakings would have to be declared bankrupt if a buyer for Eurodiol and Pantochim were not permitted before the expiry of the deadline on 16 June 2001. When BASF had ceased its financial support they would have unavoidably been compelled to leave the market.

The first of the three conditions recognized in the Kali und Salz Decision was met. What about the available alternative buyers? BASF argues that there were none. The Tribunal de commerce of Charleroi authorized the Commissaires au sursis in charge of the administration of the plants to find a suitable buyer for the assets of Eurodiol and Pantochim right away the decision to open pre-bankruptcy proceedings and a number of competitors were contacted. No other company apart from BASF approached by the Court Commissioners was prepared to submit a feasible offer for these companies.

The South African company Sasol Chemical Industries belonging to the Sasol Limited Group (Sasol), had at first shown some interest in acquiring Eurodiol and Pantochim. After carrying out a full due diligence procedure, Sasol communicated to the Commission by letter of 25 May 2001 that they had decided not to pursue their acquisition plans. Consequently, the second condition identified in Kali und Salz has been also met.

Is the exit inevitable? The Commission admitted that the assets of the failing firm would certainly exit from the market in this case. This exit would most probably result in a considerable deterioration of market conditions, to the disadvantage of the customers. The Commission considers that these elements are equally relevant for the application of the rescue merger concept. Thus the Commission has looked at whether there would be any likelihood that Eurodiol's capacity for the relevant products might be kept on the market after bankruptcy. The Commission’s investigation has established some particular economic conditions linked with special features of chemical plants of this type as well as some features of the Belgian bankruptcy proceedings.

Firstly, an immediate takeover of Eurodiol and Pantochim, after bankruptcy, by a third party seems to be unlikely. The operation of the two plants involved certainly not only high costs but also substantial environmental risks, resulting from the sensitive production process used at Eurodiol and Pantochim. Moreover any company taking over the business within six months after bankruptcy would be legally bound to take over the entire workforce.

Secondly, a restart of the plants at a later stage, after the expiry of six months, would be relatively expensive compared with an immediate takeover. The necessary maintenance work over the last years has been, due to the complex economic situation of Sisas, largely neglected. A shutdown of production would cause additional costs for new catalysts when the plant had to be restarted.

BASF reports that, during their toll-manufacturing agreement, Pantochim and Eurodiol had not been able to meet the agreed quantities due to frequent shutdowns caused by technical problems. The operation of the two plants involves not only high costs but also considerable environmental risks, resulting from the sensitive production process. Furthermore, the availability of a qualified workforce is also crucial for the operation of a chemical plant of this type. The part of the qualified workforce has already left and others will surely do so after bankruptcy is acknowledged, the incentive for any investor to take up business after bankruptcy of Eurodiol will be fairly low.

It is nevertheless not likely that a third party would buy specific assets of the two companies after their shutdown following a bankruptcy judgment. From an economic perspective the plants of Eurodiol and Pantochim can only be operated as a whole as they use a highly integrated production process which does not make it likely to purchase isolated assets. So it is established that it is very probable that the assets of Eurodiol, as well as those of Pantochim, including the capacities for the BDO-related products GBL, NMP and THF would beyond doubt leave the market.

The Commission considered also that the market conditions would have been more favorable for the customers after the merger. It was likely that price competition would cease and be replaced by a massive increase of prices. Conversely, according to the economics of the case BASF wasn’t likely to enforce major price increases after the merger.

Eurodiol's main economic problem, which led to its financial difficulties, has been its underused capacity for BDO and BDO-related products. According to BASF's business plans for the time after the takeover of Eurodiol and Pantochim, these plants have to be operated at almost full capacity in order to achieve profitability and to make use of the full cost reduction potential of the technology. It can therefore be assumed that BASF will aim to decrease costs after the merger by making efforts to market THF, GBL and NMP.

Considering these circumstances the customer may expect better supply conditions and prices from the market after the merger than under a bankruptcy scenario where the assets of Eurodiol are taken off the market. Accordingly, the Commission concluded that the worsening of the competitive structure through the merger in the specific circumstances is less significant than in the absence of the merger.

Under the specific and exceptional circumstances of the case at this definite moment in time being characterized by the imminent bankruptcy of the failing companies in the absence of the merger, the absence of an appropriate alternative offer under the Belgian bankruptcy proceedings, and the predictable exit from the market of the assets to be acquired, combined with tight capacity constraints in the industry and demand inelasticity, the Commission has established that the worsening of the competitive structure resulting from the notified operation will be less significant than in the absence of the merger.

4.2.3. Bertelsmann Case

This is a case of concentration via purchase of shares, i.e. an acquisition. *Bertelsmann* was the common parent company of the leading German media group. *CLT-UFA* was a joint venture between *Bertelsmann* and *Audiofina SA*, in which the parent companies had merged their European television interests. These included the shareholding in *Premiere*. *Taurus* was a holding company belonging to the *Kirch* group. *Kirch* was the principal German supplier of feature films and entertainment program for television and was also active in commercial television. The relevant market is the German pay-TV. The failing merging party was *DF 1 GmbH & Co. KG*, a division of *Kirch*. The argument of parties that the market shares of *DF 1 GmbH & Co. KG* will fall to *Premiere* has not been accepted by the Commission. The lack of causal link could not be established.[34]

[34] Case IV/M.993 Bertelsmann/Kirch/Premiere [1999] O.J. L53/1

4.2.4. Saint-Gobain Case

This case concerns a merger in silicon carbide sector between Société européenne des produits réfractaires belonging to Saint-Gobain group France and Elektroschmelzwerk Kempten belonging to Wacker-Chemie group Germany and Nom owned by the Kingdom of Netherlands. Wacker-Chemie was the failing firm and Saint-Gobain the acquiring firm. The lack of causality could not be established in this case; Wacker-Chemie's financial situation was not so bad and alternative purchases could be available.[35]

4.2.5. Aerospatiale Case

In Aerospatiale case, in terms of number of aircraft sold, de Havilland was the most successful competitor of ATR.[36] In the relevant product market of 40 to 59 seats, Fokker had a higher market share than de Havilland, but Fokker at the end of 1990 had a backlog of only 27 orders for the Fokker 50 whilst de Havilland had a backlog of 72 orders for the Dash 8-300, second only to ATR with 103 orders for the ATR 42. Furthermore, de Havilland had plans to develop a new aircraft, the Dash 8-400, to compete in the top segment 60 seats and over. If the concentration went ahead, therefore, de Havilland would have been eliminated as a potential competitor from this segment where ATR had a market share of 76 %. The parties argued that if the proposed concentration did not proceed, although de Havilland wouldn't have been immediately liquidated, its production might have been phased out by Boeing so that de Havilland might have in any case been eliminated as a competitor in the medium to long term.

[35] Case IV/M.774 Saint-Gobain/Wacker-Chemie/NOM [1997] O.J. L247/1
[36] Case IV/M.053 Aerospatiale-Alenia/de Havilland [1991] O.J. L334/42

Without prejudice as to whether such a consideration is relevant pursuant to Article 2 of the Merger Regulation, the Commission considered that such elimination was not probable. According to a pre-acquisition review of de Havilland carried out for Aerospatiale-Alenia at the end of 1990, the following factors, inter alia, were identified as critical in assessing the investment decision from a business/financial point of view. De Havilland produced high quality, well-known and highly respected products, the net selling prices of which have been increasing; progress has already been made in reducing excess employees, and relations with trade unions have improved; there was still however scope for further improvement in production management since de Havilland's productivity was relatively poor.

On the evidence made available to the Commission, there was therefore no likelihood that de Havilland, in the absence of the proposed concentration, would have in any case been phased out. Boeing had however expressed its preference to sell de Havilland rather than continue to operate it. This would have seemed possible given that the parties were not the only potential buyers. British Aerospace, for example, has expressed an interest to buy de Havilland.[37]

4.2.6. Rewe-Meinl Case

The present case concerns an acquisition. The German Rewe intended to purchase the shares of Meinl, Austria controlling 341 shops, including supermarkets, discount stores and hypermarkets. The case concerns the application of the failing division theory; the parties invoked the lack of competitiveness and insolvency of these subsidiaries. The decision to sell the failing division is a management choice and not an unavoidable consequence of an irreparable financial situation. Other less-anti-competitive solutions existed as well. The lack of causality test has not been passed.[38]

[37] O.J. L334/42, 1991

[38] Case IV/M.1221 Rewe/Meinl [1999] O.J. L274/1

4.3. Application of the Failing Firm Doctrine in EU

4.3.1. The legal definition of the Failing Firm

The FFD, a long-established concept in US case-law, was presented in EU merger control praxis for the first time in the 1990's.[39] It today exists in the majority of OECD jurisdictions. This "rescue merger" clears the creation of a dominant market under the condition that there is no casual link between the concentration, made through the merger involving a failing firm, and a firm's dominant position. An undertaking is i.e. permitted to acquire a competitor which is experiencing a difficult time even though anticompetitive concerns are involved. Stringent standards have been developed by the Commission in accordance with CJEU case law[40] and through its "Horizontal Merger Guidelines"[41] in order to satisfy the defense of a failing firm.

4.3.2. Failing Division in the EU

The theory of the failing division is not even mentioned in the Guidelines on horizontal mergers, but the Courts and the Commission have taken into account in certain cases, Bertelsmann/Kirch/Premiere[42]. The Commission has considered the theory failing division for the first time during its examination of the acquisition and joint control. The acquisition has been prohibited by the Commission, which considered that Premiere would reach a potential monopoly position on the German market. The Commission examined the transaction in light of the FFD, but concluded that it was not applicable to this case because the transaction did not meet any of the conditions defined in the Kali und Salz.

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[39] Directorate for financial and enterprise affairs, Competition Committee: Roundtable on failing firm defence –Contribution by the United State, 6 October 2009, p.2.

[40] Commission Decision of 14 December 1993 in case IV/M.308 - Kali+Salz, Commission Decision of 11 July 2001 in case COMP/M.2314 - BASF/Eurodiol/Pantochim.

[41] Commission Communication, Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings (Official Journal C 31, 05.02.2004, pp. 5-18), paragraph 89.

[42] December Comm. EC, May 27, 1998, case. IV/M.993, Bertelsmann/ Kirch/Premiere

The Commission however stressed that this case does not involve a failing firm but a failing division, since DF1 is only a part of the activities of Kirch in the field of pay TV. Therefore, even if DF1 might disappear from the market, Kirch as a whole was not threatened and could meet the needs of its division. The Commission emphasized that the conditions for authorization of a transaction involving a failing division must be more stringent than in the case a failing firm. The concentration in question in this case did not meet the criteria of the FFD and could therefore not be allowed on that basis. The fact that the Commission takes into consideration the theory of failing division at least potentially in European law, even though it would apply it only in exceptional circumstances.

5. The outcome of Merger Control during the crisis

5.1. Assessment of rescue merger in the U.S. and EU

Heinz[43] is the key case in the U.S. exactly like the Airtours[44] is the most relevant for the EU jurisprudence on the matter of the substantive assessment. Council Regulation 139/2004 on the control of concentration between undertakings relies on the SIEC test, significant impediment to effective competition. This is the assessment test employed by EU. The pursuit of the SIEC goes beyond the dominance test and covers post-merger situations where unilateral effects detrimental to competition occur despite the fact that none of the competitors has reached the level required for dominance.

The SIEC test has been introduced by the new Horizontal Merger Guidelines[45] and the definition of FFD criteria adopted in this document are extracted from the previous case law. The declared aim is to increase the legal certainty and improve the economic reasoning. The criteria of assessment are:

1. First, the supposedly failing firm would in the near future be forced out of the market because of financial difficulties if not taken over by another undertaking.
2. Secondly, there is no less anti-competitive alternative purchase than the notified merger.

[43] US District Court, Columbia, FTC v HF Heinz Company et al., 00-5362a (2000)
[44] Case T-342/99 Airtours v Commission [2002] 5 C.M.L.R. 317
[45] "Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings" [2004] O.J. C31/5

3. Thirdly, in the absence of a merger, the assets of the failing firm would unavoidably exit the market.

Buyers may be interested in buying the failing firm's assets after the firm exits the market and it may be more favorable for competition for more than one firm to procure these assets in order to avoid concentration of market power.

5.2. Substantive tests used today, SLC compared to SIEC

The U.S. authorities and the EU counterparties have collaborated in the case Boeing McDonnell Douglas.[46] In compliance with the Agreement between the European Communities and the Government of the United States of America regarding the application of their competition laws, the European Commission and the Federal Trade Commission have carried out all necessary notifications.

Pursuant to Article VI of the Agreement, the European Commission has sought an appropriate way to take account of important national interests of the United States, particularly those stemming from the consolidation of the U.S. defense industry. Furthermore, pursuant to Article VI of the Agreement, the European Commission notified to the U.S. authorities on 26 June 1997 its preliminary conclusions and concerns and asked the Federal Trade Commission to take account of the European Union's important interests in safeguarding competition in the market for large civil aircraft. Chairman Pitofsky of the Federal Trade Commission responded with a letter the same day indicating that the Federal Trade Commission would take into account the expressed interests of the European Communities when reaching its decision. On 1 July 1997, the Federal Trade Commission reached a majority decision not to opposite the merger.

The 2002 discussion revealed that while a number of different tests can be used to assess mergers, there were two main tests in use: (i) the dominance test, where a merger is considered anti-competitive if it creates or strengthens a dominant position and (ii) the significant lessening of competition test (SLC), where mergers are anti-competitive if competition is likely to be significantly impaired after the merger is consummated. Do the two tests cover the same set of anti-competitive effects that can arise from mergers?

[46] Case No IV/M.877; 97/816/EC O.J. L334/42, 1991

Under the dominance test, a merger has anti-competitive effects only if the merged firm can be viewed as having a dominant position. In other words, a merger can be prohibited if it is likely to create or strengthen a dominant position in the market. While the notion of dominance is not well defined in economics, it is certainly associated with a transaction creating a leader in the market, i.e. a company with substantial market power enabling it to behave independently of competitors, customers and ultimately consumers. In many countries, the notion of dominance has been interpreted extensively to also include collective dominance, i.e. situations where the merger modifies the structure of the market and favors a collusive equilibrium among the remaining firms (collusive oligopolies).

Under the significant lessening of competition test, a merger has anti-competitive effects if the merger is likely to substantially lessen competition on the market. As opposed to the dominance test, the SLC test is less focused on structural issues. In particular, while under the dominance test, market definition and market shares play crucial roles in finding a prima facie indication of anti-competitive effects, the focus of the SLC test lies predominantly on the impact of the merger on existing competitive constraints and on measuring market power post-merger. In other words, under the SLC test the investigation is more concerned with whether prices are likely to raise post-merger.

The significant impediment to effective competition (SIEC) is considered to be equivalent to a significant lessening of competition and is interpreted as extending, beyond the concept of dominance, to the anti-competitive effects of a concentration resulting from the non-coordinated behaviour of undertakings which would not have a dominant position on the market concerned.

In T-Mobil/Tele.ring Case no merger leader has been created as a result of the merger. The reduced competition resulted in higher prices by eliminating a competitive constraint on the incumbents. The Commission focused its attention on the likely effects that the merger would have on prices in the Austrian end-customer market and concluded that even if prices would not rise in the short term, the elimination of Tele.ring as a pricing constraint would make it unlikely for prices to continue falling significantly as previously.

A question may be asked whether the unilateral effects analysis brings American law closer to the dominance analysis of the EU. In some respects it does. Different substantive test in US and EU to examine the anticompetitive effects but the purposes in both jurisdictions are the same. In U.S. the focus is on the probable price evolution, so to say a test that analyzes the conduct. In the EU before 2004 the test used was a dominance type of assessment, but now the new test, SIEC, comprises both dominance and conduct.

As in single firm dominance cases, the analysis does not depend on any inference or proof of likely collusion. The Guidelines' unilateral effects threshold of a 35% combined market share at least begins to come up to the thresholds employed by the EU in determining dominance. Because the response of rivals must be examined, the unilateral effects analysis could lead to a direct examination of their strengths and weaknesses. The analysis differs, however, from that employed by the European Commission in several respects. The American unilateral effects analysis is limited to particular types of cases. The European concept of dominance is more ample. Nor do unilateral effects focus on the impact of the merger on rivals. The European Commission has frequently described brand preferences as barriers to entry, but has not otherwise embraced the American unilateral effects standards.[47]

5.3. The financial crisis and the eventual renewal of the FFD

Moreover, in the name of public interest considerations, the competition authorities have inevitably been called to ease the application of competition rules, particularly regarding the implementation of FFD. Some signs of pressure and preventive measures for it have been apparent the U.S. authorities and the European Commission unanimously indicated their intention in principle not to apply less strict in determining whether a merger should be allowed on the grounds of the FFD.

Neelie Kroes, competition commissioner, has stated that Commission will *"continue to enforce existing rules, including, if appropriate, the theory of the failing firm"*[48]

[47] Thomas E. Kauper, MERGER CONTROL IN THE UNITED STATES AND THE EUROPEAN UNION: SOME OBSERVATIONS Saint John's Law Review Spring 2000

[48] N. Kroes, Facing the current financial crisis, in October 2008, available at http://europa.eu/rapid/press-ReleasesAction.do?reference=SPEECH/08/498

This commitment to respect the existing principles of control concentrations, even if they are designed to cope with exceptional circumstances, is opposed to the more pragmatic approach adopted by some Member States. The existence of different approaches adopted by the Commission, the OFT[49], the Italian State[50] and other Member States may, at least in part, and outside political pressure, can be explained by the different schools and views that oppose regarding the application of the FFD in times of crisis.

Those in favor of relaxing the conditions of application of the FFD suggested that the rescue mergers are desirable because in times of financial crisis, in particular, companies may be forced to exit the market for reasons that have nothing to do with the competitive game like shortage of liquidity for example[51].

Some have suggested that a more flexible approach could, by increasing market power and profitability in times of financial crisis, encourage new entrants. Thus, a policy of flexible concentration control can lead to expect increased profitability in times of financial crisis. This could, in turn, encourage firms that are not yet active in the market to enter and consequently reducing future concentration. In general, companies would invest more if they knew that the FFD was applied more leniently.[52]

Other proponents of a more lenient concentration control also stress that the social costs resulting from the blocking of a transaction in which one firm is failing are more visible and serious in times of crisis. According to Waits[53], social harm that is to say the harm to employees, shareholders, creditors and to all members of the community surrounding the failing firm should be considered and balanced against the anticompetitive effects. In this regard, Waits refers to the judgment of the Supreme Court of the United States, International Shoe case.

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[49] http://www.oft.gov.uk/news/press/2009/62-09. OFT decision on the anticipated acquisition by First West Yorkshire Limited of Black Prince Buses Limited, May 26, 2005

[50] L. n° 166/2008, Decreto-legge 28 agosto 2008, n° 134, Disposizioni urgenti in materia di ristrutturazione di grandi imprese in crisi, published in the Ufficiale n° 201, 28 août 2008, cf. <http://www.parlamento.it/leggi/decreti/08134d.htm>

[51] Mason R. and Weeds H., The failing firm defence: Merger Policy and Entry, 15 janv. 2003; Waits A. L.Surviving the shipwreck. A proposal to revive the failing division defence, William and Mary Law Review, oct. 2003

[52] Mason R. and H. Weeds, Prev., P. 4, § 2

[53] Waits A. L., préc., p.458

In contrast, the advocates of a strict application of the FFD in times of crisis, for example John Fingleton of the OFT[54] argue that the arguments based on the FFD and efficiencies generated by mergers must be treated with caution and taking into account that market power leads to less not more efficiency in companies. Others point out that in times of crisis, a rise in anti-competitive price and concentration of market power is even more harmful since it slows the process of economic recovery. As for the argument that a rescue merger would encourage firms to enter the market, they respond that they could instead be attracted to markets where the FFD is applied more leniently, which could result distort competition[55].

Regarding the argument concerning the social costs of blocking a rescue merger, the former General Counsel of the Federal Trade Commission, Debra A. Valentine noted the questionable arguments based on the rescue of jobs by asserting that jobs are likely to be deleted as the merger is blocked or it is authorized. If a transaction is blocked and a firm fails the job cuts will obviously result of the plant closure. But if a merger causing problems for competition is allowed it will, according to the theory of oligopoly, cause loss of jobs when the industry raised prices and reduced production. The difference is that the job cuts in this case widely disseminated, progressive and can be severe, drastic and essential when an employer located in the community disappears[56].

Moreover, historical experience argues in general against suspending competition policy in times of economic crisis. A number of measures taken in the past to protect failing firms often have prolonged the economic crisis. For example in 1933, the Roosevelt administration authorized a regulation facilitating cartels and monopolies in order to protect companies weakened by the Great Depression, The National Industrial Recovery Act (NIRA)[57], June 16, 1933 the NIRA was to expire in June 1935, but the Supreme Court of the United States declared the unconstitutionality of Title I of NIRA May 27, 1937, on the grounds that the Act extended the meaning of the commerce clause.

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[54] http://www.oft.gov.uk/news-and-updates/press/2009/47-09 2012-05-30 10.22

[55] Heyer and K. S. Kimmel, Merger Review of Firms in Financial Distress

[56] Valentine D. A., Horizontal Issues: What's happening and what's on the horizon, 8 déc. 1995, Federal Trade Commission, cf. <http://www.ftc.gov/speeches/other/dvhorizontalissues.shtm>

[57] The National Industrial Recovery Act (NIRA), June 16, 1933 (Ch 90 48 stat. 195, codified in 15 USC sec 703)

More recently, the decision by the UK Secretary of State Peter Mandelson on the concentration Lloyds TSB / HBOS may also be considered an example of anti-competitive measure which proved to be a poisoned chalice for the acquirer. In fact, since the completion of the merger, the financial health of the entire group deteriorated significantly.

For the reasons stated above, the current debate is not clearly in the direction of a change in the conditions of application of the FFD in the context of an economic crisis. However, the rapid deterioration of the situation in the real economy, which is just beginning, advocates of an appeal to all forms of legally confirmed and proven competition policy and in particular

- An approach based on the previous General Dynamics. That is to say, a dynamic analysis of competition issues
- A case by case more thorough and complete economic efficiencies on the basis of criteria may be more open than those applied currently
- Full use of procedural tools that allow faster assessment of cases and less bureaucratic

6. Conclusion

The rationale for allowing a merger is often whether it brings positive effects on public welfare; the loss of rivalry at the market lessens the effectiveness in competition, provides lower quality, offers less consumer choice and results in a price increase.[58] Allowing a merger involving a failing firm can for example lead to job losses for the failing firm's employees but so can also the blocking of such a merger. Factors such as employment, the existence of possible innovative efficiency in the new merger, social and public costs and benefits are taken into account by the Commission in a FFD context.[59] It has however been heavily argued that social policy considerations such loss of jobs and similar social complications could be the result of bad management and therefore should not be taken into consideration on application of antitrust law. These issues belong to another policy forum and should therefore not affect competition policy.[60]

[58] Persson: The failing firm defense, (2005) p. 177.
[59] Kokkoris: Failing firm defence in the European Union: A Panacea for mergers? (2006) p. 507.
[60] Kokkoris: Failing firm defence in the European Union: A Panacea for mergers? (2006), p. 506.

The defense is at times explained on the ground that when the acquired firm is a competitive nonentity, its acquisition causes no harm, in any case when its assets would otherwise leave the market. This justification is not completely acceptable, since it might still be preferable to see its market share dispersed among remaining firms rather than going to a single undertaking. Nor is this now standard explanation wholly consistent with International Shoe case, which emphasized, i.a. that failure would cause injury to the communities where the failing firm's plants operated, as well as to its shareholders. This alternative explanation has clear overtones of industrial, rather than competitive policy. It reflects a concern of business failure for social reasons.

These issues are considered by the controlling authorities in both U.S. and EU, as one can understand by studying the guidelines and the case-law. In a merger case involving non-failing undertakings the benchmarking is the situation existing on the market before the merger while in a merger with a failing firm the benchmarking is the post-merger market conditions. The expected liquidation of the failing firm makes clear that the pre-merger market conditions would not prevail anyway. An important question in this context is: How harmful the exit of the failing firm is for the consumer welfare? The more harmful the post-merger situation caused by the exit is, the bigger are the chances that the FFD would apply with success. Another relevant question is: Does the failing firm really risk failing?

Different factors that in any way can affect the competitive structure on the internal market should be taken into account when the prospective market analysis is carried out, for example rapid changes of market conditions. In the recent use of rescue mergers between banks due to the financial crisis, Member States have also experienced problems of jurisdictional and procedural character[61]. The Commission has through its practice however shown that those factors are not considered to be enough for having a looser application of the FFD and the merger control in general[62].

[61] Foecking, Ohrlander & Ferdinandusse: Competition and the financial markets: The role of competition policy in financial sector rescue and restructing (2009), p. 9.
[62] Ibid

Further, no FFD cases have so far, been introduced to the Commission in which the defense was based on the current difficult economic environment. Instead governments have been using various policy instruments for example state aid to save failing businesses during the financial crisis[63]. The financial sectors and important industries have received large amounts of state aid from the Member states[64]. The Commission has thus indicated that even though the current merger regulations including the practice of FFD are and will stay unreformed, it may permit a restraint from the so called stand-still obligation during the time a merger is being reviewed. In this way an urgent rescue merger can, in order to avoid worse complications in the market as a result of rapid changes, be started before the Commission has approved it. This is applied only in extraordinary situations.[65]

> "*Competition works like a catalyst in this environment; it promotes and speeds up economic activity and helps the internal market deploy its full potential. In addition, the public policies that promote competition and the completion of the internal market are perfect examples of what we can do in Europe to boost growth and create jobs at no cost for the taxpayer…The themes that we are debating today are linked by a basic principle; competition is one of the most powerful engines of growth in the EU. I don't need to tell you how, in these dire times, the benefits of competition are extremely valuable – and not only for our companies. Many people in Europe are bearing the brunt of the crisis and of the fiscal consolidation strategies introduced to rein in public deficits. Together with this framework of fiscal discipline, the EU needs to modernize and strengthen its economy; and competition drives firms to look for a competitive edge and towards innovation. Therefore, if competition means growth, what we need today to reverse the decline in the standards of living of our citizens is more, well-regulated competition in the internal market. Releasing the creative and productive forces of our economy will bring lasting results*."[66]

[63] Kokkoris & Mardsen: The role of competition and state aid policy in financial and monetary law (2010) p, 873.
[64] European Commission: Report on Competition Policy, 2009, Competition reports (2009) p.12.
[65] The „failing firm" defence in difficult times, In-House Lawyer, EU & Competition, July (2010).

[66] European Competition Forum, Brussels, Joaquín Almunia 2 February 2012

As has been shown, the FFD has seldom been successfully invoked by companies and thereby been cleared by the Commission in a limited range. The approval of FFD is a complicated process consisting of several trade-off considerations; besides the satisfaction of three strictly enforced cumulative conditions, a prospective market analysis has to be carried out in every case. It is also important to keep in mind, before clearing a merger involving a failing firm, that companies actually may exaggerate the failing firm's economic difficulties.

> "*Put differently, if anticompetitive mergers and other business practices are permitted during an economic crisis, it is likely to cause reduced innovation and output, and consumers will lose the benefits of lower prices. Thus, I would suggest that competition laws need to be implemented at least as strictly during a time of economic crisis as they are otherwise*."[67]

The analysis becomes even more complicated due to the social, legal and economic concerns that a FFD involves or it also may give rise to. There is for example the risk of loss of the failing firm's future technical and innovative contributions if such a merger is prohibited. This will in the long run have a negative impact on the public welfare. However, seen from a competitive perspective the remaining companies at the market would compete for the failing firm's costumers which will consequently lead to more aggressive and better competition.

The most crucial element considered by the Commission is whether the lack of causality-requirement is fulfilled and that the prospective merger is considered being totally neutral in regard to the development in the common competitive market. When making the trade-off between social benefits and anticompetitive concerns, failing firms which are contributing to the future economic growth by their production and innovation are probably prioritized. The Commission is also more likely to permit a FFD if the absence of a merger involving failing firm affects consumer welfare negatively and give rise to adverse competition affects. The public welfare is therefore highly stressed. For example would a merger between banks probably be permitted considering the negative public impacts that the liquidation of a financial institution would have. There are however problems in how to measure the degree of social costs and benefits. In general it is hard to know when to apply the FFD.

[67] Commissioner Thomas Rosch had a more expansive explanation in a speech in January 2009

I think, however, that the current model that is being used by the Commission in analyzing the applicability of FFD is a well-balanced one. The economic principles that FFD are based upon are, as I can see it, supposed to be applied equally whether the economy is a healthy or a struggling one. In view of the global financial distress, the Commission has therefore in its application of the FFD not shown any sign or tendency of becoming more tolerant to allow mergers involving failing firms. A higher frequency of FFD cases were expected to be raised as a result of struggling economic environment.

However, the amount of FFD cases did not increase. The main reason was that there are other tools available, such as state aids, which are designed to be used for these types of scenarios. The Commission has therefore been strict in its treatment regarding FFD in order to guarantee that the benefits of competition will remain and not be sacrificed because of tendencies of protectionism. There is still the possibility for the Commission to use some flexibility in the market analysis by taking account of the crisis market conditions. The use of FFD is, in my opinion, considered to be the very last solution in saving a firm if other reorganization solutions simply cannot be applicable. Important to have in mind is that, as in FFD cases, it is obviously also difficult to make trustworthy forecasts about other possible reorganization methods.

The FFD is in my opinion unquestionably working as an important safeguard which guarantees the public a certain degree of welfare. I therefore think that the Commission should keep its strict approach when making the trade-off between social benefits and anticompetitive concerns. There is still room for flexibility in upcoming cases in accordance with the analysis being made in each case. It would be interesting to follow the evolution of the ongoing financial crisis and its impact on the application of competition rules within the internal market.

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