

FOOD FOR THOUGHT: THE EFFICIENCIES ACHIEVED BY TRIMMING AN INDUSTRY AT OVERCAPACITY THROUGH MERGERS VS. CHAPTER 11 REORGANIZATIONS

As Americans become more health conscious, the high-preservative snack food industry feels the pressure to trim market overcapacity. Fewer and fewer people are reaching for foods brimming with trans-fats, cholesterol, and calories.¹ Certainly, consumers' taste for healthier foods may be good for the body, but changes in demand for certain foods, products, or services can have a huge impact on the market. The free market allows consumers to change their preferences; this potential for profit in turn spurs innovation and modernization. But industries that are left behind, such as the high-preservative snack food industry, suffer, become "sick," and possibly even fail to stay in the market. A "sick" industry overproduces a given product or service compared to the demand for that product or service, and thus, the industry operates at overcapacity.² While at one time this sick industry sufficiently matched consumer demands, it now either shrinks or operates at overcapacity due to decreased demand for that product.

Change in demand is due to many factors, such as the age of consumers, a disruptive technology, or the creation of a more innovative alternative. For example, the newspaper industry operated at overcapacity as readers began choosing news services from the internet or television. The oversaturated newspaper market responded with several newspapers merging, others failing, and ultimately only one newspaper remaining in publication per city.³ Other examples of sick industries include the American car industry, the asbestos industry, and the airline industry. Basic economics suggests that sick industries should have every means available, including merging, to alleviate

¹ Interstate Bakeries Corporation (IBC), the owner of Hostess, Wonderbread, and other smaller brands entered Chapter 11 in 2004. IBC had inefficient operations, and sales were down due to the popularity of the low-carbohydrate diet. The company also lists declining sales, a high fixed-cost structure, and excess industry capacity as reasons for the bankruptcy filing. *Twinkies' Maker Files Bankruptcy: Interstate Bakeries, Hit by Accounting and Low-carb Woes, Seeks Chapter 11 Protection*, Sept. 22, 2004, http://money.cnn.com/2004/09/22/news/fortune500/interstate_bankruptcy/.

² Harry First, *Structural Antitrust Rules and International Competition: The Case of Distressed Industries*, 62 N.Y.U. L. REV. 1054, 1069 (1987).

³ See generally *id.*

overcapacity. However, current legal barriers may prevent the efficient trimming of these industries.

Antitrust law strives to ensure competition and preserve the health of the free market. The Clayton Act was created to clarify specific antitrust principles by prohibiting certain activities which were deemed always harmful to the market.⁴ Section 7 of the Clayton Act prohibits a merger that may substantially lessen competition.⁵ The Failing Company Doctrine is an affirmative defense to a merger that would otherwise be a § 7 violation, and makes the merger lawful because one of the companies is failing.⁶ This law, codified in the Merger Guidelines,⁷ is congruent with antitrust principles because a company that is failing would not lessen competition if the alternative to the merger would be the company exiting the market. Therefore, the merger is the “lesser of two evils.”⁸

A company will not qualify as a “failing company” under this defense if it can be reorganized through Chapter 11 (hereinafter “the Chapter 11 requirement”).⁹ Originally, this requirement ensured that the failing company was truly on the verge of exiting the market.¹⁰ However, now certain companies and industries, such as the airline industry, do not fail but rather are continuously bolstered by the Chapter 11 reorganization process. Repeat reorganization may not be the most efficient market pattern for a sick industry. This Comment argues that the Chapter 11 requirement must be removed from the Merger Guidelines to ensure that merger can always be an option to alleviate market overcapacity. The government could then analyze a proposed merger more broadly through a lens of economic efficiency.

This Comment demonstrates that, in certain situations, the market would benefit if a failing company were allowed to merge, even if it could be reorganized under Chapter 11. Because there are some instances in which a

⁴ Clayton Act § 7, 15 U.S.C. § 18 (2006).

⁵ *Id.*

⁶ Richard D. Friedman, *Untangling the Failing Company Doctrine*, 64 TEX. L. REV. 1375, 1376 (1986).

⁷ The Merger Guidelines are produced and updated by the Federal Trade Commission and Department of Justice. “The Guidelines are designed primarily to articulate the analytical framework the Agency applies in determining whether a merger is likely substantially to lessen competition, not to describe how the Agency will conduct the litigation of cases that it decides to bring.” U.S. Dep’t of Justice and Fed. Trade Comm’n Horizontal Merger Guidelines (1992), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104, at 20,569-3 (1997) [hereinafter 1992 Merger Guidelines].

⁸ *United States v. Gen. Dynamics Corp.*, 415 U.S. 486, 507 (1974).

⁹ 1992 Merger Guidelines, *supra* note 7, at 20,569-3.

¹⁰ *Citizen Publ’g v. United States*, 394 U.S. 131 (1969).

merger that may substantially lessen competition is economically preferential to that company's reorganization, the Merger Guidelines should eliminate the Failing Company Doctrine's Chapter 11 requirement.

This Comment is organized into five parts. Part I explains § 7 of the Clayton Act and its failing company defense. This first part focuses on the development and objectives behind the doctrine and the underlying antitrust goal of economic efficiency.

Part II delves into the reorganization requirement of the failing company defense: its creation in a sick newspaper industry, its development, and the modern defense. Finally, this section discusses how the government operates in the shadow of antitrust law, and how the failing company defense analytical methods have been applied recently to cases in sick regions or sick industries.

Part III of this Comment analyzes the natural incongruity of Chapter 11 reorganizations with antitrust law due to Chapter 11's objectives of serving the public interest and protecting companies from failure.¹¹ This section also addresses three primary problems with Chapter 11 reorganization: (1) the difficulty of predicting the future success of the reorganized firm; (2) the imperfect valuation of the firm; and (3) the potentially high costs of the reorganization.

Returning to the antitrust goal of efficiencies, Part IV of this Comment discusses potential efficiencies achieved through a merger.

Finally, Part V of this Comment concludes with a detailed economic analysis of the intersection of the Failing Company Doctrine and Chapter 11 reorganization in the atmosphere of the sick industry. It determines that in order to benefit the market, the Chapter 11 requirement of the Failing Company Doctrine should be deleted from the Merger Guidelines. The sick industry should alleviate overcapacity in the most economical way possible; this could be Chapter 11, merger, or even failure, but the options should be analyzed simultaneously.

¹¹ Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 673-74 (2003).

Sick Industry Hypothetical of Little Betty

Consider the following hypothetical case. There are four packaged bakery snack companies in the geographic market.¹² All except Mabisco, which created a 100 calorie version of its products, are struggling. The industry is “sick” in that, as a whole, it is operating at overcapacity. One of the bakery snack companies, Little Betty, cannot cover its costs of operating with dwindling sales of cupcakes, cake rolls, and pastries, and thus loses money on every sugary morsel produced. Little Betty has decreased overall production but still cannot cover overhead costs. Additionally, Little Betty has been unable to create successful lower-fat versions of its products. Little Betty, pessimistic about the prospects of innovation and strapped with debt, considers Chapter 11 reorganization for a second time. Little Betty hopes that a makeover in management could help lower its costs and make the company more appealing, thus helping it to increase demand for its products and become profitable again. Industry experts, but not the bankruptcy judges, project that this reorganization plan, like Little Betty’s reorganization a few years ago, will only aid the company in the short term before it starts to become unprofitable again.

Before Little Betty files a petition for Chapter 11 reorganization, it is approached by Tastypie, which has amazing recipes but lacks the facilities to produce them efficiently. Tastypie knows that a merger with Little Betty would be extremely attractive to investors and could create a strong, profitable bakery snack company with healthy revenues.¹³ Little Betty sees the benefits of this merger and the great potential value that consolidation would create.

Little Betty essentially has three options: (1) liquidate by selling off all of its assets piecemeal; (2) reorganize through another Chapter 11 with the hope that changes would result in long term improvements; or (3) merge with Tastypie to become one viable bakery snack company. These three options must be analyzed in terms of which course would produce the highest overall

¹² If there are only five bakery snack companies in the market, then the market is considered highly concentrated by antitrust law. Telephone Interview with Catharine Moscatelli, Assistant Dir. of the Mergers Dep’t, Bureau of Competition, Fed. Trade Comm’n, in Wash., D.C. (Nov. 6, 2007).

¹³ This exact scenario presented itself to Delta in 2006: a potential merger with US Airways. Thomas Olson, *US Airways Feels Out Delta over Merger*, PITTSBURGH TRIB.-REV., Aug. 1, 2006. US Airways subsumed America West Airlines, which was considering liquidation, in May 2005 and created \$800 million in merger capital. After the merger, US Airways had stellar financial results and big investors were eager to support a larger merger between Delta and US Airways. *Id.*

value for the company.¹⁴ Determining the highest valuation is difficult because the Chapter 11 valuation is done by a third party—a bankruptcy judge often hindered by imperfect knowledge of the present value of the company and its potential for future value.¹⁵ Hypothetically, Little Betty has perfect market knowledge and agrees to merge with Tastypie. A merger of the companies puts the assets in the hands of those who can create the most value from them and thus creates the most value for Little Betty and the market.

Little Betty realizes that among the three options, Tastypie valued Little Betty the most. Economically, it made sense to merge with Tastypie because Little Betty would realize the most economic value. However, in this situation Little Betty faces a legal barrier: the Federal Trade Commission and Department of Justice will not approve this merger because it does not meet the Chapter 11 requirement of the failing company defense in the Merger Guidelines. Little Betty does not satisfy the requirement because it can reorganize under Chapter 11. Thus, the snack company's failing company defense will be rebutted and the merger will be prohibited. Therefore, Little Betty is forced to proceed in Chapter 11 reorganization for the second time.

It is more economically efficient and healthier for the market for Little Betty to merge with Tastypie instead of reorganizing in Chapter 11 a second time. This Comment will demonstrate that the economically flawed law presented in the hypothetical scenario may be exposed in a number of current sick industries. The exception to § 7 of the Clayton Act is the failing company defense. However, the Merger Guidelines codify that a company is not "failing" if it could be reorganized under Chapter 11. This provision narrows the spectrum of the failing company exception of § 7 too severely and could force what may turn out to be an economically ineffective Chapter 11. Instead, the Chapter 11 requirement should be eliminated from the Merger Guidelines and all the options for the failing company should be weighed simultaneously through a lens of economic efficiency.

At the time of a proposed merger, uncertainty surrounding the reorganization atmosphere makes it extremely difficult to make reliable predictions as to whether the potentially acquired company could successfully

¹⁴ This is the economic theory of allocative efficiency which will be discussed *infra*.

¹⁵ The potential future value must be measured in present day dollars to account for the overall valuation of the company. This will also be further discussed *infra*.

reorganize as the Merger Guidelines require.¹⁶ In the context of the current environment of Chapter 11 reorganization and the state of the Merger Guidelines, there are three avenues of market “failure” in the sick industry: (1) exit the market; (2) merge and create a less competitive market; or (3) return to the market aided by reorganization, sometimes ineffectively. The Merger Guidelines compel the third avenue: that a company attempt to reorganize before considering a merger.¹⁷

This Comment proposes that the various avenues of exit and reductions in market overcapacity should be analyzed simultaneously through a lens of economic efficiency. A company should be considered “failing” in some situations regardless of whether it could reorganize through bankruptcy. For courts to have the ability to weigh each exit option, the Chapter 11 requirement must be removed from the Merger Guidelines.

I. THE FAILING COMPANY DOCTRINE

*The basic consequence of the doctrine is clear enough: in some cases a merger that would otherwise violate Section 7 is rendered lawful because one of the merging companies is in imminent danger of failure. Beyond that, much is murky. The difficulty begins with the question of why the doctrine should exist.*¹⁸

The Failing Company Doctrine is the exception to § 7 of the Clayton Act, the rules of merging companies, also codified in the Merger Guidelines.¹⁹ This exception is in the form of an affirmative defense. A merger that would otherwise be a § 7 violation is lawful because one of the companies is failing.²⁰ If the company can reorganize through Chapter 11, it is not “failing” under the doctrine.²¹ Thus, the Chapter 11 requirement is the exception to the exception. The Clayton Act does not permit a merger if it “may substantially lessen

¹⁶ *The Failing Company Defense: Statement Before the Fed. Trade Comm’n*, (Nov. 14, 1995) (statement of Edward O. Correia, Professor of Law, Northeastern University School of Law), <http://www.ftc.gov/opp/global/final.shtm>. The Merger Guidelines as explained *infra* codify the Failing Company Doctrine as originally used in *Citizen Publishing Co. v. United States*, 394 U.S. 131 (1969). The reorganization which *Citizen Publishing* anticipates is one from which the company could emerge as a “strong competitive compan[y].” *Id.* at 138.

¹⁷ 1992 Merger Guidelines, *supra* note 7, at 20,574.

¹⁸ Friedman, *supra* note 6, at 1376.

¹⁹ 1992 Merger Guidelines, *supra* note 7, at 20,574.

²⁰ *Id.*

²¹ *Id.*

competition, or tend to create a monopoly,”²² unless the company is failing; a company that is faltering cannot use the defense if it could be reorganized under Chapter 11. To fully understand the spirit and original unity of the Failing Company Doctrine and its Chapter 11 reorganization exception, it is helpful to understand how and why they were both developed. This section tracks the development of the Failing Company Doctrine and the reasoning behind the Doctrine as a defense to § 7 of the Clayton Act.

A. *Development of the Failing Company Doctrine*

In the early twentieth century, the United States court system relied on the Sherman Act²³ as the definitive antitrust law. However, this Act gave the courts overly broad power to reach their own conclusions. Congress passed the Clayton Act²⁴ in 1914 in response to the overly broad Sherman Act²⁵ to clarify that the court system did not have the power to validate mergers and acquisitions that had anticompetitive effects.²⁶ Essentially, the Clayton Act specifies that certain actions are always illegal.²⁷

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 . . . where in any line of 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.²⁸

Specifically for our purposes, § 7 of the Clayton Act articulates that no person should acquire part or all of the stock of another company such that “the effect of such acquisition may be substantially to lessen competition, or to

²² Clayton Act § 7, 15 U.S.C. § 18 (2006).

²³ Sherman Act of 1890, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1–7 (2006)).

²⁴ 15 U.S.C. § 18.

²⁵ Sherman Act.

²⁶ E. THOMAS SULLIVAN & HERBERT HOVENKAMP, *ANTITRUST LAW, POLICY, AND PROCEDURE: CASES, MATERIALS, PROBLEMS* 827 (5th ed. 2003).

²⁷ *Id.* Congress wrote the Clayton Act to be very specific in response to the overly broad Sherman Act of 1890. *Id.* The courts were arguably abusing the broad standards of the Sherman Act and developed the “Rule of Reason” in *Standard Oil Co. v. United States*, 221 U.S. 1, 60 (1911). *Id.* Therefore, Congress sought to make illegal specific practices such as where a company acquired its competitor with an anticompetitive effect. *Id.*

²⁸ 15 U.S.C. § 18.

tend to create a monopoly.”²⁹ To establish a prima facie case under § 7 of the Clayton Act, a plaintiff must first define the relevant market and then demonstrate that the proposed merger would create a substantial danger of anticompetitive consequences.³⁰ It is important to note that the core concern of § 7 is the competitive impact of a merger.³¹ Furthermore, § 7 is concerned with “probabilities, not certainties”³² and requires that the fact finder make a determination about future effects.³³

While the premise of § 7 is the current rule of antitrust law, the Clayton Act was heavily scrutinized in the 1950s in an attempt to clarify the original deficiencies in language that, in application, had altered its true meaning and purpose.³⁴ The Celler-Kefauver Act resolved the language issues in 1950 and unequivocally validated the failing company defense.³⁵

Additionally, in 1950 the Senate passed a bill amending § 7 to include the “failing company defense.”³⁶ Senator O’Conor³⁷ discussed the Supreme Court dictum from *International Shoe Co. v. Federal Trade Commission*³⁸ that

²⁹ *Id.*

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

Id.

³⁰ *United States v. Phila. Nat’l Bank*, 374 U.S. 321, 362 (1963). The relevant market is determined not by where the two parties to the proposed merger do business or compete, but instead where they overlap such that the effect of the merger would be immediate and direct. *Id.* at 357.

³¹ Friedman, *supra* note 6, at 1378.

³² *Brown Shoe Co. v. United States*, 370 U.S. 294, 323 (1962).

³³ Friedman, *supra* note 6, at 1380.

³⁴ SULLIVAN & HOVENKAMP, *supra* note 26, at 827. There were three primary problems with § 7: (1) a split infinitive, which was amended to read “substantially to lessen competition”; (2) the company could acquire all of its competitors assets; and (3) it only applied to competition “between” competitors which therefore did not refer to vertical acquisitions. *Id.* Another language issue was that the 1914 Clayton Act only pertained to the acquisition of stock, so companies could still acquire all of the assets of a competitor simply leaving behind the competitor’s name, which certainly had anticompetitive effects. *Id.*

³⁵ Celler-Kefauver Act of 1950, ch. 1184, 64 Stat. 1125–26 (codified as amended at 15 U.S.C. § 18); see 4 EARL W. KINTNER, FEDERAL ANTITRUST LAW §§ 33.2–.3 (1984). See generally 4 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶¶ 902c–903 (2d ed. 1980).

³⁶ John P. Ludington, Annotation, “Failing Company” Defense to Actions for Violations of § 7 of Clayton Act (15 USC § 18), 11 A.L.R. FED. 858, 862 (1972).

³⁷ Herbert O’Conor served in the U.S. Senate from 1947 until 1953 representing the state of Maryland.

³⁸ *Int’l Shoe Co. v. Fed. Trade Comm’n*, 280 U.S. 291, 302 (1930).

allowed for the merger on an alternative basis: a failing company was a “corporation with resources so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure.”³⁹ The original use of the failing company defense in *International Shoe* included weighing social costs. It required that a court determine whether the acquisition would result in a substantial lessening of competition to the degree that would injuriously affect the public and, if so, the acquisition must be declared illegal.⁴⁰ In weighing the factors, however, the court found that the purpose of the merger was not “to lessen competition, but to facilitate the accumulated business of the purchaser and with the effect of mitigating seriously injurious consequences otherwise probable” to the public.⁴¹ Interestingly, *International Shoe* did not create a “defense,” but rather used the company’s financial status as a factor in the Court’s broad analysis of the anticompetitive effects on the market.⁴² However, both the House and Senate read *International Shoe* as creating the failing company defense to the Clayton Act.⁴³

Although Congress discussed the failing status of a company as the only affirmative defense for a merger or acquisition that would otherwise be anticompetitive under § 7, nothing in the statute expressly stated the “failing company defense.”⁴⁴ The 1992 Merger Guidelines dictate that the failing company defense is available if:

- 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 under Chapter 11 of the Bankruptcy Act; 3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers of acquisition of the assets of the failing firm that would both keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger; and 4) absent the acquisition, the assets of the failing firm would exit the relevant market.⁴⁵

³⁹ 96 CONG. REC. 16,435 (1950) (statement of Sens. O’Conor and Kefauver) (quoting *Int’l Shoe*, 280 U.S. at 302) (referring to companies in a failing or bankrupt condition that propose to merge).

⁴⁰ *Int’l Shoe*, 280 U.S. at 298.

⁴¹ *Id.* at 302.

⁴² Edward O. Correia, *Re-examining the Failing Company Defense*, 64 ANTITRUST L.J. 683, 684 (1996).

⁴³ See S. REP. NO. 81-1775, at 7 (1950); Correia, *supra* note 42, at 684.

⁴⁴ Clayton Act § 7, 15 U.S.C. § 18.

⁴⁵ 1992 Merger Guidelines, *supra* note 7, at 20,574 (citations omitted).

For the purposes of this Comment, the requirement that the company must make a good faith effort to find a less anticompetitive buyer will not be discussed.

B. Reasoning behind the Failing Company Doctrine

The justification for the failing company defense is that it “recognizes a general preference for having assets productively utilized rather than withdrawn from a market.”⁴⁶ In essence, the reasoning behind legalizing an anticompetitive acquisition is that it is the “lesser of two evils.”⁴⁷ There would be a less significant reduction in competition by allowing the companies to merge rather than having a company liquidate. The two so-called “evil options” are that the failing company will either (1) merge or be acquired by a competitor or (2) exit the market.⁴⁸ The next section will evaluate the competitive effects of both exiting the market and allowing the merger.⁴⁹

If the company is acquired by a firm with dominant market power, the acquiring company will increase its share of the market and would likely produce less, thus driving up the price of each unit.⁵⁰ However, if the company exits, its assets are not likely to be “divided up by the remaining firms in proportion to those firms’ shares of the remainder of the market.”⁵¹ Assuming that the other companies in the industry are operating efficiently, at marginal cost, they would not want to acquire the failing firm’s output unless the price of the product would increase.⁵² And in the basic competitive economic model of supply and demand, if the price increases, the demand will decrease, thus signaling that market output should be reduced.⁵³

Nevertheless, the fact that a company claims an imminent exit if the merger is not allowed is not a defense in and of itself, but just another factor that should be weighed for its competitive significance.⁵⁴ Deriving a conclusion

⁴⁶ 4 Trade Reg. Rep. (CCH) ¶ 13,200, at 20,904 (1988).

⁴⁷ United States v. Gen. Dynamics Corp., 415 U.S. 486, 507 (1974).

⁴⁸ *Id.*

⁴⁹ Thomas J. Campbell, *The Efficiency of the Failing Company Defense*, 63 TEX. L. REV. 251, 257 (1984).

⁵⁰ See generally GEORGE J. STIGLER, *THE THEORY OF PRICE* ch. 13 (3d ed. 1966).

⁵¹ RICHARD A. POSNER & FRANK H. EASTERBROOK, *ANTITRUST: CASES, ECONOMIC NOTES, AND OTHER MATERIALS* 471 n.1 (2d ed. 1981).

⁵² Campbell, *supra* note 49, at 261.

⁵³ *Id.*

⁵⁴ See John E. Kwoka & Frederick R. Warren-Bolton, *Efficiencies, Failing Firms, and Alternatives to Merger: A Policy Synthesis*, 31 ANTITRUST BULL. 431 (1986).

from the balancing of the two factors is difficult but can be done by comparatively quantifying economic losses using elementary price theory.⁵⁵ One must balance the effects of each possibility in regards to (1) decreasing output of the product, (2) raising prices, and (3) efficient use of assets, essentially the market efficiencies. As the law is now, the market efficiencies of the varying options cannot be weighed evenly because of the Failing Company Doctrine's reorganization requirement, discussed in the next section.

II. THE REORGANIZATION REQUIREMENT

As codified in the 1992 Merger Guidelines, the reorganization requirement of the failing company defense states that a company is failing only if it is unable to reorganize successfully under Chapter 11 of the Bankruptcy Code.⁵⁶ This section of this Comment explains the origin of the reorganization requirement, its development, and its role in the modern Failing Company Doctrine. The premise of the reorganization requirement is derived from *Citizen Publishing v. United States*, and asserts that a company is not truly failing if it could be reorganized to remain as a viable competitor in the market.⁵⁷ This Comment will argue that with the evolving subjectivity in bankruptcy procedures, the goals of bankruptcy do not align with the antitrust core of economic efficiency. First it is vital to understand the spirit of the Chapter 11 requirement of the Failing Company Doctrine and how it has progressed to the point that even Justice Douglas,⁵⁸ author of the defense, would no longer find it a reflection of his original intent.

A. *Creation of the Reorganization Requirement: Citizen Publishing*

In 1969, a crucial opinion discussing the failing company defense came down from the Supreme Court.⁵⁹ In *Citizen Publishing*, two newspapers, the *Star* and the *Citizen* competed vigorously in Tucson, Arizona.⁶⁰ Although

⁵⁵ Campbell, *supra* note 49, at 257.

⁵⁶ 1992 Merger Guidelines, *supra* note 7, at 20,574.

⁵⁷ See generally *Citizen Publ'g v. United States*, 394 U.S. 131 (1969).

⁵⁸ Justice William Douglas was on the Supreme Court from 1939–1975. 4 THE JUSTICES OF THE UNITED STATES SUPREME COURT: THEIR LIVES AND MAJOR OPINIONS 1220 (Leon Friedman & Fred L. Israel eds., 1997).

⁵⁹ *Citizen Publ'g*, 394 U.S. 131.

⁶⁰ *Id.* at 133. Tucson only had two newspapers, the *Citizen* and the *Star* in circulation. The *Citizen* was the older of the two, having been in circulation since before 1900, whereas the *Star* was a younger newspaper. *Id.*

approximately equal in circulation, the *Star* sold more advertising and operated at a profit, whereas the *Citizen* operated with annual losses.⁶¹ Two stockholders bought the *Citizen* and independently financed the paper.⁶² In 1940 they negotiated a joint operating agreement between the two newspapers in a formation called Tucson Newspapers, Inc. (“TNI”).⁶³ The purpose of the agreement was to end competition between the two newspapers.⁶⁴ The Court held that the merger violated § 7, as it substantially lessened competition in daily newspaper publishing.⁶⁵

Justice Douglas upheld the *International Shoe* requirements that a company have “the grave probability of a business failure” and that there is no less anticompetitive buyer;⁶⁶ however, he added a third requirement: that the prospect of reorganization must be “dim or nonexistent.”⁶⁷ Therefore, under Justice Douglas’s view, a company is failing only when “resources of one company [a]re so depleted and the prospect of rehabilitation so remote that ‘it face[s] the grave probability of a business failure.’”⁶⁸ Justice Douglas believed that the companies were not failing if reorganization was possible because companies that reorganized “often emerged as strong competitive companies,” sometimes even stronger and better able to compete.⁶⁹ Therefore, in confining the failing company defense, the Court held the formation of TNI violated § 7.⁷⁰ Perhaps the Court intended the failing company defense to be a narrow defense. However, the additional requirement that the company be unable to reorganize has muddied the analytical waters. As the antitrust and bankruptcy reorganization law have evolved, the intended purpose of the third requirement has not been carried out.

⁶¹ *Id.* The *Star* sold fifty percent more advertising space for annual profits averaging about \$25,825. The *Citizen* had annual losses of about \$23,550. *Id.*

⁶² *Id.*

⁶³ *Id.* The newspapers agreed that TNI would be owned in equal shares by the *Star* and the *Citizen* and TNI would control the production and distribution between the two. Thus, the competition between the two was eliminated and profits surged to \$1,727,217 in 1965. *Id.* at 133–34.

⁶⁴ *Id.* at 134.

⁶⁵ *Id.* at 134–35. In addition to eliminating competition, the agreement also provided that TNI as one unit would control: (1) price fixing, (2) profit pooling, and (3) market control. *Id.* at 134.

⁶⁶ *Id.* at 136–37 (citing *Int’l Shoe Co. v. Fed. Trade Comm’n*, 280 U.S. 291 (1930)).

⁶⁷ *Id.* at 138.

⁶⁸ *Id.* at 137 (quoting *Int’l Shoe*, 280 U.S. at 302).

⁶⁹ *Id.* at 138.

⁷⁰ *Id.* at 139–40. Thus, the Court forced the divestiture of the *Star* from TNI to ameliorate the substantial lessening of competition the agreement caused. *Id.* at 140.

B. The Interaction of the Failing Company Defense and the Reorganization Requirement After Citizen Publishing

A series of antitrust cases emerged in the early 1970s that solidified and contributed to the modern Failing Company Doctrine. The defense was supported and clarified even though it did not often prevail in court. In 1976, the Supreme Court described the Failing Company Doctrine as “a ‘lesser of two evils’ approach, in which the possible threat to competition resulting from an acquisition is deemed preferable to the adverse impact on competition and other losses if the company goes out of business.”⁷¹ The 1968 Department of Justice Merger Guidelines declared that it

regards as failing only those firms with no reasonable prospect of remaining viable; it does not regard a firm as failing merely because the firm has been unprofitable for a period of time, has lost market position or failed to maintain its competitive position in some other respect, has poor management, or has not fully explored the possibility of overcoming its difficulties through self-help.⁷²

The Court used the *International Shoe* language throughout all of its cases in the 1970s, demonstrating its retained faith in the original Failing Company Doctrine.⁷³ However, these cases struggled to define the scope of the doctrine by continuously redefining “failing” and questioning what efforts were necessary for the company to take before qualifying as a failing company.

In 1970, the courts tackled the failing company case of *U. S. Steel Corp. v. FTC*.⁷⁴ In that case, U.S. Steel, the country’s largest manufacturer of steel, had acquired Certified, a ready-mix concrete producer and consumer of cement.⁷⁵ The Federal Trade Commission (“FTC”) charged U.S. Steel with a violation of § 7.⁷⁶ In response, U.S. Steel denied that the merger had anticompetitive effects and claimed it was immune under the Failing Company Doctrine.⁷⁷

⁷¹ *United States v. Black & Decker Mfg. Co.*, 430 F. Supp. 729, 777–78 (1976) (referring to the interpretation of *Int’l Shoe*).

⁷² U.S. Dep’t of Justice and Fed. Trade Comm’n Horizontal Merger Guidelines (1968), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,101, at 20,524 (1988) [hereinafter 1968 Merger Guidelines].

⁷³ *Int’l Shoe*, 280 U.S. at 302.

⁷⁴ *U.S. Steel Corp. v. Fed. Trade Comm’n*, 426 F.2d 592 (6th Cir. 1970).

⁷⁵ *Id.* at 594–95. U.S. Steel acquired Certified in 1964, and in January 1965 the FTC issued its complaint. The FTC found that (1) the acquisition might substantially lessen competition and (2) the failing company defense did not immunize Certified from § 7 because there was no interest in keeping Certified from bankruptcy.

⁷⁶ *Id.* at 593.

⁷⁷ *Id.*

Although the FTC found that the vertical integration of the two companies would have deteriorated competitive conditions, it also found that Certified was in a failing condition.⁷⁸

The court found that both U.S. Steel and the FTC had “devoted insufficient consideration to the prospects of reorganizing Certified into a vital, competitive company,” and therefore, they had not proven that Certified’s vitality through bankruptcy would be “dim or non-existent.”⁷⁹ The court went through the detailed analysis of *Citizen Publishing*, ultimately holding that (1) the burden of proving the failing company doctrine is on “those who seek refuge under it;”⁸⁰ (2) the failing company’s ability to emerge from bankruptcy must be “dim or non-existent;”⁸¹ and (3) the present scope of the Failing Company Doctrine is narrow⁸² and does not grant absolute immunity under § 7.⁸³

The Supreme Court did not allow the use of the Failing Company Doctrine in the 1971 case *United States v. Greater Buffalo Press, Inc.*⁸⁴ Greater Buffalo Press, Inc. (“Buffalo”), King Features Syndicate (“King”), and International Color Printing, Co. (“International”) all worked in the printing and sale of color comic supplements for newspapers.⁸⁵ International printed the comics exclusively for King to license and sell, while Buffalo just printed and sold the color comics.⁸⁶ International’s owners did not want to raise capital for a necessary modernization and expansion, but instead wanted to sell the company as a whole.⁸⁷ After Buffalo acquired all of International’s stock, Buffalo controlled about seventy-five percent of the color comic supplement

⁷⁸ *Id.* at 605. Certified had a reasonable probability of failing within the near future and there was a “lack of availability of (any) other purchasers besides U.S. Steel.” *Id.* at 606 n.28 (internal quotations omitted).

⁷⁹ *Id.* at 609 (“We may fairly infer from the Court’s holding in *International Shoe* the ‘failing company doctrine’ would not have applied . . . had the prospects for going through receivership not been ‘wholly speculative.’”).

⁸⁰ *Id.* (citing *Citizen Publ’g v. United States*, 394 U.S. 131, 138–39 (1969)).

⁸¹ *Id.* at 608 (citing *Citizen Publ’g*, 394 U.S. at 138).

⁸² *Id.* at 609.

⁸³ *Id.* at 606.

⁸⁴ 402 U.S. 550 (1971).

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* International approached both King and Buffalo in an attempt to sell the company. *Id.* at 549.

printing business.⁸⁸ After the acquisition, King depended on Buffalo for all of its printing, which it simultaneously sold in competition with Buffalo.⁸⁹

The Court's decision in *Greater Buffalo Press* solidified the elements of *Citizen Publishing* and *International Shoe* so that the failing company test "is met only if two requirements are satisfied: (1) that the resources of International were 'so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure,' . . . and (2) that there was no other prospective purchaser for it."⁹⁰ Because International wanted to be bought out but still had the King contract, it was not facing business failure.⁹¹ There were other potential purchasers, and thus, the Failing Company Doctrine could not be used to support Buffalo's buyout of International.⁹²

The Supreme Court, specifically Justice Douglas, loosened the failing company defense in *United States v. General Dynamics Corp.* and allowed for a weak competitor argument.⁹³ In that case, Material Service Corporation ("Material") was a large Midwestern producer and supplier of building materials, which had been acquiring stock from United Electric Coal Companies ("United"), a coal company that operated only strip or open-pit mines from 1954–1959.⁹⁴ In 1959, Material was acquired by General Dynamics Corporation ("General"), a large diversified company, and in 1966, United became a wholly owned subsidiary of General.⁹⁵ The government challenged the acquisition of United by Material as a violation of § 7, in that it substantially lessened competition.⁹⁶ While United was considered a "healthy and thriving company" at the time of the acquisition, General sought to use the

⁸⁸ *Id.* at 549–50. The Supreme Court rejected the district court's holding that the act of printing versus the syndicating act of selling/licensing were separate commerce lines. It held that the acts were submarkets of the broader color comic supplement printing market. *Id.*

⁸⁹ *Id.* at 553. At the time of trial, there was evidence that Buffalo had already taken accounts from King after the acquisition, but the price of the comics was still above the price Buffalo charged King for printing. *Id.*

⁹⁰ *Id.* at 555 (citing *Citizen Publ'g Co. v. United States*, 394 U.S. 131, 138 (1969); *Int'l Shoe Co. v. Fed. Trade Comm'n.*, 280 U.S. 291, 302 (1930)).

⁹¹ *Id.*

⁹² *Id.* at 555–56.

⁹³ Correia, *supra* note 42, at 687.

⁹⁴ *United States v. Gen. Dynamics Corp.*, 415 U.S. 486, 488–89 (1973).

⁹⁵ *Id.* at 489–90. General made most of its revenues from selling aircraft, communications, and marine products to government agencies. However, by acquiring Material, it became the nation's fifth largest coal producer. *Id.* at 513.

⁹⁶ *Id.* at 490. The government's complaint alleged the violation for the geographic markets of Illinois and/or the Eastern Interior Coal Province Sales Area (Illinois, Indiana, and parts of Kentucky, Tennessee, Iowa, Minnesota, Wisconsin, and Missouri). *Id.*

affirmative defense of the Failing Company Doctrine because of the company's weak coal reserves.⁹⁷

The Court held that the merger did not violate § 7 because the current combined market share of the two companies overstated the expected long-term market share since United Electric's nonrenewable asset, coal, was relatively low and depleting.⁹⁸ In summary, the *General Dynamics* Court held that when market conditions demonstrate that if the company remained in the market, it would not be able to compete in the future, the merger would not substantially lessen competition and thus not be illegal.⁹⁹ This conclusion directly from Justice Douglas, who sought to narrow the Failing Company Doctrine in *Citizen Publishing*, essentially broadened the defense, in that it allowed an exception for the weak competitor.

While the court in *United States v. Black & Decker Manufacturing Co.* held that the company could not use the failing company defense because the company did not pursue alternative purchasers, the court did state that the company must have resources so depleted "as to make the prospect of rehabilitation remote and the probability of business failure great."¹⁰⁰ McCulloch dominated the gasoline powered chain saw market, whereas Black & Decker had a "dominant position on the edge of the market."¹⁰¹ The government admitted that the merger affected neither vertical nor horizontal competition, but nevertheless contended that the merger of Black & Decker and McCulloch could lessen competition.¹⁰² After a detailed analysis of McCulloch's financial situation, the court determined that, but for the merger, McCulloch would cease operations and liquidate.¹⁰³ The government argued that McCulloch could rehabilitate by cutting unprofitable product lines and focusing on its strong position in the growing gasoline powered chain saw

⁹⁷ *Id.* at 507–08. The Court used the standard from *International Shoe Co. v. Federal Trade Commission* requiring that, to assert the failing company defense, a company must prove that its "resources [were] so depleted and the prospect of rehabilitation so remote that it faced the grave probability of business failure." *Id.* at 507 (citing *Int'l Shoe Co. v. Fed. Trade Comm'n*, 280 U.S. 291, 302 (1930)).

⁹⁸ *Id.* at 498; Correia, *supra* note 42, at 687.

⁹⁹ *See Gen. Dynamics*, 415 U.S. at 488–89.

¹⁰⁰ *United States v. Black & Decker Mfg. Co.*, 430 F. Supp. 729, 781 (D. Md. 1976).

¹⁰¹ *Id.* at 733–34. The Government argued an actual potential entrant claim: that Black & Decker could have been a successful market entrant due to its expertise and prestige in electronic tools. *Id.*

¹⁰² *Id.*

¹⁰³ *Id.* at 781. McCulloch's auditors would not have valued the company as a going concern because "[i]ts assets were pledged as collateral for debt, the company was seriously in default of its Bank obligations, its trade debts were severely past due, and new sources of capital were non-existent." *Id.*

market.¹⁰⁴ However, the court's financial analysis revealed that "the company's debts were so large, its cash shortage so acute, its paucity of unpledged assets so pronounced, and its possibilities for obtaining new capital so slight that business failure would probably still have resulted."¹⁰⁵

Because McCulloch's prospect of rehabilitation was remote and the probability of business failure was great, the court determined that it satisfied the "failing" element of the Failing Company Doctrine.¹⁰⁶ In summary, this case reveals that, while not mandated by law, a few courts have looked at whether failure would occur at any point in time rather than whether failure would occur immediately.

It is still true that the failing company defense may be used to allow companies with failing assets to consummate proposed mergers that would otherwise violate § 7.¹⁰⁷ According to the 1992 Merger Guidelines, a company asserting the defense must prove (1) it is "unable to meet its financial obligations in the near future;"¹⁰⁸ (2) it is unable "to reorganize successfully under Chapter 11 of the Bankruptcy Act;"¹⁰⁹ (3) it made good faith efforts to find less-anticompetitive buyers;¹¹⁰ and (4) without the merger, the company would exit the market.¹¹¹ While the 1950 interpretation of the defense was narrow in scope, the failing company defense now applies to vertical, conglomerate, and product extension acquisitions, in addition to horizontal mergers.¹¹² Ever constricted and stretched, the Failing Company Doctrine has survived seventy-eight years of merger enforcement.¹¹³

These cases—*Citizen Publishing*, *U.S. Steel*, *Greater Buffalo Press*, *General Dynamics*, and *Black & Decker*—demonstrate that the requirements of the Failing Company Doctrine have remained constant but have been more loosely interpreted by some courts. Specifically, in *General Dynamics* and *Black & Decker*, the courts considered that a company may be "failing" under

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ See Amanda L. Wait, Note, *Surviving the Shipwreck: A Proposal to Revive the Failing Division Defense*, 45 WM. & MARY L. REV. 429 (2003).

¹⁰⁸ 1992 Merger Guidelines, *supra* note 7, at 20,574.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*; see also Wait, *supra* note 107.

¹¹² Ludington, *supra* note 36, at 863 (citing *U.S. Steel Corp. v. Fed. Trade Comm'n*, 426 F.2d 592 (6th Cir. 1970); *Brown Shoe Co. v. United States*, 370 U.S. 294 (1962)). See generally *id.* at 870–72.

¹¹³ Wait, *supra* note 107, at 430 (citing Friedman, *supra* note 6, at 1375–76).

the Doctrine if it is an extremely weak competitor or if it would likely fail even in the future. The tendency of courts to want to interpret the Failing Company Doctrine more loosely in certain situations suggests that the defense should allow leeway for specific analysis and interpretation.

C. Antitrust Law as Regulation: The Legal Doctrine in the Shadow of the Law

The Failing Company Doctrine controversy might appear to have lost some steam in the past three decades. However, the failing company defense in the Merger Guidelines, while perhaps more regulatory in nature, is still being applied in the “shadow of the law”—in government analyses and negotiations—as well as in cases. Catharine Moscatelli, Assistant Director of the Merger Department of the Bureau of Competition of the FTC, confirmed that the failing company defense is “alive and well at the agency.”¹¹⁴

This section, derived primarily from discussions with Moscatelli and Gabe Dagen, the Head of Financial Analysts at the FTC, reveals how the government analyzes potential § 7 violations and the Failing Company Doctrine. These discussions revealed that the FTC is moving from a strict interpretation of the Doctrine towards a simultaneous assessment of the elements. This provides an opportune time to remove the prohibition on corporate reorganization under Chapter 11 from the Failing Company Doctrine.

In premerger negotiations, most attorneys “throw the defense on the wall” if the company could possibly be perceived as failing or flailing, even if, for example, it had three profitable years and just one bad year.¹¹⁵ However, few cases meet the standards of the failing company defense where: (1) the

¹¹⁴ Telephone Interview with Catharine Moscatelli, *supra* note 12.

¹¹⁵ Telephone Interview with Gabe Dagen, Head of Fin. Analysts, Fed. Trade Comm’n, in Wash., D.C. (Nov. 6, 2007). According to Moscatelli, the FTC finds the failing company defense as an element of a substantial number of cases and almost all of the hospital merger cases. But most companies will never fail. While the failing company defense is an affirmative defense which the companies may assert in response to an illegal merger, the FTC can rebut with evidence that a company is trying to use the defense “through the backdoor.” In one coal case, the companies never claimed the defense, and yet the CEO of the company testified during the trial that the company was failing. The judge in that case did not allow the FTC to rebut the defense, even though the FTC had attempted to rebut it before trial. Such a case is atypical, yet proves the point that many companies do not officially raise the defense but use it “atmospherically,” essentially saying “we don’t fit the criteria (of the defense) but consider it (the failing facts).” Telephone Interview with Catharine Moscatelli, *supra* note 12. For the most part this strategy is ineffective, especially if the merger would create a monopoly. However, if there would still be three or four companies in the market after the merger, the FTC and/or a judge may occasionally consider the “atmospheric” defense. Telephone Interview with Gabe Dagen, *supra*.

company could not reorganize under Chapter 11, and (2) the assets would leave the market but for the merger.¹¹⁶ Moreover, the FTC can rebut the defense.

To determine whether a company is failing or how well it would do in reorganization, the FTC first analyzes cash flow.¹¹⁷ To successfully come out of Chapter 11, a company must retain or obtain sufficient cash.¹¹⁸ Consequently, one can determine how long a company can operate before reorganizing or liquidating by analyzing its cash flow.¹¹⁹ Under the Hart-Scott-Rodino (HSR) Act, the FTC has thirty days after the potentially merging companies provide the required information to approve the merger or request more information.¹²⁰

After the FTC initially analyzes cash flow, it then performs a basic merger analysis.¹²¹ If the analysis indicates that the merger may substantially lessen competition and violates § 7, the FTC will make a second request for information.¹²² Because of the predictive nature and change in the worth of a company for an investigation, the number of second requests is proportionately very small.¹²³ Additionally, the firms that receive a second request are “rarely

¹¹⁶ *Id.* Most companies do not have enough money to invest, but have positive cash flow to continue working. The company’s owners and investors perceive this as failing and want to sell and get out of the business. The investors want to get returns on the investment, so if there is no profit in the business, it is no good to them at that point. *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ Telephone Interview with Catharine Moscatelli, *supra* note 12.

¹²¹ *Id.*

¹²² *Id.*

¹²³ Antitrust Division Workload Statistics, FY 1997–2006, <http://www.usdoj.gov/atr/public/workstats.htm>.

shocked” that the merger needs to be scrutinized; antitrust lawyers are very familiar with what to expect from the FTC.¹²⁴

In analyzing the lessening of competition, the FTC and antitrust lawyers alike know that the Failing Company Doctrine does not always hinge on whether a company is statutorily “failing.” The primary difficulty in meeting the failing company defense is proving that although merging with a certain buyer would lessen competition, no other eligible buyers exist.¹²⁵ Often the company wants to merge with the acquiring company that would create a potential Clayton Act violation because the acquiring company offered the highest price.¹²⁶ Thus, it is not always that the firm could not find another buyer; but, for obvious reasons, it wanted the best price.¹²⁷ The strategies and problems with finding other eligible buyers are beyond the scope of this Comment, but it is important to remember them as elements of contention within the Doctrine.

Additionally, even if the merger is blocked, Chapter 11 is not inevitable. Management may try to negotiate outside of bankruptcy in the fear that it may be replaced in Chapter 11. Therefore, even if the FTC does not allow the merger because the company could reorganize under Chapter 11, it is not inevitable that the company will promptly file for bankruptcy.¹²⁸

Lastly, the “atmospheric” failing company defense has occasionally prevailed when judges choose not to follow the FTC’s prima facie approach. In *United States v. International Harvester Co.*,¹²⁹ although the government showed prima facie illegality, the judge relied on the loosened Failing Company Doctrine from *General Dynamics*¹³⁰ to permit the merger. The

In 2000, there was a major change in the threshold of HSR. Before the change, companies with \$15 million or more in assets had to file HSR premerger notifications, while after the change, only companies with \$50 million or more in assets had to do so. Additionally, the FTC administered more second requests overall in the late 1990s. Telephone Interview with Gabe Dagen, *supra* note 115.

¹²⁴ Telephone Interview with Catharine Moscatelli, *supra* note 12. Merging companies typically use an antitrust law firm that is knowledgeable about which mergers will be scrutinized under a second request. *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.* According to Moscatelli, if a failing company comes to the FTC and says that it could make \$50 million by selling to an anticompetitive buyer versus only \$25 million if it were bought by a legal buyer, that is not a legitimate justification for the merger: “We simply say that is not good enough.” *Id.*

¹²⁸ Telephone Interview with Gabe Dagen, *supra* note 115. Often after lengthy negotiations, banks will refinance the company as opposed to accepting pennies on the dollar in bankruptcy. *Id.*

¹²⁹ 564 F.2d 769, 774 (7th Cir. 1977).

¹³⁰ 415 U.S. 497, 497–98 (1974).

General Dynamics Court had declared that “no substantial lessening of competition occurred or was threatened”¹³¹ due to the company’s weakened financial state. In *International Harvester*, Steiger, the failing company, produced tractors at a loss for years before it was in need of added financing to continue.¹³² International Harvester sought to have Steiger manufacture certain four wheel tractors with Harvester’s components, which Harvester then promised to buy.¹³³ Steiger signed a manufacturing agreement while Harvester simultaneously signed a stock purchase agreement for thirty-nine percent of Steiger’s common stock.¹³⁴

The government argued that the prima facie illegality outweighed the special circumstances of Steiger’s weakened financial condition.¹³⁵ The court stated that “even though the defendants do not rely on the failing-company doctrine, . . . they have shown that even if Steiger remained in the market, it did not have sufficient resources to compete effectively.”¹³⁶ While this case is an exception, it is important to note that the court has the authority to use the company’s financial weakness as an evidentiary factor even though the company is not statutorily “failing” under the doctrine.

D. The Modern Doctrine in the Sick Industry

*[The Failing Company Doctrine] involves speculation about future costs and revenues arising from operation under changed circumstances and consideration of the peculiar economics [of the sick market].*¹³⁷

Currently, there is controversy as to whether a failing company must prove that it could not successfully reorganize under Chapter 11.¹³⁸ In most cases where the court has allowed the defense, the companies have been hopelessly insolvent, and so organization has not been an issue.¹³⁹ It is important to note

¹³¹ *Id.* at 498.

¹³² *Int’l Harvester*, 564 F.2d at 774–75. In 1972 Steiger had shareholders’ equity worth negative \$757,000 and a negative working capital of \$752,000. *Id.* at 775. The company showed a small profit by the end of 1973, but the availability of capital did not improve. *Id.* Steiger did not argue the failing company defense because Steiger’s numbers indicated that the defense may not have been effective. *Id.* at 775 n.12.

¹³³ *Id.* at 775. Simultaneously, Steiger promised to make available to Harvester no more than forty-eight to fifty-two percent of Steiger’s annual production. *Id.* at 771.

¹³⁴ *Id.* at 776.

¹³⁵ *Id.* at 774.

¹³⁶ *Id.* (citation omitted).

¹³⁷ *Reilly v. Hearst Corp.*, 107 F. Supp. 2d 1192, 1203–04 (N.D. Cal. 2000).

¹³⁸ *California v. Sutter Health Sys.*, 130 F. Supp. 2d 1109, 1135 (N.D. Cal. 2001).

¹³⁹ *Campbell*, *supra* note 49, at 255.

that while the “sick region,” a geographic area in which the industry is operating at overcapacity, is beyond the scope of this Comment, the market structure and potential use of the Failing Company Doctrine is very similar.¹⁴⁰ This section demonstrates the modern use of the defense using a prime example of a sick industry: the newspaper industry.

Critics have argued that for the sick newspaper industry to shrink naturally, the market analyzed for threats to competition should be overall news media and not just the market made up of a city’s newspapers. Unfortunately, the scope of this article prevents full discussion of market definitions, which are inherently controversial in the antitrust field. However, most courts agree that although the areas of news competition may overlap, media products are not fungible goods and therefore do not comprise the same market.¹⁴¹

In a 2000 case, *Reilly v. Hearst Co.*, a newspaper merger was allowed because one of the newspapers satisfied the *Citizen Publishing* standard of the Failing Company Doctrine.¹⁴² Interestingly, the newspaper merger in *Reilly* was very similar to that in *Citizen Publishing*, and yet met the failing company

¹⁴⁰ An example of the sick industry use of the Failing Company Doctrine is *Sutter Health System*. In that case, Summit, a hospital, successfully asserted the failing company defense. *Sutter Health Sys.*, 130 F. Supp. 2d at 1133. Summit and Alta Bates, two of twenty hospitals in the Bay area, contracted to merge into a single hospital business to provide all the necessary services. *Id.* at 1115. In proving the failing company defense for Summit, the defendants questioned whether the bankruptcy requirement was necessary yet still expended the effort to satisfy the prong. *Id.* at 1135. Interestingly, the opinion cited a book by Judge Richard Posner in which he “criticiz[es] [the] requirement because the purpose of the defense is ‘precisely to avert bankruptcy.’” *Id.* (citing RICHARD POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 21 (1976)). Summit’s financial expert testified that the company would not survive in reorganization but would have to liquidate if the merger was not allowed because the financial problems were systematic and would only get worse as resources became depleted. *Id.*

An element unique to hospitals that would make reorganization difficult is the fact that almost all of Summit’s money was from funds that are only allotted for specified uses and could not be used freely where needed in reorganization. *Id.* at 1134. This hospital scenario is not uncommon, as almost every city has a hospital that is not profitable because of a large number of patients who are unable to pay for services; however, one could argue that reorganization is a possibility in this area. Therefore, Summit exemplifies the current standard necessary to successfully establish the failing company defense.

¹⁴¹ *Reilly*, 107 F. Supp. 2d at 1201. The market power of individual media sources is determined by branding, technological preferences, and consumer loyalty. *Id.*

¹⁴² *Id.* at 1205 (citing *Citizen Publ’g Co. v. United States*, 394 U.S. 131 (1969)).

When that [*Citizen Publishing*] test is met, the parties to a JOA [Joint Operating Agreement] may discontinue the failing publication and may dispose of assets associated with it; neither the NPA [Newspaper Preservation Act] or any other antitrust law requires the parties to ensure that some other competing publication comes into evidence; nor do JOA participants have a legal obligation to spin off some of the JOA’s assets to a third party for purposes of establishing a competitor.

Id. at 1211.

standards that the earlier case created.¹⁴³ The court in *Reilly* admitted that “[w]hile a merger of the two dominant San Francisco dailies in 1965 might well have posed an unquestionable threat of undue concentration of market power under the old paradigm, that threat today [2000] is far from clear.”¹⁴⁴

In *Reilly* the two daily newspapers of San Francisco had agreed that the Hearst Corporation, publisher of the *San Francisco Examiner*, would acquire the *San Francisco Chronicle*.¹⁴⁵ The plaintiffs succeeded in demonstrating a prima facie showing of undue concentration in the market.¹⁴⁶ The papers argued, however, that the *Examiner* was so debilitated that the acquisition would not have anticompetitive effects on competition.¹⁴⁷ The court used the traditional definition of a failing company: “resources are so depleted and the prospects of rehabilitation so remote that it faces grave probability of business failure.”¹⁴⁸ The court had conceded earlier in the opinion that determining the future cost and revenues in the ever-changing newspaper business was highly speculative.¹⁴⁹

On the issue of potential for reorganization, the plaintiff’s expert witness declared the evidence of the *Examiner*’s stand-alone economic viability “highly speculative and anecdotal.”¹⁵⁰ The optimistic projections of the *Examiner*’s worth were rebutted implicitly in the valuation made during negotiations with Hearst.¹⁵¹ Therefore, the court found that the *Examiner* satisfied the failing company defense and that the merger was “economically efficient and otherwise in the public interest.”¹⁵² This case suggests that the

¹⁴³ *Id.* at 1205. The Newspaper Preservation Act (“NPA”), 15 U.S.C. §§ 1801–1804 (2006), draws attention to the lack of revenue in the newspaper market, so that an otherwise unlawful merger of two newspapers’ business operations may be lawful if the newspaper market does not support enough revenue for independent publication of the newspapers. *Id.* at 1195. The merger will be allowed under the NPA, but the newspapers must continue to print separate newspapers. *Id.* Thus, the NPA brings distinctly noneconomic factors into antitrust statutes “which otherwise exclusively confine their scope to matters of economic consequence.” *Id.* at 1195 (discussing the NPA).

¹⁴⁴ *Reilly*, 107 F. Supp. 2d at 1201.

¹⁴⁵ *Id.* at 1196.

¹⁴⁶ *Id.* at 1200.

¹⁴⁷ *Id.* The NPA requires a more stringent failing company defense, and the antitrust division imposes a rigorous application of the more stringent defense when a JOA wants to discontinue one of the newspapers. *Id.* at 1202.

¹⁴⁸ *Id.* at 1203 (quoting *Citizen Publ’g Co. v. United States*, 394 U.S. 131, 137 (1969)).

¹⁴⁹ *Id.* at 1203–04.

¹⁵⁰ *Id.* at 1204.

¹⁵¹ *Id.*

¹⁵² *Id.* at 1205. In its conclusions of law, the court stated that the merger of the newspapers without a spin off paper would increase allocative efficiency because advertisers would still have the same outlet that they

company does not need to be in bankruptcy, but rather “it is sufficient that it is heading in that direction with the probability that bankruptcy will ensue.”¹⁵³

Return to the Little Betty Hypothetical Case: Successful Failing Company Doctrine

Although Little Betty, Tastypie, and investors are excited about the prospect of the merger, as two of the largest companies in the high-preservative bakery snack food industry, all fear antitrust interference. After submitting the necessary materials about the proposed merger to the FTC, Little Betty waits anxiously and anticipates a second request for information, indicating that the merger will be challenged. As expected, the FTC challenges the merger under § 7, determining the relevant product market to be high-preservative bakery snack foods¹⁵⁴ in the United States.¹⁵⁵ The merger between Little Betty and Tastypie would reduce the number of firms in the industry from five to four. Under a § 7 analysis, the merger would substantially lessen the competition because now only four companies would compete for the bakery snack market.¹⁵⁶

Little Betty asserts the failing company defense. Little Betty must meet the Merger Guidelines’ definition of a failing company. To succeed, Little Betty must prove: (1) it is “unable to meet its financial obligations in the near future;”¹⁵⁷ (2) it is unable “to reorganize successfully under Chapter 11 of the Bankruptcy Act;”¹⁵⁸ (3) it made good faith efforts to find less anticompetitive buyers;¹⁵⁹ and (4) without the merger the company would exit the market.

First, the FTC analyzes Little Betty’s cash flow and determines that the snack company has a dire cash flow situation and cannot meet its financial obligations in the near future.

had in the two papers but conserve substantial resources and decrease the content for readers only negligibly. *Id.* at 1211.

¹⁵³ Ludington, *supra* note 36, at 863.

¹⁵⁴ High-preservative bakery snack foods is the defined product market.

¹⁵⁵ The United States is the geographic market. The combination of the product market and geographic market is the relevant market for antitrust analysis.

¹⁵⁶ Clayton Act § 7 also says “tend to create a monopoly” even though industries with only a few companies do not collude or necessarily mean that a monopoly will be created. 15 U.S.C. § 18 (2006).

¹⁵⁷ 1992 Merger Guidelines, *supra* note 7, at 20,574.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

Second,¹⁶⁰ Little Betty looks in good faith for alternative buyers to no avail for two reasons: (1) all the potential buyers within the snack food industry that would have enough capital to successfully and productively merge with Little Betty would cause an antitrust threat, and (2) potential buyers outside of the industry do not want to invest in any company in a sick industry.

Third, relying on language from the recent *Reilly v. Hearst Co.* decision, Little Betty presents evidence that its standalone economic viability is “highly speculative and anecdotal” and that any optimistic projections for Chapter 11 reorganization are unrealistic. Little Betty argues that reorganization, if possible, would only be a temporary solution. It projects that at best Little Betty could be viable in the short-term but would ultimately liquidate.

Last, Little Betty presents evidence that, but for the merger with Tastypie, Little Betty would exit the market. The court determines that the FTC successfully rebutted Little Betty’s failing company defense because Little Betty has an option besides exiting the market: Chapter 11 reorganization.¹⁶¹ Little Betty argues that it does not want to enter reorganization and that it is more efficient to merge. Although recent case law and regulatory evidence has demonstrated that the FTC takes a much more reasonable approach to the Merger Guidelines, the reorganization requirement is still the law and strict constructionists will enforce the requirement. In the case of the hypothetical merger, the judge strictly interprets the Merger Guidelines to read that because Little Betty can reorganize, the failing company defense is successfully rebutted.

The judge’s decision, however, does not necessarily force Little Betty immediately into Chapter 11 reorganization. There are reasons Little Betty may resist Chapter 11.

¹⁶⁰ The second prong of the Merger Guidelines, that a company be unable to reorganize under Chapter 11, will be considered last in this analysis.

¹⁶¹ As will be discussed in the next section, Chapter 11 reorganization allows creditors to be paid a fraction of what they are owed so that the company can have a fresh start in the market.

III. THE CURRENT STATE OF CHAPTER 11 REORGANIZATION

*Capitalism without bankruptcy is like Christianity without hell.*¹⁶²

While bankruptcy as market failure is viewed as one of the more painful aspects of capitalism, Chapter 11 bankruptcy is intended to be an opportunity and means of redemption. Redemption comes at a price, however, and it is frequently difficult to predict whether a company's Chapter 11 redemption will forever change its position in the market or just temporarily spare it from liquidation. This section reveals that Chapter 11 reorganization is not always an effective means to achieve economic efficiency, the prime goal of antitrust law, because: (1) the purpose of reorganization is saving the company, which is not always congruent with efficiency; (2) it is difficult to predict the success of Chapter 11, and valuation is determined by a judge; and (3) the social cost of reorganization is high.

There has been a recent boom in Chapter 11 bankruptcy. However, in the current state of Chapter 11 many companies convert to Chapter 7 liquidation or sell the company in some capacity.¹⁶³ This Comment will not address all types of Chapter 11 bankruptcies. In *Citizen Publishing*, Justice Douglas meant to exclude only companies that could reorganize through Chapter 11 from the Failing Company Doctrine, not all the companies that could enter Chapter 11 before exiting the market or being acquired. This is evident from Justice Douglas's observation that reorganization can be accomplished through receivership, or through Chapter X or Chapter XI of the Bankruptcy Act.¹⁶⁴ Currently, for larger companies, reorganization is done through Chapter 11.¹⁶⁵ Therefore, consistent with Justice Douglas's intent, this Comment will generally cover modern Chapter 11, but will only analyze the traditional reorganization aspect of Chapter 11.

Some experts say that "traditional" Chapter 11 reorganizations have almost disappeared because liquidation is probably the only option for small

¹⁶² Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 79 AM. BANKR. L.J. 153, 158 (2004) (quoting Frank Borman, Chairman, Eastern Airlines).

¹⁶³ *Id.* at 188–89, 192.

¹⁶⁴ *United States v. Black & Decker Mfg. Co.*, 430 F. Supp. 729, 778 (D. Md. 1976).

¹⁶⁵ *Id.* The opinion refers to the idea that a company is not failing if it could reorganize through one of the aforementioned avenues and emerge as a "strong competitive compan[y]." *Id.* at 778 (quoting *Citizen Publ'g Co. v. United States*, 394 U.S. 131, 138 (1969)).

companies, and larger companies are typically either sold or come into reorganization with a prepackaged plan and nothing to negotiate.¹⁶⁶ Critics say that traditional corporate reorganization law only works where three conditions hold: (1) the company has value as a going concern; (2) investors cannot bargain outside of Chapter 11; and (3) the business cannot be sold in the market as a going concern.¹⁶⁷ This set of conditions is unlikely to hold today for a failing company.¹⁶⁸ Intuitively, a company proposing a merger or acquisition would not meet these conditions because it has the option to be sold in the market.

Still, modern Chapter 11 reorganization offers other options beyond traditional reorganization and can be used strategically to fulfill the company's needs. For example, a debtor may want to sell the company but there may not be a buyer in the market willing and able to pay the price the debtor wants.¹⁶⁹ As a result, the debtor may use reorganization to postpone the sale until there are appropriate buyers in the market.¹⁷⁰ Chapter 11 also offers a platform from which it is easier for the reorganizing company to negotiate with investors. One more practical reason that companies often enter reorganization is that courts are hesitant to approve the sale of an entire business.¹⁷¹

A. *The Purpose of Chapter 11 Reorganization*

The free market structure is by definition competitive and promotes the Darwinian notion of survival of the fittest. Bankruptcy is therefore like temporary captivity in which the rules of the market do not fully apply in an attempt to help the failing company survive. Bankruptcy law often assumes that the market is always better off when a company stays in business, so long as the present value of the company is greater than the liquidation value of its assets;¹⁷² in other words, "a business is worth more alive than dead."¹⁷³ Complicated procedures are necessary to determine who can create a plan for

¹⁶⁶ See, e.g., Paul Povel & Rajdeep Singh, *Sale-Backs in Bankruptcy*, 23 J.L. ECON. & ORG. 710 (2007).

¹⁶⁷ Baird & Rasmussen, *supra* note 11, at 673–74 (2003).

¹⁶⁸ *Id.* at 674.

¹⁶⁹ Rachael M. Jackson, Comment, *Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates*, 2005 COLUM. BUS. L. REV. 451, 463 (2005).

¹⁷⁰ *Id.* at 463–64.

¹⁷¹ *Id.* at 464.

¹⁷² Douglas G. Baird, *The Uneasy Case for Corporate Reorganization*, 15 J. LEGAL STUD. 127, 133–34 (1986).

¹⁷³ CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 6–7 (1997) (quotation omitted).

reorganization and how creditors can use the right to reject or approve such a plan.¹⁷⁴ One must wonder whether the complications and strategic games played by creditors and debtors are worth the benefits. When is the reorganization justified because a company is worth more as a whole than in pieces?¹⁷⁵

This Comment suggests that even at its core, Chapter 11 reorganization goals are incongruent with the principles of basic free market structure and antitrust law because preserving the company's and creditors' interest in terms of bankruptcy does not always promote the most efficient economy. The next section reveals the development of reorganization through receiverships and the original goals of reorganization bankruptcy.

1. Origins of the Protection from Failure

The need for bankruptcy law became a national concern in the late nineteenth century with the railroad failures.¹⁷⁶ The concept of bankruptcy reorganization developed with the railroad equity receiverships.¹⁷⁷ During this period, when approximately one third of railroads failed in receivership attempts similar to reorganization, the law sought to protect and manage the assets of the failing railroad companies.¹⁷⁸ Railroads symbolized innovation and progress; thus, receiverships were viewed as a necessity for preserving modern commerce. Congress created receiverships in the public interest and codified them in bankruptcy law in the 1930s.¹⁷⁹ Even within the bankruptcy realm, “academics are questioning whether the reorganization paradigm constructed in the late nineteenth century—that a debtor’s business can be reorganized and rehabilitated under the protection of a court and returned to the business world as a viable economic unit—remains viable today.”¹⁸⁰

In a free market, economic efficiency indicates that if there is a change in consumer preference towards other more efficient forms of transportation then a substantial portion of the railroads would fail and leave the market. Yet bankruptcy principles are founded in the public interest, which does not always

¹⁷⁴ Baird, *supra* note 172, at 139.

¹⁷⁵ *Id.*

¹⁷⁶ Miller & Waisman, *supra* note 162, at 158.

¹⁷⁷ *Id.* at 160. The equity receivership would attain control of the failing railroad company's assets and control them in a way that ideally would make them profitable again. *Id.* at 161–62.

¹⁷⁸ *Id.* at 161.

¹⁷⁹ *Id.*

¹⁸⁰ *Id.* at 190.

coincide with efficiency and are sometimes incongruent with a free market. “The anti-Chapter 11 theorists argue that Chapter 11 reorganization cannot rehabilitate a crippled business, even if it maintains hard assets dedicated to such business, if the underlying business plan and objectives are fatally flawed.”¹⁸¹ Furthermore, the modern Chapter 11 reorganizations of larger companies bear no resemblance to receivership and the failing companies bear no resemblance to the railroads.¹⁸²

Chapter 11 cannot rehabilitate a business whose reorganization plan is fatally flawed or when the industry is sick. Thus, merging may offer a more economically beneficial alternative to Chapter 11 reorganization. Moreover, because Chapter 11 reorganization is vastly different from receivership, Justice Douglas’s intent in adding the receivership requirement to the Failing Company Doctrine in *Citizen Publishing* may not be reflected in the current defense. Lastly, the goals of bankruptcy and antitrust law are different or, at a minimum, have different strategies about how to achieve social welfare. The aims of these differing areas of law occasionally conflict, and the Chapter 11 requirement of the Failing Company Doctrine is one place in which they unnecessarily have a forced coexistence.

B. The Difficulty in Predicting Successful Reorganization

*The bankruptcy judge is no longer a mere brooding presence in a bankruptcy case; the judge has made a comeback as the producer, the director, and, perhaps, the star of the Chapter 11 reorganization passion play.*¹⁸³

¹⁸¹ *Id.* at 187.

¹⁸² Baird & Rasmussen, *supra* note 11, at 699.

A court-conducted sale of Fruit of the Loom in which the high bidder is Warren Buffett bears no resemblance to an equity receivership. Even in those cases that look most like a traditional large corporate reorganization, the stakes are quite small. A collection of Marriotts and Holiday Inns is nothing like a railroad.

Id.

¹⁸³ Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431, 464–65 (1995).

Unlike the role of the debtor-in-possession, the role of the bankruptcy judge has come full circle to that which it played under the Bankruptcy Act. A major objective of the Code was the unequivocal separation of the judicial and administrative functions of the bankruptcy judge. During the past seventeen years, however, the bankruptcy judge has become an increasingly active participant in Chapter 11 cases with the power to take numerous actions *sua sponte*, including appointing mediators, conducting status conferences, and issuing case management

Universally, real prices—those determined in an auction or market setting—are more accurate than hypothetical prices—those created in an artificial setting, such as a court.¹⁸⁴ The bankruptcy judge is completely dependent on the parties to provide the necessary facts, because she does not have the resources to do an independent financial and operational analysis of the reorganization plan's feasibility.¹⁸⁵ In the words of one commentator:

[J]udges lose nothing if the value they attach to the firm is inaccurate, and they win the praise of those who would have lost out if the guess had been more astute. Judges are neither selected for ability to value assets correctly nor selected-out on account of poor business judgment.¹⁸⁶

Conversely, competition naturally leads to a more accurate pricing.¹⁸⁷

Bankruptcy judges must derive the fictional value in Chapter 11 reorganization through a difficult process involving participants with varying conflicts of interest.¹⁸⁸ For example, senior creditors want the company to have a low bankruptcy valuation so that they have a larger fraction of the reorganized company, whereas equity holders clearly want a high valuation of their company.¹⁸⁹ Negotiating and bargaining among the bankruptcy participants helps to mitigate the differing valuations, but these remain imperfect.¹⁹⁰

orders on the basis of such conferences. The bankruptcy judge is no longer a mere brooding presence in a bankruptcy case; the judge has made a comeback as the producer, the director, and, perhaps, the star of the Chapter 11 reorganization passion play. While its full impact remains to be seen, the melding of judicial and administrative functions should increase the efficacy and economy of the bankruptcy process.

Id.

¹⁸⁴ Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, reprinted in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, at 408, 409 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

¹⁸⁵ Miller & Waisman, *supra* note 162, at 200.

¹⁸⁶ Easterbrook, *supra* note 184, at 409.

¹⁸⁷ *Id.*

¹⁸⁸ Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, reprinted in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, at 370, 373 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.* at 374. Valuation is determined in the bankruptcy reorganization plan, which must be agreed upon by a majority of the classes. Classes are comprised of those with substantially similar interests. A class can approve a plan without unanimity among its members, and a plan can be confirmed against the wishes of an opposing class. *Id.*

1. *Problems with Imperfect Valuation*

The problems with the bargained value of the reorganizing company are threefold: (1) participant deviation can lead to getting more or less than they deserve; (2) an inefficient capital structure can result from the reorganization; and (3) the process is costly and time consuming.¹⁹¹

Participants may inadvertently get more or less than they deserve because of incorrect valuation, or they may purposely delay the plan confirmation to lobby for better terms.¹⁹² Second, in economic terms, the reorganized company's capital structure should maximize the company's value; however, competing strategic factors often force the reorganized company away from its highest value.¹⁹³ As discussed later in this Comment, the reorganization process has substantial costs. Beyond litigation costs, the company does not operate efficiently during reorganization. The time spent in the reorganization process trying to get participants to agree is costly, and, as the old adage goes, time is money.¹⁹⁴ Chapter 11 reorganization valuation has improved through Bankruptcy Code updates and statutes, but a reorganization inherently contains inaccuracies due to imperfections of bargaining and judicial valuation.¹⁹⁵

This Comment does not suggest that Chapter 11 is always the least efficient option. In many situations, reorganization offers the time or protection needed to pursue the most market effective plan. For example, going concern sales¹⁹⁶ are another option but are very difficult to orchestrate. The company must spend enough money to get the best buyer, but not waste too much money and resources finding the buyer or trying to sell for more than anyone will pay.¹⁹⁷

Still, shareholders favor a merger because, in reorganization, the shareholders' interests are worthless.¹⁹⁸ If the shareholders have confidence that the reorganization will be successful, they may prefer the risk of Chapter

¹⁹¹ *Id.* at 374–75.

¹⁹² *Id.* at 374.

¹⁹³ *Id.*

¹⁹⁴ *Id.* at 374–75.

¹⁹⁵ *Id.* at 374.

¹⁹⁶ This is a sale for a company with going concern value. To have going concern value, the value of the enterprise as an active business with future earning power must be greater than the liquidation value of the company and its assets. BLACK'S LAW DICTIONARY 1587 (8th ed. 2004) (definition of "going-concern value").

¹⁹⁷ Baird, *supra* note 172, at 137.

¹⁹⁸ In a merger the acquiring company will buy the shareholders' stock, whereas in a reorganization shareholders' equity is typically none or minimal.

11 for potentially greater returns in the long term. For the most part, “[r]eorganization may keep the firm afloat as a competitive unit[,] but it is usually far less beneficial to shareholders and creditors than a bail-out merger would be.”¹⁹⁹

Besides shareholders, a sick industry as a whole may prefer a merger to Chapter 11 reorganization, especially if the reorganized company maintains its prebankruptcy level of production. If the sick industry is producing at overcapacity, the market would indicate that production should be reduced. If the reorganized company or companies continue to produce at prebankruptcy levels, then the industry will remain sick at overcapacity. Thus, Chapter 11 reorganization in some industries may leave in place excessive competition such that the industry remains inefficient as a whole.²⁰⁰ Further, some experts maintain that the high social costs of reorganization are valid only in a small set of circumstances.²⁰¹

C. *Social Cost of Bankruptcy*

[Corporate reorganization is]

*thoroughly buttered with learning and frosted with distinguished names. Here the union of law and economics is celebrated by one of the wildest orgies in intellectual history. Men work all night preparing endless documents in answer to other endless documents, which other men read in order to make solemn arguments.*²⁰²

Critics question whether Chapter 11 actually achieves its social policy goals at an acceptable cost to justify the process.²⁰³ Douglas Baird argues that due to the “potential distortions from a fictive valuation of a firm” the costs of the “sale are likely to be less than the cost of the procedures needed to prevent manipulation and game playing by the participants in a hypothetical sale.”²⁰⁴ If it is true that a corporate reorganization is preferable to a corporate

¹⁹⁹ Friedman, *supra* note 6, at 1406 n.115.

²⁰⁰ See Daniel P. Rollman, Comment, *Flying Low: Chapter 11's Contribution to the Self-Destructive Nature of Airline Industry Economics*, 21 EMORY BANKR. DEV. J. 381, 400 (2004) (suggesting that the multitude of Chapter 11 reorganizations in the airline industry has preserved the industry's excessive capacity).

²⁰¹ See, e.g., Baird, *supra* note 172, at 133–34.

²⁰² Miller & Waisman, *supra* note 162, at 153 (internal quotations omitted).

²⁰³ See, e.g., Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 209–24 (1986); Rollman, *supra* note 200, at 382.

²⁰⁴ Baird, *supra* note 172, at 128.

liquidation for only a narrow set of conditions,²⁰⁵ then it is likely that some reorganizations should instead be mergers. Finding buyers for companies that are worth operating as a going concern may not be more expensive or difficult than the other options.²⁰⁶ This is true because of the bankruptcy judge's difficulty in accurately valuing a firm.²⁰⁷ On the other hand, a third party buyer has the most to gain or lose from incorrectly valuing a company. Thus, because the third party buyer takes on all consequences of the purchase and accurate or inaccurate valuation, it has the most incentive to value the company correctly.²⁰⁸

The two types of distressed firms are (1) those that are economically inefficient, where the best outcome would be to liquidate or sell parts to allow capital to move to higher value uses, and (2) those that are economically efficient but financially distressed, where reorganization is optimal since the capital has no higher value.²⁰⁹ When analyzed in bankruptcy court, both types of firms are alike, with revenues that do not cover costs of operations; thus, they are incurring losses.²¹⁰ Naturally, some inefficient firms have been erroneously categorized as efficient and reorganized.²¹¹

The error of reorganizing an inefficient firm has associated costs.²¹² The reorganization process will probably fail to save it in the long term due to its inefficient nature or sick industry environment.²¹³ The reorganization causes economic stagnation and moves the assets more slowly from the less efficient

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 136.

²⁰⁷ *Id.* There is a risk involved in allowing a third party to value the firm, as it will likely overestimate or underestimate the true worth of the firm. *Id.* The Supreme Court and most lower courts read § 105 of the Bankruptcy Code as giving "broad authority" to bankruptcy judges. Jackson, *supra* note 169, at 472 (citing *United States v. Energy Res. Co.*, 495 U.S. 545, 549 (1990)). Section 105 specifically says that the bankruptcy judges "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code]." 11 U.S.C. § 105(a) (2006). Beyond the authority given in § 105, the majority of courts allow the bankruptcy judges to "fill the gaps" of the Code as well. 2 COLLIER ON BANKRUPTCY ¶ 105.01[2] (Alan N. Resnick & Henry J. Somer eds., 2008).

²⁰⁸ Baird, *supra* note 172, at 136. The third party buyer has the incentive to value as low as they think the company will agree to sell for without being so low that more astute buyers can purchase the company. *Id.*

²⁰⁹ Michelle J. White, *The Costs of Corporate Bankruptcy: A U.S.-European Comparison*, reprinted in CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, at 467, 488 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² *Id.* at 489.

²¹³ *Id.*

to more efficient uses.²¹⁴ This delay is very costly. Costs increase based on how long the economically inefficient firms continue in the reorganization process or if they reenter reorganization.²¹⁵

The traditional account of corporate reorganizations assumes a financially distressed business faces three conditions simultaneously: (1) It has substantial value as a going concern; (2) its investors cannot sort out the financial distress through ordinary bargaining and instead require Chapter 11's collective forum; and (3) the business cannot be readily sold in the market as a going concern.²¹⁶

D. Weighing the Bankruptcy Option: Market Valuation over Judicial Valuation

When selling or merging benefits the stockholders and creditors, bankruptcy should be a backup.²¹⁷ Yet the Merger Guidelines' Failing Company Doctrine forces a business to pursue, or be ineligible for, Chapter 11 reorganization before allowing the potentially more efficient merger. Because the costs of reorganization may be justified in only a narrow set of circumstances, the tendency for incorrectly forcing Chapter 11 when applying the Failing Company Doctrine is significant. To prevent the inefficiency caused by obligating a futile reorganization, the Chapter 11 requirement should be removed from the Failing Company Doctrine. Consider the Chapter 11 possibilities of the previous Little Betty hypothetical case:

Little Betty Chapter 11

After the merger between Little Betty and Tastypie was barred, Little Betty's management scrambles to stay out of Chapter 11 by taking immense risks. The company spends millions of dollars trying to create low-fat, low-calorie versions of its products. The management justifies the investment by rationalizing that the perfect healthy recipe could keep Little Betty from bankruptcy. Even though the alternate world of Chapter 11 reorganization offers many benefits, such as reducing debt, the right to assume, reject or

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ Baird & Rasmussen, *supra* note 11, at 673–74.

²¹⁷ Easterbrook, *supra* note 184, at 413.

assign contracts, and ease in attaining future financing, Little Betty's management fears that they will lose their jobs in the process.²¹⁸

If the new product venture fails, the snack company is already headed toward bankruptcy. At this point, the risky strategy of the failing company may be the only saving strategy for management.

Like the previous recipes, the new recipes fail to satisfy customers, and now Little Betty must enter bankruptcy. The stockholders, furious with recent management decisions, fire the current management through the board of directors. They bring on a team that specializes in reorganizing companies and claims it can turn the business around. Obviously, the stockholders and some of the risk taking creditors do not want to liquidate this multimillion-dollar snack company and thus, present a Chapter 11 reorganization plan to the bankruptcy judge. Little Betty blames the decrease in revenue and losses on the previous managers and convinces the judge that it is an economically efficient firm. The bankruptcy judge and creditors confirm the Chapter 11 reorganization plan.

In this hypothetical case, perfect market knowledge reveals that Little Betty cannot be run efficiently in the long term because the industry is at overcapacity and Little Betty has no way to reduce overhead costs. This reorganization, compounded with Little Betty's inability to maximize the potential value of a merger due to the Chapter 11 exception of the Failing Company Doctrine, has made this situation extremely costly and inefficient for the market.

IV. ECONOMIC ANALYSIS OF THE FAILING COMPANY DOCTRINE AND CHAPTER 11 REORGANIZATION

Almost everyone professionally involved in antitrust today—whether as litigator, prosecutor, judge, academic, or informed observer—not only agrees that the only goal of the antitrust laws should be to promote economic welfare, but also agrees on the essential tenets of

²¹⁸ Companies in Chapter 11 reorganization often bring in new management who are experts in reorganizing companies. Ron Hutchinson oversaw Kmart Corporation's reorganization and was the Chief Financial Officer of Interstate Bakeries during its 2004 reorganization. *Interstate Bakeries Names Ron Hutchinson as CFO*, MORNING SUN (Pittsburgh, Kan.), July 11, 2004.

*economic theory that should be used to determine the consistency of specific business practices with that goal.*²¹⁹

Removing the Chapter 11 requirement from the Failing Company Doctrine would further the economic welfare goals of antitrust law. The Merger Guidelines now recognize that efficiencies “can enhance the merged firm’s ability and incentive to compete which may result in lower prices, improved quality, or new products.”²²⁰ Promoting efficiency by changing the Failing Company Doctrine to a more economic approach would not only improve the antitrust law but be a logical approach as well. This next section will: (1) explain how the Merger Guidelines in the past few decades have focused more on the efficiencies of mergers; (2) explain how certain mergers can achieve economic welfare; and (3) analyze the potential efficiencies achieved through mergers in the sick industry.

A. *The Merger Guidelines’ View of Efficiencies*

The Merger Guidelines’ revisions since 1968 have placed increasing weight on efficiencies, specifically the efficiency defense.²²¹ In 1968, the first Merger Guidelines had one small paragraph on efficiency stating that under “exceptional circumstances” the Department of Justice would accept “economies” as a justification for a merger.²²² However, the 1968 Merger Guidelines also stated that efficiencies could be a reason to block a merger, presuming that if the merger produced a more efficient firm, then the firm would compete better than others in the industry and induce the exit of the others.²²³

²¹⁹ RICHARD A. POSNER, *ANTITRUST LAW* ix (2d ed. 2001); see also Maurice E. Stucke, *Behavioral Economists at the Gate: Antitrust in the Twenty-First Century*, 38 *LOY. U. CHI. L.J.* 513 (2007).

²²⁰ *Fed. Trade Comm’n. v. H.J. Heinz Co.*, 246 F.3d 708, 720 (D.C. Cir. 2001) (quoting 1992 Merger Guidelines, *supra* note 7, at 20,573-11).

²²¹ Thomas W. Ross & Ralph A. Winter, *The Efficiency Defense in Merger Law: Economic Foundations and Recent Canadian Developments*, 72 *ANTITRUST L.J.* 471, 497 (2005) (citing 1968 Merger Guidelines, *supra* note 72; U.S. Dep’t of Justice and Fed. Trade Comm’n Horizontal Merger Guidelines (1984), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,103 (2002) [hereinafter 1984 Merger Guidelines]; U.S. Dep’t of Justice and Fed. Trade Comm’n Horizontal Merger Guidelines (rev. 1997), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104 (2002) [hereinafter Rev. 1997 Merger Guidelines]).

²²² Ross & Winter, *supra* note 221, at 497 (citing 1968 Merger Guidelines, *supra* note 72).

²²³ *Id.* In prior cases, efficiencies were weighed in favor of the illegality of a merger. In *In re Foremost Dairies*, anticipated efficiencies added to the argument that post merger the firm would gain market power and thus the merger with its efficiencies was illegal. *In re Foremost Dairies*, 60 F.T.C. 944 (1962), *modified*, 67 F.T.C. 282 (1965). Still, in 1967 the Supreme Court rejected the weighing of efficiencies against the legality of a merger. *Fed. Trade Comm’n v. Procter & Gamble Co.*, 386 U.S. 568 (1967). Considering that economies would have been achieved through the merger, the Court still leaned towards protecting competition by

In 1984, efficiencies became part of the analysis of whether a merger substantially lessened competition, thereby moving efficiencies from a defense against the merger to a portion of the analysis.²²⁴

Cognizable efficiencies include, but are not limited to, achieving economies of scale, better integration of production facilities, plant specialization, lower transportation costs, and similar efficiencies relating to specific manufacturing, servicing, or distribution operations of the merging firms. The Department may also consider claimed efficiencies resulting from reductions in general selling, administrative, and overhead expenses, or that otherwise do not relate to specific manufacturing, servicing, or distribution operations of the merging firms, although, as a practical matter, these types of efficiencies may be difficult to demonstrate.²²⁵

Further, the 1992 Merger Guidelines lowered the standard of proof for efficiencies by removing the requirement that they be proven by “clear and convincing evidence.”²²⁶ The 1997 revisions included two guideline changes which articulated what efficiencies would be considered.²²⁷ The first revision was the addition of the sentence “[t]he Agency also will consider the effects of cognizable efficiencies with no short term, direct effect on prices in the relevant market.”²²⁸ Analysts suggest that this addition changed the standard of efficiency to one that considered both consumer welfare and total market welfare.²²⁹ The addition of footnote thirty-six indicated that the Department of Justice and the FTC would sometimes be willing to accept anticompetitive effects in one market if the merger created efficiencies in another market.²³⁰

prohibiting the merger. *Id.* A series of articles by Oliver Williamson beginning in 1968 may have influenced the government. Williamson proposed that the efficiencies from mergers are desirable and could offset market-power effects. This is now generally accepted as the Williamson merger analysis. Alan A. Fisher & Robert H. Lande, *Efficiency Considerations in Merger Enforcement*, 71 CAL. L. REV. 1580, 1583 (1983) (citing Oliver E. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968); Oliver E. Williamson, *Economies as an Antitrust Defense: Correction and Reply*, 58 AM. ECON. REV. 1372 (1968); Oliver E. Williamson, *Allocative Efficiency and the Limits of Antitrust*, 59 AM. ECON. REV. 105 (1969); Oliver E. Williamson, *Economies as an Antitrust Defense: Reply*, 59 AM. ECON. REV. 954 (1969); Oliver E. Williamson, *Economies as an Antitrust Defense Revisited*, 125 U. PA. L. REV. 699 (1977)).

²²⁴ Ross & Winter, *supra* note 221, at 497 (citing 1984 Merger Guidelines, *supra* note 221).

²²⁵ 1984 Merger Guidelines, *supra* note 221, at 20,564.

²²⁶ Ross & Winter, *supra* note 221, at 497 (comparing 1984 Merger Guidelines § 3.5, *supra* note 221, at 20,564 with Rev. 1997 Merger Guidelines § 4, *supra* note 221, at 20,573-11).

²²⁷ *Id.* (citing Rev. 1997 Merger Guidelines, *supra* note 221).

²²⁸ *Id.* at 497-98 (citing Rev. 1997 Merger Guidelines § 4 n.37, *supra* note 221, at 20,573-13).

²²⁹ *Id.* at 498 (citing William J. Kolasky & Andrew R. Dick, *The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers*, 71 ANTITRUST L.J. 207, 211 (2003)).

²³⁰ *Id.* (citing Rev. 1997 Merger Guidelines § 4 n.36, *supra* note 221, at 20,573-13).

Simply put, if the efficiencies substantially outweigh the anticompetitive effects²³¹ and the anticompetitive effects are unavoidable, then the merger may be approved.²³²

Because recent changes in the Merger Guidelines have led to a greater focus on the economic efficiencies of mergers, the Failing Company Doctrine should be allowed greater economic focus as well. The Chapter 11 requirement should be removed from the Failing Company Doctrine in the Merger Guidelines so that the government can analyze a potential merger through a lens of economic efficiency.

Critics claim the entire failing company defense should be applied more as a component of the competitive effects analysis when “taking into account the likelihood of exit as well as the magnitude of likely competitive harm.”²³³ Friedman argues that only the competitive strand of the doctrine should be applied, because “it is virtually always more competitive for the company to be acquired” than to have assets leave the market.²³⁴ The merger should be allowed even if there is only a moderate probability of failure.²³⁵

²³¹ It is not clear whether the failing company defense was meant to incorporate consideration of social costs. Compare Paul M. Laurenza, *Section 7 of the Clayton Act and the Failing Company: An Updated Perspective*, 65 VA. L. REV. 947, 965 (1979) (arguing that Congress intended for social costs to be considered when determining the use of the failing company defense) with Derek C. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 340 (1960) (arguing only the economic efficiencies should be considered in relation to acquisition by the failing company defense). Later cases using the defense and concerning antitrust in general argue both ways. *The Failing Company Defense: Statement Before the Fed. Trade Comm’n*, *supra* note 16. Still, it is difficult for the judiciary to weigh social costs. *Id.*

²³² Ross & Winter, *supra* note 221, at 497 (citing Rev. 1997 Merger Guidelines § 4, *supra* note 221, at 20,573-11 to -13).

²³³ Correia, *supra* note 42, at 689.

²³⁴ Friedman, *supra* note 6, at 1412.

The courts should apply only the competitive strand of the failing company doctrine. In doing so, they should realize that, when the price of a company’s failure is removal of its assets from the industry, it is virtually always more competitive for the company to be acquired, even by a dominant firm within the industry, than for it to fail. How likely such failure is, and how much more competitive the acquisition is than failure, are difficult issues of fact, and the decision to apply the doctrine may depend on their determination. In a case otherwise close to the line, even a moderate probability of failure may be decisive.

Id. at 1412–13.

²³⁵ *Id.* at 1413.

B. *Who Should Enjoy the Benefits of Efficiency?*

The efficiencies of mergers are assessed by the impact on individuals' welfare, the principle appropriately named "welfarism."²³⁶ Total surplus is the value of all products bought in a given market in excess of the cost of producing those products and is achieved by efficiently bringing together buyers and sellers.²³⁷ All individuals benefit if total surplus is created.

Ideally, total surplus is enjoyed by sellers in the form of profits and buyers in the form of consumer surplus. Consumer surplus is the difference between what buyers are charged and what they were willing to pay.²³⁸ If a merger creates surplus for either buyers or sellers without harming any others, the merger should be allowed; this is an example of the Pareto Efficiency Principle.²³⁹ Yet mergers rarely increase the surplus of some individuals without harming the surplus of others. While it is certain that the change in surplus of individuals is the appropriate measure of the efficiencies achieved by a merger, it is not certain how to weigh the changes in surplus of those affected by the merger.²⁴⁰

If one weighs consumer surplus and profits equally, the total surplus standard would be implemented.²⁴¹ However, typically with a merger that may substantially lessen competition, the merged firms have the ability to raise prices. Therefore, the profits may greatly increase but consumer surplus may be reduced. If one places greater weight on retaining consumer surplus regardless of the change in total surplus, this may indicate the price standard.²⁴² Using the price standard, "the merger is acceptable if and only if cost efficiencies are so strong that they overwhelm any market power increase so that price does not rise with the merger."²⁴³ Therefore, the merger is only allowed if there is a benefit to consumer surplus.²⁴⁴

²³⁶ Ross & Winter, *supra* note 221, at 474.

²³⁷ *Id.*

²³⁸ *Id.*

²³⁹ *Id.* Pareto Efficiency is when there is no way to change things to make any one person better off *without* making *anyone* worse off. See Org. for Econ. Co-operation & Dev., Glossary of Industrial Organisation Economics and Competition Law 41, 65 (1993), <http://www.oecd.org/dataoecd/8/61/2376087.pdf>.

²⁴⁰ Ross & Winter, *supra* note 221, at 474.

²⁴¹ *Id.*

²⁴² *Id.* at 475.

²⁴³ *Id.*

²⁴⁴ *Id.* at 475 n.18.

Some economists argue that the weight applied to the additional surplus of an individual should not depend on whether that individual is a consumer or shareholder.²⁴⁵ However, government policy makers are generally concerned about the distributional impact in terms of changing surplus, especially in terms of individuals in different socioeconomic levels.²⁴⁶ Regardless of how government may treat nonequivalent changes in surplus, there are mergers in which the efficiencies are so strong that no consumer surplus is diminished through increase in prices. When a merger produces surpluses without injury, it should be permitted regardless of whether the failing company could be reorganized through Chapter 11.

C. Efficiencies Achieved Through Mergers

*[M]ergers have the potential to generate significant efficiencies by permitting a better utilization of existing assets, enabling the combined firm to achieve lower costs in producing a given quantity and quality than either firm could have achieved without the proposed transaction. Indeed, the primary benefit of mergers to the economy is their potential to generate efficiencies.*²⁴⁷

While the 1992 and 1984 Merger Guidelines have added weight to the relevance of the overall efficiencies produced by the merger, the next step should be to further the efficiency goal by deleting the Chapter 11 requirement. Without the rebuttal that a firm could reorganize under Chapter 11, the government could equally weigh the firm's options with an eye towards economic efficiency. This section demonstrates the efficiencies usually achieved through mergers by focusing on failing companies.

1. Types of Efficiencies Achieved Through Mergers

Mergers generally produce efficiencies in three ways; they: (1) minimize cost of production; (2) maximize allocative efficiency; and (3) encourage innovation.²⁴⁸ These three methods of producing efficiencies will be explained in turn.

²⁴⁵ *Id.* at 476.

²⁴⁶ *Id.* Interestingly, it is not always the case that those with lower socioeconomic status are the consumers and those with greater wealth are the shareholders. For example, in an airline merger, the consumers are likely to be wealthier than those that own airline stock; thus, an increase in prices may redistribute wealth in a way the government supports. *Id.*

²⁴⁷ Rev. 1997 Merger Guidelines § 4, *supra* note 221, at 20,573-11 to -13.

²⁴⁸ Neil W. Averitt & Robert H. Lande, *Using the "Consumer Choice" Approach to Antitrust Law*, 74 ANTITRUST L.J. 175, 186 (2007).

The first type of efficiency is productive efficiency, which measures the performance of a company in terms of achieving the best possible results for its efforts.²⁴⁹ So, if productive efficiency is optimized there will be a decrease in manufacturing costs.²⁵⁰ Productive efficiencies are also called operating efficiencies and are derived from economies of scale, specialization in product line, resource allocation, transportation costs, technological complementarities, and other transaction cost economies.²⁵¹ These efficiencies translate into “lower costs to produce the same product, unchanged costs to produce a better product, or a totally new quality/cost combination that customers prefer to the old package.”²⁵² Especially in sick industries with chronic excess capacity, mergers permit consolidation of operations and elimination of excess capacity, which reduces fixed costs and advances more efficient operation.²⁵³

Allocative efficiency describes how a society’s resources are allocated among different production and consumption uses.²⁵⁴ Essentially, allocative efficiency creates total surplus because ideally all resources would be employed in their highest value.²⁵⁵ This is measured by how much someone is willing to pay for the product.²⁵⁶ Critics say that of the three merger efficiencies, allocative efficiency is the least far reaching in that it operates only at the margin, valuing existing stock in the market.²⁵⁷ This explanation of allocative efficiencies is in terms of output of individual products. This Comment focuses on the allocative efficiency achieved by placing the entire firm in the hands of those who value it most: in this ongoing scenario, a merger instead of a Chapter 11 reorganization.

Lastly, mergers create new efficiencies by encouraging innovation.²⁵⁸ The pooling of resources and development teams allows for the synthesis of knowledge and the opportunity for the successful exploitation of new ideas.

²⁴⁹ See David W. Barnes, *Nonefficiency Goals in the Antitrust Law of Mergers*, 30 WM. & MARY L. REV. 787, 798 (1989).

²⁵⁰ See, e.g., *id.* at 798–99.

²⁵¹ Fisher & Lande, *supra* note 223, at 1584 (citing PHILLIP E. AREEDA & D. TURNER, *ANTITRUST LAW* ¶ 939 (1st ed. 1980)); FREDERIC M. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 127, 137–38 (2d ed. 1980).

²⁵² Fisher & Lande, *supra* note 223, at 1600.

²⁵³ *Id.* at 1583.

²⁵⁴ See Barnes, *supra* note 249, at 800.

²⁵⁵ See *id.*

²⁵⁶ See *id.*

²⁵⁷ Joseph F. Brodley, *The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress*, 62 N.Y.U. L. REV. 1020, 1027 (1987).

²⁵⁸ Averitt & Lande, *supra* note 248, at 186.

Innovation by definition must either increase consumer or producer value. Successive innovation fuels the growth of the economy as a whole. The government agrees that innovation moves society forward and is beneficial to social welfare.²⁵⁹ In summary, “[i]nnovation efficiency is achieved through the invention, development, and diffusion of new products and production processes that increase social wealth.”²⁶⁰

2. Case Study of Merger Efficiencies

*Federal Trade Commission v. H.J. Heinz Co.*²⁶¹ illustrates some of the potential efficiencies that could be achieved if two companies with differing strengths could have merged. In that case, the second and third largest baby food manufacturers, Heinz and Beech-Nut, sought to merge in hopes of competing with the largest baby food company, Gerber.²⁶² Gerber controlled 65% share of the jarred baby food market, while Heinz had only 17.4% and Beech-Nut had 15.4%.²⁶³

Both Heinz and Beech-Nut could not compete with Gerber for various reasons. Heinz not only lacked the brand recognition, but due to less desirable recipes was known as a value brand, selling at several cents below the Gerber price.²⁶⁴ Beech-Nut had presumptively tastier recipes and price parity with Gerber, as a premium brand.²⁶⁵ However, Beech-Nut had inefficient operating costs because it manufactured all of its baby food in a manufacturing plant that was built in 1907.²⁶⁶ Therefore, because Beech-Nut and Heinz occupied different corners of the market, the merger would not have lessened competition between the two companies.²⁶⁷ However, antitrust law is about the lessening of competition in the market, not between competitors.²⁶⁸

Both argued that the merger would allow them to better compete with Gerber.²⁶⁹ Heinz and Beech-Nut projected the following efficiencies:

²⁵⁹ Richard J. Gilbert & Steven C. Sunshine, *Incorporating Dynamic Efficiency Concerns in Merger Analysis: The Use of Innovation Markets*, 63 ANTITRUST L.J. 569, 570 (1995).

²⁶⁰ Brodley, *supra* note 257, at 1025.

²⁶¹ 246 F.3d 708 (D.C. Cir. 2001).

²⁶² *Id.* at 711, 720.

²⁶³ *Id.* at 711.

²⁶⁴ *Id.* at 712, 722.

²⁶⁵ *Id.*

²⁶⁶ *Id.*

²⁶⁷ *See generally id.*

²⁶⁸ *Id.* at 719 n.17.

²⁶⁹ *Id.* at 720.

decreased advertising costs, ability to launch new products with greater shelf space, creation of better products from pooled research and development teams, decreased manufacturing costs, increased name recognition and consumer appeal, and better utilization of existing assets.²⁷⁰ However, the court did not weigh those efficiencies heavily enough and ultimately granted the preliminary injunction, finding it was in the public interest.²⁷¹

Perhaps the potential efficiencies likely to be achieved by the merger were overstated by Heinz and Beech-Nut. However, the *H.J. Heinz Co.* case demonstrates efficiencies that by law would not be considered if one of the companies were failing but did not meet the Chapter 11 requirement. To allow uninhibited consideration of these potential efficiencies when one of the companies is failing, the Chapter 11 requirement of the Failing Company Doctrine must be eliminated.

D. Efficiencies Created in the Little Betty and Tastypie Merger

If the requirement that a firm be unable to reorganize under Chapter 11 was removed from the Failing Company Doctrine, the government could more easily analyze the proposed merger through a lens of economic efficiency. If the FTC no longer has the obligation to initially analyze whether Little Betty could reorganize through Chapter 11, it would examine all of the company's options with the goal of maximizing the company's value. The FTC should weigh the probable lessening of competition against the efficiencies of the merger, taking into account the financial status and trend of Little Betty and the sick industry.

Little Betty is still faced with the original three options: (1) liquidate by selling off all of its assets piecemeal; (2) go through another Chapter 11 reorganization; or (3) merge with Tastypie to become one company. For this hypothetical case, assume that it is clear that liquidating Little Betty is the least economically advantageous of the three options and only Chapter 11 reorganization and the merger will be considered. Also, recall that Little Betty wants to merge with Tastypie. The FTC will analyze the potential for Chapter 11 reorganization and the merger evenly in turn.

²⁷⁰ *Id.* at 721.

²⁷¹ *Id.* at 726–27.

1. Chapter 11 Reorganization

Little Betty has reorganized before, and now, a few years later, it is in the position to reorganize yet again. A successful reorganization would maintain the number of competitors in the high-preservative snack food industry and not substantially lessen competition. Maintaining Little Betty as its own entity may also provide other benefits to the public because the number of people employed by the companies will not be significantly reduced as it might by the merger. Reorganization would relieve Little Betty from debt and provide the cash it needs to create a product line that will make it successful in the future. However, the reorganization is a risky bet given Little Betty's financial history and the downward trend of the snack food industry.

Reorganization is less likely to succeed in this industry plagued by overcapacity in which there is immense pressure to consolidate. A Chapter 11 reorganization would prop up Little Betty for about two years before the company would be liquidated. In the second year after reorganization, Little Betty will incur great amounts of debt again injuring the market as a whole by wasting resources.

Technically, Little Betty could reorganize through Chapter 11; however, without the Chapter 11 requirement of the Failing Company Doctrine, the FTC can consider the Tastypie merger simultaneously. Because the FTC technically does not have to stop the analysis after learning that Little Betty can reorganize, it looks at longer term projections of the industry. Little Betty's reorganization would likely be contentious, time consuming, and costly, and experts predict that five years from now the market will only support three bakery snack food companies. There is a chance that Little Betty would be one of the three survivors, but the FTC now fully comprehends the dire long term nature of the snack food industry and can consider the Tastypie merger.

2. Tastypie Merger

Although some may fear that a merger would lessen competition, it is unlikely that having four companies in the market will encourage collusion. Moreover, the merger of Little Betty and Tastypie will allow them to compete as a unit with Mabisco. If Tastypie's tasty recipes could be manufactured using Little Betty's efficient and technologically advanced facilities, the merged company may be able to recapture some of Mabisco's market power.

The cost efficiencies predicted by Little Betty and Tastypie outweigh any market power increase, such that the merged company would have lower prices, consumer surplus, more profit, and producer surplus. First, production costs will decrease because Little Betty's facilities can produce more quality recipes in less time than Tastypie's could premerger. Second, the overall merger would create allocative efficiencies because Tastypie places a higher value on Little Betty than a reorganization does. Last, investors and the companies alike are confident that the merged research and development team could join the knowledge of quality recipes with the knowledge of efficient means of production to create better overall products. While potentially merging companies are generally optimistic, the efficiencies achieved by the merger even with the increased market power would likely not diminish consumer surplus.

Uninhibited by the Chapter 11 requirement, the FTC approves the merger of Little Betty and Tastypie. In this sick industry hypothetical case, the market benefits of the merger outweigh the amount of competition foreclosed upon. The attainment of these benefits is only possible when the FTC does not have to consider the possibility of Chapter 11 reorganization prior to the balancing of the foreclosed competition and efficiencies.

V. CONCLUSION: ANALYZING THE EFFICIENCIES OF CHAPTER 11 REORGANIZATION VS. MERGER WITHOUT THE CHAPTER 11 REQUIREMENT OF THE FAILING COMPANY DOCTRINE

The following three available options for a failing firm should be analyzed simultaneously through a lens of economic efficiency: (1) liquidate, (2) merge with potentially anticompetitive effects, or (3) reorganize through Chapter 11. Basic economics suggests that all sick industries should have every means, including merging, to alleviate overcapacity. Therefore, the requirement that a company be unable to reorganize by Chapter 11 to be a failing company should be removed from the Failing Company Doctrine. Removing the Chapter 11 reorganization requirement from the law would allow for greater economic focus in merger analysis.

The Merger Guidelines currently require that if a failing company can reorganize through Chapter 11 reorganization, then the companies cannot merge. The intent of the reorganization requirement was to ensure that the company was truly failing. The merger would be the "lesser of two evils" because the assets of the failing company would remain in the market instead

of exiting.²⁷² But due to the social costs of Chapter 11 reorganization, even if a company has a moderate chance of an unsuccessful reorganization, a merger that may substantially lessen competition should be permitted.

Sometimes Chapter 11 reorganization may be more efficient, because it allows a company to reject unprofitable contracts. However, contentious reorganizations present a significant risk of inaccurate valuation. Critics argue that the cost of manipulation by reorganization participants outweighs the value added through reorganization. Additionally, the social costs of reorganization are very high, including the time invested by judges, lawyers, and company management. Traditional corporate reorganization theory presupposes that the failing company has the three following characteristics: (1) it has substantial going concern value; (2) its investors require Chapter 11's collective bargaining forum; and (3) it cannot be sold as a going concern in the market.²⁷³ Companies that seek to use the failing company defense have a buyer and yet could be thrust into reorganization.

This Comment demonstrates that due to the problems with imperfect valuation and the costs of reorganization process, Chapter 11 is efficient for a sick industry in only a limited set of situations. Therefore, the requirement that a company be unable to reorganize to qualify as failing under the Failing Company Doctrine should be removed from the Merger Guidelines.

A. Through the Lens of Economic Efficiency

If the Chapter 11 requirement of the Failing Company Doctrine was removed, all of the options for a failing company could be analyzed simultaneously through a lens of economic efficiency. Assuming that in the potential merger the price is of a going concern, the following four scenarios illustrate when a company should be permitted to merge instead of reorganizing in Chapter 11:²⁷⁴

1. Scenario One: Chapter 11 Reorganization

Government and courts should not permit a merger which may substantially lessen competition if the market environment has the following characteristics: (1) the company is in a healthy industry with new market

²⁷² United States v. Gen. Dynamics Corp., 415 U.S. 486, 507 (1974).

²⁷³ Baird & Rasmussen, *supra* note 11, at 673–74.

²⁷⁴ If not of going concern value, the company should liquidate and sell its assets piecemeal.

entrants and a stable demand for the product or service; (2) the company has significant cash flow; and (3) purging unprofitable contracts could make the company economically viable in the long run. These factors do not indicate a failing company as intended by the Failing Company Doctrine because, but for the merger, the assets would not leave the market. Chapter 11 reorganization would likely be successful and would be the most economically efficient option in this scenario.

2. Scenario Two: Likely Chapter 11 Reorganization

In the sick industry, Chapter 11 reorganization may be more efficient if the following characteristics are present: (1) the industry is operating at overcapacity but does not seem to be a dying industry²⁷⁵ because there is not a downward trend in the demand for the product or service; (2) the company has positive cash flow; (3) the company, after rejecting certain unprofitable contracts, would be profitable; and (4) the company is not one of the weakest in the industry. The scenario may require a greater depth of market analysis especially in terms of the long term projections for the industry²⁷⁶ and company. A company in this scenario would likely have more than a moderate chance of successful reorganization. Therefore, if the market cost due to the substantial lessening of competition from the merger would be greater than the cost of Chapter 11 reorganization, the merger should not be permitted.

3. Scenario Three: Balance Between Chapter 11 Reorganization and the Merger

In a healthy industry where the efficiencies of the proposed merger and Chapter 11 reorganization would have to be carefully weighed, but may lean towards merger, the scenario could have the following characteristics: (1) the company could possibly emerge from Chapter 11 as economically viable; (2) the company has a weak but positive cash flow; (3) the company has many creditors with opposing interests and would likely have a contentious reorganization; or (4) the demand for the company's product or service is at

²⁷⁵ The airline industry is an example of a sick but certainly not dying industry. It is reasonable to assume that until further technology is introduced, air travel will remain the preferred means for long distance trips. The industry needs to shrink, but competition should be maintained.

²⁷⁶ The number of companies in the industry may also be a factor in weighing how the merger would substantially lessen competition compared to the costs of Chapter 11 reorganization. If the industry is moving from five companies to four, a court might weigh in favor of the merger; whereas if the industry is moving from three companies to two, a court would probably bar the merger.

least stable. Where both Chapter 11 and the merger are options, both must be weighed carefully in terms of market costs and economic efficiencies achieved. In this evenly weighed scenario the courts should lean towards allowing the merger. The merger may lessen competition by reducing the number of competitors in the industry, but at worst, this could lead to the companies colluding and forming cartels. Some critics say that even cartelization could in some cases even be more efficient.²⁷⁷

4. Scenario Four: Merge

A merger should be permitted in the sick industry scenario with the following characteristics: (1) the industry is operating at overcapacity; (2) projections show that many companies in the industry will leave the market; (3) the company has positive cash flow; and (4) a Chapter 11 reorganization plan could be confirmed. In this scenario, the courts should permit the merger even if technically Chapter 11 reorganization is possible. The merger could allow weak companies to pool assets to become more viable and compete with a dominant firm in the industry, such as illustrated in the *H.J. Heinz Co.* case. Additionally, the benefits from the efficiencies achieved through the merger will likely outweigh the amount of competition protected by reorganization. This scenario illustrates that even if a company could reorganize under Chapter 11, it would be more efficient to permit the merger.

B. Analysis

Removing the Chapter 11 requirement would allow the government and courts to permit the merger when necessary in Scenario Three and always in Scenario Four. This Comment does not suggest that allowing a merger that would substantially lessen competition is always economically more efficient, but rather that there are specific situations in which a merger would be more beneficial to the market.

In sick industries, such as the snack food industry, the airline industry, the American car industry, the newspaper industry, and the asbestos industry,

²⁷⁷ RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 311 (5th ed. 1998). Cartelization is the creation of a contract, explicit or tacit, to fix the price or supply of a product to acquire monopoly prices. *Id.* at 309; see also Rollman, *supra* note 200, at 398 n.112. If an industry is characterized by high fixed costs and significant assets that are almost useless in other industries, then a cartel that increases the power to fix prices by trimming overcapacity may be more beneficial because the remaining airlines can operate more efficiently with fuller flights and therefore greater revenue. *Id.* at 399.

overcapacity should be alleviated by the option that is most efficient and beneficial to the market. In this era of technology and globalization, certain industries are more successful in other parts of the world or are bested by new technology. The law should be updated to reflect the understanding that the market is not always better off when companies are kept “alive;” a certain amount of failure is a healthy sign of capitalism.

The market, especially the “sick” industries, should have every means to alleviate overcapacity in the most economically efficient manner. Therefore, the requirement that a company be unable to reorganize through Chapter 11 to be a failing company under the Failing Company Doctrine should be eliminated from the Merger Guidelines. Removing the Chapter 11 requirement from the Failing Company Doctrine would allow the government and courts to look at the options of merger and reorganization through a lens of economic efficiency and determine the most beneficial route for the market. This option, in certain situations, would allow the market to avoid the social costs of reorganization and attain profits and efficiencies created by a merger.

ASHLEY J. AUSTIN*

* Executive Articles Editor, *Emory Bankruptcy Developments Journal*; J.D. Candidate, Emory University School of Law (2009); B.A., Wake Forest University (2005). The author would like to thank Professor Arthur for his guidance during the writing process and Hunter Edwards for his unconditional love and support throughout this endeavor and all others.