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# Federal Antitrust Law-Mergers-An Updating of the "Failing Company" Doctrine in the Amended Section 7 Setting

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## COMMENTS

Federal Antitrust Law—Mergers—An Updating of the "Failing Company" Doctrine in the Amended Section 7 Setting—Section 7 of the Clayton Act[1] was enacted to supplement the operation of the Sherman Act[2] in preserving the competitive system of our economy by preventing monopoly and undue concentration in American industry.[3] As enacted, section 7 was intended to reach concentration by mergers in their incipiency and before they reached the level of restraints of trade or monopoly probabilities under the Sherman Act.[4] However, the original section 7 soon appeared to be an inadequate tool to accomplish this purpose, primarily because it prevented only acquisitions of stock and not of assets.[5] In 1950, the section was amended to reach any acquisition of stock or assets which might substantially lessen competition or tend to create a monopoly.[6] Thus strengthened, section 7 has been utilized by the Department of Justice and the Federal Trade Commission with considerable success in preventing unlawful mergers and in disentangling those which have already occurred.[7]

Even though application of section 7 has become increasingly effective, a specific exception to its coverage has been recognized by Congress[8] and the Supreme Court.[9] This exception is commonly referred to as the "failing company" doctrine. In short, the doctrine holds that an acquired or to-be-acquired firm which is in a "failing" condition, or the acquiring corporation, may

1 64 Stat. 1125 (1950), 15 U.S.C. § 18 (1958), amending 38 Stat. 731 (1914).

2 Sherman Act §§ 1, 2, 26 Stat. 209 (1890), 15 U.S.C. §§ 1, 2 (1958).

3 See Brown Shoe Co. v. United States, 370 U.S. 294, 315 (1962); H.R. Rep. No. 1191, 81st Cong., 1st Sess. 3 (1949); 96 Cong. Rec. 16433 (1950) (remarks of Senator O'Conor). See also United States v. Aluminum Co. of America, 148 F.2d 416, 429 (2d Cir. 1945).

4 38 Stat. 731-32 (1914) provided: "[N]o corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly in any line of commerce."

5 See Arrow-Hart & Hegeman Elec. Co. v. FTC, 291 U.S. 587 (1934); FTC v. Western Meat Co., 272 U.S. 554 (1926). For a brief summary of § 7's weaknesses prior to the 1950 amendment, see Report of Att'y Gen. Nat'l Comm. To Study the Antitrust Laws 115-17 (1955). For a discussion of the doctrine, see Wiley, *The "Failing Company": A Real Defense in Horizontal Merger Cases*, 41 B.U.L. Rev. 495 (1961).

6 See note 1 *supra*.

7 See Handler & Robinson, *A Decade of Administration of the Celler-Kefauver Antimerger Act*, 61 Colum. L. Rev. 629 (1961).

8 See H.R. Rep. No. 1191, 81st Cong., 1st Sess. 6 (1949); S. Rep. No. 1775, 81st Cong., 2d Sess. 7 (1950); 96 Cong. Rec. 16434-35 (1950).

9 See, *e.g.*, International Shoe Co. v. FTC, 280 U.S. 291 (1930).

interpose this condition as a defense to any prosecution under section 7 seeking to prevent or undo the acquisition of the failing company's stock or assets by the other. This discussion will attempt to explore the development of the doctrine, consider its significance and justification in our competitive system, and suggest possible guidelines for its application.

## I. HISTORICAL DEVELOPMENT OF THE "FAILING COMPANY" DOCTRINE PRIOR TO 1950

The first attempt to formulate an exception to the antitrust laws based on the potential financial failure of a competitor was made in *American Press Ass'n v. United States*,[10] a Sherman Act prosecution. In that case, the American Press Association was acquired by Western Newspaper Union, its only competitor in the relevant printing market. The acquisition was held not to result in an undue restraint of trade or the creation of a monopoly within the meaning of the Sherman Act since it was not injurious to the public interest, but, on the contrary, was beneficial to the public.[11] Supporting this contention were the facts that: (a) the market was in decline, with American and Western representing the only survivors; (b) American had been losing 3,000 dollars per month and was not able to build the modern printing facilities necessary to enable it to achieve competitive status; and (c) there were no other probable buyers for the failing firm's assets. These facts convinced the court that if the merger had been prevented American would soon have failed, leaving Western as the sole producer in the industry.[12] Injury to the public would have resulted from the destruction of a usable plant, and stockholder damage would have been represented by the lost value of the company as a going concern and the constantly diminishing worth of its idle assets. The court indicated that an agreement between American and Western setting prices at levels sufficiently high to provide profits for American would have avoided the consequences of failure and maintained a competitor in the field. This solution would still have caused the public to suffer, however, since the public would have been paying for the "profitable operation of an inefficient concern [which] is an injury," and, therefore, it was rejected.[13] Under either remaining alternative—allowing the pur-

10 245 Fed. 91 (7th Cir. 1917).
11 *Id.* at 93.
12 *Ibid.*
13 *Ibid.*

chase, or preventing it with the ultimate consequence that American would fail—Western would still remain alone in the industry. Since the merger course would not increase the injury to the public that was likely to occur regardless of the choice, and would be beneficial in the respects outlined above, the court concluded that the purchase did not violate the antitrust laws.

This defense again appeared, although not in definitive form, in the first *Aluminum Co.* case,[14] where the Aluminum Company and the Cleveland Company had devised a complex plan for joint ownership in a third company to be formed—the Aluminum Rolling Mills Company. The court found, in this section 7 case, that such a transaction would have the effect of substantially lessening competition between the Cleveland Company and the Aluminum Company, and, in addition, that the purchase of the Rolling Mills stock by the Aluminum Company would tend to create a monopoly.[15] The Aluminum Company contended that its intent was not to by-pass the Clayton Act but rather to gain capacity to meet the demands of war production and to relieve Cleveland of a difficult business situation in which it was incurring losses.[16] The majority opinion summarily dismissed this contention indicating that effect rather than motive was controlling, and found that the effect here was illegal under the act. The dissent,[17] on the other hand, argued that the transaction represented a prudent business decision with a legitimate purpose. If it had been otherwise, the Aluminum Company could merely have waited a short time until both Cleveland and Rolling Mills had failed and then acquired the Rolling Mills stock or assets.

The second *Aluminum Co.* case[18] bore out the prophecy voiced by the dissent in the earlier decision.[19] With the Cleveland Company having permanently terminated all business activities, the Aluminum Company indicated that it would bring a creditor's bill to collect on notes owed to it by Rolling Mills, which itself had ceased operations. The FTC sought to prevent this action on the ground that the Aluminum Company, as the judgment creditor, would acquire the assets at the ensuing sheriff's sale, which result would be contrary to the holding in the first *Aluminum Co.*

14 Aluminum Co. of America v. FTC, 284 Fed. 401 (3d Cir. 1922), *cert. denied*, 261 U.S. 616 (1923).
15 *Id.* at 408.
16 *Ibid.*
17 *Id.* at 409-11.
18 Aluminum Co. of America v. FTC, 299 Fed. 361 (3d Cir. 1924).
19 284 Fed. at 409-11.

case. The court decided that since Cleveland had withdrawn from the industry and Rolling Mills was competitively dead, section 7 would not deprive a creditor of his right to collect debts owing to him in the manner prescribed by law.[20]

The true foundations of the "failing company" doctrine were laid in the famous Supreme Court decision in *International Shoe Co. v. FTC.*[21] In that case the International Shoe Company had acquired the stock of the W. H. McElwain Company in a transaction involving two of the largest shoe manufacturers in the world. The Court held in the alternative that: (1) the two companies were not competitors in the relevant market and, accordingly, there was no indication that the merger might substantially lessen competition;[22] and (2) section 7 should not be applied where the acquired company is in a failing condition[23] (this latter holding being the prime concern of this discussion).

The facts supporting the second holding[24] indicated that the McElwain Company had sustained a loss in excess of 6,000,000 dollars in 1920, which had wiped out its surplus and left a deficit of about 4,900,000 dollars. The corporation also owed 15,000,000 dollars to banks and trust companies and an additional 2,000,000 dollars on current accounts. In 1921, production had fallen to about 15 percent of capacity, and dividend payments had stopped on common and second preferred stock and were to be discontinued on first preferred. Finally, the annual filing of the financial statements required by the law of Massachusetts would have disclosed the firm's insolvency and brought it to the point of involuntary liquidation.

Against this setting the situation of International Shoe was vividly contrasted.[25] The company was in excellent financial condition and its efficiency had even justified a reduction in its shoe prices. Business had increased by about 25 percent and the company found itself unable to fill its orders due to a lack of capacity. McElwain approached International Shoe with the idea of selling out. The merger was accomplished by means of exchanging securities rather than by purchase of assets, so that the acquired facilities could be put into operation quickly by existing personnel. After

20 299 Fed. at 365.
21 280 U.S. 291 (1930).
22 *Id.* at 299.
23 *Id.* at 302-03.
24 *Id.* at 299-300.
25 *Id.* at 300-01.

summarizing the above facts, the Court indicated that the possible alternatives open to McElwain, such as securing additional loans or receivership, were, at best, speculative and provided no assurance that such action would save the corporation. The acquisition, therefore, would not be invalidated merely because such alternatives existed.[26]

That oft-quoted paragraph which has been interpreted as the first concrete formulation of the "failing company" doctrine then followed:

> "In the light of the case thus disclosed of a corporation with resources so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure with resulting loss to its stockholders and injury to the communities where its plants were operated, we hold that the purchase of its capital stock by a competitor (there being no other prospective purchaser), not with a purpose to lessen competition, but to facilitate the accumulated business of the purchaser and with the effect of mitigating seriously injurious consequences otherwise probable, is not in contemplation of law prejudicial to the public and does not substantially lessen competition or restrain commerce within the intent of the Clayton Act. To regard such a transaction as a violation of law, as this Court suggested in *United States* v. *U.S. Steel Corp.*, 251 U.S. 417, 446-447, would 'seem a distempered view of purchase and result.' See also *American Press Ass'n* v. *United States*, 245 Fed. 91, 93-94."[27]

The importance of this paragraph[28] necessitates a careful examination of its language and structure, both now, and, in more detail, later.[29] The Court initially reiterated the factual conclusions in the case and then applied a doctrine which focused upon the motive of the purchase and the probable effect on the public if section 7 were construed to prevent the merger.

As a result of the line of authority culminating in the *International Shoe* decision, the concept of a "failing company" defense had passed beyond the amorphous state and had at least been crystallized to the extent that its existence as a possible justifica-

26 *Id.* at 301-02.

27 *Id.* at 302-03.

28 This paragraph has been relied on by Congress as authority for its assertion that the "failing company" doctrine does in fact exist as an exception to § 7, and that it should remain so under the amendment (see note 8 *supra*).

29 See text at 574, 582-83 *infra*.

tion for an otherwise unlawful merger was acknowledged. No attempt had been made at a thorough definitive assessment of the thrust and import of the doctrine, however, and it received no further serious attention until after the passage of the 1950 amendment to section 7.[30]

## II. RECOGNITION AND TREATMENT OF THE DOCTRINE SUBSEQUENT TO PASSAGE OF AMENDED SECTION 7

The legislative history relating to the amended section 7 of the Clayton Act contains expressions by Congress of its intent to exclude from the statute's coverage bankruptcy and receivership cases, and to extend the exclusion to situations where the acquired company was not in a state of bankruptcy, but was heading in that direction with the probability that bankruptcy would ensue.[31] Thus, "the bill would not apply to a company in a failing or bankrupt condition."[32] In expounding a definition of the doctrine, both the Senate and the House contented themselves with reciting the previously quoted and well-known passage from *International Shoe*.[33] It is perhaps unfortunate that Congress did not verbalize its own thoughts as to the scope of the defense. This has led some writers to doubt that the doctrine exists at all;[34] nevertheless, it has been since recognized in numerous judicial and administrative decisions.[35] Indeed, Representative Celler, co-sponsor of the 1950 Celler-Kefauver amendment to section 7, in hearings on a possible later amendment of the act to include banks,[36] reaffirmed the House report in stating that "any entity that would

30 In Beegle v. Thomson, 138 F.2d 875, 881 (7th Cir. 1943), *cert. denied*, 322 U.S. 743 (1944), the court in dictum indicated that a firm closing out its business because of financial difficulties could sell its facilities to a competitor without violating the antitrust laws.

31 See note 8 *supra*.

32 96 CONG. REC. 16435 (1950).

33 See text at note 27 *supra*; see also note 8 *supra*.

34 This view has been expressly stated in Connor, *Section 7 of the Clayton Act: The "Failing Company" Myth*, 49 GEO. L.J. 84 (1961); see also Note, 45 VA. L. REV. 421, 427 (1959).

35 See Crown Zellerbach Corp. v. FTC, 296 F.2d 800, 831-32 (9th Cir. 1961); Erie Sand & Gravel Co. v. FTC, 291 F.2d 279, 280-81 (3d Cir. 1961); United States v. Diebold, Inc., 197 F. Supp. 902 (S.D. Ohio 1961), *rev'd*, 369 U.S. 654 (1962); United States v. Maryland & Va. Milk Producers Ass'n, Inc., 167 F. Supp. 799, 808-09 (D.D.C. 1958), *aff'd in part and rev'd in part*, 362 U.S. 458 (1960); Farm Journal, Inc., 53 F.T.C. 26, 47-48 (1956). See also Brown Shoe Co. v. United States, 370 U.S. 294, 331 (1962), where the Court recognized the intent of Congress to preserve the "failing company" doctrine.

36 *Hearings Before the Antitrust Subcommittee of the House Committee on the Judiciary*, 84th Cong., 1st Sess., ser. 7, at 1 (1955).

be in a bad condition, could be taken over without violating the law."[37]

Recent cases in which the defense has been raised have not indicated a willingness by the courts to grapple with the conceptual problems involved in delimiting the scope and application of the doctrine. In these cases, the firm in question was usually either growing and profitable or hopelessly insolvent and on the brink of bankruptcy. In *Farm Journal, Inc.*,[38] it was determined that the purchase of the "Country Gentleman," a national farm magazine published by Curtis Publishing Company, by Farm Journal, the publisher of the only other national farm magazine, was in violation of the act. One of the defenses interposed was that "Country Gentleman" had been in a failing condition and had incurred large losses in recent years.[39] In rejecting this defense[40] the Commission indicated that Curtis itself was financially successful and its large surpluses could have been used to establish "Country Gentleman" magazine as a profitable enterprise. The holding was based essentially on the determination that, in order for the doctrine to apply, the firm itself, and not merely one of its endeavors, must be in a failing state.[41] The Commission also relied on the shaky financial condition of the acquiring company, Farm Journal, to distinguish this case from *International Shoe*.[42]

The strength of the acquiring company's business position may, in several respects, justify a court in sustaining the defense. First, it indicates a legitimate need for the capacity, which negates the claim that the motive for acquisition was illegal;[43] and, secondly, the sound financial condition of the acquirer tends to insure that the injury which the courts wish to prevent will, at least, be mitigated by keeping the facilities in operation and avoiding financial collapse.[44] A valid motive for acquisition and the mitigation of probable injury can be found in *Farm Journal*, as well as in *International Shoe*, although in a somewhat different form.

37 *Id.* at 10. This quote was in the context of a general discussion considering the necessity of inserting an "escape" proviso in the amendment to insure that those banking corporations faced with a possibility or probability of ultimate failure would be allowed to merge. It was felt that the doctrine of *International Shoe* covered this particular situation and therefore the proviso was not needed. *Id.* at 9, 10.

38 53 F.T.C. 26 (1956).

39 *Id.* at 47.

40 *Id.* at 47-48.

41 *Ibid.*

42 *Id.* at 48.

43 See International Shoe Co. v. FTC, 280 U.S. 291, 301 (1930).

44 *Id.* at 302.

Thus, the declining market for national farm magazines warranted a reduction in capacity, and merger has been recognized as one of the most painless and efficient means of accomplishing this legitimate end.[45] It is interesting to note that by the time the decision was handed down the merger question had become practically moot.[46] Curtis had ceased publication of "Country Gentleman" and Farm Journal had, for a considerable period, fully incorporated the valuable assets acquired by the transaction, such as advertising lists, subscriber lists, and use of the name "Country Gentleman" in conjunction with "Farm Journal." Divestiture at that late date was essentially a hollow remedy.

The defense was again raised in *Erie Sand & Gravel Co. v. FTC*,[47] where a liquidating corporation had sold out to the highest bidder, which happened to be a large competitor. In striking down the defense, the court stated that the mere fact the board of directors had made a final decision to liquidate the company did not permit what had been a prosperous firm up to the point of sale to come under the protection of the doctrine.[48] "The picture presented by the prosperous Sandusky Division here was the antithesis of such a 'failing company' situation"[49] (referring to the condition of McElwain in *International Shoe*). Speaking of the defense, the court suggested that it may be permitted when the corporation is in such dire financial straits that its termination and subsequent dispersal of its assets seems inevitable.[50] In determining whether the doctrine would be applicable in a particular case, the court indicated that the proper approach would involve a balancing with the possible injuries to the adverse interests involved.[51] For example, the probable damage to competition that may result if the merger is validated should be weighed against the likely injury to creditors, owners and employees of the corporation if it is prevented from selling out and thereafter fails. The precise

45 Each of the two national farm magazines were sustaining substantial losses, and, therefore, the situation is similar to and probably more dire than that involved in American Press Ass'n v. United States, 245 Fed. 91 (7th Cir. 1917), where the antitrust laws (Sherman Act) were held not to apply. See also S. REP. No. 132, 85th Cong., 1st Sess. 24 (1957), in which Professor Weston of the University of California is quoted: "Mergers may represent the most effective method of achieving stability and progress at certain stages of industrial development. It may represent the most efficient method of combining facilities and disposing of obsolete and inefficient properties."

46 Farm Journal, Inc., 53 F.T.C. 26, 49-51 (1956).

47 291 F.2d 279 (3d Cir. 1961).

48 *Id.* at 280-81.

49 *Id.* at 281.

50 *Id.* at 280.

51 *Id.* at 281.

holding of the case, however, was less broad. In order for a firm which has decided to go out of business to qualify under the defense it cannot have been in a healthy condition at the time of acquisition, but rather must have exhibited failing characteristics.[52]

Perhaps the most restrictive interpretation of the doctrine was rendered in *Pillsbury Co.*[53] The initial position taken by the Commission was that *International Shoe* must be limited to its facts. Thus, if a firm sought to qualify for this exception, evidence must be submitted to prove that the company had been in a desperate situation, with (1) resources depleted, (2) rehabilitation remote, and (3) the possibility of failure imminent.[54] It is important to remember that these three elements, which apparently represented the FTC's approach to the defense, were extracted from the characterization of the *facts* in the critical paragraph of *International Shoe.* No importance was attached to the *holding* which followed upon this characterization. Indeed, in attempting to reduce the potency of the "failing company" exception, it was suggested that there might be no exception at all.[55] After exhibiting a somewhat negative attitude toward the doctrine, the Commission was nevertheless willing to apply the broad test suggested by respondent company,[56] namely, whether there was a reasonable probability that, if the merger had not been allowed, insolvency or bankruptcy would have ensued. Even under this standard the Commission concluded that the burden had not been sustained by the respondent. The summary of the facts indicated a healthy enterprise with a long growth and profit history which was under some financial pressure due to a shortage of working capital.[57] In addition, there had been prior offers to purchase the firm and another bid was outstanding at the time of the acceptance of Pillsbury's offer.[58]

The essential facts in *Crown Zellerbach Corp. v. FTC*[59] bearing on the relevance of the doctrine were similar to those in *Pillsbury Co.* The history of the purportedly "failing" company

52 *Id.* at 280-81.
53 TRADE REG. REP. (1960-61 FTC Cas.) ¶ 29277, at 37617 (1960).
54 *Id.* ¶ 37629.
55 *Ibid.*
56 *Ibid.*
57 *Id.* ¶ 37628-29.
58 *Id.* ¶ 37630.
59 296 F.2d 800 (9th Cir. 1961).

involved indicated a growth of net worth, net assets and net sales.[60] The company had been generally profitable during the ten-year period prior to its acquisition, although its earnings had slacked off toward the end of this period,[61] and it had experienced difficulty in financing an expansion and modernization program.[62] After enumerating these facts the court determined that at the time of acquisition, the acquired corporation was an effective competitor of the acquirer, and there was no sufficient reason to believe that it was in a failing or bankrupt condition.[63] No attempt was made to define the "failing company" exception or its scope.

The "failing company" defense was successfully employed in *United States v. Maryland & Va. Milk Producers Ass'n*[64] and, more recently, in *United States v. Diebold, Inc.*[65] In the *Milk Producers* case the court had before it for consideration the acquisition of three dairies in the same relevant market by a milk producers' co-operative. The purchase of the assets of the Embassy Dairy was condemned because of the horizontal and vertical threats to competition that it posed.[66] In contrast, the acquisition of the other two dairies was permitted under the doctrine of *International Shoe*.[67] Of these two companies, one had ceased operations altogether because of financial difficulties while the other was hopelessly insolvent, being deeply in debt to the acquirer and on the brink of bankruptcy.[68]

In the *Diebold* case,[69] the court listed many factors which tended to portray the corporation as one hopelessly insolvent and faced with imminent receivership.[70] The acquisition was, therefore, not violative of section 7. The court felt that the acquired company, because of its desperate financial condition, could not long have survived as an independent competitor and that an alternative sale could not have been secured.[71] Injury to employees, creditors and stockholders of the failing corporation upon the

60 Crown Zellerbach Corp. v. FTC, 296 F.2d 800, 831-32 (9th Cir. 1961).
61 *Id.* at 832.
62 *Id.* at 831.
63 *Id.* at 832.
64 167 F. Supp. 799 (D.D.C. 1958).
65 197 F. Supp. 902 (S.D. Ohio 1961).
66 167 F. Supp. at 807.
67 *Id.* at 808-09.
68 *Id.* at 808.
69 United States v. Diebold, Inc., 197 F. Supp. 902 (S.D. Ohio 1961). On appeal to the Supreme Court, the decision was reversed on a determination that the facts were not sufficient to establish a basis for summary judgment. 369 U.S. 654 (1962).
70 197 F. Supp. at 903-05.
71 *Id.* at 907.

probable liquidation of the firm was cited as the justification for recognition of the defense.[72] It is significant that the court buttressed its conclusion by observing that after the merger there had been a continued decline in the amount of business attributable to the operation of the acquired facilities; and, but for the merger, the acquired firm would have unquestionably experienced a total business collapse.[73]

## III. THE SIGNIFICANCE AND JUSTIFICATION OF THE "FAILING COMPANY" DOCTRINE IN THE SECTION 7 SETTING

It is abundantly clear that none of the cases have adequately undertaken a thorough examination of the conceptual elements contained in the "failing company" defense, or of the appropriate criteria to be used in testing a particular factual situation. Since the facts in these decisions were either extremely favorable or unfavorable to the interposition of the defense, there was no need to explore critically the gray area in determining the scope of its application. However, there was language in some of the decisions which indicated that the rule of *International Shoe* was based on the absence of a substantial lessening of competition between the firms because the acquired failing firm had no longer been able to compete effectively with the acquiring corporation.[74] While this interpretation might have been possible under the old section 7,[75] it is fallacious to assume that these grounds would necessarily support an acquisition examined under the standards of amended section 7.[76] It must be remembered that the proscribed

[72] *Ibid.*

[73] *Id.* at 906-07.

[74] In United States v. Maryland & Va. Milk Producers Ass'n, 167 F. Supp. 709 (D.D.C. 1958), the court stated that the acquisition of capital stock or assets is not within the ban of § 7 "because the acquisition of a failing corporation that is on the verge of going out of business cannot result in lessening competition or in creating a monopoly." *Id.* at 808. Similar indications can be found in Pillsbury Co., TRADE REG. REP. (1960-61 FTC Cas.) ¶ 29277 (1960), in rejecting respondent's contention that the defense applied. "This would be so even if, as respondent contends, the *International Shoe* case establishes an absolute defense in Section 7 cases, *rather than merely establishing imminent insolvency as one of the relevant factors in assessing competitive effect.*" *Id.* ¶ 37629. (Emphasis added.) The language in United States v. Diebold, Inc., 197 F. Supp. 902 (S.D. Ohio 1961), although somewhat ambiguous, tends to support a similar interpretation. Thus, the merger "did not threaten, or actually cause a lessening of competition within the meaning of Section 7 . . . ." *Id.* at 907. See also Connor, *supra* note 34, at 98-99; Webster, *The Clayton Act Today: Merging and Marketing*, NEW YORK STATE BAR ANTITRUST LAW SYMPOSIUM 74, 100 (CCH 1955); Comment, 68 YALE L.J. 1627, 1663-64 (1959). Compare Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 340 (1960).

[75] See note 4 *supra*.

[76] Clayton Act § 7, as amended, 64 Stat. 1125 (1950), 15 U.S.C. § 18 (1958), provides: "No corporation engaged in commerce shall acquire, directly or indirectly, the whole

activity has been expanded by the amendment to cover the acquisition of assets as well as stock, and is applicable to vertical as well as horizontal mergers; nor is it limited merely to the lessening of competition between actual competitors.[77] Furthermore, recent judicial interpretations[78] have indicated that investigations for violation can focus on submarkets and subproducts, thereby including within the sweep of amended section 7 a greater variety of acquisitions than were reached by its predecessor.

It is not difficult to imagine situations where acquisition of a competitively feeble firm would not have created a substantial lessening of competition under the old act, but would be condemned under the amendment unless there exists a true exception to section 7. Purchase by a dominant firm of the assets of a competitively dying company could have the following anti-competitive effects.

(a) It would enable a dominant firm to move quickly and cheaply into a new market by acquisition of a failing company where, but for the doctrine, the transaction would be in violation of section 7.[79]

(b) By increasing the acquiring firm's capacity to fill orders which it would otherwise be unable to accept, the company could strengthen its position in the market and prevent competitors from handling the overflow of business that would otherwise result.[80]

(c) By removing productive facilities from the market a po-

or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation 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."

77 See, *e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294 (1962); Maryland & Va. Milk Producers Ass'n, Inc. v. United States, 362 U.S. 458 (1960); United States v. E. I. du Pont de Nemours & Co., 353 U.S. 586 (1957); United States v. Bethlehem Steel Corp., 168 F. Supp. 576 (S.D.N.Y. 1958).

78 *E.g.*, see authorities cited in note 77 *supra*.

79 Except for the lack of a failing company, this situation was presented in United States v. Columbia Steel Co., 334 U.S. 495 (1948), in which the merger of United States Steel with Columbia Steel escaped Sherman Act condemnation. According to Senator Kefauver, "if section 7 of the Clayton Act had been amended as the [then] pending bill propos[ed], the acquisition which was made by the United States Steel Corp. in that case would not have been permitted." 96 CONG. REC. 16502 (1950). Since United States Steel and Columbia Steel were not competitors in the relevant market, the import of this statement must be that acquisition of existing facilities by a dominant firm is in itself anti-competitive.

80 In *International Shoe Co. v. FTC*, the Court indicated that International Shoe had been forced to cancel orders because of insufficient capacity. 280 U.S. at 300-01. Therefore, if it were necessary to build new facilities, the time delay would presumably have caused a diffusion of orders throughout the industry to other competitors.

tential entrant might be forestalled from entry since he would face the increased cost of building new facilities and having these new facilities swell the total productive capacity of the market.[81]

(d) The acquiring firm would probably obtain less of the business of the defunct company if the latter experienced total business collapse than if it effectively stepped into the shoes of the failing company and appropriated the remaining good will plus valuable customer lists, price data and other important business information.[82]

(e) Of increasing importance, a large enterprise could vertically integrate by purchasing a failing company and thereby eliminate a customer of or supplier to other competitors, depending on whether the integration was backward or forward, respectively, which might result in a substantial lessening of competition in the relevant market.[83]

(f) Such an acquisition might give the acquiring firm an increased percentage of the market and increased market dominance, which has in itself been viewed as an undesirable result.[84]

This summarization of possible anti-competitive consequences of a failing firm merger is not intended, however, to support the hypothesis that there should be no "failing company" doctrine. Rather, it is designed to shed light on the problems that must be realistically faced in any consideration of the applicability of the doctrine. In short, it must be realized that the doctrine represents a valid exception to section 7, and, *but for* the exception, the transaction would be illegal as violative of the antitrust laws.

It is reasonable to assume that Congress foresaw that substan-

81 Professor Weston pointed out that "for many reasons the securities of a company may be selling below replacement costs of the firm's assets." S. REP. No. 132, 85th Cong., 1st Sess. 23 (1957). Thus, a potential entrant who must build new facilities would be faced with greater costs than if he could have purchased the existing assets. Professor Weston also indicated that most companies would desire to increase their own capacity without expanding that of the market generally. *Ibid.* It is logical to assume that a new entrant faced with existing competitors would not wish to create a greater capacity in the market which would tend to increase the amount of competition he would face.

82 Compare Comment, *supra* note 74, at 1663-64.

83 See authorities cited in note 77 *supra*.

84 Where one of the largest producers of aluminum products acquired one of eight competitors in the relevant market of aluminum "florist foil," it was held to be in violation of § 7, even though the large producer had not been in the field prior to acquisition. Reynolds Metals Co., 56 F.T.C. 743 (1960). The Commission specifically excluded as the grounds of the decision such factors as a possible lessening of competition through vertical integration, or the long growth history of Reynolds by means of merger. *Id.* at 774. Apparently the basis of the decision was that there was an actual lessening of competition because Reynolds, due to its size and resources, had upset the status quo of the market and caused some of the previously evenly balanced competitors to begin incurring losses. *Id.* at 774-76.

tial advantages to the public could be obtained by engrafting an exception on the apparent commands of section 7.[85] Although overlapping and intertwined, various economic, business, competitive and social justifications support recognition of the doctrine. First, a doctrine which allows a company to sell out before it has taken the "last gasp" in its business life minimizes the probable injury to employees, creditors, shareholders and the community in which the facilities are located.[86] The sale of plant and equipment as a going concern would probably result in continued operation of the facilities, thereby continuing to afford jobs to the employees and support to the community.[87] The value of a going concern would be greater than the income received from the distress sale of its assets,[88] and creditors would be more likely to collect their debts and shareholders could salvage a greater proportion of their investments.

Secondly, the determination of whether a declining company has, in fact, reached the "last-gasp" stage so as to assure the legality of its acquisition under section 7 may be an extremely difficult one. Since there is no clear-cut guide as to when the corporation has qualified under the exception, other than when in receivership or bankruptcy, this may cause the parties to hesitate at the prospect of a merger until the "last gasp" has indeed been taken, with the consequence that the corporation will then have already lost most of its value as a going concern. In addition, there might well be no buyer at this late date willing to burden itself with such a decaying company.

Thirdly, the public might best be served by allowing a firm which will probably fail to leave the industry at the earliest possible time. By doing so, the inefficient producer would be weeded out before there has been a lengthy misallocation of resources.[89] For example, an efficient enterprise that is working at overcapacity could acquire a failing company with unused capacity, thereby maximizing the output of both.[90] Similarly, the "last gasp" test

85 See 96 CONG. REC. 16435 (1950).

86 See, *e.g.*, International Shoe Co. v. FTC, 280 U.S. 291, 302-03 (1930).

87 As pointed out by the former Chairman of the Federal Trade Commission, Edward F. Howrey, the major reason for mergers is the desire by the acquiring firm to obtain additional capacity without creating increased competition. This was cited as the primary motive in two out of five mergers. S. REP. No. 132, 85th Cong., 1st Sess. 42 (1957). It is obvious that, with this motive, the acquired facilities would be kept in operation with resulting benefits to the community.

88 See American Press Ass'n v. United States, 245 Fed. 91, 93 (7th Cir. 1917).

89 See BAIN, INDUSTRIAL ORGANIZATION 51-55, 437-39 (1959).

90 This situation was present in International Shoe Co. v. FTC, 280 U.S. 291 (1930).

may be injurious to the public if it keeps an inefficient submarginal producer in the industry, thereby tying up additional resources that under a normal competitive situation would be diverted into more productive activities which benefit the whole economy.[91]

Finally, the "last gasp" approach does not take cognizance of modern business and economic realities. There may be circumstances in which a firm is faced with a probability of failure even though it has not as yet experienced a long loss history or become insolvent. Great technological advancements in certain industries which substantially lower the cost per unit ratio might soon place a company that cannot avail itself of these advancements in the "definitely failing" category.[92] Many reasons exist for the inability to take advantage of technological advancements. A company might not have sufficient business volume to achieve the "economies of scale"[93] inherent in the new methods and machinery which would be required to derive profits from the investment. The huge outlay required for purchase of such technology may be a factor preventing such action. A possible market decline might put the squeeze on the efficient, and especially the inefficient producer,[94] with ordinary business sense dictating to the latter that the large investments necessary to become competitive are not justified. Another problem faced by the marginal and submarginal firms might be the increased cost of production.[95] Thus, costs which are tolerable to an efficient company could force a low or no profit producer to the realization that the business's end is near. A prime example of this is so-called "pattern bargaining,"[96] by which the gains of labor at the expense of an efficient company are imposed on the less efficient members of the industry.[97]

91 See BAIN, *op. cit. supra* note 89, at 437-39. The misallocation there outlined in a "distress" industry would probably be present where a "distress" firm was producing at undercapacity and heading toward failure.

92 *Id.* at 206-07, 439-46.

93 *Id.* at 146-49. "Economies of scale" represents that volume of production which will permit the lowest cost per unit operation of existing plant and facilities, which thereby tends to maximize profits.

94 *Id.* at 579-83, where a prime example of this condition, the bituminous coal industry, is discussed.

95 This situation is present whenever an industry is faced with increases in wages, materials and costs of distribution.

96 "Pattern bargaining" is present when an industry-wide labor organization bargains with one or a few large firms in the industry. The results achieved from such collective bargaining are thereafter presented to the remaining firms who are strongly urged to follow the pattern set by the prior agreements.

97 See S. REP. No. 132, 85th Cong., 1st Sess. 31 (1957) (reported remarks of George A. Romney, former president of American Motors Corp.).

Therefore, since Congress intended to allow for a "failing company" defense, it appears, from a public interest standpoint, that such a defense is not only justified, but should be available as soon as it can reasonably be determined that the corporation is irreversibly headed toward final collapse. Little is to be gained from requiring a corporation to have taken the last gasp of its business life before an otherwise illegal acquisition would be permitted.

## IV. A SUGGESTED STANDARD FOR APPLICATION OF THE "FAILING COMPANY" DEFENSE

Concededly a construction of the "failing company" exception which departs from the relatively certain guidelines of actual bankruptcy, receivership or insolvency will require the courts to formulate standards which will be more difficult to apply. Nevertheless, as previously indicated, Congress[98] and the Supreme Court[99] have considered the exception sufficiently important to engraft it upon section 7. While not conclusive, some indication of recent acceptance of the doctrine can be gleaned from the history of the *Diebold* case, in which the Department of Justice did not attempt to disclaim the existence of the exception;[100] and, even in reversal, the Supreme Court[101] gave no indication that the doctrine lacked vitality, but only stated that the facts of the case were not sufficiently established to support the summary judgment of the district court which applied the doctrine in favor of the acquiring firm. Therefore, keeping in mind that it is an exception to the section, and but for the exception the acquisition would be condemned, the following represents a suggested approach to the problem which, it is submitted, summarizes the intent of Congress and is implicit in various case decisions.[102]

Simply stated, the suggested approach would employ a balancing test by which the apparent injury to competition in the relevant market, which is likely to occur if it is determined that the acquisition may substantially lessen competition or tend to create a monopoly, would be weighed against the probability of countervailing injury to the community, owners, employees and creditors,

98 See note 8 *supra*.

99 International Shoe Co. v. FTC, 280 U.S. 291 (1930).

100 United States v. Diebold, Inc., 197 F. Supp. 902 (S.D. Ohio, 1961).

101 United States v. Diebold, Inc., 369 U.S. 654 (1962) (per curiam).

102 See, *e.g.*, International Shoe Co. v. FTC, 280 U.S. 291, 302-03 (1930); Erie Sand & Gravel Co. v. FTC, 291 F.2d 279, 280-81 (3d Cir. 1961). See also Brown Shoe Co. v. United States, 370 U.S. 294, 331, 334, 346 (1962).

and to the economy generally (through misallocation of resources).[103] This would require a two-pronged Rule of Reason prognostication after it is determined that the merger would otherwise violate section 7. Considering all relevant factors, there would first be a determination as to whether the declining firm would have eventually terminated in failure, and, second, a consideration of whether the acquisition was the most reasonable way to achieve the desirous "effect of mitigating seriously injurious consequences otherwise probable."[104] This would, in turn, require consideration of past financial and business history of the corporation, profit and loss trends and relevant market developments, as well as, if applicable, increased cost data. Other factors which determine whether the firm could reasonably be expected to have remained a competitive force during the period of prognostication must also be considered. This would entail an analysis of costs for additional capital improvements; a judgment whether these additional investments could have been undertaken by the firm without excessive risk or whether the outlook for development and profits in the market would not have justified such an outlay; and, finally, a determination of whether the present and potential volume of the firm would sustain the maximum utilization of additional facilities so as to achieve the economies of scale inherent in its operations. To aid in obtaining as accurate a forecast as possible, if there has been a sufficient time lapse, evidence should be admitted indicating conditions after the transaction was consummated, keeping the court abreast of current developments.[105]

Application of the doctrine would not eliminate the requisite attempts to obtain alternative buyers whose acquisition of the stock or assets would not be in violation of the act. The effort to be expended by the failing firm in this regard would be inversely proportional to the state of decline exhibited by it; but there should always be a duty of the firm to solicit more than one buyer. The question of required acceptance of lower bids from an acceptable bidder is indeed a difficult one. Frequently the least acceptable prospective acquirers will be in a position to bid the most.[106] Again, all that can be suggested is that the acceptance

103 The weighing of the probability of ultimate failure is not an unfair approach since, in essence, it is balanced against another probability test, the § 7 standards.

104 International Shoe Co. v. FTC, 280 U.S. 291, 302 (1930). See also Brown Shoe Co. v. United States, 370 U.S. 294, 346 (1962).

105 The approach was taken in United States v. Diebold, Inc., 197 F. Supp. 902, 906 (S.D. Ohio 1961).

106 This is because, as the dominance of the firm that wishes to acquire increases,

of the bid from such a purchaser should have appeared to be the most reasonable choice under the circumstances. A court would balance such factors as the state of decline of the firm, the effort expended by the firm to obtain other offers, the number of bids made, the differences in the bids, and the difference between the lower bids and that amount likely to be realized if the failing company were forced to sell at a distress sale. Similarly, a court should not undermine the defense merely because there were legal alternatives available unless it is shown that such alternatives could have reasonably been expected to have averted the acquired or to-be-acquired company's otherwise probable failure.

*International Shoe*[107] is consistent with this approach once it is realized that the case involved two giants in the shoe industry.[108] The probability of injury by the lessening of competition or the tendency to create a monopoly was so great that the scales of the test were about as heavily weighted in favor of preventing merger as possible. Therefore, in order to allow the merger in the face of the statutory provisions, the countervailing injury probable in the event of failure would also have to have been great, as would the likelihood of failure itself. Increased probability of injury on the one side would have to have been balanced against that on the other side. Both parties were confronted with the severest possible fact situations, and still the scales tipped in favor of the "failing company" doctrine. With this in mind, that most important paragraph in the Court's opinion can be construed as establishing a true exception to the general scope of section 7, in providing

> ". . . that the purchase of its [the failing firm's] capital stock by a competitor (there being no other prospective purchaser), not with a purpose to lessen competition, but to facilitate the accumulated business of the purchaser and with the effect of mitigating seriously injurious consequences otherwise probable, is not in contemplation of law prejudicial to the public and does not substantially lessen competition within the intent of the Clayton Act. To regard such a transaction as a violation of the law . . . would 'seem a distempered view of purchase and result.' "[109]

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the greater is the likelihood that it is in a position to offer a larger sum, and the more objectionable would be the purchase.

107 280 U.S. at 301-02.
108 *Id.* at 304.
109 *Id.* at 302-03.