Mergers & Acquisitions

# Is a Merging Company Failing, Flailing, or Just Ailing?

By Julie Elmer and Meredith Mommers

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Companies seeking to rely on the “failing firm” defense or “flailing firm” argument in their merger advocacy should be prepared for intense scrutiny from antitrust enforcers, Freshfields attorneys explain. With transactions involving financially distressed firms likely increasing over the coming months, they offer some considerations for both strategies.

As the pandemic lingers, we are likely to see more M&A activity involving financially distressed firms. Part of the goal of securing approval from the antitrust enforcement agencies— or courts if necessary— is showing a company is indeed “failing.”

Even where such deals involve horizontal mergers in concentrated industries, firms nevertheless may be able to secure approval if they can establish three key elements: (1) that the target firm faces the grave probability of imminent failure, (2) that the target firm cannot reorganize under Chapter 11 of the U.S. Bankruptcy Code, and (3) that, despite conducting a good faith shop, the target cannot find an alternative buyer that presents less of a competitive threat than the proposed purchaser.

The theory behind this “failing firm” defense is that, in some instances, a target’s exit from the market would be more harmful to consumers than allowing a transaction that reduces competition to proceed. However, the target must be able to prove that its ability to compete effectively in the future is in serious doubt.

If the target is sitting on valuable assets, the antitrust enforcement agencies likely would be skeptical of the defense if the firm could take steps to improve its management or access more capital. But a firm that cannot generate new revenue, secure more capital, pay its bills, or meet its debt obligations has a decent shot at establishing the first element of the defense, particularly where its ability to continue as a going concern has been placed into question by an independent auditor.

**Good-Faith Shopping for Alternative Buyer**

In addition to establishing that a Chapter 11 reorganization would not be workable, the target also must show that it conducted a good-faith shop for an alternative buyer.

In assessing whether a shop was in good faith, the enforcement agencies and the courts consider whether the target used an investment banker to conduct a comprehensive shop and provided potential buyers sufficient time and information to evaluate a potential acquisition.

Because the failing firm defense is essentially a free pass for a transaction that would otherwise be deemed anticompetitive, the target must be willing to accept an offer for less than fair market value, down to the liquidation value of its assets.

A target that enters into an exclusivity agreement with its competitor, or refuses to consider alternative offers above the liquidation value of its asset, is unlikely to establish that it could not find an alternative purchaser.

The last time the failing firm defense was litigated in a federal district court, in the 2017 case *U.S. v. EnergySolutions*, the target's failure to conduct a good-faith shop was central to the court's decision to reject the defense and block the merger of two nuclear waste disposal firms.

There, the target had not only fired its investment banker and failed to provide an alternative prospective buyer access to a data room, but also refused several offers above liquidation value. Moreover, when the target finally agreed to accept a much higher offer from its largest rival, it agreed not to solicit alternative offers from any other party.

**A 'Flailing Firm' Argument Might Work**

Recently, firms have had more success with a related but different argument called the weakened competitor, or "flailing firm," argument.

The crux of this argument is that the target's existing market shares overstate its ability to compete with the purchaser going forward. This means that the merger would likely have a less significant impact on competition than the market share statistics would make it appear.

Antitrust enforcement agencies and courts have tended to be more persuaded by this argument when other mitigating factors are also present, such as merger-related efficiencies, remedies offered by the merging parties, or other competitors poised to enter the market.

**Prepare for Close Examination**

Companies seeking to rely on the failing firm defense or flailing firm argument in their merger advocacy should be prepared for intense scrutiny.

The target should consider hiring external advisers to get its house in order. These experts can assist the company in assessing its financial health, evaluating possible restructuring options, and running the auction process if the firm decides to sell.

The target also should be mindful that marketing materials, statements to investors or lenders, and confidential information memoranda that contain overly optimistic statements about the target's financial health, growth, or market position will be difficult to overcome if the antitrust enforcement agencies decide to challenge the transaction.

Although the failing firm defense has become a hot topic, it is neither a panacea for distressed firms nor a free pass for strategic investment in companies that would previously have been "off limits" to certain purchasers.

Parties to a deal with potential antitrust concerns must critically assess whether they can meet the high bar for establishing these defenses and undertake the necessary preparation before relying on these arguments in their advocacy to the antitrust enforcement agencies.

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