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## The No Other Prospective Purchaser Requirement of the Failing Firm Defense

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## THE NO OTHER PROSPECTIVE PURCHASER REQUIREMENT OF THE FAILING FIRM DEFENSE

### I. INTRODUCTION

The failing firm doctrine is a judicially created defense to actions brought under section 7 of the Clayton Act. Section 7 provides in part that “[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 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.”<sup>1</sup> It is generally thought that the defense owes its existence to the 1930 case of *International Shoe Co. v. FTC*,<sup>2</sup> although it does find some support in earlier decisions.<sup>3</sup> The legislative history surrounding the 1950 amendment to section 7 of the Clayton Act shows that Congress has sanctioned the defense<sup>4</sup> and the United States Supreme Court continues to recognize the doctrine promulgated in *International Shoe*:<sup>5</sup>

1. 15 U.S.C. § 18 (1964).

2. 280 U.S. 291 (1930).

3. Two cases in particular lend support to the doctrine. In *United States v. United States Steel Corp.*, 251 U.S. 417 (1920), the Supreme Court upheld the acquisition of a nearly worthless company by a competitor. The Court noted that it was an emergency situation and concluded that “it seems like an extreme accusation to say that the corporation which relieved it, and, perhaps, rescued the company and the communities dependent upon it from disaster, was urged by unworthy motives. Did illegality attach afterwards and how? And what was the corporation to do with the property? Let it decay in desuetude, or develop its capabilities and resources?” *Id.* at 447. In *American Press Ass’n v. United States*, 245 F. 91 (7th Cir. 1917), the court permitted the sale of a company, which was going out of business, to its only competitor when there were no other prospective purchasers. The court pointed out that “[n]ot every joinder of competing businesses or acquisition of instrumentalities that have been used in competition is an undue restraint of trade or a creation of a monopoly. Each case must be measured by the rule of reason. And a fundamental test is injury to the public.” *Id.* at 93.

*See* *United States v. International Harvester Co.*, 214 F. 987, 998 (D. Minn. 1914) (dictum), *appeal dismissed*, 248 U.S. 587 (1918); *Northwestern Consolidated Milling Co. v. William Cullam & Son*, 177 F. 786, 788 (E.D. Mich. 1910). *See also* *Aluminum Co. of America v. FTC*, 284 F. 401, 408 (3rd Cir. 1922), *cert. denied*, 261 U.S. 616 (1923); *United States v. Quaker Oats Co.*, 232 F. 499, 503 (N.D. Ill. 1916), *appeal dismissed*, 253 U.S. 499 (1920).

4. H.R. REP. NO. 1191, 81st Cong. 1st Sess. 6 (1949); S. REP. NO. 1775, 81st Cong., 2d Sess. 7 (1950).

5. Between 1930 and 1962 there was some doubt whether the United States Supreme Court would recognize the defense again. All doubts were laid to rest by the case of *Brown Shoe Co. v. United States* where the court took the opportunity to reaffirm its willingness to allow the defense. 370 U.S. 294 (1962) (dictum). *But see* *Citizen Publishing Co. v. United States*, 89 S.Ct. 927 (1969). “We confine the failing company doctrine to its present narrow scope.” *Id.* at 931.

In the case . . . 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) . . . does not substantially lessen competition or restrain commerce within the intent of the Clayton Act.<sup>6</sup>

The defense also can be raised where the converse is true. That is, where the acquired firm is financially healthy and the company acquiring it claims to be failing within the meaning of *International Shoe*.<sup>7</sup>

One reason advanced for this exception to the federal anti-trust law is that “the inferences of added dominance [in terms of market power] which might ordinarily follow from such a purchase are severely impaired if the acquired firm is so weak as to be bankrupt.”<sup>8</sup> However, it is more likely that the defense exhibits a legislative and judicial concern with protecting those interests that would probably suffer if the merger were prohibited and the failing company thus had to go out of business. This probability of “resulting loss to . . . stockholders and injury to the communities where . . . [the company’s] plants were operated”<sup>9</sup> was noted in *International Shoe*.

The defense can be claimed in suits brought by private parties as well as in actions by the United States government.<sup>10</sup> In fact, the failing firm defense is probably “the only undisputed section 7 affirmative defense other than the ‘investment exception’ specifically included in the act itself.”<sup>11</sup>

There are two elements of proof in the failing firm defense: (1) that the acquired or acquiring company was sufficiently failing, and (2) that the competitor was the only prospective purchaser. The degree of proof necessary to show that the company “faced the grave probability of a business failure”<sup>12</sup> is

6. 280 U.S. 291, 302 (1930).

7. *United States v. Pabst Brewing Co.*, 296 F.Supp. 994 (E.D. Wis. 1969).

8. Bok, *Section 7 of The Clayton Act and The Merging of Law and Economics*, 74 HARV. L. REV. 226, 283 (1960).

9. 280 U.S. 291, 302 (1930).

10. *Granader v. Public Bank*, 281 F. Supp. 120 (E.D. Mich. 1967).

11. Low, *The Failing Company Doctrine: An Illusive Economic Defense Under Section 7 of The Clayton Act*, 35 FORDHAM L. REV. 425, 426 (1967).

12. 280 U.S. 291, 302 (1930).

beyond the scope of this paper.<sup>13</sup> But, it is notable that courts in sustaining the defense have described the failing companies as "hopelessly insolvent"<sup>14</sup> or facing "imminent receivership"<sup>15</sup> and in rejecting the defense have described the companies as not being in "failing or bankrupt condition,"<sup>16</sup> or as not facing inevitable termination of the business or dispersal of its assets.<sup>17</sup>

## II. THE REQUIREMENT AND THE REASON THEREFOR

In *International Shoe* the Supreme Court noted parenthetically that there were no other prospective purchasers.<sup>18</sup> This brief reference led several writers to question whether or not this condition was a material part of the failing firm defense.<sup>19</sup> The legislative history surrounding the 1950 amendment to section 7 of the Clayton Act did not explicitly adopt this limitation,<sup>20</sup> but the courts generally have viewed it as a requirement of the defense.<sup>21</sup> The issue was clearly resolved in the recent case of *Citizen Publishing Co. v. United States* where the Supreme Court said: "The failing company doctrine plainly cannot be applied in a merger or in any other case unless it is established that the company that acquires it or brings it under dominion is the only available purchaser."<sup>22</sup>

There has been some support for the proposition that this limitation on the defense should be imposed because a firm with

13. For a discussion of this requirement see: Low, *The Failing Company Doctrine: An Illusive Economic Defense Under Section 7 Of The Clayton Act*, 35 *FORDHAM L. REV.* 425 (1967); Note, *Horizontal Mergers and the "Failing Firm" Defense Under Section 7 of the Clayton Act: A Caveat*, 45 *VA. L. REV.* 421 (1959).

14. *Maryland and Virginia Milk Producers Ass'n v. United States*, 167 F. Supp. 779, 808 (D.D.C. 1958), *aff'd in part and rev'd in part*, 362 U.S. 458 (1960).

15. *United States v. Diebold, Inc.*, 197 F. Supp. 902 (S.D. Ohio 1961), *rev'd.*, 369 U.S. 654 (1962).

16. *Crown Zellerbach Corp. v. FTC*, 296 F.2d 800 (9th Cir. 1961).

17. *Erie Sand and Gravel Co. v. FTC*, 291 F.2d 279, 280 (3rd Cir. 1961). The general statement comes from *Dean Foods Co.*, CCH, ¶ 17, 765 Trade Reg. Reports 23,112 (1966).

18. 280 U.S. 291, 302 (1930).

19. Bok, *Section 7 of The Clayton Act and The Merging of Law and Economics*, 74 *HARV. L. REV.* 226, 344-45 (1960); Wiley, *THE "FAILING COMPANY," A Real Defense in Horizontal Merger Cases*, 41 *B.U.L. REV.* 495 (1961); Note, *Horizontal Mergers and the "Failing Firm" Defense Under Section 7 of the Clayton Act: A Caveat*, 45 *VA. L. REV.* 421 (1959).

20. See H.R. REP. No. 1191, 81st Cong., 1st Sess. 6 (1949); S. REP. No. 1775, 81st Cong., 2d Sess. 7 (1950).

21. *E.g.*, *United States v. Diebold, Inc.*, 369 U.S. 654 (1962), *rev'g*, 197 F. Supp. 902 (S.D. Ohio 1961); *United States v. Pabst Brewing Co.*, 296 F. Supp. 994 (E.D. Wis. 1969); *United States v. Reed Roller Bit Co.*, 274 F. Supp. 573 (W.D. Okla. 1967).

22. 89 S. Ct. 927, 931 (1969).

other offers outstanding can not be described as “failing” within the meaning of *International Shoe*.<sup>23</sup> “[T]he courts sometimes take it as an indication that a company was prosperous enough to continue on its own.”<sup>24</sup> In *Citizen*, however, the Supreme Court said that the real reason for this requirement is that “if another person or group could be interested, a unit in the competitive system would be preserved and not lost to monopoly power.”<sup>25</sup>

### III. WHO ARE THE OTHER PROSPECTIVE PURCHASERS— THE PROBLEMS OF RECOGNITION AND DETERMINATION

To successfully invoke the failing firm defense one must prove that there were no other prospective purchasers. Although it is clear what must be proved, it is not quite so clear what will disprove this requirement. In other words, how does the failing company recognize that there are other prospective purchasers or determine that there are none.<sup>26</sup>

#### *A. The Prospective Purchaser Status:*

##### *(1) Inquiries*

As an evidentiary matter, when does one become a prospective purchaser rather than a casual inquirer. No court has made a definitive statement of what will effect this transformation, but cases show that something less than a firm offer will suffice.<sup>27</sup> Moreover, making studies of the failing company<sup>28</sup> or soliciting the ownership-management to consider tentative schemes<sup>29</sup> may elevate one to the prospective purchaser status. What other actions will confer this status is a matter of conjecture. The courts have heretofore applied objective tests to determine whether or not one was a prospective purchaser. They have con-

23. Bok, *Section 7 Of The Clayton Act and The Merging Of Law and Economics*, 75 HARV. L. REV. 226, 347 (1960).

24. Low, *The Failing Company Doctrine: An Illusive Economic Defense Under Section 7 of the Clayton Act*, 35 FORDHAM L. REV. 425, 434 (1967).

25. 89 S. Ct. 927, 931 (1969). Although the reasoning of the Court is well taken, this statement is predicated on the assumption that acquisition by any other person or group could not itself create a monopoly.

26. See also Wiley, *THE “FAILING COMPANY,” A Real Defense in Horizontal Merger Cases*, 41 B.U.L. REV. 495 (1961).

27. See, e.g., *United States v. Diebold, Inc.*, 369 U.S. 654 (1962), *rev'd*, 197 F. Supp. 902 (S.D. Ohio 1961); *United States v. Reed Roller Bit Co.*, 274 F. Supp. 573 (W.D. Okla. 1967).

28. See *United States v. Reed Roller Bit Co.*, 274 F. Supp. 573 (W.D. Okla. 1967).

29. See *United States v. Diebold, Inc.*, 369 U.S. 654 (1962), *rev'd*, 197 F. Supp. 902 (S.D. Ohio 1961).

sidered overt manifestations of intent—known to the failing firm—which could reasonably lead the observer to conclude that the actor was more than a mere casual inquirer.

Notably, the Supreme Court recently reworded the requirement. In *International Shoe* the Court spoke of no other *prospective* purchasers.<sup>30</sup> In *Citizen* the Supreme Court said that the requirement was satisfied if there were no other available purchasers.<sup>31</sup> It is arguable that this change in words indicates a tacit approval of the common sense standards previously applied by courts in determining whether this requirement had been met. At any rate, it does not appear that the failing firm will have to consider every inquirer a prospective purchaser.

### (2) Other Offers

Closely akin to the casual inquiry problem is the question of whether any other offer will destroy the defense. Manifestly, this question is addressed to the situation where the failing company has received other offers smaller than that tendered by the acquiring competitor. Since one does not even have to make a firm offer to become a prospective purchaser, it could be argued that any offeror is automatically a prospective purchaser. The answer to this contention would seem to be that just as every inquirer is not considered a prospective purchaser neither should every offeror.

The courts have been confronted with the “other smaller offer” factual situation; but, because they found that the firms were not sufficiently failing, they did not have to rule on this issue.<sup>32</sup> In one case, however, where the failing company defense was upheld, the court rejected the idea that other offers would defeat the requirement that there be no other prospective purchaser.<sup>33</sup> The court construed this requirement to mean, that when there are two or more offers, the failing firm is only required to accept “the best offer in light of the circumstances.”<sup>34</sup>

There are good reasons for requiring the failing firm to consider other offers. “Frequently the least acceptable prospective

30. 280 U.S. 291, 302 (1930).

31. 89 S.Ct. 927, 931 (1969).

32. *United States v. Third Nat. Bank*, 390 U.S. 171 (1968); *Erie Sand & Gravel Co. v. FTC*, 291 F.2d 279 (3rd Cir. 1961); *United States v. Jos. Schlitz Brewing Co.*, 253 F. Supp. 129 (N.D. Cal. 1966).

33. *Granader v. Public Bank*, 281 F. Supp. 120 (E.D. Mich. 1967).

34. *Id.* at 123.

acquirers will be in a position to bid the most.”<sup>35</sup> Also, “the owner’s desire to receive a high price is only one of several interests underlying [and protected by] the failing-firm defense.”<sup>36</sup> But requiring the failing company to consider other offers is not the same thing as saying that every offeror is a prospective purchaser. Thus, it is reasonable to assume that although the courts may (and probably should) require the failing firm to prove that it accepted only “the best offer under the circumstances,” they will not hold that the mere existence of other offers runs afoul of the “no other prospective purchaser” requirement.

### *B. A Duty To Solicit Other Prospective Purchasers*

The two potential problems just discussed could arise if the failing firm did nothing. That is, the failing firm theoretically could receive inquiries or other offers through no effort of its own. But, what if there are no inquiries or other offers? Can the failing company thus conclude that there are no other prospective purchasers? Or, does it have a duty to solicit other prospective purchasers? There was some early support for the proposition that a failing company could satisfy the “no other prospective purchaser” requirement by showing that the company was failing so badly that it “could not have achieved a sale to anyone else.”<sup>37</sup> Now, however, it is settled that the failing firm must prove that it made affirmative efforts to sell to someone other than the acquiring competitor if it hopes to establish that there were no other prospective purchasers.<sup>38</sup>

The question now becomes, what efforts must the failing firm make in order to satisfy this “duty to solicit” requirement? One writer suggests that “[t]he effort to be expended . . . [should] be inversely proportional to the state of decline . . . [of the failing firm], but [that] there should always be a duty . . . to solicit more than one buyer.”<sup>39</sup> The courts have not been quite so formulistic. Moreover, they have indicated that the failing com-

35. Comment, *Federal Antitrust Law—Mergers—An Updating Of The “Failing Company” Doctrine In The Amended § 7 Setting*, 61 MICH. L. REV. 566, 582 (1963).

36. Bok, *Section 7 of the Clayton Act and The Merging of Law and Economics*, 74 HARV. L. REV. 226, 346 (1960).

37. *United States v. Diebold, Inc.*, 197 F. Supp. 902, 907 (S.D. Ohio 1961), *rev’d*, 369 U.S. 654 (1962); *accord*, *American Press Ass’n v. United States*, 245 F. 91, 93 (7th Cir. 1917); *see* *Aluminum Co. of America v. FTC*, 284 F. 401, 410 (3rd Cir. 1922) (dissenting opinion), *cert. denied*, 261 U.S. 616 (1923).

38. *Citizen Publishing Co. v. United States*, 89 S. Ct. 927, 931 (1969).

39. Comment, *Federal Antitrust Law—Mergers—An Updating Of The “Failing Company” Doctrine In The Amended § 7 Setting*, 61 MICH. L. REV. 566, 582 (1963).

pany should make "every reasonable effort to explore alternative management and merger possibilities."<sup>40</sup> This would include "a well-conceived and thorough canvass of the industry such as to ferret out viable alternative partners for merger."<sup>41</sup> But casual conversations at chance meetings and industry conventions probably would not be considered a well considered and thorough canvass of the industry.<sup>42</sup>

The courts have not attempted to specify exactly what steps a failing firm must take in order to show that it made every reasonable effort to find other prospective purchasers. In *Citizen* the Court noted that "no effort was made to sell the Citizen; its properties and franchise were not put in the hands of a broker."<sup>43</sup> The Court was probably suggesting that this would have been a reasonable procedure to adopt under the facts of that case, not that it must be done in every case. It is likely that the courts would agree that they "cannot apply a simple rule of thumb, for the particular circumstances of the failing firm and the industry within which it operates will doubtless determine whether a reasonable attempt shall include sounding out rival firms, contacting a business broker, or advertising in a financial periodical."<sup>44</sup> The failing firm will likewise have to determine what is reasonable under the circumstances, and act accordingly.

#### IV. CONCLUSION

Any company claiming the failing firm defense will have to prove that there were no other prospective purchasers. Since this defense is predicated on the assumption that the merger or combination under attack does in fact violate the letter, if not the spirit, of Section 7 of the Clayton Act the requirement is a reasonable one. If another non-objectionable purchaser could be found there would be no reason to fit the transaction within an exemption to the federal anti-trust law. Thus the courts should require that the company raising the defense be able to prove that it was reasonably sure, and that it was reasonable in so believing, that there were no other prospective purchasers. Apparently this is all that the courts will ask and all that is required of the failing company.

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40. United States v. Pabst Brewing Co., 296 F. Supp. 994, 1002 (E.D. Wis. 1969).

41. *Id.*

42. See Dean Foods Co., CCH ¶ 17, 765 Trade Reg. Reports 20,093 (1966).

43. 89 S. Ct. 927, 931 (1969).

44. Bok, *Section 7 Of The Clayton Act And The Merging Of Law And Economics*, 74 HARV. L. REV. 226, 346 (1960).