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The "Failing Firm" Antitrust Defense for Acquisitions of Distressed Assets

The U.S. District Court for the District of Delaware recently issued an injunction sought by the Department of Justice ("DOJ") to block Energy Solutions, Inc.'s proposed acquisition of a rival radioactive waste disposal business Waste Control Specialists LLC,[1] finding that the proposed combination would substantially lessen competition in the market for disposal of low level radioactive waste.[2] In doing so, the court rejected the parties' "failing firm" defense, providing valuable guidance for parties seeking to pursue the defense before the antitrust agencies or in court. A failing firm defense can enable an otherwise anticompetitive acquisition to proceed if the transacting parties are able to prove that the target is likely to exit the market but for the proposed transaction and that there is no alternative buyer for the failing assets.[3] For strategic buyers of financially distressed businesses, the defense can appear attractive. However, the *Energy Solutions* decision serves as a reminder that the failing firm defense requires more than just a financially troubled target, as courts will also thoroughly examine the extent of the seller's efforts to market the assets to alternative bidders.

In *Energy Solutions*, the court evaluated the parties' failing firm arguments using a two-prong test, examining whether: 1) the resources of the target were "so depleted and the prospect of rehabilitation so remote that it faced the grave probability of a business failure;" and 2) there was no other prospective purchaser for the target.[4] The court referred to the failing firm defense as a "choice of evils," where "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."[5]

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1 Waste Control Specialists LLC is wholly owned by Valhi Inc. through its subsidiary Andrews County Holding, Inc.

2 *United States v. Energy Solutions, Inc.*, No. 16-1056-SLR (D. Del. June 21, 2017).

3 As discussed *infra*, the court in *Energy Solutions* relied on a two-prong test based on case law to determine the parties' burden for prevailing on the failing firm defense. In contrast, the Horizontal Merger Guidelines provide three requirements for the defense: that the target 1) would be unable to meet its financial obligations in the near future, 2) would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act, and 3) has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger. Horizontal Merger Guidelines (2010) § 11.

4 *United States v. Energy Solutions, Inc.*, No. 16-1056-SLR, slip op. at 49 (D. Del. June 21, 2017) (citing *United States v. Greater Buffalo Press, Inc.*, 402 U.S. 549, 555 (1971)).

5 *Id.* (citing *United States v. Gen. Dynamics*, 415 U.S. 486, 507 (1974)).

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The court rejected the parties' failing firm defense because the seller had failed to make a "good faith effort" to elicit "reasonable alternative offers … that would both keep it in the market and pose a less severe danger to competition." As a result, the court did not decide whether the business was actually at risk of imminent failure.[6] Focusing on the limited efforts by the seller to market the business to other potential buyers, the court emphasized that the seller engaged with only one other rival bidder "and left it in the dark about the sale process before abruptly ending discussions without obtaining a bid."[7] The court rejected the parties' argument that, despite the target holding itself out for sale, no alternative buyers made a firm offer. Rather, the court noted that Energy Solutions had made many proposals to purchase the target prior to the transaction and had been repeatedly refused, and that no "clear 'for sale' sign" was apparent until the seller had signed an agreement with Energy Solutions, which contained a no-talk provision[8] effectively foreclosing a deal with an alternative buyer.

The *Energy Solutions* decision makes clear that in evaluating the failing firm defense, the courts will extensively examine the efforts made by the seller to market the purportedly failing business. Hiring an investment banking firm to lead the sales process, engaging with multiple bidders, and running the sales process for a sufficient duration are the types of efforts that will help establish that the parties made a good faith effort to elicit alternative purchasers.[9] Even if the failing firm operates in an industry with few potential strategic buyers, simply asserting that no other buyers surfaced will not be sufficient. In addition, restrictive covenants that prohibit the seller from engaging with other potential buyers, such as "no-talk" or "no-shop" provisions in letters of intent or executed agreements, particularly without a fiduciary exception, will weaken any argument that no alternative buyers were available.[10] Furthermore, courts are unlikely to permit a failing firm defense where alternative buyers were available, but were rejected because the purchase price they offered was unattractive. As the court's opinion in *Energy Solutions* pointed out, the antitrust agencies' Horizontal Merger Guidelines require sellers to consider any offers above the liquidation value of the target.[11]

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6 *Id.* at 49-50 (citing *e.g.*, Dr. Pepper/Seven-Up Co. v. Fed. Trade Comm'n, 991 F.2d 859, 865 (D.C. Cir. 1993)).

7 *Id.* at 50.

8 The no-talk provision prevented the seller from responding to or sharing information with another interested party. *Id.* at 51.

9 *See id.* (citing to *IXC Commc'ns, Inc. v. Cincinnati Bell, Inc.*, 1999 WL 1009174, at *6 (Del. Ch. Oct. 27, 1999)).

10 The court in *Energy Solutions* noted that Delaware courts had found no-talk provisions without a fiduciary-out amounted to "willful blindness" that "may prevent a board from meeting its duty to 'be informed of all material information reasonably available,'" including reasonable alternative offers from other bidders. *Id.*

11 *Id*. at 51 (citing to Horizontal Merger Guidelines (2010) § 11 n.16). The Guidelines state that "any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets will be regarded as a reasonable alternative offer.") *Id.*

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