CLIENT ALERT

Failing the Failing Firm Defense

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A federal district court last week reaffirmed the extremely high bar applicable to the failing firm defense, rejecting its application in a case where the parties had not sufficiently shopped the assets. In an opinion unsealed on July 12, 2017, the District Court for the District of Delaware enjoined the proposed acquisition of Waste Control Specialists (WCS) by Energy Solutions, Inc. (ESI), two low-level radioactive waste (LLRW) disposal companies.

The Court held that the target company’s truncated in-house sales process and inclusion of strict deal protections in the resulting merger agreement fell far short of the good faith efforts required to elicit reasonable alternative, less-anticompetitive bids. The opinion highlights the difficulties in successfully asserting the failing firm defense and offers additional guidance on the sales process required to satisfy its terms.

ESI and WCS are among a handful of companies specializing in the disposal of LLRW in the United States. For higher-activity LLRW, the transaction would have resulted in a merger-to-monopoly, as the merging parties operate the only two disposal sites available to customers in a 36 state region. For lower-activity LLRW, the merging parties held a combined share of over 90 percent and were considered particularly close competitors. Despite the apparent antitrust issues, the parties proposed to combine, arguing that WCS was a “failing firm” on the verge of exiting the business.

The failing firm doctrine deems an otherwise anticompetitive transaction lawful based on the premise that, for a company on the brink of collapse, the adverse effect of the transaction is preferable to the impact of those assets exiting the market altogether. This narrow affirmative defense requires a company to show: (1) it is in danger of imminent failure, (2) the absence of any other prospective purchaser with less anticompetitive impact, and, in most circuits, (3) the inability to successfully reorganize the company through bankruptcy. In this case, the Court focused on the parties’ failure to satisfy the second prong.

In 2014, after being approached by ESI, Valhi, Inc., WCS’s parent company, engaged an investment bank to pursue potential acquirers for the disposal company. After contacting 14 potential acquirers, and receiving multiple indications of interest, Valhi rejected an offer from ESI and entered into exclusive negotiations with a private equity company, which ultimately fell through in early 2015.

In mid-2015, WCS and ESI renewed their negotiations about a potential merger. Without hiring an investment banker, Valhi agreed to an exclusivity period with ESI that subsequently resulted in a merger agreement and the transaction under review. Prior to entering exclusivity with ESI, Valhi contacted only one other potential buyer, to whom it failed to provide basic due diligence. Following the announcement of the transaction with ESI, WCS was approached by several other interested parties, but the “no talk” provision in the merger agreement prevented it from engaging. A similar “no shop” provision prevented WCS from entertaining any alternative offers, even if doing so would have been required by the Board’s fiduciary duties.

The Court, focusing only on the 2015 sales period, held that Valhi’s sales process did not constitute a good faith effort to elicit reasonable alternative (and less anticompetitive) offers. In doing so, the Court rejected arguments that the earlier investment
banker-led process was sufficient, noting that transaction was focused on a minority investment as opposed to an outright acquisition. The Court referred to the use of the “no shop” and “no talk” provisions in the merger agreement as “willful blindness” on behalf of Valhi and WCS to any alternative offers.

This decision continues a line of cases that reinforce the very narrow scope of the failing firm defense. Courts are particularly wary of sales processes that do not involve an outside investment bank and merger agreements that contain strict deal protection measures without a “fiduciary out” to entertain superior offers. Additionally, this particular case makes it clear that a company cannot rely on a sales process conducted for a prior contemplated transaction as the basis for a “reasonable alternative offer” search under the failing company defense. Any client considering a failing firm argument should take note of this decision and its specific guidance regarding the steps necessary to successfully assert that defense.

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