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ARTICLES

DEBT INVESTMENTS IN COMPETITORS UNDER THE FEDERAL ANTITRUST LAWS

*Hanno F. Kaiser**

INTRODUCTION

When a firm extends credit to a competitor, or a bank or an investment fund holds debt in two or more competing firms, the question arises whether these investments are likely to substantially lessen competition or unreasonably restrain trade. Conceivably, the lender could exploit its contractual position to exercise control over the borrower and/or to gain access to the borrower's confidential information. In addition, holding a financial interest in the debtor might create an incentive for the creditor to unilaterally raise prices following the investment or enable the creditor, the debtor, and other firms in the industry to engage in coordinated interaction that harms consumers.

This Article examines whether debt investments are, in fact, likely to produce meaningful anticompetitive effects of that nature.¹ Taking comparable minority equity investments as a benchmark, the answer is mostly negative. Unlike partial ownership, debt investments do not significantly reduce the investor's incentives to compete and are largely

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1. Surprisingly, there is very little case law, agency practice, or legal scholarship addressing the competitive effects of debt investments as such. If debt investments are discussed at all, they usually appear as an afterthought to the analysis of partial ownership.

ineffectual as commitment devices.² With respect to corporate control and information exchange, the answer depends on the financial condition of the target. As long as the borrower is solvent (and, as a consequence, has viable refinancing options), the creditor's influence will generally not be meaningful. However, once the creditor can accelerate the loan and thereby cause the borrower's bankruptcy, the creditor's *de facto* influence over the target increases significantly and may even exceed the influence conferred by comparable equity investments (unless the creditor eliminates competitive concerns by making its debt investment passive). Based on these findings, this Article recommends deferential treatment of most debt investments in competitors under the federal antitrust laws. Unless the investment has certain clearly defined features that permit an inference of probable competitive harm and the creditor refuses to eliminate such concerns, debt investments are presumably efficient.

The discussion below is organized as follows: Part I outlines a framework of analysis that has successfully been applied to equity investments. Part II extends the equity framework to the competitive analysis of debt investments, with a special focus on the use of debt as a commitment device to enable collusion. Part III discusses the treatment of debt investments by the courts. Part IV summarizes the key findings and concludes with policy recommendations.

I. COMPETITIVE EFFECTS OF PARTIAL OWNERSHIP

In a typical minority investment case, company A acquires a non-controlling equity stake in its competitor, company B. That acquisition may be challenged under §7 of the Clayton Act ("§7"), which applies to the acquisition of any part of the stock or the assets of a company.³ In

2. The terms "minority equity investment," "equity investment," and "partial ownership" are used interchangeably, as are "creditor," "lender," and "debt investor" and "debtor," "borrower," and "target."

3. 15 U.S.C. § 18 (2004). Section 7 applies to partial ownership even if the acquirer does not obtain control over the target. *See, e.g., Denver & Rio Grande W. RR. Co. v. U.S.*, 387 U.S. 485, 501 (1967) ("A company need not acquire control of another company in order to violate [§7]."); *U.S. v. E.I. du Pont de Nemours & Co.*, 353 U.S. 586, 592 (1957) ("[A]ny acquisition of all or any part of the stock of another corporation, competitor or not, is within the reach of [§7] whenever the reasonable likelihood appears that the acquisition will result in a restraint of commerce or in the

assessing whether the acquisition is likely to substantially lessen competition, courts and agencies have focused on the *target*, specifically, whether post-acquisition, A would be able to exercise control over B's competitive decisions; and/or whether A would gain access to B's confidential business information.⁴ Only recently has there been an increased emphasis on how investments in a competitor might change the competitive behavior of the *investor*.⁵

creation of a monopoly of any line of commerce.”). Challenges under §7 have frequently been accompanied by claims of violations of §§1–2 of the Sherman Act, 15 U.S.C. §§ 1, 2 (2004) [hereinafter §§1, 2]. This Article does not focus on monopolization offenses involving debt.

4. See, e.g., *du Pont*, 353 U.S. at 602–03, 607 (stating that 23% stock acquisition violates §7 where acquirer had gained influence over the target, a customer, and was receiving information from the target); *F. & M. Schaefer Corp. v. C. Schmidt & Sons, Inc.*, 597 F.2d 814, 818 (2d Cir. 1979) (stating that acquisition of 29% of competitor's stock violates §7 as acquirer would have obtained power to designate directors, gained access to sensitive information, and discouraged the target's management); *Briggs Mfg. Co. v. Crane Co.*, 185 F. Supp. 177, 180–82, 184 (E.D. Mich. 1960) (stating that §7 includes within its scope a percentage interest sufficient to elect nominees to the board of directors who could influence the competitive decisions of the target and divulge information to the acquirer); *Am. Crystal Sugar Co. v. Cuban-Am. Sugar Co.*, 259 F.2d 524, 526, 531 (2d Cir. 1958) (stating that 23% stock acquisition violates §7 where acquirer was seeking to control the target); *Hamilton Watch Co. v. Benrus Watch Co.*, 114 F. Supp. 307, 313, 317 (D.Conn. 1953), *aff'd*, 206 F.2d 738 (2d Cir. 1953) (stating that acquisition of 24% of competitor's stock with the intent to obtain board representation violates §7). Numerous agency challenges have focused on the corporate control and information exchange aspects of partial ownership. See, e.g., *U.S. v. AT&T Corp.*, Proposed Final Judgment and Competitive Impact Statement, 65 Fed. Reg. 38, 584 (D.O.J. June 21, 2000); *U.S. v. The Gillette Co.*, 1990 WL 126485 (D.D.C. July 25, 1990) [hereinafter *Gillette II*]; *U.S. v. The Gillette Co.*, Proposed Final Judgment and Competitive Impact Statement, 55 Fed. Reg. 12,567 (D.O.J. Apr. 4, 1990); *U.S. v. The Gillette Co.*, Public Comments and Response, 55 Fed. Reg. 28,312 (D.O.J. July 10, 1990) [hereinafter *Gillette I*]; *U.S. v. Rockwell Int'l Corp.*, Proposed Final Judgment and Competitive Impact Statement, 45 Fed. Reg. 69,314 (D.O.J. Apr. 4, 1980); *Medtronic, Inc.*, Analysis to Aid Public Comment, 63 Fed. Reg. 53,919 (F.T.C. Oct. 7, 1998); *Shell Oil Co., Texaco Inc.*, Analysis to Aid Public Comment, 62 Fed. Reg. 67,868 (F.T.C. Dec. 30, 1997); *Time Warner, Inc.*, Proposed Consent Agreement with Analysis to Aid Public Comment, 61 Fed. Reg. 50,301 (F.T.C. Sept. 25, 1996).

5. The following consent orders have focused on changes in the financial incentives of the investor. *U.S. v. AT&T Corp.*, Proposed Final Judgment and Competitive Impact Statement, 64 Fed. Reg. 2506 (D.O.J. Jan. 14, 1999); *U.S. v. US West, Inc.*, Proposed Final Judgment and Competitive Impact Statement, 61 Fed. Reg. 58,703 (D.O.J. Nov. 18, 1996); *In the Matter of Golden Grain Macaroni Co.*, 78 F.T.C.

A. Effects on the Target

The theories of anticompetitive harm from acquiring corporate control and information access are straightforward. As a shareholder, A can sabotage the target through strategic voting at the shareholder meetings, designation of hostile directors, shareholder lawsuits (the costs of which would be borne mainly by the other shareholders), abusive information requests, etc.⁶ The significance of A's influence depends, among other things, on the size of its stake in B in absolute terms and relative to the other shareholders; the concentration of the market; and whether B is a private or a public company. As a practical matter, passive investments of less than 15% have rarely been challenged in court, whereas shareholdings sufficient to designate at least one director have been subject to intense litigation under both the federal antitrust laws and state corporation laws. The shareholder/director threshold not only is of obvious importance for the exercise of corporate control but also changes the nature of the investor's access to sensitive information of the target.⁷

A shareholder has a common law right, based on its beneficial ownership of corporate assets, to inspect "the books of his corporation at

63 (1971), *modified in other respects*, 472 F.2d 882 (9th Cir. 1972). For a comprehensive analysis of the unilateral effects of partial ownership, see Daniel P. O'Brien & Steven C. Salop, *Competitive Effects of Partial Ownership: Financial Interest and Corporate Control*, 67 ANTITRUST L.J. 559 (2000) [hereinafter O'Brien & Salop, *Competitive Effects*]; Jon B. Dubrow, *Challenging the Economic Incentives Analysis of Competitive Effects in Acquisitions of Passive Minority Equity Interests*, 69 ANTITRUST L.J. 113 (2001); Daniel P. O'Brien & Steven C. Salop, *The Competitive Effects of Passive Minority Equity Interests: Reply*, 69 ANTITRUST L.J. 611 (2001) [hereinafter O'Brien & Salop, *Competitive Effects: Reply*]; David Reitman, *Partial Ownership Arrangements and the Potential for Collusion*, 42 J. INDUS. ECON. 313 (1994); Wilson A. Alley, *Partial Ownership Arrangements and Collusion in the Automobile Industry*, 45 J. INDUS. ECON. 191 (1997). For a discussion of the coordinated effects of passive equity investments among competitors, see David Gilo, *The Anticompetitive Effect of Passive Investment*, 99 MICH. L. REV. 1, 2-3 (2000).

6. O'Brien & Salop, *Competitive Effects: Reply*, *supra* note 5, at 613. Alternatively, A could use its inside position to organize a cartel. Cross investments are particularly useful as facilitating devices. Where the creditor has significant market power, abusive conduct may constitute (attempted) monopolization in violation of §2.

7. The shareholder/director distinction is also reflected in §8 of the Clayton Act, 15 U.S.C. § 19 (2004), prohibiting simultaneous service as a director or officer of competing companies.

a proper time and place and for a proper purpose.”⁸ The scope of the shareholder’s inspection right is broad and encompasses the list of shareholders, board minutes, financial records, sales journals, invoices, contracts, correspondence, sales projections and business plans.⁹ The main qualification of the right to access is the good faith or proper purpose requirement, pursuant to which the company may deny a request for access if the shareholder’s purposes are either unrelated to its interest as an investor or inimical to the corporation. Among the improper purposes are harassment, blackmail, and the aid of a competitor.¹⁰ With respect to the latter, the mere fact that a shareholder is a competitor (or a shareholder of a competitor) does not defeat the right to information access,¹¹ even though it may limit the scope of, or require the imposition of conditions upon, the inspection.¹² Only where the shareholder’s primary purpose is to obtain competitively sensitive information to harm the corporation and to aid a competitor may the company deny access to its books and records.¹³ The shareholder may enforce its information right through the state courts (traditionally by

8. *Lau v. DSI Enter., Inc.*, 477 N.Y.S.2d 151 (N.Y. App. Div. 1984). Most states also provide the shareholder with statutory inspection rights. The shareholder may inspect the books in person and with the help of his or her agents. JAMES D. COX ET AL., *ON CORPORATIONS* § 13.05 (2d. Ed. 2003).

9. *Meyer v. Ford Industries, Inc.*, 538 P.2d 353 (Or. 1975); *Kortüm v. Webasto Sunroofs, Inc.*, 769 A.2d 113, 117 n.8 (Del. Ch. 2000). To ensure the company’s interest in protecting highly sensitive information (*e.g.*, trade secrets), courts have been willing to grant limited protective orders excluding specific items from review and placing narrowly tailored non-disclosure obligations on the shareholder. *Id.* at ¶13.

10. For an overview of proper and improper purposes, see COX, *supra* note 8, at § 13.03. Once the shareholder seeks to enforce his or her right in court, the burden of showing improper motives generally falls upon the corporation. *Crane Co. v. Anaconda Co.*, 382 N.Y.S.2d 707, 711 (N.Y. 1976); *Indianapolis Street Railway Company v. Cohen*, 181 N.E. 365, 368 (Ind. 1932).

11. *Skoglund v. Ormand Indus., Inc.*, 372 A.2d 204, 212 (Del. Ch. 1976) (“[If] misuse of the information obtained threatens harm to the corporation, it has a remedy in the courts in an appropriate action.”).

12. *Kortüm*, 769 A.2d at ¶11.

13. If the disclosure of sensitive information is incidental to an otherwise proper purpose, the request for information must be granted. *Skoglund*, 372 A.2d at 207 (“If a proper purpose is established, it is no defense that the stockholder may also have another, or secondary purpose, which may be improper.”).

writ of mandamus) if the corporation refuses to comply with a proper demand for access.¹⁴

A director's right to inspect the corporate books and records is more extensive than that of a shareholder, because it is a corollary to the director's fiduciary duties.¹⁵ Without access to information, the director cannot manage the company.¹⁶ The scope of the director's information right is all encompassing; every company record that is reasonably related to the director's position is at the director's disposal.¹⁷ Unlike the shareholder's inspection right, which is qualified by the proper purpose requirement, the director's right has been described as absolute, unqualified,¹⁸ and (by a majority of the courts) without regard to motive.¹⁹ Thus, even a hostile director is entitled to receive what the other directors are given, because "[t]he duty to manage the corporation rests alike upon each and every one of the directors."²⁰ Of course, the shareholders may remove a director from the board. Until then, however, courts have held that the company's remedies against misuse of information are generally *ex post*.²¹

14. *Carter v. Wilson Constr. Co., Inc.*, 348 S.E.2d 830 (N.C. 1986); COX, *supra* note 8, at § 13.08.

15. *Henshaw v. Am. Cement Corp.*, 252 A.2d 125, 128-29 (Del Ch. 1969); *Moore v. State Bank of Hallsville*, 561 S.W.2d 722, 724-25 (Mo. App. 1978); COX, *supra* note 8, at § 13.11.

16. *Machen v. Machen & Mayer Elec. Mfg. Co.*, 85 A. 100, 102 (Pa. 1912) ("It is the duty of directors to manage the affairs of the corporation . . . and for that purpose they should secure all information affecting the corporation from every available source . . . [including] the books and documents of the corporation itself.").

17. *Kortüm*, 769 A.2d at 118; *Machen*, 85 A. 100 at 104.

18. *Machen*, 85 A. 100 at 104 ("The right of a director to inspect the books . . . is unqualified . . . The protection of the interests of the company . . . require that [a director's] right to an inspection of the books be absolute."); *See also Moore*, 561 S.W.2d at 725; *Lau v. DSI Enterprises, Inc.*, 477 N.Y.S.2d 151 (N.Y. App. Div. 1984).

19. *Pilat v. Broach Sys., Inc.*, 260 A.2d 13, 17 (N.J. Super. Ct. Law Div. 1969) ("A showing of hostile intent . . . will not affect a director's right of inspection."); *Dusel v. Castellani*, 350 N.Y.S.2d 258 (1973); *Davis v. Keilson Offset Co. Inc.*, 79 N.Y.S.2d 540, 542 (1948). For an inspection right qualified by the absence of a hostile purpose, see *Paschall v. Scott*, 247 P.2d 543, 548-49 (1952); *Hemingway v. Hemingway*, 19 A. 766 (1890).

20. *Machen*, 237 Pa. at 218.

21. *Dusel*, 350 N.Y.S.2d at 258; *Moore*, 561 S.W.2d. at 725. *See also Kortüm*, 769 A.2d at 124 (holding that the director's "inspection rights shall be unrestricted, except

Consequently, with respect to corporate information, a director is an insider with real-time access to company contracts, customer information, business plans, and records circulated among the board members. A shareholder, in contrast, relies on company disclosures made voluntarily or compelled through the courts. Given that competitively sensitive information tends to expire quickly, delay is often as effective as denial.²² A minority equity stake that does not entitle its holder to designate at least one director is therefore generally not sufficient to provide an investor with a meaningful listening line into the strategic decision making process of the target.

B. Effects on the Investor

Partial ownership, even if it is a purely passive minority interest, is likely to adversely impact the competitive incentives of the investor-competitor.²³ Those effects may be classified as either unilateral or coordinated.

Unilateral theories of competitive harm assume that the investor (A) and the target (B) are not attempting to collude and make their competitive decisions independently of one another.²⁴ Even if A's investment in B does not confer any control or information rights, A will take into account the effect of its decisions on B in order to maximize the sum of its own profits plus the return on its investment in B. Consider the following example:

for the . . . restriction that no information derived from the inspection will be shared with" a competing subsidiary).

22. That is true for most price information and contract terms. However, trade secrets, information about marginal cost, and long term contracts are examples of competitively relevant information that is less time sensitive.

23. O'Brien & Salop, *Competitive Effects*, *supra* note 5, at 571-73, 575-76; O'Brien & Salop, *Competitive Effects: Reply*, *supra* note 5, at 613; Gilo, *supra* note 5, at 8-9. In this context, competitive effects "arise solely because [partial ownership] arrangements link the fortunes of actual or potential competitors, producing a positive correlation among their profits." HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 548 (2nd Ed. 1999); *see also* R.J. Reynolds & B.R. Snapp, *The Competitive Effects of Partial Equity Interests and Joint Ventures*, 4 INT'L J. INDUS. ORG. 141, 142 (1986); *but see* Dubrow, *supra* note 5, at 131-37 (being critical of the overly abstract nature of the underlying model).

24. O'Brien & Salop, *Competitive Effects*, *supra* note 5, at 568-69.

A makes red widgets and B, A's closest competitor, makes blue widgets at constant marginal costs of \$8/widget. At a price of \$10, A and B sell 10 widgets each. If A were to raise the price for red widgets from \$10 to \$11, it would lose three customers to B and one customer would stop buying widgets (of any color) altogether. A's total profits would drop from \$20 (10\$2) to \$18 (6*\$3). Now suppose that A first acquires 35% of B's stock and then increases the price for red widgets from \$10 to \$11. B gains \$6 (3*\$2), \$2.10 of which belong to A (\$6*0.35). A loses \$2 from its own operations and gains \$2.10 from its investment in B. Thus, A's total profits have increased from \$20 to \$20.10. The investment made the price increase profitable, and thus diminished A's incentive to compete with B at the margin.*

While in a unilateral effects model, B does not react to A's price increase, theories of coordinated effects take into account B's incentives to adjust its own prices in reaction to A's price increase. The coordinated effects model presented below assumes a duopoly of A and B in a differentiated product market and that A and B only have two choices, to compete (c) or to hold back (h). The model further assumes that there are two different types of firms, aggressive firms and cooperative firms.²⁵ Suppose that an aggressive firm has the following order of preferences: (c,h) > (h,h) > (c,c) > (h,c) and that a cooperative firm's order of preferences is (h,h) > (c,h) > (c,c) > (h,c).²⁶ The aggressive firm thus derives greater profits from competing against a firm that is holding back than from mutual cooperation, *i.e.*, (c,h) > (h,h). By contrast, a cooperative firm derives greater profits from

25. Gilo, *supra* note 5, at 15–20.

26. See MARTIN J. OSBORNE, AN INTRODUCTION TO GAME THEORY 15, 17–21 (2004). Both orders of preferences have been suggested to model an arms race between two countries. The “aggressive” country's favorite outcome is that it has bombs and the other country doesn't (c,h); the second best outcome is that neither country has bombs (h,h); the third best outcome is that both countries have bombs (c,c), and the least favored outcome is that only the other country has bombs (h,c). A game between two aggressive countries results in a prisoner's dilemma situation. An alternative model of the arms race assumes “cooperative” preferences, *i.e.*, both countries prefer a situation in which neither has bombs (h,h) to a situation in which it has bombs and the other country doesn't (c,h), because “the cost of arming outweighs the benefit if the other country does not arm itself.” *Id.* at 20–21. A game between two “cooperative” players (a “stag hunt” game, in Osborne's terminology), results in two Nash equilibria.

mutual cooperation than from competing with a firm that is holding back, *i.e.*, $(h,h) > (c,h)$.²⁷

Consider four initial games (Tables 1.1–1.4), where A and B have no financial interests in each other, with the following payoffs (in \$) assigned to the firms' preferences: $(c,h)=3 > (h,h)=2 > (c,c)=1 > (h,c)=-1$ for the aggressive firm and $(h,h)=3 > (c,h)=2 > (c,c)=1 > (h,c)=-1$ for the cooperative firm.²⁸

27. Aggressive firms tend to have lower marginal costs and/or smaller market shares. A typical aggressive firm would be a new entrant with superior technology in a market dominated by a higher cost incumbent with a large market share. Lower marginal costs lead to higher profits in a price war. Likewise, smaller firms gain market share more quickly (which offsets the lost profits from a lower unit price), while the market share leader incurs relatively greater margin losses from matching a lower price. For the same reasons, the firm with the larger market share has more to gain from collusion than the smaller firm. Note that both effects tend to counteract each other over time, as low cost firms tend to expand their market shares at the expense of high-cost firms. Thus, a high-cost firm with a small share can be (or can become) more aggressive than a low cost firm with a large market share; it depends on which effect dominates. See Gilo, *supra* note 5, at 16–20 & n.39. Likewise, high levels of debt may increase a firm's aggressiveness.

28. While these payoffs (and the assumptions regarding investment levels and penalties discussed below) are illustrative for a certain range of situations, they are by no means exhaustive. For example, increasing the aggressive firm's payoff for (c,h) from \$3 to \$4 changes the order of preferences and eliminates the (h,h) equilibria from (unilateral or cross) equity investments in Tables 2.1, 2.2, 2.3, and 3.2; the debt analysis remains unaffected as long as the payoff from (h,h) exceeds the payoff from (c,h) minus the debt penalty. With a \$3 payoff, the order of preferences for A in, say, Table 3.2 is $(h,h) > (c,h) > (c,c) > (h,c)$, resulting in two Nash equilibria at (c,c) and (h,h) . With a \$4 payoff, however, the order of preferences remains identical to that in Table 1.2; *i.e.*, $(c,h) > (h,h) > (c,c) > (h,c)$, resulting in only one equilibrium at (c,c) . Thus, the greater the payoff from (c,h) relative to (h,h) , the lower the likelihood that a minority shareholding generates anticompetitive effects by changing the aggressive firm's order of preferences from $(c,h) > (h,h)$ to $(h,h) > (c,h)$. Given the influence of the payoffs (and/or investment levels, debt penalties) on the order of preferences in Tables 2–5, applying the results of the analysis to a particular case requires that the order of preferences in that case correspond to the preferences expressed in the respective tables. However, even if there is no direct match for every permutation, the methodology remains valid and the results below may still serve as a benchmark.

		B+	
		c	h
A+	c	1	3
	h	-1	2

Table 1.1

		B-	
		c	h
A+	c	1	3
	h	-1	2

Table 1.2

		B+	
		c	h
A-	c	1	2
	h	-1	3

Table 1.3

		B-	
		c	h
A-	c	1	2
	h	-1	3

Table 1.4

Table 1.1 pictures a game between two aggressive firms.²⁹ Tables 1.2 and 1.3 describe games between an aggressive and a cooperative firm, and Table 1.4 describes a game between two cooperative firms. In Table 1.1, (c) is the dominant strategy for both A and B, resulting in a (c,c) equilibrium. This outcome is referred to as a prisoner's dilemma, because even though (h,h) would yield greater benefits for both players, coordination would break down as A and B each have an incentive to cheat.³⁰ In Table 1.2, A's dominant strategy is (c), whereas B does not have a dominant strategy. However, as A's choice to compete is clear, B will choose likewise and the resulting equilibrium is (c,c). The outcome for Table 1.3 is identical to that of Table 1.2, with the positions of A and B reversed. In Table 1.4, both firms value mutual cooperation (h,h) more highly than competing against a firm that is holding back (c,h). As a result, there are two Nash equilibria (c,c) and (h,h). Thus, in the games described in Tables 1.1, 1.2, and 1.3, both firms choose to compete, whereas in Table 1.4 they (may) choose to cooperate.³¹

Now suppose that A and B both purchase 30% of each other's stock. Following the acquisition, A participates in 30% of B's profits and losses and vice versa.³² The effect of that cross-investment on the firms' incentives is shown in Tables 2.1–2.4.

29. In the tables, A+(B+) indicates that A(B) is an aggressive firm and A-(B-) that A(B) is a cooperative firm. Each player's best response functions are indicated in bold.

30. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 38–42 (4th ed. 2003) (discussing game theory and the prisoner's dilemma).

31. Both Nash equilibria in Table 1.4 are equally stable in a strategic game with no temporal component. However, if the game is played sequentially (e.g., as an extensive form game with perfect information), backwards induction produces a unique result at (h,h). Sequential moves are particularly plausible in the games described below, where one player invests in the other.

32. After the investment, the preferences of the investor are no longer strictly "selfish." For example, the payoff function p for A after a unilateral 30% equity investment in B is $p(A)+p(B)*0.3$. A's payoff function after a 30% cross-investment in and by B is $p(A)*0.7+p(B)*0.3$, i.e., A captures 30% of B's profits (leaving 70% to B) and B diverts 30% of A's profits (leaving 70% to A). Thus, if the payoff for (c,c) in

		B+	
		c	h
A+	c	1	0.2
	h	1.8	2

Table 2.1

		B-	
		c	h
A+	c	1	0.2
	h	1.1	2.7

Table 2.2

		B+	
		c	h
A-	c	1	-0.1
	h	1.8	2.3

Table 2.3

		B-	
		c	h
A-	c	1	-0.1
	h	1.1	3

Table 2.4

In each of the Tables 2.1–2.4 two equilibria exist at (c,c) and (h,h). Compared to the pre-investment situation (Tables 1.1–1.3), where (c) was the dominant strategy for the aggressive firm, the cross-investment has enabled stable coordination by decreasing the payoffs for competing against a firm that is holding back (c,h) across the board³³ and, in Tables 2.2 and 2.3, by increasing the aggressive firm’s payoff from mutual cooperation (h,h).³⁴ The cross-investment, by modifying the respective payoffs, has changed the order of preferences for the aggressive firm from (c,h) > (h,h) to (h,h) > (c,h). That change constitutes a characteristic anticompetitive effect of a financial interest in a competitor within the coordinated effects model. Consequently, equity cross-investments of sufficient size have a distinct anti-competitive potential.

The effect of unilateral equity investments is shown below. A purchases 30% of B’s stock. B has no equity interest in A.

		B+	
		c	h
A+	c	0.7	-0.7
	h	2.1	1.4

Table 3.1

		B-	
		c	h
A+	c	0.7	-0.7
	h	1.4	2.1

Table 3.2

		B+	
		c	h
A-	c	0.7	-0.7
	h	2.1	1.4

Table 3.3

		B-	
		c	h
A-	c	0.7	-0.7
	h	1.4	3.9

Table 3.4

Only in Table 3.2, where investor A is an aggressive firm and target B is a cooperative firm, does the investment lead to a new equilibrium at

Table 1.1 is (1,1), the payoff after a 30% unilateral investment of A in B as expressed in Table 3.1 is (1.3,0.7) and after a 30% cross-investment as expressed in Table 2.1 is (1,1), i.e., A keeps 70% of its own and gets 30% of B’s profits and vice versa.

33. Compare, for example, A’s payoff for (c,h)=3 in Table 1.1 to (c,h)=1.8 in Table 2.1.

34. Compare, for example, A’s payoff for (h,h)=2 in Table 1.2 to (h,h)=2.3 in Table 2.2.

(h,h).³⁵ An investment by a cooperative firm (A) in an aggressive firm (B) as in Table 3.3 does not change the equilibrium results. In Table 3.1, (c) remains the dominant strategy for both players and in Table 3.4 (h,h) remains the likely outcome. Interestingly, where A and B are both aggressive firms as shown in Table 3.1, the investment increases the investor's (A's) gains from (c,c) by 30% compared to the pre-investment situation in Table 1.1.³⁶ Thus, only where (i) the incentives of A and B are not symmetrical and (ii) the aggressive firm invests in the cooperative firm (but not vice versa) does a sufficient unilateral equity investment change the incentives of the investor.³⁷

II. COMPETITIVE EFFECTS OF DEBT INVESTMENTS

Debt investments, such as loans or bonds, differ significantly from equity investments in terms of corporate control (over the debtor) and financial interest (of the creditor). Courts and agencies have been chiefly concerned with equity investments. There has only been a small number of cases where anticompetitive effects of debt investments have been central to the courts' or the agencies' analysis.³⁸ As with partial ownership, the courts' main concerns have been corporate control and access to information, not the incentives of the creditor from the financial investment.³⁹ The following analysis explains why, as a rule, lenient treatment of debt investments under the antitrust laws is well justified.

35. In Table 1.2, before the investment, A's order of preference was (c,h) > (h,h). In Table 3.2, after the unilateral investment in B, it is (h,h) > (c,h).

36. Consequently, an aggressive firm may choose to invest in another aggressive firm and still compete vigorously, e.g., where in a growing market, A predicts that it will not be able to expand capacity proportionally to the increase in demand so that A and B will both earn economic profits.

37. See Gilo, *supra* note 5, at 16 ("[I]f all firms in the industry are equally trigger-happy, the only way passive investment can facilitate collusion is if each firm in the industry passively invests in a competitor."). In contrast, "[i]n markets in which some firms are more trigger-happy than others, it is enough if the more trigger-happy firms invest in a competitor for collusion to be facilitated." *Id.* at 17.

38. See *infra* Part III.

39. See Gilo, *supra* note 5, at 33 ("In debt cases the courts have focused only on whether the creditor would attempt to exert its influence over the debtor through its position as creditor.").

A. Debt and Equity

A firm generates cash flow from its capital, which is the property and the money that the firm requires to do business.⁴⁰ There are two main sources of capital, equity and debt, and two constituencies representing these sources, shareholders and creditors. In economic terms, shareholders and creditors are both security holders in the firm with different claims to the firm's cash flows from operations and, in the event of liquidation, from the sale of assets.⁴¹ Shareholders have a claim to the residual cash flows, left over after meeting all other promised payments. Creditors have a prior claim to interest and principal payments on a periodic basis and a prior claim to the firm's assets in the event of liquidation.⁴² The creditors' claims are contractual in nature, fixed in time and capped in value.⁴³ In contrast the shareholders' claims are based on a property right and are indefinite in both time and value.

Among the most significant differences between equity and debt are the consequences of the different attitudes of shareholders and creditors towards risk.⁴⁴ Both creditors and shareholders are in control of their downside risk: the shareholders because their liability is limited to the investment and the creditors because they cannot lose more than the principal of the loan. However, the upside potential of the shareholder is unlimited while the creditor has a fixed rate of return no matter how large a part of the firm's profits are generated as a result of its capital contribution. Shareholders make (and lose) money at the margin, creditors do not. Consequently, shareholders are willing to pay for potential upsides with an increased risk of default, while creditors, who are compensated *ex ante* for the expected default risk, are opposed to

40. See RICHARD A. BOOTH, FINANCING THE CORPORATION § 1:04 (2002).

41. Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW 413, 416 (1986).

42. ASWATH DAMODARAN, APPLIED CORPORATE FINANCE: A USER'S MANUAL 214 (John Wiley & Sons 1999).

43. In practice, debt is generally rolled over so that its fixed maturity is more of a legal distinction than an economic reality, which is nevertheless important for classification purposes. See *generally id.* at 214–24 (discussing the many varieties of debt including secured, unsecured and hybrid debt instruments).

44. There are, of course, other significant differences, for example, that under the U.S. tax laws dividend payments are made from after-tax cash flows while interest payments are deductible as expenses. See BOOTH, *supra* note 40, at § 3:14.

any alteration of that risk.⁴⁵ The conflict between shareholders and creditors becomes more and more pronounced the more highly leveraged the firm is, *i.e.*, the higher the ratio of debt to equity. That is because the shareholders as a group have less to lose (in absolute terms) and more to gain (in relative terms), while the creditors only stand to lose as illustrated by the following example.⁴⁶

Consider a company with \$100 in cash as its only asset. The company's debt is \$80 (a loan from B) and its stock, owned by A, is worth \$20. An investment opportunity arises that has a 50% chance of yielding \$150 and a 50% chance of yielding \$10. From A's point of view, this is an investment risk worth taking. If the project yields \$10, A receives \$0. If the project yields \$150, A receives \$70. Given that the chances for either outcome are 50%, the expected stock value is $(\$70 + \$0)/2 = \$35$, compared to a present equity value of \$20. B, as a creditor, would be adamantly opposed to the investment. If the project yields \$150, B receives \$80. If the project yields \$10, B receives \$10. Thus, the expected value of the debt is $(\$80 + \$10)/2 = \$45$. Note that the expected value of the company would decline from \$100 to \$80 ($\$45 + \35), which confirms that increasing shareholder value does not necessarily coincide with increasing firm value.

The risk of creditor expropriation by the company's management,⁴⁷ as described in the example above, is the primary reason for including protective covenants in credit agreements and bond indentures.⁴⁸ Typical covenants restrict dividends, additional debt, risk altering investments such as major acquisitions, and the disposition of significant

45. McDaniel, *supra* note 41, at 418.

46. The example is based on Yakok Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. REV. 447, 454 (1999); RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 517-18 (Irwin/McGraw Hill 6th ed. 2000).

47. BOOTH, *supra* note 40, at § 3:12 (explaining that management is the shareholders' agent to whom it owes fiduciary duties. Management generally owes no fiduciary duties to the firm's creditors.) See BREALEY & MEYERS, *supra* note 46, at 721-22; McDaniel, *supra* note 41, at 419-21 (illustrating that the conflict between shareholders and creditors and the resulting management agency problem is not limited to *ex post* alteration of risk through investment decisions. Other ways of benefiting shareholders at the expense of creditors are dividend distributions, spin-offs, and increasing the debt/equity ratio through taking on additional debt or stock repurchases.)

48. BREALEY & MYERS, *supra* note 46, at 720; McDaniel, *supra* note 41, at 424.

assets.⁴⁹ In addition, credit agreements may contain “state-of-the-firm” covenants, requiring, e.g., minimum financial ratios, and net worth or equity cushions.⁵⁰ Virtually every credit agreement provides for creditor information rights, generally in the form of an affirmative duty of the debtor to supply the creditor with relevant information.⁵¹ These veto and information rights are significant from an antitrust point of view, as they have given rise to claims of corporate control and information exchange in violation of §7 and §1 based on the acquisition of debt.⁵²

B. Corporate Control and Information Exchange

Even though credit agreements generally require the borrower to provide the lender with regularly updated financial information (audit reports, financial statements, notice of reportable events) and give the lender a right to request additional financial and other information,⁵³ these provisions should not require the borrower to make accessible competitively sensitive information and records, such as detailed strategic plans, marketing plans, and customer specific pricing information. The lender has a legitimate interest in receiving information only to the extent necessary for assessing changes in the credit risk. Where the creditor’s request goes beyond what is required to assess the risk of default, the debtor is under no obligation to provide that information.⁵⁴ And even where the creditor rightfully demanded the

49. Robert M. Lloyd, *Financial Covenants in Commercial Loan Documentation: Uses and Limitations*, 58 TENN. L. REV. 335, 340–43 (1991); see also BOOTH, *supra* note 40, at § 3:06; Amihud et al., *supra* note 46, at 454–55.

50. Lloyd, *supra* note 49, at 340–43.

51. Amihud et al., *supra* note 46, at 463–65.

52. See *infra* Part III.

53. Financial statements are the lender’s primary source of information about a borrower. The frequency with which financial statements are required depends on the borrower’s creditworthiness. Public company borrowers are usually required to make available SEC filings. In addition, creditors require notices of litigation, regulatory action, ERISA compliance and—depending on the borrower’s business—other information, such as age of receivables or inventory turnover from a retailer borrower. See SANDRA STERN, *STRUCTURING AND DRAFTING COMMERCIAL LOAN AGREEMENTS* ¶¶ 5.01 [4]–[5] (A. S. Pratt & Sons rev. ed. 2001).

54. Consequently, where the debtor voluntarily provides detailed information to a competing creditor, inferences of collusion may be warranted; the loan could be a facilitating device. However, where there is no evidence of collusion and a debtor first

information, so that the debtor's refusal results in a breach of an affirmative covenant, the only remedy generally available to the creditor is acceleration of the loan.⁵⁵

Consider a situation in which A and B are competitors and A is also B's creditor. B intends to acquire C, which would significantly strengthen its competitive position vis-à-vis A. B informs its creditors (banks, bondholders, corporate lenders) of the planned acquisition. The creditors conclude that the acquisition would not increase B's default risk and all give their consent with the exception of A. Having received advance warning of B's competitive move, A now wants to block B's acquisition of C. Since there is no alteration of risk, A's actions are motivated solely by its competitive relationship with B.

As an attempt to exercise corporate control, A's obstruction is unlikely to succeed, because B may simply choose to ignore A's opposition and consummate the transaction. Even if B was in breach of a negative covenant, thereby giving A the right to accelerate the loan (which is unlikely, given that the acquisition does not alter the risk of default), A has no incentive to in fact demand immediate repayment (other than maybe protecting its reputation), because the quality of A's investment in B has not declined.⁵⁶ Another option for B is to refinance the loan and remove A as a creditor.⁵⁷ Unlike a shareholder who is a

provides large amounts of data to a competing creditor that go beyond its obligation under the credit agreement and subsequently claims to have been injured by its competitor's information access, one may reasonably infer that the information was not in fact competitively sensitive. Cf. STERN, *supra* note 53, at ¶¶ 5.01 [4]–[5] (listing the kind of information which may be requested by a creditor for purposes of assessing a (potential) debtor's creditworthiness).

55. While breach of a negative covenant gives the creditor the right to immediate acceleration, the debtor in breach of an affirmative covenant generally has a grace period to cure the defect, e.g., provide the competing creditor with some, but not all, information regarding a potential acquisition. See STERN, *supra* note 53, at ¶ 5.01[2][d].

56. As indicated, the principal legal remedy for breach of a covenant by the borrower is acceleration of the loan. Amihud et al., *supra* note 46, at 467; BOOTH, *supra* note 40, at § 3:06. That puts the borrower in a relatively strong position where (i) the creditor provokes the breach (e.g., by unreasonably withholding consent) and (ii) there are refinancing options available.

57. Early repayment is generally permitted, even though some loan agreements provide for penalties. In any event, refinancing is not without cost for B, which may make a "debt greenmail" strategy attractive to competing creditors. However, debt

partial owner of the company, A can be removed against his will.⁵⁸ Lastly, B may seek to compel A's consent by enforcing the covenant of good faith implicit in every loan agreement (e.g., by threatening litigation for bad faith acceleration).⁵⁹

The creditor's influence over the debtor increases significantly where the debtor is in financial distress, because the distressed debtor has fewer (and therefore more expensive) refinancing alternatives. If the debtor is in a financially hopeless situation, refinancing options may no longer be available at all. Once accelerating, the loan would result in the debtor's insolvency, the creditor has gained significant *de facto* influence over the debtor's management. A nearly insolvent borrower will most likely be in breach of a number of state-of-the-firm covenants, giving its creditors the right to accelerate the loan. The debtor thus relies on its creditors to grant periodic waivers of covenants for its survival. Under these circumstances a creditor-competitor might be able to justify a refusal to grant a waiver solely on the basis of its creditor interests, regardless of its (further) motivations as a competitor.⁶⁰

Therefore, as long as the debtor remains solvent and has viable refinancing options, debt investments do not provide the creditor with meaningful corporate control or information access rights. Where such rights exist under a credit agreement, their enforceability by a competing creditor is likely to be severely limited. However, once the debtor is in financial distress and consequently has run out of viable refinancing alternatives, the creditor's influence increases significantly to a point where it may well exceed the influence conferred by a comparable

greenmail could expose A to contractual liability under the loan agreement and may in addition be actionable as a business tort, and, if A has sufficient market power, as (attempted) monopolization. For purposes of this Article, debt is assumed to be repayable at any time without penalties.

58. In the case of a syndicated loan, B may require consent of (some of) the other lenders in order to remove A.

59. EDWARD F. MANNINO, *LENDER LIABILITY AND BANKING LITIGATION* §§ 5.03[3][a], [b][ii] (Law Journals Seminars Press rev. ed. 2004) (1989) (discussing the scope of the good faith performance obligation implicit in every contract).

60. However, accelerating the loan, even under these circumstances, is not without risk, as courts have found creditors liable "for breaching the implied duty of good faith in accelerating a loan even where the borrower was in default and such action was permitted under the lender's security agreement." *Id.* at § 5.03 [3][b][ii].

equity investment, provided that the creditor has a legal basis for unilaterally accelerating the loan.⁶¹

C. Financial Interest

Does extending a loan to competitor B change the competitive incentives of creditor A? Unlike a shareholder that participates in the residual cash flows of the target, the loan agreement does not allow A to share in an increase of B's value. Thus, as a creditor, A would not recapture any portion of the profits from sales diverted to B as a result of a unilateral price increase. Debt, unlike equity, does not automatically link the economic fortunes of the parties.

One exception to the rule that creditor A does not profit from debtor B's operational gains might be a situation where B is a company in distress. Suppose that A purchases B's distressed debt at a discount. Subsequently, A raises its own prices to supra-competitive levels, which causes operational losses of \$2 for A and operational gains of \$6 for B. B's gain lowers its risk of default, as a result of which the value of B's debt increases. If the gains from A's debt investment in B exceed \$2, the price increase would be profitable. However, unlike equity, which provides A with a continuous income stream from its investment in B, the debt appreciation is a one shot deal with a ceiling. If A loses \$2 from the price increase in the first period and gains \$3 from bond appreciation to par, the price increase is profitable. In the second period, however, A continues losing \$2, while the bonds no longer appreciate. B's operational gains now increase the value of B's residual cash flow,

61. Where a syndicate of lenders has provided a loan, a single creditor may not have the right to *unilaterally* accelerate the loan. Usually, acceleration requires the consent of a majority (or a super-majority) of the lenders in the syndicate. Where the debtor is already in default and relies on the continued grant of waivers by the syndicate, a member of the syndicate may be able to veto the extension of the waiver. Many syndicated loan documents require a threshold investment for exercising a veto, e.g., one-third of the syndicated loan. In that instance, a debt holding below the threshold level does not confer any meaningful power of the nature discussed above to the creditor even if the debtor has no other refinancing options. See *Vantico Holdings S.A. v. Apollo Mgmt., LP*, 247 F. Supp. 2d 437, 447 (S.D.N.Y. 2003) (describing a case where lender's debt ownership requirement for vetoing borrower's decisions was 34%).

in which A has no stake.⁶² As a consequence, the unilateral effects of (passive) debt investments are generally much less significant than those of partial ownership.⁶³

D. Coordinated Effects

In order for a debt investment to enable collusion, it must serve as a credible commitment of the creditor not to compete with the debtor. No commitment is credible as long as competing (c) remains the creditor's dominant strategy. Consequently, the creditor must change its incentive structure, so that the payoff for (h,h) exceeds that of (c,h) and it must make sure that the debtor is aware of that change. Tipping the scale in favor of cooperation can be achieved through increasing the payoff for cooperation or through decreasing the payoff for competition. Equity does both, but debt only does the latter. As a commitment device, debt functions as a self-imposed conditional penalty, not unlike a performance bond. If A fails to cooperate, it forfeits the bond, which must be sufficiently large to offset any gains from competition.⁶⁴ Under these circumstances, it is rational for A to cooperate, which enables collusion (h,h) between A and B.

Suppose that the creditor loses the entire loan with certainty if it decides to compete with the debtor. The tables below describe situations where A and B have granted loans to each other (cross debt investment). If either of them chooses to compete, it incurs a penalty of -\$3.

		B+	
		c	h
A+	c	-2	-1
	h	0	2

Table 4.1

		B-	
		c	h
A+	c	-2	-1
	h	0	3

Table 4.2

		B+	
		c	h
A-	c	-2	-1
	h	0	2

Table 4.3

		B-	
		c	h
A-	c	-2	-1
	h	-1	3

Table 4.4

62. Theoretically, A could sell the bonds after the first period and then drop prices back to pre-investment levels. In this scenario, there would be a competitive effect; however, it would probably be rather limited.

63. Gilo, *supra* note 5, at 21.

64. A calculates the amount of the penalty as a function of the size of the bond and the probability of forfeiture in the event of non-compliance. If the bond's size is \$10 and the probability of forfeiture is 100% (*i.e.*, every breach of the promise not to

Compared to the initial games (Tables 1.1–1.4), new (h,h) equilibria appear in Tables 4.1–4.3. The debt penalty renders (c,h) and (c,c) unprofitable. Holding back (h) becomes the new dominant strategy for A and B across the board. Thus, in a situation where the party deciding to compete triggers a penalty sufficient to wipe out any gains from such competition, cross debt investments may have distinct anticompetitive effects.⁶⁵

The effects of unilateral debt investments are shown in the tables below. In these examples, A extends credit to B. If A competes, it incurs a penalty of -\$3.

		B+	
		c	h
A+	c	1 -2	-1 0
	h	3 -1	2 2

Table 5.1

		B-	
		c	h
A+	c	1 -2	-1 0
	h	2 -1	3 2

Table 5.2

		B+	
		c	h
A-	c	1 -2	-1 -1
	h	3 -1	2 2

Table 5.3

		B-	
		c	h
A-	c	1 -2	-1 -1
	h	2 -1	3 3

Table 5.4

Following the debt commitment, holding back (h) has become investor A's dominant strategy. However, because the debt investment is unilateral, B's competitive incentives remain unaffected. Thus, whether B chooses to compete or to hold back depends entirely on whether B is an aggressive firm (in which case B will compete) or a cooperative firm (in which case B will hold back). Only in Table 5.2 does A's investment create an equilibrium at (h,h). However, and more importantly, in Tables 5.1 and 5.3, the debt investment creates a (h,c) equilibrium, which effectively precludes A from fighting back if B decides to compete. Thus, the unilateral debt investor faces a significant risk of error. If B is an aggressive firm or if B turns into an aggressive firm subsequent to A's investment, A may set a trap for itself. The latter is an important difference to the equity investments discussed above, where partial ownership in an aggressive firm was merely ineffectual as a commitment device; see Tables 3.1 and 3.3. In contrast, debt

compete will lead to complete forfeiture), the expected value of the penalty is \$10. If the probability of forfeiture drops to 50%, the expected value of the penalty is \$5.

65. The qualifier ("may") is warranted because triggering the debt penalty by competitive actions (and competitive actions only) with a sufficient degree of reliability is highly unlikely.

investments in an aggressive competitor leave the investor worse off compared to the initial games in Tables 1.1 and 1.3.

The model above rests on the assumption that the creditor's choice to compete does, in fact, trigger the penalty. However, creating and/or maintaining that condition in the real world would be a daunting task, because explicit non-compete and penalty provisions are unlawful under §1 and thus unenforceable in court. Commentators and litigants have therefore focused on the debtor's bankruptcy as the *de facto* link between competitive action on the part of the creditor and the incurring of the penalty, *i.e.*, the loss of the loan.⁶⁶ Bankruptcy, however, is a poor device for connecting the market behavior of a creditor to the inability of a competing debtor to repay a loan with any degree of reliability. As a threshold matter, the debtor must remain at the brink of bankruptcy for the duration of the arrangement. As soon as the debtor returns to a minimal state of financial health, the creditor's commitment is no longer credible and competitive behavior might ensue. Moreover, as a consequence of the debtor's required state of continued financial weakness, the debtor will not only be vulnerable to the creditor's competitive actions but also to unrelated events in the marketplace (*e.g.*, changes in input costs, interest rates, shifts in demand, etc.). The creditor therefore faces a significant risk of incurring the penalty by accident. Even if the triggering condition could be calibrated to the creditor's actions with sufficient accuracy, there would still be no predictable connection between the debtor's insolvency and the loss of the loan. What happens to a significant loan in bankruptcy is highly uncertain. It may be repaid in full, in part, not at all, deferred, or converted into equity, to name just a few possibilities in reorganization. Only if the debtor's assets are, in fact, entirely non-competitive and worthless (in which case coordination would probably not significantly lessen competition to begin with) would the creditor lose its loan with sufficient certainty.⁶⁷

66. Gilo, *supra* note 5, at 21. For case discussions, see *infra* Part III.

67. Creating a stable cartel equilibrium with a weak competitor is less troublesome from an antitrust perspective than collusion among strong competitors. However, in settings with more than two firms involved, A could be the only aggressive firm that makes a broader cartel equilibrium among, say, A, B, C, and D impossible. If A commits itself through a loan to the weakest competitor B, it may not gain much from B's cooperation in a (h,h,h,h) state; however, A may gain substantially from not having to compete with C and D.

Another problem with debt as a commitment device is that the debtor's required state of financial weakness might change its competitive incentives so that coordination ultimately breaks down. Suppose that A invests in B in order to change its (A's) dominant strategy from (c) to (h). As a consequence of its financial weakness, B's market share deteriorates to the point that B has more to gain from starting a price war with A (c,h) than from continued cooperation (h,h). As long as B remains susceptible to A's attack, A is caught in its own trap, as (h,c) remains a better choice than (c,c), *see* Tables 5.1 and 5.3 above. B can use the threat of bankruptcy to compete against A with impunity. Once B returns to financial health (*e.g.*, after having gained sufficient market share at A's expense), A's strategic commitment is no longer effective.

While cross debt investments have a tendency to increase the probability of a collusive equilibrium, the same cannot be said for unilateral debt investments without further qualifications. Unless certain threshold conditions are met, unilateral debt as a commitment device is by and large ineffectual, because there is no predictable link between the creditor's actions and the triggering of the penalty. Thus, from a financial interest point of view, debt investments have no significant anticompetitive potential unless (i) the debtor is in poor financial health; (ii) the creditor (and only the creditor), through specific competitive actions, can significantly increase the probability of the debtor's insolvency; (iii) once the debtor has become insolvent, its assets would exit the market;⁶⁸ and (iv) liquidation of the assets is insufficient to

68. The assets exit the market when the insolvent company ceases to exist as a going concern with the consequence that its production capacity will no longer be available to serve market demand. The assets do not exit the market if they are bought by a financial investor or a strategic buyer with the intent to continue operations and to reintroduce capacity into the market. Thus, implicit in the "exiting the market" assumption is that B has a non-competitive asset base. If B's assets were competitive, the firm would be a takeover target and its assets would likely remain in the market under different management. The "exiting the market" condition also relates to a broader issue. If B's assets are non-competitive, then A could drive B from the marketplace by competitive means and subsequently enjoy monopoly profits. Thus, for A, the desirability of (c,h) relative to (h,h) increases with B's weakness. Conversely, a strong rival makes (h,h) more desirable (yet less obtainable) relative to (c,h). That relationship further underscores the partially self-refuting character of a debt-commitment strategy. A more complete model would have to take the relative strengths and weaknesses of the rivals into account.

guarantee repayment of the creditor's loan.⁶⁹ Moreover, (v) taking into account the overall probability of the creditor's competitive action resulting in the ultimate loss of the loan, the debt penalty must be of sufficient size to offset any gains from competition. As a result, the anticompetitive potential of debt investments from the financial interest in a competitor is much more limited than that of a (passive) minority equity stake.⁷⁰

III. DEBT INVESTMENTS IN THE COURTS

Courts have addressed the competitive effects of debt investments in *Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp.*, *Mr. Frank, Inc. v. Waste Management, Inc.*, and, most recently, *Vantico Holdings S.A. v. Apollo Management LP*.⁷¹ The consent order in *United States v. The Gillette Co.* also touches upon competitive effects of debt holdings, even though the primary focus is on the partial ownership aspects of the transaction.⁷² Thus, there is little guidance as to how courts and

69. As a consequence, the ideal debt commitment device would be a substantial unsecured loan. In contrast, fully secured senior debt would be a poor choice for a competitor, as chances of (at least partial) repayment are higher even in the event of a bankruptcy with minimal assets. Here, the inherent tensions between the roles of the investor as a competitor and as a creditor come to a head. As a practical matter, obtaining board approval for a significant unsecured loan to a competitor in distress is a tall task for any firm's management, in particular as there is a significant risk of shareholder lawsuits should the debtor default on the loan.

70. Gilo, *supra* note 5, at 21.

71. *MGM, Inc. v. Transamerica Corp.*, 303 F. Supp. 1344, 1350 (S.D.N.Y. 1969); *Mr. Frank, Inc. v. Waste Mgmt., Inc.*, 591 F. Supp. 859, 867 (N.D. Ill. 1984); *Vantico Holdings, S.A. v. Apollo Mgmt. Ltd. P'ship*, 247 F. Supp. 2d 437, 456 (S.D.N.Y. 2003). The author represented Apollo Management LP in the *Vantico* litigation.

72. *Gillette II*, *supra* note 4; *Gillette I*, *supra* note 4. In 1989, Gillette had agreed to purchase (i) Wilkinson's world-wide wet shaving business and (ii) a 23% non-voting equity stake and 50% of the subordinated debt (valued at \$69 million) in Eemland, Wilkinson's corporate parent. *Gillette I*, *supra* note 4, at 28,314. Following the DOJ's challenge, Gillette abandoned the acquisition of Wilkinson's U.S. business. *Gillette II*, *supra* note 4, at *1. The consent decree allowed Gillette to keep its 23% equity stake and its debt holdings in Eemland, provided that Gillette refrained from, *inter alia*, acquiring additional equity and debt, from seeking board representation, and from influencing Eemland's business. Specifically with respect to debt, the consent decree stipulated that:

agencies would analyze competitor debt investments, which forces corporate lenders to operate under significant uncertainty.⁷³

A. MGM v. Transamerica (1969)⁷⁴

The seminal case concerning debt investments under the antitrust laws is *MGM v. Transamerica*, decided by the district court for the Southern District of New York in 1969.⁷⁵ Tracy Investment Company ("Tracy") made a cash tender offer for 17% of MGM's shares, which, if successful, would have given Tracy "working control" of and board representation at MGM.⁷⁶ The tender offer was valued at \$36.5 million, \$30 million of which was to be financed through a loan from Transamerica Financial Corp ("Financial").⁷⁷ The loan was fully secured, *inter alia*, by the MGM shares.⁷⁸ The crux of the case was that Financial's parent, Transamerica Corp., happened to be the controlling shareholder of United Artists, a direct competitor of MGM.⁷⁹ The court considered two issues: (i) did the share pledge (*i.e.*, using MGM's shares as collateral for the loan) violate §7; and (ii) assuming that the parties

Gillette shall not . . . use or attempt to use its creditor position in Eemland: (a) to prevent or restrict Eemland's ability to refinance or obtain additional credit or capital; (b) to initiate any action the effect of which reasonably could be expected to cause Eemland to become insolvent or bankrupt; or (c) in the event of a proposed reorganization of Eemland because of insolvency or bankruptcy concerns, to vote against any reorganization plan proposed or supported by Eemland.

Gillette II, *supra* note 4, at *5.

73. The legal classification of debt investments under the antitrust laws is not just a domestic problem; it also raises questions under the merger control regimes of other jurisdictions. In *Vantico*, the German Federal Cartel Office investigated whether a 35% debt investment constituted a concentration under §37(I)(4) of the Act against Restraints of Competition ("GWB"). Ultimately, the agency did not take any action after the debt was repaid. However, Cartel Office staff acknowledged that there was disagreement within the Cartel Office as to whether debt investments would be prosecuted under §37(I)(4) GWB on a going forward basis.

74. 303 F. Supp. 1344 (S.D.N.Y. 1969).

75. *Id.* at 1344.

76. *Id.* at 1346-49.

77. *Id.* at 1346.

78. *Id.* at 1347.

79. *Id.* at 1346 ("The root of the controversy lies in the fact that the cash tender offer is being financed by Financial, whose parent, Transamerica, owns 99.6% of United Artists Corporation, a major competitor of MGM.")

removed the pledge, would the loan by itself violate §7?⁸⁰ With respect to (i), the court decided that the share pledge constituted a violation of §7, because Financial could have chosen to acquire the MGM shares in the event of Tracy's bankruptcy.⁸¹ With respect to (ii) the court merely enjoined Tracy and Financial from exchanging MGM-related information.⁸² The court explicitly held that the debtor-creditor relationship by itself posed no threat to competition.⁸³

The *MGM* court was concerned with threats to competition from corporate control and information exchange. The creditor's financial interest did not factor into the analysis.⁸⁴

A bare debtor-creditor relationship, standing by itself, gives the creditor no control over the debtor's right to vote its stock. In this respect the relationship differs sharply from those which have been condemned because a company, either by contract, stock ownership, market position or similar factors, possesses the power to control or influence its competitor's decisions.⁸⁵

Even though the bare debtor-creditor relationship lacks anticompetitive potential, there may be "surrounding circumstances" that could conceivably lead to a substantial lessening of competition, "including the expressed purpose of the relationship, the debtor's solvency or insolvency, the terms and size of the loan, the percentage which it bears to the debtor's entire debt and capital structure, the existence of other contracts or relationships between the parties, etc."⁸⁶ Consistent with the analysis above, most of the circumstances identified by the *MGM* court are in fact necessary (albeit not sufficient) conditions for control through debt investment, in particular insolvency and the resulting lack of refinancing options combined with a significant loan.

80. *Id.* at 1350 ("Reduced to its simplest terms the essential question before us is: Does the status of a major MGM competitor (Transamerica-United Artists-Financial) as a substantial creditor of the prospective controlling shareholder (Tracy) pose a sufficient threat to competition to run afoul of §7?").

81. *Id.* at 1349.

82. *Id.* at 1352, 1354.

83. *Id.* at 1350 ("In the case before us . . . it is difficult to foresee the probability of anti-competitive effects flowing from the debtor-creditor relationship alone.")

84. *Id.* at 1351.

85. *Id.* at 1350.

86. *Id.* at 1351.

However, the threat of insolvency must at least be probable.⁸⁷ The mere fact that “Tracy has not advanced any present plans for refinancing, absent which Financial might have considerable power over it”⁸⁸ was not sufficient to establish a §7 violation.⁸⁹ Thus, under *MGM*, absent special circumstances, debt investments in competitors are lawful under §7.⁹⁰

B. Mr. Frank v. Waste Management, Inc. (1984)⁹¹

In 1984, the district court for the Northern District of Illinois decided *Mr. Frank v. Waste Management, Inc.*⁹² Waste Management Inc. (“WMI”) provided waste disposal services.⁹³ Chem-Clear, a competitor in the same geographic market, was one of WMI’s potential acquisition targets.⁹⁴ Chem-Clear was in financial distress; nevertheless, it received a \$140,000 loan from WMI.⁹⁵ Mr. Frank, Inc. (“Mr. Frank”), a customer of WMI and Chem-Clear, brought suit against WMI’s “pattern of acquisitions” in violation of, *inter alia*, §7.⁹⁶ The court denied WMI’s motion for summary judgment and found that there were

87. See *id.* at 1350 (“[T]he mere *possibility* of anti-competitive effects is insufficient In the absence of circumstances indicating a *probability* that the creditor would use its position to influence MGM . . . , we do not believe that such a debtor-creditor relationship should be categorically outlawed as a matter of law.”) (emphasis added).

88. *Id.* at 1351.

89. *Id.* at 1351–52 (“[T]he question of whether a debtor-creditor relationship must be enjoined as threatening competition in violation of [§]7 depends upon whether such *probability* is revealed by surrounding circumstances.”) (emphasis added).

90. Responding to comments regarding the prop’osed final judgment in *Gillette*, the Justice Department relied on the absence of special circumstances under *MGM* to justify its refusal to require *Gillette* to give up its debt position in *Eemland*. *Gillette I*, *supra* note 4, at 28,323.

91. 591 F. Supp. 859, 859 (N.D. Ill. 1984).

92. *Id.*

93. *Id.* at 862.

94. *Id.*

95. *Id.* at 867.

96. *Id.* at 865. In addition to its loan to Chem-Clear, WMI also had ties to two other waste disposal service companies in the same geographic area. This Article focuses on Chem-Clear, because “WMI’s *only* present interest in Chem-Clear is that Chem-Clear owes WMI approximately \$140,000.” *Id.* at 862 (emphasis added).

triable issues of fact.⁹⁷ The court held that “WMI’s status as a substantial creditor could give it appreciable power over Chem-Clear’s actions.”⁹⁸ The court focused solely on the corporate control dimension of the relationship. “If . . . Mr. Frank is able to prove that WMI’s creditor’s interest gives WMI significant control over Chem-Clear, then that interest would be a ‘contemporary violation’ of the Clayton Act.”⁹⁹ Three factors surrounding the loan influenced the court’s reasoning, the fact (i) that Chem-Clear was “in financial straits,” (ii) that the loan was “substantial,” and (iii) that “WMI did not press for collection while it and Chem-Clear negotiated WMI’s proposed takeover of Chem-Clear,” *i.e.*, the existence of a relationship between the parties beyond the loan.¹⁰⁰ These factors also appear in the *MGM* court’s list of “surrounding circumstances,” which is significant because there is no indication that the *Mr. Frank* court was aware of the *MGM* decision.¹⁰¹

The *Mr. Frank* opinion contains an important discussion of the applicability of §7 to debt investments, a logical prerequisite for the analysis, which is missing entirely in the *MGM* decision where the court simply assumed that debt investments fall within the scope of §7.¹⁰² In *Mr. Frank*, the court addressed the issue of §7 applicability in the context of determining whether a loan constitutes an “asset” under §7¹⁰³ and held that “Chem-Clear’s \$140,000 debt to WMI may constitute an . . . ‘asset’ because Chem-Clear is in financial straits.”¹⁰⁴ It follows *e contrario* that but for Chem-Clear’s dire financial situation, the debt as such would not have been an asset and not be subject to §7 scrutiny. Thus, only qualified debt, *i.e.*, debt in connection with other circumstances that give the creditor “appreciable power over [the debtor’s] actions”¹⁰⁵ constitutes an asset, the acquisition of which may

97. See *id.* at 871 (holding that defendants motion for summary judgment was denied in all aspects except those concerning divestiture and price fixing allegations).

98. *Id.* at 867.

99. *Id.*

100. *Id.* at 862.

101. The *Mr. Frank* decision contains no reference to *MGM*.

102. *MGM, Inc.*, 303 F. Supp. at 1350.

103. *Mr. Frank, Inc.*, 591 F. Supp. at 866 (stating that “[Assets] is not a word of art, nor is it given a built-in definition by statute As used in this statute, and depending upon the factual context, ‘assets’ may mean anything of value.”).

104. *Id.* at 867 (emphasis added).

105. *Id.*

be analyzed under §7.¹⁰⁶ The court appears to have employed the following analytical framework: As a rule, debt investments are analyzed under §1, because debt as such is not an asset for purposes of §7.¹⁰⁷ However, in rare circumstances where the debt investment is qualified by giving the creditor “appreciable power over [the debtor’s] actions,” debt falls within the definition of an asset and §7 is applicable.¹⁰⁸ That analysis is appealing, because its rule/exception character reflects the different effects of debt investments and partial ownership. In a partial ownership situation, the potential effects standard of §7 is the rule, unless the investment is in fact competitively harmless, in which case the actual effects standard of the “solely for investment” exemption, which is substantively identical to that of §1, applies.¹⁰⁹ In a debt investment situation, the rule/exception relationship is reversed. The actual effects standard of §1 is the rule, unless the investment is of a narrowly defined type that confers meaningful corporate control to the competing lender, which justifies the application of §7’s potential effects standard. Thus, *Mr. Frank* stands for the proposition that debt investments in competitors, unless they convey a meaningful degree of corporate control over the target to the investor, fall outside of the scope of §7.

106. See *id.* at 866.

107. See *id.* at 867.

108. *Id.*

109. See *U.S. v. Tracinda Inv. Corp.*, 477 F. Supp. 1093 (C.D. Cal. 1979):

An acquisition may escape a challenge under Section 7, even though it may be in violation of the section’s substantive provisions, if it falls within the specific exemptions provided for in Section 7, one of which provides that acquisitions of stock where the acquisition is made solely for the purposes of investment are not included in the prohibition of Section 7.

Id. at 1098; *The Anaconda Co. v. Crane Co.*, 411 F. Supp 1210 (S.D.N.Y. 1975):

In cases where the “solely for investment” exemption does not apply, a plaintiff need only show a reasonable probability of a lessening of competition [However, o]nce it is established to the satisfaction of the Court that the acquisition is “solely for investment,” the statute requires a showing that the defendant is “using the (stock) by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition.”

Id. at 1219.

C. Vantico v. Apollo (2003)¹¹⁰

Apollo Management LP (“Apollo”), a private equity fund management company, acquired 35% of Vantico’s senior bank debt at a substantial discount to par through one of its funds (Fund V).¹¹¹ Another fund, Fund IV, held a controlling equity stake in Resolution Performance Products, LLC (“Resolution”), a competitor of Vantico. Vantico sued to enjoin Apollo from purchasing more debt and from voting its debt against a restructuring plan that was proposed by a major subordinated bondholder.¹¹² The district court denied the injunction, finding that the acquisition of debt by Apollo did not violate §7, §1, or §2.¹¹³ Following *MGM*, the court implicitly assumed the applicability of §7 to debt and started its analysis with the observation that “[t]he mere fact that a company’s horizontal competitor may have acquired the debt of the company and is a creditor is not a sufficient basis to conclude that such an acquisition is a violation of §7.”¹¹⁴ Even though Vantico claimed to be on the brink of insolvency, the court found that the “circumstances created by the acquisition . . . does [sic] not establish a probability of anti-competitive effects.”¹¹⁵ The court arrived at that result after a careful analysis of Apollo’s incentives as a fund manager.¹¹⁶ Unlike a holding company that serves the interests of one shareholder constituency (*i.e.*, the shareholders in the holding), a fund manager serves the interests of multiple constituencies; in Apollo’s case those of the investors in Fund V (debt in Vantico) and Fund IV (equity in Resolution).¹¹⁷ While a holding company might have an incentive to consider anticompetitive trade-offs between investments, a fund manager generally does not.¹¹⁸

[W]hile the insolvency of a competitor might be of some benefit to the investors in Fund IV, which controls Resolution, it would

110. *Vantico Holdings, S.A. v. Apollo Mgmt. Ltd. P’ship*, 247 F. Supp. 2d 437 (S.D.N.Y. 2003).

111. *Id.* at 442–43, 447.

112. The bondholder was in fact funding the litigation. *Id.* at 446, 458.

113. *Id.* at 457–58.

114. *Id.* at 455.

115. *Id.* at 456.

116. *Id.*

117. *Id.* at 442–43.

118. *Id.* at 456.

significantly harm the investors in Fund V, and risk the recoverability of Fund V's \$160 million investment [in Vantico.] Consequently, Apollo has little or no incentive to engage in the anti-competitive behavior that is envisioned by Vantico.¹¹⁹

The Vantico case is significant because the court made the financial incentives analysis of the investor the centerpiece of its opinion.¹²⁰ Because Apollo, as a fund manager, had no incentives to harm Vantico, there was no likelihood of a substantial lessening of competition.¹²¹ The court's reliance on the incentive analysis, however, narrows the applicability of Vantico as precedent in the context of debt investments. The court did not decide whether the acquisition of Vantico's debt by Resolution (Vantico's competitor) would have violated §7. To the contrary, the court explained that Apollo, even though it controlled Resolution, was in fact not Vantico's competitor and would not "be likely to pressure Vantico in Vantico's competitive business decisions. Apollo's interest in Vantico is a creditor's interest in assuring that the value of Apollo's debt is protected and that any increase in the value of the debt can be realized."¹²² Thus, arguably, *Vantico* is at its core a case of debt investment in a non-competitor and may only be tangentially related to the issues raised in *MGM* and *Mr. Frank*.

IV. CONCLUSION

The competitive effects of debt investments differ significantly from those of partial ownership in all three relevant dimensions, financial interest, corporate control, and access to competitively sensitive information. With respect to financial interest, debt investments are much less likely to lessen competition, because debt, unlike partial ownership, does not reduce the investor's incentives to compete at the margin.¹²³ With respect to corporate control and information exchange, the degree of the creditor's influence depends on

119. *Id.*

120. *Id.*

121. *See id.* 456-57 ("Vantico has not shown that the acquisition of 35% of Vantico's senior debt by Apollo has created the probability of anticompetitive effects and unlawful restraints of trade prohibited by the Clayton Act.").

122. *Id.* at 456.

123. *See supra* Part II.C.

the borrower's refinancing options. As long as the debtor has practical refinancing alternatives, the creditor's influence over the debtor's management and its access to competitively sensitive information is limited to the cost of refinancing.¹²⁴ Thus, debt investments in solvent competitors are presumably efficient and are not likely to significantly lessen competition or unreasonably restrain trade.¹²⁵ However, once the debtor's financial situation deteriorates and the refinancing costs

124. See *supra* Part II.B.

125. Whether the rule of reason analysis is carried out under §1 or §7 is only of secondary concern here. It has been held and argued that the substantive standards of §1 and §7 have converged. *U.S. v. Rockford Mem'l Corp.*, 898 F.2d 1278, 1281–83 (7th Cir. 1990); *Vantico Holdings, S.A. v. Apollo Mgmt. Ltd. P'ship*, 247 F. Supp. 2d 437, 458 (S.D.N.Y. 2003); 4 PHILIP AREEDA ET AL., *ANTITRUST LAW*, ¶ 906 (rev. ed., 2002). Older case law and recent commentary suggest, however, that the incipiency standard of §7 is easier to meet (at least on an evidentiary basis) than the actual injury standard of §1. *Minnesota Mining & Mfg. Co. v. New Jersey Wood Finishing Co.*, 381 U.S. 311, 323 (1965); *U.S. v. Penn-Olin Chem. Co.*, 378 U.S. 158, 161, 170–71 (1964); *Brown Shoe Co. v. U.S.*, 370 U.S. 294, 328–29 (1962); *Crown Zellerbach Corp. v. F.T.C.*, 296 F.2d 800, 814–15 (9th Cir. 1961); *Briggs Mfg. Co. v. Crane Co.*, 185 F. Supp. 177, 183 (E.D. Mich. 1960), *aff'd per curiam*, 280 F.2d 747 (6th Cir. 1960); *Am. Crystal Sugar Co.*, 259 F.2d at 527 (2d Cir. 1958); 4 EARL KINTNER, *FEDERAL ANTITRUST LAW* § 35.8, at 197 (1984); O'Brien & Salop, *Competitive Effects, supra* note 5, at 565; Phillip Proger, *Application of the Sherman Act to Health Care: New Developments and New Directions*, 59 *ANTITRUST L.J.* 173, 182 (1990). If one were to adopt the latter position, then there is a strong systematic argument for the exclusive application of §1 to debt investments. Unlike equity investments, debt investments are not significantly correlated with competitive effects. That correlation, however, is the justification for applying the incipiency standard to acquisitions of stock and assets. Notably, Section 7A of the Clayton Act, 15 U.S.C. § 18a (2004), which requires pre-merger notification of certain acquisitions of voting securities and assets to the Federal Government, specifically *exempts* "acquisitions of bonds, mortgages, deeds of trust, or other obligations which are not voting securities" from the notification requirement. 15 U.S.C. § 18a (c)(2). The rationale for the exemption is that the acquisition of bonds and other obligations is not sufficiently likely to cause competitive effects as to warrant advance warning. Moreover, if the acquisition of debt was treated as an asset acquisition, the conspicuous omission of "assets" from the language of the "solely for investment" exemption in §7 strongly suggests that the exemption would not be available to an acquisition of debt. Consequently, §7 would be even more broadly applicable to debt investments than to equity investments, which is a systematically unsatisfactory result. Here, the framework underlying *Mr. Frank* might offer a compromise solution: As a rule, debt investments come under the actual injury standard of §1 unless they confer control over the target, in which case §7 applies. See *supra* Part III.B.

increase, the creditor's *de facto* influence increases.¹²⁶ Where the creditor can unilaterally accelerate the loan and drive the debtor into bankruptcy, the creditor may have greater influence over the borrower's management (and access to its competitively sensitive information) than a comparable shareholder.¹²⁷ However, as debt investments do not meaningfully alter the creditor's competitive incentives, the creditor—unlike the partial owner—is in a position to eliminate potential concerns from its investment in a financially troubled competitor by making the loan passive, *e.g.*, by implementing undertakings similar to those in *Gillette*,¹²⁸ or, in the case of a syndicated loan, by voting its debt proportionally with the other, non-competing lenders, and/or by agreeing to only receive information that does not contain any competitively sensitive information. With these qualifications in mind, debt investments in competitors should receive deferential treatment under the antitrust laws.

126. See *supra* Part II.B.

127. Desirable as controlling the target may be from a competitor's perspective, influencing a flailing borrower's strategic business decisions is a dangerous practice from a creditor's point of view. See MANNINO, *supra*, note 59, § 2.02 [1] ("In the lender's lexicon, control is a very dangerous word. Control theories may lead to holding the lender liable for the borrower's contract, or even tort, liabilities, or to subordinating the lender's loan to debts owed to other creditors."). Depending on the circumstances of the case, the liability risk from controlling the debtor might outweigh the expected gains from influencing the debtor's management and serve as a deterrent to exercising control.

128. See *supra* note 72.