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Mitigating Antitrust Risk In Defense Deals Amid Scrutiny

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(March 4, 2022, 6:00 PM EST)

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As the Biden administration calls for tougher antitrust enforcement, the aerospace and defense industry faces increased antitrust scrutiny.

This article highlights how policy changes by the Federal Trade Commission, the Antitrust Division of the U.S. Department of Justice and the U.S. Department of Defense may affect A&D industry participants in various aspects of their businesses, including mergers and acquisitions, teaming agreements and labor practices. We also offer suggestions to help these companies mitigate antitrust risk arising from heightened antitrust scrutiny of the industry.

Mergers and Acquisitions

Recent policy changes at the DOD and the antitrust agencies have ushered in a new era for mergers and acquisitions in the A&D space.

The DOD is aggressively evaluating M&A.

The DOD reviews transactions among suppliers of military products, and works closely with the FTC and DOJ in their investigations. In July 2021, President Joe Biden issued a sweeping executive order on antitrust, which directed a whole-of-government approach mandating cooperation among federal agencies for competition enforcement.

The order also directed agencies, including the DOD, to prepare reports identifying steps to promote competition within their areas of responsibility.

When it released its report in February, the DOD noted that since the 1990s, the number of defense sector prime contractors has declined from 51 to just five. According to the report, the department views the defense industrial base as

> historically consolidated ... making heightened review of any further mergers and acquisitions (M&A) necessary[1] [and will] assess its approach to evaluating vertical and horizontal mergers, with adequate attention to risks to national security.[2]

Notably, the DOD issued this report shortly after the FTC sued to block Lockheed Martin Corp.'s proposed $4.4 billion proposed vertical acquisition of Aerojet Rocketdyne Holdings Inc.[3] and participated closely in that merger review process. Under the whole-of-government approach, the DOD appears to be more deferential to the antitrust agencies' views on a proposed transaction, including any potential remedies.[4]

The report also emphasizes that a strong defense industrial base with alternative suppliers at various levels is important to national security and competition. The DOD noted the importance of ensuring that sub-tier suppliers of key technologies or materials are available to prime contractors to promote competition at the platform level. The heightened review, therefore, is likely to include a focus on acquisitions or other strategic collaborations between prime contractors and lower-tier suppliers.

The antitrust agencies are increasingly hostile toward mergers.

While Biden campaigned as a moderate Democrat, his administration has been very progressive on antitrust issues. Biden named Lina Khan as FTC chair and Jonathan Kanter as DOJ assistant attorney general for antitrust.

Both Khan and Kanter have been vocal advocates for more vigorous antitrust enforcement. Under their leadership, the FTC and DOJ have adopted new policies to aggressively challenge transactions and to prevent deals from even being proposed.

Increased Appetite for Full-Stop Challenges and Litigation, Including for Vertical Transactions

A vertical transaction combines two companies at different levels of the supply chain — e.g., a prime contractor and a subcontractor.

Because of the prevalence of subcontracting and teaming relationships in the industry, A&D transactions frequently raise vertical antitrust issues. Historically, when the antitrust agencies believed a transaction raised vertical concerns, they typically entered into a consent order allowing the transaction to proceed with behavioral conditions — generally information firewalls, and sometimes merchant supply obligations.

Examples include:

- Northrop Grumman Corp.'s 2018 acquisition of Orbital ATK;[5]
- The 2007 formation of United Launch Alliance;[6] and
- Northrop Grumman's 2003 acquisition of TRW.[7]

Recently, however, the antitrust agencies have come to strongly disfavor behavioral remedies. Under the Trump administration, the DOJ expressed a clear preference for structural remedies — i.e., divestitures — rather than behavioral remedies.[8]

The FTC under the Biden administration has adopted a similar position. Khan has stated that she strongly disfavors behavioral consent orders.[9]

In a letter to Sen. Elizabeth Warren, D-Mass., addressing consolidation in the defense industry, Khan expressed skepticism "that behavioral remedies alone are sufficient to prevent a vertical merger from

causing harm." She went on to state, "I prefer structural remedies that prevent the harmful integration of assets, or would support the Commission moving to block the merger altogether."[10]

The FTC's investigation into Northrop Grumman's compliance with the 2018 consent order related to its acquisition of Orbital ATK likely influences the agency's views as well.[11] In keeping with this policy shift, the FTC recently sued to block Lockheed Martin's proposed vertical acquisition of Aerojet Rocketdyne, which would have combined a missile prime contractor with a propulsion subcontractor.[12]

The FTC sued to block two other vertical mergers in 2021:

- Illumina Inc.'s planned purchase of GRAIL Inc.; and
- NVIDIA Corp.'s planned purchase of Softbank Group Corp.'s Arm, Ltd.[13]

Prior to these actions, the FTC had not filed suit to block a vertical transaction outright in more than four decades.

The DOJ has gone beyond a stated preference for structural over behavioral relief by questioning the effectiveness of structural relief altogether. Kanter recently stated that when the antitrust agencies find a competitive problem with a transaction, they should generally seek to block the deal rather than require divestitures.[14] He believes that only in rare instances can a divestiture remedy an otherwise anti-competitive transaction.[15]

This position is a more extreme manifestation of trends that have been developing for several years as the FTC and DOJ increasingly insist on clean divestitures of isolated and segregable businesses. In recent years, the agencies have allowed several A&D transactions to proceed with divestitures, including L3 Techonologies' merger with Harris Corp., and Raytheon Co.'s merger with United Technologies Corp.[16]

Contractors must demonstrate that the divestiture package represents a stand-alone business, and the agencies will conduct significant diligence on the asset package, the divestiture process and the proposed buyer.

While agency policies may have shifted to discourage transactions, the law has not changed, and the FTC and DOJ still must convince a federal court that a transaction is anti-competitive in order to block it. It seems likely that more parties will be putting the agencies to that test.

Updated Merger Guidelines

In 2021, the FTC withdrew its support for the vertical merger guidelines that the FTC and DOJ had issued just one year prior.[17] The FTC viewed the 2020 guidelines as too supportive of vertical transactions, expressing particular concern regarding the guidelines' focus on the pro-competitive efficiencies of vertical deals.[18]

The DOJ similarly has indicated that it considers the 2020 guidelines to be too permissive. In January 2022, the agencies also sought public comment on the horizontal merger guidelines, which have guided the agencies' review of horizontal transactions for decades.

The FTC is pursuing novel theories of harm in relation to mergers, including evaluating potential anti-competitive impacts on employees in instances where the merging companies are two of only a few

firms competing for the services of a talent pool, such as employees who work in a particular industry in a specific geographic area. Any updated merger guidelines may include new sections related to employment and other novel theories of competitive harm, and are likely to be more restrictive than the current guidelines.

Prior Approval

In July 2021, the FTC reversed decades of precedent and reinstated a policy requiring parties settling matters through consent orders to agree to prior approval provisions.[19] These provisions give the FTC broad discretion to approve or deny a transaction unilaterally. A&D firms should consider the implications of prior approval requirements when contemplating potential transactions where a divestiture pursuant to a consent order is likely.

"Close at Your Peril" Letters

In 2021, the FTC and DOJ began issuing letters to some merging parties at the end of the Hart-Scott-Rodino Act waiting period to advise them that their investigation remained open, and that if they closed the transaction, the agencies could later take action to unwind it. While the antitrust agencies have always been able to challenge consummated transactions, these letters create further uncertainty for merging parties.

Teaming Agreements

Teaming agreements are common in the A&D industry. By teaming, companies agree to work with each other, generally in pursuit of a specific procurement or bidding opportunity. Some teaming agreements are horizontal, combining two companies that otherwise likely would have bid in competition with each other. Others are vertical, combining a prime contractor with an input supplier.

Teaming is often pro-competitive, enabling the firms to offer superior products, technology and pricing relative to what would be available without the teaming arrangement. However, teaming arrangements can be anti-competitive if they reduce competition compared to what would have existed in the absence of the agreement.

In general, teaming agreements that are disclosed to the customer in advance of a procurement have been evaluated as civil matters under the rule of reason. Horizontal teaming agreements can be investigated as market allocations or bid rigging, however, and potentially could be challenged as per se illegal under the antitrust laws without regard to any business justification.[20]

The DOJ is focused on detecting and prosecuting collusion affecting government procurements and formed a Procurement Collusion Strike Force in 2019. The Procurement Collusion Strike Force has noted that subcontracting arrangements between competing primes could be "red flags" that could indicate bid rigging.[21] A&D contractors should evaluate all potential teaming agreements to assess their competitive implications.

Labor Issues

In 2016, the FTC and DOJ issued their joint Antitrust Guidance for Human Resource Professionals.[22] That guidance advised the industry of the government's belief that agreements or arrangements

between employers that purport to limit workers' employment options could be considered anti-competitive.

Such arrangements may take various forms, including no-hire agreements, nonsolicitation agreements and wage-fixing agreements. Notably, the DOJ has further argued that alleged naked wage-fixing and no-poach agreements — i.e., agreements between employers that the DOJ believes are not related to a legitimate underlying transaction — should be treated as criminal violations. This represents an important shift in the DOJ's enforcement priorities, as prior to the 2016 guidance, the government had challenged such agreements civilly rather than criminally.

In late 2021, the DOJ charged six executives, including a former manager within Raytheon Co.'s Pratt & Whitney aircraft engine business, with participating in a long-running conspiracy to restrict the hiring and recruiting of engineers and skilled workers.[23] The indictment alleged that the former Pratt & Whitney manager orchestrated an agreement with various outsourced engineering suppliers pursuant to which they would not hire or solicit one another's employees.[24] Since then, Raytheon has publicly disclosed that it is the target of an ongoing criminal investigation related to this matter.[25]

Given the DOJ's aggressive posture in this area, A&D contractors should assess whether their existing hiring practices comply with antitrust laws, including the 2016 guidance.

Mitigating Risk

Given today's heightened antitrust scrutiny, A&D contractors should evaluate their compliance and training programs to ensure they meet the challenges of the current environment. Suggestions include the following:

When involved in a merger or acquisition, conduct a meaningful antitrust risk assessment early in the transaction lifecycle to realistically evaluate the likelihood of clearance. Doing so is vital to understand and manage antitrust risk when negotiating the contract provisions related to antitrust, such as break fees, drop-dead dates and the required antitrust efforts.

An antitrust risk assessment also informs the business team of the likely regulatory review process and timing. Parties should also realistically assess whether an acceptable remedy can be crafted in light of the agencies' more restrictive approaches to both behavioral remedies and divestitures.

Assessment of Teaming Agreements

It is important to conduct a meaningful assessment of whether a teaming agreement is likely to raise competitive concerns. Relevant considerations include the competitive landscape for the given procurement and whether the proposed agreement is exclusive.

Contractors should pay close attention to teaming or subcontracting arrangements with other firms that would otherwise be expected to bid for the same program. Contractors should also be able to articulate and document how the proposed team combines complementary skills that will benefit the customer.

In addition, contractors also might consider disclosing the proposed agreement to the government customer, or even to the antitrust agencies.

Antitrust Training

Contractors should train their executives, managers and human resources personnel to be aware of the antitrust issues that can arise from hiring restrictions and other employment arrangements. Human resources professionals should understand the consequences of anti-competitive employment agreements, including potential criminal implications for the company and its personnel.

For employment arrangements, contractors should ensure that training and compliance programs cover labor-related antitrust issues in addition to more traditional topics, given the DOJ's assertive approach and the risk of criminal liability.

Conclusion

A&D firms are facing greater antitrust scrutiny on multiple fronts as the federal government, under Biden's leadership, takes a whole-of-government approach to antitrust enforcement. A&D firms' primary customer, the DOD, has expressed concerns about the state of the A&D industrial base and has promised to perform heightened reviews of future mergers and acquisitions involving A&D firms.

The DOD will closely scrutinize not only horizontal transactions between A&D competitors, but also vertical deals between firms at different levels of the supply chain. Meanwhile, the FTC and DOJ are stepping up their enforcement efforts, ushering in new policies to aggressively challenge and discourage transactions.

The antitrust agencies are pursuing novel theories of competitive harm in their merger reviews, such as harm to workers. At the same time, the antitrust agencies are increasingly skeptical of merger remedies, including behavioral consent orders that historically have been used to resolve vertical issues in the A&D space, and they have raised the bar on what is an acceptable divestiture.

The agencies have shown a greater willingness to challenge transactions outright rather than negotiate a remedy with merging parties. These FTC and DOJ initiatives are not targeted toward A&D contractors. Nevertheless, the combination of these newly aggressive policies, the Biden administration's focus on competition overall, and the DOD report indicate that the standard of review is changing for government contractors.

While the agencies are signaling a more aggressive approach to antitrust enforcement, there is still room for many transactions to proceed, and M&A continues at a record pace while the agencies face daunting workloads. We expect that more companies may make the agencies prove their novel theories in federal court. Of course, changes in agency policy are not binding on judges who evaluate transactions applying legal precedent.

As always, careful and timely consideration of the antitrust implications of M&A and other strategic activities early in the process will best position companies trying to navigate these changing waters.

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[1] DoD, Report: State of Competition within the Defense Industrial Base 1 (Feb. 2022), available at https://media.defense.gov/2022/Feb/15/2002939087/-1/-1/1/STATE-OF-COMPETITION-WITHIN-THE-DEFENSE-INDUSTRIAL-BASE.PDF.

[2] Id. at 27.

[3] See FTC Press Release, FTC Sues to Block Lockheed Martin Corporation's $4.4 Billion Vertical Acquisition of Aerojet Rocketdyne Holdings Inc., Jan. 25, 2022, available at https://www.ftc.gov/news-events/press-releases/2022/01/ftc-sues-block-lockheed-martin-corporations-44-billion-vertical.

[4] DoD's directive on its review of mergers and acquisitions, joint ventures, and strategic alliances of major defense contractors provides that "[i]f requested by the responsible antitrust agency" DoD will "recommend[] actions the government should take to prevent or mitigate negative impacts resulting from assessment of a covered transaction." DoD Directive 5000.62, Review of Mergers, Acquisitions, Joint Ventures, Investments, and Strategic Alliances of Major Defense Suppliers on National Security and Public Interest 4 (emphasis added).

[5] See Modified Decision and Order, In the Matter of Northrop Grumman Corp. and Orbital ATK, Inc., No. C-4652 (Dec. 4, 2018), available at https://www.ftc.gov/system/files/documents/cases/181_0005_c-4652_northrop_grumman_orbital_atk_modified_decision_and_order_12-4-18.pdf.

[6] See Decision and Order, In re Lockheed Martin Corp., The Boeing Company, and United Launch Alliance, L.L.C., No. C-4188 (May 1, 2007), available at https://www.ftc.gov/sites/default/files/documents/cases/2007/05/0510165do.pdf.

[7] See Final Judgment, United States v. Northrop Grumman Corp. and TRW Inc., No. 1:02-cv-02432 (June 10, 2003), available at https://www.justice.gov/atr/case-document/final-judgment-147.

[8] See DOJ, Merger Remedies Manual 13 (Sept. 2020), available at https://www.justice.gov/atr/page/file/1312416/download ("Structural remedies are strongly preferred in horizontal and vertical merger cases because they are clean and certain, effective, and avoid ongoing government entanglement in the market.").

[9] See Letter from Chair Khan to Senator Warren (Aug. 6, 2021), available at https://www.warren.senate.gov/imo/media/doc/chair_khan_response_on_behavioral_remedies.pdf.

[10] Id. at 3.

[11] See Form 10-K Annual Report, Northrop Grumman Corporation (Jan. 27, 2022), available at https://www.sec.gov/ix?doc=/Archives/edgar/data/0001133421/000113342122000004/noc-20211231.htm (disclosing that in October 2019 Northrop Grumman received a civil investigative demand from the FTC requesting information regarding the company's compliance with the 2018 Orbital ATK consent order and that the company has recently resumed discussions with FTC staff).

[12] Complaint, In the Matter of Lockheed Martin Corporation and Aerojet Rocketdyne Holdings, Inc., No. 9405 (Jan. 25, 2022), available at https://www.ftc.gov/system/files/documents/cases/d09405lockheedaerojetp3complaintpublic.pdf.

[13] Complaint, In the Matter of Illumina, Inc., and GRAIL, Inc., No. 9401 (March 30, 2021), available at https://www.ftc.gov/system/files/documents/cases/redacted_administrative_part_3_complaint_redacted.pdf; Complaint, In the Matter of Nvidia Corp., Softbank Group Corp., and Arm, Ltd., No. 9404 (Dec. 2, 2021), available at https://www.ftc.gov/system/files/documents/cases/d09404_part_3_complaint_public_version.pdf.

[14] AAG Jonathan Kanter, Remarks Delivered to New York State Bar Association Antitrust Section, Jan. 24, 2022, available at https://www.justice.gov/opa/speech/assistant-attorney-general-jonathan-kanter-antitrust-division-delivers-remarks-new-york ("I am concerned that merger remedies short of blocking a transaction too often miss the mark. Complex settlements, whether behavioral or structural, suffer from significant deficiencies. Therefore, in my view, when the division concludes that a merger is likely to lessen competition, in most situations we should seek a simple injunction to block the transaction. It is the surest way to preserve competition.").

[15] Id.

[16] See DOJ Press Release, Justice Department Requires Harris and L3 to Divest Harris's Night Vision Business to Proceed with Merger, June 20, 2019, available at https://www.justice.gov/opa/pr/justice-department-requires-harris-and-l3-divest-harris-s-night-vision-business-proceed; DOJ Press Release, Justice Department Requires Divestitures in Merger Between UTC and Raytheon to Address Vertical and Horizontal Antitrust Concerns, March 26, 2020, available at https://www.justice.gov/opa/pr/justice-department-requires-divestitures-merger-between-utc-and-raytheon-address-vertical-and.

[17] See FTC Press Release, Federal Trade Commission Withdraws Vertical Merger Guidelines and Commentary, Sept. 15, 2021, available at https://www.ftc.gov/news-events/press-releases/2021/09/federal-trade-commission-withdraws-vertical-merger-guidelines.

[18] Statement of Chair Khan, Comm'r Chopra, and Comm'r Slaughter on the Withdrawal of the Vertical Merger Guidelines (Sept. 15, 2021), available at https://www.ftc.gov/system/files/documents/public_statements/1596396/statement_of_chair_lina_m_khan_commissioner_rohit_chopra_and_commissioner_rebecca_kelly_slaughter_on.pdf.

[19] FTC, Statement of the Commission on Use of Prior Approval Provisions in Merger Orders (July 21, 2021), available at https://www.ftc.gov/system/files/documents/public_statements/1597894/p859900priorapprovalstatement.pdf.

[20] See Gary Spratling, Will Teaming Be a Problem?, Address Before the American Bar Association Section of Public Contract Law Annual Meeting, Aug. 7, 1994.

[21] DOJ, Recognizing Antitrust Conspiracies and Working with the Antitrust Division, available at https://www.justice.gov/atr/page/file/1214191/download (citing "[w]inning company subcontracts to losing company" as an example of a suspicious bid pattern).

[22] DOJ and FTC, Antitrust Guidance for Human Resource Professionals (Oct. 2016), available at https://www.ftc.gov/system/files/documents/public_statements/992623/ftc-doj_hr_guidance_final_10-20-16.pdf.

[23] Indictment, United States v. Mahesh Patel et al., No. 3:21-cr-00220-VAB (Dec. 15, 2021), available

at https://www.justice.gov/opa/press-release/file/1457091/download.

[24] Id.

[25] Nivedita Balu, Raytheon Says It Is a 'Target' of a DOJ Probe into Industry Hiring Practices, Nasdaq, Feb. 11, 2022, available at https://www.nasdaq.com/articles/raytheon-says-it-is-a-target-of-a-doj-probe-into-industry-hiring-practices.