Antitrust and Trade Regulation Bulletin™

Enforcement

MERGERS AND ACQUISITIONS

BNA Insights

Navigating the Approaching Wave of Consolidation in the Defense Industry

BY MARK BOTTI AND JESSICA HOLE VAN DER MILLER

Anticipating a wave of defense industry consolidation, federal antitrust and competition policymakers are stiffening their resolve and preparing for the public debate on pushing back.

In April—in response to an earlier, controversial decision by the US Department of Justice (DOJ) to clear Lockheed’s acquisition of Sikorsky—the U.S. Department of Defense (DoD) in essence demanded more deference to DoD’s views and a stricter review by the antitrust agencies. DOJ and the U.S. Federal Trade Commission (FTC) embraced DoD’s request, issuing a joint statement of their intent to enforce vigorously the nation’s antitrust laws when reviewing defense industry mergers and acquisitions and promising to work closely with DoD.

In June, DOJ went further: Acting Associate Attorney General Bill Baer endorsed a strict review of defense industry mergers, even when DoD is protected, because “price and other contractual terms can be locked-in for a long period.” Rather than give a pass to defense mergers where higher prices were not a threat, DOJ emphasized the importance of competition among defense contractors. According to Baer:

. . . rivals compete to improve the quality of their offerings for the next round of contracting and for the next generation of products . . . . Our duty remains “to maintain competition going forward for the prod-
ucts and services purchased by DoD” so that the “DoD has a variety of sourcing alternatives and the most innovative technology to protect American soldiers, sailors, marines, and air crews, all at the lowest cost for the American taxpayer.”

What does this spirit of vigorous antitrust enforcement portend for defense consolidation? It comes in an unprecedented environment (for the modern era of antitrust enforcement) of vigorous merger enforcement, in which the agencies have taken a restrictive view of permissible mergers, regularly taking small and large mergers to court and rejecting proposed settlements and divestitures. Significant insight can be gained from a brief review of merger enforcement in the defense industry, including the varying degrees of cooperation between the federal antitrust enforcement agencies and DoD.

Ebb and Flow in Scrutiny

The rigor of regulatory review of defense industry consolidation in the United States has waxed and waned over the past 30 years. This ebb and flow has included a period where major players consolidated with little oversight, followed by a seemingly abrupt change in course with intense scrutiny and challenges from the antitrust authorities. Subsequent episodic mergers were reviewed in the regular course of the merger enforcement agencies with little merger or enforcement activity of significant note. Recently, however, the pace of consolidation has quickened and controversy over enforcement standards has reappeared.

Moving forward, the antitrust agencies will consider a defense contracting industry composed of a handful of major prime contractors and a larger number of small niche contractors generally supporting these prime contractors. We have undertaken below to briefly recount this history of enforcement and recent decisions in order to set forth some suggestions for those looking to understand and possibly navigate the next wave of consolidation in light of the agencies’ stated intentions.

History of Consolidation Within the U.S. Defense Industry

Today’s defense industry would be unrecognizable to an industry observer from the Cold War era. With increased levels of military and defense spending during the Cold War, approximately 40 companies made up the defense industry. Even in the years following the Cold War, continued increased spending was able to support these contractors. This changed in the early 1990s, when excess capacity challenged the industry due to decreasing spending.

At a summit of executives of top U.S. defense contractors (known as the “Last Supper”), then Deputy De-


From 1990 to 1998, the number of contractors in the tactical missiles section alone dropped from 13 down to three.2 Antitrust enforcement was at most a moderating influence on this consolidation, but clearly not a roadblock. Following this intense consolidation, the US defense industry had approximately six major players.

A Change in Course

In 1998, the regulatory response changed, with a challenge to the proposed merger of Lockheed Martin and Northrop Grumman. At the time, many in the industry believed that this merger was necessary to preserve the strength of assets of Northrop Grumman and provide another large contractor to counter-balance the size of Boeing and Raytheon. Conventional wisdom held that there was little to no likelihood of major contract awards for tactical aircraft and that, because of its failure to win contracts in that area and others, Northrop would fade and its capabilities erode due to lack of work. Initially, both the Navy and the Air Force reported to the DoD that the merger would not reduce competition. However, after a nine-month antitrust review, DOJ sued to block the merger, with DoD’s support. This marked the first time that either agency had sought to prevent a major defense industry acquisition.

It also marked a change in the relationship between DOJ and DoD. Until that time, DoD’s comfort level with consolidation appeared to keep the antitrust agencies calm and technical, requiring some adjustments in transactions but not major objections. The challenge to the Lockheed/Northrop deal appeared to go the other way, with DOJ asserting its competition expertise and motivating DoD to recognize the risks to its budget and weapons procurement environment from a loss of competition.

According to DOJ’s complaint, the merger “would result in unprecedented vertical and horizontal concentration in the defense industry which would substantially lessen, and in several cases eliminate, competition in major product markets critical to the national de-
fense.”3 The specific product markets affected by this merger included Airborne Early Warning (AEW) radar, high performance fixed-wing military aircraft and “stealth” technology, among many others. In some of these markets, including AEW radar, Lockheed Martin and Northrop Grumman were the only suppliers. “Internal planning documents of both Lockheed and Northrop identify the other as its primary competitor in the US military AEW radar market.”4 Additionally, “Lockheed and Northrop are the only companies with proven capability in developing, producing and integrating AEW radars for use on US military aircraft. Successful entry into the production and sale of AEW radars for US military aircraft would be difficult, time consuming, and costly.”5 DoD ultimately agreed with DOJ’s assessment of the merger, concluding that “the Department’s interests would be best served if Lockheed Martin and Northrop Grumman do not merge.”6 After failing to reach a pre-trial settlement with DOJ, Lockheed Martin and Northrop Grumman eventually abandoned the transaction during the litigation DOJ brought to block it.

In October 2001, DOJ again moved to stop another major defense industry acquisition, the proposed merger of General Dynamics and Newport News Shipbuilding. Again, DoD supported DOJ’s lawsuit, believing that this combination would constitute a merger to monopoly. In fact, DoD supported a different proposed acquirer of Newport News Shipbuilding, Northrop Grumman. According to DOJ’s complaint, “the DoD has benefited, and likely will benefit in the future, from the ongoing, vigorous competition between General Dynamics and Newport News for the design and construction of submarine and rocket engines. The competition will be eliminated in these product markets if General Dynamics acquires Newport News, leading to higher costs, less innovation and higher prices to the DoD.”7 In response to DOJ’s complaint, General Dynamics dropped its bid and Newport News Shipbuilding was eventually acquired by Northrop Grumman, with the acceptance of DoD and no challenge from DOJ.

While questioned at the time, DOJ’s analysis and identification of the issues proved prescient. Although Northrop Grumman was a smaller contractor at the time of these mergers, it has grown much larger since. Based on 2015 defense industry revenue, Lockheed Martin and Northrop Grumman are ranked first and second, with Raytheon and Boeing third and fourth. Additionally, these contractors have continued to innovate and compete. Northrop Grumman recently announced it is building a sixth-generation fighter which will compete in the aircraft segment.8

Recent Defense Industry Mergers and Coordination Between the Regulators

Consolidation among defense industry contractors slowed significantly following the challenges to the Lockheed/Northrop and General Dynamics/Newport News transactions. However, mergers in the industry did still occur, and were subject to the normal regulatory review by an antitrust agency (either DOJ or the FTC) and DoD.9 The environment appeared to change, however, and neither the antitrust agencies nor DoD evidenced significant concern with further incremental consolidation. Some mergers clear with little investigation. For example, a recent deal between Lockheed Martin’s Information Systems and Global Solutions business unit and Leidos closed at the end of the HSR waiting period, with no second request.

Even in more “difficult” mergers, the agencies appeared to be on the same page. Recently, for example, DOJ and DoD agreed on the outcome of the review of the merger between ATK and Orbital. Both parties participated in the space and satellite industry, along with competitors including Lockheed Martin, Boeing and SpaceX. Despite this competition, the merger was spurred by declining government demand for rockets and rocket engines. According to Orbital Chief Executive David Thompson, the combined company would be able to compete for a new US strategic missile, something the separate companies would have been unable to do.10 DoD did not note any concerns over the merger, and DOJ unconditionally cleared the merger, with no investigation beyond the initial 30-day waiting period.

Fissures in the government position began to appear, however, in GenCorp’s 2013 proposed acquisition of Pratt & Whitney Rocketdyne. Both parties designed, developed, manufactured, sold and supported liquid rocket propulsion systems for spacecraft, strategic missile systems and ballistic missile defense systems. During its review, the FTC staff believed that the merger would create a durable monopoly and lead to higher prices and inferior products for its government defense customers. However, DoD identified potential non-economic benefits of the transaction, and requested that the transaction be allowed to proceed “for both national security and industrial base reasons.”11 The FTC deferred to DoD’s request, stating:

“It has been and continues to be the Commission’s practice to defer to the DoD’s assessment of those benefits and to accord that assessment significant weight in exercising the Commission’s prosecutorial discretion. If the DoD believes that the proposed acquisition is necessary to achieve important benefits

---

4 Id. at 20.
5 Id. at 21.
6 Id. at 4 (citing Letter from Secretary of Defense William S. Cohen, to Attorney General Janet Reno (March 23, 1998)).
9 The Committee on Foreign Investment in the United States (CFIUS) also reviews proposed mergers involving foreign purchases or investment in US companies.
of this nature, that would clearly impact the Commission’s decision of whether, overall, a challenge of the transaction would be in the public interest.¹²

The FTC ultimately closed its investigation, and the acquisition proceeded as proposed.

The successful assertion of primary responsibility by DoD in GenCorp/Rocketdyne, however, did not fully restore the pre-Lockheed/Northrop relationship. While the FTC had learned to salute, DOJ had not yet had a disengagement with DoD on a transaction. That came last year in, ironically, Lockheed Martin’s acquisition of Sikorsky. Sikorsky specialized in building helicopters. Lockheed Martin, although the world’s large defense company by revenue, did not build helicopters. For this reason, DOJ cleared the acquisition with no additional investigation. DoD was clearly concerned. Frank Kendall, DoD Undersecretary for Acquisition, summarized DoD’s concerns:

“We believe that these types of acquisitions still give rise to significant policy concerns . . . . The trend toward fewer and larger prime contractors has the potential to affect innovation, limit the supply base, pose entry barriers to small, medium and large businesses, and ultimately reduce competition—resulting in higher prices to be paid by the American taxpayer in order to support our warfighters.”¹³

Kendall called the Lockheed-Sikorsky merger “the most significant change at the weapon system prime level since the large scale consolidation that followed the end of the Cold War.”¹⁴

In the wake of the Lockheed-Sikorsky merger, DoD moved to assert its influence over DOJ, apparently frustrated with the decision DOJ made in the Lockheed-Sikorsky transaction. In January 2016, Undersecretary Kendall announced that a draft legislative proposal was available and would be circulated for review by Congress. Under this legislative proposal, existing antitrust laws would be changed to add a separate, independent national security review to the merger review process. This proposal also sought to give DoD the ability to block transactions that it believed would have a negative effect on national security.

DOJ clearly got the message, however, and on April 12, 2016, joined the FTC through a joint statement reaffirming a commitment to ensuring “that our military and innovative products at competitive prices over both the short- and long-term, thereby protecting both our troops and our nation’s taxpayers.”¹⁵ The statement briefly explains the application of the DOJ/FTC 2010 Horizontal Merger Guidelines (“Merger Guidelines”) to mergers in the defense industry, summarizing that the Merger Guidelines “are also sufficiently flexible to address DoD concerns that reductions in current or future competitors can adversely affect competition in the defense industry, and thus, national security.”¹⁶

The statement also emphasizes that DOJ and the FTC “rely on DoD’s expertise, often as the only purchaser, to evaluate the potential competitive impact of mergers . . . between firms in the defense industry. When assessing proposed consolidation in this sector, the overriding goal of the Agencies in enforcing the antitrust laws is to maintain competition going forward for the products and services purchased by DoD.”¹⁷ According to Defense News, in a statement from Pentagon spokesman Mark Wright, the DoD “welcomes the joint statement” as affirmation that the Merger Guidelines “provide enough flexibility to address DoD concerns that reductions in present-day or future competitors, including among weapon system prime contractors, can adversely affect national security.”¹⁸

This statement apparently struck the right note for DoD, as Undersecretary Kendall withdrew his legislative proposal in May 2016. According to a report from an event hosted by the Center for Strategic and International Studies, Undersecretary Kendall said he is “now persuaded that [legislation] is not needed.”¹⁹ A June speech from DOJ’s Acting Associate Attorney General Bill Baer further emphasizes this renewed coordination. In this speech, DOJ reemphasized the points made in the joint statement and recognized DoD as “the largest or only customer of [defense industry] firms, and sometimes price and other contractual terms can be locked in for a long period.”²⁰ Despite this, competition is still important so that “rivals compete to improve the quality of their offerings for the next round of contracting and for the next generation of products.”²¹ These statements serve to remind defense industry contractors that coordinating with both the antitrust agencies and the DoD is paramount to successfully concluding a merger.

**Advice for Clearing the Regulatory Hurdles**

Over the years, the balance of power in the defense industry may have shifted, but that doesn’t necessarily imply that there are any problems with the current review system. In some reviews, like the GenCorp/Rocketdyne acquisition, DoD’s views will clearly carry the day. In others, like the Lockheed Martin/Northrop Grumman transaction, the antitrust views are disposi-

---


¹⁴ Id.


¹⁶ Id.

¹⁷ Id.


²¹ Id.
tive. In fact, recent contractual awards and innovative developments, like Northrop Grumman’s newly announced aircraft fighter system, appear to confirm DOJ’s position. At the end of the day, parties should not look into the Lockheed Martin/Sikorsky transaction and assume that DoD might have a hard time persuading DOJ to bring aggressive cases. Generally, an assertive DoD should align with an overall aggressive position from the antitrust agencies.

With the potential for significant changes in defense spending, defense industry consolidation is likely to continue. At the same time, antitrust agencies will continue scrutinizing such mergers, as promised by the recently issued DOJ/FTC statement. Merging parties will need to carefully consider the best strategic defense arguments to make to DoD first, in light of necessary antitrust considerations that DOJ and the FTC will ultimately contemplate.

In order to clear the regulatory hurdles between the parties and the successful close of a defense industry merger, it is important to keep in mind the following considerations:

- Product and geographic markets will likely be narrow. Oftentimes, the only customer will be DoD. Additionally, because of national security concerns, the geographic market will likely be limited to the United States. These issues will become more important when combined with DoD’s position in the review driver’s seat.
- Due to the small number of large prime contractors, competitors are important in defense industry mergers. Messaging regarding DoD’s opinions of the parties’ position in the industry, and the position of the parties’ competitors, should be carefully considered. Additionally, the complex nature of defense systems means that competitors will often need to cooperate, or at a minimum, access specific systems owned by a competitor, to meet DoD’s contractual requirements. DoD understands this, and will make this point clear to the antitrust agencies.
- Remember vertical considerations. Subcontractors play a major role in most defense contracts. Prime contractors often find themselves managing many of their direct competitors acting as subcontractors. Therefore, DoD understands that consolidation will affect both the number of prime contractors and subcontractors available to compete for large contracts. These vertical operational considerations will continue even after a merger, when these contractors need to work together for the successful operation of the project.
- Efficiencies analysis will focus on multiple considerations, but most importantly, the needs of the DoD. Innovation is always an important efficiency due to the need to continually advance and develop new technologies for evolving world-wide defense concerns. However, beyond traditional antitrust efficiencies, there is a need to focus on defense-specific efficiencies, such as national security concerns and the need to maintain the industrial base and related capabilities.
- Divestitures will require strategic analysis. If a merger presents antitrust concerns, the antitrust agency may require divestitures in order to clear the merger. In this case, the parties will need to analyze DoD’s concerns as the customer, as well as defense budgetary considerations, in addition to standard competition considerations.