Antitrust Concerns In Defense Transactions Under Trump

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Law360, New York (December 7, 2016, 1:11 PM EST) --

President-elect Donald Trump has called for a dramatic increase in defense spending including purchases of new ships and warplanes as well as the addition of tens of thousands of new troops. This increase in spending generally bodes well for the aerospace and defense industry and potentially signals a new era of growth for companies in this space. This article examines how merger and acquisition transactions are likely to be reviewed in a Trump administration, with particular focus on “vertical” transactions.

**In Depth**

A Trump administration is likely to create a more favorable environment for M&A in the aerospace and defense industry. Stock prices of aerospace and defense industry participants have
seen significant increases with the S&P Aerospace & Defense index increasing more than 9 percent in the two weeks following the U.S. presidential election.

The substantial growth in this sector may make it a target for M&A activity and raises the question of how a Trump administration will address antitrust concerns in defense industry transactions. Trump has not been outspoken about his potential antitrust policies and was unpredictable throughout his campaign. Therefore, we can only speculate as to how his administration will approach antitrust enforcement. Nonetheless, the entrance of a Republican administration and a presumably pro-defense, pro-business president suggests a more permissive antitrust policy for transactions in this sector.

**Fewer Enforcement Actions and Less Focus on Vertical Theories**

Antitrust enforcement with respect to horizontal transactions — which combine two competitors at the same level of production — appears likely to remain stable. Past enforcement and the horizontal merger guidelines make clear that transactions which combine two players with significant market share and will likely limit the number of potential bidders for upcoming procurements will continue to receive diligent review by the antitrust regulators with input from the U.S. Department of Defense, which plays a vital role in the investigations of competition for future procurements. This theory of harm through horizontal concentration is a bedrock principle of antitrust enforcement that has been applied in Republican and Democratic administrations. Despite that consensus, at the margins, Democratic administrations tend to be more enforcement minded. At the end of the second Bush administration, for example, the U.S. Department of Justice chose not to challenge several transactions which it seems very likely that the Obama DOJ would have challenged, such as Whirlpool/Maytag and XM/Sirius.

On the other hand, it is likely that the Trump administration will reduce enforcement for vertical transactions. These are transactions that combine two players that do not compete against each other, but operate at different stages of production. Examples include a combination of a platform provider with a company that produces a payload used on that platform. Given the nature of the subcontracting and teaming relationships in the business, the aerospace and defense industry raises more vertical antitrust issues than most other industries. For this reason, a very high proportion of government challenges using vertical theories over the past several decades have involved transactions in the defense industry.

While it is not unprecedented for Republican administrations to bring a case alleging vertical harm to competition, such as Northrop Grumman/TRW under the Bush administration, these transactions generally receive less scrutiny under Republican administrations. Therefore, this is one area where a Trump administration is likely to reach different enforcement decisions than an Obama administration. Keep in mind, however, that the staff at the Federal Trade Commission and DOJ are not political appointees. This means that the same people will be investigating transactions under the Trump administration.

The staff generally will investigate the same competitive issues under the Trump administration that it would have investigated under the Obama administration, which means that vertical theories will remain part of the antitrust review process. The biggest difference is likely to be at
the leadership of the DOJ Antitrust Division and the FTC, where the “front office” leadership will switch from Democrat to Republican. Those leadership teams are less likely to authorize staff to challenge transactions raising more nuanced or novel issues, including vertical theories of harm. Thus, while investigations are not likely to be much different, we do expect to see differences in the ultimate enforcement decisions.

**Vertical Theories of Competitive Harm**

Even if vertical concerns are less likely to lead to a challenge under a Trump administration, they are still likely to be fully investigated. Therefore, it is important for businesses to understand exactly what vertical antitrust concerns are. Vertical analyses are often highly fact-specific, but there are several primary theories of competitive harm that the regulators will consider.

**Input Foreclosure**

Input foreclosure is the most straightforward vertical theory of anticompetitive harm. Input foreclosure arises when one company that provides a critical component or input (e.g., a payload) that is used by suppliers of a downstream product (e.g., an aircraft) combines with one of the downstream competitors. In this scenario, the transaction may provide the combined entity with the ability and incentive to deny, or raise the prices of, the key input to its downstream competitors and thereby reduce competition. In evaluating the competitive impacts of a transaction that presents a risk of input foreclosure, regulators will assess a number of factors to predict whether the company will have both the incentive and ability to deny the component to its rivals including:

- The availability of a competitive substitute supplier of the input
- Whether the downstream competitors can realistically turn to the alternative suppliers
- Whether the combined entity has the opportunity to increase its sales of the downstream product if it withholds the necessary input from competitors
- The relative revenues and profit margins available from the sale of the input component compared to the downstream product

It should be noted that antitrust regulators are not just examining the current products and production relationships between the parties, but also reviewing a transaction’s impact on product innovation. The regulators are concerned that the combined entity may have the incentive to raise the costs of developing new products for other competitors or foreclose these competitors from a vital innovation partner going forward. Key factors in this analysis will include the existing relationships between various players in the industry and the viability of other competitors as potential innovation partners.

**Customer Foreclosure**
Customer foreclosure arises when a very large purchaser of an input combines with a supplier of that input. If the large purchaser directs all of its purchases to its in-house supplier of the input, that may leave insufficient business opportunities for competing upstream suppliers of the input to operate at an efficient scale, thus reducing competition at the input level. A key factor in this analysis will be the portion of the demand for the input that is likely to be foreclosed by the combination.

**Improper Information Exchanges**

Perhaps the most common vertical concern arises when a company in an M&A transaction possesses sensitive proprietary information of a competitor to the other M&A transaction party. The risk here is that post-transaction the combined entity will now pass the sensitive information in-house and improperly use it, leading to a reduction in competition.

**Substandard Products through Selection Bias**

The concern here arises when an acquisition leads a downstream product supplier, which does not face significant competition in the downstream market, to opt to use its newly acquired in-house input rather than a competing input even though the in-house solution is inferior. The concern is this type of selection can create a lower-quality or higher-priced good and harms consumers of the downstream product.

**Remedies for Vertical Transactions**

If a transaction raises vertical concerns, the regulators will want to ensure a remedy is implemented to prevent anticompetitive effects from arising. In vertical transactions, remedies have often involved “conduct remedies” rather than requiring divestiture of one of the vertically related businesses.

Examples of conduct remedies are firewalls to prevent the misuse of competitively sensitive information, or nondiscrimination provisions requiring a critical input supplier to support multiple competitors. However, while regulators have been willing to accept these conduct remedies in the past, parties cannot assume that conduct remedies will always be accepted in the future. A senior DOJ official recently stated “[s]ome vertical transactions may present sufficiently serious risks of foreclosing rivals’ access to critical inputs or customers, or otherwise threaten competitive harm, that they require some form of structural relief or even require that the transaction be blocked.”

**Conclusion**

Parties considering M&A transactions in the aerospace and defense industry should continue to evaluate the potential for vertical antitrust concerns and be prepared to defend their transactions. While the Trump administration may be less aggressive than the Obama administration, the staff at the antitrust agencies are likely to pursue the same theories, and parties need to be prepared to counter those theories.
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