

Aerospace and Defense Series: DOJ and FTC Vertical Merger Guidelines Will Impact Government Contractors

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Last month, the Department of Justice Antitrust Division (DOJ) and Federal Trade Commission (FTC) released [updated Vertical Merger Guidelines in draft form](#). These guidelines provide a useful resource for aerospace and defense contractors involved in M&A transactions. Vertical competition issues frequently arise in this industry given the nature of the supply base and contracting and supply relationships between companies operating at different levels of the supply chain.

This is the first time the antitrust agencies have released updated guidelines for analyzing vertical mergers since 1984. Although the agencies have updated the Horizontal Merger Guidelines several times since then (most recently in 2010), they have not provided similar updated guidance to businesses regarding vertical merger enforcement until now. The new guidelines summarize the practices, standards, and theories the agencies have used in evaluating vertical mergers for a number of years. Although the guidelines do not signal any shifts in current agency practice, they do provide the business community greater transparency about how the agencies analyze vertical mergers. This is helpful for the aerospace and defense industry, which is particularly susceptible to vertical competition issues given the heavy reliance on contracting out important elements at different levels of the supply chain.

Background

The most common competitive issue in merger enforcement is horizontal consolidation, which occurs when two firms that compete to supply the same product or service combine. An example of horizontal consolidation would be if two suppliers of tactical missiles to the US government merged. The agencies' Horizontal Merger Guidelines address this type of consolidation. The new draft guidelines address *vertical* consolidation, which occurs when two companies at different levels of the same supply chain combine. For example, if a missile supplier were to acquire a company that produces infrared seekers that are incorporated into missiles, this would be considered a vertical transaction.

Vertical mergers can raise competitive concerns because they have the potential to reduce competition if the vertically integrated firm could act in a manner that makes it more difficult for rivals

to compete. The agencies frequently have taken action to address competitive issues raised by vertical consolidation in the aerospace and defense industry. One recent case was [Northrop Grumman's acquisition of Orbital ATK](#). Northrop Grumman was one of only a few companies capable of supplying missile systems to the US government. Orbital ATK was the premier US supplier of solid rocket motors (SRMs), which are an essential input for missile systems and propel missiles to their intended targets. The FTC concluded that acquiring Orbital ATK would allow Northrop Grumman to harm competition for missile prime contracts by denying its competitors access to Orbital ATK SRMs or increasing SRM prices to its competitors. The FTC was also concerned that the acquisition would give Northrop Grumman access to the competitively sensitive information that its missile competitors shared with Orbital ATK. To address these concerns, the FTC required Northrop Grumman to supply SRMs to its missile competitors on a non-discriminatory basis, and to establish a firewall between Orbital ATK's SRM business and the rest of the merged company. The agencies have applied similar principles and theories in many other vertical transactions in the aerospace and defense industry.

The New Guidelines

For the most part, the new vertical merger guidelines describe the theories and analytical tools the agencies have already applied in cases like Northrop Grumman/Orbital ATK.

Theories of Competitive Harm

The guidelines discuss several types of competitive harm that can result from vertical mergers. The primary theories of harm set forth are: (1) raising rivals' costs, (2) foreclosure and (3) access to competitively sensitive information.

1. **Raising Rivals' Costs.** The guidelines explain that a vertical merger may allow "the merged firm to profitably weaken . . . one or more of its actual or potential rivals in the relevant market by changing the terms of those rivals' access" to necessary inputs. If a merger combines an input supplier with a downstream customer, then the merged company may have the incentive and ability to supply the input to the downstream customer's competitors on less favorable terms than prevailed prior to the combination. This type of concern often arises in the aerospace and defense industry when a company that competes at the prime level for a platform combines with a company that supplies an input for that platform. For example, if a sensor supplier were to combine with a company that makes aircraft incorporating sensors, then the merged company might be able to raise the price of sensors for competing aircraft suppliers. Raising rivals' costs could make it harder for them to compete and result in worse outcomes for customers.
2. **Foreclosure.** Foreclosure is a more extreme variant of the raising rivals' costs theory. Rather than supplying an input on less favorable terms to its rivals, the merged company might simply refuse to supply the input entirely. Taking the same example, the sensor supplier might stop supplying sensors to the merged company's aircraft rivals. This type of foreclosure is referred to as "input foreclosure." Without access to the key input, the rival cannot offer any competition to the vertically integrated firm. The agencies also consider another type of foreclosure, known as "customer foreclosure," in reviewing vertical mergers. If a dominant purchaser of a product combines with a supplier of that product and then purchases only from itself, other suppliers of that product may not be able to compete because so much of the customer sales base is foreclosed to them. Input foreclosure concerns arise far more frequently than customer foreclosure concerns in merger reviews. The guidelines lay out four

key conditions for raising rivals' costs or foreclosure theory. All of these conditions are relevant to evaluating whether a merged company is likely to have both the ability and the incentive to execute a foreclosure strategy.

1. **The foreclosure makes it more difficult for the company that is foreclosed to compete effectively.** For example, if an aircraft supplier can no longer bid on a prime contract because it has been foreclosed from obtaining an essential sensor, then this foreclosure would make it impossible for the aircraft supplier to compete. Making a strong foreclosure argument requires showing that the merged firm's rivals need the foreclosed item to compete and cannot obtain it from another source. In practice, the DOJ and FTC investigate thoroughly whether there are strong alternative sources of supply.
2. **The newly merged firm is likely to win more business if it denies the input to its rival.** The agencies will inquire about whether a foreclosure strategy would benefit the merged company. For example, if there are five viable prime contractors and only one of them faces the potential foreclosure of an input because the other four have multiple viable alternative sources for that input, then it is unlikely that the merged company will execute a foreclosure strategy. Even if the merged company were to withhold the input from one rival, it will face strong competition from three others and therefore may not win the prime contract. It would be harder to make a foreclosure argument under those conditions than it would be if there were only two prime contractors, and one of them would need to obtain the key input from its rival post-merger.
3. **The merger or acquisition makes the foreclosure strategy profitable, when it would not have been premerger.** To have a viable foreclosure theory, the government needs to show that the foreclosure opportunity arises because of the transaction. That is, premerger, the key input supplier would be incentivized to act as a merchant, and post-merger, when it is vertically integrated, it will be incentivized to withhold the key input because that might enable it to win a much larger prime contract.
4. **The impact of the foreclosure is meaningful and not *de minimis*.** The item that could be foreclosed needs to have the potential to significantly influence the prime contract award.

3. **Information Sharing.** The guidelines discuss an additional type of harm that can arise from vertical mergers: "[T]he combined firm may, through the acquisition, gain access to and control of sensitive business information about its upstream or downstream rivals that was unavailable to it before the merger." For example, an aircraft supplier could gain access to sensitive business information about its rivals by acquiring a sensor maker that supplies to those rivals. The mere fact of information access is not sufficient to cause competitive concerns. That access could violate trade secrets or confidentiality obligations, but that is a different question than whether the access will lessen competition. In some circumstances, access to a rival's competitively sensitive information may lead the merged company to take actions that lessen competition, such as reducing its R&D spending in favor of freeriding off of its rival's information. The government looks not only to the access to information but also to the way in which that access will reduce competition compared to the premerger world.

Historically, the agencies have resolved this type of concern by imposing consent decrees that require firewalls. Whether these types of firewalls remain a viable remedy is in question because the DOJ under the Trump administration has a firm policy to insist on structural remedies (*i.e.*, divestitures), rather than conduct remedies such as firewalls.

Efficiencies

The updated guidelines also acknowledge that vertical mergers, because they combine “complementary economic functions,” can create efficiencies that benefit competition and consumers. In particular, the guidelines discuss efficiencies under the economic theory of the “elimination of double marginalization.” If an input supplier takes a profit and a downstream supplier that uses the input also takes a profit, then there are two profit margins built into the price the customer pays. After a merger, the combined, vertically integrated entity will only take a single profit, which may provide more flexibility and incentive to reduce pricing. In the aerospace and defense industry, arguments that a merger will eliminate “profit on profit” because of government contract regulations can be a strong argument that a merger is procompetitive. Any such efficiencies ultimately need to be weighed against any potential anticompetitive impacts.

No Presumption of Anticompetitive Effects

A key difference between the Horizontal Merger Guidelines and the new draft Vertical Merger Guidelines relates to presumptions. In a horizontal merger of rivals, if the companies have sufficient market share (or are two of few bidders), the government and courts will presume that the transaction is unlawful, and the merging parties must overcome that presumption, which is extremely difficult. The new Vertical Merger Guidelines include no such presumption for vertical mergers, which is consistent with the case law.

The new guidelines indicate transactions are unlikely to create competition concerns if the companies have a share of less than 20% in the relevant markets. For example, if a sensor producer were to merge with a supplier of aircraft that integrate sensors, their merger would be unlikely to create competition concerns if the aircraft supplier had less than 20% of the aircraft market (however defined), and the other party’s sensors were used in less than 20% of the aircraft in that market. This provision is not intended to be a hard-and-fast rule. The guidelines merely state that the agencies are “unlikely to challenge” a vertical merger that falls in this category and note that some mergers with shares below the thresholds “can give rise to competitive concerns.” However, the 20% thresholds are valuable in analyzing the antitrust risks of vertical transactions.

Conclusion

While the new guidelines provide greater transparency to the business community, they embody principles that the regulators have already been applying to vertical merger situations and likely will not change how the agencies review vertical transactions. As before, the most important issues in analyzing vertical mergers are *ability* and *incentive*. Parties to vertical mergers should consider the following questions:

- Will the transaction provide a party the *ability* to foreclose an input to a competitor, or offer the input on less favorable terms?
- Will the transaction provide a party the *incentive* to foreclose the input, or offer it on less

favorable terms?

The regulators remain focused on these two questions in reviewing vertical transactions in the aerospace and defense and other industries.

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