

Expanded Scrutiny Of Defense Deals Raises Scope Concerns

By **Daniel Wilson**

Law360 (January 12, 2024, 8:14 PM EST) -- An inconspicuous portion of the 2024 legislation establishing U.S. Department of Defense priorities grants the agency greater ability to scrutinize mergers and acquisitions, but knowing which deals will merit close inspection is a guessing game without regulatory guidance.

Section 857, buried on Page 211 of the nearly 1,000-page National Defense Authorization Act, mandates that companies involved in a potential merger or acquisition within the defense industrial base provide notification and supplemental information to the DOD, if they are currently required to make such notifications to the U.S. Department of Justice and Federal Trade Commission under the Clayton Act, an antitrust law.

Until now, the DOD office tasked with scrutinizing M&A deals has had to rely heavily on the FTC and the DOJ for information about relevant transactions, and receiving information directly from private businesses could increase its ability and readiness to help prevent a small number of companies from dominating the defense space.

However, the brief 67-word paragraph in the NDAA does not specify if notifications to the DOD's M&A office should be made at the exact same time as notifications to the DOJ and FTC, and the language regarding which specific deals could trigger the requirement to notify the DOD is ambiguous.

"That is really the thing to watch out for — to see what the scope of this is where the mandatory filings are triggered," Crowell & Moring LLP counsel Michael Samuels said.

An existing DOD directive states that deals involving a "prime contractor of a major system" should be reviewed by its M&A office, but that requirement is not otherwise mandated in law or regulation.

And even though Section 857 refers to concurrent notifications to the DOD, DOJ and the FTC within an antitrust review period, experts said it remains unclear if the notifications have to be made at the exact same time or at different times during that time frame.

The expectation for providing information to the DOD is particularly murky when an antitrust agency proactively reaches out for further information from the parties involved in a proposed transaction, according to Covington & Burling LLP partner Ross Demain.

"There's ... a question around the provision of information in the sense that parties who receive a

second request from the DOJ or the FTC frequently will provide information to the reviewing agency over a period of weeks, or months, or longer, and how promptly information provided to the antitrust agencies needs to be provided to the Department of Defense," Demain said.

That lack of clarity could limit the amount of insight the DOD can actually provide within the review window if the agency isn't careful when crafting its future regulations to implement Section 857, and potentially cut against lawmakers' intent for the section, Samuels said.

The DOD and lawmakers have frequently raised concerns in recent years about consolidation in the defense industry, citing potential issues such as higher prices, supply chain gaps and reduced innovation. According to a February 2022 DOD report, the number of prime contractors supporting the department's weapon system programs dropped from 51 during the 1990s to five at the time of the report.

But the department's M&A office, which scrutinizes proposed defense-related deals and suggests adjustments and mitigations to antitrust regulators, has very limited resources, with only two or three staff members at any given time, according to an October 2023 U.S. Government Accountability Office report.

That leaves the office reliant on referrals from the DOJ and FTC when deciding which deals to scrutinize, and those antitrust agencies are statutorily limited in how much information they can share, don't always reach out to the DOD straight away, and sometimes don't recognize when a proposed merger or acquisition has a potential defense component and therefore don't reach out to the DOD at all, the GAO said.

Section 857 appears to help the DOD bypass those hindrances, and boost the number of deals scrutinized by the DOD's M&A office — currently about 40 on average of the estimated 400 M&A transactions each year involving the defense industry, according to the GAO.

"I think the idea, certainly, is that [the DOD] would review a greater number of transactions, because the resources can be entirely focused on the review rather than locating the transactions in the first place," Samuels said.

Whatever the exact parameters of a Section 857 rule, the prospect of increased DOD scrutiny over M&A deals means greater pressure on companies considering mergers or acquisitions to conduct due diligence and proactively "head off any concerns that might arise as a result of the information sharing," said Alexander Hastings, of counsel at Covington & Burling.

"I think it underscores the importance of [preparation] in these transactions that involve a target operating in the defense industrial base," he said.

--Editing by Robert Rudinger.