Business Combinations Desk Book

Deputy Under Secretary of Defense
(Industrial Policy)

Deputy General Counsel (Acquisition & Logistics)

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Please send comments, suggestions, and questions associated with this deskbook to: Stephen Hull, Office of the Deputy Under Secretary of Defense (Industrial Policy), 3330 Defense Pentagon, Washington, DC 20301-3330. (703) 601-0058.

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1 Introduction

Department of Defense (DoD) research, development, and acquisition policies, funding and program decisions, have a major impact on competition and industry transformation. DoD assessments of proposed business combinations (generally, domestic and foreign firm mergers, acquisitions, and joint ventures) must complement such policies and decisions to sustain credible competition in an evolving industrial environment.

This deskbook describes the process that the Department of Defense uses to ensure that its evaluations of proposed business combinations:

- facilitate the creation and maintenance of a competitive, cost-effective industrial base;
- protect the industrial and technological capabilities needed to supply critical warfighting products;
- provide a robust foundation from which DoD decision makers can develop a Department view;
- provide a timely, fair review for the companies (parties) involved; and
- ensure a single DoD voice within the interagency review process and a coordinated U.S. Government position to the companies.

The processes described in this deskbook are analytically rigorous yet sufficiently flexible to take into account the unique circumstances of individual business combinations in the 21st Century. The Department and the industrial structure on which it depends are changing from the platform-centered warfighting capabilities of today to the network-centered warfighting capabilities the nation will employ in the future. Operations Enduring Freedom and Iraqi Freedom underscored the need for multi-dimensional, unconventional, and transformational warfighting capabilities to sustain the nation's security. The concept of warfare is being transformed, warfighting capabilities are being transformed, and the industry that will support defense will transform as well.

The implications of transformation are clear. The unique ideas and products of less traditional, and potentially smaller, companies will be increasingly important for transformational warfare; and the future defense industrial landscape may be significantly different from today's because of their importance and contributions.

The Department's challenge is to match the innovative capabilities of its suppliers with a defense industrial strategy that provides beachheads and bridges – not barriers – to their effective participation. It must establish, maintain, and strengthen industrial relationships that ensure that

the defense industrial base is both healthy and vital. In doing so, the Department also must balance the need to encourage competitive forces for innovation with the need to permit companies to scale up or combine with other firms to create new industrial capabilities essential for future warfare. Such flexibility is essential if the Department is to capitalize on the revolutionary technologies of tomorrow.

Compounding the challenge, national borders increasingly are irrelevant to how businesses are organized and staffed. Among the consequences of industrial consolidation and globalization are multinational companies with interlocking corporate boards and production presence in multiple countries. By-products of industrial consolidation and globalization also include the possible loss of domestic industrial capabilities, and an increasing degree of mutual defense interdependence between the United States and its allies. In recognition of this interdependence, the Department now participates in reviews of proposed mergers between non-U.S. firms when the defense material provided by those firms has significant U.S. DoD applications.[1]

This deskbook provides procedural guidance and context for the Department's review of business combinations involving defense suppliers. The concepts, processes, and analyses described herein apply to:

(1) proposed mergers or acquisitions for which filings have been made pursuant to the Hart Scott Rodino Antitrust Improvement Act of 1976;

(2) proposed acquisitions of U.S. defense contractors by non-U.S. firms for which filings have been made pursuant to the Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988; and

(3) other collaborations (joint ventures, mergers and acquisitions) among competitors that have been made public that are of special interest to the Department that do not meet the Hart Scott Rodino Act filing threshold (currently, transactions valued at more than $50 million) or have not been filed with CFIUS.

[1] European Union and U.S. Antitrust Agencies have agreed to review large mergers with international impacts, simultaneously. Although there is no guarantee that decisions of the European and U.S. regulators would be identical, parallel reviews permit differences of opinion to be surfaced and addressed earlier than would be the case for serial reviews.

2 Defense Business Combinations in the 21st Century

2.1 The Importance of Competition

Robust, credible competition is vital to providing the Department with high quality, affordable, and innovative products. Competition produces innovation and industrial efficiencies that lead to improved affordability. The innovation that competition stimulates in defense markets is paramount in an unsafe world where technological superiority on the battlefield provides critical military advantage. DoD's responsibility is to foster an appropriate enabling framework for industrial development and competition in defense markets that are marked by dynamic change. The Department believes that the competitive pressure of the marketplace is the best vehicle to shape an industrial environment that supports the defense strategy. Therefore, the Department of Defense takes action to intervene in the marketplace only when necessary to maintain appropriate competition and develop and/or preserve industrial and technological capabilities essential to defense that the marketplace, left unattended, would not.

2.2 Consolidation and the Market

Consolidation is a normal market response to reduced demand. The post-Cold War defense budget drawdown of the 1990s has been the single greatest influence on today's significantly consolidated defense industry. Defense procurement spending dropped almost 70 percent between the Cold War high in 1985 and the defense budget trough of 1998. The result was fewer major new programs with longer intervals between starts and lower production quantities per program. Industry responded by consolidating. Firms concentrated horizontally at the prime and sub-tier levels and gained more vertical integration capabilities than in the past. The result is fewer domestic prime contractors and major sub-system providers. Consolidation also reduced industry overcapacity and increased capacity utilization – reducing overhead costs allocated to DoD programs – and saved money.

The Department of Defense has no blanket policy of discouraging further consolidation or divestiture, or encouraging a specific industry structure. The Department evaluates each proposed transaction on its particular merits in the context of the individual market and the changing dynamics of that market. For example, a consolidation from five suppliers to four in a product market raises fewer complex issues than a change from three to two. Accordingly, mergers in some market segments may raise competitive issues while mergers in other segments may not. Therefore, while DoD's standards remain constant, prime contractor level mergers in a concentrated industry are more likely to raise competitive concerns than would be the case in an industry that is not so concentrated. Nevertheless, there appears to be sufficient competition to permit consolidation in some product areas – especially in less-concentrated 2nd, 3rd, and lower tiers – without raising competitive concerns.

Conversely, as new companies emerge around new defense requirements, the Department will monitor acquisitions involving limited sources of critical technology to ensure that new industry sectors can flourish and grow. In addition, as the Department increasingly focuses its weapons systems requirements and acquisition processes on operational capabilities sectors and

not platforms, reviews of financial transactions affecting the structure of the defense industrial base will also be viewed in the context of these broader system-of-system sectors.

2.3 Sustaining Competition in the 21st Century

Sustaining competition to meet the transformational warfighting requirements of the 21st Century poses special challenges. As the defense industry evolves, the Department seeks to sustain effective competition by considering several factors:

- As the Department moves from platform-centered warfighting capabilities to sensor/network-centric capabilities, the need to develop and sustain industrial and technological capabilities for legacy systems will decline, as will the need to maintain platform competition after DoD awards last-of-type platform program contracts.

- New entities may gain horizontal and/or vertical capabilities that permit them to provide netcentric, transformational, or system of system solutions to defense needs that were not previously possible.

- Conversely, the primacy of information technology capabilities will heighten interest in potentially anticompetitive aspects of vertical integration resulting from proposed business combinations. Vertical integration could impact the Department's ability to mix and match industry-best information/sensor capabilities that might reside in competing firms.

- As a consequence of worldwide defense industry consolidation and collaboration, the Department must determine the effects of competition from non-U.S. defense firms on the anticompetitive risks associated with U.S. defense firm combinations.

- The Department also must assess whether foreign firm acquisitions of U.S. defense firms likely will result in the transfer of critical technologies from the U.S. industrial landscape or move the strategic direction of the acquired firm away from U.S. national security priorities.

- Finally, it will be difficult to forecast all of the industrial and technological capabilities necessary for DoD's desired transformational warfighting capabilities, and the Department will likely have an interest in traditionally "non-Defense" sectors such as media and pharmaceuticals.

2.4 DoD and the Shape of the Defense Industry

As the principal customer, DoD influences the shape of the defense industry through its research, development and acquisition plans, budgets, evaluations, and decisions. They focus the market demand DoD's decisions take a long view on competition. In the case of potential last-

of-type platforms such as Joint Strike Fighter, for example, DoD selected from one industry team in order to minimize costs and maximize program efficiency. Its winner-take-all acquisition strategy decision was not anticompetitive. Rather, it reaffirmed DoD's recognition of the need to focus the resources of the tactical fighter industry on unmanned and other futuristic systems.

While market forces and a strong budget normally sustain credible competitive sources, for some critical defense products the number of suppliers may be limited. In the past several years, to try to overcome such limitations, the Department has taken steps to broaden of reliable sources globally. As the Department transforms warfare, and portions of the defense industrial base "right-size" themselves, domestic industrial base in certain mature product areas may become unsustainable and competition from abroad may complement a remaining U.S. source. On the other hand, new entrants to the defense industrial base may represent sole sources of transformational technologies until sufficiently large requirements induce other competitive sources.

The Department also participates in Executive Branch reviews of proposed business combinations that, in fact, have the authority to intervene in the market – by blocking the combination – where necessary to preserve competition and industrial and technological capabilities. The Department participates in reviews conducted by antitrust agencies for proposed mergers or acquisitions under the Hart-Scott-Rodino Antitrust Improvement Act and on reviews conducted by the interagency Committee on Foreign Investment in the United States (CFIUS) for proposed foreign acquisitions of U.S. defense contractors.

Evaluating the consequences of a proposed business combination can be done only on a case-by-case basis. There is no single criterion for all occasions. Given the consolidated industrial structure and a constrained defense modernization budget, the Department must be vigilant to ensure that its actions foster an environment that develops and sustains a sufficient number of capable competitors in core defense markets.

3 DoD Mergers and Acquisitions (M&A) Reviews

3.1 The Hart-Scott-Rodino Antitrust Improvement Act of 1976: Process Timelines

Mergers and acquisitions are subject to regulatory review to enforce several legislative acts regarding anticompetitive behavior. For example:

- Section 7 of the Clayton Act (prohibited if their effect "may be substantially to lessen competition, or to tend to create a monopoly.");
- Section 1 of the Sherman Act (prohibited if they constitute a "contract, combination . . . , or conspiracy in restraint of trade."); and
- Section 5 of the FTC Act (prohibited if they constitute an "unfair method of competition.").

The antitrust laws are enforced by both the Federal Trade Commission's (FTC's) Bureau of Competition and the Antitrust Division of the Department of Justice (DoJ). Additional information about the antitrust agencies and the process can be found at http://www.ftc.gov/ftc/antitrust.htm and at http://www.usdoj.gov/atr/. In order to prevent duplication of effort, the two agencies consult before opening any case and "clearance" is granted to an agency.

The Hart-Scott-Rodino Antitrust Improvement Act provides filing requirements and time periods for companies (parties) proposing mergers. A generalized timeline is shown in Figure 1. The time periods encourage the antitrust agencies to expedite their investigation and enforcement decisions. For mergers or acquisitions above a certain size (currently, $50M), the parties must provide prior notification, via a premerger filing, to the FTC and the DoJ. The premerger filing includes general information about the companies involved, the lines of business in which the companies are engaged, and the proposed transaction. Once filings have been submitted, either the FTC or DoJ reviews the proposed transaction for possible antitrust concerns. The transaction thresholds for filing premerger notification under the Hart-Scott-Rodino Act do not preclude antitrust review and enforcement for transactions below the thresholds. In addition, the antitrust agency can review and file suit for anticompetitive combinations after a merger has taken place.

Once filings are submitted, companies wait an initial 30 days (15 days for an all-cash transaction) while the antitrust agency conducts its investigation. The companies may consummate the merger or acquisition at the end of the waiting period or earlier if the antitrust agency terminates its review. The antitrust agency may extend the period by issuing a request for additional information (a "second request") to both parties prior to expiration of the initial Hart-Scott-Rodino review period. The second request extends the period until all parties have complied with the request (or, in the case of a tender offer or a bankruptcy sale, after the acquiring person complies). This additional time provides the reviewing agency with the opportunity to analyze the information and to take appropriate action before the transaction is consummated.

Once the merging parties certify satisfactorily that they are in substantial compliance with a second request the antitrust agency has 30 days to bring an action to block the proposed transaction in federal court; seek remedies that would mitigate antitrust objections; or allow the merger. In the case of a cash offer, the reviewing agency has 15 days from substantial compliance take action. If the reviewing agency believes that a proposed transaction may substantially lessen competition, it may seek an injunction in federal district court to prohibit consummation of the transaction. If no action is taken within the allotted time period, the parties may consummate the transaction.

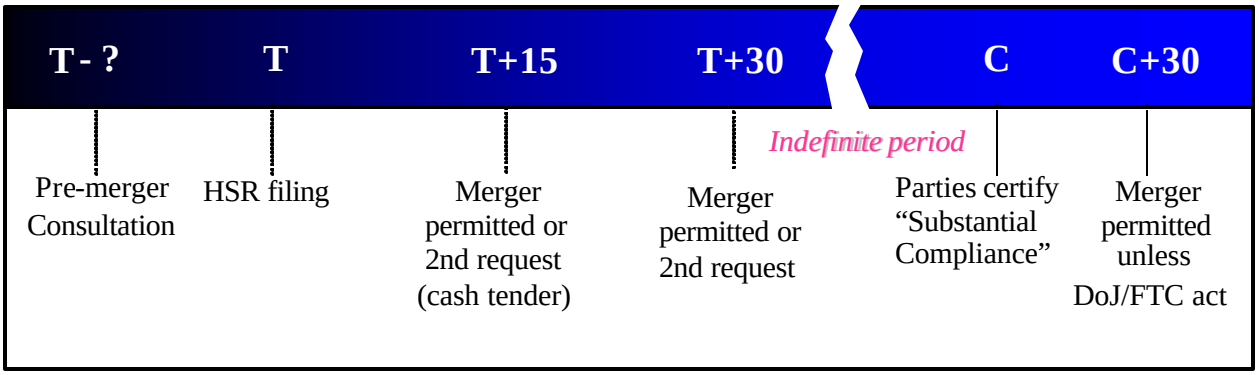

Figure 1 – Hart-Scott-Rodino Timeline

3.2 The Department and Antitrust Reviews

Prior to 1994, the Department generally did not take formal positions with the antitrust agencies on proposed mergers or acquisitions. However, in 1994, in the midst of significant industry consolidation, the Department chartered the Defense Science Board Task Force on Antitrust Aspects of Defense Industry Consolidation to advise how it should formulate and express its views on proposed mergers. The Task Force report (which can be found at http://www.acq.osd.mil/dsb/antitrust.pdf) noted that, over the previous 20 years, the Department had not taken a formal position supporting or opposing mergers except those that led to foreign ownership of vital technologies. The report further noted that, in the past, individual DoD employees often expressed their opinions; and that, in several instances, DoD officials took opposing positions on the same transaction. The Task Force report concluded that competition in the defense industry differs from commercial industry, and that flexibility in the antitrust merger guidelines would allow the antitrust agencies to consider unique defense circumstances in their evaluations. The report recommended that the Department establish an institutional capacity to assess mergers and then communicate its views on a transaction to the antitrust agencies.

The Department agreed with these recommendations and promulgated related polices, responsibilities, and protocols in DoD Directive 5000.62, *Impact of Mergers or Acquisitions of Major DoD Suppliers on DoD Programs* (October 21, 1996) (which can be found at http://www.acq.osd.mil/ip/docs/5000_62.pdf). This directive states that the Department opposes mergers or acquisitions that create unhealthy or unfair competition for DoD systems,

components, and services. However, it also provides for mitigation measures and enforcement mechanisms that can and allow transactions to go forward.

3.3 DoD's Internal Review Process

As the primary customer impacted by defense business combinations, DoD's views are particularly significant because of its special insight into a proposed merger's impact on innovation, competition, national security, and the defense industrial base. Department reviews also provide a robust foundation from which DoD decision makers can develop a uniform view; provide a timely, fair review for the parties involved; and ensure a single DoD voice to the antitrust agencies and a coordinated U.S. Government position on the transaction. Accordingly, the Department has established a formal, rigorous, internal process to develop and communicate its views on proposed transactions to the antitrust agencies. Business combinations that do not meet the HSR filing thresholds but that might adversely affect the competitive landscape, such as joint ventures, teaming arrangements, acquisitions of foreign companies by U.S. companies, and acquisitions of U.S. firms by foreign entities, may also be reviewed using this process. In cases where the acquiring company is foreign, the review of the competitive implications will be done in conjunction with the Exon-Florio/CFIUS review outlined in Section 4.

There are three categories into which most proposed transactions fall: readily resolvable cases, moderate interest cases, and high interest cases. The Department's review process uses graduated "gates" to determine the category and level of the concern, and the level of decision-making and coordination required to establish the Departments' position. Figure 2 summarizes this process. The three types of reviews are:

- Initial Reviews to make early identification of potential interests;
- Comprehensive reviews to identify, clarify, and resolve potential issues; and
- Joint consultation committees to conduct high interest reviews with particularly significant concerns.

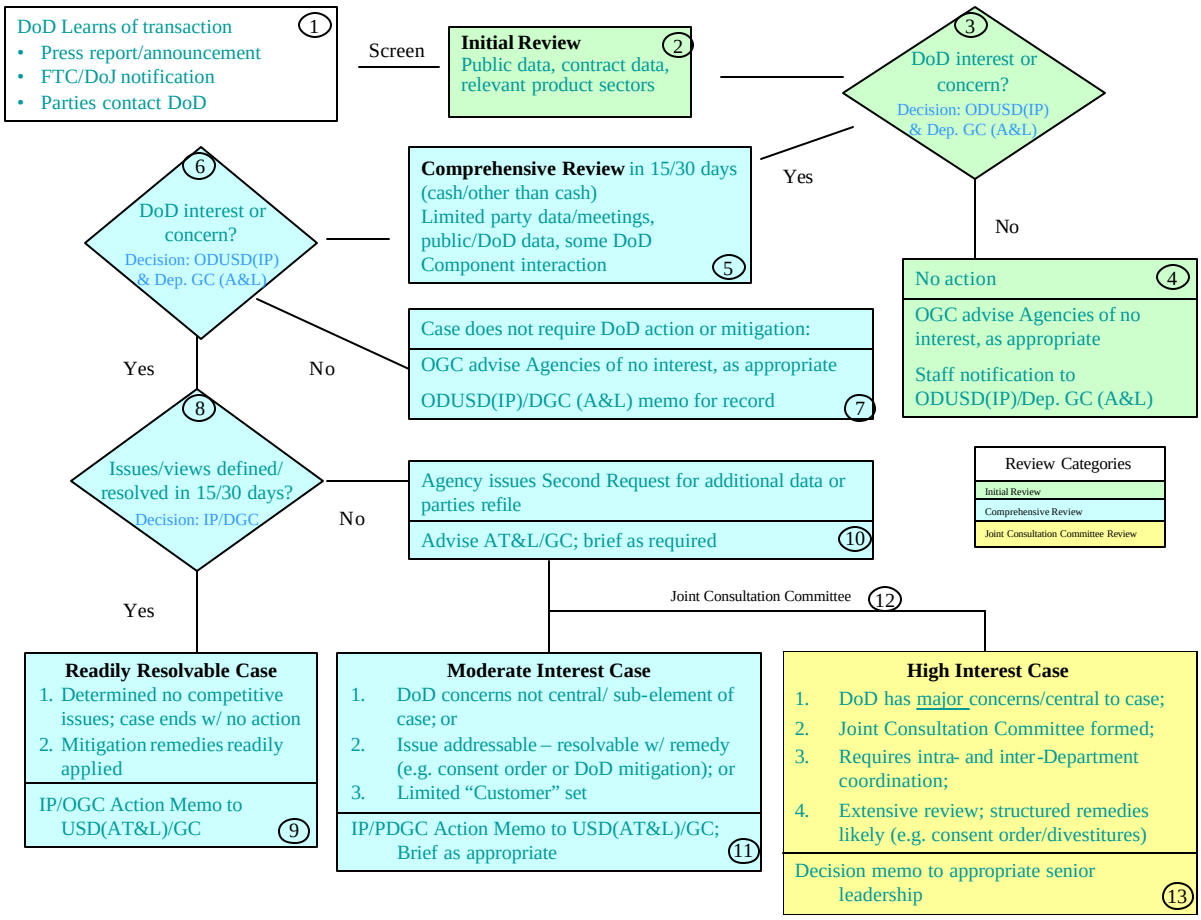

Figure 2 -- DoD Review Process Flow

3.3.1 Initial Reviews

When parties make a Hart-Scott-Rodino Act filing, a transaction is identified through public announcements, or when the companies inform the Department (step 1), DUSD(IP) and DGC(A&L) representatives begin an Initial Review to determine whether there may be further interest in the transaction (step 2). As there are numerous defense-related mergers (InfoBase Publishers, Inc. tracked 252 in 2002 and 343 in 2001), many are screened out as not meriting further review.

Representatives of the DoD Deputy General Counsel for Acquisition & Logistics (DGC[A&L]) and the Deputy Under Secretary of Defense for Industrial Policy (DUSD[IP]) typically evaluate publicly-available information and contact appropriate DoD Component personnel. If the Initial Review determines that DoD has little interest in or concerns for the matter, a DGC(A&L) representative can advise the antitrust agency as needed and the Department will terminate its review (steps 3 & 4).

3.3.2 Comprehensive Reviews

Once an Initial Review identifies potential interests or concerns, DUSD(IP) and DGC(A&L) representatives begin a more in-depth Comprehensive Review (step 5). The representatives, in coordination with the antitrust agency:

- Advise the Under Secretary of Defense for Acquisition, Technology & Logistics (USD[AT&L]) and DoD General Counsel (DoD GC) that the review has begun.

- Ask the appropriate DoD Components to provide preliminary information and concerns; and make personnel available to support the review as necessary.

- Establish a team, as needed, that will draw on the DoD Components to obtain factual information from, and conduct interviews with, DoD program and contractor product and technology experts.

If as a result of the comprehensive review DUSD(IP) and Deputy GC(A&L) reach agreement and find that the Department does not have a significant concern, the matter is closed and its views are provided to the antitrust agency (steps 6 & 7). Similarly, if concerns are identified and resolved within 30 days (15 days for an all cash transaction), the case is closed as a "Ready Resolvable" and its views are provided to the antitrust agency (steps 8 & 9).

For these Comprehensive Reviews, the Department will attempt to complete its analysis and provide its views to the antitrust agency in advance of the agency issuing a "second request" to the parties. However, if the concerns are significant enough to require additional information, the antitrust agency will issue a second request for information (step 10).

If the Department's concerns are resolved with a remedy, the case is closed as a "Moderate Interest Case" and its views are provided to the antitrust agency (step 11). If the case is exceptionally critical, and the Department has major concerns that require broad participation of Senior DoD officials to formulate the position on the transaction a Joint Consultation Committee may be formed – step 12), These "High Interest" matters (step 13) are described next.

3.3.3 Joint Consultation Committee High Interest Case Reviews

The DUSD(IP) and the DGC(A&L) may recommend that certain transactions (based on complexity, value, potential impact on DoD, criticality of technology, and national security issues) be reviewed more actively by a larger group representing various technical and business interests in the Department. In such cases, the Department generally will use a review process similar to the process summarized in Figure 3 below. The joint committee is used to assure that all necessary information is gathered in a systematic, efficient manner to provide advice and counsel to the Department decision makers. The review process depicted is a notional construct with notional timelines.

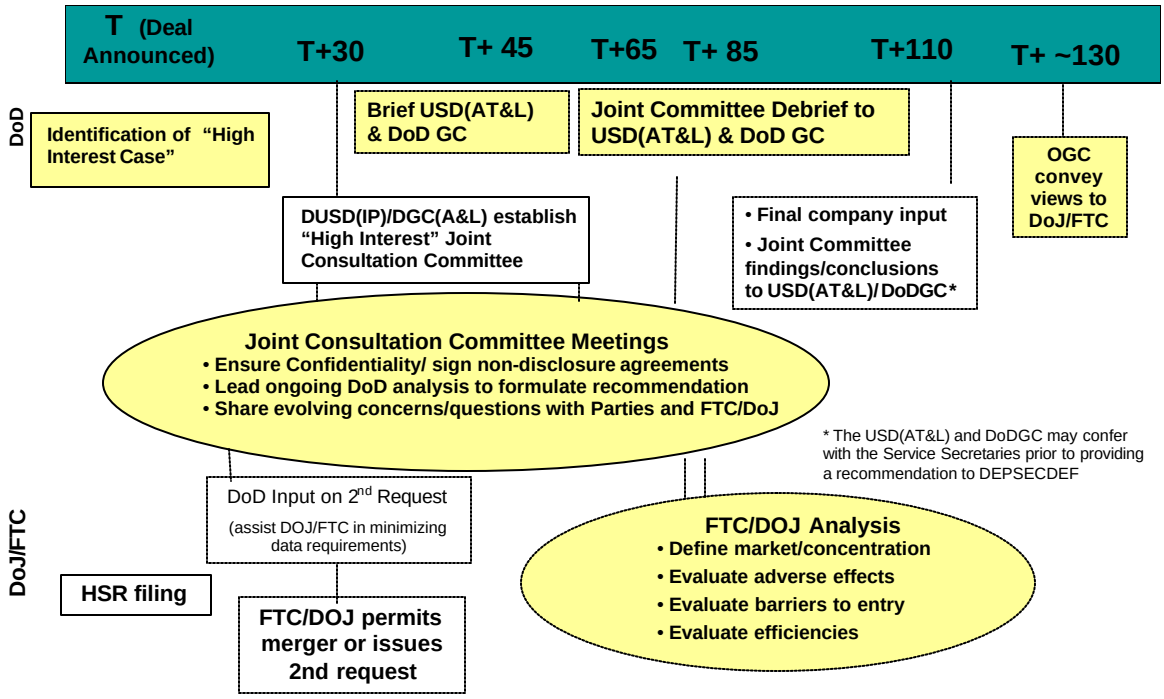

Figure 3 - High Interest Case Process Flow

3.4 Antitrust Agency Review Considerations

The DoD conducts its review concurrently and collaboratively with the responsible antitrust agency. The antitrust agencies evaluate the:

- Market and market concentration. Further analyses are generally not required when mergers do not significantly increase market concentration or the largest firm's market share.

- Potential adverse competitive effects of the merger. Market concentration affects the likelihood that one firm, or a small group of firms, could successfully exercise market power to the detriment of the customer(s) in the form of less innovation, higher prices, and/or reduced availability.

- Extent to which entry barriers discourage new entrants. A merger is not likely to create or enhance market power or to facilitate the exercise of market power if entry into the market is so easy that the pricing power of the acquirer could be diluted easily by other participants.

- Efficiencies and other benefits of the merger. Efficiencies generated through merger can enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products.

3.5 DoD Review Considerations

The Department's review process ensures that DoD's senior leaders are appropriately engaged in a rigorous, disciplined, and expeditious review of business combinations.

DoD reviews are managed as a deliberative process in anticipation of litigation and conducted under strict confidentiality standards. They are structured to identify impacts on national security and on defense industrial capabilities; evaluate the potential for loss of competition for current and future DoD programs, contracts and subcontracts, and for future technologies of interest to the Department; and address any other factors resulting from the proposed combination that may adversely affect the satisfactory completion of current or future DoD programs or operations. The following considerations are illustrative.

3.5.1 Initial Review Considerations

When first considering the potential impacts of a proposed business combination, the Department considers four broad assessment areas:

- Does the proposed transaction involve critical technology or raise national security concerns?

- Does the proposal pose horizontal or vertical competition concerns? (For more information on vertical integration issues see the Defense Science Board report on Vertical Integration and Supplier Decisions http://www.acq.osd.mil/dsb/verticle.pdf).

- Are there potential antitrust concerns that must be remedied. If so, what adjustments (remedies) could be made that would alleviate the Department's concerns?

Based on its initial review, the Department normally would: (1) notify the antitrust agency that it has no objections, or (2) cooperate with the Agency to pursue a second request for additional information from the companies. Generally, the Department would not object to a proposed business combination if:

- The combination likely would not result in the transfer of critical technologies from the U.S. industrial landscape nor move the strategic direction of the acquired firm away from U.S. national security priorities, and

- The products of the company to be acquired do not possess a "discriminating difference" compared to those of other firms. Absent a discriminating difference, market entry barriers are relatively low and additional, credible competitors (with

similar capabilities and capable of capturing a reasonable market share) can enter the market relatively quickly (for example, less than one year to market, modest investment required).

Even given the presence of discriminating differences, the Department would not normally object to a transaction if:

- There is little or no impact from horizontal competitive effects. That is, there are no identified horizontal overlaps; market concentration is not increased significantly; there are some horizontal overlaps, but credible competitors exist; or the companies are not competitors in current and upcoming DoD major acquisition program competitions.

- There is little or no impact from vertical integration. That is, there are no identified vertical supply relationships now and no exclusive supply agreements; or there is some vertical integration, but market competition exists; or there is little likelihood of future harm (for example, because competitors also have access to vertical products).

- There are no identified organizational conflicts of interest.

- There are no complainants citing horizontal competitive effects or vertical integration concerns; or the nature of the market does not support a complainant's concerns.

3.5.2 Comprehensive and High Interest Case Review Considerations

In Comprehensive and High Interest cases for which the Department determines that it requires additional information before it can render its recommendations to the antitrust agency, the Department may help the antitrust agency prepare and issue a second request for information; and then conducts a detailed analysis of all available information. The Department and the antitrust agency make every effort to narrow the scope of the second request to require only information essential for the review. The antitrust agency encourages the companies to provide information on a "rolling basis" in order to expedite the review process to the maximum extent possible.

In its review, the Department performs a competitive market analysis, financial analysis, transaction benefits analysis, and an analysis to identify and evaluate potential remedies.

In its competitive market analysis, the Department:

- defines the product markets for all horizontal overlaps and vertical relationships;

- assesses the likely competitive effects of the transaction for each market segment, based on current and future market demand and current and/or potential suppliers; and

- evaluates factors that might alter the market in the future (for example, technology/innovation trends, changing customer requirements, and changing business relationships).

In its financial analysis, the Department determines if the acquiring company likely will be able to finance and sustain the business. The Department also assesses the financial viability of the company being acquired to determine if it has the financial capabilities to continue in business if the transaction is not completed.

In its transaction benefits analysis, the Department identifies and evaluates, with the antitrust agency, potential restructuring actions, vertical efficiencies, and the resulting savings that would accrue to the Department.

Finally, during the course of the review, the Department and antitrust agency may communicate potential concerns to the companies. The Department, antitrust agency, and companies then discuss, and may negotiate, remedies to mitigate concerns, including:

- information firewalls to protect proprietary information,

- agreements to rescind exclusive teaming arrangements, and

- targeted divestitures of businesses and/or individual contracts.

These remedies may be included in a consent decree and be appropriate, effective, enforceable, and consistent with maintaining competition and innovation. A consent decree will require specific actions to be taken.

For concerns that do not warrant a consent decree, the Department can take independent action often working cooperatively with the merging companies. Where organizational conflicts of interests are identified, the parties may rely on contract provisions to protect proprietary information, establish firewalls, or transfer contracts to an alternate source. Where vertical integration concerns are identified, the Department may require merchant supplier assurances or may require increased visibility into make/buy decisions. Where horizontal concentrations are identified, the Department may alter specific program acquisition strategies to ensure additional competitive pressures are maintained. Where financial concerns are identified, the Department may monitor the companies' financial and investment activities for negative trends that affect the Department's programs.

By carefully evaluating the effects of a proposed business combination – and clearly and expeditiously articulating its views to the appropriate antitrust agency – the Department can ensure that consolidation in the defense industry occurs in a way that protects national security as well as financial resources. The Department's views on the impact that a proposed combination would have on cost-effectiveness, preservation of a healthy research, development and production capacity, preservation of skilled workforce, and assurance of efficiency and quality will help shape the antitrust agency's ultimate decision to permit or seek to block a proposed business combination.

After the Department communicates its views to the appropriate antitrust agency, that agency may: (1) allow the transaction to be consummated without change; (2) negotiate remedies with the acquiring company that will mitigate U.S. Government concerns; or (3) bring action in federal court to block the transaction.

4 Foreign Acquisitions of U.S. Defense Contractors

4.1 The Exon-Florio Amendment

The Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988 amended the Defense Production Act to authorize the President to suspend or block foreign acquisitions, mergers, or takeovers of U.S. firms when credible threats to national security cannot be resolved through other provisions of law.[2] The President delegated management of the Exon-Florio Amendment to the interagency Committee on Foreign Investment in the United States (CFIUS), chaired by the Department of the Treasury. More information can be found at http://www.ustreas.gov/offices/international-affairs/exon-florio/.

The CFIUS has 12 permanent members (the Departments of Defense, State, Justice, Commerce, Treasury, Homeland Security; the Office of the United States Trade Representative; the National Security Council; the Office of Management and the Budget; the Office of Science and Technology Policy; the Council of Economic Advisors; and the Council on National Economic Policy). Other Federal departments and agencies attend meeting when cases pertain to matters within their jurisdiction.

As is the case for antitrust reviews conducted pursuant to the Hart-Scott-Rodino Act, the Exon-Florio Amendment prescribes time limits for the CFIUS review shown in Figure 4.

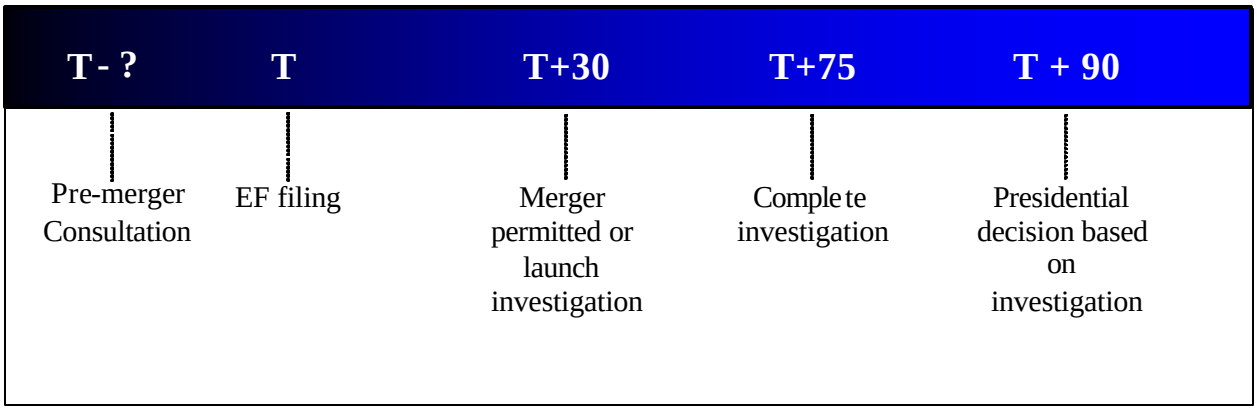

Figure 4 – CFIUS Timeline

Under Exon-Florio, the President has 30 days from notification of a foreign acquisition to initiate an investigation of the transaction. During the first 30 days after formal notification, CFIUS members conduct a preliminary review to determine whether the transaction poses credible threats to national security and, if so, whether there are means to adequately mitigate

[2] One provision specifically excepted is the International Emergency Economic Powers Act which enables the President to prohibit virtually any economic transaction involving a foreign country or entity after declaring that a national emergency exists with respect to the threat from that country or entity. This act does not need to be exercised prior to use of the powers under Exon-Florio, which addresses individual transactions.

those threats. By the 30th day, the CFIUS must either approve the transaction, with or without risk mitigation measures, or initiate an investigation. If the CFIUS begins an investigation, it must complete a report on the investigation within 45 days. The President then has 15 additional days to decide what action to take. Amendments to Exon-Florio enacted in 1992 require the President to inform Congress of his decision in each case involving an investigation.

The 1992 amendments to Exon-Florio also require that the Department of Defense determine if the company or business unit being acquired possesses critical defense technology under development or is otherwise important to the defense industrial and technology base. If the Department determines that either of these criteria is met, one of several DoD intelligence agencies must prepare an Assessment of the Risk of Technology Diversion and share that assessment with all CFIUS members. The Under Secretary of Defense (AT&L) has been delegated the authority to make the technology and industrial base determinations.

Since 1988, the CFIUS has reviewed over 1,450 transactions. Only 20 of these transactions resulted in investigations; and in only one case did the President formally prohibit an acquisition. The low number of investigations and blocked transactions is due to the fact that most transactions that involve credible threats to national security are resolved by risk mitigation measures negotiated either by individual departments or by the CFIUS itself. In a few cases, risk mitigation measures have been negotiated after an investigation was begun or completed.

In eight cases the parties requested and received permission to withdraw a notification during an investigation either because they wanted to negotiate risk mitigation measures off the clock or because they wanted to avoid the risk of an unfavorable outcome. In addition, parties to a transaction may request withdrawal of a petition during the initial 30-day review period in order to facilitate resolution of national security issues or risks or adequate risk mitigation measures.

Withdrawals in major cases are frequent because of the inflexibility of the 30-day period and the amount of time necessary to review national security issues, including potential concerns stemming from other related acquisitions by the same firm or other firms. Because of the inflexibility of the timeframe for the preliminary review period, the DoD encourages the parties to discuss the transaction, prior to formal notification, with those agencies with national security responsibilities for which it is a supplier. In this way, CFIUS members can assess national security issues and possible mitigation measures without the pressures of the review clock. Within the DoD, the Office of the Deputy Under Secretary of Defense for Industrial Policy can serve as the initial point of contact for such preliminary discussions and will arrange for discussions with relevant DoD Components with which the firm being acquired has contracts, the Defense Technology Security Administration (DTSA), and, if there are facility security clearances, the Defense Security Service (DSS) and the Under Secretary of Defense for Intelligence (USD(I)).

4.2 DoD's Internal Review Process

The Deputy Under Secretary of Defense for Technology Security Policy (DUSD(TSP)) is the DoD lead for CFIUS reviews. The DUSD(TSP) also heads the DTSA. Figure 5 depicts the review flow among the Department's components. Key DoD Components which provide views to DTSA on national security issues and the acceptability of possible risk mitigation measures include:

- Representatives of the USD(AT&L) (block 2), who determine if that firm possesses critical defense technology under development or is otherwise important to the defense industrial and technology base.

- Representatives of the USD(I) (block 3), who oversee DSS development of risk mitigation measures for those foreign-owned, U.S.-located firms that possess a facility security clearance and therefore are covered by the National Industrial Security Program Operating Manual (NISPOM) and its program to mitigate Foreign Ownership, Control or Influence (FOCI).

- The Military Departments and agencies (blocks 4 &5) that are supplied directly or indirectly by the firm being acquired.

- The Defense Intelligence Agency (DIA) (block 6), which provides a risk assessment for each transaction to DTSA and other involved DoD Components, which is distributed to all CFIUS members where USD(AT&L) finds that the firm being acquired possesses critical defense technology under development or is otherwise important to the defense industrial and technology base.

- Representatives of the DoD GC (block 7), who review draft mitigation measures and jurisdictional issues involving CFIUS filings.

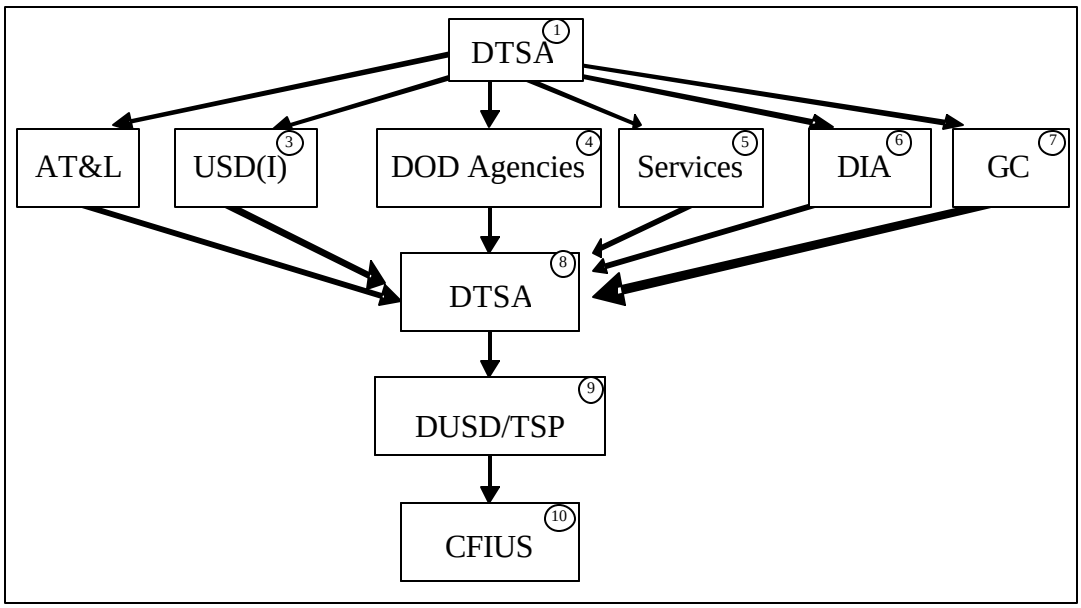

Figure 5 – Key DoD Components for CFIUS Reviews

The Department may develop risk mitigation measures for any transaction when such measures are considered appropriate when the firm being acquired possesses a facility security clearance for classified contracts, any risk mitigation measures must include measures required under DoD industrial security regulations. The major difference between CFIUS and FOCI reviews is that the CFIUS review is subject to time limits while FOCI is not.

4.3 DoD Review Considerations

In reviewing foreign acquisitions under the CFIUS process, the Department focuses on risks including:

- The nature of the technology possessed by the firm being acquired. In general, the presence of critical defense technology, either under development or mature, increases potential risks to national security. Presence of technology that is export-controlled under the International Traffic in Arms Regulations or requires a validated license for export under the Export Administration Regulations covering dual use commodities also increases risks to national security. Increasingly, the Department is concerned about transfer of dual use technologies and technologies possessed by less traditional suppliers that are relevant to network-centric warfare (such as information technologies) and those technologies of interest to terrorist and counter-terrorist activities (such as producers of fertilizer and bio-chemical detection equipment).

- Unique production capabilities. The extent to which the firm being acquired has unique production capabilities (for example, it is a sole source supplier to the

Department or possesses state-of-the-art manufacturing technology) or is otherwise important to the defense industrial and technology base.

- The level of any classified contracts. Generally, the higher the level of classification, the greater the potential risks to national security.

- If the firm being acquired has a DoD facility security clearance. FOCI risk mitigation measures affecting corporate structure that can be applied to mitigate national security threats stemming from factors discussed in this section include:

    1) A Special Security Agreement requiring the appointment of several DoD approved, U.S. citizen, cleared Outside Directors for the Board of the acquired firm in cases where the foreign firm is acquiring majority control of the U.S. firm.

    2) A Proxy Agreement or Voting Trust in which the Proxy Holders or Trustees are DoD approved, cleared U.S. citizens for cases in which a foreign firm is acquiring majority control of a U.S. firm and the potential threats to national security are particularly great.

    3) A Security Control Agreement in which one DoD-approved, U.S. citizen, cleared Outside Director may be appointed to the Board of the acquired firm in those cases where the foreign firm is acquiring a minority interest in the U.S.-located firm.

    4) The Department frequently includes a Technology Control Plan with any of the above measures affecting corporate structure. A Technology Control Plan explains the internal procedures and training that will be applied to prevent unauthorized disclosure of export-controlled technology.

- The extent and nature of the foreign control of the acquired firm. In general, a majority foreign ownership interest poses a greater potential threat to national security. In general, if the acquiring firm is owned, controlled, or influenced by a foreign government, the potential threats to national security are greater. In fact, the 1992 amendments pertaining to Exon-Florio require an investigation if the acquiring foreign firm is owned or controlled by a foreign government.

- The record of the acquiring firm and its host country in complying with U.S. export control laws and international agreements relating to technology transfer. The record includes nonproliferation of weapons of mass destruction, missile technology control regimes, combating international terrorism, and anticipated reliability as a supplier of defense-related goods and services to the DoD.

The DoD's position on each Exon-Florio transaction is decided on a case-by-case basis, Representatives of the DUSD(TSP) establish a coordinated DoD position on the transaction, including risk mitigation matters. Once that coordinated position is established, the DUSD(TSP)

submits that position to the Department of the Treasury for full CFIUS consideration and decision.

5 Conclusion

Each year there are thousands of mergers and acquisitions involving U.S. companies. The Department has reviewed over 230 HSR transactions since 1994 and over 1,450 transactions involving a foreign buyer since 1988. The Department has generally supported the process of consolidation, because it enables firms to eliminate excess capacity, reduce costs, and provide better value for DoD and the U.S. taxpayer. Mergers and acquisitions may allow established firms to assimilate innovation from emerging defense suppliers and provide smaller firms the ability to leverage their innovation across the broader scale of larger companies—and monetize their own intellectual and capital investments..

At the same time, the Department does not support transactions that reduce competition for DoD programs. As the consolidation within the defense industry matures, access to an integrated, global industrial base will enhance alliances, ensure competition for innovation and efficiency, and yield shared economic benefits. The Department's policies on domestic and foreign mergers and acquisitions will help facilitate cost savings while preserving the benefits of competition and protecting the industrial and technological capabilities needed to supply critical warfighting products.

The U.S. government's review of antitrust mergers is analytically rigorous and is conducted using well-defined criteria and procedures. Similarly, our policies regarding acquisitions of U.S. companies by foreign parties are less restrictive than those of many other countries. Our reviews of business combinations ensure we can continue to rely on a secure, competitive industrial base in meeting our warfighting needs while being sufficiently flexible for unique circumstances. These reviews are especially relevant as the Department increasingly focuses its requirements and acquisition processes on operational capabilities sectors – thus allowing for a broader contextual view of the impact of a merger of capabilities.

The Department's policies and procedures outlined in this deskbook will help to ensure an appropriate enabling environment that allows firms involved in defense to compete, rationalize operations, and, in so doing, provide affordable and innovative products to meet our national security needs.