WILMER, CUTLER & PICKERING
2445 M STREET, N.W.
WASHINGTON, DC 20037-1420

TELEPHONE (202) 663-6000
FACSIMILE (202) 663-6363
WWW.WILMER.COM

399 PARK AVENUE
NEW YORK, NY 10022-4697
TELEPHONE (212) 230-8800
FACSIMILE (212) 230-8888

100 LIGHT STREET
BALTIMORE, MD 21202-1036
TELEPHONE (410) 986-2800
FACSIMILE (410) 986-2828

1600 TYSONS BOULEVARD
10TH FLOOR
TYSONS CORNER, VA 22102-4859
TELEPHONE (703) 251-9700
FACSIMILE (703) 251-9797

4 CARLTON GARDENS
LONDON SW1Y5AA, ENGLAND
TELEPHONE 011 (44) (20) 7872-1000
FACSIMILE 011 (44) (20) 7839-3537

RUE DE LA LOI 15 WETSTRAAT
B-1040 BRUSSELS, BELGIUM
TELEPHONE 011 (32) (2) 285-4900
FACSIMILE 011 (32) (2) 285-4949

FRIEDRICHSTRASSE 95
D-10117 BERLIN, GERMANY
TELEPHONE 011 (49) (30) 2022-6400
FACSIMILE 011 (49) (30) 2022-6500

January 8, 2003

# *Antitrust Update:*

*DOJ/DOD Approve Behavioral Remedy in Defense Merger*

On December 11, 2002, the Department of Justice (DOJ) filed a proposed consent decree, permitting Northrop Grumman to proceed with its $7.8 billion acquisition of TRW. Northrop Grumman/TRW shows that the DOJ and the Department of Defense (DOD), which plays a leading role in reviewing defense industry transactions, continue to bring cases based on possible competitive issues from vertical consolidation in the defense industry. But, perhaps most notably, the agencies accepted unusually broad "behavioral" remedies to address competitive concerns. It is important to recognize, however, that the defense industry is unusual in several respects. Northrop Grumman/TRW should not be read to suggest that the antitrust agencies are likely to begin accepting similar far-reaching behavioral remedies in other industries.

## *The Allegations and Remedy*

According to the DOJ complaint filed with the consent decree, the acquisition will lessen competition for reconnaissance satellite systems and "payloads," which are inputs for those systems. DOJ alleges that (a) TRW is one of the only companies able to serve as a prime contractor for reconnaissance satellite systems purchased by the United States and (b) Northrop is one of only two firms that supply radar and EO/IR "payloads," sophisticated instrument packages that are incorporated in those systems. Vertical integration from the transaction, DOJ claims, threatens to lessen competition in both the prime contracting (downstream) and payload (input) markets.

Specifically, as the prime contractor, Northrop/TRW allegedly might unreasonably favor its own payloads, even if a rival offers better or cheaper payloads. Similarly, DOJ/DOD were concerned that Northrop might attempt to gain an advantage in competitions for prime contracts by refusing to supply its payloads to rival prime contractors or supplying such payloads only on unfavorable terms. The vertical concerns alleged in DOJ's complaint are similar to those that DOJ/DOD have raised in several prior defense transactions, most prominently in their challenge to the subsequently abandoned Lockheed Martin/Northrop Grumman transaction.

To address these concerns, the consent decree requires that when Northrop is the prime contractor for a reconnaissance satellite system and has an opportunity to select its own payload, it must (a) announce non-discriminatory criteria for selection of the payload before soliciting bids, (b) provide information about the satellite system to competing payload suppliers on a non-discriminatory basis, and (c) obtain prior approval from a DOD-appointed "Compliance Officer" if it ultimately selects Northrop as the payload supplier for such a contract. When Northrop is competing for a prime contract for a satellite system, it must (a) provide payloads to Northrop's prime contracting competitors on a non-discriminatory basis, (b) negotiate contracts or teaming arrangements with those competitors on a commercially reasonable basis, and (c) obtain advance approval from the Compliance Officer for any such teaming arrangement or contract.

The consent decree also provides for "firewalls" to insulate the former TRW prime contractor operations from Northrop Grumman's existing payload business. The parties have agreed, among other things, to maintain the operations in physically separate buildings and maintain independent information technology infrastructures. These firewalls are designed to limit the possibility that Northrop's prime contracting business could obtain competitively sensitive information about its rivals through Northrop's payload business (which will work with those rivals) or, alternatively, that Northrop's payload business could gain information about its rivals through Northrop's prime contracting business.

Under the consent decree, the Secretary of Defense will appoint a Compliance Officer, who will be a government employee. The Compliance Officer will play an integral part in overseeing and enforcing the consent decree's behavioral remedies, at Northrop's expense. He or she will, among other things, have broad authority to approve certain Northrop business decisions, investigate potential violations of the decree, and hire additional staff as required. Violations of the consent decree can result in severe sanctions against Northrop. All provisions of the consent degree expire in seven years, although DOJ has authority to extend the decree provisions for an additional three years.

***Potential Implications of Northrop Grumman/TRW***

The Northrop Grumman/TRW consent decree is an unusual mechanism to address antitrust concerns. It introduces long-term, close government scrutiny and oversight of the competitive process, including purchases and sales of products and the terms and decision making processes therefore. The U.S. antitrust agencies have generally been reluctant to accept behavioral undertakings to remedy competitive concerns, especially when the remedies involve ongoing government oversight of business decision making. They have traditionally seen behavioral remedies as overly regulatory, hard to administer effectively, difficult to apply in evolving marketplaces, and awkward to enforce. The antitrust agencies have accordingly usually insisted on divestitures or other "structural" remedies.

As reflected in Northrop Grumman/TRW, the antitrust agencies are open to considering non-traditional remedies to address vertical antitrust concerns. It is important to remember, however, that this case involves the defense industry, which has unusual characteristics. Defense suppliers typically sell to only one, sophisticated U.S. customer, the Department of Defense, in a highly regulated environment. Although DOD generally gives prime contractors substantial

autonomy in selecting subcontractors, when it chooses to do so, DOD has the resources closely and effectively to supervise the selection and supply of inputs for military systems. Accordingly, DOD and DOJ apparently determined that a strict set of behavioral requirements -- overseen by a government-employed Compliance Offer and backed up by the threat of strict sanctions for non-compliance -- would sufficiently ensure that the transaction would not lessen competition for payloads or satellite systems.

It is unlikely that the antitrust agencies will become dramatically more receptive to far-reaching behavioral remedies in more typical industries (or even for defense-related products that also have substantial commercial applications). When the merging parties sell to many customers, in a constant stream of transactions, it can become exponentially more difficult effectively to administer behavioral remedies similar to those in Northrop Grumman/TRW. Furthermore, unlike with large military contracts, many customers may lack adequate incentives, expertise, or resources effectively to monitor compliance with behavioral undertakings and work with the antitrust agencies to address violations. For these reasons, behavioral remedies may require substantially greater continuing regulatory oversight and prove much less effective outside the defense industry.

There will, to be sure, be circumstances where the antitrust agencies will accept limited behavioral remedies outside of the defense industry, for example when the remedy addresses a competitive concern of only short duration. The antitrust agencies are continuing to review prior consent decrees in merger cases and evaluate their effectiveness, and we believe their policies towards remedies will continue to evolve. But behavioral remedies will almost certainly continue to be rare, and parties considering transactions should understand that in most circumstances the agencies strongly prefer divestitures to remedy competitive issues.

Merging parties and their counsel are well advised to evaluate possible remedies early in the planning process for any transaction likely to receive substantial scrutiny from the antitrust agencies. Understanding the likelihood and business implications of possible remedies is critical to evaluating the business case for a transaction and negotiating the allocation of antitrust risk. Depending on the circumstances, moreover, it will sometimes be appropriate to propose remedies to the agencies early in the review process. By doing so, the parties may obtain a more favorable remedy package and a speedier closing than would otherwise have been possible.

Whenever the parties begin remedy discussions with the government, it is critical for them to have considered how various remedies will affect the business goals of the transaction and be well prepared to explain why their preferred remedies will protect competition. This is especially important when the parties propose remedies other than divestitures of free-stranding businesses, which the agencies tend to prefer. Finally, parties are better positioned to argue for a

narrower or non-traditional remedy when they can demonstrate that the remedy will preserve efficiencies that a broader divestiture would eliminate (while still proving effective).

* * * * *

If you have any questions about the Northrop Grumman/TRW consent decree or any other issues concerning U.S. or foreign antitrust/competition law, please contact us at (202) 663-6000.

Doug Melamed
Robert Bell
Veronica Kayne
Thomas Mueller

Jim Lowe
Ali Stoeppelwerth
Lee Greenfield