

TOP 10 CONSIDERATIONS FOR MERGERS & ACQUISITIONS INVOLVING GOVERNMENT CONTRACTORS

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Corporate transactions involving companies holding government contracts present a unique set of considerations ranging from the treatment of intellectual property to the specific requirements for transferring government contracts. These considerations can significantly impact the diligence process, deal structure, valuation, applicable representations and warranties, integration efforts, and the ultimate success or failure of the venture post-closing. In this article, we describe ten of the most common issues impacting buyers and sellers in mergers and acquisitions involving government contractors (including both prime contractors and subcontractors and other downstream suppliers to government contractors).

1. Assignment and Novation

A contract with the government cannot be transferred to a third party without approval by the government through the process of novation. The formal novation process typically begins after the close of the transaction and can take a considerable amount of time. As a result, the parties must take steps to address this uncertainty in the transaction documents, outlining each party's post-closing responsibilities with respect to the novation process and performance while novation is pending. In addition, under the novation regulations, the transferor (i.e., the seller) remains legally responsible for performance of the transferred contracts even after the novation is approved. Because novation is generally not required when the transaction is structured as a stock purchase, the parties can often avoid the novation process through careful planning. Note, however, that subcontracts may still require notice and consent from the prime contractor (and, in some cases, from the government) upon a change in control.

2. Government Contracts & Intellectual Property

As a government contractor, the target's intellectual property (IP) may be governed by a complex set of regulations and contract clauses. During the diligence process, the buyer should identify the different IP rights held by the government or higher-tier contractors. With respect to patents, the government generally obtains, at a minimum, a broad license to practice, or have practiced on its behalf, inventions that are conceived or first actually reduced to practice in performance of the contract,

and in some cases will even obtain title to the invention. For rights in technical data and computer software, there are generally five categories of rights. (1) Unlimited Rights are broad and enable the government to use the IP in any way and for any purpose, including the unrestricted ability to provide such data and software to third parties. (2) Limited or Restricted Rights allow the government to use the data or software within the government, but do not generally allow the government to release the data to third parties (with certain exceptions). (3) Government Purpose Rights allow the government to release and disclose data or software to third parties for "government purposes" only. (4) Specifically Negotiated Rights are agreed upon on a case-by-case basis. (5) Commercial License Rights may apply when the government is procuring commercial items or commercial computer software. If IP is important to the valuation and success of the target, a potential buyer must vet these issues during diligence.

3. Organizational Conflicts of Interest

An organizational conflict of interest (OCI) arises when a government contractor may be unable to render impartial assistance or advice to the government, the contractor's objectivity in performing contract work is or might be impaired, or the offeror would have an unfair competitive advantage. In these situations, if an actual or potential OCI exists, there is risk that the buyer or target may be precluded from future opportunities or be stripped of current contracts. Note that an OCI is attributed broadly across a corporate entity (e.g., the contracts and interests of a wholly owned subsidiary are attributed to corporate affiliates). This broad application requires that the diligence team consider and review its own business combined with the target's business in a holistic manner during diligence. There are three broad categories of OCIs that require careful scrutiny. (1) An "unequal access to information" conflict arises in situations where a firm has access to non public information because of its performance of a government contract and possession of that information may provide an unfair competitive advantage in a later procurement competition (including contracts that the buyer may be seeking). (2) A "biased ground rules" conflict arises when a firm, as part of its performance of a government contract, has in some manner set the ground rules of compe-

tion for another contract (such as writing a specification or statement of work) performed or sought by any affiliate (including buyer and its affiliates post-closing). (3) An “impaired objectivity” conflict arises when a contractor’s objectivity in performing a contract’s requirements may be impaired because the substance of the contractor’s performance has the potential to affect other interests of the contractor.

4. Small Business Matters

A buyer must consider whether the target qualifies as a “small business concern.” To qualify for this designation, the contractor and affiliates must have less than a specified number of employees and/or receive less than a specified amount of revenue. If any of the target’s material contracts with the government were set aside for entities that qualify as “small business concerns,” the buyer should analyze how the contemplated transaction might affect the target’s qualifications and future revenue stream. If the target no longer qualifies for the designation, either independently or as a result of the proposed transaction, it can sometimes continue performance on its existing contracts but will not be eligible for new small business set-aside contracts or work.

5. Socio-Economic Requirements

The government requires contractors to fulfill public policy objectives through government contracts, including affirmative action programs, prevailing wage obligations, and employment eligibility verification (E-verify). In many cases, the implementation of these programs must be passed onto subcontractors pursuant to “flow down” clauses. Assessing the target’s compliance with these requirements is a crucial piece of due diligence as failure to comply can be associated with substantial penalties, contract termination, and exclusion from future government contracting.

6. Inverted Domestic Entities

An inverted domestic entity is a former U.S. corporation or partnership that is now incorporated in a foreign country or is a subsidiary of a parent corporation that is incorporated in a foreign country. Using various legislative and regulatory tools and with varying levels of aggressiveness, the federal government has sought to restrict the ability of inverted domestics to win government contracts. If government contracts are part of the target’s portfolio, the buyer should consider whether these restrictions could apply (thereby impacting the value and pipeline of government funded contracts). As part of this analysis, the buyer must engage in “self-diligence” to make sure that neither it, nor the combined entity, qualifies as an inverted domestic entity.

7. Cost and Price Issues

Buyers must consider three separate types of cost/price issues if the target holds government contracts. (1) Cost Accounting Standards requirements, although not applicable to all contracts, are onerous and dictate how a contractor must maintain its accounting system. (2) The Federal Acquisition Regulation establishes under what circumstances a contractor’s incurred costs are recoverable under a government contract. (3) When the Truth in Negotiations Act applies, the contractor is required to disclose “cost or pricing data” and to certify that the data are accurate, complete, and current. Noncompliance can lead to government enforcement, including significant disallowances across multiple contracts. From a valuation standpoint, a buyer should understand that these rules may require adjustment of the target’s rates as a result of the transaction.

8. Bonds and Guarantees

The government commonly insists on some type of performance guarantee, which can be costly to replace and, in the case of an ongoing procurement, extremely difficult or disruptive to replace. The government typically has little incentive to allow release of the guarantee and/or permit substitution. Because of the potential ongoing exposure, guarantees are often priority items for sellers. If not addressed early in the process, and factored into the transaction structure and novation process, guarantees can lead to significant issues for buyers and sellers.

9. Classified Information

Classified contracts often complicate a buyer’s ability to value the target because relevant information cannot be obtained through the normal diligence process. To mitigate the uncertainty associated with this lack of transparency, the buyer can deploy other mechanisms. For example, an earn-out provision can incentivize future performance across all business lines (including classified contracts). A buyer can also include robust representations in the transaction documents that apply to all contracts, including classified contracts.

10. Responsibility and Performance

The government has an ongoing affirmative obligation to evaluate the “present responsibility” and past performance of government contractors. Contractors that do not comply with law, regulation, and contract or otherwise engage in conduct that suggests a lack of integrity can face suspension or debarment. Separate from suspension and debarment, the government can terminate contracts for default and provide negative past performance ratings. A termination for default or adverse past performance rating can dramatically impede a contractor’s ability to secure future government contracts for several years. Understanding the target’s responsibility and past performance is a critical part of diligence and should be incorporated into representations and warranties.

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