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Government Contracts

Ten Unique Issues to Consider When Buying or Selling a Government Contractor

BY TODD R. OVERMAN

Over the last 12 months, the deal activity in the government services market has been really fierce. The political, budgetary and competitive environment has created a market ripe for acquisitions and consolidation. Initially, prime contractors were looking at targeted investments in health IT, cybersecurity, etc. to add capabilities, customer relationships, and technologies. More recently, there has been a trend towards consolidation of service providers to increase scale and lower costs, as well as plans by certain prime contractors to divest lower margin businesses and divisions. Publicly, three companies are known to be exploring spinoff or potential sale of their government services segments – L-3 ($1.2 billion national security solutions business), BAE Systems ($1.5 billion services unit) and Lockheed Martin's announced $6 billion divestiture of its IS&GS unit — not to mention potential sales of two private equity backed firms – Vencore, Inc. (Veritas) and PAE (Lindsay Goldberg). So, there will be no shortage of acquisition opportunities in the government services market in the months to come to help companies reshape, and potentially redefine, themselves in the federal market.

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This active merger, acquisition and reorganization market raises a host of issues for buyers and sellers to consider when looking at deals involving government contractors. This article highlights 10 issues unique to government contractors and provides some practical advice on how to deal with each.

Structuring the Transaction – Stock vs. Asset Purchase? A critical initial consideration for any deal is how the acquisition will be structured – i.e., a stock or asset purchase and which entity will survive the transaction. This is particularly important with deals involving government contractors, as government consent for the transfer of the government contracts may be required in certain situations. For instance, no government consent is required for the purchase of the stock of the legal entity performing the government contracts. However, if in connection with the acquisition the contractor undergoes a change of name, the contracting officer should be notified and a ''Change of Name Agreement'' package should be submitted.

If the parties prefer an asset purchase, they must be mindful that in order for the government to recognize the successor in interest to the seller's prime contracts, the parties must submit a request for the government to ''novate'' the contracts from the seller to the buyer. Note that the novation request occurs *after* the parties close the deal, and the novation dates back to the date of closing. Similarly, if the transaction involves a merger, and the seller (or contracting party) is merged away, the government requires a novation agreement to recognize the buyer as the holder of the seller's prime

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contracts. Finally, government contractors should be aware that no matter the acquisition structure, the government reserves the right to enter into other types of ''formal agreements'' to address issues related to the change in ownership of a prime contractor.

How to Deal with a Corporate Conversion. In recent years, buyers and sellers within the government services sector have elected to ''convert'' the corporate structure of the seller as part of the transaction. Statutory conversions under certain state laws allow a business to change its legal form without changing the practicality of the business and are generally done for tax purposes. For instance, a corporation can be converted to a limited liability company, with all assets and liabilities remaining the same. So, in essence, all that has changed is that the legal entity has changed from ''Company Inc.'' to ''Company LLC.''

The Federal Acquisition Regulation (''FAR'') does not specifically address how to handle statutory conversions. While it appears a Change of Name Agreement would be sufficient, more has certainly occurred to the entity than just a name change. Similarly, a novation agreement does not seem appropriate as no assets have transferred from buyer to seller, rather, the seller is still in possession of the prime contracts, only its legal form has changed. Under the FAR's Subpart 42.12 provision discussing ''other formal agreements,'' some contracting officers have permitted contractors to address this change of the contracting entity through a ''Conversion Agreement.'' These agreements are a hybrid novation agreement which confirm the conversion was properly executed under state law and that all the assets necessary to perform the contracts are retained by the contractor of record, despite the change in name and legal status.

Novation Tips for the Unwary. If a transaction type requires a novation agreement (i.e., asset purchase or merger), there are number of best practices to keep in mind, including:

- Notification to and cooperation with the contracting officer is essential as contracting officers have discretion to waive documentation requirements for novation agreements or withhold consent to transfer the contract.

- Security clearance and bonding requirements should be assessed early in the acquisition in order to mitigate potential negative effects.

- The transfer of individual task orders under GSA Schedule contracts or proposals during the competitive process will require careful attention.

- Managing client expectations regarding the transfer of prime contracts due to the uncertain timing of novation approvals. Assessment of client expectations can be further complicated when novation requests must be addressed to multiple agencies (despite FAR direction, DCMA, GSA and other agencies, generally will want to process their own novations).

- In certain situations, it may be appropriate to provide the contracting officer with a draft novation package prior to closing the transaction. In this case, the government can review the novation package and identify any deficiencies as a dry run, minimizing unpleasant surprises.

- Once a novation is executed, the buyer should confirm that modifications on individual prime contracts are executed to document the novation approval.

Early identification of issues and open communication with contracting officers, proper agency officials and other clients as well as flexible mitigation strategies are essential when pursuing the novation of a government contract.

Will the Seller Lose its Small Business Set-Aside or 8(a) Contracts? If the seller is a small business contractor, special issues can arise when the buyer is a large business, or if when combined after closing, the buyer and seller no longer qualify as a small business. As an initial matter, there is no requirement in the FAR for contracting officers to terminate a small business set-aside contract if the contractor is sold to a large business. Rather, if the seller has been awarded a small business set-aside contract or represented itself as a small business in connection with the award of a full and open contract, the seller must recertify its size status for the NAICS code applicable to that contract within 30 days of closing the transaction or within 30 days of executing a novation agreement. Upon receipt of this information, the contracting officer should update the public procurement databases and no longer count the contract towards its small business contracting goals. Thus, the formerly small business may continue to perform the contract, but contracting officers retain the discretion to terminate the contract for convenience or not exercise option years. While a boon for small businesses that grow larger as a result of successful government contracting, when acquired, a party evaluating a small business that derives a majority of its revenue from set-aside contracts should be aware that the transaction may cause a contracting officer to take a second look at who is performing the set-aside contracts, and may limit future recompete opportunities. To prevent losing contracts, review of contracts for small business recertification clauses and ''on and off'' ramp provisions must be careful and confirmed.

Contractors in SBA's 8(a) program face additional rules and procedures when sold to a non-8(a) company. Upon entering into an agreement (or agreement in principle) with any party regarding a change in ownership, an 8(a) contractor must notify the SBA of the potential acquisition. If the contractor is performing 8(a) contracts and executes an agreement to sell the business to a non-disadvantaged entity, the government is required to automatically terminate any unexpired 8(a) contracts unless the SBA waives the requirement. A waiver request needs to start early in the acquisition process, and should be requested by the 8(a) contractor as soon as the parties have reached an agreement in principle. Obtaining a waiver is not guaranteed, as absent special circumstances, to obtain a waiver for the 8(a) contract to be transferred to a non-8(a) firm, the head of the contracting agency must certify that terminating the contract would severely impair attainment of the agency's program objectives or missions. Thus, buyers looking at contractors with 8(a) contracts would be wise to make the transaction contingent upon the seller's receipt of the waiver, or factor this risk into the valuation of the 8(a) contractor.

Assessing Organizational Conflict of Interest Risk. Whenever a government contractor is considering a proposed merger or acquisition, the due diligence review should include careful consideration of any poten-

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tial or actual Organizational Conflicts of Interests (''OCI'') that would disqualify the buyer or seller from existing or future government work. Identifying OCI issues early on will enable both parties to address existing mitigation plans and develop new ones, if necessary. A firewall, for instance, is insufficient on its face for some types of OCIs and insufficient for all OCIs if there is evidence it has been breached. Contracting officers are charged with identifying and evaluating OCIs and as such, regulations specifically limit the award of some contracts to contractors providing specific services so as to prevent bias in a contractor's judgment and prevent unfair competitive advantage. If actual or potential OCIs are not carefully reviewed, the acquiring firm may be forced to relinquish existing contracts to avoid or mitigate OCI concerns.

Accounting and Business System Compliance. Increased scrutiny from the DCAA has resulted in more frequent negative audit findings for all types of government contractors. The increased emphasis on accounting and business system compliance has created potential hidden exposure for those contractors that have not invested in key infrastructure components. Moreover, commercial companies looking to expand into the government marketplace through acquisition should be mindful of these unique government contracting requirements.

To guard against this risk, as part of due diligence, buyers should test a seller's knowledge of Cost Accounting System (''CAS'') requirements and review both prime and sub-contracts for FAR CAS clauses to determine if it is acquiring a CAS-covered entity. When a CAS-covered entity is a potential acquisition target, the buyer must also assess whether maintaining the structure can isolate the CAS risk. If a CAS-covered entity is absorbed into a commercial organization, the buyer may have unwittingly exposed the entire organization to DCAA audit and disclosure requirements. Further, depending on the nature of the business, there may be contractual IT system requirements for compliance with specific agency rules. Certifications and IT mechanisms may need to be carefully preserved or reestablished to meet those requirements.

What Happens to Classified Contracts? A host of unique issues can arise when acquiring a cleared contractor and without appropriate due diligence, such as, a U.S. company's ability to retain its security clearance and classified contracts may be adversely and permanently affected. The National Industrial Security Program Operating Manual (''NISPOM'') limits access of classified information to entities and individuals who hold a security clearance. Foreign citizens and corporations are ineligible. In change of ownership situations, cleared contractors must notify the Defense Security Service (''DSS''), and if being acquired by a foreign entity, must notify DSS upon entering discussions regarding an acquisition.

As part of diligence, it is therefore critical for both buyers and sellers to carefully review the target business' DD 254 and classified access requirements. To the fullest extent possible, a buyer should also disclose whether the acquisition will result in any foreign ownership control or influence (''FOCI''). If the transfer of ownership will result in continued U.S. control of the cleared contractor, the security clearance will remain in place, and at most, the new owner will be required to get a facility clearance of its own or become an ''excluded'' parent organization for security clearance purposes.

However, if the acquisition will result in FOCI of the cleared entity, the parties should voluntarily seek clearance from the Committee on Foreign Investment in the United States (''CFIUS'') and propose approved methods to mitigate the FOCI. For instance, a simple resolution by the U.S. company's board can provide an adequate solution if the foreign interest is minimal, e.g. is not entitled to board representation. However, where FOCI is more significant, a Special Security Agreement or Security Control Agreement can be put into place to preserve the foreign interest's right to board representation, while preserving the government's interest in limiting access to classified information. A Voting Trust or Proxy Agreement, allowing the U.S. company to operate effectively independently, is the most stringent mitigation approach, but where cleared by the Government, can effectively mitigate FOCI issues. The FOCI mitigation will be negotiated and agreed to during the CFIUS process and will ensure that the cleared contractor's security clearance and classified contracts remain in place post-acquisition.

GSA Schedule Contract Compliance. Focused due diligence on compliance with unique contract clauses in GSA Federal Supply Schedule (''FSS'') contracts is imperative when acquiring a government contractor that has significant sales through the FSS program. Recent spikes in government oversight and *qui tam* False Claims Act actions focused on FSS compliance have heightened the risk of post-closing exposure. To guard against this risk, buyers should focus on the following areas as part of their due diligence efforts:

- Examine the adequacy of the seller's recent commercial sales practices disclosure statement to confirm that commercial practices have been properly disclosed.

- Confirm basis of award customer for each FSS contract and test monitoring for price reduction clause purposes.

- Review FSS sales reporting, Industrial Funding Fee (''IFF'') payment, and Open Market designation practices.

- Assess applicability and compliance with Trade Agreement Act requirements.

Finally, where buyer and seller have multiple GSA Schedule contracts, special attention post-closing will be required to harmonize labor rates and GSA may require the early termination of overlapping contract vehicles.

Optimizing Seller's Intellectual Property. When considering a target's intellectual property (''IP'') portfolio, the acquirer should pay special attention where IP may have been created or delivered under government prime and sub-contracts. Target companies who fail to file invention disclosure reports or properly mark technical data can unknowingly diminish the value of its IP. One of the most common causes is the failure of the target to properly segregate government funded modifications or enhancements, which ultimately calls into question the proprietary nature of that IP. Understanding of the government's contractual rights (e.g. a li-

cense or required deliverable) to the IP under the contract is paramount to protecting the value of the target. During diligence, a careful assessment of the target's data rights assertions and marking procedures may reveal potential issues. Consider engaging an IP consultant to confirm that the IP portfolio of privately and government funded software applications have been properly segregated and that overlap in development and funding is minimal.

Managing Change of Control Communications. Perhaps most importantly, the parties need to remember that the U.S. government is the end customer and managing change of control communications is paramount to a successful post-closing relationship. The parties must assess and understand prime contract notice requirements and trigger points. Absent a contract novation, there is generally no requirement for the government to consent to a transaction, but there are two FAR provisions that appear in most prime contracts that may require contractual notice to the government. For instance, FAR 52.215-19 requires notice to the contracting officer of a change in ownership in certain situations, and FAR 52.219-28 requires small business to rerepresent their size status upon completing an acquisition. In addition, there may be other special contract clauses requiring notice upon a change of control or change in key personnel. Confirming that these notices are properly managed and conveyed is critical to the long-term success of the transaction.

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