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FEATURE COMMENT: No Stone Unturned—Mitigating Risk In A Government Contracts Due Diligence

The expected defense budget cuts required by Congress to balance the U.S. budget may very well ignite a renewed process of reconsolidation, divestitures and acquisitions among U.S. Government contractors and financial sponsors aiming to streamline and integrate their core businesses in the aerospace and defense marketplace. An acquisition transaction involving a Government contractor brings with it a unique set of rules and regulations. There is no shortage of frequently changing and complex requirements regulating a Government contractor's operations. A firm grasp of these requirements is crucial both to arriving at a proper valuation of a target company and to understanding the risks involved in the transaction. Although risk areas vary by transaction, this Feature Comment highlights risk areas that we frequently encounter during a Government contracts-related due diligence.

Contract Basics—An assessment of the degree of risk associated with a particular Government contract begins with the contract type. Under a firm-fixed-price contract, a contractor is responsible for any cost overruns. Under a cost-reimbursement contract, a contractor is reimbursed only for costs that are reasonable, allowable and allocable, and failure to segregate such costs properly may result in financial liability. Where a contract provides for an award fee or incentive fee, the Government may withhold a portion of the payment unless certain contractual criteria are met or exceeded.

Some contracts even provide for draconian price reductions and penalties if certain pricing conditions are not met. For example, the General Services Administration Federal Supply Schedule contracts contain most-favored customer pricing terms, which are enforced through the GSA Acquisition Regulation Price Reductions clause. Failure to comply with this contract provision by giving a customer a better deal can be extremely costly. Contracts awarded on a sole-source or restricted basis carry different risks than contracts awarded through full-and-open competition because the award of such contracts is often premised on the complete disclosure of certain cost data and, if those data are incomplete, inaccurate or not current, financial liability may follow. Option periods under contracts are not guaranteed, and the Government must exercise any options in strict conformity with the terms of the contract, unless waived by the contractor. Hence, when assessing backlog and valuation, all of the above contract issues must be considered.

Anti-Assignment Act/Novation—The Anti-Assignment Act prohibits the transfer of a Government contract to a third party. A Government contract may be transferred, however, if a buyer purchases all of a seller's assets or all of a seller's assets involved in the performance of a contract, and the Government consents to the transfer. The Government provides its consent to a transfer through a novation agreement, which is executed by the buyer, the seller and a designated Government representative.

The Federal Acquisition Regulation contains a standard novation template and requires that the parties submit detailed corporate, financial, legal and performance-related documentation. Even after the Government has consented to the transfer of a Government contract, a seller remains liable to the Government in the event of default by a buyer. Structuring a transaction as a stock purchase or a reverse triangular merger generally may obviate the need for Government consent where only a change in ownership—without more—is involved. (A recent Delaware case, however, has introduced some uncertainty in this area by holding, in the context of a motion to dismiss, that a reverse triangular merger may implicate a contract's anti-assignment provision; so, as always, it is important to involve experienced counsel to advise on the need for a novation in this context and to assess the attendant risks.)

Small Businesses—The Government is required to set aside certain contracts for small businesses, as defined by revenue or number of employees as established for specific industries. Large businesses often target companies that hold small business contracts so as to capture an otherwise inaccessible revenue stream. As a result of an acquisition transaction, however, the small business may lose its identity as small and, thus, lose its preferential status.

The Small Business Administration regulations require a contractor to certify its size status within 30 days after the execution of a novation agreement or within 30 days after the consummation of a merger or other agreement not requiring a novation. If a company no longer qualifies as small, the Government contract may be terminated for convenience (in which case an informed decision would likely need to be made about the risk of termination). A contract issued to a small disadvantaged business concern under SBA's 8(a) program *must* be terminated for convenience unless a waiver is obtained from the SBA administrator prior to closing.

Mandatory Disclosure Rule—The mandatory disclosure rule consists of two components. The FAR Business Ethics and Conduct clause (FAR Ethics clause) applies to contractors holding a contract valued over $5 million and having a period of performance of 120 days or more. The Suspension and Debarment clauses apply to all contractors. The clauses require a contractor to make a timely disclosure to the contracting officer and agency inspector general when the company or one of its principals has credible evidence of a violation of certain crimes under title 18, U.S. Code, a violation of the civil False Claims Act or a significant overpayment.

Since the clauses require disclosure of such issues until three years after final payment on a contract, a contractor may be required to conduct a "look back" investigation to ascertain whether any prior conduct triggered a disclosure obligation. Apart from the foregoing, the FAR Ethics clause also may require a contractor to establish a code of business ethics and conduct, an ongoing business ethics awareness and compliance program, and an internal control system. It is thus important to ascertain whether the target has a sufficient set of systems and processes, and whether any disclosures have been made, in order to properly evaluate and value the company from a due diligence perspective.

Organizational Conflicts of Interest (OCIs)—There are three primary types of potential and actual OCIs: (1) biased ground rules, (2) impaired objectivity and (3) unequal access to information. A biased ground rules OCI may exist where a contractor drafts a statement of work, prepares performance specifications or develops testing requirements, and then competes for or performs the work. An impaired objectivity OCI may exist where a contractor evaluates its own products or services. An unequal access to information OCI may exist where a contractor has been provided access to source selection or proprietary information that is not available to other contractors, and then competes for or performs the work.

In each instance, a contractor is performing work that is perceived as providing an unfair competitive advantage and could be precluded from competing for or performing follow-on effort or related contracts. Potential and actual OCIs must be avoided, mitigated or neutralized. Some OCIs may be mitigated through confidentiality agreements or firewall arrangements. Other OCIs may require more extensive mitigation measures, such as reassignment of work or divestiture of a contract. To assess the risk of OCIs, it is imperative to examine closely whether the types of work that the target performs create conflicts with (a) the types of work the acquirer performs, or (b) the types of work that the acquirer desires the target to be able to perform after completion of the acquisition.

Export Controls—The ability to export goods or services from the U.S. is a privilege and not a right. Hence, compliance with export laws is critical if the target derives a material portion of its income from sales to foreign companies, governments or individuals, or has foreign-national employees. Violations of the export laws may result not only in large fines and penalties, but also in the denial of export privileges.

Exports of U.S. products and technology are generally governed by three regimes. The first is the Commerce Department, which administers the Export Administration Regulations. This regime generally governs commercial products and technology that are considered "dual use," meaning products that have both commercial and military uses. The second is the Department of State, which administers the International Traffic in Arms Regulations (ITAR). This regime governs “defense articles,” products and technology that are designed or modified for military or intelligence capabilities. The third is the Department of the Treasury, which, through the Office of Foreign Assets Control, administers and enforces the U.S. sanctions programs. This regime governs exports to specific countries and individuals.

Because a strong compliance plan and training minimize the risk of noncompliance with the export laws, it is important to gain an understanding of the target’s processes to gauge risk. Each of these regimes has license and paperwork requirements that should be reviewed. Further, there are registration requirements under the ITAR both for exporters and manufacturers of defense articles. Notification may be required, and registrations and licenses may need to be updated or transferred to the buyer, depending on the type of transaction.

Data Rights—Frequently the value of a target is closely aligned with the value of its intellectual property. Consequently, in any due diligence, it is imperative that the target’s rights in its intellectual property, both its patents and trade secrets, as well as the Government’s rights in those same data, be ascertained. Determining these rights requires an examination of when inventions were made and how the target obtained, funded and protected its rights in intellectual property used or developed in connection with its Government contracts. Inventions conceived or reduced to practice under a Government contract must be disclosed, or the company runs the risk of forfeiture. In most cases, the Government will be allocated a license to practice the invention.

With respect to trade secrets, there are generally three types of rights that contractors provide the Government: unlimited rights, Government-purpose rights and limited rights. The Government typically obtains unlimited rights where the data were developed exclusively with federal funds. These rights allow the Government to use the data without restriction, including giving them to a third party to use. Government-purpose rights are generally obtained where both contractor and Government funds are used to develop the data. Here, the Government’s right to use the data is restricted for five years, and then the Government obtains unlimited rights. The Government obtains limited rights where the data are developed exclusively at private expense. These rights are more akin to a specific license that the contractor would provide to a commercial purchaser.

There are both FAR and Defense FAR Supplement clauses that cover data rights, each with specific marking and other administrative requirements. Complicating things, however, is that the parties may enter into special licenses and unique terms. Hence, in order to ascertain the rights that the target has provided to the Government, it is important to examine (1) the data rights clauses in the contracts, (2) the accounting records for the development of the data, and (3) the records reflecting that the target properly protected its data rights.

Foreign Ownership, Control and Influence (FOCI)—The National Industrial Security Program Operating Manual governs the acquisition of a contractor holding a facility security clearance by a foreign interest. A contractor holding a facility security clearance must provide the Defense Security Service (DSS) with timely notice of an acquisition transaction. Any percentage of foreign ownership triggers the notice requirement. DSS examines a variety of factors to determine (a) whether a contractor is under FOCI, and (b) what mitigation measures, if any, should be implemented. An ownership interest can be deemed substantial where it consists of greater than five percent of the ownership interests or greater than 10 percent of the voting interests. Mitigation measures may range from board resolutions, to voting trusts or proxy agreements, to special security agreements or special control agreements. DSS reserves the right to impose any mitigation measure it deems necessary to prevent unauthorized access to classified materials and to protect the performance of classified contracts.

Committee on Foreign Investment in the United States (CFIUS)—CFIUS is an inter-agency committee tasked with reviewing national security implications of foreign investments. CFIUS review is generally triggered when a “foreign person” (for example, the buyer or investor) would obtain the power to “control” a U.S. company, and the acquisition transaction would threaten U.S. national security interests. The parties typically submit a voluntary notice to CFIUS to obtain “safe harbor” protections following approval of the acquisition transaction.

The parties should expect CFIUS to conduct an initial 30-day review, followed potentially by a 45-day investigation or 15-day presidential review. CFIUS must investigate certain transactions by statute.

CFIUS and the president retain the authority to initiate review of an acquisition transaction and to impose mitigation measures as a condition of approval. Certain exceptions to CFIUS review are available to the parties, such as when an investment by a passive foreign investor does not exceed 10 percent. The failure to file a notice with CFIUS, when required, exposes the acquisition transaction to post-closing rescission.

Conclusion—Many of the rules and regulations discussed above were revised recently. For example, the SBA recertification rules went into effect in 2007, and other significant changes to small business rules followed, including the Small Business Jobs and Credit Act of 2010. The rules governing CFIUS review likewise were amended in 2007 and 2008. The mandatory disclosure rule went into effect in 2008. Additional changes are on the horizon. The FAR Council recently issued proposed revisions to the OCI rules. And Commerce and State recently issued proposed rules that would significantly reform U.S. export controls.

Companies that fail to undertake a comprehensive due diligence and that fail to follow changes to the regulatory landscape expose themselves to myriad risks that could lead to monetary and non-monetary penalties, fines and sanctions, and deprive them of the "benefit of the bargain." It also is likely that these companies will not be in a position to assess accurately a target company's value. A complete and thorough due diligence led by experienced and competent advisors is critical to obtaining a complete picture of the target company, determining and assessing the risks for the buyer, and eliminating any surprises after closing.

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