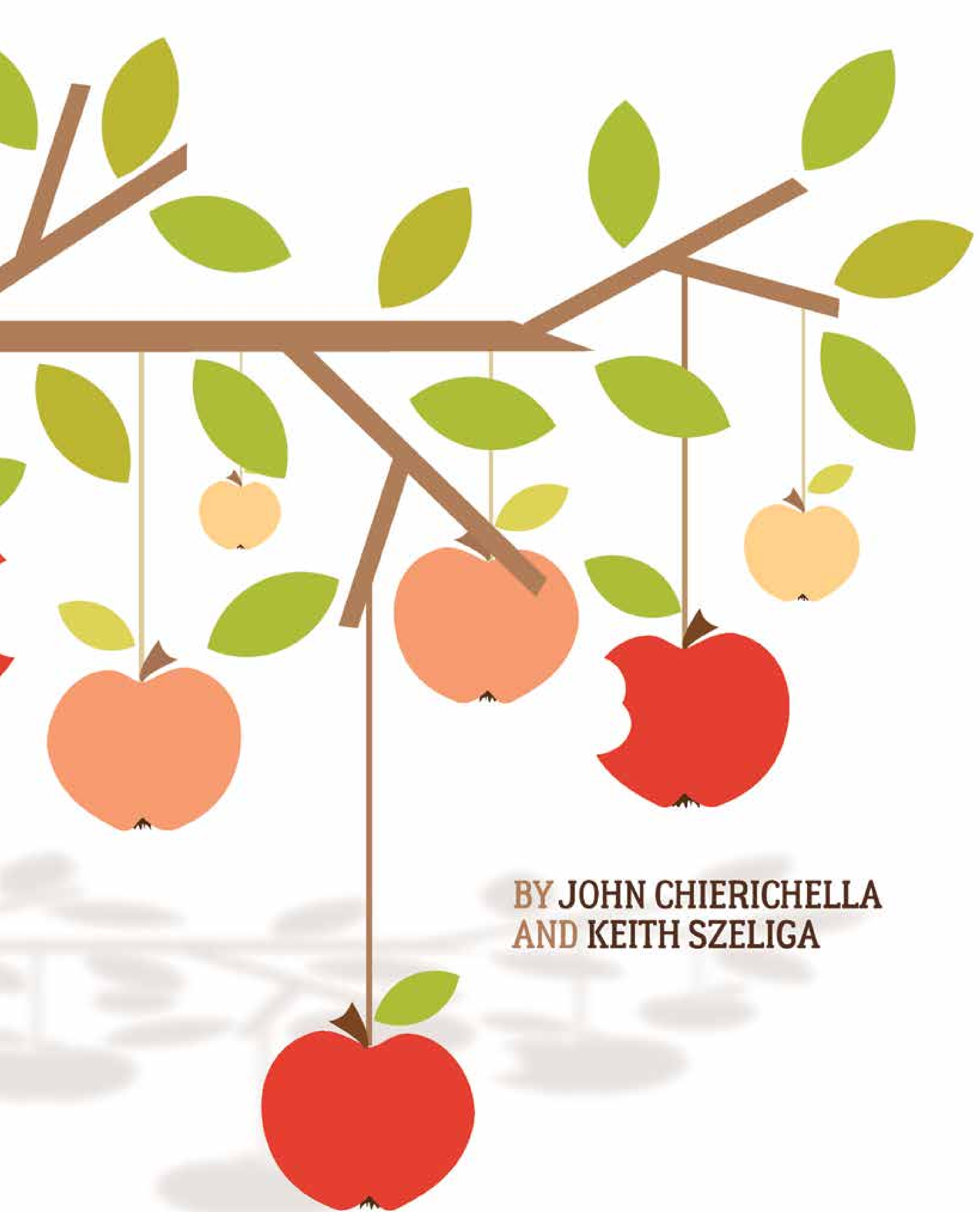
Due Diligence in Government Contracts Mergers and Acquisitions—

Where to look for the Low-Hanging Fruit



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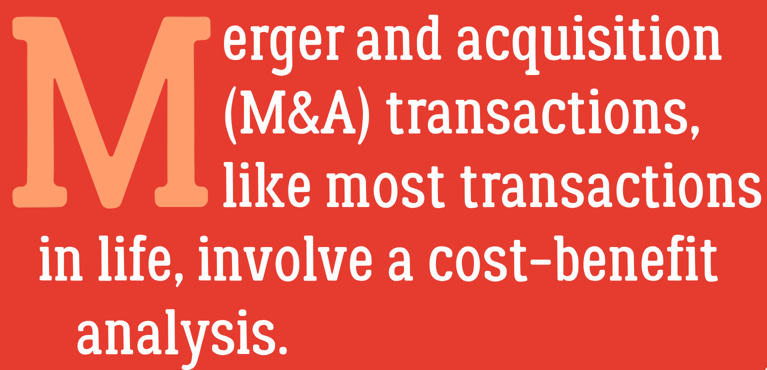


Merger and acquisition (M&A) transactions, like most transactions in life, involve a cost-benefit analysis.

Some cost-benefit analyses are relatively easy. For example, if I buy an energy-efficient appliance, I can calculate the likely savings on my energy bill over the purchase's useful life (the benefit) and compare that with its price (the cost). M&A transactions, of course, involve far more complex cost-benefit analyses. The key to any such analysis is the ability to identify and quantify the costs and benefits with some measure of confidence. Every line of business has its own quirks and idiosyncrasies, which must be understood when evaluating the acquisition of a company that operates in that line. The business of government contracting is replete with such peculiarities, and they can have a dramatic effect on the "cost" side of the cost-benefit analysis.

One of the more costly aspects of government contracting derives from the all-encompassing oversight role of the government and the uncertainties it can introduce into the evaluation of a target business. It is important, therefore, to know what to look for when your team descends on the data room, what to ask for, and what it portends. If you need a mnemonic to help guide your tour through the data room, think AID – audits, investigations, and disclosures. Access to information relating to those three topics will serve to identify risks and liabilities that can significantly affect your cost-benefit analysis.

Audits

There may be no entity subjected to more continuous and pervasive audit scrutiny than the government contractor. From cradle to grave, the government contractor encounters an army of auditors whose very existence depends on its ability to identify irregularities that, once corrected, will pay dividends to the U.S. Treasury. The government – acting principally through the Defense Contract Audit Agency (DCAA), but also through other agency-specific instrumentalities - audits, among other things, proposals, progress payments, incurred costs, and an array of business systems (i.e., the contractor's accounting, earned value management, estimating, material management, and purchasing systems). If the contractor has flexibly priced contracts, the auditors' objective is to identify, question, and urge the disallowance of costs the auditors determine to be:

1 | Unallowable as a matter of policy under one or more of the 50 "Cost Principles" set forth in Part 31 of the *Federal Acquisition Regulations* (*FAR*),

2 | "Unallocable" to government contracts, i.e., of insufficient "benefit" to warrant assignability to government work, or

3 | "Unreasonable."

If the costs are ultimately found to fall into any of these categories, the contractor eats them; if the contractor has already billed those costs and been paid for them, it must refund them. "Expressly unallowable costs" come with interest and penalties. Along the way, and irrespective of whether the contracts are flexibly or fixed price in nature, the auditor will be looking for:

1 | Any failure on the part of the contractor, if its business mix and volume require it, to have complied with its Cost Accounting Standards Disclosure Statement and the Cost Accounting Standards, as well as

2 | The auditors' all-time favorite audit target, i.e., a failure to have disclosed with sufficient specificity when reaching agreement on price "cost or pricing data" that are "current, accurate, and complete."

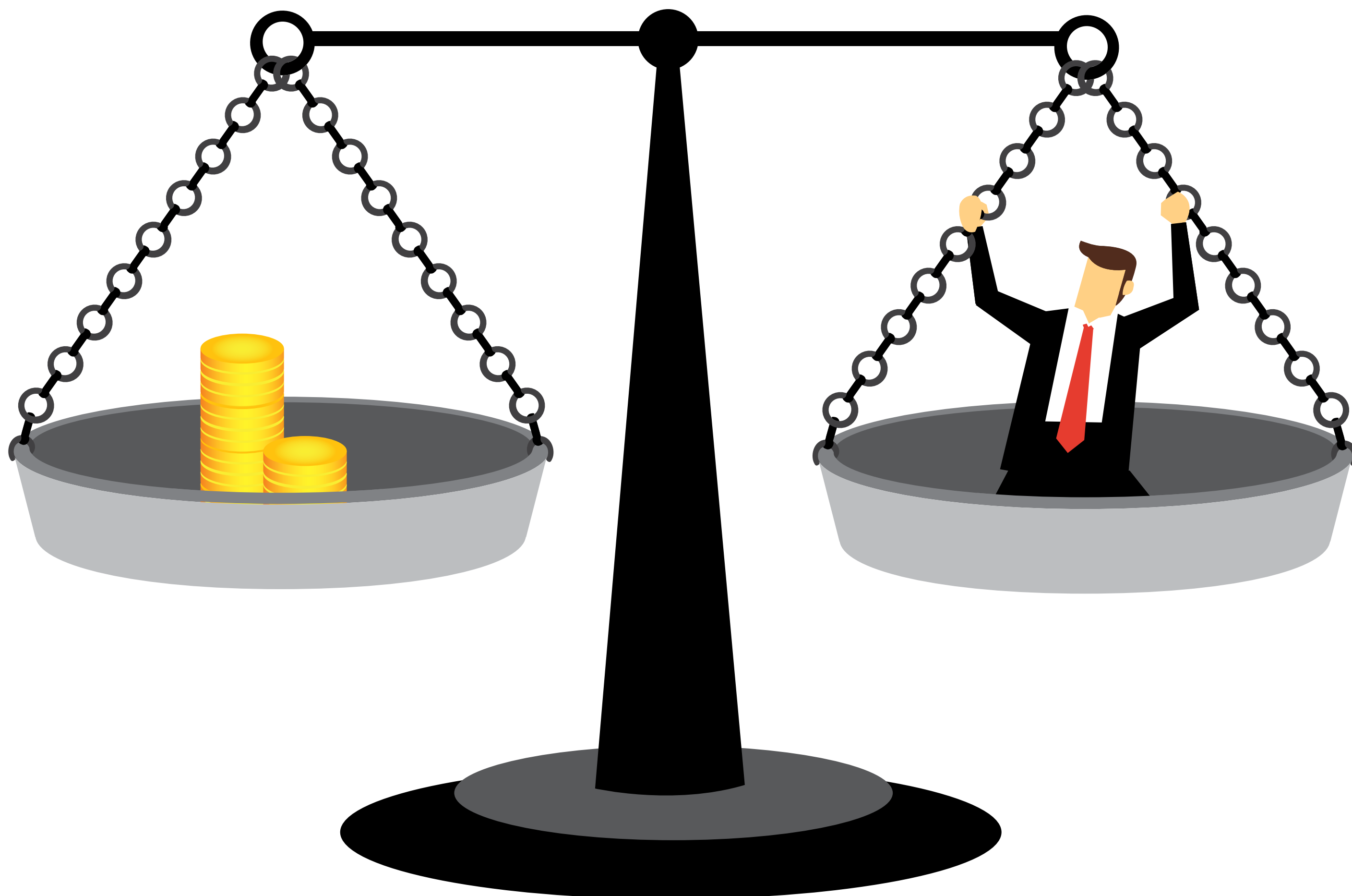
Significant deficiencies found in a defense

contractor's business systems can result in the unilateral withholding of between 5 and 10 percent of its aggregate cost vouchers until corrected. Significant deficiencies in any government contractor's business systems or compliance program may constitute evidence that the contractor demonstrated recklessness or deliberate indifference with respect to contractual or other requirements, creating the potential for liability under the False Claims Act (discussed below under Investigations).

Step 1 in assessing the impact of the government's audit rights on a corporate transaction is understanding just how all-encompassing and pervasive those rights are and whether that level of transparency and scrutiny is consistent with your business model.

Step 2 is making sure you have access to, and then reviewing and evaluating, the available information on open, unresolved audits so that you can "size" the risks that are already the subject of government focus.

Step 3 is an assessment of the target's cost accounting and other systems, and its training and compliance policies and programs generally, so that you can evaluate the likelihood of lurking audit "time bombs" in the database. Remember, (1) the statute of limitations on contract claims is six years from the date of accrual, (2) the



claim cannot accrue until the government knows or has reason to know of the basis for its claim, and (3) audits are often initiated as late as three years after final payment on the contract. In fact, DCAA is notorious for delays in completing incurred-cost audits, leaving contractors' indirect rates and interim billing rates in financial limbo for so long that Congress actually intervened. Once those three steps have been completed, you can tailor the seller's representations and certifications and decide how to allocate the risks, e.g., via indemnities, reductions in the valuation of the target, withholdings for a specified duration, or, in an asset sale, exclusion of the liabilities from the transaction.

Investigations

The line between "audits" and "investigations" is often elusive. Simply stated, every audit relating to the pricing of a government contract or subcontract and/or the billing of costs under such contracts is an investigation in waiting. Once the government concludes the pricing or billing was wrong, it has – in its view, at least – cleared the first hurdle in the development of a civil False Claims Act violation. It then need only find that the erroneous pricing or billing was "knowing," i.e., either that it was willful or that the error was the result of reckless disregard for the propriety of the underlying claims for payment or of indifference for their accuracy. At this juncture, the government's contract claim becomes something far more serious, involving potential treble damages and statutory penalties for each false "claim" submitted for payment. Errors in the construction of indirect cost pools can give rise to the most devastating false claims, because some portion of the erroneous rate finds its way into every progress payment, cost voucher, and contract price negotiated on the basis of those rates as part of the pricing package. No matter the value of the error in any one individual invoice or voucher, each payment claim can be the basis for a statutory penalty between $10,781 and $21,563 per claim. So, a "knowing" error in an overhead pool that generates a relatively small damage award (because the "inflation" in the individual claims for payment is measured in nickels and dimes) can nonetheless generate millions of dollars in penalties.

It may not be possible to identify every investigation that has been launched against an M&A target, but it is important to know those of which the target has knowledge, including self-investigations that may have originated with a hotline call or the complaint of a disgruntled employee who could later surface as a *qui tam* relator, bringing a False Claims Act case against the target in the government's name. And the uncertain-

ty that surrounds the existence of investigations merely underscores the importance of reviewing and evaluating the target's compliance systems and procedures.

Disclosures

FAR 52.203-13 requires most contractors with any appreciable level of government business to disclose in writing to agency inspectors general "credible evidence" of a violation of the civil False Claims Act or of federal criminal law involving fraud, bribery, gratuities, or conflicts of interest in connection with the award, performance, or closeout of a covered contract by a principal, employee, agent, or subcontractor of the contractor. Plainly, an evaluation of the M&A target should involve any such disclosures. That evaluation should be probing. Contractors have an incentive to minimize the nature and scope of the disclosed conduct to avoid audits and investigations. Accordingly, you should not take the disclosure at face value, but instead make further inquiries regarding the conduct that generated the disclosure and its significance to the target's business.

Every transaction has issues that require due diligence. In the case of a government contractor or subcontractor, there are significant near- and long-term liabilities that can emerge out of the government's pervasive oversight prerogatives. Knowing what to ask for in relation to these prerogatives and what to look for in what you receive are critical to a meaningful evaluation of the target. CM

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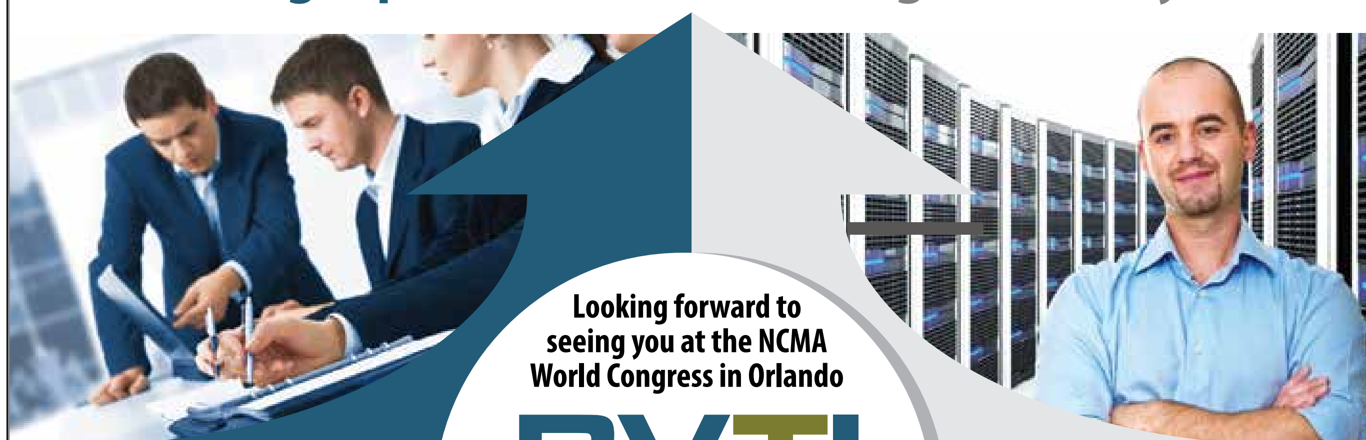

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