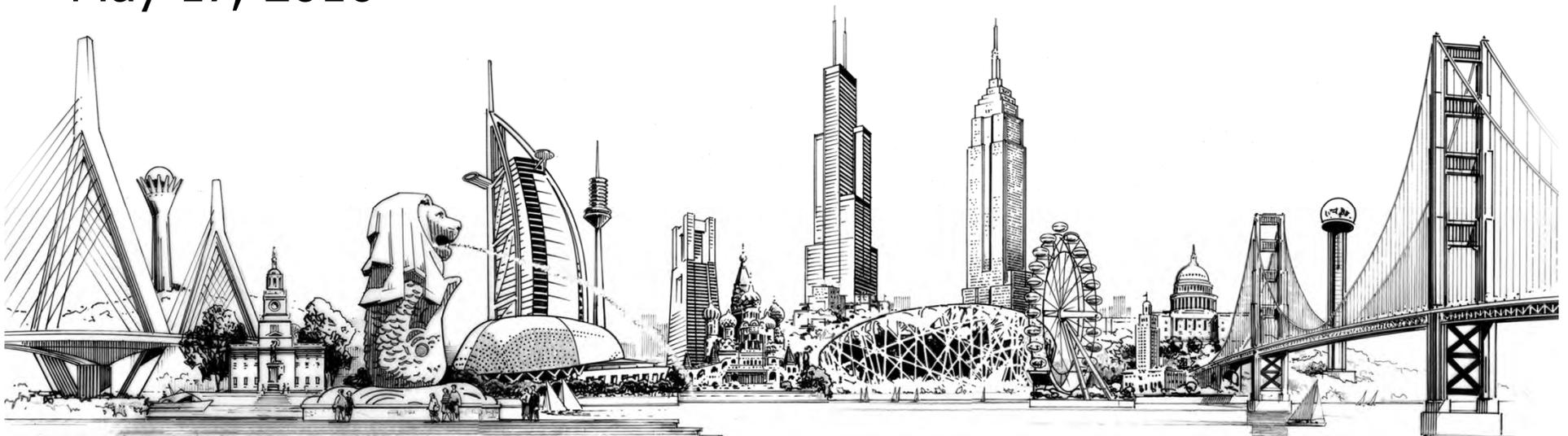


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**MORGAN LEWIS M&A ACADEMY
SPECIAL ISSUES IN MERGERS &
ACQUISITIONS INVOLVING
GOVERNMENT CONTRACTS**

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AGENDA

- Increased M&A Activity Among Government Contractors
- Understanding the Effect Transaction May Have on the Government Contracts Business
- Upfront Considerations
- Specialized Due Diligence and Representations and Warranties
- Novation
- Security Clearances and Mitigation of FOCI
- Mandatory Disclosure Rule & Debarment
- Civil False Claims Act Liability
- Protection of Intellectual Property Rights
- Notice to DDTC of Change of Control
- Sell-Side Considerations
- Buy-Side Considerations
- Questions & Answers

Increased M&A Activity

- Prospect of a declining DoD budget and end of the Afghan war increases demand for companies in hot areas such as cybersecurity, intelligence systems, cloud computing, big data analytics, healthcare IT, and unmanned platforms.
- Large prime contractors have focused on acquiring smaller contractors to round out capabilities and buy into government contracts and relationships.
- Small businesses that are about to outgrow their small-business status often seek a buyer.
- Government contractors have spun-off companies and business units to mitigate the risks that organizational conflicts of interest (OCIs) will preclude them from competing for contracts.
- Several large contractors jettisoned their government services units, as these contracts are increasingly awarded based on lowest price and technically acceptable criteria, and also raise OCI concerns.

Importance of Specialized Due Diligence

- Thorough due diligence is crucial because a failure to comply with the terms of a government contract can result in treble actual damages and statutory penalties under the civil False Claims Act (FCA) and potentially lead to suspension and debarment, which may be the death knell of the company.
- Compliance with international trade laws must be reviewed as export violations under the International Traffic in Arms Regulations (ITAR) or Export Administration Regulations (EAR) can result in large penalties and loss of export privileges. Conducting due diligence by foreign persons may require export licenses.
- Threshold issues can affect the structure of the transaction and planning such as (1) whether any foreign ownership or control is contemplated, (2) whether the target has security clearances, (3) whether the target is subject to ITAR, and (4) whether the target benefits from special preferences or set aside programs.

Specialized Due Diligence Considerations

- Materiality Threshold
 - Does the materiality threshold established for the deal make sense for the target's government contracts?
 - Consider lower or no materiality threshold for government contracts due to greater risks.
- Lookback Period
 - Is the lookback period for the deal sufficient?
 - Government audit rights generally extend for 3 years after final payment.
 - FCA considerations; statute of limitations is 3/6/10 years.
 - May consider looking at certain contracts performed prior to the lookback period.
- Escrow Period
 - Is the escrow period long enough to protect the company from issues arising from its government contracts?
 - Consider holding a portion of the escrow for a longer period if concerns involving the target's government contracts arise during due diligence.

Importance of Specialized Representations and Warranties

- Specialized representations and warranties are necessary to force disclosure of government contract issues and to set up appropriate indemnities.
- We have a standard set of representations and warranties that should be customized to the transaction in question.

The Transaction May Affect the Target's Business Prospects

- Loss of eligibility for contracts set aside for small businesses, veteran-owned businesses, 8(a) companies, woman-owned businesses, and HUBzone companies.
- Service-Disabled Veteran status is usually lost.
- Contracts set aside under the 8(a) program may be terminated for convenience.
- Small business size recertification may be required under IDIQ and long-term contracts.
- OCI concerns may arise due to the acquisition that can preclude a company from bidding on certain programs.

Novation Agreements

- Prime contracts with the government are subject to the Anti-Assignment Acts. These Acts preclude the assignment of contracts and claims and operate to annul a contract assigned to a third party without written government consent.
- If a transaction is structured as a stock purchase or a reverse triangular merger, then the novation process generally can be avoided.
- An agency may approve the assignment of a government contract through the novation process. The agency typically seeks assurance that the transferee is responsible and has the financial and technical ability to perform the contract.

Novation Agreements (cont'd)

- If a novation is required –
 - Identify appropriate lead contracting officer and discuss with target when to begin discussions
 - May require a subcontract for performance from close until novation is complete
 - Can take months for contracting officer to process novation
- Restrictions on assignment may be included in subcontracts for competitive reasons. During diligence, identify all subcontracts that limit assignments or require approval of a change of control.
- The standard novation agreement provides that (1) the transferor guarantees performance of the contract by the transferee; (2) the transferee assumes all of the transferor's obligations; and (3) the transferor waives all rights under the contract against the government.

Security Clearances

- The Defense Security Service (DSS) serves as the interface between the government and the contractor community to ensure that classified information is adequately protected.
- A US company must obtain a facility clearance (FCL) to access classified materials.
- Personal security clearances are required for key management personnel and the Facility Security Officer (FSO) and persons who need access.
- Cleared US companies must submit an SF-328 disclosing any foreign ownership, control, or influence (FOCI) (5% ownership may be significant).
- An acquiring company should review the results of the annual inspections by DSS for each facility, the SF-328, and any FOCI mitigation measures in place.
- A company under FOCI cannot hold an FCL unless the FOCI is negated or mitigated to the satisfaction of the government.
- Asset sales raise issues because FCLs do not transfer with assets. The acquiring company will need an FCL to accept the assets.
- Approach DSS early in the process to address any questions/concerns.

Mitigation of FOCI

- A foreign interest that owns or controls a cleared US company may take steps to mitigate the FOCI and maintain the company's FCL.
- FOCI issues and mitigation plans must be considered in structuring the transaction and in the contemplated board membership.
- When a contractor with an FCL enters into negotiations that could result in takeover by a foreign interest, DSS must be notified at the "commencement of such negotiations." NISPOM 2-302(g).
- FOCI mitigation plans may include board resolutions, a Security Control Agreement, Voting Trust, Special Security Agreement, and other measures.
- A notice of change of control and a revised SF-328 normally must be submitted when the merger or acquisition of a cleared company is completed, or when there have been changes to the answers on the SF-328.
- Access to Top Secret, SCI, COMSEC, and other types of information by a company subject to FOCI may require other approvals such as National Interest Determination.
- Mitigation of FOCI is separate from the Exon-Florio/CFIUS process.

Mandatory Disclosure Rule

- FAR 52.203-13 applies to contracts valued at more than \$5M with a performance period upwards of 120 days.
- Requires the contractor to:
 - Have a written code of conduct that is available to all employees.
 - Exercise due diligence to prevent and detect criminal conduct and promote an ethical culture committed to compliance.
 - **Timely** disclose in writing to the contracting officer and agency inspector general **credible evidence** that a principal, employee, agent, or subcontractor has committed a criminal violation or violation of the FCA **in connection with the award, performance, or closeout of a contract.**
- FAR 9.4 extends this obligation to **significant overpayments**, which are reason for most of mandatory disclosures we file.

Mandatory Disclosure Rule (cont'd)

- Under the “look back” provision, the rule requires disclosure of covered misconduct “until 3 years after final payment” under the contract.
- The terms “timely disclosure” and “credible evidence” are intentionally undefined and confirm that the contractor has some time for a preliminary investigation before a disclosure is mandatory.
- Contractors must document investigations of misconduct and promptly reach conclusions regarding the existence of credible evidence.
- Buyers must include diligence requests and insist on representations that will facilitate disclosure of internal investigations and violations of procurement statutes, regulations, and contract terms so that these risks can be fully evaluated and, if necessary, disclosed.
- Discovery of significant issues may affect escrow amounts/time period or in some instances could impact deal price

Civil False Claims Act

- Primary enforcement tool used by DOJ to combat federal program fraud
- Cases can be brought by the government or *qui tam* relators who receive 15%-30% of proceeds
- In FY2014: DOJ recovered \$5.69 billion under the FCA
 - Nearly \$3 billion of this in *qui tam* cases
 - Whistleblowers recovered \$435 million
- Matters historically settled as breach of contract actions are now frequently alleged to violate the FCA
- In general, the FCA provides for civil liability for (1) knowingly presenting, or causing to be presented, a false claim for payment or approval to the government; (2) knowingly presenting, or causing to be presented, a false record or statement material to a false claim; and (3) conspiring to commit a violation of (1) or (2) above.

Civil False Claims Act (cont'd)

- “Knowingly” means that a person, with respect to information, (1) has actual knowledge of the information; (2) acts in deliberate ignorance of the truth or falsity of the information; or (3) acts in reckless disregard of the truth or falsity of the information.
- ***Recklessness standard implicates adequacy of contractor systems***
- Specific intent is not required.
- Claim defined in 31 U.S.C. § 3729(b)(2) as:
 - Any request or demand for money or property
- False
 - Factually false, express false certification, implied false certification
- The FCA includes *qui tam* provisions that permit a whistleblower to bring an action on behalf of the government, to share in the government’s recovery, and recover attorney fees if successful.

Liability Under the Civil FCA

- Treble damages are automatically imposed and many courts believe they lack discretion to reduce the award of damages absent a voluntary disclosure by the violator.
- In addition to treble damages, a minimum statutory penalty is imposed of \$5,500 to \$11,000 per false claim.
- The successful relator (whistleblower) can share in 15% to 30% of the government's recovery. Relators are protected.
- Government audit rights extend many years after final payment, and the FCA statute of limitations is 6 years.
- During due diligence, any actual or threatened investigations or issues that could lead to FCA liability must be identified and assessed.

Debarment and Suspension Risk

- Suspension and debarment are administrative actions to protect the government from contractors that are not **presently** “responsible” by excluding the contractor from government contracts, grants, and other programs.
- Debarment from contracting with the government typically lasts 3 years and **can be the death knell** of a contractor.
- Individuals can be debarred for ethical reasons, and certain “Principals” can be debarred for not reporting violations of law involving fraud and other issues to the IG and CO.
- Between FY 2009 and FY 2014 debarments rose by 188% to 1,929 actions.
- During due diligence, the acquirer should use representations and diligence to uncover and assess any matters or investigations that could potentially lead to suspension or debarment.

Protection of Intellectual Property Rights in Government Contracts

- Protection of intellectual property rights is uniquely challenging in government contracts.
- Under the Bayh-Dole Act, if the government has funded the creation of any intellectual property, the government contractor may be permitted to retain title if timely notice is provided to the government, but the government is entitled to a royalty-free license in perpetuity and has “march-in rights” that allow the government to sublicense to others including competitors in certain circumstances.
- The government obtains “unlimited rights” in technical data and software where the government paid all or part of the development costs.
- Unlimited rights in technical data includes the right to disclose the data to the originating contractor’s competitors.

Protection of Intellectual Property Rights in Government Contracts (cont'd)

- The government obtains only “limited rights” in technical data where an item was developed exclusively at private expense.
- Limited rights in technical data include the right to disclose the data for maintenance or emergency repair of the item. Any third party to whom a disclosure is made must agree to protect the originating contractor’s limited rights.
- The government obtains “restricted rights” in software developed at private expense. The government can disclose the software to a support services contractor that agrees to the restrictive rights.
- Generally, in a commercial item procurement, the government obtains only the same data and data rights provided to commercial customers.
- *Campbell Plastics* case – The Federal Circuit determined that the company forfeited its title to a patent on aircrew gas masks by failing to disclose the invention within two months after the inventor disclosed it to its patent counsel.

Notice to DDTC of Change of Control

- A registrant under ITAR must notify Directorate of Defense Trade Controls (DDTC) within **5 days of the event**, if there is a material change in its Statement of Registration, including:
 - A change in senior officers (e.g., directors, officers, partners, owners);
 - the establishment, acquisition or divestment of a subsidiary as a foreign affiliate, or a merger;
 - the dealing in an additional category of defense articles or defense services.
- A registrant must notify DDTC “at least **60 days in advance** of any intended sale or transfer to a foreign person of ownership or control of the registrant or any entity thereof.”
- Notices to other agencies such as ATF may also be required.

Sell-Side Considerations

- Sellers should review their Codes of Conduct and compliance programs for FCA, FCPA, and ITAR violations, as well as other areas, as these will be scrutinized, especially by a strategic buyer. Consider cleaning house and making voluntary disclosures of past non compliance.
- If transaction will result in foreign ownership or control, consider need for Exon-Florio/CFIUS review and mitigation of FOCI. If clearances are required, need to assess how easily the buyer can qualify. These issues may increase deal completion risk.
- Sellers may prefer a stock transaction or reverse triangular merger to avoid a novation agreement that provides for sellers' continued liability to the government for contract performance.

Buy-Side Considerations

- Buyers should conduct specialized due diligence and include specialized representations and warranties.
- Buyers should consider special indemnities and escrows to cover potential government contract liabilities.
- If buyer is a foreign person, then clearance under Exon-Florio/CFIUS and mitigation of FOCI need to be addressed and associated deal completion risk.
- Consider restructuring the transaction as a stock purchase or reverse triangular merger to avoid the need for novation of government contracts.
- Develop plan for maintenance of required security clearances and export control licenses.

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