



Morgan Lewis

SPECIAL ISSUES IN MERGERS & ACQUISITIONS INVOLVING GOVERNMENT CONTRACTS

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About Morgan Lewis Tech May-Rathon

- Morgan Lewis is proud to present Tech May-Rathon, a series of programs focused on current issues, trends and developments that are of key important to technology industry companies
- This year is our 5th annual May-Rathon and we are offering more than 16 in-person and virtual events
- Recordings of all of our Tech May-Rathon programs can be found at www.morganlewis.com
- Be sure to Tweet!  **#ML15MayRathon**

Panelists



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Andrew Ray represents public and private companies, financial sponsors, and management teams in a broad range of corporate and finance matters. Additionally, he counsels extensively in the telecommunications, media, and technology (TMT); government contracts; energy; and financial services sectors. Various industry publications recognize Andy as a leader in both M&A and in communications. He recently led the team representing Oculus VR in its \$2 billion sale to Facebook, which was named the M&A Advisor M&A Deal of the Year.



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Ed Kirsch focuses on government contracts and telecommunications law. He counsels clients in government contracts-related litigation; defending civil False Claims Act allegations, internal investigations, mandatory disclosure matters, debarment matters, and corporate mergers and acquisitions involving government contractors; compliance; and negotiating government contracts, teaming agreements, concession contracts, grants, and other complex contracts. He works on VoIP, cyber-security, and telecommunications issues. He also represents clients before the FCC, state public utility commissions, and the courts on rulemakings, arbitrations, and litigation to enforce contract and interconnection agreement terms.

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AGENDA

- Increased M&A Activity
- Understanding the Effect Transaction May Have on the Government Contracts Business
- Need for Specialized Due Diligence and Representations and Warranties
- Novation
- Security Clearances and Mitigation of FOCI
- Committee on Foreign Investment in the United States
- Civil False Claims Act liability
- Mandatory Disclosure Rule & Debarment
- Sell-Side Considerations
- Buy-Side Considerations
- Questions & Answers

Increased M&A Activity

- Declining DoD budget and end of Afghan war increases demand for companies in priority government spending areas such as cyber security, intelligence systems, cloud computing, Big data analytics, health care IT, C4ISR, and unmanned platforms, and forces divestiture in non-core areas.
- 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 out grow 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 production & systems contracts.
- Cloud computing and migration consulting may be a hot area for M&A in 2015 as the federal market is projected to grow 29.4% CARG to 2018.
- With low interest rates private equity companies are buying professional services and other companies.

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 and lead to suspension and debarment which may be the death knell of the company.
- 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; (4) whether the target benefits from special preferences or set aside programs.
- Specialized representations and warranties are necessary to force disclosure of government contract issues and to set up appropriate indemnities.

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, and HUBzone companies.
- Service Disabled Veteran status is usually lost.
- Contracts set aside under the 8(a) program are generally terminated for convenience.
- Small business size recertification may be required under IDIQ and long-term contracts.
- Organizational conflicts of interest (“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 the transaction is structured as a stock purchase or a reverse triangular merger than the novation process can be avoided.
- An agency may approve the assignment of a Government contract through the novation process. The agency typically seeks assurance the transferee is responsible, and has the financial and technical ability to perform the contracts.
- The novation process is unlikely to be finished prior to closing. Transition arrangements must be negotiated.

Novation Agreements *(cont'd)*

- Restrictions on assignment may be included in subcontracts under government contracts for competitive and other 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 remains liable and guarantees performance of the contract by the transferee; (2) the transferee assumes all of the transferor's obligations; (3) and the transferor waives all rights under the contract against the government.
- Substantial documentation must be submitted to the lead CO as part of the novation process.

Security Clearances

- A U.S. company must obtain a facility security 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 U.S. companies must submit and 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.

Mitigation of FOCI

- A foreign interest that owns or controls a cleared U.S. 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.
- Mitigation of FOCI is separate from the Exon Florio/CFIUS process.

Committee on Foreign Investment in the United States (“CFIUS”)

- CFIUS consists of 16 representatives from various agencies (*e.g.*, DoD, Treasury, State, Commerce, Justice, Homeland Security) tasked to review the national security implications of transactions involving the acquisition of a U.S. business by a foreign person.
- CFIUS may review “Covered Transactions” which consist of any transaction by or with any “foreign person” that could result in “control” of a U.S. business by a foreign person.
- Filing a CFIUS notification is voluntary. However, CFIUS can require a filing upon the initiative of any member agency.
- If a notification is not filed, CFIUS can review the transaction long after closing and even order divestiture. Voluntary Notification can act as a safe harbor from subsequent CFIUS review.

CFIUS Process

- Pre-Filing Submission 5 days before Formal Filing with CFIUS.
- Formal filing triggers 30 day period for CFIUS to review and decide whether to conduct a full investigation.
- Full investigation should be completed within 45 days.
- CFIUS then clears the transaction or refers it to the President who has 15 days to clear or block the transaction. Presidential determinations are not subject to judicial review.
- The timeline may be extended by requests for “voluntary” extensions by CFIUS.
- Voluntary Notices must include substantial information such as: details about the transaction and foreign persons; information on U.S. government contracts; information on the target’s products, services, market share, and future plans.

Civil False Claims Act (“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, or used a false record or statement material to a false claim; and (3) a conspiring to commit a violation of (1) or (2) above.
- “Knowingly” means that a person, with respect to information, has (1) 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.
- Proof of specific intent is not required.
- 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 attorneys’ 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 from dismissal.
- Government audit rights extend many years after final payment and the FCA statutes 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.
- In FY 2014, the DoJ recovered of a total of \$5.69 billion in settlements and judgments under the FCA. Whistleblowers accounted for \$3 billion.

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 last 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.
- Under the present administration with the encouragement of Congress suspensions and debarments have risen rapidly from about 1,900 in 2009, 3,000 in 2011, to 5,179 in FY 2014.
- 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.

Mandatory Disclosure Rule

- A contractor may be suspended or debarred for a knowing failure by a Principal, until 3 years after final payment on any government contract awarded to the contractor, to timely disclose to the Government, in connection with the award, performance, or closeout of a government contract or subcontract thereunder, credible evidence of –
 - (A) Violation of federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations;
 - (B) Violation of the Civil False Claims Act (31 U.S.C. § 3729-3733); or
 - (C) Significant overpayments on the contract.
- This new ground for suspension and debarment in FAR § 9.406-2 applies to all contracts covered by the FAR, including commercial item contracts, and is an independent ground for debarment.
- FAR 52.203-13 applies to contracts over \$5 million with a duration of 120 days or more and imposes a formal compliance program.

Mandatory Disclosure Rule *(cont'd)*

- The terms “timely disclosure” and “credible evidence,” while not defined, 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 request 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.
- All contractors with contracts where any portion of FAR 52.203-13 is triggered, including commercial item contractors not subject to internal control system requirements, must have a written ethics code and provide it to each employee engaged in performance of the contract.

Compliance Program Mandate

- FAR 52.203-13 mandates, for contracts over \$5 million and 120 days duration, that the contractor shall:
 - have a written code of conduct within 30 days of contract award and make a copy available to each employee performing on the contract;
 - exercise due diligence to prevent and detect criminal conduct;
 - promote an organizational culture that encourages ethical conduct and compliance with law;
 - establish a business ethics and internal control system that includes conducting effective training programs; facilitates timely discovery of improper conduct; and ensures corrective actions are promptly carried out. (Formal 52.203-13(c) requirements are not applicable to small business or acquisition of commercial items.)

Notice to DDTC of Change of Control

- A transaction may trigger notice to the Department of State under ITAR.
- A registrant under ITAR must notify Directorate of Defense Trade Controls 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);
 - A change in ownership or control;
 - the establishment, acquisition or divestment of a subsidiary or foreign affiliate or a merger;
 - the dealing in an additional category of defense articles or defense services
 - A change in the registrant's name.
- 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.”

Sell-Side Considerations

- Sellers should review their Code of Conduct and compliance programs for FCA violations, FCPA, ITAR, and 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 which provides for Seller's 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.

QUESTIONS & ANSWERS

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