

M&As – Complications Involving Government Contracts



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Overview Of M&A Process



OUTLINE

1. Anti-Assignment Act & Novations
2. Possible Loss of Small Business Status
3. Anti-Trust: the Gov't Takes a Hard Look
4. Organizational Conflicts of Interests
5. Facility Security Clearances & FOCI
6. “Alligators” Hiding in the FAR
7. Due Diligence “Tips”
8. Compliance Review Essential

Anti-Assignment Act & Novations

The Anti-Assignment Act prohibits the transfer of government contracts and provides that "any such transfer shall cause the annulment of the contract."

Anti-Assignment Act & Novations

- Notwithstanding the Anti-Assignment Act, the Government may consent to the transfer of its contracts.
- The standard government novation agreement is the mechanism for formally providing this consent.
- A novation agreement is necessary only when the transfer would otherwise be prohibited by law.

Anti-Assignment Act & Novations

FAR § 42.1204(b) recognizes three forms of successor in interest:

- (1) An asset sell
- (2) Merger or corporate consolidation
- (3) Stock purchase

Anti-Assignment Act & Novations

(1) An Asset Sell

- Does not constitute a transfer by operation of law
- Requires a novation agreement

Anti-Assignment Act & Novations

(2) Merger or Corporate Consolidation

The ASBCA has found an assignment invalid where the original contractor was voluntarily dissolved and a new company formed to perform. The appeal was dismissed because the successor corporation lacked standing.

Anti-Assignment Act & Novations

(3) Stock Purchase

“A novation agreement is unnecessary when there is a change in the ownership of a contractor as a result of stock purchase with no legal change in contracting parties and where the contracting party remains in control of the assets.”

FAR § 42.1204(b)

Anti-Assignment Act & Novations

A novation agreement may:

- ease the administration of ongoing contracts by ensuring that Contracting Officers and disbursing officials deal only with, and make payments to, the new corporate entity
- preclude later disputes concerning the standing of the successor corporation

Anti-Assignment Act & Novations

Novation Agreements = Nuisance

FAR seeks:

- “authenticated copy of the instrument effecting transfer of assets; *e.g.*, bill of sale, certificate of merger”
- “opinion of legal counsel for transferor and transferee stating that the transfer was properly effected under applicable law.”

Anti-Assignment Act & Novations

Novation Agreements = Nuisance

FAR seeks:

- Board resolutions and minutes of stockholder meeting.
- “balance sheets of the transferee as of the dates immediately before and after the transfer of assets, audited by independent accountants.”

Anti-Assignment Act & Novations

Novation Agreements = Nuisance

The Contracting Officer has broad discretion to determine “whether or not it is in the Government’s interest to recognize the proposed successor in interest.”

FAR § 42.1203(c)

Anti-Assignment Act & Novations

Novation Agreements = Nuisance

- FAR contemplates novation being brought to govt after transaction completed.
 - No assurance Govt will agree
- Pending government approval of the novation, contractors frequently structure their transactions so that the transferee will perform as a subcontractor to the transferor.

Anti-Assignment Act & Novations

Gov't Overreaching In Novations:

“the Govt is not obligated to pay...any related increases ... that the Government would have been obligated to pay”

FAR § 42.1204(i)

Anti-Assignment Act & Novations

Gov't Overreaching In Novations:

Example: a cost reimbursement contract where the transferee has a higher G&A expense rate and a lower labor O/H rate than the transferor, the increase in G&A costs would not be allowable and the disallowance would not be offset by the savings in labor overhead costs.

Anti-Assignment Act & Novations

A novation agreement and its limitation on post-transfer costs has been held binding on a contractor even though the agreement was unnecessary because the transfer occurred by operation of law.

ITT Gilfillan, Inc. v. U. S.

Assignment of Proposals

The GAO has determined that "assignment of proposals when such transfer is effected by operation of law, or merger, or corporate reorganization, or sale of an entire business, or sale of an entire portion of a business embraced by a proposal, or any other means not barred by [the Anti-Assignment statutes]" is allowed.

Numax Electronics, Inc., 54 Comp. Gen. 580 (1975)

Assignment of Proposals

The acquisition of an offeror before award will not render an agency's evaluation of a proposal invalid where the change in ownership has no effect on the offeror's key personnel, resources, or information contained in the proposal on which the evaluation was based.

Consortium HSG Technischer Service GmbH, B-292699, June 24, 2004

II.

Possible Loss Of Small Business Status

Possible Loss of SB Status

The small business is “a concern, including its affiliates, that is independently owned and operated ... and is qualified as a small business under the SBA's size standards.”

FAR § 19.001

Possible Loss of SB Status

Within 30 days of an approved contract **novation**, a contractor must recertify its small business size status to the procuring agency, or inform the procuring agency that it is other than small. If the contractor is other than small, the agency can no longer count the options or orders issued pursuant to the contract, from that point forward, towards its small business goals.

13 C.F.R. § 121.404(g)(1)

Possible Loss of SB Status

8(a) Contracts

A contract awarded to an 8(a) concern shall be performed by the concern. If the owner relinquishes ownership, the contract shall be terminated for the convenience of the Government.

15 U.S.C. § 637(a)(21)(B)

Possible Loss of SB Status

8(a) Contracts

The 8(a) contractor must notify the SBA “immediately upon entering an agreement (either oral or in writing) to transfer all or part of its stock or other ownership interest to any other party.”

15 U.S.C. § 637(a)(21)(D); 13 C.F.R. § 124.515(g)

Possible Loss of SB Status

8(a) Contracts

To obtain a waiver, the SBA requires a certification from the head of the contracting agency or another authorized agency official that “termination of the contract would severely impair attainment of the agency's program objectives or missions.”

15 U.S.C. § 637(a)(21)(B)(ii); 13 C.F.R. § 124.515(b)(4)

Possible Loss of SB Status

8(a) Contracts

- IDP, an 8(a) contractor was awarded an IDIQ contract in 1997 for desktop computers. Estimated quantity was \$100 million
- In 1998, IDP was acquired by a non 8(a) firm
- Government had paid IDP for over \$35 million worth of products
- Government terminated for convenience
- Government insisted successor be responsible for warranty obligations

Possible Loss of SB Status

SBIRs

To be eligible, a small business concern must (1) be a for-profit business concern incorporated in the United States, (2) together with its affiliates, have no more than 500 employees, and (3) be at least 51% owned and controlled by one or more individuals who are citizens of, or permanent resident aliens in, the United States.

III.

Anti-Trust: The Gov't Takes A Hard Look

Anti-Trust: Govt's Harder Look

“Agencies are required ... to report to the Attorney General any bids or proposals that evidence a violation of antitrust laws.”

FAR § 3.303

Anti-Trust: Govt's Hard Look

Examples

- Lockheed Martin & Northrop Grumman merger
blocked by DOJ in 1998
- General Dynamics & Newport News merger
blocked by DOJ in 2001

Anti-Trust: Govt's Hard Look

U.S. v. Alliant Techsystems, Inc.

- Alliant and Aerojet-General competed against each other in the Combined Effects Munition (CEM) market
- In 1990, the Air Force “downsized” to one vendor—Alliant
- After the Gulf War, Air Force issued RFP seeking competition

Anti-Trust: Govt's Hard Look

U.S. v. Alliant Techsystems, Inc.

- Alliant and Aerojet entered into a teaming agreement and submitted a single bid for the CEM contract with Alliant acting as the prime
- The price submitted by the Alliant/Aerojet team was higher than previous contracts
- DOJ brought an A-T action

Anti-Trust: Govt's Hard Look

U.S. v. Alliant Techsystems, Inc.

Alliant and Aerojet subsequently entered into a consent decree with DOJ. Alliant agreed to pay \$2,047,500.

Anti-Trust: Govt's Hard Look

FTC & DOJ Guidelines

In 2000, the Federal Trade Comm'n and Dep't of Justice issued Antitrust Guidelines for Collaborations Among Competitors to clarify when anti-trust enforcement is likely.

Another Anti-Trust Like “Snare”

- Exon-Florio Amendment to the Defense Production Act of 1950
 - Committee on Foreign Investment in the United States (CFIUS)

IV.

Organizational Conflicts of Interest

Organizational COI

An organizational COI means a contractor is unable or potentially:

- unable to render impartial assistance or advice to the Govt;
- lacks objectivity in performing work; or
- has an unfair competitive advantage

FAR § 2.101

Organizational COI

As part of the due diligence, ascertain if the acquisition will result in a COI.

- Propose a mitigation plan such as firewalls separating the conflicted sectors of the merged entity.
 - The GAO has held that firewalls were “virtually irrelevant” for mitigating impaired objectivity OCIs
- Offer to divest that portion of the target's business that creates the COI concerns.

The SAIC / Leidos Split

“SAIC’s old way of doing business — where units offering similar services operated in silos — meant the company often got in its own way because of organizational conflicts of interest, executives said. Its sprawling bureaucracy made it difficult to chase new markets. So the company divvied up its operating segments.”

**One Year Later: The One Year Later: The Tale of SAIC
And Leidos, Washington Post, Sept 28, 2014**

Torch Spinning Off nLogic

“The acquisition provided a mechanism for both companies to mitigate Organizational Conflict of Interest (OCI) issues. Historically, Torch Technologies has provided services directly to government customers, while Torch Systems, LLC, primarily focused on providing services to prime contractors. Following this divestiture, Torch Technologies can now focus exclusively on providing services to government agencies.”

<https://www.torchtechnologies.com/torch-technologies-completes-sale-of-torch-systems-llc>

July 7, 2009

V.

**Facility Security
Clearances &
FOCI**

Facility Security Clearances & FOCI

- Access to classified information requires a security clearance; only U.S. citizens are eligible.
- To have access to classified information, a contractor must have a facility security clearance

Facility Security Clearances & FOCI

- Facility clearances are granted only to contractors organized under U.S. law and located in the United States
- A company that is under foreign ownership, control, or influence (FOCI) is not eligible to receive a security clearance

Facility Security Clearances & FOCI

The National Industrial Security Program Operating Manual (NISPOM) requires contractors currently holding security clearances to report to the Government any change of ownership.

VI.

**“Alligators”
Hiding In
The FAR**

“Alligators” Hiding In The FAR

- Organizational costs are generally unallowable. FAR § 31.205-27
- Possible exception – DOD may allow restructuring costs if anticipated cost savings of two to one. DFARS § 231.205-70

“Alligators” Hiding In The FAR

“For tangible capital assets, when the purchase method of accounting for a business combination is used, ... the allowable depreciation ... shall be based on the capitalized asset valued measure and assigned” IAW CAS.

FAR § 31.205-52

“Alligators” Hiding In The FAR

If the acquirer is taking over the pension plans of the acquiree and plans to terminate the plan, curtail benefits, or close segments where the plan is overfunded, the Government is entitled to share in any asset reversions.

FAR § 31.205-6(j)(4)

VII.

Due Diligence
“Tips”

Due Diligence “Tips”

1. Valuation Considerations
2. Past Performance
3. Service Contract Act
4. GSA Schedules
5. Truth In Negotiations Act
6. IP Pitfalls
7. Compliance Programs
8. Disgruntled Employees

Due Diligence - Valuation

The Curious Impact of AMCOM EXPRESS on Valuation

- Companies that fared well ... *Madison Research; Gray Research; ASI; MagnaCom; CAS; Camber; Belzon*
- The saga of growing beyond small business size. *Sigmatech v. Intuitive Research*
- Will AMCOM EXPRESS lose market share to OASIS?

Due Diligence - Valuation

Backlog is a key factor for valuation

- Most contracts tied to options
 - What is the likelihood of the option being exercised?
- Many contracts are IDIQ with nominal minimum quantities
- Many contracts are incrementally funded
- Cost reimbursement contracts
 - Overruns?
 - LOC notice given?

Due Diligence - Valuation

- Warranty liabilities?
- Pending disputes (including subcontractor)?
- Pending indirect cost rates proposals – overpayment by government?

Due Diligence - Past Performance

- Past performance is the single most important nonprice evaluation factor in source selections
- “Agencies shall prepare an evaluation of contractor performance for each contract in excess of \$1,000,000”

FAR §42.1502

Due Diligence - Past Performance

- Reviewing Contractor Performance Assessment Reports (CPARs) is an essential step in the due diligence of any government contractor.
- A vendor's failure to contest a negative CPARS under FAR 42.1503(d) should be a "red flag."

Due Diligence - SCA

FAR § 22.1003-5 Examples of SCA Employees

- Electronic equipment maintenance and operation engineering support services
- Maintenance and repair of all types of equipment....
- Operation, maintenance, or logistics support of a federal facility
- Data collection, processing and analysis services

Due Diligence - SCA

- By statute, debarment for three years is mandatory (unless DOL finds "unusual circumstances" exist)
- The exception should be rare because the “legislative history leaves no doubt about the intended rarity of the exception.”

www.usdoj.gov/osg/briefs/1990/sg900863.txt

Due Diligence - SCA

Coast Janitorial Service v. DOL

- In 1995, Coast was awarded a janitorial services contract at Redstone Arsenal for \$19,128,277
- Coast's Project Manager, "to keep overhead low," did not pay "time and a half" to employees who worked overtime

Due Diligence - SCA

Coast Janitorial Service v. DOL

- Instead, Coast credited employee with “comp time” which was paid at regular hourly rates.
- DOL found SCA violation involving two employees and \$6,596.

Due Diligence - SCA

Coast Janitorial Service v. DOL

- Coast responsible for “willful and deliverable” violations of supervisor
- Coast debarred for 3 years
- President, Mr. Grimes, debarred
- VP, Mr. Scott, debarred

Due Diligence – GSA Schedules

Under the "Price Reductions" clause, the contractor must maintain the negotiated price/discount relationship. If a change in the contractor's commercial pricing that was the "basis for award" results in a less advantageous relationship for the Govt, the Govt is entitled to a price reduction.

Due Diligence – TINA

The Government is entitled to a price reduction from the prime contractor for any subcontractor cost or pricing data that is not complete, accurate and current.

FAR § 52.215-10

Due Diligence – TINA

Typically, the Government's demand for a price reduction does not occur until after performance is complete and the alleged defective pricing surfaces as a result of a DCAA audit.

Due Diligence – IP

- IP ownership can justify a sole source award.
- IP can impact valuation
 - *If Govt has unlimited rights – drop valuation*
 - *If Govt has limited/restricted rights – increase*
- Does IP have value for commercial markets?
- Has IP been properly protected?

Due Diligence – IP Pitfalls

- Campbell, an 8(a) contractor, had been awarded a contract by the Army for tooling to produce protective masks for aircrews.
- While performing the contract, Campbell devised a sonic welding process

Due Diligence – IP Pitfall

- “The contract contained standard FAR Patent Rights clause
- Under the clause, Campbell was obligated to disclose its invention to the Government within 60 days after the inventor informed the “Contractor personnel responsible for patent matters.”

Due Diligence – IP Pitfalls

- The clause further states that, if the Contractor does not disclose the invention within the sixty days, the Government may request the title to the invention.
- On three occasions in early 1993, Campbell informed the COTR about the sonic welding process.
- On the DD Form 882, Report of Inventions, Campbell no “subject inventions”

Due Diligence – IP Pitfalls

- Campbell filed a patent application for the sonic welding process
- The patent application disclosed that the invention was made while performing an Army contract and stated that the Government was entitled to a license.
- Campbell provided a copy of the issued patent to the C.O. The cover letter acknowledged that the Government had a license.

Due Diligence – IP Pitfalls

- Because Campbell had made a misrepresentation on DD Form 882, the Army demanded that Campbell transfer the title to the patent to the Government.
- Campbell appealed what he dubbed a “draconian penalty” to the ASBCA.
- The ASBCA upheld the Army’s right to demand the title to the patent.

Due Diligence – Compliance Program

- DFARS Subpart 203-70 mandates a compliance program
- A credible compliance program can thwart being debarred or suspended
- Due diligence should ascertain if program is “paper only”
 - Should impact valuation

Due Diligence – Compliance Program

Mandatory Disclosure --The FAR Business Ethics and Conduct clause applies to contractors holding a contract valued over \$5 million. Under risk of suspension and debarment, the clauses require a contractor to make a timely disclosure to the 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.

Due Diligence – Compliance Program

- Export Control vigilance
- DCAA approved accounting system
- DCAA contractor purchasing system review
- DCMA business system audit
- DODIG subpoenas
- DOJ CIDs
- Perform own “floor audit” as part of due diligence

Due Diligence – Disgruntled Employees

- Interview HR Director for disgruntled employees
- Disgruntled employees are the most likely instigators of *Qui Tam* law suits.



“Harris, I want you to buy up anything that has Local in their title.”

**No top 100
Government
contractor is a
Huntsville
company.**