Acquiring a Federal Contractor: *Doing Your Due Diligence*

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A proper due-diligence checklist used in vetting the acquisition of a federal contractor contains all of the elements in a traditional M&A due-diligence checklist – i.e., boxes to check after reviewing real estate, labor, tax, environmental, intellectual property and litigation matters, etc. But in view of the highly regulated environment in which federal contractors toil (whether for DOD or a non-defense agency), the checklist should also include a robust list of issues peculiar to the industry. See our Annotated Due Diligence Checklist focused on just the issues uniquely implicated in an M&A transaction with a federal contractor: https://www.kaufcan.com/news/articles/annotated-due-diligence-checklist-acquisition-of-a-federal-contractor/.

Although this federal-contractor add-on lengthens the typical M&A checklist considerably, particular emphasis might be given to the following items:

Novation Issues (¶ 1.1): Consider whether the transaction will be structured so as to require novation of existing prime government contracts. If so, how likely is it that the contracting officer with decision-making authority will determine that novation is in the best interest of the Government? Further, the Government will not approve a novation until the acquisition transaction has closed, meaning that there can be a period of uncertainty following the closing. Ominously, the seller will remain liable under the novated contracts post-closing in case the buyer fails to perform under the novated contract. For these and other reasons, the parties often prefer to structure a deal as a stock purchase so that a novation will not be required.

Pending Bids (¶1.1(c)): With respect to the target company's bids and proposals pending at the time of transaction, the Government will be concerned that the target company's "intended approach to performance" (i.e., the technical approach, resources, personnel and management capabilities cited in the proposal) might be changed as a result of the acquisition. Among the questions to be examined by the contracting officer include: (i) Does the target company rely upon a parent company's resources to perform its contracts and will those resources no longer be available? (ii) Will the acquisition affect fully burdened labor rates or G&A rates on cost reimbursement contracts? (iii) Will key management and technical employees of the target company remain in place post-acquisition? (iv) Will employees with necessary personnel security clearances remain? (v) Would a contract award to the buyer create any type of organizational conflict of interest?

Subcontracts/Teaming Agreements and Joint Ventures (¶¶1.1(b), 1.1(e) and 1.1(f)): If the buyer is picking up obligations under these agreements, then a contractor teammate and/or the Government may need to approve a contractual assignment. If the transaction is structured as a stock purchase, a change in control provision in a subcontract or teaming agreement may come into play, triggering a potential default by the seller and/or termination rights on behalf of the teaming partner. In a joint venture context, the buyer will want to kick the tires for potential capital calls, indemnification liability and similar obligations to the joint-venture partner.

GSA Federal Supply Schedule Contracts (¶ 1.2): If the target company makes significant sales through the GSA FSS Program, it behooves the buyer to examine the target company's commercial sales practice disclosure statement and its systems and training practices for compliance with the "most favored customer" pricing requirement under FSS contracts, noncompliance with which could result in financial exposure under the FSS "price reduction" clause.

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Small Business Issues (¶ 1.4): If the target company relies on small-business or socio-economic set-aside contracts, consider what the fate of these contracts will be after the acquisition. Also, be careful to avoid a trap for the unwary: under the SBA's "present-effect" rule, letters of intent and MOUs that are tantamount to "agreements in principle" can create affiliation between the seller and buyer before closing, potentially resulting in a premature change in size status of the target company, which would complicate self-certifications in any proposals or bids submitted for small-business or other set-aside contracts after the LOI or MOU is inked, but before closing.

If the target company will remain a small business following the closing, then its size must be recertified within 30 days following the closing. However, the Government is required to terminate any open 8(a) contracts of the target company unless this termination requirement is affirmatively waived by the SBA Administrator based on certifications from the contracting agency(ies) that termination would "severely impair attainment of the [procuring] agency's program objectives or mission". Such a waiver must be requested before closing.

Due diligence should be performed to confirm that the putative small-business has made accurate certifications to the Government. The buyer should be comfortable that the target company does not have any affiliations with other concerns that, upon a protest or audit, might disqualify the target company under existing contracts or pending bids. The buyer should be sure that the target company, in performing under its prime contracts, does not place undue reliance upon an "ostensible subcontractor" that, in actuality, is a large business calling the shots on such contracts (thereby creating affiliation between the prime and ostensible sub). Finally, if the target company has violated the limitation on subcontracting rules under its small business contracts, the penalties "assumed" by the buyer could be significant.

Cost Reimbursement Contracts (¶ 1.7): With your accounting team members, scour the target company's internal audit reports and any government audits, including DCAA incurred-cost audits, "defective pricing audits," and audits of requests for equitable adjustments under pending contracts. Incurred-cost audits may particularly shed light on the reasonableness, allowability and allocability of the target company's direct and indirect costs charged on its government contracts. It is also important to determine if the DCAA has issued any "Form 1s" to the target company regarding disallowed contract costs (e.g., golden handcuff payments).

Also, look at the target company's internal practices related to compliance with the Truthful Cost or Pricing Data Act (formerly known as the Truth in Negotiations Act and still commonly referred to as "TINA") in order to get comfortable that the target company has not submitted defective pricing or cost data to the Government, which would entitle the Government to a price reduction on continuing contracts. Also consider whether disclosure of the pending acquisition is required under TINA because it will cause a change in the indirect cost pool applied to current or pending contract awards.

Organizational Conflicts of Interests (¶ 1.9): Consider whether the transaction might result in an OCI, which could arise if the target company (a) evaluates bids, proposals or performance of the buyer under existing procurements, (b) provides systems engineering or has prepared government specifications for procurements being pursued by the buyer, or (c) has obtained proprietary information relating to competitors of the buyer. If an OCI will result from a transaction, an OCI mitigation plan must be submitted to the Government to satisfy the requirements of FAR Subpart 9.505.

Facility Security Clearances (¶ 1.10): Consider the ultimate ownership or control over the buyer. If the buyer is subject to foreign ownership, control or influence (FOCI), a target company with facility security clearances must notify the cognizant security agency (usually the Defense Counterintelligence and Security Agency, or DCSA) immediately upon entering into discussions for a sale. A greater than 5% foreign ownership interest or 10% foreign voting interest is typically considered substantial enough to create FOCI. If FOCI is implicated in a deal involving a "cleared" target company, a FOCI mitigation plan should be submitted to DCSA (or other cognizant security agency) prior to the closing.

"Exon-Florio Provision", as updated by the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) (¶ 1.10): The Committee on Foreign Investment in the United States (CFIUS) is an interagency group with representation from the Defense, State, Homeland Security, Treasury, Commerce, Justice, Energy and Labor departments, together with various intelligence agencies. If an acquisition implicates national security due to the transfer of "control" of the target company's business, or if even a non-controlling investment implicates U.S. "critical technologies," "critical infrastructure" or "sensitive personal data", then the parties should coordinate a filing with CFIUS to obtain a safe-harbor assurance that the transaction will not be blocked or, even worse, subsequently unraveled by the Government. FIRRMA also authorized CFIUS to regulate foreign acquisitions of U.S. real estate connected to air or port operations, or located close to U.S. military installations or other sensitive facilities.

Past Performance (¶ 1.15): The buyer is well advised to review the target company's past-performance evaluations (or CPARs). It should also review any determinations that the target company was not "responsible" under any prior proposals. Such a finding of non-responsibility would make future contract awards significantly more difficult in related procurement areas.

Intellectual Property (¶ 1.23): The buyer should develop a good understanding of what rights in the target company's IP have been granted to the Government under past and current government contracts. For example, where software development occurs at private expense, the Government receives only "limited rights" in data and "restricted rights" in software. However, the Government receives an unrestricted license in patented inventions first conceived or reduced to practice in the performance of a government contract. Similarly, the Government gets "unlimited rights" in data and software developed entirely at the Government's expense while it retains "government-purpose rights" in data and software developed from a mix of private and government expense.

Compliance (¶¶ 1.15 to 1.25): The remaining parts of the annotated checklist focus on the target company's compliance with various regulatory and FAR requirements, including export-control regulations.

The above is a quick tour through the Annotated Due Diligence Checklist for the acquisition of a federal contractor, found here: https://www.kaufcan.com/news/articles/annotated-due-diligence-checklist-acquisition-of-a-federal-contractor/. I hope you will enjoy the full tour when the proper occasion arises. ■