

Transactional Attorneys Beware – Avoiding Pitfalls When Acquiring a Federal Government Contractor

By Erin L. Toomey

Over the past several years, federal government contractors have increasingly been involved in merger and acquisition activity. Given the unique laws, regulations, and other requirements that apply to government contractors, transactional attorneys must take a different approach in the way these deals are structured, the due diligence process, and the formation of the applicable purchase agreement. A failure to appropriately understand, appreciate, and mitigate against potential risks can result in a significant devaluation of the stock or assets post-acquisition. This article will identify the factors to be considered when structuring the transaction, describe how to identify the government contract requirements with which the target must comply, provide guidance regarding how to assess the target's compliance with such requirements, suggest tips for mitigating both identified and unknown risks in the purchase agreement, and highlight various post-acquisition government notification requirements.

Step 1: Structuring the Transaction

Novations

The federal Anti-Assignment Act prohibits a government contractor from assigning a federal government prime contract (i.e., a contract directly between the contractor and the U.S. Government) to a third party.¹ The Anti-Assignment Act aims to ensure that the contractor that receives a federal contract actually performs the contract, providing the government with the performance for which it bargained. The government may waive the Anti-Assignment Act and permit the transfer of a federal government prime contract to a third party when the third party's interest in the contract arises out of the transfer of: (i) all of the contractor's assets; or (ii) the entire portion of the assets involved in performing the contract.² Such a transfer is effected through the execution of a novation agreement.³ The

Federal Acquisition Regulation ("FAR")⁴ provisions implementing the Anti-Assignment Act provide that "a novation agreement is unnecessary when there is a change in the ownership of a contractor as a result of a stock purchase, with no legal change in the contracting party, and when that contracting party remains in control of the assets and is the party performing the contract."⁵ Therefore, while a novation is required for an asset purchase, a corporate consolidation or a merger, a novation is *not* required for a stock purchase provided there is no legal change in the contracting party, the contracting party remains in control of the assets, and the contracting party performs the contract. Note, however, that in a stock purchase the government may still insist that the contractor execute an agreement addressing identified issues and providing the government with reassurances related to the change in ownership.⁶

Under FAR Subpart 42.12, a contractor can request that the government recognize a successor-in-interest to its contracts by submitting a written request for a novation to the responsible contracting officer.⁷ The FAR contains a laundry list of documents that a contractor must submit to the contracting officer with the novation request, including several signed copies of a form novation agreement contained in the FAR, which must be executed by all three parties – the government, the contractor (i.e., the transferor) and the successor-in-interest (i.e., the transferee).⁸ When submitting the requested documentation to the responsible contracting officer, given the facts and circumstances of each transaction, the contractor and the successor-in-interest can request the submission of alternative documents to provide the agency with the information and reassurances the agency needs in order to approve the transfer of the contract to the successor-in-interest. Although some of the key documents can be submitted to the responsible contracting officer prior to the close of a transaction, im-

portantly, the novation request and related documents cannot fully be processed by the contracting officer until *after* the transaction closes.

The contracting officer responsible for processing the novation retains discretion regarding whether to execute the novation agreement and approve the transfer of the contract. The contracting officer's decision is based on a number of factors, including the proposed transferee's responsibility under FAR Part 9, input from the contracting officer(s) on the contract(s) at issue, and the proposed transferee's ability to successfully perform the contract from both a technical and a financial perspective.⁹ Therefore, in submitting the novation documents, it is important to provide the government with as much reassurance as possible regarding the successor-in-interest's ability to perform the contract, the continuity of personnel and facilities in the performance of the contract, and the successor-in-interest's financial stability.

Until a novation agreement is fully executed by all parties, including the government, and the applicable government contracts are modified to incorporate the novation agreement and recognize the successor-in-interest, the original contractor remains responsible for performing the outstanding contract. Since in an asset transfer, the transferor typically no longer has the assets or personnel necessary to perform the government prime contract; while the novation is pending, the transferor and transferee typically enter into a subcontract agreement under which the transferee agrees to perform the contract and the transferor agrees to transfer all payments received from the government to the transferee. During this time, the contractor must remain in corporate existence, maintain its Central Contractor Registration account through which the contractor receives payment from the federal government, and have at least one employee who can act on behalf of the company.

Given the time and effort involved in pursuing a novation, the relationship between the buyer and seller that must continue post-acquisition while a novation is pending, and the discretion of the government in granting a novation, buyers and sellers should consider the novation process when determining whether to pursue a stock or an asset purchase. If a novation is required, it is important to address in the purchase documents each of

the parties' responsibilities post-closing with regards to pursuing the novation, especially since a novation cannot be effected without the submission of documents by the transferor and the transferee and the execution of the novation agreement by both parties.

Small Business Concerns

The United States' policy is to provide "small business concerns" and special types of small business concerns (e.g., women-owned small business concerns, small disadvantaged business concerns, service-disabled veteran-owned small business concerns, etc.) with the maximum practicable opportunity to participate in performing federal government prime contracts and subcontracts.¹⁰ To assist in satisfying these goals, the government restricts certain procurements to small business concerns and provides price evaluation preferences to them. To the extent the target is a small business, or a special category of small business, the buyer must assess whether the company will still qualify as a small business concern post-acquisition.

Under the Small Business Administration ("SBA") regulations and the North American Industry Classification System ("NAICS") codes established by the SBA, an entity qualifies as a small business concern either by counting the entity's employees or "annual receipts" (i.e., annual average gross revenue for the preceding three fiscal years), including those of all its domestic and foreign affiliates.¹¹ Affiliation between companies can be found in a variety of ways, but an individual, entity, or business concern (a "person") is automatically considered an affiliate of another concern if the person owns or controls, or has the power to control, 50 percent or more of the concern's voting stock. For the purpose of determining affiliation, it does not matter whether the control is exercised, so long as the power to control exists. Additionally, business concerns are affiliates of each other if, directly or indirectly, another concern controls or has the power to control both. As a result, private equity or venture capital firms that plan to own more than 50 percent of a target's voting stock must take into account the number of employees or annual receipts of all other holdings in which the firm owns a majority interest, or substantial interest, when determining whether the target will still qualify as a small business post-acquisition.

The Anti-Assignment Act aims to ensure that the contractor that receives a federal contract actually performs the contract, providing the government with the performance for which it bargained.

If the successor-in-interest no longer qualifies as a small business post-acquisition, the new company will not be eligible to compete for prime contracts that are set aside for small businesses. The new company will be able to complete its performance of existing small business set-aside contracts, but the government will not be permitted to count any options exercised, modifications issued, or additional orders issued to the contractor under such contracts towards the government's small business contracting goals. Also, if the contractor's customers relied on purchases from the small business contractor to satisfy their small business subcontracting goals under their small business subcontracting plans with the government, the contractor's customers will no longer be able to count purchases from the successor-in-interest towards their small business subcontracting goals. Furthermore, there are some requirements from which small business concerns are exempt that the successor-in-interest could potentially be exposed to post-acquisition, such as the government's Cost Accounting Standards, creating and adhering to a small business subcontracting plan, and implementing a business ethics awareness and compliance program and a robust internal control system. All of these factors should be considered in assessing the valuation of the target.

Non-U.S. Buyers

If the buyer is not a U.S. company or if the buyer is subject to foreign ownership, control, or interest ("FOCI"), the buyer should be aware of various laws that could restrict a contractor's ability to continue performing federal government contracts post-acquisition. First, if the target has classified federal government contracts or contracts involving classified information, the target will hold a security clearance to permit the target to perform the contract. The target could lose its clearance, and thus its ability to perform the contract, if the target is acquired by a non-U.S. company or a company with FOCI. To avoid the loss of the contract, the target and the buyer must work together pre-acquisition to implement mitigation steps and corporate control measures acceptable to the government.

Second, if the target has export control licenses under the Export Administration Regulations ("EAR")¹² or the International Traffic in Arms Regulations ("ITAR"),¹³ the target

must notify the government prior to the close of the acquisition of the impending change in ownership and work with the government post-acquisition to transfer the registrations and licenses to the new entity. Since the EAR and ITAR even prohibit the transfer of technical data to "foreign persons"¹⁴ within the United States, to the extent the new company will have foreign owners, the company will need to seek a license from the applicable government agency to permit the foreign persons to have access to the export-controlled data, or otherwise implement firewalls and other screens to prevent the foreign persons from having access to such data.

Third, the Committee on Foreign Investment in the United States ("CFIUS") is authorized to review transactions that could result in the control of a U.S. business by a foreign person to determine the effect of the transaction on national security. While the CFIUS review is a voluntary process, this review is effectively mandated for acquisitions involving federal government contractors with security clearances, particular EAR/ITAR-controlled exports, or significant defense, national security, or homeland security contracts. The benefit of a positive CFIUS review is that it creates a "safe harbor" from future Exon-Florio review and the possibility of the unwinding of the transaction post-acquisition.¹⁵ Therefore, when the buyer is a non-U.S. company or the company is subject to FOCI, the buyer must determine at the outset of the acquisition how it will address these various issues during the due diligence process and in the structure and timing of the acquisition.

Step 2: Identifying the Government-Unique Requirements with which the Target Must Comply

Federal government contractors are potentially subject to a myriad of unique requirements, including, but not limited to, import and export restrictions, intellectual property rights,¹⁶ restrictions on recruiting and hiring former government employees, the Anti-Kickback Act, wage and hour laws, the Truth in Negotiations Act,¹⁷ Cost Accounting Standards,¹⁸ audit requirements, lobbying restrictions, and, in some instances, laws that impose a preference on the use of domestic sources or materials. While some of these requirements apply to all federal government prime contracts and subcontracts, oth-

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ers only apply depending on the value of the contract, the type of work to be performed under the contract, and the contracting government agency.

At the start of the government contracts due diligence process, the buyer should first review copies of the target's open federal government prime contracts and subcontracts and those for which the target has received final payment in the last three years¹⁹ to assess the requirements and obligations that apply to the target. For example, if the target only accepts and performs FAR Part 12 commercial item prime contracts and subcontracts, then the target will likely be exempt from the TINA and CAS.²⁰ If, however, the target contractually accepted FAR clauses implementing these laws in their contracts, then the target may be contractually obligated to comply with these requirements. Thus, it is critical to review full and complete copies of all of the target's government prime contracts and subcontracts, including all related contract modifications, to identify which government-unique requirements apply to the target.

Step 3: Assessing the Target's Compliance with Government-Unique Requirements

Once the buyer has identified the universe of government-unique requirements with which the target must comply, the buyer must then assess the target's compliance with applicable laws and regulations. In particular, a buyer's due diligence should delve into those areas that could significantly impact the target's ability to maintain its existing government contracts or receive future government contracts, as well as issues that could result in significant civil or criminal liability, or even suspension or debarment of the target post-acquisition.

A primary method of assessing a target's compliance with its government contracts is to assess the strength of the target's compliance program. Although only contractors with a federal government prime contract or subcontract in excess of \$5 million with a period of performance longer than 120 days are *required* to have a code of business ethics and conduct and a compliance program, even if not required, a robust compliance program is clearly a best practice for all government contractors. During its due diligence, the buyer should review copies of the target's code of conduct, employee handbook, and

government contract-related written policies and procedures. To the extent the target does not maintain written policies or procedures on certain compliance topics, the buyer should talk to the individuals responsible for compliance with those requirements to understand the target's informal processes and procedures for complying with the requirements. The buyer should also inquire about the target's employee training programs and internal or external audit policies and procedures.

The buyer should review copies of the various forms and documents that a government contractor is required to maintain or submit to the government on a periodic basis, such as affirmative action programs, EEO-1 reports, VETS-100A reports, small business subcontracting plans, export control licenses, standard purchasing terms and conditions, and all recently executed representations and certifications. Additionally, the buyer should review copies of all documents relating to any civil or criminal investigations or audits performed by the government.

In reviewing these documents and interviewing employees, the buyer should focus on those non-compliances that could trigger the government's procurement fraud enforcement mechanisms, which come in a variety of forms. First, there are several important criminal statutes under which the government prosecutes "procurement fraud." The statute the government uses most frequently to address all categories of procurement fraud is the False Statements Statute.²¹ This statute prohibits lying to the government, i.e., knowingly and willfully making a false statement.²² A "statement" under the False Statements Statute may be oral or written, and either sworn or unsworn.

Second, under the Civil False Claims Act, the United States may recover treble damages *and* penalties (generally up to an additional \$11,000 per claim or voucher) for the submission of false claims by either a prime contractor or subcontractor to any federal agency or entity using federal funds to pay such claims.²³ The Civil False Claims Act contains a "qui tam" provision authorizing private citizens with evidence of fraud against the government to file lawsuits in their own names (on behalf of themselves and the government) and then keep a significant share of the government's recovery.²⁴ In addition, the False Claims Act protects employee "relators" or whistleblowers from retaliation by

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their employers. Qui tam actions are often brought by disgruntled current or former employees who are aware of the company's business practices in performing its government contracts. Relators often are "rewarded" with 15 to 25 percent of the total recovery from the company.²⁵

In addition to these fraud enforcement mechanisms, the government can suspend, debar, or propose for debarment a federal government contractor. A suspension or debarment prohibits a contractor from entering into any new federal prime contracts or procurement subcontracts over \$30,000, receiving additional task or delivery orders under existing contracts, and having any options under existing contracts exercised by the government, for a specified period of time.²⁶ As a result, when acquiring a government contractor, the buyer should confirm that neither the target nor any of its principals are, or have been in the prior three years, suspended, debarred, or proposed for debarment.²⁷ Additionally, the buyer must perform due diligence to identify any possible factors that could lead to the suspension or debarment of the target post-acquisition. Bases for suspension or debarment include, but are not limited to:

Commission of fraud or a criminal offense in connection with obtaining, attempting to obtain, or performing a public contract or subcontract;

Commission of embezzlement, theft, forgery, bribery, falsification or destruction of records, making false statements, tax evasion, violating Federal criminal tax laws, or receiving stolen property;

Violation of federal or State antitrust statutes relating to the submission of offers; or

A knowing failure by a principal,²⁸ until three 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 the contract or subcontract thereunder, credible evidence of (a) violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; (b) violation of the civil False Claims Act (31 U.S.C. 3729-3733); or (c) significant overpayment(s) on the contract, other than overpayments

resulting from contract financing payments as defined in 32.001.²⁹

It is critical during due diligence that the buyer inquire about all aspects of the target's activities that could potentially trigger a suspension or debarment, including the target's failure to make a mandatory disclosure. In particular, since the loss of anticipated future contracts or future work is difficult to quantify, the financial devastation caused by a suspension or debarment often cannot be sufficiently addressed through purchase agreement indemnification clauses.

Step 4: Mitigating Against Identified Risks

As a result of the unique requirements and significant civil, criminal, and administrative penalties that apply to a government contractor, when acquiring the stock or assets of a federal government contractor, typical commercial representations and warranties relating to claims, litigation, commercial warranties, etc., are not sufficient to identify and address the unique risks encountered by a government contractor. To provide maximum protection for the buyer, the purchase agreement should contain government contract specific representations and warranties addressing issues such as the responsibility of the contractor, the contractor's knowledge of facts or circumstances that would give rise to a mandatory disclosure obligation, potential criminal or civil liability, and the contractor's compliance with various laws and regulations.

Additionally, the buyer should address in the indemnity clause of the purchase agreement any of the target's non-compliances, or potential non-compliances, with the requirements of its government contracts identified during due diligence or disclosed by the target in the purchase agreement disclosure schedules. In particular, the buyer should include within the scope of the indemnity clause any non-compliances that could result in significant criminal or civil liability, the termination of existing contracts, prevent the award of future contracts, or result in suspension or debarment.

Step 5: Post-Acquisition Requirements

Regardless of whether a novation is required, federal government contracts often require a contractor to notify the government when a change in ownership has occurred. In partic-

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ular, if the target is a small business and the target's federal government contracts contain FAR 52.219-28, "Post-Award Small Business Program Representation," the successor-in-interest will be required to re-represent its small business size status to the contracting officer assigned to the contract within thirty days of the change in ownership if no novation is required, or within thirty days of the execution of a novation agreement. Also, the target must notify applicable government agencies to transfer security clearances and export control registrations and licenses to the new entity. Last, the successor-in-interest must review its information in the Central Contractor Registration ("CCR") and Online Representations and Certification Application ("ORCA") databases to confirm that all of the previously entered information remains accurate.³⁰

Conclusion

To successfully navigate through these treacherous waters, transactional attorneys must have an understanding of federal government contracting, and government contract attorneys must understand the nuances of the proposed transaction. Just as a transactional attorney turns to environmental, intellectual property, and labor experts throughout the due diligence process, the key to a successful acquisition of a government contractor is to secure the necessary government contracts support throughout all phases of the transaction. In particular, it is important in the purchase agreement to address the post-transaction cooperation between the parties that is required during the processing of a novation. By understanding the risks and properly mitigating them in the purchase agreement, buyers will significantly reduce the risk of an unanticipated criminal or civil investigation or suspension or debarment post-acquisition. Furthermore, to the extent the successor-in-interest quickly remedies post-acquisition any compliance deficiencies identified during the due diligence process, the new company will be on solid ground to demonstrate its present responsibility and negotiate a favorable settlement with the government in the event an issue arises.

NOTES

1. 41 USC 15(a). While a federal government subcontract is not subject to the Anti-Assignment Act and the requirement to obtain a novation, during due diligence the buyer should carefully review such subcontracts to ensure there are no contractual restrictions on the target's ability to assign the subcontract to the buyer.
2. FAR 42.1204(a). Examples include: "(i) Sale of these assets with a provision for assuming liabilities; (ii) Transfer of these assets incident to a merger or corporate consolidation; and (iii) Incorporation of a proprietorship or partnership, or formation of a partnership." *Id.*
3. The novation process can be triggered by the transfer of one or many federal government prime contracts.
4. The FAR is codified at title 48 of the Code of Federal Regulations.
5. FAR 42.1204(b).
6. *Id.* If a novation agreement is not required, but the successor-in-interest intends to change its corporate name post-acquisition, the contractor will need to request that the government execute an agreement reflecting the name change. The process for pursuing a change-of-name agreement is located at FAR 42.1205.
7. FAR 42.1202 sets forth the criteria for identifying the contracting officer responsible for processing the novation.
8. FAR 42.1204(e)-(f). The form novation agreement is located in FAR 42.1204(i). The form agreement can be modified to reflect the facts and circumstances of the transaction, but any significant changes to the agreement may increase government scrutiny and delay the novation process.
9. FAR 42.1203(c).
10. FAR 52.219-8(a), "Utilization of Small Business Concerns."
11. 13 CFR 121.103.
12. The EAR apply to the exportation of goods and services not covered by the ITAR. Items regulated by the EAR include dual-use items that are suitable for either military or non-military use and are *not* designed or modified for military use. These dual-use items are subject to varying controls, depending upon the product or technology, destination, and end user. The EAR are administered by the Commerce Department's Bureau of Industry and Security ("BIS") and are set forth in 15 CFR Parts 730-774 (2012).
13. The ITAR restrict the exportation and importation of defense articles and defense services, and generally require U.S. Government approval for exportation or importation of items (or execution of services) falling within the ITAR's purview. Items regulated by the ITAR include technical data related to defense articles (e.g., blueprints, manuals, and websites), software related to defense articles, and items designed or modified for military use. The ITAR also regulate defense services, such as assisting in the design, manufacture, or operation of defense articles. The ITAR are administered by the State Department's Directorate of Defense Trade Controls ("DDTC"). The ITAR can be found in the Code of Federal Regulations (22 CFR Parts 120 - 130).
14. A "foreign person" is any person who is not a lawful permanent resident of the U.S. (e.g., non-U.S. citizens and non-Green Card holders), and includes foreign governments and organizations. 22 CFR 120.16.
15. 50 USC 2170.
16. Under federal government prime contracts and subcontracts, the government may receive certain rights in a contractor's technical data, computer software, and inventions. Therefore, if the target's intellectual property is an important asset to the buyer, it is critical that the buyer assess the rights the government received in the target's intellectual property.

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17. When it applies, the Truth in Negotiations Act (“TINA”), 10 USC 2306a, 41 USC 254b, requires a contractor to disclose to the government all of its cost or pricing data as of the date of the price agreement and certify that its disclosure is current, accurate, and complete. “Cost or pricing data” is defined broadly in FAR 2.101 as “all facts that, as of the date of price agreement...prudent buyers and sellers would reasonably expect to affect price negotiations significantly.” If the government later determines that the cost or pricing data disclosed were not current, accurate, and complete, i.e., they were “defective,” the government is entitled to a price adjustment (reduction) to exclude the amount by which the price was increased because of the defective data, plus interest. There is also the possibility of double recovery by the government if the contractor “knowingly” submitted defective data or omitted data, and, in extreme cases, the contractor could face possible False Claims Act liability or criminal false statement allegations, for a fraudulent or false certification.

18. The federal government’s Cost Accounting Standards (“CAS”) govern the measurement, timing, and the ability to allocate costs charged to certain negotiated government contracts. The CAS rules and regulations impose major accounting requirements on contractors having contracts subject to them and requires the negotiation of impacts of changes to the contractor’s cost accounting practices. Violations of these accounting principles or the contractor’s disclosed cost accounting practices can result in the repricing of contracts, civil False Claims Act liability, or criminal charges.

19. A contractor’s obligation to make a mandatory disclosure to the government under the suspension and debarment regulations in FAR 9.406 and 9.407, applies up to three years after final payment on a government contract. Three years is also the timeframe within which the government can audit a federal government prime contract or subcontract.

20. Pursuant to FAR 15.403-1(c)(3), commercial item prime contracts and subcontracts are exempt from the Truth in Negotiations Act. Pursuant to 48 CFR 9903.201-1(b)(6), firm-fixed price and fixed price with economic price adjustment contracts and subcontracts for the acquisition of commercial items are exempt from the Cost Accounting Standards.

21. 18 USC 1001.

22. *Id.*

23. 31 USC 3729–3733.

24. 31 USC 3730.

25. *Id.*

26. The suspension period can last for up to twelve months. An Assistant Attorney General may request an additional six month extension. FAR 9.407-4(b). A debarment typically lasts for three years, although the contractor may attempt to negotiate a shorter duration with the debarment official. FAR 9.406-4(a)(1).

27. Through the Excluded Parties List System (“EPLS”) available at www.sam.gov, the government maintains a publicly available list of individuals and companies that are suspended, debarred, or proposed for debarment. Many state and local agencies, as well as private companies, check the EPLS system and will not contract with companies that are currently suspended, debarred, or proposed for debarment.

28. A “principal” is defined as an “officer, director, owner, partner, or a person having primary management or supervisory responsibilities within a business entity (e.g., general manager; plant manager; head of a division or business segment; and similar positions).” FAR 2.101.

29. See FAR 9.406-2 and 9.407-2 for a complete list of causes for debarment and suspension, respectively.

30. CCR and ORCA can be found at www.sam.gov.



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