

Good Deals: Due Diligence and Other Challenges for Government Contractor Mergers and Acquisitions

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Agenda

- Government Contractor M&A
 - Trends
 - Issues and Process
- Organizational Conflicts of Interest (OCIs)
- Pending Proposals

Government Contractor M&A Trends

M&A Trends for Government Contractors

- Increased M&A activity both in number of closed transactions and total deal volume
- Refocusing growth strategies on "core" capabilities
- Enhance capabilities
- Add scale to increase revenue and cost synergies
- Obtain access to
 - Key contracts
 - Customers/agencies
 - Personnel
 - Intellectual property

Contributors to Increased M&A Activity

- Public market increases + low interest rates + tax reform
- Budget
 - Increase in defense spending
 - Visibility into near-term federal spending
 - IT modernization efforts
 - Total backlog and funded backlog suggest future earnings and contract awards
 - Improved overall confidence, strong valuations

Priority Areas

- Cyber
- Data, cloud, artificial intelligence
- National security, classified
- Unmanned systems and ISR
- IT and professional businesses

Notable M&A Activity

- Northrop Grumman's purchase of Orbital ATK
- Veritas Capital's purchase of now-Peraton from Harris
- Jacobs acquisition of CH2M
- DMA's acquisition of DigitalGlobe
- Xator Corp. acquired Merlin International's professional services business
- United Technologies' acquisition of Rockwell Collins
- DXC Technology's three-way deal with Vencore and KeyPoint Government Solutions to create a new publicly traded contractor
- On Assignment's acquisition of ECS Federal
- General Dynamic's purchase of CSRA

Government Contractor M&A Issues and Process

M&A Risks Associated with Government Contractors

- Multiple award IDIQs
- Noncompliance with public laws, other regulatory/contract requirements
- Small business
- Classified programs
- Foreign buyers
- Inverted domestic corporation
- CFIUS review process
- DSS/facility clearance
- Cyber
- Deals gone bad; protecting sensitive information

Understand Business Objectives to Drive Due Diligence

- What do we really want out of this deal?
- IP focus requires more scrutiny of data rights
 - Did the contractor purposefully or inadvertently grant unlimited rights?
 - Was all the work government funded?
- Great contracts focus means attention on ability to maintain pipeline
 - Small business?
 - Multiple award IDIQs?
- Key personnel focus results in less time evaluating contracts/IP

Anti-Assignment

- Anti-Assignment Act, 41 U.S.C. § 6305: "[t]he party to whom the Federal Government gives a contract or order may not transfer the contract or order, or any interest in the contract or order, to another party"
- FAR 42.1204(c): "[w]hen it is in the Government's interest not to concur in the transfer of a contract from one company to another company, the original contractor remains under contractual obligation to the Government, and the contract may be terminated for reasons of default, should the original contractor not perform"

Asset Deals/Novation Agreement

- FAR 42.1204(a): a novation agreement is necessary for the government to recognize a successor-in-interest to a contract when the transfer involves
 - All of the contractor's assets; or
 - The entire portion of the assets involved in performing the contract

Stock Deals/Novation Agreement

- FAR 42.1204(b): a novation agreement is not necessary 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
 - When that contracting party remains in control of the assets and is the party performing the contract

Other M&A Considerations

- FAR 42.1204(b): "[h]owever, whether there is a purchase of assets or a stock purchase, there may be issues related to the change in ownership that appropriately should be addressed in a formal agreement between the contractor and the Government"
 - Long-term incentive compensation plans
 - CAS noncompliances
 - Environmental cleanup costs
 - Final overhead costs

OCIs

Important Topic

- FAR 9.504(a): COs have an obligation to avoid, neutralize, or mitigate significant potential conflicts before award
- Failure to avoid or mitigate an OCI may prevent award
 - A CO may decide to disqualify a government contractor if significant OCIs cannot be mitigated (*Noonan & Assocs.*, B-409103, 2014 CPD ¶ 29 (Comp. Gen. Jan. 10, 2014))
 - *Ernst & Young, LLP v. United States*, No. 17-1329, 2018 WL 1151011 (Fed. Cl. Mar. 5, 2018)
 - COFC set VA's award decision aside
 - CO violated FAR 9.504(a) by failing to identify, evaluate, and mitigate a significant unequal access to information OCI prior to award
 - CO knew VA provided proprietary nonpublic government information to one bidder for use in developing methodology in pilot study preceding solicitation

OCI Types

- Biased ground rules: contractor, in the performance of a government contract, has, in some sense, set the ground rules for the competition for another procurement and may compete for it (FAR 9.505-1; FAR 9.505-2)
- Impaired objectivity: a firm's ability to render impartial advice to the government would be undermined by the firm's competing interests (FAR 9.505-3)
- Unequal access to information
 - Firm has access to nonpublic information as part of its performance of a government contract, and where that information may provide the firm an unfair competitive advantage in a later competition for a government contract (FAR 9.505(b); FAR 9.505-4)
 - *Dell Servs. Fed. Gov't, Inc.*, B-414461, *et al.*, 2017 CPD ¶ 192 (Comp. Gen. June 21, 2017)

OCI Issues in the Context of M&A

- Does an OCI actually exist: a financial interest alone is insufficient and hard facts must show an actual OCI exists
 - *Interactive Info. Solutions, Inc.*, B-415126.2, *et al.*, 2018 CPD ¶ 115 (Comp. Gen. Mar. 22, 2018) ("[a]bsent any hard facts supporting the protester's allegation of impropriety, or appearance of an impropriety, we are provided no basis to sustain the protest ground alleged")
 - Buyer also needs to consider its own pipeline/set of contracts

Prevention of OCIs

- Difference between "shaping" a procurement and designing/providing specifications
- OCI policy that outlines firewalls and guidance on sharing of information
 - Particularly important where multiple business functions provide advice/assistance and developing products/services
 - Identification, disclosure, and mitigation plan
 - OCI training to all employees
 - How to prevent OCIs
 - What to do when an OCI is discovered
 - Communication is key

Mitigation Plans

- Complexity varies based on OCI complexity and size of the acquisition
- Part of communications with CO regarding transaction
- Require a conflict-free subcontractor/team member to perform the conflicted work
- Structural or behavioral barriers, internal controls, or both
 - Board resolution prohibiting participation by certain directors, officers, or employees
 - Nondisclosure agreements
 - Addition of an "independent director"
 - Compliance official to oversee OCI issues
 - Firewalls for certain capture activities
 - Obtain a government determination that the risk presented by the OCI is in the government's best interest

Waiver

- Available through FAR 9.503 when enforcement of the OCI regulations would not be in the government's interest
- *CACI, Inc.-Federal; Gen. Dynamics One Source, LLC, B-413860.4, et al.*, 2018 CPD ¶ 17 (Comp. Gen. Jan. 5, 2018)
 - Protesters argued the waivers' rationales were insufficient to constitute the best interests of the government
 - GAO rejected this argument, holding the FAR provides for agency discretion in determining the government's best interest

Pending Proposals

Proposal Evaluation May Take a Long Time

- Numerous changes can occur while waiting for an award decision
- Changes could include the sale of all, or relevant parts, of the offeror's business
- Issue: offerors face significant risk of successful protest of contract awards resulting from pending proposals involved in a corporate transaction
- "[W]hen an agency becomes aware of an impending corporate transaction prior to award—either through information in an offeror's proposal or through other information resources—and such transaction is imminent and essentially certain (or already consummated), an agency should analyze the effect on proposals of the corporate restructuring at issue" (*Lockheed Martin Integrated Sys., Inc.*, B-410189.7, 2017 CPD ¶ 258 (Comp. Gen. Aug. 10, 2017))

Pre-Transaction Organization and Assets

- *Wyle Labs., Inc.*, B-408112.2, 2014 CPD ¶ 16 (Comp. Gen. Dec. 27, 2013)
 - Protest sustained
 - Agency failed to consider the impact of an impending corporate transaction
 - Awardee advised agency during discussions about transaction and its material effect on performance; awardee's proposed costs and its technical approach were based on then-existing organizational structure, assets and resources
 - GAO concluded agency was unreasonable to not give meaningful consideration to the transaction

Material Changes in Approach to Performance

- *FCi Fed.*, B-408558.7, 2015 CPD ¶ 245 (Comp. Gen. Aug. 5, 2015)
 - Sale materially altered the approach to contract performance set forth in the originally submitted proposal; resources and experience of former parents was eliminated
 - Agency failed to consider effect on the awardee's past performance rating and pricing
 - GAO found the original proposal no longer reflected the intended approach to contract performance

Key Principles

- Notify agencies through proposal revisions when the intended approach to contract performance is materially different from the proposed approach
- Agencies evaluate how a pending corporate transaction will impact a proposal with particular emphasis on
 - Technical ability to perform the contract work
 - Past performance representations by the pre-transaction entity
 - Cost and pricing issues
- Award likely cannot be made to a contractor based on a proposal that differs materially from the contractor's intended performance

Key Principles (cont.)

- Offerors are obligated to disclose "material changes" to their pending proposals arising out of corporate transactions
- If the material change occurs
 - Before final proposal revisions are due, revise proposal to reflect any changes to proposed resources, performance or price of the offered supplies/services
 - After submission of the final proposal revisions, send a letter to CO to request that it be permitted to revise the proposal
 - Note: CO may reopen discussions with all offerors
 - Risk: CO will reject offeror's request and disqualify the proposal as technically unacceptable or otherwise not responsive to the solicitation

Best Practices for Disclosure in Proposal

- *Enter. Servs., LLC, B-415368.2, et al.*, 2018 CPD ¶ 44 (Comp. Gen. Jan. 4, 2018)
 - Lockheed anticipated the sale of its IT business segment in its proposal, proposed a series of steps it and purchaser would take to minimize any adverse impact
 - CO gave this disclosure in the price proposal to technical evaluators
 - Evaluators assessed the transaction's effect on contract performance; concluded no material impact

Best Practices for Disclosure in Proposal (cont.)

- Disclosure presented in price proposal
 - Announcement of definitive agreement
 - Expected close
 - Government IT business that submitted the proposal and would perform any resulting contract is part of transaction
 - Proposal structured so that the transaction would not have a material impact on performance of any resulting contract
 - Lockheed personnel, equipment, technology, or services identified in the proposal would be converted to subcontract/supply agreements with Leidos
 - Same products/services/capabilities
 - Consistent schedules and pricing terms
 - Details regarding transition period

Take-Home Points from *Lockheed* Decisions

- Assess and plan to minimize the impact on future work
- Disclose the plan, in as much detail as possible, to win over evaluators
- Result: arm evaluators with information needed to defend a favorable evaluation of the proposal

Questions?