THE NATIONAL LAW JOURNAL
NOVEMBER 5, 2018
Online Feature
An ALM Publication

Three Hot Topics for Federal Contractor M&A Transactions

Although certain key legal and business issues are common to most M&A deals regardless of industry sector, unique issues arise in M&A transactions involving federal government contractors.

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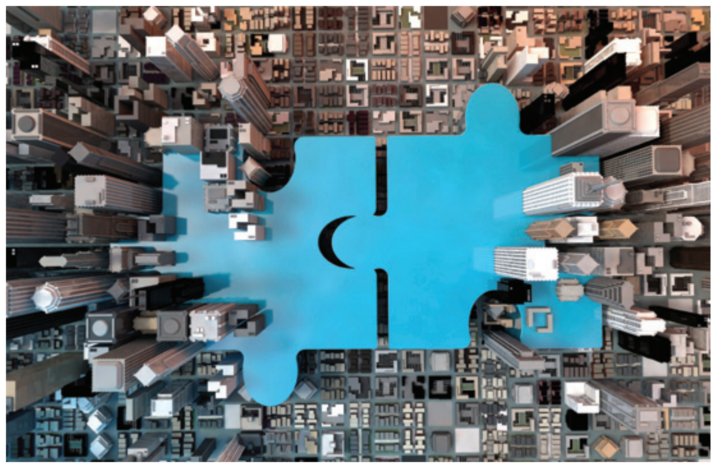
The combination of a generally active mergers and acquisitions market and increased U.S. government spending (particularly in the areas of defense, cybersecurity and health care) continues to drive significant deal activity involving government contractors.

Active acquirers include both long-term strategic players buoyed by rising profits and stock prices and private equity funds with unprecedented levels of capital to invest. Although certain key legal and business issues are common to most M&A deals regardless of industry sector, unique issues arise in M&A transactions involving federal government contractors.



Small Business

One frequently arising topic is how best to address small business and other set-aside contracts in the context of M&A deals. It is common for owners of businesses that have recently (or will soon) outgrow their small business status to seek an M&A liquidity event and, in most of these instances, the company to be sold will have some number of set-aside contracts in its portfolio (i.e., contracts for which only a small business or other socioeconomically disadvantaged business (e.g., woman-owned or minority-owned) was entitled to bid).

As a general matter, if a large business (including a private equity fund) acquires a controlling interest in a small or otherwise disadvantaged business, then the target will become a large business and lose its former special designation after the deal closes. The threshold issue is the extent to which the target has been issued set-aside contracts tied to its size or other ownership status, which will require a review of the target's contracts and related documents (sometimes including bid materials).

However, in most instances, the changed designation will not result in any immediate action even under set-aside contracts. Although the government always has the right to terminate a contract for convenience, early termination following a change of control is rare unless there is a performance problem.

For practical reasons—particularly the service disruption, time and effort required by the procurement process—the government will rarely trigger an early contract recompete. The more nuanced legal issues relate to the target's post-closing ability to be awarded new option years under its existing contracts, as well as its ability to bid on new task or delivery orders under schedule-type or other indefinite delivery, indefinite quantity master contracts. To understand the consequences of the deal, the affected set-aside contracts should be individually analyzed to determine the impact of the target's becoming a large business.

From a business perspective, the key question is whether revenue from set-aside contracts is likely to continue beyond the current contract option or term. If the target is providing unique products or services or is a long-time incumbent, then the government is more likely to issue future contracts as full and open so that the target/buyer will be eligible to bid and win.

Although the easy answer for a buyer may be to heavily discount set-aside revenue and profit for valuation purposes, that approach may not reflect reality and, regardless, may not be an option in a competitive sale process. In those circumstances, buyers should try to engage in direct communication with key customers or otherwise gather broader market intelligence to determine their relative comfort with future prospects.

Audit Risk

Another area of increasing attention in government contracts M&A deals is how to address future incurred cost audits and rate adjustments for acquisition targets. For companies that generate significant revenue under contracts subject to these audits, there is potential for material amounts to be owed to the government following the completion of audits of open contract years. Since the government may be years behind on its audit activity (a phenomenon that is becoming more common), an acquisition target may have multiple open periods that could trigger post-closing liability.

Front-end due diligence, including evaluating a target's track record and audit history, can be helpful in evaluating and mitigating risk, but will not eliminate the concern. Including representations and warranties in the acquisition agreement that specifically address incurred cost audit adjustments is one tool to address the risk, but buyers will need to ensure that 1. the representations survive long enough to provide the desired protection, and 2. the indemnification basket or deductible or other limitations will not unduly reduce the benefit.

Depending on the magnitude of the audit risk, a specific indemnity—covering the risk from dollar one and for the statute of limitations—may be appropriate. From a seller's perspective, if they are responsible for downside risk, then it is likely fair to propose that audit adjustments go both ways so that the seller gets credit for any increased reimbursement. In addition, sellers may push for a meaningful role in the audit process, such as the right to approve settlements with the government, at least within some parameters.

Foreign Ownership

A third hot topic relates to increased scrutiny of deals under the purview of the Committee on Foreign Investment in the United States, such as those involving buyers subject to foreign ownership, control or influence (which includes many large U.S.-based private equity funds with foreign investors). Under the current administration, CFIUS has looked harder at more deals—but without additional staff to undertake those reviews. There is obvious complexity for deals with significant complicating factors, such as those involving Chinese investors or highly sensitive contract activities. However, deals that were previously viewed as simple are now more likely to be reviewed and potentially delayed. As a result, a CFIUS review process of more than six months is now the norm.

The recently enacted Foreign Investment Risk Review Modernization Act of 2018 effectively codifies CFIUS's expanded purview and alters the filing and review timelines. While the impact of FIRRMA remains to be determined, market consequences from CFIUS uncertainty include parties altering deal structures to carve out sensitive government businesses not essential to the buyer's investment interest, and sale processes being limited to domestic buyers to avoid CFIUS delay.

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