Acquiring a Company with Government Contracts: A Checklist of Unique Issues

A Presentation and Webinar by Matt Koehl

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9:00 – 10:00 a.m. MST
Introduction
Introduction

- Investor Interest in Government Contractors
  - Improving but sluggish conditions in commercial market
  - Homeland security
  - Foreign wars
  - Cyber-security

- “Government Contractors”
  - Specialty contractors (e.g., IT security, biodefense)
  - Traditional government contractors (“USA, Inc.”)
  - Commercial companies with some public sector customers
Introduction

- Presentation focus is Federal government prime contracts

- Federal subcontracts
  - Many of the same unique considerations apply via “flow down” clauses (e.g., intellectual property)
  - Some issues implicated to lesser extent (e.g., GSA multiple award schedule contract program)

- State and local government contracts have many of the same considerations
  - Often less complex and lower risk
Background
Due Diligence and Sales Agreement Negotiations

- Due diligence process follows the term sheet and letter-of-intent between Buyer and Seller
- Buyer assesses quality and risk areas in Seller’s business (i.e., “am I really buying what I think I am?”)
- Negative findings can affect valuation or terminate transaction
- Buyer provides list of questions and requests for key documents to Seller
  - Customized list for government contractors
- Discussions with Seller’s management and key employees
Due Diligence and Sales Agreement Negotiations

- Sales agreement with Seller representations and warranties
  - E.g., no litigation except as disclosed

- Customized Seller representations and warranties for government contracts
  - E.g., no subpoenas or on-going government contract audits

- Refine Seller representations and warranties based upon due diligence
  - E.g., specific technical data developed exclusively at private expense
Due Diligence and Sales Agreement Negotiations

- Modify other Sales Agreement terms based upon results of due diligence
  - E.g., increase size of purchase price escrow to account for possible government contracts liabilities
  - E.g., increase duration of purchase price escrow to better match statutory limitations period for government claims
  - E.g., make government approval of Seller’s transfer of key contracts a closing condition
Transaction Structures

- **Asset Purchase**
  - Buyer purchases some or all of seller’s assets. Buyer may or may not assume liabilities

- **Stock Purchase**
  - Buyer purchases seller’s stock. Corporation continues to exist with assets and liabilities, but with new stockholders

- **Merger**
  - Combination of firms where one survives to hold the assets and liabilities of the combined firms and the others are dissolved
Transaction Structures

- **Asset Purchase**
  - Pro: avoid assumption of some liabilities.
  - Con: (i) subject to novation agreement approval process; (ii) cross-guaranty of past and future performance. Note: unclear if novation agreement “guaranty” includes extraordinary penalties

- **Stock Purchase**
  - Pro: (i) no government approval; (ii) no Seller guaranty of future performance
  - Con: retain all government contract liabilities, including penalties. Note: limitations period 6 years or more

- **Merger**
  - Same as stock purchase except novation agreement may be required depending upon government agency
Novation Agreement and Associated Issues

- Government contracts and contract claims are transferable only with government consent (41 U.S.C. § 15; 31 U.S.C. § 3727)

- Concern about persons of influence selling government contracts dates to Civil War

- Consent to transfer routinely granted, but must be in “government’s best interests”

- Novation Agreement is attached to a contract modification demonstrating the government’s consent to the transfer

- Attachment A – FAR Subpart 42.12, “Novation and Change-of-Name Agreements”
Novation Agreement and Associated Issues

- 3-party agreement between Seller, Buyer and Government
- Accompanied by FAR-specified document package
  - Practice Tip: Sales agreement should specify post-close obligation for Seller to timely provide required documents
- Buyer guarantees Seller’s past performance, Seller guarantees Buyer’s future performance
- Required for asset purchase contract transfers, but generally not required for stock purchases
  - Practice Tip: GSA requires for corporate mergers, structure transaction documents accordingly
Novation Agreement and Associated Issues

- “Lead Agency” contracting officer (CO) approves all transferred government contracts
  - Lead agency CO is generally largest contract CO
  - Consults with other agency COs
  - Some opportunity to “forum shop”

- Practice Tip: Include GSA Schedule contract Blanket Purchase Agreements (BPAs) and outstanding task and delivery orders on list of transferred contracts

- No government “pre-approval” of Novation Agreement but sometimes advisable to speak with CO during due diligence phase
Novation Agreement and Associated Issues

- Time required for government review and approval varies, can require 2-6 months

- Seller remains the legal party to the contract until novation is approved

- Subcontract necessary to cover approval “gap”
  - Buyer performs in the Seller’s name
  - Invoicing and payment issues
  - Government approval (not for “commercial items”)
  - Transition services agreement should include required assistance on government contracts
Checklist Issue Number One: “Small Business” Set-Aside Contracts
Small Business
Set-Aside Contracts

- Federal government procurement preference programs for “Small Business”

- Small Business size standards are industry-specific, based upon -
  - total employees (manufacturing) or
  - average annual revenue (services)

- “Small Business” is “affiliated” with its owners

- “Affiliate” revenue and employees count when determining a company’s size status
Small Business Set-Aside Contracts

- Small Business status can be a key ingredient in a company’s success
- Loss of Small Business status could result in
  - Immediate termination of some contracts
  - Re-compensation among Small Businesses instead of exercising contract renewal options
- Loss of Small Business status bars participation in future competitions for Small Business set-aside contracts
- Possible competitive disadvantage relative to federal subcontracts
Small Business Set-Aside Contracts

- Old Rule: SB contractor required to update size status representation only for asset purchase
  - Buyer could structure acquisition as stock purchase if “small business” contracts were key to acquisition

- Current Rule: SB contractor must “rerepresent” its size status within 30 days of stock purchase or merger. FAR 52.219-28

- Practice Tips: (i) reach out to CO for key small business contracts before closing; (ii) closing condition of government approval of the contract transfer
Small Business Set-Aside Contracts

- Does the Seller hold set-aside contracts?
  - Red Flags: (i) Contract standard form (SF) with “set-aside” box checked; (ii) listed in government databases as “Small Business” (e.g., www.sam.gov)

- If the Seller holds set-aside contracts:
  - Would Seller qualify post-close in key industries
  - Value of contracts and contract options that could be affected by loss of size status
  - Impact of Seller’s exclusion from future Small Business set-aside procurements
Checklist Issue Number Two:
GSA Schedule Contracts
GSA Schedule Contracts

- GSA’s “Schedule” contracts program is the premier sales program for “commercial items” ($37.5 billion in FY 2012 sales)

- Medical supplies and services Schedules administered by Department of Veterans Affairs

- Complex pre-award pricing disclosure and post-award price reduction requirements

- Commercial companies often have compliance problems with their GSA Schedule contracts

- Office of Inspector General and the Department of Justice focus on GSA Schedule contract audits
GSA Schedule Contracts

- Does the Seller hold a GSA Schedule contract?
  - Red Flag. Seller listed in GSA Schedules E-Library. Check for d/b/a and previous names.  
    http://www.gsaelibrary.gsa.gov/

- If Seller holds a GSA Schedule contract, review:
  - Pre-award sales practices disclosures
  - Procedures for monitoring post-award price reductions
  - Payment of administrative fee to GSA (IFF)
  - Procedures for selling only GSA-approved items
  - Compliance with product country of origin rules (TAA)
  - Procedures for supplying qualified professional staff
GSA Schedule Contracts

- Post-Close Administrative Considerations
  - Identify and confirm “tracking customer” based upon Seller’s new structure
  - Unwritten GSA policy allows only one Schedule per contractor (unevenly enforced)

- Significant Potential Buyer Exposure
  - December 2004, Oracle acquires PeopleSoft
  - PeopleSoft employee files *qui tam* False Claims Act lawsuit
  - October 2006, Oracle agrees to pay $98.5 million fine for PeopleSoft GSA contract pricing errors
    - [http://www.justice.gov/opa/pr/2006/October/06_odag689.html](http://www.justice.gov/opa/pr/2006/October/06_odag689.html)
Checklist Issue Number Three: Intellectual Property Rights
Intellectual Property (IP) Rights

- Government gains substantial rights in IP developed with government funds
  - Enhanced rights also to “mixed-funding” IP (public/private)
- IP includes Inventions, Technical Data and Software
- Potentially unrestricted competitor access to government-funded IP on future procurements
- The Contractor gains exclusive commercial market rights to IP, but only if it meets notice and marking requirements
  - Possibly releasable under Freedom of Information Act (FOIA)
 Intellectual Property (IP) Rights

- Was the Seller’s IP developed exclusively at private expense?
  - Red Flag: Seller performs government research and development (R&D) prime contracts or subcontracts

- If not developed exclusively at private expense, examine:
  - Extent of government’s rights in the IP
  - Is it subject to release under FOIA?
  - Did contractor perfect its ownership (and commercial market exclusive rights) in IP developed with government funds? If not, is defect subject to cure?

- Is original IP valuation affected? If so, by how much?
Checklist Issue Number Four: Open Proposal Submissions
Open Proposal Submissions

- Seller often has outstanding, open proposals
- Proposals can sometimes result in a new contract without further action by Seller
- Buyer may inherit unanticipated, new obligations
- Protest risk (confusion with regard to “offeror”)
- Practice Tip: Create procedure to amend novation agreement if awarded new contracts in Seller’s name after close but before novation agreement approval
Outstanding Proposals

- Does the Seller have outstanding proposals?
  - Red Flags: (i) recently dated proposals; (ii) recently dated “discussion” letters with a government agency; (iii) “notice of intent to award” letters

- If so, examine:
  - Performance requirements, terms and price
  - If unfavorable, subject to withdrawal?
  - Whether to exclude/include resulting contract in asset purchase
Checklist Issue Number Five: Organizational Conflicts of Interest
Organizational Conflicts of Interest (OCI)

- OCI rules specified in FAR subpart 9.5
- OCI rules are designed to prevent unfair “structural” competitive advantages
  - E.g., evaluating an affiliate for award
  - E.g., helping to draft specifications that you’ll later bid on
- OCI could bar participation in procurements where the Seller is in the same or similar industry as the Buyer
  - Surrender of existing contracts to avoid or properly mitigate OCI
Organizational Conflicts of Interest (OCI)

- Does the transaction create a potential OCI?
  - Red Flag: Buyer and Seller compete on government procurements for complex requirements in the same or substantially similar industries

- If there is a potential OCI, examine:
  - Value of potentially affected programs
  - Whether existing mitigation plan is sufficient
  - Cost of additional mitigation steps
  - Restriction on future business development resulting from OCI
Government Contracts: Compliance Risks and Extraordinary Penalties
Compliance Risk/Extraordinary Penalties

- Substantial government audit rights
  - Especially for cost-reimbursement and GSA Schedule contracts

- Extended statutory limitations periods

- Potential for negative press coverage
Compliance Risk/Extraordinary Penalties

- Termination for Default
  - Excess re-procurement costs

- Negative past performance ratings

- Suspension/debarment for up to 3 years
Compliance Risk/Extraordinary Penalties

- Civil False Claims Act
  - “Reckless disregard” standard, no intent required
  - Treble damages, $11k per invoice

- Oracle pays $98.5 million fine (PeopleSoft) and $46 million fine (Sun Microsystems) to settled alleged false claims submitted by acquired companies
  
  http://www.justice.gov/opa/pr/2006/October/06_odag_689.html

- Criminal penalties for intentional violations
Questions?