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An Early Start Of Specialized Due Diligence Is Key To Successful M&A Transactions Involving Government Contractors – Part IV

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*Editor's Note: The first part of this article, which appeared in the June issue of The Metropolitan Corporate Counsel, discussed understanding "materiality" and the scope of information needed for due diligence. It can be found at <http://www.metrocorp-counsel.com/current.php?artType=view&EntryNo=12386>. The second part, which appeared in July, discussed valuing the seller's government contracts backlog. It can be found at [*p?artType=view&EntryNo=12431. The third part, which appeared in August, discussed identifying special risks and obtaining financing. It can be found at <http://www.metrocorp-counsel.com/current.php?artType=view&EntryNo=12605>.*](http://www.metrocorp-counsel.com/current-ph</i></p></div><div data-bbox=)*

Negotiating And Executing A Purchase Agreement

Just as it is important to have an early

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start of specialized due diligence in a transaction involving government contracts, it is also important to have government contracts counsel involved in early stages of negotiating the purchase agreement. Transaction counsel without government contracts expertise cannot be expected to draft and negotiate provisions in the purchase agreement that address the unique risks of doing business with the federal government. Government contracts expertise is important for contract provisions involving representations and warranties, preparation and review of disclosure schedules, conditions to closing, and post-closing covenants. If the principal value of a business comes from its government contracts, contract provisions in the purchase agreement relating to those contracts must be negotiated simultaneously with other key provisions determining the allocation between the parties of the risks and rewards of owning and operating the business – such provisions as purchase price, survival of representations and warranties, and indemnification.

An acquisition in the government contracts sector needs all of the typical representations and warranties relating to the target business such as seller's authorization to enter into the purchase agreement, accuracy and completeness of the financial statements, compliance with labor and employment, environmental and other laws and regula-

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tions, but it also needs representations and warranties tailored to the risks and liabilities of the types of government contracts held by the target. There is no standard set of government contracts representations and warranties that is appropriate for all government contractor acquisitions. The risks of an information technology systems integrator are very different from the risks of an operator of a nuclear waste treatment plant. Similarly, the risks of a fixed price construction contract are very different from the risks of a cost reimbursable weapons development contract.

Typically, the government contracts representations and warranties are included in a separate section within the contract article containing all the representations and warranties. Keeping them separate facilitates negotiations between the government contracts legal and accounting experts representing each party in the transaction. Negotiating the representations and warranties is an extension of due diligence. Sweeping positive statements about the nature and status of the business set forth in management presentations must be honed into more precise factual statements that can be verified by the seller before closing and by the buyer after signing and consummating the purchase agreement. If a representation or warranty is breached after signing but before closing, the buyer should have the right to walk away from the transaction. If a breach becomes apparent after closing, the buyer may have the right to make a claim against the seller for indemnification.

Representations and warranties typically call for the seller to prepare disclosure schedules that set forth in detail the matters covered by the representations and warranties. For example, a representation might provide that, except as set forth on the disclosure schedule, no costs have been questioned in writing or disallowed by a government auditor or contracting officer. The schedule would need to disclose every incident during the time period covered by the representation when a cost had been questioned in writing or disallowed. Preparing accurate and complete disclosure schedules is typically a significant challenge for sellers. They do not want to begin the formidable effort of preparing the schedules until they are ready to announce the potential deal to their employees who have the knowledge that needs to be disclosed. The buyer, on the other hand, needs the detailed information to make important decisions about purchase price, post-closing purchase price adjustments, how long the representations and warranties need to survive after the closing, and the extent of indemnification. The representations and warranties, complemented by the disclosure schedules, are the key contractual provisions that allocate the liabilities of the acquired

business between seller and buyer. Consequently, seller and buyer must allow considerable time to prepare, review, and negotiate the disclosure schedules as well as to make other contract revisions in response to the disclosures. For these efforts, corporate counsel and special government contracts counsel must work together closely to assure that risks disclosed in connection with the government contracts representations and warranties are appropriately addressed in such contractual provisions as conditions to closing, indemnification, and post-closing covenants.

Sellers and buyers in a typical commercial transaction usually include in a purchase agreement a short list of conditions that, if not fulfilled between signing and closing, allow the buyer to walk away from the transaction without liability. Given the expense and risk to the business of a transaction that does not close, sellers are adamant that a buyer with which it enters into a purchase agreement not be able to walk away easily. The typical conditions are that there be no material breach that is reasonably likely to result in a material adverse effect on the acquired business, that the parties have each complied with all of their obligations under the purchase agreement including deliveries required at closing, that necessary consents have been obtained, and that there not be any judgment or decree enjoining the consummation of the acquisition.

In a government contracts transaction there are additional considerations to take into account in negotiating conditions to closing because a number of government officials and agencies may have explicit, or at least tacit, power to completely undermine the buyer's ability to operate the acquired business after closing. Perhaps one of the most unique aspects of transactions involving government contractors is the "novation" process that must be followed in order to transfer government contracts from one entity to another. As discussed above, the Anti-Assignment Act prohibits the assignment of contracts from one entity to another without the consent of the government. The novation process is the mechanism by which that consent is provided. It may be possible to structure a transaction to avoid the need to novate the seller's contracts – for example, where the transaction is a stock purchase. Even then, however, applicable regulations provide that 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, thus providing a contracting officer ample discretion to require a formal agreement even when a transaction is structured as a stock sale.

Where novation is required, as is the case for any asset sale, it presents a classic

"chicken or the egg" scenario. This is because the formal novation process begins only after the transaction has closed – indeed, the evidence of closing is one of the many documents that must be presented to the government as part of the novation request. As a result, substantial planning and negotiating are required for the parties to be comfortable that it is prudent to consummate a sale even though the transfer of the key assets of the business, the government contracts, will take place after the closing. In addition to having well-devised plans to communicate with the government about the pending transaction, the purchase agreement should have conditions to closing that equitably share the risk if the communications are not favorably received by the government. The purchase agreement must also include covenants for the parties to take specific steps after the execution of the purchase agreement and after the closing to accomplish the novations. The agreement must also provide for a mechanism for the seller to delegate to the buyer certain authority relating to the performance of the government contracts during the period after the consummation of the sale but prior to the completion of the novation.

Another issue that must be analyzed during due diligence and is often addressed in a condition of closing concerns facility security clearances. In circumstances where most of a contractor's work is performed in cleared facilities, the value of the target business could be suddenly reduced to the liquidation value of its assets if it loses access to facility clearances. A transaction involving classified contracts may need the explicit or tacit approval of several federal agencies and officials. For example, if the buyer may be subject to influence by foreign persons, the Defense Security Service may revoke or decline to renew facility clearances, and the U.S. Treasury's Committee on Foreign Investment in the United States also has broad power to block or unwind an acquisition. Similarly, contracting officers may consider the impact of a transaction on classified contracts when determining whether or not, after the closing takes place, the government contracts may be novated from the seller to the buyer. In these and other instances where the government has broad discretionary powers, the parties must negotiate conditions to closing that provide for an equitable sharing of the risk that the buyer will not be allowed to operate the business after closing.

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To mitigate the unique risks associated with transactions that involve government contractors, buyers and sellers need to understand what those risks are and how to deal with them. A careful and thorough due diligence process guided by experienced government contracts counsel will help ensure that buyer and seller agree to an equitable and efficient allocation of risk between them.