

Due Diligence In The Acquisition Of A Government Contractor – Part I

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With the increasing number of mergers, stock purchase agreements, and asset sales going on today in corporate America, increased due diligence has been a must for any responsible party to such transactions. If the target is a federal government contractor, there is an overlay of due diligence requirements because of the many statutes and regulations governing those who hold federal contracts that must be addressed before the transaction is closed to assure compliance and avoidance of later issues being raised by government procurement and audit officials. There are: (a) procedural aspects of the transaction, including novation requirements, sub-contracts, national security implications, status of proposals to the Government or cost accounting compliance considerations and (b) financial aspects of the transaction, including allowability of costs relating to the transaction, pension cost implications and asset evaluation. These matters are covered in Part I of this article. Part II to be published in a subsequent article, will cover (a) evaluation of the contract assets acquired, including validity of the contracts, funding, overruns, status of options, research and development status if applicable, terminations pending, and assignment of revenues, and (b) pending or possible government claims and contractor claims, defaults, convenience terminations, inspection and acceptance, warranties, cost disallowances, cost accounting violations, defective pricing, change orders and constructive changes, and contractor fraud matters unique to federal contracting. The majority of due diligence concerns are covered in these Parts.

1. Procedural Aspects Of The Transaction

A. Novation Agreements

Because of the Anti-Assignment Statute (41 U.S.C.15), prohibiting transfer of a government contract to a third party unless the government in its discretion agrees to recognize the third party as successor in interest, it is important to understand the regulations governing the novation of contracts and change of name requirements as set forth in the Federal Acquisition Regulations Part 42.1200 et seq. Those regulations provide for formal notice to the government, the submission of detailed information to the contracting officials, and the execution of a standard nova-



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tion agreement that details the rights and obligations of the transferor and the transferee, certain documentation specified that must be submitted with the agreement and certain affirmations of the parties. Novation agreements are required when all of the contractor's assets are being transferred, or the entire portion of the assets involved in performing the contract or contracts are being transferred. Novation agreements are not necessary when there is a change of ownership 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. Even then, the regulations note that there may be issues related to the change in ownership that should be addressed in a formal agreement. The genesis of the Anti-Assignment Statutes and regulations is simply that the government needs to know who it is dealing with when such transactions take place and the contracts change hands. It behooves the parties to know the regulations well when a sale or merger is being negotiated.

B. Subcontracts

Regardless of whether the acquisition is a stock or asset sale, review of all existing subcontracts of the acquired company is necessary to ensure that they will not be affected by the acquisition. If any subcontracts include provisions regarding assignment, the parties must ensure that the assignment can take place and all necessary actions are taken. The subcontracts should also be reviewed to make sure they contain all of the flow-down clauses required in the Federal Acquisition Regulations ("FAR") and to determine whether the prime or subcontractor has pending or potential claims against the other.

C. Security Clearances

If applicable, it shall be critical to determine whether the acquired company has facility clearances at any of its facilities if the transferor holds such clearances because of the nature of the contracts it holds that are national security contracts that will be transferred. If so, proper notification must be given to

the agency's cognizant security offices that in most cases are the Department of Defense, State or other such agencies which award contracts with classified and national security requirements for facilities and the persons working on such contracts. Failure to give the required notices could result in the revocation of the clearances that were held by the transferor. If the acquired company does not have such clearances, they must be applied for and approved prior to the closing so as not to jeopardize the transaction. On a related matter, and if applicable, it should be determined whether the acquiring company is subject to foreign ownership, control or influence (FOCI). If FOCI exists, the parties must ensure that a special arrangement is reached with the Department of Defense in order to prevent the termination of existing security clearances.

D. Outstanding or Future Proposals For Government Work

The parties need to identify all of the proposals the acquired company has outstanding for possible award. If such proposals relate to negotiated procurements where the Truth In Negotiations Act applies (contract actions where the price is expected to exceed \$500,000), it should be determined whether any additional cost and pricing data disclosure needs to be made to the government and ensure that they are made. This will avoid later audit if award is made and thence possible adjustments downward in the contract price agreed to if the acquired company failed to submit and certify accurate, current, and complete cost and pricing data that could have affected the price at the time of the hand shake at the completion of negotiations with the government. If subcontracts are being used in the procurement to fulfill the needs of the procurement and cost and pricing data are required, the parties should ensure that the subcontractors proposed fulfill their obligations to submit accurate, current and complete cost and pricing data. Since there is no privity of contract between a subcontractor and the government, the prime will be held responsible for the failures of the subcontractor in failing to submit the required data. 10 U.S.C. 2306a and 41 U.S.C. 254b.

Another facet to be reviewed, if applicable, is where the acquired or acquiring company qualified as a small business and thus was eligible for small business set-asides. If either qualifies as a small business, it should be determined whether the transaction will result in the company no longer being a small business. If so, they must ensure that any future proposals are not submitted for small business set-asides and that the company does not certify itself as a small business to the procuring agencies.

E. Cost Accounting Standards

41 U.S.C. 422 requires that certain contractors and subcontractors comply

with the Cost Accounting Standards and disclose and follow consistently their cost accounting practices. The Cost Accounting Standards ("CAS") represent a comprehensive set of rules to ensure that contractor's accounting systems are reasonable and provide assurance that work billed to the government is properly accounted for. 48 CFR 9903-9904; FAR Part 30. There are exemptions from coverage which should be reviewed. The Standards cover consistency in allocating costs; allocation of home office expenses to segments; capitalization of tangible assets; accounting for unallowable costs under the FAR; use of standard costs; accounting for costs of compensated personal absence; depreciation of tangible capital assets; allocation of business unit general and administrative expenses to final cost objectives; accounting for acquisition costs of materials; composition and measurement of pension costs; cost of money as an element of the cost of facilities capital; deferred compensation; accounting for insurance costs, allocation of direct and indirect costs, cost of money as an element of the cost of capital assets under construction; and accounting for independent research and development and bid and proposal costs. Due diligence requires a determination of whether the acquired or acquiring company is subject to CAS or whether as a result of the acquisition will become subject to CAS. If currently applicable, the parties will need to determine whether revisions must be made to the CAS disclosure statements and what standards as noted above will apply.

2. Financial Aspects Of The Transaction

A. Costs of the Transaction

It will be necessary to determine how both the acquiring and acquired companies plan to account for the costs of the acquisition. The FAR must be reviewed to ensure that those organizational costs currently identified in these regulations as unallowable are accounted for in a manner as not to be charged to the government through the contracts.

B. Pension Plans

Because of requirements in the FAR, it must be determined whether any pension plan of the acquired company is over-funded and if so, whether the acquiring company intends to terminate the plan or continue contributions. The government takes the position that it is entitled to share in any gain realized from the termination of an over-funded pension plan and that it may disallow any further contributions to an over-funded plan. The parties should determine whether the government has already made any such claims.

C. Asset Valuation

The parties need to ensure that the acquiring company computes depreciation charges on the appropriate asset value whether the purchase method or pooling of interest methods are used.

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Due Diligence In The Acquisition Of A Government Contractor – Part II

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Part I of this article, which appeared in the September issue of The Metropolitan Corporate Counsel, discussed the procedural and financial aspects in the acquisition of a government contractor through a merger, stock purchase or asset sales agreement. It pointed out that with the increasing number of mergers, stock purchase agreements, and asset sales going on today in corporate America, increased due diligence has been a must for any responsible party to such transactions. If the target is a federal government contractor, there is an overlay of due diligence requirements because of the many statutes and regulations governing those who hold federal contracts that must be addressed before the transaction is closed to assure compliance and avoidance of later issues being raised by government procurement and audit officials.

Evaluation Of The Acquired Company's Federal Contract Assets

Validity Of The Contracts

Review all contracts to assess whether each was properly issued pursuant to the federal procurement statutes and regulations, determine the source of funds to satisfy the government obligations, and whether the contracts limit the government's obligations to annually appropriated funds.

Funding

The current contract prices should be identified and compared to the funds currently obligated to the contract, the amounts appropriated but not yet obligated to the contract, and the amount of funds needed for completion but not yet appropriated. Assess whether there will be a funding shortfall and if so whether termination or program cancellation is likely.

Overruns

Review the acquired company's methods for estimating the cost to complete contracts and whether they are reasonable. Assess whether there are projected losses. Cost reimbursable contracts, if any, should be reviewed to compare the costs that have been incurred to the amounts that have been obligated to the contracts and if such costs exceed seventy-five percent of the funds obligated, determine whether the government has been given notice of this fact as required in the contract and if the costs incurred exceed the amount obligated to the contract, whether performance has continued (i.e. whether there is an overrun issue). Fixed Price contracts should be reviewed that contain progress payments, determine the methodology used for determining progress billings, and then assess whether the contract is over-progressed by comparing the total amount of progress billings to the actual percent of contract completion.

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Options And Multiyear Contracts

With respect to options contained in contracts, assess whether funds have been appropriated for the options and the likelihood that the options will be exercised and funds obligated for those options. As to multi-year contracts, it should be determined whether funds have been appropriated for future years. Check the contracts for cancellation charges for failure to authorize future years and assess whether those charges would cover the costs amortized over the expected life of the contract. Check for pre-priced options for the out years of any multiyear contracts to compare the value of those pre-priced provisions to the current estimate of cost needed to perform the work. Check for any price escalation clauses in the contracts that would protect the contractor.

Research Development Test And Evaluation Contracts (RDT&E)

A review of such contracts, if involved in the acquisition, is necessary to determine whether any of such contracts require the contractor to invest its own funds in the RDT&E effort and if so, how much additional contractor funding will be required. For any such contracts that anticipate the recovery of the contractor's investment through follow-on production contracts, the likelihood of a production contract award or cancellation of the program before the RDT&E is completed should be assessed.

Terminations For Convenience Of The Government

Something unique to federal contracting is the government's right to terminate a contract for the convenience of the government and such termination rights are in almost all federal contracts. In conducting due diligence the parties must determine whether there are any existing terminations in effect and if so whether the convenience termination funding is there to obligate the funds necessary to satisfy the contractor's termination claim in full. If the acquired company's operations are largely debt-financed based on the strength of anticipated contract revenues, the acquiring company should assess whether the termination claim would satisfy the debt obligations. One important question to address is whether the government is likely to contest the quantum of the termination claim.

Assignment Of Revenues

It should be determined whether the acquired company has assigned any contract payments to a financing institution and, if so, a review of all such assignments should be accomplished to ensure that they are in compliance with the procurement regulations and will not affect the transaction. (FAR 52.232-36 and 32.1110(d)).

Pending Or Possible Government Claims

Default Terminations

If there are existent any default actions that have been taken or are threatened with cure notices or show cause letters, the parties need to explore whether the grounds under the particular default clauses of the contracts are valid and if not, should be challenged. An assessment must be made of what financial impact will occur as a result of the termination action. The government's rights under the standard Default



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Clause are to re-procure the item and charge the contractor with the delta between the new contract price and what the price was under the defaulted contract plus the government's expenses in having to re-procure the item or service.

Inspection And Acceptance

The main focus here would be to determine for contracts involving repetitious deliveries of the same item, the extent to which items have not passed inspection and have been rejected by the government. It should then be determined what cost impact there is in furnishing additional quantities to satisfy the contractual requirements to obtain acceptance by the government. If there are contracts which involve a few major items, assess whether such items have failed inspection tests and the cost impact to the contractor. Lastly, assess whether the government may have latent defect claims.

Warranties

The acquiring party should review all delivery records of all government contracts to determine how many units or services already delivered to the government are subject to a warranty provision and, if so, the cost impact of any warranty claims already asserted by the government or likely to be asserted.

Cost Disallowances And Cost Allowability

The acquiring company should review the acquired company's policies and procedures for segregating costs which are unallowable under the Federal Acquisition Regulations Cost Principles, Part 31. Check the relative proportion of fixed price to cost type contracts. A review of all outstanding government audit reports and an ongoing audit should be undertaken to assess whether any costs will be disallowed. Determine whether any public vouchers issued under cost type contracts have been rejected for the inclusion of unallowables.

Defective Pricing

The Truth In Negotiations Act, implementing regulations and contract clauses discussed above apply to negotiated contracts and/or contract actions over \$500,000 and require the submission of and certification by the contractor of accurate, current, and complete cost and pricing data as of the date of the agreement on price. Accordingly, due diligence will require first determining the number of contract actions that are subject to the Act. Next, a review of all post-award government audit reports should be conducted to learn whether any defective pricing allegations have already been made. Lastly, the acquiring company should also review the acquired company's policies and procedures covering the negotiation of contracts to ensure compliance with the Act and to minimize or eliminate the risk of defective pricing claims.

Cost Accounting Standards Violations

It is first to be determined as noted above whether the acquired company is subject to the Cost Accounting Standards and, if so, the extent of its coverage as noted in the earlier discussion on the Procedural Aspects of the Transaction. Due diligence next dictates that the acquiring company review the most current CAS Disclosure Statement by the acquired company to the government to detect any CAS violations. Lastly, all audit reports relating to CAS should be reviewed to learn of any violations or possible violations.

Pending Or Possible Contractor Claims Formal Change Orders

All open contracts should be reviewed to identify formal change orders issued by the government and whether they have been priced, negotiated, or pricing is still under development. In the case of unilateral changes under the Changes clause of the contracts, an assessment of the validity of an increase in price should be made.

Constructive Change Orders

These types of changes claims have been recognized in government contract law for many years when the government without the issuance of a formal change order or bi-lateral supplemental agreement directs work to be performed. In due diligence, the history of performance of any open contract should be undertaken to learn whether the acquired company has been or is performing work not called for by the contract itself. Assess whether any constructive changes claims have been or will be filed and the likelihood of success of such claims.

Contractor Liability For Fraud

It is first to be determined whether any procuring agency has referred any contractor-related activities for investigation for civil or criminal fraud against the government. It should also be determined whether any activity of the acquired company whether contract related or not is the subject of a Grand Jury investigation. Lastly it should be determined whether the acquired company has been suspended or debarred from future contracting under the suspension and debarment regulations set forth in the Federal Acquisition Regulations Part 9.405 or has received notices to this effect proposing such sanctions. These regulations were promulgated on the basis that federal contractors using public funds must be responsible sources of supply and that any activities they engage in that reflect negatively on their responsibility as a contractor requires consideration of the application of these regulations. An assessment should be made as to the extent of the suspension or debarment, in other words, whether it is company wide (where divisions or subsidiaries are involved), what the length of time is for the suspension or debarment, what impact this has or will have on the acquired company's contracts and its business base.

Internal Government Contract Compliance Programs

The central inquiry here is whether the acquired company has conducted any government contract compliance reviews or audits and, if so, whether it has been determined that the company is in compliance and has policies to insure compliance with the laws and regulations which apply to government contracting. It should be determined also whether corrective action has been taken if noncompliance issues have surfaced. Compliance reviews cover principally the following areas: Government Cost Accounting; Purchasing Systems; Material Management (if applicable); Government Furnished Property; Ethics; Bid and Proposal Development and Negotiation Practices; Contract Administration, Financial Control and Quality Assurance; and International Contracting (if applicable).

The above represents the principal areas of due diligence concerns when the target is a government contractor. Careful review of the matters set out herein will give assurance to the buyer that the acquisition is a wise one and presents limited risks legally and financially.

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