For the first time in more than a decade, US defense budgets are shrinking and security planners must make hard choices with respect to priority mission and investment areas. However, M&A activity in the aerospace and defense (A&D) sector continues to be strong.

In 2010, approximately 58 A&D transactions, each with a value of $50 million or more, were announced. Of these, approximately 45 involved a US target or a US acquiror. In 2011, this pace appeared to be continuing with approximately 54 A&D transactions, each with a value of $50 million or more, being announced. Of these, approximately 37 involved a US target or a US acquiror. Deal value also jumped in 2011 with United Technologies Corporation’s September 2011 announcement of an agreement to acquire Goodrich Corporation for $16.5 billion in cash.

There are several drivers of the continuing strength of A&D transaction flow, including the following:

- Many potential strategic buyers have significant available cash earning low returns. As seen in the United Technologies/Goodrich transaction, some of these strategic buyers also have strong borrowing abilities and banks are eager to provide acquisition financing.
- Many potential private equity buyers have high levels of unused commitments as a result of the deal slowdown in 2008–2009.
- Organizational Conflict of Interest (OCI) rules drove several large dispositions in this sector (see below OCI Rules). For example, Northrop Grumman Corporation’s sale of its TASC Inc. consulting unit, Lockheed Martin Corporation’s sale of its Enterprise Integration Group, and ITT Corporation’s sale of its CAS, Inc. systems engineering and technical advisory services business. Although it appears that the major players have now made the divestitures necessary to satisfy OCI rules, these rules may continue to prompt additional divestiture transactions.
- Anticipated defense budget cuts are driving both the purchase and sale of A&D companies. Purchasers are acquiring companies that specialize in areas that are expected to endure cuts, such as cyber security, intelligence and reconnaissance, while smaller defense companies that may be more susceptible to cuts are selling themselves to seek perceived safety in larger firms.
- Acquirors, especially private equity buyers, may continue to view government contract businesses as safe havens with relatively stable cash flows.
However, M&A transactions in this sector present many industry-specific issues. M&A practitioners should have a thorough understanding of the policy considerations, laws and regulations, and government and other stakeholder relationships unique to the A&D industry.

This article identifies certain key issues and considerations that arise for deal-makers, including:

- The relationship between the Department of Defense (DOD), on the one hand, and the Department of Justice (DOJ) and the Federal Trade Commission (FTC), on the other hand, in the context of antitrust approvals.
- The International Traffic in Arms Regulations (ITAR) and export control regimes.
- Issues particular to government contractors.
- Issues relevant to acquisitions of US targets by foreign acquirors, in particular, review by the Committee on Foreign Investment in the United States (CFIUS).

**ANTITRUST APPROVAL INVOLVES THE DOD**

Generally, A&D transactions (like most other US transactions) that meet statutory premerger thresholds require a notification and expiration or termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act) before the transaction can close.

In addition to the antitrust agencies, the DOD plays a key role in reviewing A&D transactions and can significantly influence the decision reached by the DOJ or the FTC. Although the antitrust agencies base their review on the principle that competition is critical in all markets, the analysis of A&D transactions can be particularly challenging because of the unique characteristics of the industry. For example:

- The DOD is often the principal or only buyer of the products and services of the merging firms, and its procurement processes are different from those in most industries.
- National security concerns may be implicated and need to be weighed alongside the agencies’ competition mandate.
- The antitrust agencies are sensitive to considerations of national security and, in particular, whether a merger will enable the DOD to achieve its national security objectives in a more effective manner. However, the antitrust agencies still examine the competitive implications of the transaction. In addition to regular antitrust planning, there are some practical steps deal-makers can take to address the unique aspects of A&D transactions to avoid unwanted surprises from the antitrust agencies. For example:

  - Ensure that the customers at the program level are informed and comfortable with the transaction. Customers at the program level are the governmental or military organizations that are supervising the budget, procurement and delivery of the goods and communicating with the supplier.
  - If the A&D transaction raises competition or national security concerns, take steps to:
    - ensure that the pro-competitive reasons for the transaction are well-developed and understood; and
    - manage the creation of transaction-related documents (including e-mail).

  For more information on how to manage transaction-related documents, search 4(c) and 4(d) Documents: Hart-Scott-Rodino on our website.

- In addition to speaking with the program officers, engage with more senior policy-makers when appropriate, including those in the Office of the Deputy Undersecretary of Defense and the DOD’s Office of General Counsel.

**IMPACT OF US EXPORT CONTROLS**

Unlike most other countries, the US has not one but two export control regimes:

- The US Department of Commerce’s Bureau of Industry and Security administers and enforces the “dual-use” export controls set out in the Export Administration Regulations (EAR).
- The US State Department’s Directorate of Defense Trade Controls (DDTC) administers and enforces the export controls relating to “defense articles and services” set out in the ITAR.

Because export controls are designed to advance US national security and foreign policy objectives, they raise acute liability and reputational risks, particularly for acquirors. Therefore, deal teams should give early substantive and planning consideration to export controls.

Export control issues generally arise throughout the A&D transaction lifecycle, including the due diligence phase, transaction negotiation and execution and the post-transaction integration period. During due diligence, it is vital for prospective acquirors to assess a target’s compliance with US export controls, and for targets to independently analyze and challenge (known as red teaming) their own internal compliance in advance of negotiations. This is because:

- Violation of these laws and regulations can result in significant civil and criminal penalties. Civil penalties for violations of the EAR are the greater of $250,000 per violation and twice the amount of the transaction being penalized. Criminal
penalties for violation of the EAR may reach $1 million per violation or a prison sentence of 20 years.

- There may be successor liability to an acquiror for the past violations of a target.
- In particularly egregious cases, penalties may also include debarment from US government contracts. This is fatal to a company in the business of supplying products and services to the US government.

In addition, an evaluation of a target’s compliance profile may yield important insights for valuation strategy and transaction tactics. This exercise can identify opportunities for creating value as well as mitigating risk.

Finally, the ITAR contains special notice provisions that need to be carefully observed in certain instances. For example:

- Section 122.4(b) of the ITAR requires any DDTC registrant involved in mergers, acquisitions or divestitures which result in a non-US person owning or controlling a DDTC registrant or its subsidiaries to notify the DDTC 60 days in advance of the sale or transfer.
- Section 122.4(a) of the ITAR requires a DDTC registrant to submit all material changes to a registrant’s certificate within five days of the effective date of a merger, acquisition or divestiture.

**ISSUES PARTICULAR TO GOVERNMENT CONTRACTORS**

A&D companies are largely, and sometimes exclusively, government contractors. Doing business with governmental authorities imposes numerous statutory and regulatory requirements on these companies. These requirements are not typically found in commercial contracts, and are incorporated by reference in all government contracts. A company’s failure to comply with these requirements may result in adverse action by governmental authorities, including termination of the contract for default or for cause.

In addition, if a company is alleged to have failed to comply with government contract specifications or over-charged a governmental authority, it risks government audits and investigations. If these allegations are substantiated, they can result in significant financial liability, including treble damages and statutory penalties, under the Civil False Claims Act (31 U.S.C. §§ 3729–3733). In extreme cases, a company could be subject to exclusion from future contracting with all governmental entities as a result of the Federal Acquisition Regulation (FAR) suspension and debarment process (FAR § 9.4).

Because of these inherent risks in contracting with the government, due diligence efforts with respect to A&D target companies require the assistance of government contract specialists to:

- Identify areas of significant exposure.
- Assist in developing the appropriate risk mitigation strategies in the transaction agreement or otherwise.

**ACQUIROR AS A SUCCESSOR IN INTEREST**

Government contracts raise several other issues that must be considered in the context of a change of control. Generally, the transfer or assignment of federal government contracts to a third party is prohibited by the Anti-Assignment Act (41 U.S.C. § 15). However, the federal government, in its discretion, may recognize a third party as a successor in interest. Therefore, transactions involving the purchase or change in control of a government contractor may require approval of the federal government through a novation agreement. The structure of the transaction determines whether the parties must obtain the government’s consent in connection with the transaction. For example:

- A novation agreement will be required under the FAR if the transaction involves the transfer of all of the contractor’s assets or the “entire portion” of the contractor’s assets involved in performing its government contracts to the successor contractor (FAR § 42.1204(a)(1), (2)).
- A novation agreement will not be required under the FAR if the transaction involves “a change in the ownership of a contractor 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” (FAR § 42.1204(b)).

If a transaction is subject to the FAR’s novation requirements, the government’s contracting officer will have to consider the following:

- For the affected contracts, whether it is in the government’s best interest to recognize the third party as a successor in interest (FAR § 42.1203(c)).
- The effect of the transaction on any security clearances held by the seller based on the identity of the proposed successor in interest (FAR § 42.1203(c)(3), § 42.1204(f)(7)).

If the contracting officer decides that it is not in the government’s best interest to approve the transfer of the contracts to the successor in interest, the seller will remain under contractual obligation to the government and be subject to termination for default if it is unable to perform the contracts without the transferred assets (FAR § 42.1204(c)).

If a novation agreement is required under the FAR, parties may handle this requirement in several ways in the purchase agreement. For example, the parties may make the satisfaction of the novation requirement a condition to closing. However, because a novation could take six to nine months to obtain, parties do not always make the completion of a novation agreement a closing condition to avoid delaying the
closing of the deal. Often, the novation requirement is dealt with through a combination of covenants and indemnity provisions in the purchase agreement. For example, parties will covenant to take all necessary steps to obtain the novation and the seller will agree to indemnify the buyer if the novation cannot be completed.

However, even when a novation agreement is not required under the FAR (for example, in a stock transaction), it may still be appropriate for the contractor to enter into a formal agreement with the government to address the assumption of liabilities, such as long-term incentive compensation plans, cost accounting standards noncompliances, environmental clean-up costs and final overhead costs (FAR § 42.1204(b) (citing FAR § 42.1203(e))).

OCl RULES
Generally, the FAR’s OCI rules seek to prevent:

- The existence of conflicting roles that might bias a contractor’s judgment in providing services to the government.
- An unfair competitive advantage that may arise because a contractor has access (through its performance of certain contracts) to competitor proprietary information or source selection sensitive information that is not available to all competitors.
  
(FAR § 9.505.)

If the seller is divesting a business or assets to satisfy OCI concerns, several structuring issues should be kept in mind, such as the:

- Scope of services. If the buyer will require post-closing transition services from the seller, the scope of the contemplated services must be carefully considered in light of the OCI restrictions on the seller’s business. For example, if a seller must physically separate a facility to satisfy OCI rules, the failure to separate the facility during a prolonged transition period may continue to raise OCI concerns.
- Ability to retain a financial interest. If the parties are contemplating using consideration other than just cash (such as stock, warrants or earn-outs), the ability of the seller to retain a financial interest in the divested business must also be carefully considered given the OCI rules which compelled the divestiture. This may be particularly problematic if transition services will also be provided.

SET-ASIDE CONTRACTS FOR SMALL BUSINESSES
A set-aside is a government contract which is reserved for small business bidders. Many small A&D companies have significant set-aside contracts. However, the value of these contracts may be reduced in the future because of the Small Business Administration’s (SBA’s) small business size and affiliation rules. The extent to which a target has these contracts should be a focus of due diligence, and the buyer’s acquisition, valuation should take into account any potential loss of value.

The FAR requires contractors to recertify their small business size status every five years and within 30 days after a merger or acquisition (FAR § 19.301–2(b)). If SBA small business size status is critical for a target, the ability to maintain that status after a change of control should be considered.

ISSUES PARTICULAR TO FOREIGN ACQUIRORS
Foreign acquirors face several additional challenges in completing M&A transactions in the A&D industry, including:

- Review by CFIUS.
- Issues regarding security clearances and the ability to perform current and future classified contracts.
- A challenging due diligence process.

CFIUS REVIEW
CFIUS administers the President’s authority to review all mergers, acquisitions and takeovers that could result in foreign control of any person engaged in the interstate commerce of the US (Defense Production Act of 1950 Section 721, 50 U.S.C. App. 2170 (2009)). Foreign acquirors and private equity firms (both US and non-US) seeking to effect US A&D acquisitions should consider several aspects of the CFIUS regime in structuring their transactions. For example:

- Engage experienced CFIUS counsel when identifying possible US targets and before any particular deal takes shape. Working with the core deal team, experienced CFIUS counsel can help clarify the value, risks and opportunity costs of pursuing one deal over another. This approach should also reduce time and legal fees wasted on transactions that cannot be completed.
- Consider making initial US investments in low-profile targets to acclimate the CFIUS to the foreign acquiror in a low stakes setting. Success in any given deal does not have precedential value for future deals, but it contributes to the profile of an acquiror.
- Build CFIUS risk sharing into the purchase agreement. Even though the CFIUS is a voluntary filing regime, it is effectively mandatory in the A&D setting (as opposed to other industries like technology where there may or may not be a national security concern). Therefore, a foreign acquiror will want its acquisition agreement to include a variety of CFIUS-specific provisions, including CFIUS approval, as a closing condition. Since CFIUS remedies can be implemented regardless of whether a voluntary filing has been made, foreign acquirors will want comfort that the CFIUS will not be a post-closing issue.
Consider the ownership structure of the buyer. If the buyer is a private equity firm, the CFIUS review will look-through to the limited partners (and their ultimate beneficial owners) for assessing whether the acquiring party is a foreign person for CFIUS purposes. Therefore, US-based and US-managed private equity firms that have no obvious foreign control should be analyzed with these rules in mind.

FOCI AND NISPOM REPORTING
For a company with classified contracts and subcontracts, facility clearances or personnel clearances, a transaction that could potentially result in foreign ownership, control or influence (FOCI) can raise significant issues. Importantly, the transaction could jeopardize the company’s security clearances and ability to perform current and future classified contracts.

The regulations governing classified work are administered by the Department of Defense’s Defense Security Service (DSS) on behalf of the Office of the Secretary of Defense. These regulations are found primarily in the Industrial Security Regulation (ISR) and the National Industrial Security Program Operating Manual (NISPOM). Companies that may come under FOCI should consider the following:

- Under the NISPOM, a contractor that is under FOCI is ineligible for a facility clearance and may have its existing clearances for ongoing security classified work terminated unless the contractor can effectively insulate its US classified operations from FOCI (National Industrial Security Program Operating Manual DOD 5220.22-M 2 300(c) (Feb. 2006)).

- The NISPOM requires contractors performing classified work to report to the government certain changed conditions related to the ownership or control of the corporation (NISPOM 1 302(g)). Importantly, the obligation to report changed conditions under the NISPOM exists regardless of whether the changed conditions raise FOCI concerns. The NISPOM requires that contractors submit a report concerning any change of ownership, including stock transfers that affect control of a corporation.

- When entering into discussions or consultations with foreign interests that may reasonably be expected to lead to the introduction or increase of FOCI, the contractor must report the details by letter to the relevant security agency (NISPOM 1 302(g)(5), 2 302(b)).

However, even if a transaction results in FOCI for a government contractor, the contractor may seek to negate the effects of FOCI through various measures that can mitigate the government’s security concerns by insulating the foreign entity from control of the target. Measures may include:

- Security control agreements. This agreement is used when the target is not effectively controlled or owned by the foreign entity, but the entity is entitled to representation on the board of directors.

- Board resolutions. If the foreign interest is not entitled to board representation, it can be identified and excluded from access to classified information in the board resolution.

- Proxy agreements or voting trusts. Subject to DSS approval, the contractor can appoint three proxy holders or trustees who are US citizens, are eligible for security clearance, have full voting responsibility and have a seat on the board of directors.

As the structure of the transaction moves along the continuum toward greater management responsibility and control by foreign interests, more complex arrangements may be necessary.

DUE DILIGENCE BY A FOREIGN ACQUIROR
Due diligence of classified government contracts is particularly problematic if the acquiror is foreign. In this case, the high level decision-makers of the acquiror will almost never have security clearances necessary for them to be fully briefed on classified matters. Therefore, foreign acquirors often need to rely solely on their US affiliates to complete the due diligence review. Foreign acquirors should consider this in the early stages of a transaction because the separation of the assessment team and the deal negotiation and authorization team presents complicated issues and may be a new experience for the acquiror.