Aerospace, Defense, and Government Services M&A Considerations

A Lexis Practice Advisor® Practice Note by
Jerry Howe, Leidos Holdings, Inc.; and Brian Mangino and James McCullough, Fried, Frank, Harris, Shriver & Jacobson LLP


Jerry Howe


Brian Mangino


James McCullough

This practice note covers aspects of mergers and acquisitions (M&A) particular to the aerospace, defense and government services industry. The discussion covers regulatory concerns (particularly mitigating regulatory risk, organizational conflicts of interest, small business set-aside contracts, proposal protection, and integration issues); government approvals (novation considerations, antitrust, and national security approvals); considerations for foreign buyers (CFIUS; foreign ownership, control or interest; and U.S. export controls), and the market outlook.

Calendar years 2016 and 2017 saw a very high volume of M&A transactional activity in the aerospace, defense, and government services industry, which includes aerospace and defense contractors and other companies that provide goods and services to the U.S. government. By one investment bank accounting, there were several hundred transactions announced in the sector in 2017 (over one hundred in government services alone), up over 15% from 2016. The pace in the first part of 2018 continues to be up tempo, with increased expectations of U.S. defense and civilian agency spending based on Trump administration and Congressional budget and appropriations actions to date. Over all, this is a market of ample opportunity.

Yet at the same time, there is plenty of room for miscalculation and misfortune. The strong flow of defense M&A deals, along with deals in the adjacent civilian government services industry, present greater regulatory risks. The business of government contracting is highly regulated, can be punitive for the unwary, and continually grows in its complexity. Diligence lists have continually grown in length, to be probed in increasing depth. Even the ground rules for M&A in this sector have become more challenging in recent years.

REGULATORY REQUIREMENTS

Although this business sector exhibits many positive attributes chief—among them revenue transparency and predictability—doing business with the U.S. Government imposes numerous complex statutory and regulatory requirements, which are often incorporated directly or by reference in government contracts and subcontracts. A company's failure to comply with these requirements may result in adverse action by governmental authorities, including termination of the contract for default, suspension or debarment, or civil fraud damages and penalties.

Government Contract Regulatory Risks

Government contractors are required to develop specialized business systems for performing government contracts. Even companies that perform relatively few government contracts can be subject to these regulatory provisions, which include domestic sourcing and most favored customer pricing requirements. 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). Under recent and now controlling U.S. Supreme Court case law, False Claims Act cases can be successfully brought based on implied certifications, if material. Universal Health Servs., Inc. v. United States ex rel. Escobar, 136 S. Ct. 1989 (2016). In extreme cases, a company could be subject to interim or even permanent exclusion from future contracting with all executive branch entities as a result of the Federal Acquisition Regulation (FAR) (Title 48 of the Code of Federal Regulations) suspension and debarment process (FAR subpart 9.4).

Because of these inherent risks in contracting with the government, buyers entering this market are advised to:

- *Identify areas of significant exposure*. Due diligence efforts with respect to aerospace, defense, and government services target companies require the assistance of specialists to identify areas of significant exposure. In particular, many companies in the government services sector are not solely government services providers but also have a significant commercial business. These companies often have less robust compliance programs than pure government contractors but have much the same risk profile with respect to their government business.
- *Mitigate government contract risks*. Subject matter experts can assist in developing the appropriate risk mitigation strategies in the transaction documents, including government contracts representations and warranties or covenants and indemnification provisions addressing significant risks. Key representations and warranties cover compliance with technical, pricing, cybersecurity, socio-economic and other aspects of government contracts, and the absence of adverse audits, government investigations, claims and the like. A prospective buyer should identify whether the target has sufficient recordkeeping to identify compliance.
- *Regulatory notices and approvals*. The transaction documents should anticipate and facilitate the filing of government notices, pre-closing regulatory approval requirements, and post-closing integration. Required government notices should be identified in the agreement, and the parties should agree to a process for obtaining government approvals.

Organizational Conflicts of Interest

Federal regulations prohibit government contractors from having organizational conflicts of interest (OCIs), which occur when, due to other activities or relationships: (i) a contractor is unable or potentially unable to render impartial assistance or advice to the government; (ii) the contractor's objectivity in performing evaluative work is or might be impaired; or (iii) the contractor obtains an unfair competitive advantage from the receipt of non-public information received in performance of a contract (FAR 9.505) (proposed revisions pending).

Buyers should conduct diligence to identify potential OCIs that could arise from an M&A transaction where, for example: (i) one party holds a government contract that involves the evaluation of the other party; or (ii) one party is involved in developing specifications or requirements for a contract against which the other party might bid. This exercise is particularly important for strategic buyers who may trigger an OCI by acquiring a company involved in the same government program as the buyer's business, particularly when one party is a performing contractor and the other is a support contractor.

If the transaction raises OCI concerns, several structuring issues should be kept in mind, such as:

- *Mitigation efforts*. Buyers should identify and mitigate any OCIs that could arise as a result of combining the new and existing business. With some exceptions such as major defense acquisition programs and certain intelligence programs, OCIs can often be mitigated if they are promptly identified. In cases where mitigation will not satisfy the government customer, M&A transactions may require partial divestitures in order to maintain OCI compliance. Since OCI diligence usually involves the review of existing contracts and outstanding bids or proposals, it should be conducted by "clean teams" to avoid potential antitrust issues. For further discussion of clean teams and clean team agreements, see Potential Antitrust Issues during Marketing, Preliminary Discussions and Due Diligence — Preliminary Business Discussions and Due Diligence.
- *Transition 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 any 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 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 in light of the OCI rules. There is also the potential for lingering personal conflict of interest (PCI) issues if employees receive stock or warrants from the other party to the transaction (FAR subpart 3.1).

Small Business Set Aside Contracts

Many small and mid-sized government contractors earn much of their revenues from contracts that are "set aside" for small businesses and other preferred bidders. However, as the result of an M&A transaction, the target company's revenues from this type of contract may be reduced because it can be determined to exceed the applicable size standards (https://www.sba.gov/contracting/getting-started-contractor/make-sure-you-meet-sba-size-standards/table-small-business-size-standards) through affiliation with the buyer, which may render it ineligible for new set-aside contracts. Even an agreement in principle to acquire a small contractor can establish affiliation (13 C.F.R. § 121.103(d)(1)) and result in the target company becoming ineligible for new set-aside contracts. Accordingly, if the target company holds small business set-aside contracts, it is important for buyers to consider the following issues:

- *Affiliation*. A merger or acquisition will typically result in affiliation between the buyer and seller, which could lead to the acquired company exceeding the size standards. However, in transactions in which the buyers take a minority ownership stake and the sellers retain control, or where the combined revenues or headcounts of the buyers and sellers are close to the applicable size threshold(s), a more fact-intensive inquiry should be conducted to determine whether the affiliation rules are triggered.
- *Valuation*. The extent to which a target has small business contracts should be a focus of due diligence and the buyer's acquisition valuation should take into account any potential loss of value from the target being unable to receive small business contracts post-closing. If small business size status is critical for a target, the ability to maintain that status after a change of control, or develop alternative sources of revenue, should be considered.
- *Government notices*. The FAR requires contractors to recertify their small business size status annually and within 30 days after a merger or acquisition (FAR 52.219 28). Companies that perform specific types of small business contracts, including participants in the "8(a)" Business Development Program, may be required to provide notice to the Small Business Administration once a transaction is agreed in principle and may risk losing "8(a)" contracts upon a change of control.

- *Legacy small business contracts*. Even if a company is no longer a "small business," generally it may continue to perform any small business contracts that were awarded prior to the change in status. Once a contractor represents that it is "other than small," it is typically no longer eligible to receive new contracts that are based on the company's small business size status.
- *False Claims Act exposure under the Small Business Jobs Act of 2010*. Under this legislation, there is a presumption of loss arising from a misrepresentation by an offeror of its small business size status. United States ex rel. Savage v. Wash. Closure Hanford LLC, No. 2:10-CV-05051-SMJ, 2017 U.S. Dist. LEXIS 136507 (E.D. Wash. Aug. 24, 2017).

Proposal Protection

Another issue that government contractors must consider in connection with government contractor transactions arises from pending proposals. Where a company or business unit has submitted a proposal to a federal agency in response to a solicitation, but that company or business unit undergoes a corporate transaction (*e.g.*, a spin-off, divestiture, merger, or acquisition) prior to the agency's award decision, there is a risk that a resulting contract award to the company can be overturned as the result of a bid protest, which are claims that the U.S. government awarded a contract improperly. Recent bid protest cases, including the FCi Federal, Inc. decision (http://www.gao.gov/products/B-408558.7,B-408558.8), have held that when an agency knows that an offeror is undergoing or has undergone a corporate transaction that may impact the manner or proposed cost of performance of that offeror's proposal, the agency is required to consider the impact of that corporate transaction in connection with the proposal evaluation. If the agency does not do so, the contract award may be set aside. Offerors are often obligated to inform agencies of material changes to their proposals, including changes attendant to a corporate transaction. On the other hand, where a corporate transaction is pending or recently concluded, but it will not impact proposal performance – and that has been disclosed in the proposal and evaluated accordingly by the agency in its source selection process – then bid protests have been denied, as in the recent decisions in SRA International, Inc. (https://www.gao.gov/assets/690/685088.pdf) and Enterprise Services, LLC (https://www.gao.gov/assets/690/689960.pdf).

These situations are very fact-specific, but companies involved in government contractor M&A transactions generally can take steps to protect pending proposals from subsequent challenge through a bid protest, including the following:

- *Evaluate the impact*. Assess whether the contemplated transaction will have a material impact on the performance of the contract, including whether it will alter or impact the proposed technical solution, corporate experience/reach-back capabilities, availability of key personnel, past performance citations, proposed prices/costs, or small business plan targets.
- *Describe the transaction*. To the extent the transaction is announced prior to closing, include in all proposals and proposal revisions submitted prior to closing a description of the transaction and disclose whether and how the transaction will have a material impact on the performance of any contract.
- *Notify the agency*. For any proposals submitted before announcement of the transaction and still pending, consider notifying the agency of the transaction and any material impact on the performance of any contract that will result from the transaction.
- *Disclose the transaction*. Determine whether the solicitation contains any clauses specifically requiring offerors to disclose a potential change of ownership or contemplated corporate transaction and, if it does, ensure that any disclosure of the transaction comports with the strictures of that solicitation provision. At the same time, take care not to violate any solicitation ground rules, or inadvertently submit what are in effect proposal changes after the proposal due date.

- *Write proposals accordingly*. Tailor proposals submitted prior to closing to minimize any reliance on assets -- including financial resources, employees, past performance references, subcontracts, materials, or infrastructure -- that will not be transferred with the company or business unit submitting the proposal.

Integration Issues for Strategic Buyers

Mergers and acquisitions between strategic buyers in the government contracts space pose particular challenges for post-closing integration. To the extent possible, these issues should be addressed upfront in the transaction documents or transition agreements. For example, companies should consider the following:

- *Cost accounting issues*. Of particular concern to companies that are covered by the Cost Accounting Standards (CAS), which are typically larger and more mature contractors, are potential changes to cost accounting practices arising from a merger or acquisition. Companies should thoughtfully consider the impacts of corporate changes on long term incentive compensation plans, indirect rates, CAS noncompliances, environmental clean-up costs, final overhead costs, and similar issues.
- *Overlapping contract vehicles*. Companies in this industry will often hold the same large indefinite delivery, indefinite quantity (IDIQ) contracts and, as a result of an M&A transaction, may be forced to abandon duplicate contracts. In that event, companies often face challenges transitioning existing task or delivery orders from one IDIQ contract to the other, as well as in handling pricing issues arising from varying indirect rates.
- *Past performance*. Particularly with carve-out transactions, issues can arise with respect to which entity can claim past performance credits for the part of the business that is spun-off. This should be addressed in the transaction documents if it is expected to be a concern, often by including pertinent sub definitions within the agreed definitions of transferred and excluded assets.

GOVERNMENT APPROVALS

Transactions involving aerospace, defense and government services firms often require pre- and post-closing notifications and consents from the U.S. Government, including (i) novation agreements and (ii) antitrust approvals.

Government Recognition of a Successor-in-Interest

Government contracts raise several 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. However, the federal government may in its discretion, and often does, recognize a third-party as a successor in interest to a government contract. Such approvals are typically manifested in the form of “novation agreements.” When considering a potential requirement for novation, the parties should consider the following:

- *Whether novation is required*. The structure of the transaction determines whether the parties must obtain the Government’s consent in connection with the transfer of government contracts. A novation agreement will be required if the transaction involves the transfer of the government contracts as part of an asset sale; a novation agreement is generally not required for stock purchases (see FAR 42.1204).
- *Delays are possible*. The FAR provides a well-defined novation approval process and a lengthy checklist of documents (https://www.acquisition.gov/far/html/Subpart%2042_12.html) that must be provided for the Government’s consideration. While delays and difficulties in the novation approval process often arise, it is rare for approval to be withheld altogether.
- *Address novations in the purchase agreement*. If a novation agreement is required, parties may handle this requirement in several ways in the purchase agreement, often through a combination of covenants and

indemnity provisions. For example, parties will covenant to take all necessary steps to obtain the novation promptly after closing, and the seller may agree to indemnify the buyer if the novation cannot be completed (in whole or in part).

- *Subcontracts pending novation*. Since there is often a gap between closing and the Government's approval of the novation agreement, the parties must enter into alternative contracting arrangement to ensure performance of the contracts during this period. Typically, these will take the form of a subcontract pending novation, which will require and enable the buyer to perform the contracts as a subcontractor to the seller until the novation is approved.

Antitrust Approval Involves National Security Considerations

Generally, defense and government contractor transactions (like most other U.S. 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 Department of Defense (DOD) plays a key role in reviewing transactions involving defense contractors and can significantly influence the result reached by the Department of Justice (DOJ) or the Federal Trade Commission (FTC). Although the antitrust agencies base their review on the principle that competition is critical in all markets, the analysis of defense contractor transactions can be particularly challenging because of the unique characteristics of the industry. For example, the DOD is often the principal or only buyer for the products and services of the combining firms, and its procurement processes are different from those in most industries. Moreover, 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. Nevertheless, the antitrust agencies still examine the competitive implications of defense and government contractor transactions. Since the late 1990s, it has been understood that M&A transactions would be prohibited among the five to ten largest U.S. defense contractors, and that understanding appears to stand. Proposed transactions in the past few years illustrate the line between what will and will not be acceptable from an antitrust standpoint: Lockheed Martin Corporation's acquisition of Sikorsky Aircraft Corporation was approved, but the proposed combination of Honeywell International, Inc. and United Technologies Corporation was scuttled. In April 2016, in response to concerns expressed by the DOD, the DOJ and the FTC released a formal statement emphasizing their important role in conducting antitrust reviews of these transactions and noted that they would take steps to preserve competition for current and future defense procurements and ensure that the U.S. military continues to receive the most effective and innovative products at competitive prices.

There are some practical steps dealmakers can take, in addition to regular antitrust planning, to address the unique aspects of government contractor transactions and to avoid unwanted surprises from the antitrust agencies. For example:

- *Communicate with the customer*. 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.
- *Competition or national security concerns*. If the defense and government contractor transaction raises competition or national security concerns, take steps to: (i) ensure that the pro-competitive reasons for the transaction are well-developed and understood; and (ii) manage the creation of transaction-related documents (including board briefings, management reviews, and e-mail).

- *Engage with policymakers*. In addition to speaking with the program officers, engage with the senior policy makers when appropriate, including those in the Office of the Undersecretary of Defense for Acquisition and Sustainment and the DOD's Office of General Counsel.

For further discussion of the antitrust approval process in M&A deals more generally, see Potential Antitrust Issues during Marketing, Preliminary Discussions and Due Diligence, Negotiating Antitrust Issues in the Definitive Transaction Agreement, and Pre-Closing Integration Planning.

FOREIGN BUYERS

Foreign buyers may face several additional challenges in completing M&A transactions in this sector, including: (i) review by the Committee on Foreign Investment in the United States (CFIUS); (ii) issues regarding security clearances and the ability to perform current and future classified contracts; and (iii) a more difficult due diligence process, including compliance with U.S. export control regimes.

CFIUS Review

CFIUS has been delegated the President's authority to review all mergers, acquisitions and takeovers that could result in control by a foreign person over a U.S. business (50 USCS § 4565). The Foreign Investment Risk Review Modernization Act (FIRMMA), the first major CFIUS reform legislation in nearly ten years, was signed into law by President Trump on August 13, 2018, and has expanded CFIUS's jurisdiction. While some provisions will take effect immediately upon enactment, many important details will be finalized only through the CFIUS rule making process or will be developed over time pursuant to CFIUS practice. Foreign buyers and private equity firms (both U.S. and non-U.S.-based) seeking to effect U.S. defense and government contractor acquisitions should consider several aspects of the CFIUS regime in structuring their transactions, and should do the following:

- *Engage experienced CFIUS counsel when identifying possible U.S. 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.
- *Note that CFIUS may have jurisdiction over the acquisition of non-U.S. companies*. If a foreign company has a U.S. subsidiary or branch that conducts interstate commerce in the U.S., the entire transaction may fall within CFIUS's jurisdiction if that business will be controlled by foreign persons.
- *Consider making initial U.S. investments in low profile targets to acclimate CFIUS to the foreign buyer in a low-stakes setting*. While success in any given deal does not have precedential value for future deals, it does contribute to the profile of a buyer.
- *Build CFIUS risk sharing into the purchase agreement*. Even though CFIUS is a voluntary filing regime, it is effectively mandatory in the aerospace, defense and government services setting (as opposed to other industries like technology where there may or may not be a national security concern). Therefore, a foreign buyer 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 buyers will want comfort that CFIUS will not be a post-closing issue. The parties can also negotiate the types and extent of potential mitigation measures that the buyer is required to accept in order to obtain CFIUS approval, as well as any termination or payment provisions in case a deal is blocked or abandoned as a result of the CFIUS process.
- *Note that CFIUS takes a broad view of control*. CFIUS interprets the term "control" very broadly. Foreign persons may be considered to exert control over a business, even if they do not have majority or operational

control, as long as they may influence the major decisions of the business. This could include a combination of equity ownership, board seats, or other agreements to direct business decisions. FIRRMA has also broadened the scope of its jurisdiction to include certain non-controlling investments where certain critical infrastructure or technologies or personal data are involved.

- *Consider the ownership structure and foreign status of the buyer*. If the buyer is a private equity firm, CFIUS review will look-through to the firm itself to its limited partners (and their ultimate beneficial owners) for assessing whether the acquiring party is a foreign person for CFIUS purposes. FIRRMA added a carve-out for foreign limited partners so long as a portfolio investment by a private fund meets a specific five-factor test ensuring the fund is U.S.-managed and foreign limited partners do not possess certain indicia of control. Therefore, even U.S.-based and U.S.-managed private equity firms that have no obvious foreign control should be analyzed with these rules in mind. For companies, their status must be considered even if the company has large U.S. connections, as the recent Broadcom/Qualcomm situation illustrated.
- *Foreign government-controlled transactions will be subject to mandatory filings.* FIRRMA has introduced mandatory filings to the CFIUS regime. A U.S. business being acquired by a foreign person in which a foreign government has a substantial interest will be required to file an abbreviated notice. This requirement has not yet been implemented in regulations by CFIUS. It will take effect on the earlier of (1) February 13, 2020 or (2) 30 days after publication in the Federal Register of a determination by the CFIUS chairperson that the required regulations, structure, personnel, and resources necessary to administer the new provisions are in place.
- *Real estate*. Foreign persons purchasing real estate (other than single family housing or certain urban real estate) in the United States now fall under CFIUS jurisdiction in certain circumstances post-FIRRMA. If the real estate is part of an airport or a port or is in close proximity to a U.S. military or otherwise sensitive governmental facility, CFIUS now has jurisdiction over the transaction. This now includes greenfield purchases of empty land, which were formerly excluded from CFIUS jurisdiction.

The relatively high levels of activity by foreign buyers in 2017, along with greater awareness of and sensitivity to CFIUS risk, led to a record number of CFIUS filings in calendar year 2017. This heavier workload at CFIUS has significantly increased the average length of the CFIUS review process.

Classified Government Contracts

Numerous government contractors, particularly those providing intelligence, communications, or national security products and services, hold security clearances that provide them with access to classified materials and contracts. Due diligence of classified government contracts is particularly problematic because high level decision-makers of the buyer infrequently hold security clearances necessary for them to be fully briefed on classified matters. Therefore, buyers often need to rely on cleared personnel or consultants to complete the due diligence review. Foreign buyers, in particular, 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 buyer.

A transaction that could potentially result in foreign ownership, control or influence (FOCI) of a company with a facility security clearance may also require pre-closing government approvals. Completing the transaction without an approved method of mitigating the FOCI could jeopardize the company's security clearances and ability to perform current and future classified contracts. Companies that may come under FOCI should do the following:

- *Assess whether the target will come under FOCI*. A U.S. company will typically be considered to fall under FOCI whenever a foreign interest has the power, direct or indirect (whether or not exercised), to direct or

decide matters affecting the management or operations of the company. The Defense Security Service (DSS) considers a foreign minority interest to be "substantial" for these purposes if it consists of greater than five percent of the ownership interests or greater than 10 percent of the voting interest.

- *Consider FOCI mitigation*. Under the National Industrial Security Program Operating Manual (NISPOM) and DSS regulations, a contractor that is under FOCI is ineligible for a facility clearance and may have its existing clearances for ongoing classified work terminated unless the contractor can effectively insulate its classified operations from the foreign owners. The appropriate mitigation measure will depend on the level of foreign investment and may include: (i) board resolutions; (ii) a security control agreement; (iii) a special security agreement; or (iv) a proxy agreement or voting trust.
- *Execute the commitment letter*. If the merger or acquisition will involve significant foreign participation, DSS will require the buyer to submit an acceptable "FOCI Action Plan" at least 30 days prior to closing. DSS must agree prior to closing to the proposed mitigation method and interim security measures through the execution of a "Commitment Letter" and draft FOCI implementation agreements, which are typically preceded by negotiations with DSS concerning the specific mitigation efforts.
- *Consider restructuring issues*. Since the implementation of a special security agreement, proxy agreement, or voting trust may result in the foreign owner losing direct control over the affected entity, it is often preferable to establish a subsidiary that is focused on performing classified contracts, and over which the independent directors or proxy holders imposed by these agreements can sit. Savvy sellers will appropriately structure their business prior to a sale in which there are potential foreign buyers.
- *File necessary post-closing reports*. The NISPOM requires contractors performing classified work to report to DSS certain changed conditions related to the ownership or control of the corporation. The obligation to report changed conditions under the NISPOM exists regardless of whether the changed conditions raise FOCI concerns. For example, U.S.-based private equity buyers with relatively low levels of foreign investment may be expected to provide general information concerning the nationalities of its investors as part of this process.

Impact of U.S. Export Controls

Unlike most other countries, the United States has not one but two export control regimes, each with particular relevance to defense and government contractors: (i) the U.S. 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 International Traffic in Arms Regulations (ITAR); and (ii) the U.S. 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).

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

Export control issues generally arise throughout the aerospace, defense, and government services contractor 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 buyers to assess a target's compliance with U.S. export controls, and for targets to independently analyze and challenge (known as "red teaming") their own internal compliance in advance of negotiations. Failure to do so can have significant consequences, including the following:

- *Penalties*. Violation of these laws and regulations can result in significant civil and criminal penalties. Civil penalties for ITAR violations are up to over $1 million per violation. Civil penalties for EAR violations may

be up to the greater of about $295,000 per violation or twice the amount of the transaction being penalized. Criminal penalties for ITAR or EAR violations may reach $1 million per violation or a prison sentence of 20 years.

- *Successor liability*. There may be successor liability to a buyer for the past violations of a target, potentially even in an asset sale.
- *Denial of export privileges/debarment*. In particularly egregious cases, penalties may also include denial of export privileges or debarment from U.S. government contracts. Such results could be fatal to a company in the business of supplying products and services to the U.S. Government or to any significant exporter.

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. Moreover, voluntary self-disclosures under the ITAR or EAR are often made in the acquisition context because past violations may be identified during due diligence and the company has the opportunity to start with a clean slate with new owners and possibly a new compliance program.

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

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

In addition, the target company may need to transfer any existing export authorizations post-closing. The parties should also be mindful that controlled technology or technical data cannot be transferred to the foreign buyer -- either before or after closing -- without proper export authorization.

The National Defense Authorization Act for FY2019 included the Export Control Reform Act of 2018 (ECA) alongside FIRRMA. Though the exact contours of future export controls under the ECA will be defined in regulations to come, the ECA requires additional controls on "emerging and foundational technologies." Export licensing requirements may be imposed on items found to fall under this umbrella, and at minimum, exports to comprehensively sanctioned countries and countries subject to an arms embargo (including China) will require licenses.

MARKET OUTLOOK

These complex and often cumbersome regulatory requirements have not deterred companies from engaging in very substantial M&A activity in this space. Several trends have emerged that are likely to continue into 2018 and beyond:

- *Portfolio Reshaping by Major Prime Contractors*. Within the highest tiers of the aerospace, defense and government services industry, the major prime contractors have actively participated in portfolio reshaping. This has recently involved expanding their holdings of platform/hardware companies and shedding services businesses. For example, Lockheed Martin acquired the Sikorsky helicopters business in 2015, but divested its main information technology and technical services business in 2016—with L-3 and Harris also divesting their government services businesses.

- *Robust Activity Levels in the Services Segment*. In parallel, the services segment has seen a robust level of activity in recent years, continuing into early 2018. High-end, technology-enabled professional services companies have led the way, commanding the highest valuations and most attention. The current scale of the defense services sector -- roughly equal in size to the hardware sector -- has come about since the 1990s and the dramatic consolidation of the defense industry following the end of the Cold War. Until recently, the service contracting sector had never experienced a major wave of consolidation. In recent years, however, defense services companies have been combining in order to achieve economies of scale, as well as to expand their customer coverage. The biggest deal to date was the merger in 2016 of the Leidos and Lockheed Martin services businesses, resulting in an enterprise with combined revenue in the range of $10 billion. Others are following, in particular the recently concluded (in April 2018) merger between CSRA and the General Dynamics information technology business.
- *Financial and Foreign Buyers*. On the buy side, the aerospace, defense and government services M&A market has continued to see a range of participants, extending well beyond the core of U.S.-based strategic acquirers. Private equity firms have continued to be active in recent years, perceiving the defense and government contracting sector to be relatively safe, with stable cash flows and good revenue predictability. In part based on their past successes, many private equity firms have been "repeat buyers" into the industry. Calendar year 2017 also saw high levels of activity by foreign buyers, leading to a record number of filings with CFIUS, as discussed in CFIUS Review in Foreign Buyers above.
- *Targeting of Smaller Companies with Key Technologies*. In spite of the recent tightness in defense funding —or perhaps because of it—defense and government contracting M&A activity has been driven in significant measure by technological innovation. Now, with the immediate prospects for defense and civilian agency spending greatly enhanced in the U.S., market participants are looking to acquire and expand into hot technology areas. As strategic buyers seek to reposition into the fast lanes of defense budgets, smaller and mid-sized companies with certain key capabilities have become attractive targets -- cybersecurity, data analytics, artificial intelligence, unmanned systems, and advanced sensors, for example. And of course, private equity firms are seeking to assemble such capabilities, to be groomed and later sold to the strategic buyers. Technological innovation and the emergence of new technical leaders will continue to feed M&A activity in this sector.

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- Client Alerts and News: Congress Proposes Significant CFIUS Reform

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Articles

- Recent Trends in Government Contracts M&A

Jerry Howe
General Counsel at Leidos Holdings LLP

Jerald S. Howe, Jr. is a Leidos executive vice president and the company's general counsel. Howe has responsibility for legal, contracts, corporate governance, environmental health and safety, and administrative oversight of the ethics and compliance and internal audit functions. He joined Leidos in July 2017 after serving as partner at Fried, Frank, Harris, Shriver & Jacobson LLP (Fried Frank) where he was a member of the firm's government contracts, mergers and acquisitions (M&A), and aerospace and defense practices.

Howe is an accomplished leader who has demonstrated solid ethics and integrity throughout his 30 years of experience advising and representing clients (including Leidos) in government contracts litigation, investigations, and bid protests as well as in M&A and private equity transactions. His experience includes the aerospace, defense, intelligence, and government services sectors.

Before joining Fried Frank, Howe was the senior vice president and general counsel at TASC, a leading aerospace and defense company. In this position, he oversaw the company's legal affairs, corporate development and M&A, ethics and compliance programs, government relations, and security. Previously, he was owner and principal of InSequitur LLC, a consulting firm, and executive vice president of the Olive Group. Howe also served as senior vice president and general counsel of Veridian Corporation, a publicly traded company that provided advanced technology services and solutions to the intelligence community, military, and homeland defense agencies.

Before first joining the corporate world, Howe was a partner for nine years at a Steptoe & Johnson LLP, where his practice focused on aerospace law and transactions, government contracts law, litigation with an emphasis on high-technology procurement, and federal court civil and appellate litigation. He represented preeminent defense, aerospace, and information technology companies including Boeing, Hughes, McDonnell Douglas, and Motorola. Previously, he served as law clerk to Judge George E. MacKinnon of the United States Court of Appeals for the District of Columbia Circuit.

Brian Mangino
Partner at Fried, Frank, Harris, Shriver & Jacobson LLP

Brian T. Mangino is a corporate partner resident in Fried Frank's Washington, DC office. He joined the Firm's London office in 2000 and transferred to the Washington, DC office in 2003.

Mr. Mangino focuses his practice on private equity transactions and mergers and acquisitions representing both private equity firms and public and private companies and corporate financings.

Mr. Mangino is consistently recognized by *Chambers Global: The World's Leading Lawyers for Business* as a leading individual in Private Equity: Buyouts and by *Chambers USA: America's Leading Lawyers for Business* as a leading individual in Corporate/M&A & Private Equity and Private Equity: Buyouts. He is also consistently recognized by *Legal 500* in Private Equity Buyouts and is recognized by *IFLR1000* as a leading lawyer in Private Equity.

Mr. Mangino was selected by Law360 as a 2012 "Rising Star" in private equity. He was also selected as one of *Institutional Investor's* "Rising Stars" of private equity and M&A law and was a finalist for the *Washington Business Journal's* 2008 Top Washington Lawyers Award.

James McCullough

Of Counsel at Fried, Frank, Harris, Shriver & Jacobson LLP

James J. McCullough is litigation of counsel resident in Fried Frank's Washington, DC office. Mr. McCullough is a member of the Firm's Government Contracts and Aerospace & Defense Practices. His experience spans a broad range of industries and government agencies, with a focus on aerospace and defense companies.

Mr. McCullough's practice includes pre-award litigation and counseling on contract formation issues, post-award disputes and litigation, and the representation of government contractors in various civil proceedings, including Procurement Integrity and Freedom of Information Act disputes, and enforcement matters involving mandatory disclosure and suspension and debarment. He has been lead counsel in numerous bid protests before the US Government Accountability Office, the United States Court of Federal Claims, and other federal courts. Mr. McCullough also has extensive litigation experience involving claims and terminations at various Boards of Contract Appeals and the Court of Federal Claims. In addition, he has frequently participated in the resolution of government contract disputes through the use of alternative dispute resolution techniques, including mediation and arbitration, and has frequently participated as government contracts counsel in mergers and acquisitions, private equity investments, and joint venture transactions involving aerospace and defense companies.

Prior to joining Fried Frank, Mr. McCullough served as a trial attorney and assistant to the general counsel in the Office of the General Counsel of the Navy (1976-1979). He also served on active duty as an officer of the United States Navy (1969 to 1973).

Mr. McCullough has lectured and written extensively on government contract matters. In addition, he has co-authored a book titled *Contracting with the RTC and FDIC* (Prentice Hall Law and Business, 1991), co-authored a chapter on bid protests in *Multiple Award Schedule Contracting* (Xlibris Corporation, 2002), and annually co-authors a chapter on US procurement in *The International Comparative Legal Guide to Public Procurement* (Global Legal Group, 2017).

Mr. McCullough has been selected as one of the top ten "Leading Lawyers" in government procurement by the *Legal Times* of Washington (2004), selected as one of "Washington's Top Lawyers" by *Washingtonian* magazine (2013 - 2015), recognized as a "Go-to Attorney" in government contracts by *SmartCEO* magazine of Washington (2009), and awarded the Boards of Contract Appeals Bar Association Life Service Award for his many years of dedication, loyalty and outstanding commitment to the Association. He is consistently recognized by *Chambers USA: America's Leading Lawyers for Business* as a leading individual in Government Contracts and Government Contracts: Bid Protests (Spotlight Table). Clients enthuse that "he's thoughtful, accurate and gives good advice based on years of excellence. He's seen every single thing in the government contracts space." He is also recognized as an elite leading lawyer by *Legal 500* in Government Contracts.

Learn more

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