Practical Guidance

Aerospace, Defense, and Government Services M&A Considerations

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This practice note covers key 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.

For additional discussions regarding M&A transactions, see Public Merger Transaction Resource Kit and Private Merger Transaction Resource Kit in the Corporate and M&A practice area. For a resource kit setting forth content addressing various federal contracting issues, see Federal Government Contracts Resource Kit.

The past five years have seen a continued 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. There are typically several hundred transactions announced in the sector each year. Although the pace in the first part of 2022 slowed somewhat as compared to 2021, activity may be picking up. Overall, this remains a market of ample opportunity for both strategic and private equity buyers.

Yet at the same time, there is always 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 than generic M&A transactions. The business of government contracting is highly regulated, can be punitive for the unwary, and continually grows in complexity. Diligence lists have persistently grown in length and breadth, 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 contracts for default, suspension or debarment, or civil fraud damages and penalties. There historically have been many cases of post-M&A legal enforcement.

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 caselaw, 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 (and sometimes sub-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 support 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 and timeline 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:

- One party holds a government contract that involves the evaluation of the other party –or–
- 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. See, e.g., Protest of SGT, Inc., 20-ODRA-00872 (Findings and Recommendations and Interlocutory Order, dated January 29, 2021) (setting aside OCI waiver and finding the awardee had unmitigated OCIs arising from the merger of two predecessor entities, one of which supported the Federal Aviation Administration's planning for the procurement in question), recon. denied, Protest of SGT, Inc., 20-ODRA-00872 (Decisions on Requests for Reconsideration, dated March 24, 2021), remanded by FAA Order No. ODRA-21-893 for further proceedings. In addition, some OCIs could raise antitrust issues if, as a result of the OCI, the merged firm has an incentive and ability to harm competition by disadvantaging its competitors, see Antitrust Approval Involves National Security Considerations.

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 Due Diligence: Antitrust Issues.
- **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. A new rule that took effect in November 2020 requires an offeror to recertify its size status prior to award if a merger, sale, or acquisition occurs after the offer but prior to award. Additionally, under the new rule, an offeror will not be eligible as a small business to receive the award of the contract it the corporate transaction occurs within 180 days of the offer and the offeror is unable to recertify as a small business.
- **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 prior 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. See, e.g., Vertex Aerospace, LLC (https://www.gao.gov/assets/b-420073.pdf). 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 decision in ICI Services Corp. (https://www.gao.gov/assets/b-418255.5.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 multiple-award, 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 an 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 independently 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 potential combination of Honeywell International, Inc. and United Technologies Corporation (UTC) failed to proceed in part due to antitrust concerns. To allow the merger of Harris Corporation and L3 Technologies Inc., the DOJ (in cooperation with DOD) required the divestiture of Harris' night vision business. As a condition for the approval of the 2020 combination of Raytheon and UTC, the DOJ required the divestiture of Raytheon's military airborne radios business and UTC's military global positioning systems and large space-based optical systems businesses to resolve horizontal and vertical concerns. See Dep't of Justice, Justice News (June 20, 2019). Similarly, based on its review of UTC's acquisition of Rockwell Collins in 2018, the DOJ required the divestiture of Rockwell Collins's pneumatic ice protection systems and trimmable horizontal stabilizer actuators businesses. Dep't of Justice, Justice News (Oct. 1, 2019).

Most recently, the FTC filed a complaint to block Lockheed Martin's acquisition of Aerojet Rocketdyne after an extended investigation. The focus of the FTC's complaint was that Lockheed is one of four prime contractors capable of supplying missile systems to the Pentagon, and Aerojet is one of two U.S. firms that develop and manufacture propulsion systems that meet the capabilities required to propel such missile systems. The FTC alleged that the merger would provide Lockheed with access to its rivals' competitively sensitive information (as the other three prime contractors also have relationships with Aerojet) and the ability to raise component prices for those rivals' ongoing bids and programs, and the merger would also give Lockheed the ability to reallocate Aerojet staff to focus on Lockheed bids, delay competitor access to new Aerojet developments, and delay negotiations on agreements necessary for the joint development of defense projects. Less than three weeks after the complaint was filed, the companies abandoned the deal.

Similarly, in June 2022, the DOJ filed a complaint seeking to block Booz Allen Hamilton's proposed acquisition of EverWatch, alleging that the two companies were the only competitors in a narrowly defined market consisting of a single procurement opportunity to provide signals intelligence modeling and simulation to the National Security Agency through a program called Optimal Decision. The complaint is notable in that it was filed only 3.5 months after the transaction was announced, showing a willingness by the DOJ to act quickly where it perceives an imminent risk to loss of competition for a pending solicitation. In addition, the DOJ alleges that the parties' signing of the merger agreement itself, including an interim operating covenant that granted Booz Allen Hamilton a consent right prior to EverWatch entering into certain new customer contracts, has already resulted in a loss of competition even prior to the potential closing of the proposed merger. The litigation remains pending as of the time of publication of this article.

In addition to the antitrust agencies' recent challenges of transactions in this sector, in February 2022, the DOD issued an official report on the State of Competition in the Defense Industrial Base. This report discusses inadequate capacity and competition in a number of base sectors as well as the defense labor market. The report also notes that, between 1993 and 2000, the total number of US-based prime contractors decreased from 51 to five. The report suggests actions to confront the challenges posed by industry consolidation, including revisiting DOD's approach to evaluating mergers, strengthening relationships with the DOJ and FTC to conduct further research on defense consolidation, and continuing to pursue a number of ongoing adjustments and rulemaking changes to its contracting processes.

The 2022 report portends a sea change in the DOD's attitude towards efforts to preserve competition and comes several years after a 2016 statement by the DOJ and the FTC. The 2016 statement points to the joint DOJ/FTC Horizontal Merger Guidelines as general guiding principles for defense companies seeking to engage in mergers. However, the DOJ and the FTC are currently engaged in the process of drafting new merger guidelines. See Federal Trade Commission and Department of Justice Antitrust Division Launch Public Inquiry Aimed at Modernizing Merger Guidelines.

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:

- **Engage legal counsel early**. Understand the risk of an antitrust challenge, the potential impact to closing timing, and begin building advocacy to use with the agencies and key customers.
- **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 email).
- **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 Due Diligence: Antitrust Issues, Merger Review Antitrust Fundamentals, and Integration Planning: Antitrust Considerations.

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 U.S.C. § 4565). The Foreign Investment Risk Review Modernization Act (FIRRMA) of 2018 expanded CFIUS's jurisdiction, and the final implementing regulations under FIRMMA became effective on February 13, 2020. The mandatory filing rules were further amended effective October 15, 2020, and require a mandatory filing for foreign investments in U.S. businesses that produce, design, test, manufacture, fabricate, or develop critical technologies that would require a license to export to the foreign party or other persons with certain ownership interests in the investor. The final regulations also expand the jurisdiction of CFIUS to include certain non-control investments in a "TID U.S. business" which include U.S. businesses that deal in or maintain specified critical technology, critical infrastructure, or sensitive personal data of U.S. citizens, if the foreign investor obtains one of the following rights: (1) access to material nonpublic technical information; (2) membership or observer rights on the board of directors; or (3) other involvement, including consultation rights, in the substantive decision-making process of the TID U.S. business.

- **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 largely 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.
- **CFIUS has jurisdiction over certain non-control transactions**. FIRRMA expanded CFIUS jurisdiction to cover certain non-control, but not-passive, foreign investments in a "TID U.S. business," as described above. However, this expanded jurisdiction does not apply to "excepted investors" that meet strict criteria for close connections to one or more "excepted foreign states." The initial "excepted foreign states" are Canada, Australia, and the United Kingdom, although more countries may be added to the list in the future. The

strict criteria are intended to ensure that a significant percentage of the investor and each of its parent companies is owned and controlled by nationals of excepted foreign states.

- **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 may 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 may be subject to mandatory filings**. FIRRMA 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. Specifically, a foreign government must have at least a 49% voting interest in a foreign person that acquires at least a 25% interest in a TID U.S. business. This requirement took effect on February 13, 2020, and includes an exception for investments by U.S.-owned and managed investment funds.
- **Critical technology investments may be subject to mandatory filings**. The final CFIUS regulations amended effective October 15, 2020 require a mandatory declaration for foreign transactions involving any U.S. business that produces, designs, tests, manufactures, fabricates, or develops a "critical technology" that would require a license to export to the foreign parties to the transaction and persons that hold, individually or in a group, a 25% or greater voting interest in those foreign parties. This requirement includes exceptions for "excepted investors," U.S.-owned and managed investment funds, and foreign persons that hold a facility security clearance pursuant to the National Industrial Security Program Operating Manual rule (the NISPOM Rule), see 32 C.F.R. Part 117, and are subject to a foreign ownership, control or influence (FOCI) mitigation agreement.
- **Real estate**. Foreign persons purchasing or leasing 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 as well as property leases and concessions, which were formerly excluded from CFIUS jurisdiction.
- **Consider CFIUS review timeline in transaction planning**. The relatively high levels of activity by foreign buyers in recent years, along with greater awareness of and sensitivity to CFIUS risk, led to an ever-increasing number of CFIUS filings, with 313 filings made in 2020. See the CFIUS Annual Report to Congress, CY 2020. 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 FOCI of a company with a facility security clearance may also require pre-closing government approvals. FOCI determinations are primarily but not exclusively made by the Defense

Counterintelligence and Security Agency (DCSA) (formerly the Defense Security Service). Completing a 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 DCSA considers a foreign minority interest to be "substantial" for these purposes if it consists of greater than 5% of the ownership interests or greater than 10% of the voting interest.
- **Consider FOCI mitigation**. Under the NISPOM Rule codified at 32 C.F.R. Part 117 (which, effective August 24, 2021, replaced the manual previously issued as a DOD policy (DOD 5220.22-M)) and other DCSA 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 (1) board resolutions, (2) a security control agreement, (3) a special security agreement, (4) a proxy agreement or voting trust, or (5) a combination of these measures.
- **Notify DCSA and Negotiate FOCI Mitigation Measures**. When entering into discussions, consultations, or agreements that may reasonably lead to effective ownership or control by a foreign interest, companies holding facility clearances must report details of the proposed merger or acquisition to the Cognizant Security Officer in writing. Although DCSA no longer must agree to a mitigation method and interim security measures prior to closing, contractors must notify the Cognizant Security Officer of the commencement of transaction negotiations, including identifying the type of transaction and the potential foreign interest investor, and must propose a plan to negate or mitigate the FOCI. So long as the contractor is negotiating mitigation measures with DCSA in good faith (and there is no indication that classified information is at risk), the existing clearance may continue in effect pending the implementation of an acceptable FOCI mitigation plan.
- **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 Rule requires contractors performing classified work to report to DCSA certain changed conditions related to the ownership or control of the corporation by submitting an updated Certificate Pertaining to Foreign Interests (SF 328). The obligation to report changed conditions under the NISPOM Rule 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: (1) 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 (2) 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 life cycle, 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 $1.27 million per violation. Civil penalties for EAR violations may be up to the greater of about $328,000 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. 22 C.F.R. § 122.4(a).
- 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 60 days in advance of the sale or transfer. 22 C.F.R. § 122.4(b).

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.

Market Outlook

These complex and often cumbersome regulatory requirements have not deterred companies from engaging in very substantial M&A activity in this space. The extent of the impact of record high inflation, the Federal Reserve's interest rate hikes, and the war in Ukraine may have on the market remain to be seen, but several recent trends are likely to continue into 2022 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 involved expanding their holdings of platform/hardware companies and shedding services businesses. For example, Northrop Grumman divested its main information technology and technical services business in 2021 — as Lockheed Martin, L-3 and Harris had previously.
- **Robust activity levels in the services segment**. In parallel, the services segment has seen a robust level of activity in recent years. 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. This big wave started with the merger in 2016 of the Leidos and Lockheed Martin services businesses, resulting at the time in an enterprise with combined revenue in the range of $10 billion. Others have followed— in particular the 2018 merger between CSRA and the General Dynamics information technology business, the 2021 merger between Peraton and Perspecta, and the 2022 acquisition of Cerner by Oracle.
- **Financial 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. For example,

private equity firm Carlyle, a frequent participant in this market, has announced plans to acquire ManTech International in a transaction valued at $4.2 billion. Another trend in the past couple of years has been the use of special purpose acquisition companies (SPACs, or so-called "blank-check companies") to acquire and finance satellites and related space assets and technology, with examples including Black Sky and Virgin Galactic.

- **Targeting of smaller companies with key technologies**. Defense and government contracting M&A activity has long been driven in significant measure by technological innovation. Now, with defense and civilian agency spending increased 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 and civilian budgets, smaller and mid-sized companies with certain key capabilities remain attractive targets— cybersecurity, data analytics, artificial intelligence (i.e., machine learning), autonomy (i.e., unmanned systems), hypersonics, 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 undoubtedly continue to feed M&A activity in aerospace, defense, and government services.

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