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Recent Trends in Government Contracts M&A

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While multi-billion dollar transactions grab headlines—such as the combination of Computer Sciences Corp.'s public sector business with SRA International, the merger of Leidos Holdings, Inc. with Lockheed Martin's Information Systems & Global Solutions business, and Harris Corporation's acquisition of Exelis Inc.—there are a few trends in federal government contracts mergers and acquisitions that have flown under the radar. The use of indefinite delivery / indefinite quantity (IDIQ) vehicles is widespread in the government contract space. Transferring these contract vehicles involves issues that buyers and sellers alike should be aware of to stay one step ahead of the market. In this article we discuss these issues and also highlight certain compliance issues and potential pitfalls that may occur in government contracts transactions.

Transferring Contract Vehicles

Significant amounts of government procurement dollars flow through multiple-awardee IDIQ vehicles, whether large single-agency vehicles or government-wide acquisition contracts (GWACs). Although the contracts themselves do not guarantee work for a vendor/contractor, these vehicles have flashy, multi-billion dollar ceiling values and provide access to a wide range of task orders from the government. The government selects only a handful of qualified contractors to be on each vehicle and sometimes limits the field to only certain types of small businesses. For those contractors who do not receive such an award, these vehicles have recently developed significant market value. We have seen this value demonstrated in the many asset acquisition transactions that include an IDIQ contract and related assets from an awardee who has struggled to win subsequent task orders. These transactions benefit both the government, by weeding out less competitive awardees, and industry, by allowing contractors who would like to use these vehicles to acquire them. However, you must approach these transactions with careful attention to (1) novation and (2) small business credit.

Addressing Novation – and the Time Before Novation

The word novation gives nightmares to contractors. Novation, or the process of getting government consent for an asset acquisition, involves significant amounts of paperwork, has no time limit, and worst of all, is entirely at the government's discretion. That said, numerous novations are approved every year, and if an asset transaction otherwise makes sense, novation should not be an impediment to getting it done. The problems occur with formulating the transaction so it can receive approval and planning for the period when you are waiting for approval.

The novation process is fairly straightforward: all you need is a novation agreement executed by the government, the assignor (transferor), and the assignee (transferee) on the standard form in the Federal Acquisition Regulation (FAR) 42.1204(i) (48 CFR 42.1204(i)). Under FAR 42.1204(a), the government will only approve a novation if the request "arises out of the transfer of—(1) All the contractor's assets; or (2) The entire portion of the assets involved in performing the contract . . ." In the context of an IDIQ vehicle where a contractor has no task or delivery order awards, the concept of the "entire portion of the assets involved in performing the contract" can be tricky. The government's goal is to approve only those transfers in which the acquirer can seamlessly fulfill the current and future obligations of the contract—so contractors need to start from that premise in the novation request. Clearly, the transfer must involve the contract and the underlying proposal, but contracts cannot simply be exchanged for cash. Instead, think broadly about what assets are actually tied to a contract for which there currently is no work. Perhaps there is goodwill, leased space, hardware, software, intellectual property, or bid-tracking tools that should be conveyed. Often there are pending proposals for other contracts that have not been awarded yet should be addressed as well.

Another major issue is timing. Novations must occur after closing. There is no deadline for approval of a novation agreement, and every experienced practitioner has stories of novations taking a year or longer. During the pre-approval period, the contracts remain in the possession of the transferor, and payments under the contracts are made to the transferor. As a result, the parties must develop a transition plan to bridge the gap until the novation agreement is signed. Generally, this involves the transferee working as a subcontractor under the transferor, with some protections for the transferor. Keep in mind, however, that many contracts require consent to subcontract (i.e., that the government must approve any new company doing the work). Pass-through subcontracts, where a subcontractor does all of the work, may raise cost accounting issues. Furthermore, this subcontract should set out a plan for the possibility that the government might reject the novation request, leaving the subcontract in place for an extended period of time.

Transferring Small Business Contracts

According to the Small Business Administration, in fiscal year 2015, 25.75% of government prime contracts (those directly with the government) and 31.3% of subcontracts under government contracts (those with other contractors where the end customer is the government) were awarded to small businesses. As small business policy has evolved over the last decade, buyers have become more comfortable with the basic rules that apply when transferring small business contracts. Experience has shown that most small business contracts can transfer to buyers that do not qualify as small businesses under the government requirements and are not terminated at sale, with some exceptions and if the parties take proper steps. This realization has led potential buyers to take a more detailed, contract-by-contract review of small business contracts that might be part of an acquisition.

Whether you are acquiring an entire company or just a contract, the process for understanding whether a small business contract will transfer is nuanced. At a high level, there are three vital steps:

1. **Type of contract.** Determine whether the contract is a small business set-aside, and if so, what kind. Many companies are confused as to whether a contract was reserved for small businesses only, or to what type of small businesses it was set aside for specifically, which may impact the buyer's ability to qualify. The set-aside status of a contract is sometimes clear from the cover page of a prime contract, but it may also be buried in the seemingly endless list of FAR clauses. Such clauses include: FAR 52.219-6 (48 CFR 52.219-6) Notice of Small Business Set-Aside and FAR 52.219-27 (48 CFR 52.219-27) Notice of Service-Disabled Veteran-Owned Small Business Set-Aside.

2. **Recertification requirements.** Be aware of small business recertification requirements. Size recertification, or a re-representation as to whether or not the company qualifies as a small business, is required when a small business contract or a business holding a small business contract is acquired. These recertifications limit the government's ability to claim small business credit against statutory goals and may limit an acquirer's access to future task orders, even though performance on the contract (including options) can usually continue after recertification. 15 U.S.C. 637(d).

3. **Contract clauses.** During due diligence, check for tailored contract clauses called "off-ramps" and "on-ramps." An on-ramp clause, which is generally not problematic, may allow the government to add competitors to a contract, or it may let a small business graduate to a large business contract when it grows out of size status. However, whether you are acquiring a contract or a company, off-ramps can be tricky as the transfer of a contract may trigger the removal of a contractor from a vehicle or render the contractor dormant (i.e., unable to bid on future work). Off-ramp provisions are not standard and come in all shapes and sizes. To assist you in identifying these types of provisions, below are examples of off-ramps from the General Services Administration's (GSA) One Acquisition Solution for Integrated Services (OASIS) contract and the Department of Veterans Affairs' Transformation Twenty-One Total Technology Next Generation (T4NG) vehicle:

   <u>GSA OASIS</u>

   After the execution of a novation agreement or, after a merger or acquisition that does not require a novation, if the Contractor's size standard changes from a small business concern to other than a small business concern and the Contractor has active task orders, including the exercise of options and modifications at the task order level, the Contractor shall be placed in Dormant Status immediately in accordance with Section H.16. After all the active task orders are closed out, the Contractor shall be Off-Ramped in accordance with Section H.17.

   The contract goes on to define "Dormant Status" as a circumstance where:

   > the Contractor shall not be eligible to participate or compete in any subsequent task order solicitations while the Contractor is in Dormant Status; however, Contractors placed in Dormant Status shall continue performance on previously awarded and active task orders, including the exercise of options and modifications at the task order level. . .

> **T4NG**
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> The Government, in its sole discretion, may exercise the Off-Ramp if any of the following events occur: a T4NG SDVOSB [Service Disabled Veteran-Owned Small Business] or VOSB [Veteran-Owned Small Business] contract holder that was not awarded in Step One and no longer qualifies as a SDVOSB or VOSB because it is acquired by a non-SDVOSB or non-VOSB concern or is no longer listed as verified in the VIP database as a result of losing ownership and/or control of the company; a small business T4NG contract holder that was not awarded in Step One and no longer qualifies as a small business because it is acquired by a large business; or a small business that was not awarded a contract in Step One and cannot re-certify as a small business at the end of the fifth year IAW 13 CFR 121.404(g)(3). . . . If the Government elects to exercise the Off-Ramp, the Contractor will be removed from the program and thus will not be eligible to propose on any T4NG task order competitions.

Contracts with these clauses may still have some value in the current task orders that would continue after a contract transfer or acquisition, but this is of significantly less value than the potential future task orders that the buyer may have wanted to pursue.

Foot Faults and Deal Killers – Trending Compliance Issues

Complying with hundreds of regulations applicable to government contracts is not easy. It may be even harder to find compliance issues during due diligence. There are, however, a handful of issues that have come up with some frequency recently and should be front and center on your radar. These include (1) small business issues, (2) dealing with GSA Supply Schedule compliance, and (3) downstream supplier/subcontractor failures.

Small Business Size Status

Only the government will take dozens of pages to define what makes up a small business. Far from being an issue of bureaucratic minutiae, small business status is vitally important in a transaction because compliance errors are extremely common. The measure for determining whether a business is small under federal regulations is either the number of employees employed by a business (13 CFR § 121.106) or the amount of annual revenue of the business (13 CFR § 121.104). When determining if they are small businesses, small contractors often ignore their corporate affiliates, significant investors, and in some instances even their branch offices. Others simply forget to update the representations and certifications that they provide to the government. From an acquirer's perspective, these mistakes can lead to significant liability, the loss of small business set-aside contracts, and, in some instances, suspension and debarment from transacting with the government. As a result, acquirers and their counsel should review public representations, carefully study ownership records, and investigate possible affiliates with an eye towards small business compliance as part of their standard due diligence.

GSA Schedule Compliance

There have been a number of large False Claims Act settlements in recent years related to the GSA Federal Supply Schedule contracts, referred to as GSA Schedules. These contracts are a great way to access the government market, but that access comes with unique compliance burdens. For example, prior to the award of a GSA Schedule contract, a contractor is required to disclose its commercial sales practices. Based on that disclosure, the government negotiates the price. If that disclosure is incomplete or inaccurate, it could, of course, infect all future sales with potential liability. Further, in certain circumstances, the government demands discounts during the life of a GSA Schedule contract if other customers have received better pricing. Again, failure to notify the government of discounted sales can lead to overcharging on thousands of items. More recently, service contractors also have run into trouble by providing employees that do not precisely line up with the qualifications listed in their GSA Schedule contract. In all of these cases, contractors have suffered liability in the tens of millions of dollars following False Claims Act litigation. Although the benefits of GSA Schedule contracts likely outweigh the risks, buyers have to be on guard when a target does significant work through these vehicles and should have specific representations in the purchase agreement on GSA Schedule issues.

Downstream Failures

With all the focus on prime contracts, buyers may miss the importance of how an acquisition target deals with compliance in its supply chain. For their part, prime contractors often take a "see no evil, hear no evil" approach with regard to their subcontractors and suppliers by relying on outdated certifications and compliance with flow-down provisions that suppliers may ignore or simply may not understand. For example, contractors must have compliance controls down the supply chain, or obtain representations of compliance from their subcontractors, if their contracts are subject to domestic preference requirements set forth in federal statutes such as the Buy American Act, the Trade Agreements Act and the Berry Amendment. Among others, problems like counterfeit parts, improper billings, and limits on subcontracting under small business contracts also put prime contractors at risk for the actions of their subcontractors. As a result, we have seen a significant increase in subcontractor diligence in contract and contractor acquisitions. That diligence needs to start with a review of subcontract forms, but should also include a detailed discussion of internal controls, certifications and subcontractor spot checks. Contractors who fail to sufficiently monitor their subcontractors and suppliers—and acquirers who fail to ask these questions of their targets—put themselves at risk for False Claims Act litigation and suspension or debarment.

Conclusion

The government contracts M&A marketplace is dynamic, with hundreds of players exploring different paths to success. Although the recent focus on IDIQ contract vehicles in asset transactions can be beneficial to both the government and the industry, these vehicles and transactions pose unique challenges. Even when an IDIQ vehicle is not involved, buyers and sellers need to remain aware of the many compliance issues that could complicate or kill a transaction.