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MERGERS & ACQUISITIONS—SPECIAL ISSUES WHEN PURCHASING GOVERNMENT CONTRACTOR ENTITIES

By Agnes P. Dover

In the 1990s, while the commercial high technology sector was the darling of Wall Street, traditional Government contractors were often overlooked by investors. Today, companies servicing the federal and state market are no longer wallflowers. Significant increases in defense spending and the strong valuation of companies providing defense and homeland security solutions have attracted both domestic and foreign investors to the growing U.S. Government market.[1] Meanwhile, companies already in the Government arena have been looking to diversify their holdings or increase their market share through consolidations. Recent statistics confirm the mergers and acquisitions trend as 57 transactions in the Government services sector were announced for the first half of 2004—a 39% increase over last year.[2]

The purchase and sale of Government contractor entities are likely to continue as federal agencies look increasingly to supplement their declining employee ranks with outsourced solutions. However, transactions involving Government contract entities raise unique issues for both the buyer and the seller. For example, contracts with the U.S. Government cannot be assigned without the consent of the Government Contracting Officer. Although the Federal Acquisition Regulation spells out a process—novation—for obtaining that consent, the process can be cumbersome, and some COs rigidly insist on following the procedures even when they are not required.

When one Government contractor acquires another in a similar or related field, the acquiring entity may find itself barred from receiving certain types of business due to the organizational conflict-of-interest rules. An acquisition can also affect the size status of a small business entity, suddenly making a company ineligible to participate in the Small Business Administration's 8(a) or other set-aside programs.

IN BRIEF

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  4-013-413-5

Another obstacle to acquiring or selling a Government contractor entity arises when a foreign-owned company seeks to purchase a company that performs classified work for one or more federal agencies. Under the U.S. national security laws and regulations, foreign-owned companies may not hold a security clearance unless the foreign ownership, control, and influence has been "mitigated" through certain special mitigation mechanisms. In addition, proposed foreign investment in a U.S. company may trigger a review—and potentially a blockage of the transaction—under the Exon-Florio process.

To ensure that a merger or acquisition achieves the parties' desired business objectives, both the buyer and seller must be aware of and be prepared to address the unique Government contracting requirements. Thus, this BRIEFING PAPER examines the relevant statutory and regulatory requirements for transactions involving Government contractors and identifies strategies to help shape transactions to conform to those requirements. Specifically, this PAPER discusses (1) the Anti-Assignment Act and the related issues regarding the novation of contracts, the assignment of proposals, and the contractor change-of-name procedure, (2) organizational conflicts of interest, (3) acquisitions of small business concerns, (4) foreign ownership, control, and influence, and (5) the Exon-Florio review process.

Anti-Assignment Act

Depending on how the transaction is structured, the Government's two anti-assignment statutes can slow or prevent the acquisition of a Government contractor entity. The Assignment of Claims Act[3] addresses claims under Government contracts for work that has already been performed. The Anti-Assignment Act[4] is more relevant in the merger or acquisitions context as it pertains chiefly to those Government contracts with continuing obligations.[5]

The Anti-Assignment Act was enacted in response to procurement abuses that surfaced during the American Civil War. Government contracts were often awarded to middlemen who neither manufactured nor supplied the goods being procured but who then, to maximize their profit, contracted with the cheapest possible supplier or manufacturer of the goods. The result was often poor quality, substandard merchandise.[6]

In enacting the Anti-Assignment Act, Congress sought to ensure that the Government would deal exclusively with the original contracting party, rather than with multiple or sequential parties.[7] Therefore, the transfer of a Government contract from the party holding the contract (the "transferor") to another party (the "transferee") was generally prohibited.[8] Under the Act, "[n]o contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned."[9] By voiding, upon attempted transfer, both the assignment of performance and the underlying Government contract, the Act is designed to ensure that the entity awarded a Government contract would actually perform it with its own resources. While the Act appears to prohibit categorically any transfer

THOMSON WEST

BRIEFING PAPERS

BRIEFING PAPERS® (ISSN 0007-0025) is published monthly except January (two issues) and copyrighted © 2004 ■ Valerie L. Gross, Editor ■ Periodicals postage paid at St. Paul, MN ■ Published by West, a Thomson business / 901 15th Street, NW / Washington, DC 20005 ■ http://www.west.thomson.com ■ Customer Service: (800) 328-4880 ■ Postmaster: Send address changes to Briefing Papers / PO Box 64526 / St. Paul, MN 55164-0526

of a Government contract from the original awardee to another party, courts and boards of contract appeals have consistently held that the Act is not violated where the Government consents to the transfer or where the transfer occurs "by operation of law."[10]

The Anti-Assignment Act is intended for the protection and benefit of the Government. Therefore, courts have reasoned, the Government should be able to waive its protections under the Act if it deems that such a waiver furthers its interests.[11] That waiver may be given implicitly by Government knowledge, assent, and action consistent with the terms of the assignment[12] or explicitly by a *novation agreement*, as discussed below.

The judicially created "by operation of law" exception to the Anti-Assignment Act generally exempts assignments to statutory receivers and assignees in bankruptcy, as well as those transfers that result from mergers.[13] The "by operation of law" exception is premised on the assumption that such transfers do not contravene the Act's purpose of ensuring that the entity awarded a Government contract actually performs it because the same entity is generally still performing the contract after a bankruptcy or merger. Indeed, the courts and boards of contract appeals have limited the categorical exemption, holding that a statutory merger will only be deemed a transfer that does not require governmental consent if the merger will have little or no effect on the personnel, management, and resources engaged in performing those contracts. When considering whether a given contract transfer occurred by operation of law, courts look to whether the Government continues to deal with the party with which it first contracted (i.e., the same employees, management, and other resources), and whether it continues to receive the benefits for which it contracted.[14]

Novation Of Contracts

■ Novation Requirement

If a contract transfer is of a type that does not fall under the "operation of law" exemption, it will be prohibited unless the Government consents, either implicitly by ratification or waiver[15] or explicitly by the execution of a novation agreement, the process by which the Government formally grants its consent to contract transfer.[16] Consistent with the judicial exception for transfers by operation of law, the FAR specifically indicates that no novation agreement is necessary when a change in ownership is the result of a sale of stock that causes no legal change in the contractor and the contractor remains in control of the relevant assets and continues to perform the contract.[17] Nonetheless, some COs still seek to obtain written assurances from the transferor in a merger relating to the transferee's performance of the Government contracts after the merger. Furthermore, although the case law supports the conclusion that a novation process is not necessary in the context of statutory mergers, there remains some risk that a CO may require parties to a statutory merger to undergo a formal novation process to address any particular concerns the CO may have.

Failure to obtain novation may bar future claims against the Government regardless of whether rights to claims have ostensibly transferred with the acquisition of assets from the contractor.[18] This is especially true when the transaction involves the sale of only a portion of the assets or personnel involved in the Government contract[19] as opposed to the transfer of the entire entity responsible for the contract.[20] It should be borne in mind, however, that failure to obtain a required novation does not necessarily foreclose a remedy. As mentioned above, the Government may waive the novation requirement through knowledge, assent, and affirmative action consistent with the terms of the assignment.[21] Nevertheless, securing the Government's explicit consent through novation remains the surest way of protecting your contract rights after the assignment of a Government contract.

■ Novation Process

Under the FAR, the Government may recognize a successor in interest to a Government contract when there is a transfer of all of the contractor's assets or the entire portion of the assets involved in performing the contract.[22] The process used for recognizing a successor in interest is to enter into a three-party novation agreement between the Government, the transferor, and the transferee. Under the agreement, the Government recognizes the transferee as the successor to the transferor, but the transferor remains liable as guarantor of the transferee's performance.[23] Most Government contract novations are entered into after the transfer has been completed and, in some cases, COs take many months or a year to process a novation request. In the interim between the closing and the execution of any necessary novation agreement, it is advisable for the transferee to enter into a subcontract under which it is given the authority to perform the contract in the transferor's name and receive payments pending approval of the novation agreement. Of course, any subcontract must conform to the provisions of the prime contract.

When required to enter into a novation agreement, you must notify the Administrative CO administering the largest unsettled balance about the pending acquisition[24] and provide that ACO with documentation as specified in the FAR.[25] The regulations require the contractor to provide certain basic information to the Government before executing the novation agreement: (a) documents describing the transaction (e.g., asset purchase agreement), (b) a list of all affected contracts, including the approximate remaining balance on each contract, (c) evidence of the transferee's capability to perform, and (d) any other relevant information requested by the CO.[26]

In addition, the regulations require the contractor to provide the following documentation: (1) an authenticated copy of the instrument effecting the transfer of assets, (2) a certified copy of each resolution of the corporate parties' boards of directors authorizing the transfer of assets, (3) a certified copy of the minutes of each corporate party's stockholder meeting necessary to approve the transfer of assets, (4) if a corporation was formed to receive the assets involved in performing the Government contract, an authenticated copy of the transferee's certificate and articles of incorporation, (5) the opinion of legal counsel for the transferor and transferee stating that the transfer was properly effected under applicable law, (6) balance sheets of the transferor and transferee as of the dates immediately before and after the transfer of assets, audited by independent accountants, (7) evidence that any security clearance requirements have been met, and (8) the consent of all sureties on all contracts if bonds are required, or a statement from the transferor that none are required.[27] Importantly, the regulations grant Government COs the discretion to waive some of the documentation requirements.[28]

Assignment Of Proposals

An issue closely related to the novation of Government contracts is the effect of a merger or acquisition on outstanding bids and proposals. This issue often arises in the context of bid protests or responsibility determinations when an offeror changes ownership after its proposal has been submitted but before contract award. Although the Anti-Assignment Act does not apply to Government contract bids and proposals, the General Accounting Office (recently renamed the Government Accountability Office[29]) has relied upon court decisions that interpret the Act to hold that assignments of bids and proposals are not precluded when made by operation of law and no harm results to the Government.[30]

Specifically, the "transfer…of rights and obligations arising out of a bid or proposal is permissible where the transfer is to a legal entity which is the complete successor in interest to the bidder or offeror [whether] by virtue of merger, corporate reorganization, the sale of an entire business or the sale of [the] entire portion of a business embraced by the bid or proposal."[31] The key requirement is that the original offeror remains intact with access to the same resources and with an intention to honor its prior commitments.[32]

Although the transfer of outstanding bids and proposals is not precluded by the Anti-

Assignment Act or GAO case law, special steps may nonetheless need to be taken. The FAR requires that before awarding a contract, the CO must determine whether the offeror submitting the proposal is a "responsible" offeror, with adequate financial resources and a satisfactory record of integrity and business ethics.[33] To avoid any confusion as to the identity of the offeror whose financial resources are being evaluated, it may be prudent to notify the Procuring CO of the transfer of the pending bid or proposal.

Before notifying the PCO, the transferee should determine on a case-by-case basis whether the transfer could negatively impact the evaluation of the outstanding bid or proposal. The transfer could, for example, affect the agency's evaluation of the proposal in areas such as past performance. Notifying the PCO of the transfer would help ensure that the responsibility determination, as well as the award determination, concerns the proper legal entity, and thereby possibly prevent potential bid protests by competitors if the transferee should get the award.[34] Taking these steps to notify the PCO and reaffirm commitments will best enable the transferee to succeed to the interests of the transferor in any bids and proposals that are pending at the time of the transfer.

Change-Of-Name Procedure

Even when no novation is required, such as when there is a stock purchase or merger transaction, if the name of the Government contracting entity is expected to change, you must prepare and submit to the Government several documents in support of an application for recognition of the name change.[35] In particular, the "Change-of-Name Agreement" package must include (1) three signed copies of a "Change-of-Name Agreement," (2) an authenticated copy of the document effecting the name change, (3) a legal opinion stating that the change of name was properly effected under applicable law, and (4) a list of all affected contracts, showing the CO for each.[36]

It is prudent to contact the Government early in connection with the preparation of the "Change-of-Name-Agreement" package. Raising the change-of-name issue with the ACO may prompt a request to undertake the novation process even when no novation is legally required. Early consultations may afford an opportunity to explain to the ACO why the novation requirements should not be triggered by the proposed statutory merger.

Similar to the notification process for novations, contractors must notify the ACO administering the largest unsettled balance about the pending merger and name change.[37] The notice should inform the ACO of the planned merger, the structure of the merger, and the contracts affected by the merger. In addition, the notice should inform the ACO that you will be forwarding the change-of-name package described above. The process to approve the change in name may require anywhere from a few weeks to a few months. Once approved by the ACO, each contract should be modified to reflect the change in name.

Organizational Conflicts Of Interest

Wall Street's recent attraction to Government contract companies has also encouraged traditional defense contractors to expand through acquisition of other defense contractors. For instance, in the summer of 2003, General Dynamics Corp. acquired Veridian Corp. in a $1.5 billion transaction.[38] The transaction was designed to significantly strengthen General Dynamics Information Systems and Technology Group by capitalizing on Veridian's expertise in providing solutions in command and control, intelligence, surveillance, and reconnaissance services. Other larger transactions have involved combinations of more or less equals, such as Northrop Grumman's purchase of TRW, Inc. in December 2002. This acquisition vaulted Northrop Grumman to the status of one of the nation's largest defense contractors, with over $25 billion in annual sales and nearly 120,000 employees.[39]

Mergers and acquisitions in which both the buyer and seller are Government contractor entities—particularly service contractors—raise additional unique issues. When the buyer and seller operate in related business areas, especially advisory and assistance services, the acquisition of one entity by another could create organizational conflicts of interest (OCIs) that jeopardize existing and future Government contract work. Therefore, to plan for and guard against an unexpected loss of business or future business opportunities, reviewing OCIs potentially resulting from an acquisition is an important step in regulatory due diligence.

■ Basic Rules

Under FAR Part 9.5, an OCI "may result when factors create an actual or potential conflict of interest on an instant contract, or when the nature of the work to be performed on the instant contract creates an actual or potential conflict of interest on a future acquisition."[40] COs are charged with identifying and evaluating potential OCIs as early in the acquisition process as possible. Once an OCI is identified, the CO must "avoid, neutralize, or mitigate significant potential conflicts before contract award."[41] In executing this responsibility, COs are guided by two underlying principles: (1) preventing the existence of conflicting roles that might bias a contractor's judgment, and (2) preventing unfair competitive advantage.[42]

To protect against OCI concerns, the regulations specifically limit the award of some contracts to contractors providing specific services. For instance, a contractor providing systems engineering and technical direction cannot be awarded a contract to supply the system or any of its major components.[43] Similarly, if a contractor prepares and furnishes contract specifications, that contractor is generally not allowed to furnish these items, as a prime contractor or as a subcontractor.[44] FAR 9.508 also provides examples of nine different situations in which questions regarding OCIs might arise.[45]

■ OCI Avoidance & Mitigation

As the regulations suggest, FAR 9.5 was not drafted with the specific purpose of directing COs to continuously review contracts for potential OCI concerns—particularly in the context of mergers and acquisitions. Nonetheless, the force and effect of the regulations remain throughout the life of an awarded contract, and any mitigation approach adopted at contract award must be sufficient to guard against any actual or potential OCI issues that may arise in the event of a subsequent change of ownership or organizational structure.

Therefore, a careful review of potential OCI concerns is an important and necessary consideration of any merger or acquisition involving Government contractors. First, the transaction could result in a situation where the resulting entity could be disqualified from certain competitions. Second, the merger could create OCIs that force the acquirer to relinquish some of its or the target's existing contracts to avoid or mitigate OCI concerns. To guard against these unintended consequences of an otherwise attractive acquisition, the companies must be forward-thinking and suggest strategies to the CO for avoiding or mitigating any potential OCI concerns.

The initial step in an OCI due diligence review is for the companies involved in the merger or acquisition to identify those sectors of their businesses where OCI issues are likely to develop. For example, if the target specializes in advisory and assistance services, the acquirer should review whether it is currently supplying products connected to those services. Similarly, if the target is providing systems engineering and technical assistance services for certain products, the acquirer should evaluate what effect the provision of these services will have on its future business opportunities.

Once an actual or potential OCI issue is identified on a particular contract, the owner of the contract—either the target or the acquirer—should determine whether existing mitigation plans, if any, are sufficient to handle the potential OCI. The parties must also determine whether the owner of the contract is prepared to take the necessary steps to avoid or mitigate the resulting OCI issue. For instance, a mitigation plan can provide for firewalls separating the conflicted sectors of the merged entity. A more drastic approach for avoiding a potential OCI is for the acquirer to divest that portion of the target's business that creates the OCI concerns.

The management of this process during the period of time between the announcement and close of the transaction is extremely important. Under applicable antitrust rules, both parties need to manage their existing contracts independently.[46] However, to the extent that an announced transaction has the potential to create OCI issues, contractors need to communicate with their respective COs and be prepared to implement mitigation plans immediately upon closing.

Acquisitions Of Small Business Entities

Special issues also arise when a large business acquires a small business concern that is receiving contracts under various Small Business Administration programs. In particular, buyers must pay careful attention to the rules and regulations surrounding the acquisition of small disadvantaged businesses that are recipients of set-aside contract's under the SBA's 8(a) program.[47]

■ General Rules

Generally, a business that qualifies as a "small business concern" may be eligible to receive preferential treatment in connection with certain Government contracts or grants. The term "small business concern" means a concern, including its affiliates, that is independently owned and operated, not dominant in the field of operation in which it is bidding on Government contracts, and is qualified as a small business under the SBA's size standards.[48] Importantly, the SBA determines the size status of a firm, including its affiliates, as of the date the firm submits to the procuring agency, as part of its initial proposal, a written self-certification that the firm is "small."[49] Thus, there is no requirement that an agency terminate a contract where a small business concern becomes "large" after the self-certification.[50]

In addition, the GAO has indicated that the Government may exercise an option to extend the term of a small business set-aside contract notwithstanding the fact that the contract is no longer held by a small business. In a case in which a protester argued that the Army improperly exercised an option to extend a small business set-aside contract that had been novated by the small business concern to a large business, the GAO held as follows:[51]

> We know of no regulatory or statutory requirement that a small business offeror must retain throughout contract performance its small business status after it has legitimately self-certified that it is small, and the award was proper when made....Nothing in the regulations requires a re-determination of size status during performance of the contract. The initial size status certification controls.

Because there exists no regulatory requirement that a CO must take into account socioeconomic programs, including the small business set-aside program, before exercising a contract option, the GAO rejected the protester's argument.

■ 8(a) Contractors

The general rules described above are different if the contract is performed by a small disadvantaged business concern participating in the SBA's 8(a) program and the contract was set aside for award to 8(a) contractors. Technically, 8(a) contracts are subcontracts to the SBA, which acts as the prime contractor to the actual buyer agency.[52] In general, 8(a) contracts must be performed by the company that obtained the original 8(a) contract award.[53] The SBA's affiliation rules require that the acquired company be considered together with the controlling parent company for purposes of determining both size status and ownership by qualifying minority persons, even if the business were to continue in existence as a subsidiary.[54]

Additional rules and procedures come into play when an 8(a) contractor (or its assets) is sold to a non-8(a) company. Importantly, an 8(a) contract, whether in the base or an option year, must be terminated for the convenience of the Government if the 8(a) concern to which it was awarded transfers ownership or control of the firm, unless the Administrator of the SBA waives the termination requirement.[55] The same waiver requirement applies in an asset sale, which requires a novation to assign contract performance to the acquiring entity.

The 8(a) contractor must notify the SBA "immediately upon entering an agreement (either oral or in writing) to transfer all or part of its stock or other ownership interest to any other party."[56] (This requirement is inartfully worded in that it refers to the 8(a) "concern" entering an agreement to sell, whereas, at least in the case of a stock transaction, it is the shareholders of the concern who transfer the ownership interest. However, the notice must be given whether it is the concern itself or third-party owners who are transferring interests, and whether it is an asset or stock deal.) The contracting agency also must be notified.[57] This notice requirement generally is triggered by entering into a purchase agreement and not upon signing of a nonbinding statement of intent.

To continue performance of an 8(a) contract after a transfer of ownership or control by a non-8(a) concern, a timely waiver must be obtained from the SBA. As noted above, if such waiver is not obtained, the CO must terminate the contract for the convenience of the Government.[58] The contractor must request a waiver from the SBA before "actual relinquishment of ownership or control," i.e., the closing.[59] In doing so, the 8(a) contractor must specify the grounds on which it requests the waiver and demonstrate that such grounds are met.[60]

Occasionally, closing or finalizing of the acquisition is made contingent upon obtaining the waiver. In this regard, potential deal negotiations should consider whether waiver rejection is a ground for a price adjustment at closing. If the parties close while waivers are still pending, it may be appropriate to have a contingent deferred payout of part of the price based on contract revenues.

To obtain a waiver, the SBA requires a certification from the head of the contracting agency or another authorized agency official that "termination of the contract would severely impair attainment of the agency's program objectives or missions."[61] Upon notice of the transfer, the CO must take action "immediately to preserve the option of waiving the termination requirement."[62] In this regard, if the CO determines that transfer of the contract from the current 8(a) contractor to another firm would impair attainment of the agency's program objectives, the CO *must* notify the SBA in writing and indicate that the agency is requesting a waiver.[63] The CO "shall either confirm or withdraw" the request within 15 days or "such longer period as agreed to by the agency and the SBA."[64] As a practical matter, if contract performance is well underway at the time of the acquisition, an agency generally will find it easier and less disruptive to continue the contract than to terminate and conduct a new procurement.

The SBA suggests that waiver requests be made as early as possible and notes that requests submitted before a definitive purchase agreement is signed will be processed. In any event, the contract will not be terminated before the CO has had an opportunity to opine to the SBA on the waiver request, since only the CO can terminate the contract. Should a waiver request be denied, the 8(a) contractor may appeal the decision to the SBA Office of Hearings and Appeals under the procedures set forth at 13 C.F.R. Part 134.[65] A contractor wishing to appeal must file its petition within 45 days of the date of service of the denial by the SBA Administrator.[66]

Foreign Ownership, Control & Influence

Special issues arise when a foreign entity acquires an interest in a U.S. company that performs Government contract work requiring access to classified information. Access to classified information requires a security clearance, for which only U.S. citizens are eligible. Thus, a non-U.S. corporate citizen or a company that is under foreign ownership, control, or influence (FOCI) is not eligible to receive a security clearance.[67]

NISPOM Requirements

Executive Order 12829 established the National Industrial Security Program, which is administered by the Defense Security Service (DSS), and authorized the establishment of policies and procedures concerning access to classified information.[68] Key regulations implementing the program include Department of Defense Regulation 5220.22-M, known as the National Industrial Security Program Operating Manual (NISPOM).[69] To have access to classified information, a contractor must have a valid facility security clearance granted by the appropriate cognizant security agency administering the classified contract at issue, such as the DSS or the Department of Energy. As a general rule, if a company is structured as a single corporation with multiple facilities, the NISPOM requires the corporate headquarters to be cleared at a level equal to the highest security classification of any contract performed by any facility within the corporation.[70]

Importantly, facility clearances are granted only to contractors organized under U.S. law and located in the United States.[71] In addition, the contractor must not be subject to FOCI.[72]

Thus, a U.S. contractor's ability to retain its security clearance may be adversely affected if all or a portion of the contractor's ownership is acquired by a foreign entity. As an initial point, the NISPOM requires contractors currently holding security clearances to report to the Government several types of changed conditions, including any change of ownership.[73] Likewise, contractors must inform the Government when they enter into discussions that may result in either a merger, acquisition, or takeover involving a foreign person.[74] The NISPOM defines a "foreign person" as "[a]ny foreign interest and any U.S. person effectively owned or controlled by a foreign interest." [75]

FOCI Factors

The NISPOM indicates that a U.S. company is considered to be under FOCI in the following circumstances: [76]

> [W]henever a foreign interest has the power, direct or indirect, whether or not exercised, and whether or not exercisable through the ownership of the U.S. company's securities, by contractual arrangements or other means, to direct or decide matters affecting the management and operation of that company in a manner which may result in unauthorized access to classified information or may affect adversely the performance of classified contracts.

The NISPOM defines "foreign interest" as follows:[77]

> Any foreign government, agency of a foreign government or representative of a foreign government; any form of business enterprise or legal entity organized, chartered or incorporated under the laws any country other than the U.S. or its possessions and trust territories, and any person who is not a citizen or national of the United States.

When considering whether a contractor is under FOCI, the cognizant security agency will consider several different factors in the aggregate: [78]

(a) Foreign intelligence threat.

(b) Risk of unauthorized technology transfer.

(c) Type and sensitivity of the information requiring protection.

(d) Nature and extent of FOCI, including whether a foreign person occupies a controlling or dominant management position, and source of FOCI, including identification of immediate, intermediate, and ultimate parent organization.

(e) Record of compliance with pertinent U.S. law, regulations, and contracts.

(f) Nature of bilateral and multilateral security and information exchange agreements that may pertain.

In addition to consideration of these factors, a company applying for a facility clearance must provide the cognizant security agency with the following information that will be considered and reviewed in the aggregate: [79]

(1) Ownership or beneficial ownership, direct or indirect, of 5% or more of the applicant company's voting securities by a foreign person.

(2) Ownership or beneficial ownership, direct or indirect, of 25% or more of any class of the applicant company's nonvoting securities by a foreign person.

(3) Management positions, such as directors, officers, or executive personnel of the applicant company held by non-U.S. citizens.

(4) Foreign person power, direct or indirect, to control the election, appointment, or tenure of directors, officers, or executive personnel of the applicant company and the power to control other decisions or activities of the applicant company.

(5) Contracts, agreements, understandings, or arrangements between the applicant company and a foreign person.

(6) Details of loan arrangements between the applicant company and a foreign person if the applicant company's (the borrower's) overall debt to equity ratio is 40:60 or greater; and details of any significant portion of the applicant company's financial obligations that are subject to the ability of a foreign person to demand repayment.

(7) Total revenues or net income in excess of 5% from a single foreign person or in excess of 30% from foreign persons in the aggregate.

(8) 10% or more of any class of the applicant's voting securities held in "nominee shares," in "street names," or in some other method that does not disclose the beneficial owner of equitable title.

(9) Interlocking directors with foreign persons and any officer or management of the applicant company who is also employed by a foreign person.

(10) Any other factor that indicates or demonstrates a capability on the part of foreign persons to control or influence the operations or management of the applicant company.

(11) Ownership of 10% or more of any foreign interest.

■ FOCI Mitigation

A foreign-owned company that acquires a cleared U.S. company may take steps to "mitigate" the FOCI concerns and thereby maintain the company's security clearance. First, if the foreign person at issue does *not* own sufficient voting stock to elect board members and is not otherwise entitled to board representation, a simple resolution by the U.S. company's board will generally prove adequate to resolve the situation. The resolution must (a) identify the foreign shareholder and describe the number and type of the foreign owned shares, (b) acknowledge the need to comply with the industrial security program and export control laws, (c) certify that the foreign shareholder will not require, will not have, and can be precluded from gaining unauthorized access to classified and export controlled materials, (d) state that the foreign person will not be permitted to hold positions that that may enable the foreign person to influence contracts involving classified information, and (e) agree to provide an annual certification acknowledging the resolution's continued effectiveness.[80]

Other options to mitigate FOCI include implementing Voting Trust or Proxy Agreements whereby the voting rights of foreign shareholders are vested in three trustees or proxy holders who are U.S. citizens and have been cleared by the U.S. Government. The trustees or proxy holders must be disinterested individuals with no prior involvement with the U.S. company, corporate affiliates, or the foreign person and must be made directors of the applicant company.[81] The Voting Trust or Proxy Agreement approach is the most stringent mitigation approach in that it requires the foreign owner to relinquish day-to-day control of the cleared U.S. entity.

The third—and most commonly utilized option—is to implement a Special Security Agreement (SSA) or Security Control Agreement that (1) imposes substantial industrial security and export control measures within the U.S. company's polices and procedures, (2) necessitates considerable involvement of senior management and board members, and (3) creates a Government Security Committee to monitor the above-referenced policies and procedures.[82] A key element of the SSA is the appointment of up to three outside directors to the cleared company's board of directors. The outside directors must be U.S. citizens who are approved by the cognizant security agency and eligible to receive a security clearance.[83]

This type of arrangement preserves the foreign person's right to board representation and a say in company management, yet protects against unauthorized access to classified information.[84] However, a company under an SSA, unlike a company under a Voting Trust or Proxy Agreement, is still considered foreign owned. A company under an SSA is authorized to have access to secret information; however, to receive a contract at the Top Secret level or above, the CO must make a so-called "national interest determination" to justify the award.[85] Having to obtain a national interest determination for certain classified contracts could put a company at a competitive disadvantage if other U.S. companies are available to perform the work.

The final option is a "limited" facility clearance that—if certain criteria are met—allows a foreign-owned company to obtain some access to classified information.[86]

Exon-Florio Process

The Exon-Florio Amendment to the Defense Production Act of 1950 authorizes the President to suspend or prohibit a proposed foreign acquisition of a U.S. entity if the President believes that the foreign person might take action that would threaten national security.[87] The President is authorized to seek divestment in the case of a completed acquisition of control. However, this authority terminates if the transaction is examined pursuant to established procedures and a decision is made not to take action.[88]

The Committee on Foreign Investment in the United States (CFIUS) is the inter-agency committee responsible for reviewing transactions subject to the Exon-Florio Amendment. CFIUS is chaired by the Secretary of Treasury and composed of representatives from the Departments of State, Defense, Commerce, and Justice, the Office of Management and Budget, the U.S. Trade Representative, the Office of National Security Affairs, the Office of Economic Policy, the Council of Economic Advisers, and the Office of Science and Technology Policy. [89]

Reviews of foreign investment transactions are not mandatory. They may be initiated either by a member of the Committee or voluntarily by parties to the transaction.[90] Parties to a transaction are not required to file with CFIUS at any particular time, i.e., before or after the transactions closes. However, as noted above, the President retains his authority to block a transaction until such time that the review is completed and no action is taken.[91]

Under the applicable regulations, a voluntary notice must describe, among other things, the nature of the transaction, the assets of the U.S. person being acquired, the business activities of the parties, information concerning contracts relating to products and services relevant to U.S. defense needs, and the foreign person's plans with respect to the U.S. person.[92] All information provided is treated confidentially and is not made public except in the case of an administrative action or judicial proceeding.[93]

CFIUS has 30 days to conduct a preliminary review. At the end of that period, it must decide whether to terminate the proceedings or initiate an in-depth investigation.[94] If an investigation is initiated, it must be completed within 45 days.[95] A report on the investigation must be submitted to the

President, who decides whether to exercise his authority to block or unwind a transaction within 15 days of the completion of the investigation.[96] The President's determination of a threat to national security is not subject to judicial review.[97] Importantly, once a transaction is cleared, the President cannot later seek to exercise his blocking or divestment authority.[98]

As a practical matter, the Exon-Florio process ties closely to the FOCI mitigation process under the NISPOM. Therefore, to avoid the investigational stage of the Exon-Florio process, you should take steps to develop and propose a FOCI mitigation plan that is acceptable to the cognizant security agency. Because of the short timeframes for the review, it is prudent to have the FOCI mitigation plan in place at the time the voluntary notice is submitted under the Exon-Florio regulations. In some cases, parties to a transaction have chosen to withdraw their voluntary notice under Exon-Florio and adjust the terms of the deal if CFIUS or the cognizant security agency raises any national security concerns.

The President has reportedly only exercised his divestiture authority once since the Exon-Florio Amendment passed in 1988. In that case, the China National Aero-Technology Import and Export Corporation (CATIC) acquired MAMCO Manufacturing, Inc., a Seattle, Washington company that fabricated metal parts for aircraft. The transaction closed before the completion of the Exon-Florio proceeding. At the conclusion of the proceeding, the President concluded that CATIC might take action that threatened the national security and ordered CATIC to divest its interest in MAMCO.[99] In most other cases, CFIUS or the President has found no national security threat or, as described above, the threat has been eliminated by action taken by the parties to the transaction.

As noted above, there is no legal requirement that a foreign company notify CFIUS of any planned acquisition. The risk in not filing, however, is that a foreign investor will remain vulnerable to a review of the transaction indefinitely.[100]

Neither the statute nor the regulations define the term "national security" and in fact, both are purposefully ambiguous so as not to curtail the President's broad decisionmaking authority.[101] The preamble to the regulations notes that Congress intended the term to be interpreted "broadly and without limitation to a particular industry."[102] Because of this lack of limitation, the focus of Exon-Florio proceedings has gravitated to include industries and issues that were not specifically contemplated when the statute was enacted. For example, in the early 1990s, acquisitions in the telecommunications sector cleared the Exon-Florio process without the imposition of any special requirements. However, just a few years later, the Exon-Florio proceedings relating to such acquisitions placed emphasis on law enforcement issues as well as traditional national defense issues. As a result, some transactions in the communications sector have only received Exon-Florio clearance after the parties have entered into formal agreements that addressed issues such as the continued ability of law enforcement agencies to conduct lawful electronic surveillance.

GUIDELINES

These *Guidelines* are intended to assist you in understanding and addressing the special issues that arise when mergers and acquisitions involve Government contractors. They are not, however, a substitute for professional representation in any particular situation.

1. Remember that the Anti-Assignment Act will not bar the transfer of a Government contract from the original awardee to another party as long as the Government consents to the transfer, either implicitly by ratification or waiver or explicitly through a novation agreement, or where the contract transfers occur "by operation of law."

2. Be aware that application of the "by operation of law" exception to the Anti-Assignment Act, which generally exempts assignments of contracts to statutory receivers and assignees in bankruptcy, as well as transfers that result from mergers, depends on whether the Government continues to deal with the party with which it first contracted (i.e., the same employees, management, and other resources) and whether the only change is a change in ownership of the company's stock.

3. Bear in mind that obtaining the Government's explicit consent through a novation agreement remains the surest way of protecting your contract rights if the transaction does not come within one of the established exceptions. To request a novation agreement in which the Government recognizes the successor in interest to Government contracts, notify the Administrative CO administering the largest unsettled contract balance about the pending acquisition and provide that ACO with all of the documentation specified in the FAR.

4. To avoid any confusion regarding the identity of the offeror being evaluated, notify the Procuring CO of the transfer of any pending bid or proposal to another legal entity due to a merger or acquisition.

5. Even when no novation is required in a stock purchase or merger transaction, if the name of the Government contractor entity is expected to change, notify the ACO administering the largest unsettled contract balance about the pending transaction and name change and submit a complete "Change-of-Name Agreement" package. Early consultation with the ACO will allow you to explain to the ACO why a novation agreement is not required.

6. Make certain that your due diligence review of a proposed merger or acquisition includes careful consideration of any potential organizational conflicts of interests that could disqualify the resulting entity from certain types of Government business. Consider and suggest to the CO strategies for avoiding or mitigating OCI concerns, ranging from erecting firewalls to separate conflicted sectors of a merged entity to having the acquirer divest the portion of the acquisition target's business that creates the OCI concerns.

7. Keep in mind that an SBA 8(a) program contract must be terminated by the CO for the convenience of the Government if the 8(a) concern to which it was awarded transfers ownership or control of the firm to a non-8(a) entity, unless the Administrator of the SBA waives the termination requirement. An 8(a) contractor may appeal the denial of a waiver to the SBA Office of Hearings and Appeals.

8. Recognize that a U.S. contractor's ability to retain its security clearance may be adversely affected if all or a portion of the contractor's ownership is acquired by a foreign entity and the contactor is considered to be under foreign ownership, control, and influence.

9. To maintain a valid security clearance, the foreign company must take steps to mitigate FOCI concerns. The possible mitigation steps depend on the amount of control the foreign entity will have over the U.S. company. If the foreign entity will not own sufficient voting stock to elect board members and is not otherwise entitled to board representation, a simple resolution by the U.S. company's board will generally prove adequate to resolve the FOCI concern. When the foreign entity has greater control, other options include establishing a Voting Trust or Proxy Agreement whereby the foreign owner relinquishes day-to-day control of the cleared U.S. entity or implementing a Special Security Agreement or Security Control Agreement that preserves the foreign person's right to board representation and a say in company management, yet protects against unauthorized access to classified information.

10. Be aware that a proposed foreign investment in a U.S. company may trigger a review of the transaction by the Committee on Foreign Investment in the United States and potentially its blockage by the President under the Exon-Florio process. Consider filing a voluntary notice under Exon-Florio with a proposed mitigation plan and be prepared to adjust the terms of the deal if CFIUS or the cognizant security agency raises any national security concerns.

★ REFERENCES ★

1/ McCarthy, "Post-9/11 Mergers Brought Problems," Wash. Post., Aug. 23, 2004, at E1, available at 2004 WL 82778025.

2/ Stack, "Update: Government Services M&A," Aerospace, Defense, Government Strategic Overview 6 (Houlihan Lokey Howard & Zukin, 2d Quarter 2004).

3/ 31 U.S.C. § 3727(b).

4/ 41 U.S.C. § 15.

5/ See White, "To Dance With the One You Came With: Federal Government Regulation of Assignments of Contractual Performance," 29 Pub. Cont. L.J. 601, 603 n.11, 620 n.126. (Summer 2000).

6/ See id. at 607.

7/ See Johnson Controls World Servs., Inc. v. United States, 44 Fed. Cl. 334, 343 (1999); see also Keydata Corp. v. United States, 504 F.2d 1115 (Ct. Cl. 1974), 16 GC ¶ 450.

8/ 41 U.S.C. § 15.

9/ 41 U.S.C. § 15(a).

10/ See Johnson Controls, 44 Fed. Cl. at 342; Keydata Corp., 504 F.2d 1115 (tracing history of Anti-Assignment Act and discussing development of "operation of law" exception); see also Thompson v. Comm'r, 205 F.2d 73 (3d Cir. 1953) (extending to 41 U.S.C. § 15 an "operation of law" exception that previously had only been applied to the interpretation of 31 U.S.C. § 3727).

11/ Monchamp Corp. v. United States, 19 Cl. Ct. 797, 801 (1990); American Nat'l Bank & Trust Co. v. United States, 23 Cl. Ct. 542, 546 (1991); Johnson Controls, 44 Fed. Cl. at 345.

12/ Tuftco Corp. v. United States, 222 Ct. Cl. 277, 287 (1980), 22 GC ¶ 113.

13/ See Seaboard Air Line Ry. v. United States, 256 U.S. 655, 657 (1921) (holding that mergers fall within the 31 U.S.C. § 3727 "operation of law" exception).

14/ See Johnson Controls, 44 Fed. Cl. at 344; United Int'l Investigative Servs. v. United States, 26 Cl. Ct. 892 (1992); Omega Envtl. Inc., SBCA No. 51639, 99-1 BCA ¶ 30,253, 41 GC ¶ 174; Pettibone Corp., ASBCA No. 41073, 91-2 BCA ¶ 23,952; Isotopes, Inc., ASBCA 15663 et al., 74-1 BCA ¶ 10,371 (recognizing the right of a successor contractor in a merger to bring a claim under the Contract Disputes Act).

15/ American Nat'l Bank, 23 Cl. Ct. at 546.

16/ United Int'l, 26 Cl. Ct. at 898; See also Rodgers Constr., Inc., IBCA No. 2777, 92-1 BCA ¶ 24,503 (the "by operation of law" exception dispenses with any legal necessity for the Government to consent by novation or otherwise); Mancon Liquidating Corp./Intercontinental Mfg. Co., Inc., ASBCA No. 18218 et al., 74-1 BCA ¶ 10,470, at 49,513.

17/ FAR 42.1204(b).

18/ Westinghouse Elec. Co. v. United States, 56 Fed.Cl. 564, 569 (Ct. Cl. 2003), 45 GC ¶ 251.

19/ Id. at 570.

20/ Omega Envtl. Inc., ASBCA No. 51639, 99-1 BCA ¶ 30,253, 41 GC ¶ 174.

21/ Riviera Fin. of Texas, Inc. v. United States, 58 Fed.Cl. 528, 530 (2003), 45 GC ¶ 498.

22/ FAR 42.1204(a).

23/ See FAR 42.1204.

24/ See FAR 42.1202, 42.1203.

25/ FAR 42.1204(e).

26/ FAR 42.1204(e).

27/ FAR 42.1204(f).

28/ FAR 42.1204(g).

29/ See Pub. L. No. 108-271, § 8, 118 Stat. 811 (July 7, 2004).

30/ See McNeil Tech., Inc., Comp. Gen. Dec. B-254909, 94-1 CPD ¶ 40; see also J.I. Case Co., Comp. Gen. Dec. B-239178, 90-2 CPD ¶ 108, 32 GC ¶ 303 (agency properly awarded contract to successor in interest where the original bidder, a wholly-owned subsidiary of the parent-successor, merged with the parent company after bid opening).

31/ Sunrise Int'l Group, Comp. Gen. Dec. B-266357, 96-1 CPD ¶ 64 ; J.I. Case Co., Comp. Gen. Dec. B-239178, 90-2 CPD ¶108, 32 GC ¶ 303.

32/ Consortium HSG Technischer Serv. GmbH, Comp. Gen. Dec. B-292699.6, 2004 CPD ¶ 134; see also Lyons Sec. Servs. v. United States, 38 Fed. Cl. 783, 787 (1997), 38 GC ¶ 530. See generally Victorino, Shirk & Kennedy, "Acquisitions & Mergers," Briefing Papers No. 85-9, at 5 (Sept. 1985), 7 BPC 159.

33/ FAR subpt. 9.1.

34/ See Ionics Inc., Comp. Gen. Dec. B-211180, 84-1 CPD ¶ 290 (indicating that the interests of the Government dictate that the contracting agency be notified of a transfer of an offer).

35/ FAR 42.1205.

36/ FAR 42.1205(a).

37/ See FAR 42.1202, 42.1203.

38/ Emery, "General Dynamics Completes Veridian Acquisition," Wash. Tech., Aug. 11, 2003, available at http://www.washingtontechnology.com/news/1_1/daily_news/21400-1.html.

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40/ FAR 9.502(c). See generally Goddard, "Business Ethics in Government Contracting—Part I," Briefing Papers No. 03-6 (May 2003); Madden, Pavlick & Worrall, "Organizational Conflicts of Interest/Edition III," Briefing Papers No. 94-8 (July 1994).

41/ FAR 9.504(a)(2).

42/ FAR 9.505.

43/ FAR 9.505-1(a).

44/ FAR 9.505-2(a)(1).

45/ FAR 9.508(a)–(i).

46/ See Calspan Corp., Comp. Gen. Dec. B-258441, 95-1 CPD ¶ 28 (indicating that when evaluating elements of a mitigation plan the "appropriate inquiry concerns the current situation…not speculation regarding past teaming agreement and rumored mergers"). See generally Victorino, Church, Sullivan & Miller, "Antitrust Implications of Defense Industry Business Combinations," Briefing Papers No. 93-7 (June 1993).

47/ See generally Tolle, "Small Business Contracting—Part I," Briefing Papers No. 99-11 (Oct. 1999);Tolle, "Small Business Contracting—Part II," Briefing Papers No. 99-12 (Nov. 1999).

48/ FAR 19.001; see 13 C.F.R. pt. 121.

49/ 13 C.F.R. § 121.404.

50/ See Empire Home Med., Inc., SBA No. 4291, 1998 WL 79209 (Feb. 18, 1998) (firm was properly considered a small business where the firm self-certified itself as small on September 24th, but signed merger agreement on October 2d); Service Eng'g Co., Comp. Gen. Dec. B-235958, 89-2 CPD ¶ 71 (indicating that the SBA determined firm to be a small business despite its subsequent merger with a large business because its size status as of the date of the self-certification was controlling).

51/ Vantex Serv. Corp., Comp. Gen. Dec. B-251102, 93 1 CPD ¶ 221, 35 GC ¶ 273.

52/ See 15 U.S.C. § 637(a); 13 C.F.R. pt 124; FAR subpt. 19.8.

53/ See 13 C.F.R. § 124.515(a); FAR 19.812(d).

54/ See 13 C.F.R. § 121.103; see also 13 C.F.R. §§ 124.104, 124.105.

55/ 15 U.S.C. § 637(a)(21)(A); 13 C.F.R. § 124.515(a)(1); FAR 19.812(d).

56/ 15 U.S.C. § 637(a)(21)(D); 13 C.F.R. § 124.515(g).

57/ FAR 52.219-12 (standard 8(a) contract clause requiring 8(a) contractor to notify contracting agency of transfer of ownership or control); FAR 52.219-11 (clause requiring SBA to notify contracting agency).

58/ 15 U.S.C. § 637(a)(21)(A); 13 C.F.R. § 124.515(a)(1); FAR 19.812(d).

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65/ 13 C.F.R. § 124.515(i).

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67/ See NISPOM, DOD 5220.22-M, available at http://www.dss.mil/isec/nispom.pdf. See generally Burgett & Sturm, "Foreign Nationals in U.S. Technology Programs: Complying With Immigration, Export Control, Industrial Security & Other Requirements," Briefing Papers No. 00-3 (Feb. 2000).

68/ Exec. Order No. 12,829 (Jan. 6, 1993), 58 Fed. Reg. 3479 (Jan. 8, 1993); see FAR subpt. 9.4.

69/ NISPOM, DOD 5220.22-M, available at http://www.dss.mil/isec/nispom.pdf; see also Industrial Security Regulation, DOD 5220.22-R.

70/ NISPOM § 2-108.

71/ NISPOM § 2-102(b).

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73/ NISPOM § 1-302(h).

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85/ NISPOM § 2.309.

86/ NISPOM § 2-306(d).

87/ 50 U.S.C. app. § 2170(d).

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89/ Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (1975); Exec. Order No. 12,661, 54 Fed. Reg. 779 (1988); Exec. Order No. 12,860, 58 Fed. Reg. 47,201 (1993).

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99/ See Mendenhall, "United States: Executive Authority To Divest Acquisitions Under the Exon-Florio Amendment—the MAMCO Divestiture," 32 Harv. Int'l L.J. 286 (Winter 1991).

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101/ Preamble to Regulations on Mergers, Acquisitions, and Takeovers By Foreign Persons (Nov. 21, 1991), 31 C.F.R. pt. 800, app. A.

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