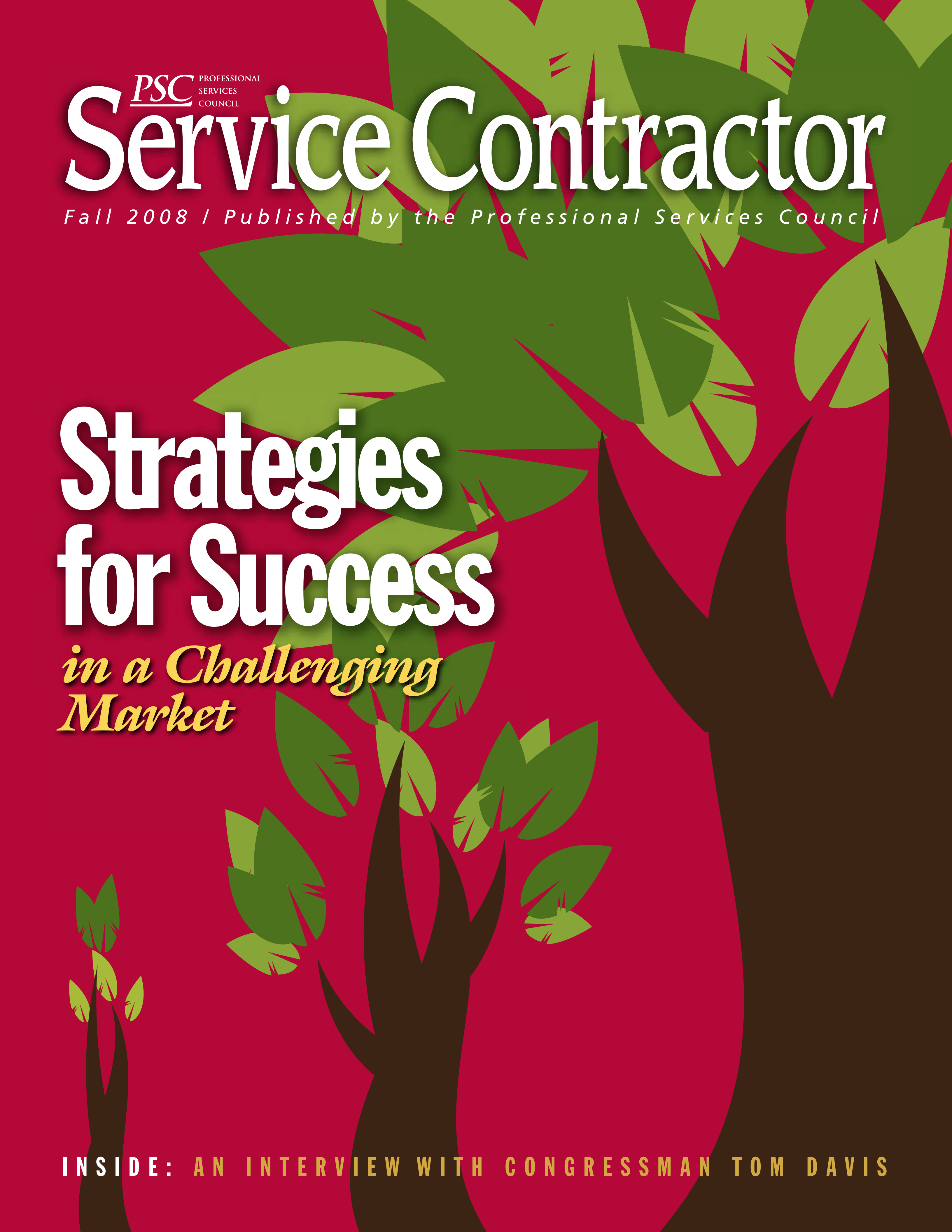

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Strategies for Success

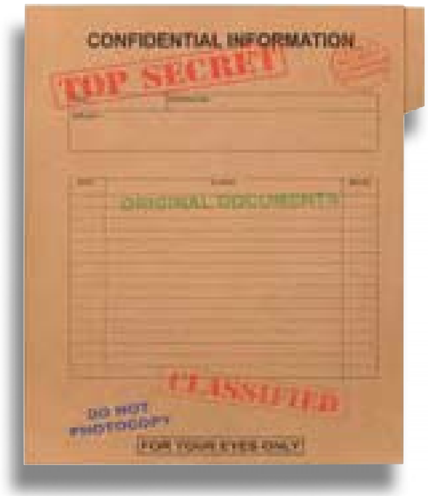
in a Challenging Market

INSIDE: AN INTERVIEW WITH CONGRESSMAN TOM DAVIS

Secrets to Investing in Companies that Perform Classified Work

By Agnes P. Dover and Edward C. Eich, Hogan and Hartson LLP

Over the last eighteen months, U.S. government contractors have become attractive targets for international investors seeking to diversify their holdings and exploit the historically low exchange rate. The statistics speak for themselves: total merger and acquisition ("M&A") activity in the aerospace and defense market increased by 5.5 percent between 2006 and 2007, while the level of foreign investment in the U.S. sector rose by 460 percent.[1] European and Middle Eastern firms invested $8.4 billion in U.S. companies during 2007, a sharp increase over their $1.5 billion the prior year.[2] Many financial analysts predict the level of foreign corporate investment in the U.S. market will continue to grow through mid-2009.[3] At the same time, government services industries have also become an attractive target for private equity funds, which are responsible for an increasing number of transactions in this space, and which often rely on foreign capital.[4]



As foreign capital flows into the U.S. defense sector directly through foreign companies or indirectly through investment funds, the federal government's requirements on foreign ownership, control, and influence ("FOCI") have taken on new significance. Only U.S. entities are eligible to receive a facility security clearance allowing access to classified or sensitive materials.[5] If a corporate recapitalization, merger, acquisition, or other transaction causes a cleared contractor to be under FOCI, the government will invalidate the clearance and terminate the company's classified contracts unless appropriate safeguards are in place to protect the information.[6] Many investors do not realize that even as little as a 5 percent indirect foreign ownership interest requires that steps be taken to mitigate the FOCI. Thus, both foreign companies and even U.S. investment funds that rely on foreign capital should be mindful of the applicable requirements so that the target's

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ability to continue its existing classified business is not jeopardized.

Various FOCI mitigation approaches are available, depending on the level of foreign ownership or control. For example, foreign investments of less than 5 percent may be mitigated rather simply through Board of Directors resolutions, so long as the entity does not have the ability to appoint members to the cleared company's Board. However, when a foreign entity has greater than a 5 percent ownership interest or has the power—direct or indirect—to control or influence the cleared company's operations, additional mitigation steps may be required. For example, a foreign entity may be required to enter into a Special Security Agreement under which, among other things, it agrees to appoint to its Board three independent Directors who are cleared U.S. citizens and to delegate responsibility for the classified business to those Directors. In a proxy or voting trust agreement, the foreign parent must relinquish control over the company's operations to three independent proxy-holders or trustees who are cleared U.S. citizens. In both situations mandatory information technology and visitation policies are required to ensure that the foreign parent does not have access to classified information or the ability to influence the performance of the classified business.[7]

In addition to the need to mitigate FOCI, cleared companies—and their foreign parents—are subject to various reporting requirements, as well as audits by the Defense Security Service or other cognizant federal agency. The additional public scrutiny sometimes comes as a surprise to U.S. private equity funds that regularly partner with foreign entities, including banks, insurance companies, and high net worth individuals, to offset the reduction in available domestic credit. Most fund managers, who zealously guard the confidentiality of their financial information,[8] find themselves required to disclose significant information in order to demonstrate the absence of foreign control.

Specifically, companies must disclose:

(i) all foreign ownership in excess of 5 percent;

(ii) whether they own 10 percent or more of any foreign entity;

(iii) whether the key management personnel and board of directors are U.S. citizens; (iv) the ability of foreign interests to appoint personnel or influence corporate operations; (v) any foreign contracts or agreements;

(vi) indebtedness to foreign interests;

(vii) 5 percent or more revenue from a single foreign person or 30 percent of revenue from foreign sources;

(viii) whether greater than 10 percent of the corporate securities are held under a "street name;" (ix) any foreign relationships involving key management personnel and directors; and

(x) all other information illustrating foreign control.[9]

The amount of confidential information that must be disclosed to the government during a security review is one of several issues that investors need to consider when pursuing a cleared U.S. government contractor. If a private equity fund, for example, purchases a controlling interest in a company, the contractor's "Certificate Pertaining to Foreign Interests" must disclose if any of the private equity fund's investors, including foreign limited partners, have a 5 percent interest in the fund even if the ownership is through one or more U.S. subsidiaries or affiliates. Private equity funds also need to review their formation documents to determine what powers foreign investors have to influence the cleared company's operations, through approval of decision-making or otherwise. Additionally, the appointment of key management personnel and directors can also be an issue as any foreign citizens must be excluded from access to classified information.

Given these issues, the secret to successful investment in, or acquisition of, a company that does classified work is to make sure that the target's classified business and potential FOCI issues are considered early in the diligence process. When there are FOCI issues, both the buyers and the sellers should understand the business options, and risks associated with possible mitigation approaches and be prepared to undertake the time and expense of putting in place mitigation plans that will be acceptable to the government.

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[1] *See* PriceWaterhouseCoopers, *Flying High: Aerospace & Defense M&A,* 6,11-12 (2008)

[2] *Id.* at 11.

[3] *See* Merrill Corp., *Global M&A and Debt Market Outlook,* 1, 10 (Apr. 2008) (76 percent of corporate executives and financial analysts surveyed predict the number of foreign corporations conducting M&A in the U.S. market will increase over the next 12 months).

[4] Prof'l Servs. Council, *At the Crossroads: 2007 PSC Services Sector Review,* 64 (2007) (Statement by Rick Knop of BB&T Capital Markets/Winsor Group); *see also* PriceWaterhouseCoopers, *Flying High: Aerospace & Defence M&A,* 14 (2008)

[5] National Industrial Security Program Operating Manual, DoD 5220.22-M § 2-102(b) (Feb. 28, 2006) (hereinafter "NISPOM").

[6] *Id.* § 2-300(c).

[7] *Id.* § 2-303.

[8] Cassell Bryan-Low, Peter Lattman, and Gregory Zuckerman, *KKR in Fishbowl, Swims With Sharks: IPO Will Bring a Capital Splash, But Other Investment Firms Find Disclosure Draws Unwanted Scrutiny,* Wall St. J., July 29, 2008, at C1.

[9] Certificate Pertaining to Foreign Interests, Standard Form 328, https://www.dss.mil/GW/ShowBinary/DSS/isp/foci/documents/sf328.pdf (last visited July 22, 2008).