Professional Perspective

Navigating the Acquisition of Distressed Government Contractors - Part 3

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Navigating the Acquisition of Distressed Government Contractors - Part 3

Contributed by Steven S. Diamond, Michael D. McGill, and Thomas A. Pettit, Arnold & Porter

This third and final installment of the series covering acquisitions of distressed government contractors focuses on due diligence considerations specific to the bankruptcy context. It is not, and is not intended to be, a discussion of all potential risk issues and diligence considerations presented when acquiring government contractors and instead focuses on issues that have unique applications in the bankruptcy context.

Part 1 discusses protections afforded to distressed government contractors through the bankruptcy process. Part 2 the Anti-Assignment of Contracts Act's restrictions on transferring government contracts to third parties.

When crafting stock or asset purchase agreements to acquire equity in, or assets from, a distressed government contractor, buyers must assess and address the unique risks presented by the seller's circumstances. As discussed in the previous articles in this series, bankruptcy can provide significant liability protections. However, acquisitions of distressed companies or their assets carry substantial risk, particularly when the debtor intends to dissolve after the transaction. Much of this risk stems from practical limitations on the utility of representations and warranties, post-closing covenants, indemnification, post-closing escrow, and other post-closing liability protections.

It is particularly important, therefore, for buyers to conduct as thorough a diligence review as possible and attempt to flush out potential problems and liabilities through information requests and comprehensive representations and warranties. Balanced against this, however, is the fact that distressed sellers generally are selling their assets at significant discounts. Therefore, they are not motivated to respond to what they may view as burdensome diligence requests and representations. Out of court asset sales by the distressed seller may present fraudulent conveyance risk.

Distressed sellers also may face restrictions imposed by creditors and the bankruptcy court that prevent them from meaningfully contributing capital to an escrow account. However, the bankruptcy process also generally allows the seller to effect a free and clear sale, which will limit the buyer's exposure to legacy liabilities and successor liability claims. All this means that it is imperative for buyers to conduct thorough diligence, carefully structure the transaction to avoid high-risk distressed sale and contractual liabilities, and consider the availability of representations and warranties (R&W) insurance to mitigate other potential risks.

As with any acquisition of a government contractor or government contract assets, it is important to perform specialized due diligence to assess issues related to the contractual and regulatory obligations that apply to government contracts. There are additional considerations buyers should be aware of when acquiring a distressed government contractor or its assets. Such considerations will vary based on the facts and circumstances of the specific target company and transaction, including whether the seller's government contracts are prime or sub contracts, defense or civilian agency, fixed-price or flexibly priced, such as cost-type or T&M, supplies or services, and commercial or non-commercial. The following highlights some of the diligence issues that take on increased or special importance in a deal involving a distressed company or assets.

Supply Chain Risks

Prospective buyers of government contractors or their assets must consider actual or potential supply chain risks. Such issues tend to be more common for distressed companies. Diligence should consider whether the prime contractor's financial challenges have resulted in breach of important first-tier subcontracts. It is important for the diligence to assess whether the supply chain is healthy and able to deliver and perform on schedule. Prime contractors are responsible for their supply chains and can be liable to the government for a subcontractor's nonperformance. This is true even when the prime contractor was not at fault for and had no control over the subcontractor's nonperformance, if the prime contractor could have obtained supplies or services from other sources or the contracting officer directed the contractor to purchase supplies or services from alternative sources, and the contractor did not comply with that directive.

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Organizational Conflicts of Interest

Government contractors generally must avoid organizational conflicts of interest. OCIs usually do not present insurmountable obstacles to doing business with the government because they may be able to be mitigated. Furthermore, agencies have broad discretion to waive OCIs, and GAO has been reluctant to second-guess agency waivers absent procedural errors, such as when the waiver was not in writing. It is still important, however, for prospective acquirers of government contractors to assess whether the transaction would create actual or apparent OCIs that could affect either the target's business, the value of assets to be acquired, or the acquirer's existing business.

It is important to identify OCI issues in diligence involving a distressed company, as there can be a tension between OCI principles and a debtor's obligation in bankruptcy to select the highest and best offer in Section 363 asset sales and to act in the best interest of creditors when developing a reorganization plan. For example, a plan might not be in the best interest of creditors if the reorganization would jeopardize existing OCI mitigation plans, such as when the plans already approved by the government, or raise new OCI concerns. These are issues the parties and the court will need to navigate as the bankruptcy proceeds, but they cannot be addressed, unless they are identified through diligence.

Property Considerations

Government contracts may require access to and use of government property. In addition, the government often holds rights to property that a contractor acquires or develops during contract performance, including intellectual property. While the allocation of rights and obligations with respect to property are important in any transaction, there are unique considerations in bankruptcy cases. The government's property interests can, for example, impact the automatic stay, as discussed in Part 1. Additionally, the government may hold prescribed rights to use technical data based on FAR and agency data-rights clauses included the seller's government contracts. In such instances, the government is essentially a licensee—it does not have title to the data, but it has certain rights to use the data. Accordingly, the government's rights in the bankruptcy context should be similar to those of commercial licensees, and the government should be able to benefit from the protections reflected in 11 U.S.C § 365(n), which allow licensees to retain its rights under a license agreement even where the debtor rejects the license.

National Security Concerns

For contractors performing classified contracts, issues regarding foreign ownership, control, or influence (FOCI) must be addressed to ensure that the contractor can continue to perform. Furthermore, transfer of facility security clearances (FCLs), export controls registrations and licenses, and requirements must be submitted for review and approval by the Committee on Foreign Investment in the United States (CFIUS). FOCI determinations and associated mitigation requirements are different in some respects for each requirement, but each assessment is aimed at evaluating and limiting the ability of foreign interests to access classified or controlled information and to control, direct, or decide, either directly or indirectly, issues related to a company's management and operations.

Although FOCI requirements apply equally to transactions involving solvent and insolvent companies, FOCI can inject challenges into bankruptcy proceedings. For instance, there may be tensions between FOCI review and mitigation and the best interests of creditors test that applies to Chapter 11 reorganizations or the requirement that a debtor accept the highest and best offer in Section 363 asset sales. If a transaction could be unwound, or if the sale price could be reduced due to national security concerns, an offer that may be the highest-priced could nevertheless prove not to be in the best interests of creditors or the best offer.

FCLs and Defense Counterintelligence and Security Agency Review

For facility security clearances, FOCI issues are addressed based on the guidance in the National Industrial Security Program Operating Manual (NISPOM). For defense agencies, determinations are made by the Defense Counterintelligence and Security Agency (DCSA), formerly the Defense Security Service (DSS). When DCSA assesses FOCI risks, it considers a variety of factors relevant to risks of disclosing classified information, including:

- Risk of espionage against the U.S.
- Risk of unauthorized transfers of technology
- The nature and level of classification of the information being accessed

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- The nature and extent of foreign ownership

If based on these factors, DCSA determines that a company is under FOCI, the company is ineligible to a hold a FCL, unless and until the company, with DCSA's approval, implements measures to mitigate FOCI. Mitigation steps can include exclusions of ultimate and intermediate parents typical in private equity structures, and various types of corporate agreements, including board resolutions, special security agreements, and agreements governing shareholder voting rights and procedures.

Export Control FOCI Restrictions

FOCI also presents obstacles where the company holds export-controlled information, though the definitions of what constitutes FOCI is different from those in the security clearance context. Any company that manufactures, exports, imports, or brokers defense articles must register with the Statement Department Directorate of Defense Trade Controls. DDTC-registered companies are required to notify The DDTC "by registered mail at least 60 days in advance of any intended sale or transfer to a foreign person of ownership or control of the registrant or any entity thereof." 22 C.F.R. § 122.4(b). The parties must also notify the DDTC that the transaction has closed within five days of the closing and begin the registration and license and agreement transfer process.

The International Traffic in Arms Regulations (ITAR) establishes significantly higher thresholds for foreign ownership and control than that applicable in the classified contracts security context. For export control purposes, a company is deemed to be under foreign ownership if "one or more foreign persons" own "more than 50 percent of the outstanding voting securities of the firm." 22 C.F.R. § 120.37. A company is presumed to be under foreign control "where foreign persons own 25 percent or more of the outstanding voting securities, unless one U.S. person controls an equal or larger percentage." The DDTC has authority to reject registration requests and requests to transfer licenses and agreements or require FOCI mitigation.

CFIUS Review

Transactions involving foreign persons can also trigger CFIUS review. CFIUS is a U.S. government interagency committee that reviews transactions involving foreign investment in U.S. businesses that raise national security concerns, including some non-control transactions. By definition, a foreign interest must hold at least 10% equity in a company—regardless of the dollar value of the interest—or, if less than 10%, have representation on the board or some other direct or indirect right to direct the company's operations.

In August 2018, Congress expanded CFIUS's jurisdiction by enacting the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA). This statute expanded CFIUS's authority to include reviewing non-controlling foreign investments in U.S. businesses involving critical infrastructure or technologies or sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security¸ such as with high volumes of data, or data relating to military personnel.

Historically, CFIUS has reviewed bankruptcy transactions. However, to avoid doubt, FIRRMA expressly extended CFIUS's jurisdiction to bankruptcy transactions. It also provided CFIUS with statutory authority to review real estate transactions involving any purchase or lease by a foreign person of any real estate that is part of an air or maritime port or is in close proximity to a U.S. military installation or another facility of the U.S. government that is sensitive for reasons relating to national security.

Conclusion

This three-part series addressed the unique opportunities and challenges facing distressed government contractors and their potential acquirers. The bankruptcy process raises issues intersecting both bankruptcy and federal procurement law requirements, where different statutory and regulatory regimes may conflict or least require careful planning, diligence, and documentation to ensure a favorable outcome for the parties.

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