

DII Best Practices Forum Panel - Due Diligence Panel

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PURPOSE OF DUE DILIGENCE

- Valuation
- Prepare for Integration
- Government and third party approvals
- Key business relationships
- Prevent unpleasant surprises
- Allocation of risk
- Identify risks to the business

PROCESS

- Start of Process: letter of intent or other indication of interest
- Degree of access may vary
- Offering memorandum and management presentations provide context and clues

TOOLS AND TECHNIQUES

- Management presentation materials
- Question outlines
- Data rooms
- Question logs
- Integration team coordination
- Report outs to management
 - Insights for the negotiating team
 - Foundation for integration

COMPLIANCE BEGINS WITH DISCIPLINED DUE DILIGENCE PROCESS

- Nondisclosure agreement administration
 - Can be automated in Microsoft Outlook®
 - Voting button
 - Signify and document acknowledgement
 - Speeds the process and facilitates record keeping
 - Facilitate response to insider trading inquiries from regulators
 - Distribution memo can remind employees of
 - Insider trading prohibitions
 - Export control warnings
 - Limitation on contacts with target company employees

COMPLIANCE BEGINS WITH DISCIPLINED DUE DILIGENCE PROCESS

- Sub-teams of an acquirer can be used to review competitively sensitive information
 - Protect freedom of action of the acquiring company
 - To review information that is competitive at the time of the due diligence review (example: target on a competing team)
 - As part of OCI mitigation plan (more on this later)

ISSUES TO CONSIDER – CLAIMS, REVIEWS

- Information concerning actual or potential customer, supplier, government claims
- Notices concerning defaults and potential terminations for convenience or default
- Information concerning subpoenas or government investigations
- Documentation relating to system reviews by DCMA (government property, time keeping, billing, pricing)

ISSUES TO CONSIDER – AUDIT REPORTS

- Audit Reports
 - Incurred cost audits
 - Defective pricing audits
 - Cost Accounting Standards Audits
 - Audits of termination, constructive changes, delay and disruption claims (which are based on representations about cost impact)

ISSUES TO CONSIDER – TARGET POLICIES

- Target's government contracting compliance policies and procedures
 - Government billing and time charging
 - Export controls and FCPA
 - Anti-kickbacks
 - Revolving door
 - Conflicts of interest
 - Anti-trust
 - Mandatory disclosure
 - Federal Awardee Performance and Integrity Information System

ISSUES TO CONSIDER - CLASSIFIED WORK

- Documentation concerning nature and extent of classified work performed by the target
 - Number and level of personnel security clearances
 - Number of cleared facilities
 - Procedures for handling of classified information

ISSUES TO CONSIDER – COST ISSUES

- Cost issues
 - Cost rules apply to
 - cost-reimbursement contracts
 - fixed price contracts awarded non-competitively
 - contracts containing price redetermination provisions
 - contracts providing for progress payments based on cost
 - contract modifications using cost analysis
 - Due diligence team should review procedures for preparation of certified rates to make sure unallowable costs are excluded

ISSUES TO CONSIDER - TINA

- Truth in Negotiations Act
 - TINA requires submission of “current, accurate and complete” cost or pricing data for contracts (and contract modifications) in excess of \$650,000
 - Commercial items and competitive procurements excepted
 - Potential sanctions:
 - Reduction in the contract price
 - Liability under Civil and Criminal False Claims Act for knowing submission of inaccurate information
 - Potential liability under government subcontracts affected by “defective pricing”
 - Suspension and debarment

ISSUES TO CONSIDER - TINA

- Truth in Negotiations Act
 - Defective Pricing and False Claims Act cases
 - can arise long after an acquisition is complete
 - are difficult and expensive to defend
 - Practices for TINA compliance, including record keeping
 - Impact of the transaction itself on contracts in price negotiations
 - When decision is made to proceed
 - Usually at time of signing and public announcement of transaction

ISSUES TO CONSIDER – GSA SCHEDULE

- GSA schedule contracts
 - Appear to be “commercial” contracts but contain pricing and discount obligations that can create potential liability
 - “most favored customer” pricing
 - TINA-like disclosure requirements
 - Contain a price adjustment clause
 - Potential civil False Claims Act liability
 - Up to treble damages
 - Penalties of \$5,500 per claim
 - Other fraud statutes
 - Suspension and debarment

ISSUES TO CONSIDER – GSA SCHEDULE

- GSA schedule contracts
 - Due diligence must evaluate target's
 - Pricing and discount policies
 - Procedures for contract pricing
 - Training for personnel involved in award and administration

ISSUES TO CONSIDER – PROCUREMENT INTEGRITY

- Procurement Integrity Act
 - Prohibits government officials from disclosing ...
 - Prohibits contractors from *knowingly* obtaining ...
... bid or proposal information or source selection information before award of the relevant government contract
 - Potential sanctions
 - Criminal and civil penalties
 - Disqualification from bidding
 - Rescission of awarded contract
 - Recoupment of payments
 - Suspension and debarment
 - Review policies and procedures
 - Have claims of violations been made or threatened?

ISSUES TO CONSIDER – PROCUREMENT INTEGRITY

- Revolving door restrictions
 - Evaluate the target's procedures to identifying revolving door issues that could be presented by hiring of new employees and engagement of consultants

ISSUES TO CONSIDER - OCI

- Organizational Conflicts of Interest
 - Fair procurement process adversely affected by contractor's performance under related contracts.
 - Can arise from
 - Advisory or assistance services in connection with government programs
 - Source selection work
 - System development and design

ISSUES TO CONSIDER - OCI

- Proposed DoD OCI rules issued April 22, 2010
 - Will apply to all new DoD acquisitions
 - Issued pursuant to Weapons Systems Acquisition Reform Act of 2009 (“WSARA”)
- Problems Addressed:
 - acquisitions of systems engineering and advisory firms by major primes
 - Different business units of the same firm may be providing advisory services and products in the same area
 - Potential for bias and impaired objectivity
 - Unfair access to information not available to other contractors
- Rules will prohibit systems engineering (SETA) contractors from being primes or major subs in development of a weapon system

ISSUES TO CONSIDER - OCI

- Under proposed rules CO must
 - Consider potential OCI when
 - Preparing solicitations
 - Evaluating offers
 - Take into account the whole “contractor organization”
 - Take into account proposed subcontractors
 - Award contract “only if all organizational conflicts of interest are resolved”

ISSUES TO CONSIDER - OCI

- Under proposed rules contractor must:
 - Inform CO of OCI before preparing offer
 - Disclose relevant information about OCIs or represent to best of knowledge that there will be none
 - Describe work in past five years that is associated with the offer
 - Inform contracting officer of OCIs that arise during performance

ISSUES TO CONSIDER - OCI

- Potential penalties for noncompliance with OCI disclosure requirements:
 - Disqualification
 - Termination for default
 - Liability for false statements
 - Liability for false claims
 - Mandatory disclosure
 - Adverse contractor performance history

ISSUES TO CONSIDER - OCI

- M&A Implications:
 - Acquirer inherits the work history of the acquired business
 - Could target's activities jeopardize acquirer's ability to obtain new DoD business?
 - Could target's activities require disclosure contracting officer during course of performance and updates to mitigation plans (e.g., firewall arrangements)

ISSUES TO CONSIDER - OCI

- M&A Implications
 - Target Due Diligence
 - Analyze target's OCI mitigation plans
 - Identify potential OCIs
 - Assess mitigation measures
 - Quantify financial impact

ISSUES TO CONSIDER - OCI

- M&A Implications
 - M&A Process Implications
 - Limit access to sensitive information
 - Non-disclosure agreements (not always enough)
 - Limit personnel assignments
 - Segregate employees and functions
 - Make sure acquisition support personnel are structurally excluded from knowledge of and involvement in potential acquisitions
 - Training and awareness
 - Work with contracting officer to disclose and mitigate potential OCIs arising during M&A activity

ISSUES TO CONSIDER – SMALL BUSINESS

- Small business issues
 - When small business is acquired by a large business
 - Government agencies and prime contractors will no longer receive credit for contracts awarded to the small business
 - Impact on continuation of prime-subcontract relationships needs to be assessed
 - The Small Business Rules at 13 CFR Parts 121 and 124 require each contracting agency to be notified of change in small business status within 30 days of the acquisition becoming final
 - Applies to non-novation transactions – mergers, stock purchases.
 - Should be added as a specific item to the Integration Plan.

ISSUES TO CONSIDER – GUN JUMPING

- Antitrust
 - Gun-jumping: coordination of pricing, marketing, production prior to closing
 - Punishable by
 - Fine of up to \$16,000 a day under the Hart-Scott-Rodino Act
 - Potential civil and criminal liability under the Sherman Act as a restraint of trade
 - Review agreements to assure that no post-signing, pre-closing restrictions on pricing, marketing, production are included
 - Counsel clients as to what types of pre-closing integration activities are permitted

ISSUES TO CONSIDER - NOVATION

- Government Contract Novation
 - The signature element of acquisition of a government contract business
 - Anti-Assignment Act prohibits transfer of a Government Contract, but the Government may recognize an assignment resulting from transfer of all of a contractor's assets or all of those involved in performing the contract in question if in the government's interest to do so.
 - Key elements of novation agreement:
 - Transferee assumes the transferor's obligations
 - Transferor waives rights against government
 - Transferor guarantees transferee's performance
 - Compliance with Federal law not excused

ISSUES TO CONSIDER - NOVATION

- Government Contract Novation
 - Extensive documentation requirements for novations prescribed in the regulations
 - Novations pursued on a customer-by-customer basis
 - Time-consuming process
 - Need for transition arrangements pending completion of the novation because payments are made to the target in the interim

ESSENTIAL REFERENCE

- Recommended Essential Reference:
 - Best Practices in the Acquisition of a Government Contractor, 2010, ABA Section of Public Contract Law

SUPPLEMENTARY MATERIAL

ISSUES TO CONSIDER - OCI

– M&A Horror Story: McCarthy/Hunt

- US Army Corps of engineers hired Company “SETA” to prepare solicitation and evaluate proposals for design and construction of a base hospital;
- SETA’s parent company, “Acquirer/SETA Parent” entered into negotiations for purchase of design firm, “Target/Team Sub”;
- Corps issued solicitation
- Executive of Acquirer/SETA Parent knew that Target/Team Sub was a member of a team pursuing the design/construction contract and failed to disclose to the CO
- Contract was awarded to Target/Team Sub’s Prime
- Merger of Acquirer/SETA Parent and Target/Team Sub announced

ISSUES TO CONSIDER - OCI

– M&A Horror Story: McCarthy/Hunt

- Losing Bidder (McCarthy/Hunt) filed GAO Protest, alleging unequal access to non-public information, biased ground rules, motive to influence the procurement because of undisclosed pending acquisition
- Target/Team Sub's Prime disqualified because of potential OCI during course of negotiations
- Existence of nondisclosure agreement between Acquirer/SETA Parent and Target/Team Sub held not to have mitigated OCI *because no effective mitigation plan had been proposed or developed during the course of the solicitation and evaluation assistance by SETA*
- Even in absence of specific evidence of manipulation of the procurement, ability and incentive to affect it were held sufficient to create and OCI and invalidate the award.
- The record must affirmatively demonstrate lack of prejudice

ISSUES TO CONSIDER – PRESENT RESPONSIBILITY

- Assessment of Present Responsibility
 - Evaluation of target's compliance program should include
 - Policies
 - Training
 - Personnel
 - Audit
 - Internal reporting and disclosure procedures
 - Role of external auditors

ISSUES TO CONSIDER -FAPIIS

- Federal Awardee Performance and Integrity Information System
 - Beginning April 22, 2010, contracting officers are required to consult a new government data base as part of determination of present responsibility
 - Acquisition best practice was formerly to consult the Excluded Parties List System (“EPLS”) maintained by the General Services Administration, with results posted online at www.epls.gov
 - Under the new rules, contracting officers are required to review both contractor integrity and quality of past performance, which will be contained in the centralized FAPIIS repository including EPLS and Past Performance Information Retrieval System (“PPIRS”) data.

ISSUES TO CONSIDER - FAPIIS

- Federal Awardee Performance and Integrity Information System
 - Data base will also contain
 - Past contracting officer nonresponsibility determinations
 - Defective pricing determinations
 - Suspension and debarment agreements

ISSUES TO CONSIDER - FAPIIS

- Federal Awardee Performance and Integrity Information System
 - NEW ELEMENT: Expanded contractor self-reporting (FAR 52.209)
 - For solicitations expected to exceed \$500,000 if contractor has \$10 million in current contracts, contractor must certify to accuracy of FAPIIS information concerning the following matters, going back five years:
 - Criminal convictions
 - Civil determinations of fault resulting in payment of fines, penalties or restitution of \$5,000 or more
 - Administrative determined of fault resulting in payment of fines and penalties of \$5,000 or more or damage of more than \$100,000
 - Settlements in criminal, civil, administrative proceedings where acknowledged fault could have led to one of the above reports

ISSUES TO CONSIDER - FAPIIS

- Federal Awardee Performance and Integrity Information System
 - Impact:
 - Chilling effect
 - Confusion concerning scope of reporting
 - Due diligence implications:
 - Review target's process for managing FAPIIS reporting
 - Targeted due diligence questions tracking FAPIIS reporting requirements
 - Bolsters credibility of/necessity for longer survival requests for representations concerning Government contract compliance