Published on *The National Law Review* https://natlawreview.com

What You Need to Know About Mergers and Acquisitions Involving Government Contractors and Their Suppliers

Article By:

John W. Chierichella

Keith R. Szeliga

Volume 1 – The Structure of the Deal and Government Consent

With today's posting, we begin a ten-part series on unique issues that arise in connection with the acquisition or disposition of a company that performs government contracts or subcontracts. These issues obviously come into play when the target company fits the bill as an established "government contractor," replete with all of the infrastructure, systems, and processes that one normally associates with that term. They also come into play, however, in connection with companies that sell standard commercial items to the Government under the auspices of the General Services Administration's schedule contracts and companies that operate at all tiers within the Government's supply chain. They apply whether such companies are selling specialized products manufactured to Government specifications or commercial items adopted or adapted for use, ultimately, by the Government.

Over the next ten months, we will examine a number of these issues, including the Government's right to approve or disapprove of the transaction; pre-closing and post-closing notifications; the impact of the transaction on pending bids and proposals; the effect of the transaction on a company's continuing eligibility for procurement preferences, such as small business set-asides; special issues posed by cross border transactions and classified contracts; the trap posed by lurking "organizational conflicts of interest"; the effect of the transaction on the recovery of certain costs; the effect of post-closing changes in cost accounting practices; and the liabilities that may lie in wait for the acquiring entity.

Today's inaugural installment in this series focuses on the government contracts considerations that should be taken into account in deciding on the form that the transaction will take, *e.g.*, a stock purchase, an asset transaction, or a merger. We recognize that there are many considerations that will drive this decision that are wholly unrelated to government contracts, principal among them tax considerations. It is not the purpose of this posting to discuss those other considerations, or to suggest that government contract considerations should be elevated above them in the hierarchy of transactional considerations. Our purpose, rather, is to identify the issues so that they can be taken

into account as part of the overall evaluation of the structure and not become an eleventh hour surprise for dealmakers anxious to close and put the transaction to bed.

So, with that prologue, why does it matter, from a government contracts perspective, what form the deal takes? The answer to this question can be found in two federal statutes, *i.e.*, 41 U.S.C. § 6305 (formerly 41 U.S.C. § 15) and 31 U.S.C. § 3727, which prohibit, respectively, the transfer of government contracts, or of interests in government contracts, and the assignment of claims and interests in claims against the Government. There are several reasons for these statutes, *e.g.*, to discourage speculation in government contracts that can then be "flipped" for profit after award; to make sure that the Government knows with whom it is dealing and that it obtains the benefits anticipated when it chose the contractor in the first instance; and to avoid duplicative claims and payments under the contracts.

If these anti-assignment statutes apply to the transaction, the Government will have the right to approve of the transfer of contracts effected under the deal and treat the acquirer/assignee as the successor-in-interest to the prior contractor. By the same token, if a prohibited transfer takes place without the required Government consent it "annuls the contract or order." 41 U.S.C. § 6305(a). Under the FAR, absent the required Government consent, "the original contractor remains under contractual obligation to the Government, and the contract may be terminated for reasons of default, should the original contractor not perform." FAR 42.1204(c). Needless to say, this is not the kind of post-closing development that will be warmly welcomed by the buyer, whose initial notice of the problem may come when the Government declines to pay invoices submitted by a "stranger" to the contract.

It becomes important, thus, to know what transactions are subject to the anti-assignment statutes, and therefore require Government consent, and which are not. The answer is not always altogether clear:

> Stock Purchases — Acquisitions made by way of a stock purchase should not implicate the anti-assignment statutes. The entity in privity of contract with the Government does not change; the only change is in the identity of the shareholder(s). Because the contracts will be performed by the same entity, utilizing the same facilities, assets, personnel, skills, and experience applied by the acquired entity before the stock purchase, none of the policy reasons that underlay the anti-assignment statutes are implicated by this type of transaction. Although there is no case that actually squarely so holds, the Federal Acquisition Regulation does not list stock purchases among the transactions that trigger the need for Government consent. *See* FAR 42.1204(a). To the contrary, FAR 42?1204(b) expressly excepts stock purchases from the requirement for Government consent.
>
> Asset Purchases — FAR 42.1204(a) identifies a sale of assets as a transaction that requires Government consent. This makes sense if one examines the policy reasons for the anti-assignment statutes – the performing entity is no longer the entity to which the contract was awarded in the first instance and the prospect of conflicting claims and misdirected payments is obvious. The case law uniformly recognizes the Government's approval rights in connection with asset transactions. The types of asset sales that will be favorably considered for consent by the Government generally include the sale of all of the assets of the original contractor, or the sale of all of its assets involved in performing the contract, with a provision for the assumption by the acquiring entity of the liabilities associated with the acquired contracts. The Government will not want to chase an entity with which it no longer has privity of contract to enforce liabilities not assumed by the new contractor.

Mergers and Consolidations – Up to now, the answers have been fairly straightforward, with predictable outcomes. This is where the road gets curvy, hilly, and bumpy. There are a number of cases – including Supreme Court, Court of Claims, and Armed Services Board of Contract Appeals precedent – holding that a merger or consolidation effects a transfer of assets "by operation of law" that is not subject to the anti-assignment statutes and for which Government consent is not required. Unfortunately, the FAR provides that consent is required for a transfer of assets "incident to a merger or corporate consolidation." FAR 42.1204(a)(2)(ii). While one might assume that the U.S. Supreme Court trumps the FAR, contracting officers do not necessarily subscribe to that view and, in the world of government contracting, they rule the roost. While one can occasionally encounter a contracting officer who will actually listen on this score, and the ASBCA has held that a reverse triangular merger is not subject to the anti-assignment statutes, most contracting officers will adopt a reflexive response that they must comply with the FAR as written. When this happens, despite the parties' compelling legal arguments for the inapplicability of the statutes, there is no way effectively to resolve the issue in advance of closing and the course almost invariably charted by the parties is to (a) advise the contracting officer of the transaction, (b) seek agreement that a novation is not necessary, (c) failing that (as will usually be the case) precondition him/her so that consent can be readily obtained promptly after closing, and (d) bemoan in private the FAR's reversal of Supreme Court precedent.

Incorporation of a Proprietorship or Partnership or Formation of a Partnership – The FAR is pretty clear on this. Consent is required and, again looking at the problems that the anti-assignment statutes are designed to avoid, this makes sense. The transaction creates a different legal entity and the Government's recourse in the event of performance problems may be radically different.

Restructures and Reincorporations – "[B]usiness restructurings, such as reincorporation, which involve no change in ownership of the business" are regarded as transfers by operation of law that are not subject to the consent requirements of the anti-assignment statutes. Once the reorganization involves changes in ownership, the need for Government consent becomes an issue.

Assignments in Bankruptcy – The question here is whether the assumption of an executory government contract by the debtor in possession is a prohibited transfer that is subject to the Government's consent prerogatives. This involves the intersection of the anti-assignment statutes and 11 U.S.C. § 365(c)(1). This latter statute provides that the "trustee may not assume . . . any executory contract . . . if . . . applicable law . . . excuses a party . . . to such contract . . . from accepting performance from . . . . an entity other than the debtor or debtor in possession…"

Unfortunately, there are cases that come down on both sides here, holding in contradictory fashion that (1) Section 365(c)(1) does not prohibit a debtor in possession from assuming an executory contract, with or without the other party's consent, *e.g.*, *In re James Cable Partners, L.P.*, 154 B.R. 813 (M.D. Ga., 1993); and (2) a debtor in possession cannot assume an executory contract if applicable law would prohibit an assignment to a hypothetical third party. *In re Catapult Entertainment, Inc., 165 F. 3d 747* 9th Cir. 1998). These cases proceed on the assumption that "a solvent contractor and an insolvent debtor in possession going through bankruptcy are materially

distinct entities." *In the Matter of West Electronics*, 852 F.2d 79, 83 (3rd Cir. 1988). Under these latter cases, thus, the Government can exercise its consent rights under the anti-assignment statutes to block the assumption of the contract by the debtor in possession.

Before closing, let's focus for a moment on pending bids and proposals. There is nothing in the anti-assignment statutes that mentions bids and proposals, which obviously are not "contracts" and are clearly pre-contractual in nature. Nonetheless, the FAR incorporates the basic principles outlined above, which empower contracting officers to reject bids and proposals that have been "transferred." *See* FAR 14.404-2(j). We leave a more meaningful discussion of that issue for a future posting.

Next month – The foregoing post discusses the need for Government consent to the transfer of contracts. Next month, we will discuss the consent process, *e.g.*, the who, what, when, and how of the Government's three-party novation agreements.

Part 2: What Else You Need to Know

Part 3: What Happens to Pending Proposals - Mergers and Acquisitions Involving Government Contractors and Their Suppliers

Part 4: Key Issues in Government Contracts Due Diligence

Part 5: Land Mines Strewn Throughout: What You Need to Know About Mergers and Acquisitions Involving Government Contractors and Their Suppliers Data Room

Part 6: Organizational Conflicts of Interest: When Whole Is Less Than Sum of Parts

Part 7: Investing in Small Businesses

Part 8: Foreign Buyers Do Make a Difference

Part 9: Unclassified Contracts? Foreign Buyers Still Make a Difference

Part 10: Accounting for Cost of Business Combinations Under Government Contracts

National Law Review, Volume VI, Number 14

Source URL:https://natlawreview.com/article/what-you-need-to-know-about-mergers-and-acquisitions-involving-government