

Maximizing Your Investment: Important Issues to Consider When Investing in Government Contracting Concerns

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Private equity and venture capital firms have grown increasingly comfortable with investing in the government contracting space, with several making significant investments in federal contractors in the past few years. Government contracting is one of the few bright spots in the economy, due to low credit risk and predictable, virtually guaranteed cash flow from long-term contracts. The sector is not without its hazards, however. Government contracts can give rise to unique risks that must be thoroughly considered by the potential investor.

Intellectual Property Issues

The federal government has extensive and complicated rules about ownership and transfer of intellectual property rights. These rules differ considerably from standard commercial principles. Investors therefore must be conscious of how IP rights are developed, protected, and enforced in the government arena.

- **Patents**

The government obtains an unrestricted, royalty-free license to use, and to allow others to use on its behalf, all patents arising during the course of performance of a government contract. Whether a patent was conceived of or reduced to practice in the performance of a government contract is a fact-intensive inquiry that is sometimes the subject of much dispute. While a contractor generally retains title to all patents developed in conjunction with a government contract, the contractor can lose this right if it fails to exploit the patent or if it does not report to the government any invention developed in conjunction with a government contract in the manner required by applicable regulations.

- **Copyrights**

The government obtains a royalty-free license in any copyrighted data delivered under a government contract.

- **Technical Data and Software**

Who owns the rights to technical data and software developed under a government contract depends upon which party paid to develop the item to which the data relates. As a general rule, the contractor retains title to all technical data and software developed under a government contract. The government obtains only restricted or limited rights in data and software developed at private expense, but is given unlimited rights in data and software developed at government expense. Data developed at mixed expense also is generally considered subject to unlimited government rights. Where the government has obtained “unlimited rights” in the data or software it can disclose it without restriction, including to the developing contractor’s competitors in a subsequent procurement.

Many government solicitations and contracts contain clauses that require contractors to specifically identify any technical data or software that it intends to provide with less than unlimited rights. The contractor’s failure to properly mark and identify its data or software can result in the loss of rights,

giving the government unlimited rights in data or software that otherwise would have been subject to greater protection.

These rules are relaxed in commercial item acquisitions where, in general, the government only obtains the same data or software rights as would a commercial customer, subject to the contractor's standard commercial license agreement.

A potential investor in a government contracting concern should assess what steps (if any) a contractor has taken to safeguard and/or maximize its intellectual property assets.

- **Small Business and Affiliation Considerations**

Small businesses are given distinct advantages in the federal marketplace. Many contracts are set aside only for qualified small businesses, and agencies receive credit for awarding other contracts to small businesses. Prime contractors also have small business goals and receive credit for awarding subcontracts to small businesses. Businesses that are other than small are also incentivized through the "Mentor-Protégé" and other programs to work with and invest in small businesses. These competitive advantages disappear when a contractor is no longer able to certify that it is a bona fide small business. Thus, prudent investors must consider a small business concern's long-term business strategy, assessing what percentage of current and future government contracting work is tied to the target's size status and what steps management has taken to plan for the "next stage" in the company's growth cycle.

Another concern is the potential loss of contracts set aside for small businesses once the target no longer qualifies as a small business concern. When a small business receives significant investments from, or is acquired by, a larger company it generally loses its small business status by virtue of the Small Business Administration's (SBA) "affiliation rules". The SBA has a very broad interpretation of affiliation, which focuses on whether or not the potential affiliates have the right to influence or control one another (regardless of whether the right is exercised). There are limited exceptions to affiliation coverage, and certain venture capital or investment firms may be able to meet the SBA's stringent exception criteria, but this is by no means guaranteed.

Since June 2007, the SBA has required small businesses to re-certify their size status: (i) within 30 days of an approved contract novation (as required with an asset purchase); (ii) within 30 days of a merger or acquisition where novation is not required (such as a stock sale); and/or (iii) for long term contracts (longer than five years), within 120 days of the end of the fifth year and, thereafter, within 120 days prior to the exercise of any option. Thus, while the regulations do not require the immediate termination of an existing contract if size status changes during the term of the contract, they may impact the exercise of options. In addition, on long-term contracts with multiple awardees where orders are awarded based on competition, a change in size status may make a contractor ineligible for future orders. Further, given that an agency's small business goals may not be credited after a contractor can no longer re-certify itself as a small business, an agency may not be incentivized to award to a contractor or to exercise options.

Another consideration is the SBA's "present effect rule." Under this rule, the SBA considers stock options, convertible securities, and agreements to merge as though the rights granted therein have been presently exercised, even when they are contingent in nature. While mere agreements in principle to negotiate a possible sale do not trigger the rule, certain SBA rulings suggest that detailed Letters of Intent may trigger affiliation between a target and a potential purchaser. Investors and purchasers should be aware of this possibility when crafting acquisition-related agreements.

- **Due Diligence Pitfalls**

From the earliest stages of acquisition discussions, extending sometimes beyond the close of the transaction, it is customary that the target share confidential information to facilitate an acquisition decision. The degree and specificity of the information sharing varies widely. Interested parties should use the due diligence process to assess the value, sustainability, and any potential liabilities and risks associated with the target's government business. The sustainability of government contracts may depend upon such factors as small business status (as discussed above), the government's ongoing need for the services or products provided, and the likelihood of required government approvals being granted to permit the novation of contracts to the purchaser, if required. Potential risks include ongoing audits, investigations, or claims which may result in cost adjustments or disallowances under current contracts. More serious problems, such as regulatory violations, price reporting irregularities, cost accounting deficiencies, and even criminal activity can impact the concern's ability to secure contracts in the future.

Classified contracts present even more complex considerations. Extensive due diligence might not be possible with such contracts, and the ability to continue performance post-acquisition may require that appropriate facilities and individual clearances be obtained well in advance of the acquisition. Government agency buy-in is especially important when classified contracts are involved.

In general, thorough due diligence of a government contractor will touch upon each of these areas:

- **Contracts** – Examine all prime contracts and subcontracts, including any modifications thereto. Review any audit reports and all correspondence related to any claim or allegation of non-compliance with any pricing disclosure, contract performance requirement, or statutory or regulatory obligation arising from any current or former government contract. Also, verify the status of any disputes, litigation, or investigations (civil or criminal) related to any current or former contract.
- **Proposal files** – Review proposals being prepared in response to current procurements as well as past proposals submitted in response to government solicitations. Where proposals were unsuccessful, try to determine why and how the company is addressing any weaknesses in order to better position it for success in the future.
- **Asset lists** – Review documentation related to the company's facilities and equipment to determine what property may be government-owned versus company-owned. Also consider whether or not there are any liens, encumbrances, or security interests on assets used for contract performance.
- **Compliance documentation** – Evaluation of a target's compliance policies is important not only to understand potential risks and liabilities, but also to determine the cost of developing an adequate compliance program going forward.
- **Government-approved systems** – Determine if the Defense Contract Management Agency or any other government agency has reviewed and approved purchasing, time-keeping, billing, inventory control, or other systems.
- **Export control or national security issues** – If applicable, verify ongoing compliance with U.S. export control regulations and adherence to procedures for the storage, control, and use of classified information.
- **Employment matters** – Verify that the company is compliant with the Davis-Bacon Act and/or Service Contract Act, if applicable. If cost contracts are involved, be certain that time-keeping policies have been followed.

The New Age of Government Austerity

Government contractors are not immune to financial downturns, and potential cutbacks due to current financial realities, budget constraints, and commitments made during the current presidential and congressional election cycle loom large. Defense spending, in particular, is in steep decline due to the slowdown in war effort commitments and significant reductions in large defense hardware programs. Moreover, absent further congressional action, budget-balancing measures slated for 2013 – including the massive and unprecedented automatic cuts known as “sequestration” – further threaten government contracting expansion.

Still, some government sectors are booming and will continue to do so for the foreseeable future. Contractors that provide cybersecurity and intelligence services will see growing demand in the coming years as there is renewed focus on the development of systems to combat hacking, computer network threats, and financial fraud. Other hot areas are healthcare, particularly in light of the Supreme Court’s recent upholding of reform efforts, and energy, especially for firms involved in renewable and “green” technologies.

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