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REGULATORY RELAY

On Nov. 12, the FAR -- or Federal Acquisition Regulations -- Council issued a final rule establishing a new business ethics compliance program and disclosure requirements for companies that sell goods or services to the federal government.

This new rule, which became effective Dec. 12, imposes novel risks for M&A transactions involving government contractors. Buyers and sellers who don't take the time to understand and comply with the new rule jeopardize their businesses and face the prospect of a failed deal.

The new rule represents a sea change in the way the government regulates federal contractors and includes four elements:

- All contractors, including commercial items contractors and small businesses, must establish and promote awareness of a code of conduct.
- All contractors must "timely disclose" to the government any "credible evidence" of (i) certain crimes, (ii) a violation of the civil False Claims Act (FCA), or (iii) a significant overpayment.
- A contractor's failure to "timely disclose" "credible evidence" of those same events -- even where the event occurred before the effective date of the new rule -- may result in suspension or debarment.
- Large companies with noncommercial item contracts must implement a comprehensive "internal control system."

Each of these elements imposes significant new risks and consequences. In the context of M&A transactions, they demand sellers and purchasers re-examine their traditional approach to doing deals. The new rule expands the threat of suspension or debarment -- the ultimate penalty -- to encompass not just a past crime or civil FCA violation but also a failure to disclose credible evidence of those crimes, violations or overpayments. Similarly, the rule imposes potential liability on a federal contractor for past misdeeds even if the matter was previously resolved with the contracting officer overseeing the relevant government contract.

This affects the way buyers and sellers value target companies because the stakes are raised for all parties. Purchasers will want to assess what impact the new rule might have on the value of a target, particularly in light of any known compliance issues. This inquiry is especially important for companies acquiring small businesses, which are exempt from certain provisions of the FAR Council rule, including the mandatory minimum requirements for internal control systems. However, since small businesses often become "large" after being acquired, because they exceed the applicable revenue or employee thresholds, these previously exempt provisions may suddenly apply to the target company. An acquirer of a government contractor therefore will need to incorporate these additional compliance costs in the valuation of the target.

The rule also affects how sellers and buyers conduct themselves in M&A transactions. While sellers generally disclose relevant information about a business being sold to prospective bidders as part of the due diligence process, it now becomes even more important for sellers to examine and assess what information may be relevant and should be disclosed under the new rule to avoid future exposure and liability.

Conversely, though buyers generally require a robust due diligence review of any business being acquired, it is now even more critical for -- and incumbent upon -- a buyer to properly evaluate a target and assess any risks. This includes ensuring that (i) any undisclosed wrongdoing is identified, (ii) the target business will not be subject to suspension or debarment after the deal closes due to known or unknown disclosure obligations, and (iii) any monetary risks associated with past noncompliance are allocated to the seller. This can be difficult and daunting under any circumstances. But given the severity of the consequences for nondisclosure under the new rule, a buyer likely will be unwilling to close a deal if it discovers any significant issues related to previously unreported mandatory disclosure or other noncompliance.

The disclosure requirements imposed by the FAR Council rule create a prisoners' dilemma for both sellers and buyers. Although a contractor will clearly avoid suspension or debarment if it makes a timely disclosure of "credible evidence" to the government, it is at risk for a host of other negative consequences. For instance:

• The contractor may still be subject to liability for the underlying conduct being reported;
• The disclosures can provide a roadmap for plaintiffs (including in qui tam actions under the FCA); and
• The disclosure itself could be viewed as an admission that credible evidence of wrongdoing exists.

These consequences can create unacceptable risks and require affirmative mitigation strategies on the part of M&A players. As a preliminary step, prospective buyers of a government contractor should expand their valuation analysis of the target company to include any costs that may be incurred as a result of the new mandatory disclosure rule. Specifically, acquirers should consider whether (i) the applicability of the new internal control system requirements will materially increase the target's costs after closing, (ii) the target has the resources and infrastructure necessary to conduct periodic audits and reviews required under the new rule, and (iii) the target may lose any key personnel as a result of a vetting requirement for new hires to ensure ethical and legal compliance. While these issues are material for any target acquisition, they are essential for small businesses that will realize a post-acquisition growth spurt requiring additional compliance costs.

To mitigate against the risks of unreported wrongdoing, a buyer should focus its due diligence inquiry on whether a target government contractor is likely to be harboring reportable but undisclosed misconduct. Buyers need to review prior disclosures to the government as well as any reports or other documents related to prior investigations and audits. Buyers also need to review the target's subcontracts, supplier agreements, and reseller agreements to ensure the new rule has been "flowed-down" appropriately through the various associated parties performing under the government contracts. Perhaps most important, the acquirer should evaluate the compliance infrastructure of the target to assess whether the relevant systems encourage or discourage wrongdoing and the reporting of wrongdoing. The due diligence process should include a review of whether the target company has (i) a written Code of Conduct made available to all employees, (ii) a formal and effective internal controls system that meets minimum mandatory requirements set forth in the new rule, (iii) an effective training program for all employees, (iv) a process for identifying, reporting and reviewing allegations of wrongdoing (for example, a hotline), (v) an effective management and compliance program, and (vi) a system for performing periodic reviews and audits.

Parties to an M&A transaction should clearly allocate any monetary risks related to past noncompliance under the definitive purchase agreement. For example, the purchase agreement should include representations and warranties from the seller that expressly provide for compliance with the new rule. Moreover, except for liabilities specifically assumed by the buyer in the purchase agreement, the seller should indemnify the buyer for any losses arising from known or unknown breaches of the new rule attributable to periods before the deal's close. Further, parties should consider other structural alternatives to allocating risk, like establishing special escrow arrangements or earnouts payable after closing once noncompliance issues associated with the relevant business have been resolved or relevant statutes of limitation have expired. The aim here being to allocate the risk of unknown liabilities to the party in the best position to know about and assume them.

Buyers and sellers must approach and structure M&A deals involving government contractors with a view to averting and mitigating risks posed by the new FAR Council rule, using advisers familiar with the legal and regulatory terrain. Armed with these protections and the right outlook, M&A players can avoid land mines as they navigate the new regulatory relay course to a successful deal.

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