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4 Considerations For Gov't Contractor Carveout Deals

By **Scott Freling and Alexander Hastings** *(May 21, 2018, 1:45 PM EDT)*

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A steady flow of M&A activity in the government contracts industry continues. Indeed, last year we saw over 100 publicly reported deals involving government contractors, and this pace has continued into 2018. This M&A activity has taken a variety of forms, including a number of "carveout" transactions, where a government-focused business is separated from its existing corporate structure. For instance, earlier this month L3 announced an agreement to sell its Vertex Aerospace to American Industrial Partners in what L3 described as an effort to optimize its portfolio of operations. Similarly, last month Siemens' sold its federal business Dresser-Rand to Curtiss-Wright in order to allow Siemens to refocus on its core strengths.

Whether a carveout is absorbed by another company — such as Lockheed Martin's sale of its IS&GS business to Leidos — or a carveout results in a new, stand-alone company — such as iRobot's sale of its robot defense and security government business to private equity firm Arlington Capital, carveout deals can create great opportunities. They can allow a seller to realize the value of the carved-out business, while also creating exciting opportunities for both the remaining and sold businesses to refocus resources on their missions. Also, carving out a business that is less than a natural fit with its larger organization can allow for the realization of synergies if the carved out business is placed in a structure more suited to the carved out business's specialties.

Despite these great benefits from carveouts, getting to the finish line often requires navigating a path riddled with challenges, especially in the highly regulated industry in which government contractors work. Challenges can range from identifying contract transfer issues during due diligence to addressing customer questions about the transaction well after closing. Therefore, those supporting a carveout transaction must be vigilant in identifying and proactively addressing many unique considerations that can arise.

In the discussion below, we offer a few examples of these carveout complexities:

Transaction Structure

Deal structure often informs the areas of focus when advising on a potential carveout. For example, a carveout that takes the form of an asset sale can implicate a host of challenges including the need to delineate the assets and liabilities that will transfer with the business, which can be time-intensive. The use of an asset sale also can have far-reaching implications that impact personnel allocation, the need for shared contracts, and the treatment of outstanding financial obligations (including direct and indirect cost audits). In the end, it is important to ensure that the carved-out entity has the resources needed to perform (including approved business systems, security clearances, licenses and permits), but does not hold liabilities not associated with the purchased business. A carveout through an asset sale also may require novation approval, consents to assignment, and a framework for post-closing performance of contracts for which the novation or consent process remains pending after closing.

By contrast, a carveout through a stock sale may not present as many of these challenges because, at least in theory, the assets that comprise the business sit within entities whose stock will transfer and the relevant assets and liabilities will convey with the ownership of the stock. That said, it is not uncommon that carveouts intended to be simple stock purchases will have some element of an asset sale because, for example, not all of the assets that comprise the business are part of the entities whose stock is transferring. In these mixed types of transactions, it is important to consider many of the same issues that arise in the pure asset deal, including whether there is a need to secure novation approval or consent for assignment.

Dependence on Parent or Other (Soon-to-Be) Affiliates

Diligencing a potential carveout typically requires a consideration of the target's dependence on its current affiliates and how those dependencies will be accounted for upon separation at closing. For instance, where a government-focused business sits within a larger commercial entity, the business may rely on its parent for resources that are not unique to government contracting, such as human resources, payroll, benefits, training, legal and IT. Such reliance makes sense and likely led to efficiencies among the combined businesses. However, when the government business separates from the mother ship it is important to think through how the dependencies will be accounted for — either by creating them within a stand-up entity or transferring dependency to another parent held by the buyer (where possible) in the event of a merger. In the short term, many of these dependencies might be addressed in a transition services agreement.

Additionally, it is important to carefully evaluate the key personnel, facilities, and security clearances, licenses or permits that are important to a contractor's performance of current and future work to assess whether they will transfer with the carved out entity or remain with the parent. Indeed, real estate and security clearance issues can become particularly thorny if the carved out business is performing classified work using facilities with cleared spaces that are not transferring with the business.

Seller Preparedness

The level of seller preparedness often can play an important role in facilitating a timely and smooth carveout. Although last-minute carveout deals are certainly possible, ensuring a smooth transition may mean starting preparations at least 12 to 18 months before beginning a formal sale process. This preparation may include consolidating the carveout assets (especially contracts) into entities that will transfer as part of a stock sale. Also, a well-prepared seller often will take steps in its proposal efforts to account for the potential carveout by restricting past performance references to portions of the business that are transferring and limiting statements of dependence on a parent's or affiliate's resources when discussing performance abilities and financial backing in the proposal. Finally, beyond contracts and proposals and similar to the discussion above, it is often important to consider proactively establishing independent systems that will allow the carved-out business to function effectively upon closing. For instance, if a carveout entity relies on its parent for human resource functions, such as payroll and benefits, it can be helpful to transfer these processes gradually to an entity that will transfer with the carveout to minimize the disruption to employees upon closing.

Customer Messaging

Last but certainly not least, customers almost always have questions regarding a transaction, and carveout transactions are no exception. Indeed, when a business is pulling away from a well-known, well-established parent to begin a separate business or combine with another business, customers are likely to seek assurance that contract performance will not be impacted and competitors may attempt to spread unfounded fear among customers. To that end, the business being carved out should be prepared to proactively address customer questions, particularly in the time between signing and closing. In addition, in certain circumstances, it may be important to preview the potential carveout with certain key customers — either before signing (if possible) or before a public announcement of the transaction — to assure them that the transaction will result in a stronger product or service.

Of course, it is virtually impossible to prepare fully for a carveout and each transaction presents its own challenges. However, the efforts described above — and potentially other measures depending on the situation — can help parties on both sides of the transaction achieve a successful carveout, while limiting business disruption, reducing legal and third-party adviser fees, and minimizing the potential for post-closing disputes.

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