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Eight Things Dealmakers Should Know About Government Contracts

Bloomberg Law

The Bottom Line

- Government contracting has many nuances and unique features that require extra attention from dealmakers.
- The much publicized in-progress overhaul of Federal Acquisition Regulations will remove some burdens on companies that sell products or services to the US government.
- But government contracting is—and will remain—a highly regulated industry and successful M&A deals involving contractors often require specialized expertise from lawyers who are well versed in the regulations that apply to government contracting.

Government contracting—historically viewed as relatively stable—has encountered novel challenges and opportunities in the first several months of the Trump administration. Even in the face of uncertainty from executive actions, public sector-focused businesses continue to be a fertile ground for mergers and acquisitions activity.

We are seeing an increased emphasis on companies leaning into the administration's focus on commerciality, rapid deployment of technology, and openness to creative contracting mechanisms. And investors are putting significant capital behind those strategies.

As many savvy private equity firms have known for some time, companies that serve the US government, either as a prime contractor or as a subcontractor, can be attractive acquisition targets because of historically stable customer demand and consistent cash flow.

However, deals involving government contractors carry their own complexities. The industry is highly regulated, and effective dealmakers should understand the specific challenges and compliance requirements that companies face when they do business with the US government. These risk factors continue to evolve as the Trump administration embarks on an overhaul of federal contracting regulations and seeks to cut through perceived regulatory red tape.

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Government Contracts Differ from Commercial Contracts

Contracts awarded by the US government, and subcontracts issued in support of those prime contracts, typically have a laundry list of [Federal Acquisition Regulation](#) clauses and other regulatory provisions that inform the rights and obligations of the parties.

The Trump administration's ongoing overhaul of the acquisition regulation looks to relax or even eliminate some of these compliance obligations, but many such requirements are ingrained by statute and will remain. And certain foundational precepts of government contracting won't change.

For example, the government has an automatic right to terminate most prime contracts for its convenience and to make unilateral changes to the scope of work and other contract terms. The government's obligations, particularly in multi-year contracts, often are subject to the availability of appropriated funds.

This means that an acquisition target's contracts need to be evaluated for the favorability of their written terms, as well as for the status of performance, funding, customer relationship, and competitive dynamics.



2 Government Contracts Often Aren't Freely Assignable Assets

Under the Anti-Assignment Act, a contractor can't assign a prime contract with the US government without approval from the customer. This prohibition often isn't addressed anywhere in the four corners of the contract.

Instead, the prohibition and the administrative process for seeking government approval are addressed in Subpart 42.12 of the FAR, which requires the assignor to submit the request for approval after it has executed the instrument effecting the assignment to the assignee. In an asset sale, the parties generally must seek post-closing approval from the government to effectuate at least part of the transaction.

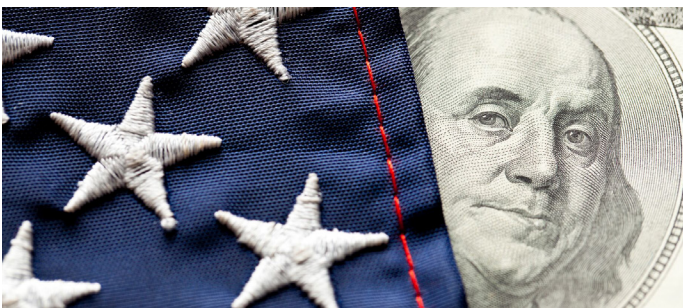
This means that transaction parties typically must establish an interim arrangement to govern performance of the contracts between closing and novation, a period that can extend for at least several months.

3 Government Contractors Must Share Detail About Their Ownership

The US government expects contractors to, at minimum, disclose their immediate owner and their highest-level owner.

Traditionally, the Defense Counterintelligence and Security Agency and other national security agencies have required companies holding security clearances to complete more extensive ownership disclosures. This includes submitting a full organizational chart and identification of foreign equity holders with interest of 5% or more, even if they're entirely passive.

More recently, we have seen an uptick in procuring agencies, such as the Department of Energy, requiring disclosure of foreign affiliates even when no industrial security issues are implicated. DCSA also is developing a pre-award entity vetting process for companies that don't hold clearances, which will subject many more defense contractors to extensive ownership disclosures.



4 Foreign Involvement Can Require Review and Mitigation

If DCSA or another US government agency determines that cleared contractor is subject to foreign ownership, control, or influence, the contractor must mitigate the FOCI to the government's satisfaction.

The required form of mitigation will depend on the nature of the FOCI and could range from a simple board resolution to a much more significant proxy agreement, which may require that governance responsibility and voting rights be placed in the hands of individuals who aren't connected to the company or its owner and who are approved by the government.

DCSA's upcoming pre-award entity vetting process for uncleared defense contractors will also assess FOCI and determine whether mitigation is required. In addition, regardless of whether a contractor holds a clearance, it may be necessary or advisable to present the transaction for pre-closing review by the Committee on Foreign Investment in the United States. A CFIUS review can significantly lengthen the time between signing and closing and can result in mitigation obligations.

5 Permits and Other Governmental Authorizations Can Become Relevant

For any deal, it is important to get a handle on the permits and other governmental authorizations that an acquisition target relies on to conduct its business and the applicable regulatory framework for each authorization.

This is particularly true for deals involving a government contractor. For example, many government contractors in the defense and national security space must maintain a registration with the Department of State under the International Traffic in Arms Regulations. The ITAR requires State Department notification in connection with, among other things, a change of ownership or control of a registrant. For foreign buyers, there is an additional pre-closing notification requirement under the ITAR that can have implications for closing timeline.

As another example, if a company engages in certain activities regulated by the Federal Communications Commission or otherwise holds FCC licenses, it often must obtain FCC approval prior to effecting a change of control.

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There Are Many Socioeconomic Preferences

The US government has established socioeconomic preferences in several aspects of the procurement process to try to boost participation from small businesses, including those owned by women, veterans, and those considered socially and economically disadvantaged.

Many prime contracts are awarded on a set-aside basis, meaning that only eligible businesses are permitted to compete for the contract. Likewise, small businesses are exempted from having to maintain a small business subcontracting plan or to comply with the [Cost Accounting Standards](#).

Where an acquisition target relies on small business or other preferential status, it is prudent to confirm during due diligence that past claims to this status make sense, including that they account for the size of the target and each of its affiliates.

This is a tricky area of compliance and continues to attract significant enforcement attention from the Department of Justice, even as the administration has shown skepticism regarding certain socioeconomic preference programs. It is also important to consider whether the proposed transaction will frustrate the acquisition target's ability to claim such status going forward, to hold on to previously awarded contracts, or to continue to pursue certain bids for new contracts.

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There Are Specialized Accounting Requirements, Cost Disclosure Obligations, and Government Audits

Many government contractors must adhere to unique accounting and disclosure practices, which can be a source of historical liability and affect a buyer's post-acquisition plans.

For example, where applicable the Cost Accounting Standards require a company to align its accounting to a set of government standards, disclose how it accounts for particular costs, and engage with the government before making certain accounting practice changes.

The [Truthful Cost and Pricing Data statute](#) obligates certain contractors to provide certified cost or pricing data to justify its proposed pricing for a contract. In fulfilling those obligations, contractors sometimes must provide their government customer with information that reveals anticipated margins.

Regardless of whether these accounting or disclosure requirements apply to an acquisition target, however, it may still be subject to government audits and other compliance reviews. This scrutiny can result in repayment obligations and other liability.

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Contractual Non-compliance Can Lead to Enforcement Action

Ordinary compliance matters in government contracting can quickly spiral into something much larger, such as a whistleblower action or a government investigation.

The [False Claims Act](#) permits the DOJ, or a private party, to pursue treble damages and statutory penalties against a company or other person that submits a false claim for payment to the US government. We have seen a substantial uptick in the use of the FCA to police contractor compliance with contract terms.

For example, the DOJ has been actively using the FCA to pursue cybersecurity-related non-compliance by government contractors since the Biden administration [announced](#) the Civil Cyber Fraud Initiative in 2021. And this past May, the DOJ [launched](#) a Civil Rights Fraud Initiative that said it aimed to use the FCA to investigate and "pursue claims against any recipient of federal funds that knowingly violates federal civil rights laws."

We expect FCA enforcement against government contractors, including in complex regulatory areas such as supply chain and cybersecurity compliance, will be a priority area of the DOJ for many years.





Key Takeaways

With the interplay of regulatory approvals, unique compliance obligations, and potential for government scrutiny and enforcement, government contracts M&A demands specialized expertise. Early and informed risk identification is a critical component of due diligence on public sector-focused businesses.

Without proper planning, regulatory complexity can erode value, lead to mid-deal surprises, or leave open significant post-closing exposure. Most representations and warranties insurers are sensitive to the range of possible losses at issue in deals involving a government contractor, and they typically identify regulatory compliance as a focus area for underwriting.

This complexity is particularly acute today, with the pace of regulatory change in the government contracts industry moving at hyperspeed. At the same time, the Trump administration's "art of the deal" approach to government contracting may give a significant edge to companies positioned to lean into the administration's policy priorities. This all calls for nuanced business and legal diligence into how companies approach their sales to the US government.

About the Authors

Scott Freling and **Nooree Lee** are partners in Covington's Government Contracts practice.

They focus their practices on guiding buyers and sellers—including a number of leading private equity firms—through the regulatory aspects of complex M&A deals involving companies that sell products or services to government customers. They have each served as the lead government contracts counsel in dozens of M&A deals, with a combined value of more than \$80 billion. In addition, Scott and Nooree represent civilian and defense contractors in traditional government contracts matters, including compliance counseling, government investigations, audits, and disputes.

Scott co-chairs the firm's Government Contracts practice, and has been recognized by *Chambers USA* as a leading practitioner in this space. Nooree recently was recognized by the *Washington Business Journal* with a "40 Under 40" Award.



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Elite Band 1-Government Contracts

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