Reprinted from The Government Contractor, with permission of Thomson Reuters. Copyright © 2014. Further use without the permission of West is prohibited. For further information about this publication, please visit *http://legalsolutions.thomsonreuters.com*, or call 800.328.9352.

THE GOVERNMENT CONTRACTOR®

WEST®

Information and Analysis on Legal Aspects of Procurement

Vol. 56, No. 18 **May 7, 2014**

Focus

¶ 147

FEATURE COMMENT: Defense Industry M&A In The Wake Of The BCA Passage And Sequestration—Avoiding Pitfalls In A Distressed Deal Context

Although there have been some strategic divestitures and continued interest in certain areas (e.g., unmanned aerial vehicles (UAVs) and cybersecurity), the Budget Control Act, sequestration and the draw-down of troops in conflict areas around the globe have resulted in a relatively cautious U.S. defense mergers and acquisitions market. Pricing expectations of targets and their potential acquirers have remained out of sync, and the deals that are getting done are with EBITDA multiples much lower than the heady days of 15x (generally now 6x to 8x).

President Obama's fiscal year 2015 budget presented to Congress in March projects zero growth in defense spending over 2014 and, after taking into account inflation, an effective reduction of one percent. A number of Government contractors are struggling as budget cuts kick in, even where positive word has come through on programs, but actual funding of those programs lags. Although these potential target companies are struggling, many potential buyers are sitting on healthy cash reserves available for deployment in the M&A market when the right opportunity arises. There has been an uptick in distressed deals in the defense sector, and the industry should expect to see more distressed deals in the coming months. Some of these deals may involve bankruptcies or other types of insolvency proceedings (such as receiverships or assignments for the benefit of creditors); others will be short of that formal process, but likely will involve the sell-off of assets by entities that have become vestiges of their former selves.

The current environment suggests that a buyer's market is generally shaping up in defense industry M&A (excepting certain businesses such as those in the UAV space). When buying assets of a distressed company, such as inventory, intellectual property, contracts, receivables or even a subsidiary, buyers need to be aware of the pitfalls. A solid knowledge of M&A law is critical, as is knowledge of national security and Government contract laws and regulations. Knowledge in these areas alone, however, is not enough, as distressed deals present unique issues and challenges. For example, a buyer may extract elaborate representations and warranties from a seller coupled with generous indemnification rights, but if after a deal closes the seller is a shell or subsequently goes through a bankruptcy proceeding, such protections will be useless, absent special provisions to deal with the distressed context. An acquisition that as of the day of closing may seem to be a bargain can end up being far more costly than anticipated.

Successor Liability—In addition to being unable to collect on indemnities for breaches of representations relating to the assets purchased, a buyer of distressed assets needs to be aware of—and, to the extent possible, should structure its transaction to protect against—claims that may be asserted by unpaid creditors of the distressed seller under various "successor liability" theories. The risks of such claims are reduced when assets are purchased in a court-supervised bankruptcy proceeding.

Today, bankruptcy is widely recognized as an effective vehicle for the sale of financially distressed assets. Bankruptcy courts are empowered to approve asset sales "free and clear" of liens, claims, encumbrances and other interests. The bankruptcy sale process, which is frequently referred to as a "Section 363 sale" (referring to the section of the Bankruptcy Code pursuant to which bankruptcy courts are empowered to approve sales

 © 2014 Thomson Reuters

of assets), is attractive to buyers who otherwise would be reluctant to acquire assets due to concerns about liens, title issues and successor liability issues.

Under common law, in both federal and state cases a buyer of assets is presumed not to be responsible for liabilities of the seller. Exceptions to this general presumption against liability include (1) where the buyer is deemed to be a "mere continuation" of the seller, (2) where the sale amounts to a "de facto consolidation or merger" of the two parties, (3) where the transfer of assets was done for the purpose of defrauding the seller's creditors, and (4) where the buyer expressly or impliedly agrees to assume the seller's liabilities. Some courts have also embraced a "product line" exception or a "continuity of enterprise" exception that essentially expands on the "mere continuation exception" noted above. The factors considered in analyzing successor liability claims include continuity of ownership, continuity of management, continuity of personnel, whether the same physical facilities are used, and whether the same trade name is used.

Fraudulent Conveyance—Buying assets from a struggling company also presents risk of fraudulent conveyance. A company's creditors or a bankruptcy trustee may assert that an earlier sale of assets by the company was a fraudulent transfer. In general, there are two types of fraudulent transfer claims: (1) actual fraud, where the sale transaction was undertaken with an intent to hinder, delay or defraud the seller's creditors; and (2) constructive fraud, where the seller received less than "reasonably equivalent value," and the sale transaction occurred at a time when the seller was insolvent, or the transaction itself resulted in the seller's insolvency or in the seller having insufficient capital to run its business and pay its debts when due. Fraudulent transfer claims may be asserted under both federal and state law.

Under the federal Bankruptcy Code, creditors and trustees may reach back to challenge transactions that occurred up to two years prior to the bankruptcy filing. Under state fraudulent transfer laws, the reach-back period may be up to six years, depending on the particular state. Even in a federal bankruptcy proceeding, creditors and trustees can elect to apply the relevant state law. If the court finds that a fraudulent transfer occurred and the buyer acted in good faith, the buyer may retain the purchased assets or be granted a lien on such assets, in either case to the extent of the value the buyer paid. Frequently, a settlement is reached whereby the buyer retains the assets, but agrees to pay a negotiated amount to the bankruptcy estate to settle the fraudulent transfer claim.

Anti-Assignment Act—The Anti-Assignment Act generally prohibits the transfer of a Government contract. One of the key rights available to a debtor in bankruptcy is the power to "assume" or "reject" unexpired contracts. In a bankruptcy sale, the buyer typically identifies the specific contracts that it wants to acquire, and those contracts are then assumed by the debtor and assigned to the purchaser. Thus, problems arise when the contracts at issue are Government contracts.

Although the Bankruptcy Code generally permits the free assignment of property rights, it includes a provision that prohibits a debtor from assuming or assigning a contract where applicable law excuses the non-debtor party to the contract from accepting performance from a party other than the debtor. The Anti-Assignment Act has been found in many bankruptcy cases to constitute applicable law that prohibits the assumption or assignment of Government contracts.

Courts have adopted different approaches in addressing the issue of whether a debtor may assume and assign Government contracts. Some courts have adopted a literal interpretation of the Bankruptcy Code and held that, absent the Government's consent, a Government contract may not be assumed or assigned. Other courts have taken a more liberal approach and held that the assumption and assignment of Government contracts is permissible, if the buyer is a related party such as a subsidiary or a successor party in a reorganization (although such a transfer may nevertheless be deemed by the Government to require a novation, or at a minimum a name change, under subpt. 42.12 of the Federal Acquisition Regulation). Parties seeking to undertake an assumption and assignment of Government contracts to an unrelated buyer in a bankruptcy sale should anticipate seeking novations from the Government and should engage early with the Government customer to highlight the benefits to the customer of such assignment.

What's a Buyer to Do?—Diligence is always important, but in a distressed context its importance cannot be overstated. One of the first critical steps is undertaking lien and security interest searches. Strong representations and warranties should be

© 2014 Thomson Reuters

sought, and extra care should be taken to make indemnification rights meaningful (although, as noted above, in many bankruptcy sales, representations and warranties are limited, and indemnification rights are not provided).

Where possible, it is advisable to utilize structures such as escrows, earn-outs and clawback rights. In some cases, guaranties from a seller's parent company or its ultimate owners are solutions; however, when buying distressed assets from a private equity fund, such solutions are often difficult if not impossible to achieve, as private equity funds typically want a clean break with certainty as of the date of close on the return (or loss) for fund participants. One additional potential solution that has gained some favor is to obtain representation and warranty insurance, often with negotiations about which party will bear the premium and deductible costs.

There is no way a buyer of assets from a distressed seller can eliminate all risk of successor liability and fraudulent transfer claims. However, many things can be done to mitigate these risks. Careful structuring of deal terms and post-closing operations should be planned and undertaken in light of factors relevant to successor liability. To mitigate the risk of a fraudulent conveyance claim, the buyer may require the seller to obtain (or the buyer may itself obtain) a fairness opinion or a solvency opinion prepared by an investment bank or other financial professional. These opinions, however, can be expensive and often are not practical in lower-value transactions. Another typically less-expensive option is to obtain a third-party appraisal of the assets. Also, the buyer should determine the extent of the seller's prior efforts to market the assets being sold. If a fraudulent transfer claim is later asserted, evidence of the debtor's solvency, the value of the assets and the seller's marketing efforts will be key in determining the bona fides of the sale transaction.

As noted above, one way to limit risk in a distressed deal is for the buyer to require that the seller use a bankruptcy proceeding to effect the sale of the assets. The bankruptcy court's order approving the sale provides notice to the world that the buyer is acquiring the assets "free and clear." The order also typically includes findings of fact and conclusions of law that protect the buyer against a broad array of claims that may be asserted by the seller's creditors or other interested parties (including title claims, lien claims, tax claims, vendor claims and various types of successor liability claims).

The bankruptcy process, however, involves significant time and expense, subjects the sale to court approval with creditors having the opportunity to object, and allows an opportunity for other potential buyers to enter the fray and submit competing bids for the assets. Furthermore, if the desired assets include Government contracts, a bankruptcy filing by the seller may jeopardize the availability of those assets. In such circumstances, as is the case with general asset sales involving Government contracts, the parties seeking to transfer Government contracts should engage early with the contracting officers to initiate the novation process.

This Feature Comment was written for The Government Contractor by **Sarah E. Kahn** ***and*** **C. Kevin Kobbe,** ***partners at DLA Piper LLP. Ms. Kahn, based in Washington, D.C., focuses her practice in the area of mergers and acquisitions, and cochairs the firm's Aerospace, Defense & Government Services Transactional practice. Mr. Kobbe, based in Baltimore, Md., focuses his practice in the areas of bankruptcy and restructurings.***

© 2014 Thomson Reuters