M&A Pre-Flight Check: Avoiding Common Issues in Aerospace & Defense Acquisitions

A Practical Guidance® Article by Zachary M. Turke and Rambod Peykar, Sheppard, Mullin, Richter & Hampton LLP

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Introduction

Mergers and acquisitions (M&A) activity in the aerospace and defense (A&D) industry has remained robust over the past decade. In 2019 alone, there were 460 corporate acquisitions in this sector. Despite a slowdown in 2020 deal activity as a result of the COVID-19 pandemic, results for at least the second quarter remained strong, with 84 deal closings. Further, analysts project that activity in certain subsegments of the industry, including defense, space technology, and cyber security, will remain vigorous for the foreseeable future, at least partially offsetting any declines in commercial aerospace transactions.

Acquiring an A&D company is complex and requires significant investment of both time and money to be done properly. So just as a pilot would perform a pre-flight check before takeoff, there are steps that a savvy buyer or seller of an A&D company can take to give themselves the best chance of a successful and smooth closing. This article discusses some of these steps by examining some of the most common issues that arise in A&D transactions to give you a leg up on your transaction.

Novation

Due to the prevalence and importance of government contracts in the A&D sector (and the related penalties for violating applicable requirements), identifying and addressing necessary government consents required to do your deal will be a fundamental focus for both buyers and sellers. Federal law generally prohibits the transfer or assignment of government contracts, but the government may nonetheless consent to a transfer of a government contract via a novation agreement obtained after the deal closes. In this area, however, the structure of your transaction matters as a novation agreement is generally required under the Federal Acquisition Regulations (FAR) in an asset sale but not with respect to the sale of equity. Accordingly, this factor may affect the structure of your transaction.

If it is determined that a novation agreement must be obtained, FAR provides necessary and detailed guidelines for helping you navigate this process. As with many areas of the government, however, delays in this process are common and you should plan ahead accordingly. Since novation cannot, by its nature, be obtained before the closing, relevant purchase agreements should include special procedural provisions detailing how the buyer and seller will cooperate with each other after the closing to obtain this approval. Under this arrangement, the seller generally retains the contract in question until the novation agreement is obtained and enters into a subcontracting arrangement with the buyer whereby the buyer performs

the underlying contract as a subcontractor during the transition. The contract in question only transfers to the buyer as a purchased asset when the novation is ultimately obtained. This structure requires careful legal drafting to avoid potential legal violations and to ensure that the requisite efforts are used to obtain a novation in a timely manner. In the event novation is not obtained in due course, buyers should also consider including a relevant indemnification obligation.

Proposal Protection

Sometimes an A&D target undergoes a corporate transaction during the period when it has submitted a bid for a government contract. The federal agency to whom the bid is submitted is generally required to consider M&A activity as part of its award process. Accordingly, if proper disclosures were not made during the bidding process, there is a risk that the awarded contract may be overturned as a result of a bid protest following the closing. Buyers and sellers should work together to alleviate this risk by evaluating the impact of a corporate transaction on a pending bid, properly notifying the applicable agency if required and narrowing any bid proposal so as to avoid reliance on any assets of the target company that may not be acquired or transferred.

Antitrust Considerations

Antitrust is a concern for M&A transactions in any highly consolidated industry. It takes on particular concern, however, in the A&D sphere due to its potential impact on the economy and national security. The DOJ and FTC highlighted this concern in a joint statement in 2016 in which they stated, "[competition] is especially critical when it comes to America's defense industry, which provides the equipment and supplies that our men and women in uniform rely on every day." So while clearing the antitrust hurdle is a challenge that must be addressed in every deal over a certain statutory threshold, buyers and sellers of A&D companies should expect heightened government scrutiny and activism in this area. Savvy counsel will plan ahead, performing internal evaluations as to whether there are genuine antitrust concerns and determining steps that can be taken to mitigate any such concerns. Some buyers and sellers may choose to communicate with the target's customers (e.g., governmental or military organizations) to gauge their comfort with the proposed corporate transaction to ensure that they continue to receive effective and innovative products at competitive prices. Penalties for violations in this area can be costly. Under the Hart-Scott-Rodino Act, for example, buyers who do not obtain the requisite approval can be fined $43,280 per day.

For more discussion on antitrust considerations in A&D transactions, see Antitrust Approval Involves National Security Considerations under Aerospace, Defense, and Government Services M&A Considerations — Government Approvals. For discussion of the antitrust approval process in M&A deals more generally, see Due Diligence: Antitrust Issues, Merger Review Antitrust Fundamentals, and Integration Planning: Antitrust Considerations.

Specialized Due Diligence

Thorough due diligence is a buyer's best tool for mitigating risk in an M&A transaction. Accordingly, over the years, due diligence request lists have grown in length so as to leave no stone unturned and to identify any material risks to the business. Buyers in A&D transactions must be aware of certain specialized areas of diligence, and sellers should pay particular attention to these areas in order to remedy any issues that can become problematic to the transaction.

With respect to government contracts, for example, these agreements can have unique regulatory provisions—such as most favored customer pricing requirements—the failure to strictly comply with may result in significant go-forward financial liability. In order to effectively perform due diligence on these agreements, counsel should closely review these contracts to identify significant areas of potential exposure to avoid any unpleasant surprises. See Government Contract Regulatory Risks under Aerospace, Defense, and Government Services M&A Considerations — Regulatory Requirements.

Organizational conflicts of interest are another area for heightened diligence review. FAR prohibits conflicts that arise when a contractor is unable or potentially unable to provide impartial service to the government or when it obtains an unfair competitive advantage as a result of receiving confidential information. A conflict may arise, for example, if a strategic buyer is involved in developing or setting the specifications for a government contract against which the target may bid. Identifying such potential conflicts of interest early in the deal process allows buyers to take actions to mitigate any potential conflicts while maintaining the thoroughness of their diligence process. A neutral "clean team" can be appointed by the parties to review highly sensitive and confidential information while reducing the risk of the seller sharing too much information with the buyer so as to raise conflict of interest issues. For further discussion of clean teams and clean team agreements, see Due Diligence: Antitrust Issues.

Given the state of the world with respect to the COVID-19 pandemic, buyers are increasingly requesting specific and detailed diligence with respect to the effects of the

pandemic on the target. Such diligence inquiries include questions regarding loans obtained to alleviate the financial hardship, disruptions that have occurred to the normal operations of the target as a result of the pandemic, and an examination of any changes with the target's customers. Buyers will also want to evaluate what steps the target has taken to support its vulnerable suppliers, how the target has managed to maintain and sustain its critical workforce of highly skilled employees, and whether there are alternative supply chain strategies (such as acquiring distressed suppliers) or new sources of supply, among other things. As a seller, you should be prepared to answer these questions. For more guidance on a variety of legal issues related to , see Coronavirus (COVID-19) Resource Kit.

For discussion of the general due diligence process, see Due Diligence Basics in M&A Deals, Due Diligence Review Tools in M&A Deals, and Due Diligence Work Product in M&A Deals.

National Security Considerations

A&D and national security are inextricably intertwined. The Committee on Foreign Investment in the United States (CFIUS) reviews investments by foreign parties into critical U.S. industries—particularly A&D—to determine whether an M&A transaction may affect national security. In these specified industries, the parties to a transaction must evaluate whether a CFIUS filing is required (or should voluntarily be made) whenever a foreign national or foreign governmental actor is involved. This involvement can be as attenuated as a foreigner being a limited partner in a private equity fund unless one of a number of limited exceptions applies. In the event that CFIUS determines that there is concern with your transaction, it has the power to block (or even force you to unwind) your deal.

CFIUS filings are complex and can inject additional cost and delay into the closing timeline. Counsel should evaluate early in the deal process the risk of a required filing and possibly weigh the costs and benefits of making a voluntary filing. This information can help sellers select which buyer to proceed with in a contested auction sale process. The parties will also want to make sure that applicable CFIUS-related provisions are included in the purchase agreement for the transaction to spell out applicable rights and obligations, as well as to allocate any potential risks.

For a detailed discussion on the CFIUS review process, see Regulatory Landscape for Contests for Control — Exon-Florio and CFIUS.

Export Controls

Export controls, particularly International Traffic in Arms Regulations (ITAR) and the Export Administration Regulations, are also of particular importance to A&D transactions. Like CFIUS review, these regulations are designed to protect national security objectives and noncompliance risks are severe. Potential penalties for violations include the imposition of civil penalties of up to $1 million per incident, the possible denial of export privileges, and even debarment from federal government contracts. It is thus imperative for prospective buyers to assess the target's compliance early in the deal process as there may be successor liability to a buyer for past violations. Sellers should consider doing their own internal compliance diligence in advance of negotiations with a buyer to get ahead of any issues in this area, including possibly making voluntary self-disclosures under ITAR to remedy past violations and give the target company a clean slate with the prospective buyer. For a discussion of U.S. export controls, see Impact of U.S. Export Controls under Aerospace, Defense, and Government Services M&A Considerations — Foreign Buyers.

Conclusion

Due to its highly regulated nature and the complexity of the technology involved, the A&D industry is not like other industries, and it should come as no surprise that doing deals in this space is different than run-of-the-mill M&A transactions. There are significant considerations that are unique to A&D that, if overlooked or not thoroughly evaluated, can mean the difference between a successful closing and a broken deal for your client. It is important for buyers and sellers to have experienced and practical professional advisors to help navigate these challenges. If you plan ahead and are proactive, you and your team can identify and address any risks early in the deal process with enough time to bring your deal in for a smooth landing.

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Areas of Practice

Zac's practice focuses on mergers & acquisition transactions across a wide variety of industries. He works with private equity firms, public companies, family-owned business, strategics and entrepreneurs in industries such as consumer products, business services, software & technology, video games & esports, cannabis, healthcare, apparel & beauty, manufacturing, retail, food & beverage and aerospace & defense. Over his career with Sheppard Mullin, Zac has successfully closed over 200 M&A transactions, giving him deep industry expertise in a number of sectors.

He also helps clients with debt and equity financings, venture capital investments, corporate governance and joint ventures and strategic alliances.

Zac specializes in getting deals done. He is adept at making complex issues comprehensible and finding practical solutions to legal problems. He is an avid writer and speaker with respect to areas of corporate law. He holds a law degree from Harvard Law School and B.A. from Duke University. He has been recognized as a leader by Super Lawyers, the Legal 500 and the M&A Advisors.

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Areas of Practice

Rambod represents companies in a variety of corporate transactions including mergers and acquisitions, corporate governance, entity formation, and other general corporate matters. He works with clients in a wide range of industries, including aerospace and defense, technology, retail, fashion, apparel and beauty, manufacturing, construction, financial services, food and beverage, entertainment, and healthcare. In addition, Rambod has advised entrepreneurs and start-up ventures in connection with formation and general corporate matters. He has also counseled public and private companies in all aspects of corporate governance.