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INSIGHTS FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

# MERGERS & ACQUISITIONS FOR GOVERNMENT CONTRACTORS: STEPS TO NAVIGATING THE POST-LOI PHASE

In this second insight of our three-part Mergers and Acquisitions (M&A) Sell-Side series for government contractors (GCs), we outline considerations and action steps to help you navigate the post-LOI (Letter of Intent) phase of selling your GC business. The LOI outlines the structure of the acquisition, as well as the pricing and terms. Generally, this is the final step prior to the seller granting exclusivity (i.e., where the seller agrees to negotiate only with a particular prospective buyer). Once exclusivity is granted, the buyer engages a team of specialized professionals to address particular issues, such as quality of earnings, tax structuring, human resources (HR), insurance review, and operational, commercial, property and IT due diligence.

To the extent possible, a GC seller may wish to consider preparing the business to address any due diligence concerns before beginning the LOI phase, as the diligence process provides significant input to the ultimate investment thesis, the risk profile of the transaction and points of negotiation (e.g., transaction service agreement, stock or asset sale, working capital negotiation). Advisors can help guide the seller in focusing on key areas that can be prioritized for maximum impact. See our first **insight** in this series for more detailed information on steps that can be taken to prepare.

Once the LOI is signed, the seller may wish to consider the following as next steps (some of which may already be underway):

1. Gather historical financial statements and supporting documents and post all documents in an electronic data room for the potential buyer to access and review.
2. Obtain release letters from the potential buyer for access to independent advisors' quality of earnings report.
3. Have your advisors assist with buyer questions and requests.
4. Determine whether there are any organizational conflicts of interest (OCI) with any of the buyer pools, and if so, seek assistance from the government compliance leadership team/advisor on possible mitigation strategies.

Armed with the quality of earnings report, information on risks uncovered during the due diligence process, synergy opportunities and the perspective of the deal team and the platform company management team (if the buyer is a private equity firm), the buyer will finalize the financial models and prepare for its investment committee meeting. The investment committee would have seen and approved moving forward with the deal several times before this final sign off, so issues should not arise at this stage.

## PURCHASE AND SALE AGREEMENT

The final offer from the buyer, also known as the "purchase and sale agreement," includes a number of critical elements, each of which may lead to multiple levels of selected diligence and negotiation. Once these are agreed upon, the legal teams and the investment banker can prepare for closing.

When reviewing the purchase and sale agreement, the seller should:

1. Review definitions of the post-closing adjustment to address any changes in the value of assets between the time of the initial agreement and the closing of the deal.
2. Understand the acquisition date. There is often confusion from a reporting perspective on closing balance sheets, and the determination of the date is a critical component that all parties should understand.
3. Ensure that all terms are defined in the net working capital (NWC), including a listing of accounting policies where necessary (such as language specifying adjustment items are calculated consistent with the seller's past accounting practices as opposed to an interpretive set of guidelines, such as GAAP.) The seller wants an "apples to apples" comparison of closing NWC and does not want the buyer to get a more favorable adjustment by changing the accounting rules.
4. Determine if there are any earn-outs or other contingent consideration, and if so, analyze the feasibility of the proposed mechanisms.
   - Ensure there is an understanding of the contingent consideration with the help of legal, accounting and valuation teams. For sellers, this can potentially lead to a higher sales price if performance criteria are met. If there are financial performance targets, it is important that the buyer is able to accurately track the performance of the acquired entity to minimize (or prevent) potential disagreements or issues relating to measurement of the performance criteria.
   - Carefully review open-ended earnouts because they can reduce cash proceeds by causing early capital gains and later year capital losses that cannot be offset. Also, earnouts unnecessarily tied to continued employment potentially could create a risk that the payments would be characterized as ordinary income. Careful consideration of the terms and purpose of a non-compete clause can avoid unfavorable ordinary income treatment. Have your tax advisor review the term sheet/LOI and transaction document to prevent these costly mistakes.

## TAX CONSIDERATIONS

Once the purchase agreement is drafted and undergoing review, the seller's law firm may offer to have their tax team review the document. The law firm's perspective is valuable and important to the process but is not a substitute for having your tax advisor review the document as well. The seller's legal and tax advisors should look at the overall tax impact to the seller based on the proposed structure of the transaction. The tax advisor often assists with modeling to help visualize the tax impact, reviews reporting deliverables post-closing and helps the seller navigate the tax representations included in the agreement.

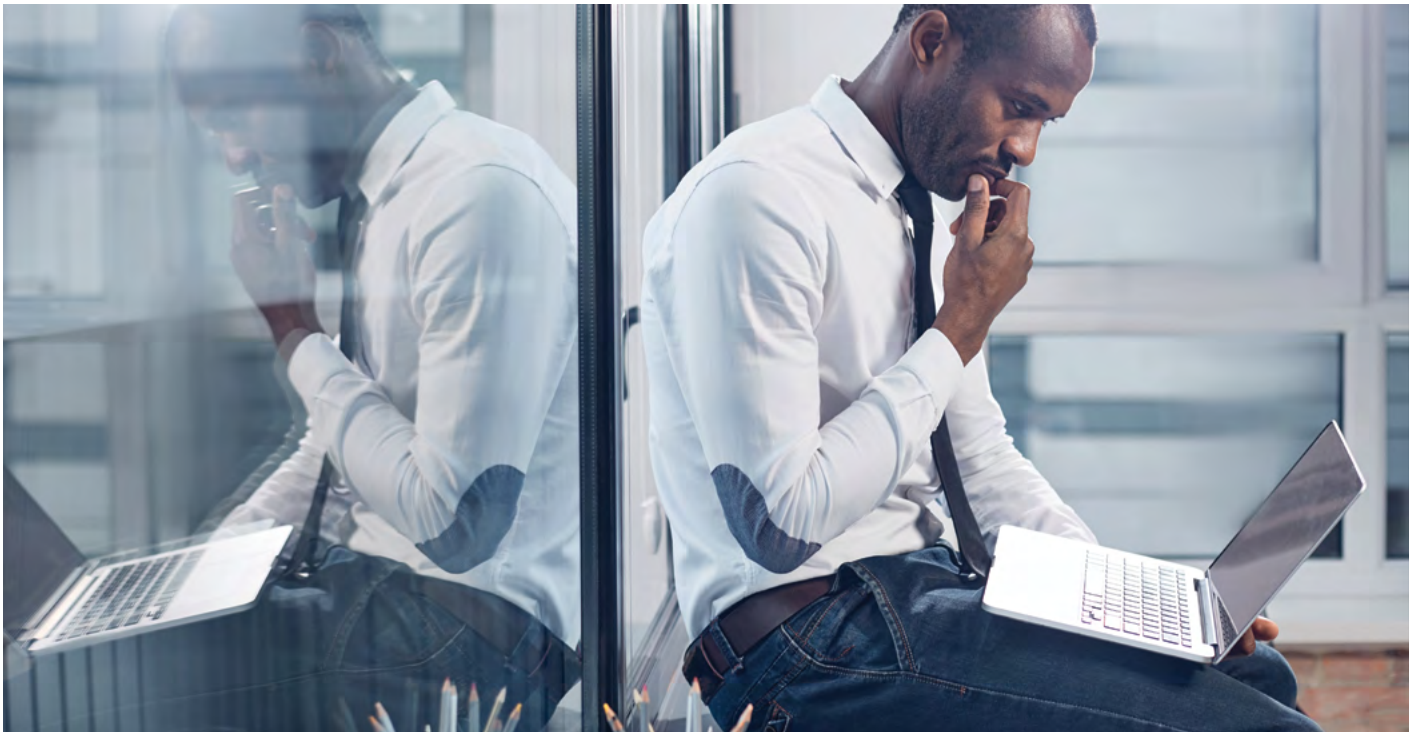
Your tax advisor should also be looking at the allocation and method for payment of taxes for the year of the transaction. Gaps in the agreement's definition of pre-closing periods and the operation of the tax rules resulting from the transaction structure could have unintended consequences.

The buyer's tax team is looking to identify any tax risks associated with the seller's business on a tight time frame. As a result, the team may estimate associated exposure amounts using the limited data made available, which potentially could result in overstated estimated exposures. A sell-side tax advisor can help minimize or eliminate purchase price reductions or special tax escrows by reviewing tax exposure analyses prepared by the buyer's tax team and helping the seller determine if better data or more appropriate assumptions should be used.

## MINIMIZING RISK

To optimize the post-LOI phase overall, the seller should consider the following:

- Be involved in the negotiation of various terms in the purchase and sale agreement to drive maximum value.
- Work with an advisor, legal and deal teams to provide support with preparation of detailed disclosure schedules.
- Ensure HR engagement to provide clarity around continuing employment of the company workforce and their benefits post-closing.
- Support customer communication and engagement. In the government contracting space, customers expect to be informed of a potential change in ownership, due to the nature of contracts.
- In a carve-out situation, evaluate the necessity of a transition services agreement (TSA), and work with advisors to ascertain requirements on both sides. A TSA provides proper documentation of each party's expectations, along with clear terms of engagement. This may include back-office services such as finance, HR or IT support, which may



be needed to support the divested organization until those functions are transitioned to a buying organization. It is also important to understand impacts if both parties financials will exist in the same accounting system during a transition period. Proper identification of the seller costs associated with the various services provided should be maintained to allow for collection of costs in the proper indirect pools and ensure that any unallowable amounts can be removed from future claims.

- While sellers are understandably motivated to get the highest sales price possible, the consequent tax exposure can make the seemingly "best" deal potentially less optimal. When a buyer and seller are negotiating the terms of the deal, there are various components that can be manipulated (such as using future earnouts, rollovers, buying assets vs stock, etc.). Having a model prepared where the seller can compare the net impact of these proposals puts the seller in a position to make the best overall decision. The highest price may not always be the best answer.

## CLOSING

Once the seller reviews and finalizes the closing statements, including the purchase and sale agreement and all associated schedules and disclosures, you should prepare the funds flow statement and communication materials, including FAQs, and communicate the change to the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Agency (DCMA).

Given the potential for substantial consideration to be paid for your company, a good and open working relationship with the buyer is paramount. Such relationships are often tested given the potential NWC issues, as defined in the agreement. We see more successful acquisitions and transitions with companies whose sellers and buyers are flexible or open to negotiation as it relates to closing balance sheet amounts. Given the demands of a highly active M&A market like we are currently experiencing, buyers and sellers should be prepared to consider a tailored approach to getting deals done.

Another typical issue is that sellers are inclined to keep the circle of knowledge around the deal small and minimize costs by excluding external advisors from due diligence requests and calls. An alternative approach may be to enlist the assistance of external advisors who can provide guidance. Business owners are not necessarily experts in all fields and can provide responses that prompt further questions from the buyer simply because of the language used or assumptions as to why a particular position was taken. Having the advisor present to speak to this precisely can help prevent additional unnecessary information requests.

In conclusion, while it's critical to have a systematic process in place during the post-LOI phase of selling a GC business, as described above, there are financial reporting and tax issues to work through. In our experience, it's equally important to focus on the "soft" issues.

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