INSIGHTS FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

M&A BUY SIDE SERIES: THE LETTER OF INTENT THROUGH CLOSING PHASE

There is no doubt that the novel coronavirus has introduced significant uncertainty into the outlook for merger and acquisitions (M&A). However, the silver lining for government contractors (GCs) is that their main customer, the government, remains open for business—so it's easier to make revenue and cash flow projections for both your firm and potential acquirees compared to other industries. For GCs looking to grow their firm through an acquisition, it's more important than ever to take a systematic approach to evaluating proposed deals. In the second Insight in our three-part M&A Buy-Side series for GCs, we move to the next phase in the deal journey: Indication of Interest (IOI) through closing. In this Insight, we'll identify considerations for issuing an IOI, as well as the key due diligence, deal drafting provisions, and integration issues to explore with a viable acquisition target before closing. For tips on identifying and evaluating acquisition targets, click here for our first Insight in the series.

ISSUING THE IOI

The IOI is typically a more informal proposal—or first step—when registering your interest in an acquisition, compared to the LOI. When sending an IOI, buyers are providing a non-binding purchase price or range that they would be willing to pay for the target company, subject to further review, meetings with management, confirmatory diligence and negotiation.

So, if the IOI is non-binding and simply an initial indication, what is the risk of sending an IOI to one or more acquisition targets that look attractive on the surface? The answer may be self-evident: The internal resources, financial resources and the managerial efforts required to pursue one or more targets can be overwhelming to a management team. In our experience, the IOI process is a very important opportunity to test the waters in terms of seller expectations and possibly drive the buyer to a quick no if value expectations between buyer and seller are too far apart to invest any additional effort.

Steps to take during the IOI phase:

1. **Determine price range:** During the development of the non-binding IOI by the GC buyer, the key is to determine the range of values that allow you to move forward in the process without providing a price that overpays for the asset. What we have found is that the seller's investment banker—while being a true fiduciary for the seller—will assist the potential buyers with understanding the target company and the potential upside opportunities. While this information needs to be verified, we recommend the

triangulation of all the available data to develop the range of values offered during the IOI, including:

- Reviewing the provided data and interviewing the seller's investment banker in detail to understand and exploit the full value of their knowledge.
- Developing a thorough investment thesis with your management team—especially if the target company is in the same field as your own business.
- Retaining trusted advisors to provide research, begin diligence and leverage their knowledge of the market.

2. Provide insight into how you might ultimately fund the transaction: When issuing an IOI, it strengthens a buyer's credibility to provide insight to the seller and its advisors regarding potential funding sources for a prospective transaction. While some believe that the seller may not care where the money will be coming from or the level of debt to be employed, sophisticated business sellers understand that prospectively leveraging the target company with too much debt may ultimately be rejected by lenders or, if the transaction actually does close, may lead to a business eventually failing under new ownership. Both buyer and seller should be concerned with this risk.

3. Evaluate the pros and cons of an earn-out provision: An earn-out is a contractual agreement to bridge the sales price of a target by providing additional compensation over time, typically by the target meeting certain financial performance goals during a prescribed period post-close—usually less than three years. The concept is straightforward, but there may be a series of unintended consequences such as friction post-close between seller—who often stays involved with the company to ensure the earn-out is achieved—and the buyer, who may have longer range plans that require added investment and less financial achievement in the short-term in favor of enhanced performance and value creation in the medium to long term.

DUE DILIGENCE CONSIDERATIONS

Due diligence processes at many companies are often designed from a commercial perspective and are not structured to address government contracting (GC) risk. This is often the case when companies are primarily commercially focused, or have a mix of commercial and United States Government (USG) business. The result is that GC risks are not adequately addressed, which can lead to unexpected surprises, post-close. Due diligence processes should include an in-depth review of all current government contracts and activities, so the buyer can ascertain current and future compliance requirements, potential government audit exposure, the state of the target's contracting policies & procedures, compliance resource requirements, and other issues. In addition to the aforementioned GC-specific issues, at BDO we've recently seen some recurring tax issues arising in GC deals that should be added to the due diligence checklist.

Here are three potentially major tax issues that are often overlooked:

1. LLC S corporation dangers: Limited liability companies (LLCs) are the preferred entity choice by many business owners due to their flexibility. However, often we see LLCs electing to be taxed as S corporations. While LLCs can be eligible to elect to be taxed as S corporations, standard LLC operating agreements contain capital account provisions normally included to comply with the partnership tax provisions. If these provisions impact either operating or liquidating distributions, the IRS will generally view the LLC as having more than one class of stock and the LLC will not meet the S corporation eligibility requirements, even if the facts are such that all parties currently would have proportionate capital accounts. If the terms were in effect as of the effective date of the S election, the result is simply that the election was not effective, which may not be a big deal if no entity classification election was signed. But if the provisions became effective after the S corporation election date, or an entity classification election was filed, the entity's seeming S corporation designation would actually be properly characterized as a C corporation and corporate level tax could be due for all open tax years. An acquirer may need deep pockets to pay these taxes if the issue is identified by the IRS in an examination rather than through seeking a private letter ruling.

2. Sales taxes for subcontractors: The perception among GCs is that the end-user is the government, so any sales are exempt from sales tax. However, if a company is operating as a subcontractor and selling hardware or other tangible personal property to a prime contractor who resells the products to the government, the company is still liable for collecting and remitting sales tax on taxable sales, unless proper sales tax exemption documentation (i.e. resale certificates) is collected from the prime contractor. This exposure also exists for service providers in jurisdictions that tax services. Given that sales taxes are based on the gross price rather than net profit, these exposures can get large quickly. Fortunately, this exposure can generally be remediated if the company undertakes an effort to go back to its primes and collect the applicable exemption certificates. If this effort isn't undertaken prior to a company going up for sale, a temporary escrow may be needed to protect the buyer until the certificates are collected—this process can take several months, depending upon the number of primes the company has worked with.

3. Impact of onsite and remote workers on state tax filing obligations: Similar to other industries, GCs employ individuals remotely in order to attract and retain talent or to meet customer requirements. However, companies often fail to realize that these remote individuals, even those performing services at government facilities, impact the company's state tax filing obligations. The bottom line is that even a single remote employee or contractor in a state can create nexus in that state, and with nexus comes state tax filing obligations. If a company has not been filing in all the states in which it has established nexus, an acquirer could be left footing the state tax bill for historical taxes.

DRAFTING THE DEAL

There are numerous financial and accounting issues to check off your list in the pre-closing phase, including:

☐ **Draft Transition Services Agreements (TSA):**

If services need to be provided to the target during a transition period, ensure a TSA provides proper documentation of expectations of each party. For one, it will help to clarify the potential impacts if both party's financials will exist in the same accounting system, post-closing.

☐ **Communicate with cognizant USG representatives:**

Once a deal has been announced, regularly communicate with cognizant contracting officers so there are no "Day 1" surprises. Contractors should keep ACOs informed regarding any required contract novations, planned segment changes, changes to home office structures, and anticipated impacts to disclosure statements, among other topics. There may also be a desire to negotiate an advance agreement for the treatment of certain restructuring costs. This coordination can help ensure that there are no interruptions to contracting activities once the deal is closed.

For Department of Defense (DOD) contractors, the government often requires an integration plan before they will approve a complex deal or one that they perceive consolidates supply chain players or threatens national security. Additionally, considerations to the structure of integration costs and approaches for measuring outcomes of consolidation are required for DOD contractors to help restructure costs in a manner that be recouped when the ROI and efficiencies are demonstrated to DOD.

☐ **Evaluate implications of deal structure to the financial statements of the surviving entities:**

This will be particularly important if the transaction is a partial acquisition/investment and/or there will be complex equity rollovers or earn outs. Focus on reporting implications, as well as cash flow requirements, financing requirements, existing bank covenants, etc.

☐ **Work out accounting related issues upfront:**

Few topics are more likely to cause stress at the end of the negotiation than the Net Working Capital (NWC), peg and true up. A best practice for each stage of the process is to: (1) confirm the definitions you will use for each of these accounting terms, upfront; (2) identify the impact at closing; and (3) determine what will happen at the post-close true up—typically 60-90 days after the closing. Developing the model for NWC and the actions at true up will remove the issue of one group attempting to take advantage of the other.

☐ **F Reorganizations – assess the pros and cons:**

In the world of S Corporation acquisitions, F Reorganizations have become a staple. At its simplest, the F Reorganization gives the buyer a tax basis step-up transaction while eliminating the need to file an IRC Section 338(h)(10) or 336(e) election. However, buyer beware: The one thing the F Reorganizations can't do is eliminate liability for prior period C Corporation tax exposures (an incremental 21% - 35% federal plus applicable state tax, depending on the tax year) in the event the company did not properly elect or maintain its S Corporation status. Only an actual asset purchase or private letter ruling can do that.

CREATING AN INTEGRATION PROCESS

After due diligence has been completed and the letter of intent (LOI) is signed by both acquirer and acquiree, it's critical to create and document an integration strategy. It may seem early to take this step since the deal has not officially "closed," but having a plan in place that lays out the goals, sequencing and expectations, will set the combined organization up for success.

Have you?

☐ **Assessed and aligned board, executive and business leaders' expectations?**

☐ **Evaluated and updated existing integration strategies?**

☐ **Defined integration roles and workstream leads?**

☐ **Facilitated senior leader working sessions?**

☐ **Outlined an integration playbook?**

Pre-"Day 1" Plan:

Armed with the information outlined above, the next step is to develop a tactical integration playbook that helps you plan for "Day 1," or the transition to a combined organization. The goal here is to help maintain the efficiency of dissimilar processes that may be temporally running concurrently.

Have you?

☐ **Defined priorities and built consensus?**

☐ **Created an inventory of key processes, people and technology for Day 1?**

☐ **Developed a transition plan by workstream (with Day 1-10-30-60-90 milestones)?**

☐ **Communicated rational for the merger and new value proposition?**

☐ **Identified transition teams to address operational questions on Day 1?**

"Day 1":

While post-transaction strategy and processes will be covered in more detail in the next Insight in this series, it behooves acquirers to envision their first day, post close.

What are some common pitfalls GCs face on "Day 1?" Failure to adequately inform leaders and employees why the deal is good for the company, employees and customers, and how that deal will impact their roles, who they report to, approval processes, and changes to their benefits or paychecks can result in frustrations at the outset of any integration initiative, let alone the disruptions to service delivery and operational performance.

For GCs in particular, failure to inform contracting officers that a deal is happening, and to inform them how that deal will impact legal and contracting entities can result in "Day 1" confusion. This can cause interruptions in contracting activity and result in the inability to ship product and delays in receiving payment.

In conclusion: Conventional wisdom dictates that the IOI through closing phase in your acquisition journey should be focused on conducting due diligence on your target and to explore accounting and tax implications of the deal. However, in our experience, it behooves GC buyers to use the parameters of the IOI to think strategically about the potential value of the acquisition to your firm before initial outreach. This phase is also the perfect time to envision how your newly integrated organization will fare on "Day 1". Creating an actionable plan now that lays out how the target will be seamlessly integrated into your firm will help to ensure customer, employee and supplier loyalty during the transition.

Learn more about how your organization can best navigate the *LOI through Closing* phase by reaching out:

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