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Conflicts of Interest

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Identifying and Mitigating Organizational Conflicts of Interest in Government Contracts Mergers and Acquisitions

By John Chierichella and Keith Szeliga

An organizational conflict of interest (OCI) arises when the performance of one contract undermines a contractor's objectivity or creates an unfair competitive advantage with respect to another contract. An agency cannot issue an award to a contractor that possesses a significant OCI unless that OCI has been avoided, mitigated or waived. Many government contracts include clauses that require contractors to avoid potential OCIs; to notify the government of any OCIs that arise after award; and to work with the government to mitigate any such OCIs. Some contracts also avoid OCIs proactively by precluding the contractor from performing specific types of work.

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Most sophisticated government contractors have procedures to screen for OCIs. This allows a contractor to comply with OCI prohibitions and analyze the impact of each opportunity on its portfolio of government business, to avoid competing for *current* contracts that would unacceptably restrict its ability to obtain significant *future* work.

Mergers and acquisitions bring together previously independent businesses. By combining two or more distinct portfolios of government contracts, they have the potential to create OCIs where none previously existed. The identification, assessment and mitigation of such

OCIs are essential — not only from a compliance perspective but also in determining whether the transaction is viable and in valuing the target.

What Is an OCI?

An OCI arises where — because of other activities or relationships — a contractor is potentially unable to render impartial assistance or advice to the government; the contractor's objectivity in performing the contract work might be impaired; or the contractor has an unfair competitive advantage. OCIs generally fall into three categories: (1) unequal access to information; (2) impaired objectivity; and (3) biased ground rules.

An *unequal access to information* OCI arises where a contractor has access to nonpublic information as part of its performance of a government contract and where that information may provide the contractor with an unfair competitive advantage in a later competition for a government contract. Such nonpublic information may include proprietary or source selection information, as well as other information beyond what is normally available to a typical incumbent contractor.

An *impaired objectivity* OCI typically occurs where a contractor's work under one government contract could entail evaluating itself, its affiliates or its competitors either through an assessment of performance under another contract or an evaluation of proposals. The concern is that the firm's ability to render impartial advice could appear to be undermined by its relationship to the evaluated entity.

A *biased ground rules* OCI typically occurs where a contractor, as part of its performance of a government contract, has set the ground rules for another procurement (e.g., by drafting specifications or the statement of work). In these cases, the primary concern is that a contractor could skew a competition, intentionally or not, in favor of its own products or services or those of an affiliate.

A contractor and its affiliates are treated as a single entity for purposes of analyzing impaired objectivity and biased ground rules OCIs. Acquiring a government contractor, therefore, can create an OCI even if the target will remain a separate legal entity.

How Do You Diligence OCIs?

Identifying OCIs requires understanding the target's business. The offering memorandum and the target's website are the best places to start. These materials often provide enough information to identify potential deal breakers and to gauge whether OCI issues are likely to become a significant issue in the transaction.

It is also necessary to review thoroughly the terms and conditions and statements of work for all of the target's significant contracts. Pay special attention to contracts that include express OCI clauses or preclusions on future work. Also insist on copies of all OCI mitigation plans.

Remember that it is not simply the nature of the target's work — but the nature of that work in relation to the buyer's work — that creates the potential for OCIs. Analyzing the OCI implications of a transaction, therefore, often requires the buyer to conduct at least some diligence on its own contracts, including the statements of work, the terms and conditions and any applicable OCI mitigation plans.

How Do You Mitigate OCIs?

Unequal access to information OCIs rarely have a significant impact on transactions. They can be mitigated by a firewall that precludes the sharing of information. The typical components of such a mitigation plan include, without limitation, nondisclosure agreements, physical and electronic access controls, regular training and periodic audits.

Impaired objectivity and biased ground rules OCIs are more difficult to mitigate. The typical strategy is to subcontract out the work that would create the OCI to a third party, and then have that third party report directly to the government. If, for example, the buyer has a contract to prepare statements of work for aircraft maintenance services generally, and the target provides maintenance services for a particular aircraft, the government may agree to allow the buyer to subcontract out preparing the statement of work for the specific aircraft maintenance services that the target desires to perform. The subcontractor would then report directly to the government to ensure that the buyer does not in any way influence the statement of work.

This strategy requires entering into a bilateral OCI mitigation plan with the government, and the government may not be inclined to approve such a plan. The government may prefer to have the prime contractor perform the work, or may not want to accept the additional administrative burden of interacting directly with a firewalled subcontractor. In some cases, the government may determine that the OCI is simply too pervasive to mitigate. If, for example, the buyer has a contract to supply a system for which the target provides systems engineering and technical assistance, mitigating the OCI using a firewalled subcontractor would require subcontracting out the entirety of the target's contract, which is not practical. The government's discretion to reject an OCI mitigation plan for any of these reasons, once a contract has been awarded, is extraordinarily broad.

Biased ground rules OCIs present an additional difficulty. Once a contractor has drafted the specifications or statement of work for a procurement, there is no generally accepted approach to mitigate the OCI. In this scenario, the key question is whether the specifications or statement of work were drafted before or after the merger or acquisition was contemplated. If they were drafted before the transaction was envisioned, one could argue that there was no biased ground rules OCI because the party drafting the specifications or statement of work did not have an economic incentive to favor the other parties' capabilities at the time the work was performed. If, however, the specifications or statement of work were drafted or modified after the parties had entered into negotiations for the merger or acquisition, preclusion is significantly more likely.

In cases where an OCI cannot be mitigated by traditional means, it may be necessary to divest a portion of the buyer's business or the target's business. Government consent will not be required in rare cases where the buyer desires to spin off a separately incorporated division or affiliate. If the divestiture takes the form of an asset sale, a novation agreement will be required. Not only the contract that gives rise to the OCI, but also all of the assets involved in performing that contract, would need to be included in the asset sale.

   ISSN 0014-9063

With the exception of selling or spinning off a separately incorporated entity, all of the OCI mitigation strategies identified above generally require government consent (i.e., approval of an OCI mitigation plan or consent to assignment). Therefore, it's critical for the parties to open up a dialogue with the relevant contracting officers as early as possible to determine whether and how any OCIs resulting from a merger or acquisition can be mitigated.