"M&A in Aerospace, Defense & Government Services"

Tuesday, October 22, 2019

Audio Archive

Each industry has their own unique issues, characteristics & style when it comes to deals. That is particularly true when it comes to deals that implicate the government in some way. Join these experts:

- **Carine Stoick**, M&A Partner, Hogan Lovells LLP
- **Michael Vernick**, Government Contracts Partner, Hogan Lovells LLP
- **Brian Curran**, International Trade/CFIUS Partner, Hogan Lovells LLP

John Jenkins, *Editor, DealLawyers.com*: Hello, this is John Jenkins, Editor of DealLawyers.com and I'd like to welcome you to today's program. It's called "M&A in Aerospace, Defense & Government Services."

Doing deals with companies that work arm-in-arm with the government involves all sorts of complexities that aren't often present in deals with companies and with private sector customers.

And joining me today to discuss some of those complexities are Carine Stoick, Michael Vernick, and Brian Curran, all of whom are partners of Hogan Lovells. I'm going to turn the webcast over to Carine who will kick things off with the discussion about the trends in ADG M&A. Carine?

General Trends in M&A in 2019

Carine Stoick, *Partner, Hogan Lovells*: Thanks John. Thanks everyone for joining us this afternoon. I'm going to first talk a little bit about trends in the Aerospace, Defense, and Government Services M&A industry. And I'll be referring to it as the "ADG industry".

So generally, just in M&A, in the third quarter, we've seen an 11.4% drop in transaction value globally on a year-over-year basis based on a quarterly report released by

MergerMarket in early October.

We can attribute some of this drop to recession fears, and global geopolitical conditions. The UK's anticipated departure from the EU and protectionist policies contributed to the decrease in value and volume of the transaction.

There is even a dip in the US market, which we haven't really seen in the recent past. In the past, it withstood the challenges in M&A.

But in the third quarter, US deal value, for example, was $262 billion, the lowest amount since the first quarter of 2016 (when deal value was $254 billion). There's also been a slowdown in the third quarter in Europe and in Asia. So, let's turn to what that means for trends in ADG M&A.

For ADG M&A, the first quarter was slower than in prior years in terms of volume. The second quarter saw an increase in deal value because of the UTC-Raytheon mega-merger which we'll talk about in more detail in a few minutes.

Notwithstanding the slight slowdown in M&A generally, the transaction volume in the third quarter in the ADG industry was the single largest quarter in M&A over the last five years.

Acquirers continue to look to M&A to supplement organic growth, get access to new customers and contract people and bolster capabilities, especially in technology and innovation. And that's really focused on IT modernization, cloud capabilities, next-gen IT, and cybersecurity.

Some of the key transactions in Q3 include Guidehouse's $1.1 billion acquisition of Navigant; Advent International's $5.1 billion acquisition of Cobham; and Parker's acquisition of Exotic Metals for 1.6 billion.

ADG Mega-Mergers and Related Impact

Now one of the trends we're seeing in addition in the ADG space are what we're calling "mega-mergers." And they started in about 2017 and 2018 and have culminated obviously in the Raytheon-UTC merger that was announced in the second quarter of 2019.

That merger will create a roughly $74 billion-revenue company and the second largest aerospace player in the US next to Boeing. It's expected to close in the first half of 2020. As of now, they don't have the antitrust approvals. The DOJ has issued a second request. But the stockholders of the constituent companies have approved the transaction, obviously subject to receipt of the antitrust approval.

What we're seeing with these mega-mergers is that it may incentivize competitors to seek to gain size to stay competitive; and also suppliers of these competitors to merge and to acquire other companies to also gain size and to have more leverage in their negotiation with these primes.

Access to New Technology and Innovation

The Raytheon-UTC transaction also represents the largest transaction for aerospace and defense sectors in the last six years. So, in addition to Raytheon-UTC in 2019, Harris' merger with L3 closed in June 2019. The merger has resulted in the formation of L3Harris Technologies. The combined company is the sixth largest defense company in the US and in the top 10 defense companies globally.

In 2018, we also saw United Technologies' acquisition of Rockwell Collins through reverse triangular merger, which was announced in 2017 and ultimately closed November 2018.

And the new company there is called Collins Aerospace Systems. And then there was also General Dynamics' acquisition of CSRA through two steps–tender offer and reverse triangular merger, which was completed in April 2018.

Private Equity Buyers

In addition to the mega-mergers, we're also seeing more private equity buyers and sellers in the space. Strategic investors remain dominant in 2019 as the investors in the ADG space.

But we continue to see more PE acquirers than in the past. And that's attributed to the fact that there have been vast levels of capital to deploy in high margins and multiple for ADG targets. And that's making this sector increasingly attractive to private equity.

Even though private equity has avoided the sector in the past partly due to the regulatory restrictions and considerations that Mike Vernick, my colleague, will talk about shortly, the high-gross margins and the US government's focus on the defense budget have made ADG companies an appealing play.

For example, in Q3 2019, PE acquirers were 23% of the buyers and PE portfolio companies represented about 27% of the buyers in the publicly announced transaction. And some of the repeat PE firms that we see in the space are Veritas Capital and Arlington Capital.

So Veritas, for example, acquired PwC's US public sector business in 2018. And that's now named–that's now known as Guidehouse and that was one of the transactions I had highlighted as a significant transaction in Q3 2019. They have announced an acquisition. So, turning now to some other kind of deal-specific trends for lawyers.

Representations and Warranties Insurance

One thing we're seeing a lot of in the ADG industry, and particularly any sort of industry where you're dealing with an auction process, we're seeing the use of representations and warranties insurance by sellers in an auction process.

And for those of you who aren't familiar with what that is, it's a type of transaction insurance that protects either buyer or seller from financial loss resulting from a breach of the target companies or the seller's representations and warranties contained in an acquisition agreement.

And what we mostly see are buy-side policies. And that's when the sellers said to the buyer, "We're not going to be on the hook for any sort of post-closing recourse," or "we're only going to give you recourse limited to an indemnity or limited to a very small escrow amount into a small post-closing survival period."

And what that results in is a buyer having to seek a reps and warranties insurer to insure the target companies' representations and warranties. So, they'd get coverage for any sort of breaches of the reps and warranties up to the coverage limit.

And who pays for the policies is subject to negotiation between the buyer and the seller. We've seen a recent surge in RWI generally in the past seven years because it's been a seller-friendly M&A market.

The frequent use of RWI has resulted in a streamlined underwriting process. Private equity funds and other sellers like ESOPs, for example, in the ADG space looked to make clean exits from investments. And so, they really can't have any sort of ongoing recourse post-closing.

And there's also been–the insurers have become readily accustomed to providing these policies and they've been very successful. So, it's resulted in lower premiums and costs and insurers being more comfortable in paying. So, that resulted in the surge.

In the ADG deals in particular, we are seeing an increasing number of sellers in auction processes, either proposing a no indemnity deal or a limited indemnity deal. Particularly, as I mentioned PE sellers and ESOPs, if it's a competitive auction you will see these sellers just coming out and saying that you won't have any sort of post-closing recourse to them, and you'll have to look to a reps and warranties policy.

Now the policy–the good news about policies is they provide a longer coverage period. Usually in a traditional indemnity deal, you may have survival of 12 to 18 months for general reps and warranties. Fundamental reps and statutory representations typically last until the statute of limitations. However, under reps and warranties policy, you'll have three years for general reps and warranties and six years of coverage for fundamental representations and taxes.

One thing to note is that having reps and warranties insurance doesn't provide a buyer protection against anything other than breaches of reps and warranties. So, buyers encountering reps and warranties policies are going to want to consider, based on their leverage and the competitive landscape in the process they're involved in, whether they should also seek recourse for breaches of pre-closing covenants, pre-closing taxes, unpaid indebtedness, and unpaid transaction expenses. That's enough on the reps and warranties.

Interplay Between National Security Concern and HSR Approval

I think the other key point to highlight in deal trends in ADG M&A is we are seeing the anti-trust agencies, the DOJ, and the FTC, in addition to kind of being involved in the competitive considerations and looking at transactions from a competitive perspective, when it relates to a government contractor, particularly in the defense space, they also are very focused on national security concerns.

So, what you may find on these types of transactions is that the DOJ or the FTC will reach out to the customer in connection with their approval process. And they may have the customer weigh in on whether or not this will minimize competition or present any sort of national security concerns. And that's something that both Brian and Mike will touch on.

So finally, what's the outlook for the rest of 2019 and 2020? Well the good news is that our defense budget – the US defense budget is a favorable longer-term budget deal. So, the defense budget remains strong for 2020. And we're still seeing valuations for quality assets at a high level.

So, the outlook for the remainder of 2019 remains positive. However, deal makers continue to monitor the geopolitical developments, the budget priorities, Brexit. And in addition, that the US-China trade talks that may also have implications and disrupt the global supply chain and may make buyers more wary about executing M&A.

And then finally in the US market, we're going to have to consider the US presidential elections and what that may result in. But, for now, the outlook looks positive. And I will now turn it over to Mike Vernick who'll talk about the specific government contracting regulatory considerations in an M&A transaction.

Government Contracting Regulatory Considerations in M&A

Michael Vernick, *Partner, Hogan Lovells*: Thank you Carine and good afternoon everyone. Yes, I'm going to cover some of the government contract-specific regulatory issues that

often come up in M&A transactions. And we'll do this in three separate pieces.

The first piece is going to cover some of the issues that deal with government contracts and moving them from one end to another. We'll touch a little bit on national security concerns, which Carine just alluded to. And then last, we'll walk through some of the key diligence issues for buyers to think about during the course of an M&A transaction.

So, starting with the issue of buying or selling a company that is a US company contractor. The transaction structure of the deal can matter because there's a statute called the Federal Anti-Assignment Act, which essentially places significant limitations on the ability to assign or transfer a US government contract.

When read literally, you can construe it as categorically prohibiting transfer of US government contracts. But in practice, there is no violation of the Act when the government consents to the transfer or when the contract transfers by operation of law, for example through a merger.

One of the key issues in an M&A transaction is if the transaction is going to be asset-focused, you're going to have to go through the process of persuading the government to approve the transfer of the government contract.

Change of Name/Novation

The government, as I noted, will recognize a successor in interest to a government contract when, as a result of the transaction, all of the contractor's assets move, or all of those assets that are necessary to perform the government contract move.

And this agreement that is used to seek and attain the government's approval is covered in the federal acquisition regulation and it's referred to as a "Novation Agreement."

A Novation Agreement is, in essence, a three-party agreement that is signed off on by the government, by the buyer, and by the seller. And by executing this agreement, the government will recognize the transferee as the successor and interest. Although notably the transfer will remain liable as a guarantor of performance.

So, some of the issues that come up during a novation process: first, there are timing issues. The novation process can only really begin after the assets are transferred, which means that has to be a post-closing activity.

Second, these agreements tend to take a long time. The government often takes months–sometimes a year or more–to process and approve a novation request. And during that period, there has to be a work around to allow the continued performance of the US government contract. And that's often affected through what's referred to as "the subcontract pending novation."

In contrast to an asset transaction, when the deal is focused on sale of the stock or equity interest, and the acquired entity is going to remain in place, you won't need to go through the novation process.

So that's something to think about on the front end; whether you want to structure the deal such that you have to go through the novation process, or whether you can avoid that because it is a pretty burdensome process from a regulatory perspective.

Closely related to the novation process, the Federal Acquisition Regulation which governs government contracts also has a requirement for a change of the US government contractor's name.

So, for example, when a novation is not required, if the name of the contracting entity is going to change, you will have to go through the process of preparing and submitting a change of name package.

This is not quite as onerous of an undertaking as the novation process - we sometimes refer to as "novation lite." But it is still a fair amount of material that has to be prepared, assembled, and submitted to the government.

And again, there will often be some time lag between when that's submitted and when the government finally gets around to approving it. So, those are two issues that deal with kind of the mechanics of moving government contracts.

FAR Change of Control

And then the final area here that I wanted to very briefly cover is that, in some cases, when the target is performing cost-reimbursable contracts, there can be a requirement to notify the government of a "change in control."

And this is essentially triggered when the transaction will cause a change in the valuation of assets. Notably, this is a notice requirement. It is not a consent requirement, unlike the novation and change of name issues that I just walked through.

So those are the first part of the discussion here. And that, as I noted, really covers and refers to some of the unique aspects of a deal where US government contracts are involved.

National Security/DSCA

Turning now to national security concerns, as Carine alluded to a few minutes ago, and as Brian will touch on after I wrap up, national security concerns are becoming an increasingly significant aspect of deals involving US government contractors.

And the part of that that I'm going to talk briefly about will involve entities that are performing classified contracts and that hold the facility security clearance, which is necessary to perform classified work.

So, when an entity that holds the facility security clearance is going to have a change in ownership taking place by virtue of a transaction, there is an obligation to inform the Defense Security Cooperation Agency, which used to be referred to as Defense Security Service.

This is a requirement that has to be complied with in terms of putting them on notice of the change. There is not really a specific time called out for making this report. We tend to do this after the purchase agreement is signed but prior to closing.

What the regulation calls for is the report being made at the time that the cleared entity enters into transaction or discussion. So, that's really effectively how we have tried to manage that.

In addition to some of the notice requirements that apply when the target holds the facility security clearance and performed classified contract, there are additional considerations that come to bear if the buyer is non-US entity.

The sale of cleared entity to a foreign-owned or controlled entity, which in some cases can include investment entities, or even in some cases, US private equity institute with foreign investors. That can trigger what's called "foreign ownership control or influence"–which goes by the acronym "FOCI"–and mitigation measures that need to be put in place.

The idea here is that the US government doesn't necessarily preclude the acquisition of a cleared contractor by a foreign entity. But there are steps that have to be taken to make sure that the work that the foreign or US entity is performing is not going to leave that entity and that the appropriate controls over the classified information are going to remain in place.

So, there are a variety of different mechanisms that can be used in this way. It can range from a board resolution all the way up to having to put in place the proxy board with independent directors.

So, depending on where the foreign buyer is from, that may vary on how DSCA views this and what sort of mitigation mechanism it is going to require. It's a discussion that has to be had, typically over a period of time.

It can go more or less smoothly. But it's something where in practice hopefully the target will have a solid working relationship with DSCA and were able to work with them in a collaborative way to put in place the mitigation measures that will get the government comfortable with the approval and allow them to move forward and keep the security clearance in place.

So that's really the end game here; to satisfy DSCA that the mitigation measures are appropriate. The cleared entity can remain cleared. There is no risk to the classified information. And it can continue business as usual.

From a deal perspective, it's a pretty significant part of the transaction, particularly if the classified work is a significant portion of the target's portfolio. And Brian is going to expand on this from a CFIUS perspective which is, in many respects, pretty closely related.

Due Diligence Issues for Buyers to Consider

Before he does that, I thought it would be helpful to also walk through some of the kind of "hot button" diligence issues that we see in transactions involving those government contractors. So, let me do that at a high level. And then I'll turn it over to Brian.

There are a variety of relatively unique diligence issues that come up when a transaction involves a US government contractor. And the first pertains to intellectual property rights.

So, when the government funds work either through a contract grant or cooperative agreement, or some other form of funding, it's going to typically obtain some sort of rights in the IP that is developed with government funds. It will also have some rights in mixed-funding IP. For example, IP that's developed both with US government funds and private funds.

So, from a diligence perspective, it can be important for the buyer during the diligence process to try to figure out whether the target IP was developed at private expense. If it was not developed at private expense, it's important to get a fulsome understanding of the government's rights in the IP, the government's rights in data.

There are a variety of hoops that a US government contractor has to jump through to try to limit the government's rights when it's possible to do that. So, another aspect of the diligence will be to make sure that the target has done whatever it needs to do either to protect its ownership in IP or to limit the government's rights.

These issues can have, in some cases, significant impact on valuation. For example, if IP is not owned in a way that one thought it was owned, that's obviously going to have a downward effect on valuation.

Secondary, that often comes up in M&A activity involving US government contractors, this is one that involved GSA scheduled contract. A scheduled contract is essentially how the US government buys commercial items; everything from office supplies all the way up to very complicated IP systems implementation projects in some cases.

Many government contractors hold scheduled contracts. And there are a whole host of disclosure obligations that apply pre-award to pricing so that the government can be satisfied that the prices it's paying are fair and reasonable. And then there are ongoing compliance obligations. For example, among others, to make sure that the government is treated as the most favored customer.

So, from a diligence process, it's often very important to look through the target sales practices and disclosures to gain an understanding of how it monitors sales on an ongoing basis to make sure that it's complying with its obligations to give the government some of its best pricing.

And non-compliance in this space can have significant risk. Everything from administrative actions taken against the contractor to false claims act enforcement. So again, potentially a risky area and one that requires some focus during the diligence process.

Next would be government accounting issues. The US government has a variety of cost accounting requirements that apply to its contracts. Those are particularly onerous for targets that are performing cost reimbursable contracts. And particularly so if the target is subject to what's referred to as the "cost accounting standard."

In a nutshell, the cost accounting standard can be thought of as a form of US government GAAP. Again, they impose a variety of obligations on the contractor in terms of disclosure requirements. There are a variety of oversight activities that occur on a regular basis in the form of audits and other types of activities.

So again, during the diligence process, it's important to understand what obligations the target is subject to, and to try to gain an understanding of whether they've met those obligations. And if they haven't, what the exposure may be.

Next is the concept of an organizational conflict of interest (OCI). This is essentially a concept in US government contractors. It comes up quite often when the buyer and the seller are performing in related areas. For example, advisory or assistance services.

And essentially, these are a set of rules that make sure that these government contractors aren't evaluating their own work or aren't drafting specifications and then bidding on those specifications. They either go to the question of the impartiality of the advice or sometimes having insider information.

So again, it doesn't mean that this is not a situation where the OCI can't exist. It just means that if there is no OCI, or a potential for an OIC, there needs to be a mitigation plan.

And again, an area that requires some work during the diligence process to assess whether the transaction may create OCIs and whether that's going to bear on the ability of the target and the new entity post-closing to continue performance or whether some portions of the portfolio may be at risk.

Last subject that I just wanted to quickly raise before turning it over to Brian is that of "in-flight" proposals. In recent years, there's been a series of bid protests that have called into question proposals that are submitted in the middle of the transaction.

There can be issues raised if the target, for example, is reliant on its existing parent for resources, people, or other capabilities. "What's going to happen after the transaction? Are we still going to have access to those resources and capabilities?" Probably not.

So, those issues need to be dealt with while the proposal is in place. And there are ways to mitigate that risk. But again, it's something during the diligence process if you want to gain an understanding of proposals that are in-flight to assess whether they will succeed or not, or whether there is risk of triggering the protests. With that, I am going to turn it over to Brian.

Other Regulatory Considerations

Brian Curran, *Partner, Hogan Lovells*: Great. Thanks Mike and good afternoon everyone. As Mike mentioned, I am going to cover some other national security aspects of ADG M&A that you might come across, and specifically, those related to CFIUS, the Committee on Foreign Investment in the United States, as well as export control. So, I'm going to divide the discussion on CFIUS and export control developments into five pieces.

So, the first is going to be just kind of a brief sort of CFIUS 101, or a refresher for those of you who's been away from CFIUS issues for a while. Second, I'll talk about some recent CFIUS developments. Third, I'll talk about some recent export control developments including one that essentially got an overlap with the CFIUS developments.

Fourth, I'll talk about things to think about in an ADG M&A context from a CFIUS and export control perspective. And finally, I'll highlight what I considered to be some of the key takeaways and some things to think about, what to expect in the months ahead in terms of CFIUS and Export Control developments that would be relevant to the ADG sector.

CFIUS Review

So, let's start again with the sort of CFIUS 101. You know, what is "CFIUS?" Just as I say as a refresher for many of you, CFIUS is an interagency committee of the US government that conducts national security reviews of foreign investments.

And CFIUS has been delegated the power from the President to clear foreign investments in the US, to negotiate agreements to mitigate national security concerns associated with these transactions, to refer transactions to the President for his decision, to request that the parties submit a filing in certain cases.

For example, in some cases, parties haven't made a filing. And then CFIUS "comes calling," as we say, and contacts the parties or their council and requests that the parties make a filing. And as you can imagine, that's a request that is typically honored by the parties.

And then CFIUS finally can unilaterally review a transaction. So, they could review a transaction that the party hasn't filed; that even if the parties don't make a filing, or in the case of a request, the parities receive a request but declined to make a filing. So, those are the general powers of CFIUS.

And then, perhaps the most important aspect of CFIUS is that under the CFIUS statute, the Defense Production Act, the President has the power pre-closing to block a transaction, and then he has the power post-closing to order divestiture. And so, it's those powers that are the most significant and that lead parties to file with CFIUS even when they are not legally required to do so.

So, that's it for CFIUS 101. Now, I will move to a discussion of CFIUS' traditional jurisdiction, what kinds of transactions it had the power to review. CFIUS' jurisdiction was

expanded by a new statute that revised the Defense Production Act of 1950, and some other changes to the CFIUS regime were introduced by this new statute.

So traditionally, as many of you know, CFIUS' jurisdiction was limited to transactions in which a foreign person could control a US business. So, CFIUS read its jurisdiction quite broadly as I'll mention in just a moment. Not quite broadly enough from Congress' perspective, but it was still quite broad.

And we saw CFIUS view even minority investments, some investments with certain governance rights where the investment would only be, say, 10%. CFIUS viewed those, again, in conjunction with certain governance rights as constituting control.

And even instances where a foreigner was investing through an asset deal, a collection of assets could be viewed by CFIUS as a US business. And so, control of those assets collectively could also be what we call a covered transaction. That is, a transaction that CFIUS has the authority to review.

So again, traditionally, CFIUS had jurisdiction over transactions over to the foreigner who could control the US business. And traditionally, all CFIUS filings were voluntary.

Parties in the past made these voluntary filings essentially because of the powers that CFIUS and the President had even if they didn't file because they wanted to receive what's called "Safe Harbor." That is CFIUS' clearance that precludes CFIUS from revisiting the foreigner's investment after it's granted the clearance.

So, a new statute was enacted in August of 2018. This statute revised the CFIUS statute, the Defense Production Act of 1950. And this statute was called the "Foreign Investment Risk Review Modernization Act of 2018." We call it "FIRRMA."

And FIRRMA expanded CFIUS' jurisdiction to acquisitions and leases even of certain real estate. So, you don't have to be acquiring an actual US business, even a vacant lot in certain circumstances if it's in proximity to certain seaports, airports, and US national security installations it could be subject to CFIUS' review.

The FIRRMA also expanded CFIUS' jurisdiction into non-controlling investments into three kinds of companies: companies involved in critical technology, critical infrastructure, and in sensitive personal data.

So, the FIRRMA in the proposed regulations refers to these three kinds of businesses collectively as "TID" US businesses. Meaning, "T" for technology, "I" for infrastructure, and "D" for data. So, the TID US businesses are where CFIUS has focused its expanded jurisdiction.

FIRRMA also gave CFIUS the authority to mandate filings for the first time for foreign investments in critical technologies under a new temporary so-called pilot program that is still in effect. And this statute also gave CFIUS the power to mandate filings for certain foreign government-backed investments. And we'll go into both of those in a bit more detail.

FIRRMA also expanded the definition of critical technologies in the statute to include a new regime that we'll talk about called emerging and foundational technologies.

FIRRMA also created a short-form filing called a "declaration," which ultimately should redound to the benefit of allied country ADG buyers because it will give them both a shorter filing to complete and a shorter review from CFIUS for such transactions that are filed under a declaration.

And finally, FIRRMA included some exemptions for foreign investors, limited partners through US-controlled funds. And it built in some exceptions for certain investors associated with what they're calling "accepted foreign states," which we expect, of course, will be allied countries. So, that will be the opportunity for certain investors from allied countries to be exempt from some of the expansion of CFIUS' jurisdiction.

So now, I'd like to just dig into three aspects of FIRRMA that I mentioned. The expansion into non-controlling investments and those TID businesses, the mandatory filings, and this expansion of the definition of critical technologies to include this new emerging and foundational technologies regime.

So, first on the non-controlling investments. Now, if a foreign person is taking a non-controlling investment in one of these TID US businesses–again, no matter how small the size of the investment–if that investment of one of those businesses affords the foreign person any of the following three rights, then it will be a transaction subject to CFIUS' review.

So, those three rights are: giving the foreign person access to material non-public technical information, giving the foreign person membership or observer rights on the Board of Directors of the US company, or the right to nominate someone to the Board, or finally, any involvement that the foreign person has, other than through the voting of their shares, in substantive decision-making related to the critical technologies or critical infrastructures of the foreign investors. So, we collectively call these the foreign investor rights.

Mandatory filings. The FIRRMA, as I mentioned, gave CFIUS the power to mandate filings in certain instances. Today that's done through the CFIUS pilot program. That's the only mandatory filing right now.

Under that program, if the foreign investor takes one of the foreign investor rights, or otherwise can control the US business, and if the US business is developing certain critical technologies, and if those technologies are utilized in certain industries, the 27 industries mentioned in the pilot program, or being specifically designed for those industries, then those are going to be transactions subject to a mandatory filing.

The proposed CFIUS regulations that just came out in September, also consistent with the statute, call for mandatory filings for certain foreign government-backed investments, essentially if a foreign government takes a substantial interest in a TID US business, that will be subject to a mandatory review.

What's a "substantial interest?" It's defined as follows: If the foreign person takes a direct or indirect voting interest of 25% or more in the TID US business, and a foreign government has a direct or indirect voting interest of 49% or more in the foreign person investing in the TID US business. So, that covers the two key features of the mandatory filings.

Now, I want to move to critical technologies' definition. Critical technologies definition was expanded. Critical technologies' definition largely consists of export C\control regimes. That's how it is defined, existing export control regimes such as the EAR and the ITAR. But it also added a new emerging and foundational technologies regime. That regime is still under development, but it's one that bears watching particularly for ADG companies.

In the fall of 2018, the Commerce Department put out an advanced notice of proposed rulemaking to highlight some of the technologies that it was looking at to control in the new emerging technologies regime. And it touched on many of the hottest technologies and ones that are clearly being developed and pursued by ADG companies.

So, examples are AI and machine learning, robotics, data analytics, advanced materials, additive manufacturing, and advanced surveillance technologies, just to name some of the ones that the Commerce Department noted.

So, this is going to be significant. Because it's going to be a subset of the definition of critical technologies, it's also going to be important because ultimately there is going to be a more robust review of any licenses that are sought from the Commerce Department from any of these emerging or foundational technologies.

So, now I'm going to move to some M&A considerations for ADG companies, both CFIUS considerations and export control ones.

For CFIUS, a target who's looking at both foreign and US bidders is going to have to consider the potential drawback of a foreign bidder who is going to have to go through the CFIUS process if, for no other reason than the timing issues, how long it's going to take that to get the review done.

And obviously, a foreign bidder has to know that in some cases, if there are other US bidders then its bid is going to be less competitive if it's going to have to go through the CFIUS process.

Another key CFIUS consideration for M&A is timing. If you're filing the full, traditional notice, it's a joint voluntary notice, so you're looking at potentially four to six months. So, that's obviously the timing there. It can have a significant impact on the closing date. You've got a plan for that as you're pulling together the transaction and finalizing the agreement.

Speaking of the agreement, things to think about within the agreement that are CFIUS-specific, there will be a covenant to cooperate that's specific to the CFIUS filing. There will be provisions in there related to required regulatory filings. As I mentioned, in some cases now, CFIIUS filings are mandatory.

Most transactions involving a CFIUS review will include CFIUS clearance as closing condition. And then another thing to consider is that CFIUS clearance often has to be considered when you're lining up the termination or long stop date, because the CFIUS filings obviously can take a number of months. And then they can be dragged out, in some cases, if there's - if for some reason, the parties have to withdraw and refile.

Two other things to note. A buyer might include in an agreement certain limitations on its willingness to agree to CFIUS-imposed mitigation. Because if the mitigation is severe enough, the deal might not any longer be palatable to the buyer.

And, we're seeing this in deals over the last number of years, sellers might ask the buyer in certain cases for a "reverse break fee," namely a fee that the buyer would pay if the transaction does not clear CFIUS.

U.S. Export Controls

As for export controls M&A considerations for ADG companies, first and foremost, as a buyer, you've got to make sure to do a proper diligence of the targets trade compliance program.

Next, you need to look at whether there are any filings that will need to be made, in particular in the ITAR context of pre-closing 60-day notice, or a post-closing five-day notice. And in the case of EAR, figuring out whether there are any license transfers that are going to need to occur as part of the transaction.

In terms of the purchase agreement, there's obviously the trade controls representation that's typically included in purchase agreements. And again, as I mentioned, if there are any required regulatory filings, those are incorporated into the purchase agreement as well.

And finally, in terms of closing conditions, often if there is the 60-day ITAR notice that's required for foreign acquisitions of ITAR registrants, then the expiration of the 60-day period is usually included as a closing condition.

So just to wrap up, in terms of what I think it all highlights and what ADG companies can expect in the coming months in terms of developments.

First, CFIUS' due diligence is really critical for any foreign investment in ADG space now with the introduction of mandatory filings. So really, whatever space you're in, if there is a foreign investment in an ADG company, you got to make an assessment as to whether that transaction is subject to CFIUS' review. And importantly, whether it's subject to a mandatory filing.

Trade controls due diligence is equally important, largely because the buyer is going to take on successor liability. So, if the target has committed violations, they are going to be the responsibility of the buyer post-closing.

Another point to just highlight is that because of CFIUS' expanded jurisdiction into non-controlling foreign investments, CFIUS is no longer restricted to straight M&A, to outright acquisitions of controlling stakes in ADG companies. So, foreign venture capital and early-stage investments in US companies, even foreign acquisitions or leases of real estate, are now within CFIUS' per view.

These days we even have some US ADG clients who are engaging us to vet the CFIUS compliance program of startup technology companies in which they're investing.

What I mean by the "CFIUS compliance program" is that these clients are asking us to figure out whether the startup knows when an investment is subject to a mandatory CFIUS filing, and to assess whether they are bringing on any increased national security risk by taking investments from certain foreign investors from particular countries.

Another thing to highlight that we haven't spoken about, but just to keep in mind, is that CFIUS is continuing to give heightened scrutiny to transactions with really any nexus to Chinese or Russian companies. Even the transactions that don't involve a Chinese or a Russia buyer, but otherwise have some nexus with individuals or companies in China or Russia.

And then finally, please do keep an eye on this emerging and foundational technologies regime that I mentioned because that will have, as I said, implications both on the export control front as well as the CFIUS front.

So that concludes Carine, Mike, and my presentation on ADG M&A. Thank you all very much for attending. And with that, let me turn it back over to John.

Jenkins: Thanks Brian. And again, I just want to add my own thanks to our panelists for a very informative webcast. And thanks to everyone out there for listening. This concludes today's webcast.