

# KIRKLAND ALERT

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## M&A and Classified Government Contracts: U.S. Defense Department Issues New Guidance

The Defense Security Service (“DSS”), an agency of the U.S. Department of Defense (“DoD”), recently published guidance<sup>1</sup> on Affiliated Operations Plan (“AOP”) requirements for government contractors holding facility security clearances (“Cleared Companies”) and their corporate parents.

DSS imposes “foreign ownership control or influence” (“FOCI”) mitigation plans on Cleared Companies and their corporate parents when a meaningful degree of foreign investment is present. The rules relating to DSS mitigation are complex. These rules are separate and different from rules relating to the Committee on Foreign Investment in the United States (“CFIUS” or the “Committee”), of which DoD is a member.

Generally, DSS FOCI mitigation plans require that additional outside directors be installed on the Cleared Contractors’ boards of directors to offset the control rights of foreign investors. These higher level mitigation plans include Security Control Agreements (one or more outside directors), Special Security Agreements (three or more outside directors), Proxy Agreements (entirely outside directors) and Voting Trusts (entirely outside directors). These outside directors serve on a Government Security Committee (“GSC”), which is responsible for maintaining policies and procedures to safeguard classified information entrusted to the Cleared Company. DSS requires an AOP as a key component for each of these types of FOCI mitigation plans.

The AOP essentially superimposes an operational framework, consistent with DSS-specified mitigation, on interactions between Cleared Companies and their corporate parents. In practice, developing a workable AOP, takes time, energy and coordination between the Cleared Company and its affiliates including corporate parents, not to mention significant costs.

### *Impact on M&A Planning*

In cross-border corporate transactions, the establishment of an AOP takes on increased significance and can impact transaction timing. The acquisition of a Cleared Company involving foreign control rights will ordinarily trigger a filing with [CFIUS](#). CFIUS will look to DSS to confirm that a Cleared Company target has made meaningful progress in developing a FOCI mitigation plan to include an AOP before issuing a formal CFIUS clearance letter. Thus, the failure to thoughtfully consider and draft an Affiliated Operations Plan either in advance of or in parallel with a CFIUS filing, may adversely impact the Committee’s review of the transaction.

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### *Affiliated Operations*

The DSS guidance defines “Affiliated Operations” as “a business or operational relationship between a mitigated company and an affiliate, to include any internal policy, process, or procedure that could give an affiliate financial or operational leverage over the mitigated company.” Affiliated operations even extend to arrangements with shared third-party providers. In the context of this broad concept, DSS outlines several common categories of Affiliated Operations including:

- Human Resources;
- Finance and Accounting;
- Internal Audits;
- Business Development;
- Marketing;
- Legal; and
- Shared Personnel.

From the DSS perspective, these common touch-points between a Cleared Company and its affiliates create potential avenues for compromising security. Accordingly, DSS requires that an AOP be developed to mitigate these perceived risks.

### *Developing the Plan*

The DSS Guide announces a straight-forward method to developing an AOP. As a starting point, affiliated operations and their attendant risks must be identified. Then, mitigation measures to offset these risks must be developed. Finally, a detailed written description of the Affiliated Operations, the risks, corresponding mitigation measures, and oversight must be provided to DSS for approval. With respect to the oversight component, DSS contemplates both an internal review by Cleared Company as well as external review by DSS.

According to DSS, “sharing a service always presents FOCI risk because any sharing allows the parent/affiliates to have a certain degree of leverage over the mitigated company, which may affect the company’s independence over its operations of the classified program(s) or information.” Further, DSS may simply not allow certain affiliated operations if they “present unacceptable risk that cannot be sufficiently mitigated...” DSS also cautions that the finalization of the AOP “usually entails two or three redline drafts.”

The inclusion of stakeholders with expertise for each Affiliated Operation in the drafting process is critical to an effective AOP. The Cleared Company and corporate parents must also make sure that the AOP remains realistic in terms of the mitigation measures and oversight of the plan. AOPs require thoughtful drafting to ensure that concrete, rather than theoretical security risks, have been identified and thoughtfully mitigated.

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## Compliance

Once the AOP has been approved, it must, of course, be followed. The GSC, for example, must certify that it has effectively monitored affiliated operations annually. DSS now also makes clear that the failure to follow the AOP will likely have significant negative consequences for the Cleared Company's security rating. In particular, DSS cautions against the use of unapproved Affiliated Operations. Moreover, "Repeated and systematic noncompliance" with an AOP may "jeopardize the status of the facility security clearance." The invalidation of a Cleared Company's security clearance can have severe consequences when the Cleared Company performs only classified work.

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<sup>1</sup> Defense Security Service, Navigating the Affiliated Operations Plan: A Guide for Industry (May 11, 2016) available at [http://www.dss.mil/documents/foci/AOP\\_Guide\\_51116.pdf](http://www.dss.mil/documents/foci/AOP_Guide_51116.pdf).

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