Government Contracts

AT THE CROSSROADS OF M&A AND GOVERNMENT CONTRACTS – THE NOVATION PROCESS
By Kimi N. Murakami

When making a strategic acquisition, the central goal of a government contractor is to buy the target company’s government contracts. Transferring government contracts, however, is prohibited under federal law by the Anti-Assignment Act enacted in the mid-19th century. The policy behind this basic tenet of public contracts law is the premise that the government has selected a particular contractor through the procurement process and that contractor is the party who will perform the work.

To allow for the assignment and transfer of contracts, the Federal Acquisition Regulation (FAR) provides a process known as a novation by which the government will give its consent and waive the prohibition of the Anti-Assignment Act. Through a three-party novation agreement, the government expressly agrees to the transfer of a government contract from one contractor, as transferor, to another, as transferee. Securing the government’s approval to transfer a government contract is mandatory under the FAR. According to the regulations:

If a contractor wishes the Government to recognize a successor in interest to its contracts or a name change, the contractor must submit a written request to the responsible contracting officer.

48 C.F.R. § 42.1203(a) (emphasis added). A determination to grant such permission is completely within the government’s discretion based on their finding of whether it is within the government’s interest. 48 C.F.R. § 42.1203(c); 48 C.F.R. § 42.1204(a).

The regulations provide that if there has been an acquisition of “all [of] the contractor’s assets” or “the entire portion of the assets involved in performing the contract” then a novation is required. 48 C.F.R. § 42.1204(a). Therefore, when structuring the asset acquisition it is important that the purchase of the subject assets include all of the assets necessary to perform the government contract. The purchased assets cannot be comprised solely of the government contract. The acquired assets must include the tangible and intangible assets needed to perform the contract such as any employees, the licenses for intellectual property, and any financial resources. Limiting the assets to the government contract alone can present issues in the novation process when the purchase agreement is reviewed. If a transaction is structured as a stock acquisition, then a novation generally will not be required. According to the regulations:

A novation agreement is unnecessary when there is a change in the ownership of a contractor as a result of a stock purchase, with no legal change in the contracting party, and when that contracting party remains in control of the assets and is the party performing the work.

48 C.F.R. § 42.1204(b). In addition to stock transfers, novations will not be required when there has been a transfer of the government contract “by operation of law.” This “by operation of law” exemption cannot be found in the FAR but is well established by case law. The classic examples that fall within this exception are transfers of government contracts that arise as a result of intestacy and bankruptcy. Generally, certain types of corporate transactions such as corporate mergers, consolidations, or reorganizations also fall within the “by operation of law” exception. Standard mergers of a subsidiary into a parent, for example, fall within the “by operation of law” exception and novation is not required. In such cases, the parent company will take full responsibility for the contact and there will be no change in the day-to-day operations of the performance of the work. The contract essentially continues with the same corporate entity.

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Variations on the classic parent/subsidiary merger, however, can muddy the water. Where a subsidiary (contract-holder) merges into a sister-subsidiary, for example, it is not crystal clear whether the transfer of the contract from the subsidiary to its sister entity falls within the “by operation of law” exception. In such a scenario, it could be argued that no novation is required because the government will continue to receive the benefit of the same management and financial resources for which it bargained for originally. The government would not be subject in such a case to multiple claimants and a full novation should not be required because this would simply be a corporate reorganization. By permitting this type of reorganization without a novation there is no subversion of the goals the Anti Assignment Act set out to establish.

The documents required to be submitted to the contracting officer as part of the novation process include, among other things, a novation agreement, the legal documents effectuating the purchase or transfer of the contracts, certain financial information of the parties, confirmation of security clearances, consent of any sureties, and an opinion of legal counsel. The novation agreement provides that both the transferor and transferee will be responsible for the obligations and liabilities arising under the contract for the entire period of performance. This means that the parties should therefore make sure in the purchase agreement to provide for strong indemnification provisions to protect itself and to cover the period when the other party is performing the work.

The novation process itself requires patience. The regulations do not specify time deadlines that contracting officers must comply with when evaluating a request for novation. This process, therefore, can take an extended period of time. It is important in any M&A transaction that will require post-closing novations of government contracts, therefore, to include provisions in the purchase agreement to account for performance of the contract during the period from the closing on the sale to the final novation approval. These transition period provisions could include, for example:

- A rescission provision which will allow for the unwinding of the transaction if the novation is not approved within a certain period of time

When novation is not required, the assignment of a contract may require compliance with the FAR regulations for a change of name procedure. The name change process requires a shorter agreement and legal opinion together with the merger documents or charter amendments effectuating the change of name of the contract holder. Generally, the name change can be accomplished by the government much more quickly than the novation procedure.

When beginning the novation process, contractors should keep in mind that approval for the transfer of a government contract is completely within the discretion of the contracting officer. Contracting officers, while very familiar with government contracts, are sometimes less familiar with corporate transactional matters. For any type of anticipated transfer of a contract it is prudent to contact the contracting officer in advance and let them know about the transaction. If it seems that the transaction may fall within the “by operation of law” exception, for example, it may require a more detailed and fulsome explanation of the circumstances to the contracting officer as they may not be familiar with any procedure outside of the novation process (such as the name change procedure) and the contracting officer may not be aware that the “by operation of law” exception to the novation process even exists.

In addition to the many general issues that arise in connection with the novation of government contracts, there are specific issues that arise depending on other unique facts such as the type of transaction structure, (joint ventures, for example) or the type of contract vehicle (8(a) contracts require recertification, STARS II and GSA schedules have special circumstances). These and other issues will be addressed in the firm’s webinar on November 4th at 2:00 p.m. when Cy Alba and I will be discussing novations and answering any questions you have. Please join us.

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