The Deal

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Standing Novation

To novate or not to novate: That is the question.

The opening line of Hamlet's famous soliloquy certainly invokes grand existential connotations. However, a derivation of the conundrum posed by the prince of Denmark finds applicability on a far more pragmatic level in the world of mergers and acquisitions involving government contractors.

When government contractors undertake to acquire a company, a plethora of unique issues must be addressed to ensure a seamless transition of the business from one owner to another. These issues include retaining small-business status, safeguarding valuable intellectual property rights, avoiding organizational conflicts of interests, scrutinizing cost allowability and allocation issues, examining export control compliance programs, obtaining prime contractor consents and, in the case of foreign purchasers, complying with Exon-Florio and FOCI reporting requirements.

While these issues demonstrate the stark contrast between commercial and government contracting, another core government contracting requirement — novation agreements — serves to further separate these already distant realms.

In simplest terms, a novation agreement is a consent granted by the government allowing for the substitution of one contractor by a new party. The requirements for executing a novation agreement are mostly straightforward. Some tension arises, however, in the context of corporate mergers and consolidations. Although the literal language of the FAR, or Federal Acquisition Regulation, often requires a novation agreement in acquisition contexts, the case law suggests — depending on the transaction structure — that no such agreement may be required if the transfer of government contracts occurs "by operation of law." In this circumstance, the acquisition transaction would fall outside the ambit of the Anti-Assignment Act. The dichotomy between regulatory mandates and judicial precedent adds an element of uncertainty to some corporate transactions about whether a novation agreement is required.

As a baseline rule, the Anti-Assignment Act prohibits the transfer of government contracts from a contractor to a third party and annuls any contract that is transferred in a manner inconsistent with its dictates. Congress was clear about the rationale behind this statutory regime: The government should only deal with the contracting party with whom it entered into an agreement and should not be put in a position of having to deal simultaneously with other entities, including in the context of litigation and "claims" emanating from multiple sources. However, as is the case with most rules, the prohibition contained in the Anti-Assignment Act is not absolute, and the Government is permitted expressly to consent to the assignment of a government contract. The rules governing such transfers are spelled out in FAR § 42.12.

The FAR is relatively clear about when a novation agreement is required and enumerates the following nonexclusive examples: (1) the sale of all of a contractor's assets or the entire portion of the assets involved in performing a contract with a provision for assuming liabilities; (2) the transfer of assets incident to a merger or corporate consolidation; and (3) the incorporation of a proprietorship or partnership, or formation of a partnership. In these circumstances, the FAR requires the government's consent before the contracts can be transferred or assigned. On the other hand, the FAR also specifically delineates a situation where a novation agreement is not required — that is, where the transaction is a stock purchase and "there is no legal change in the contracting party, and when the contracting party remains in control of the assets and is the party performing the contract." Based on these stipulations, the general rule is that the FAR requires a novation agreement in connection with a corporate merger or consolidation where the government contractor does not survive the transaction as the contracting party.

Very few things, however, especially in the context of mergers and acquisitions between government contractors, are as simple as they may seem. Federal case law has carved out an exception to the Anti-Assignment Act — an exception apart from the stock purchase exception identified in the FAR. In particular, as far back as 1921, the United States Supreme Court held that a transfer occurring "by operation of law" was exempt from the Anti-Assignment Act. The Supreme Court reasoned that Congress could not have intended to "discourage, hinder or obstruct the orderly merger or consolidation of corporations." Subsequent case law has affirmed specifically that "transfers by operation of law include corporate mergers, consolidations and reorganizations."

So the relevant question that government contractors need to answer when considering an acquisition is, "Does the sale or transfer of the business occur by 'operation of law' " Hence the dilemma. As previously mentioned, while the FAR appears to require a novation agreement (subject to certain delineated exceptions) where a merger or consolidation is the vehicle employed by the contractor to execute a transaction, federal case law appears to exclude corporate mergers and consolidations affected "by operation of law" from the reach of the Anti-Assignment Act. Two sources of law — regulatory and case law — could be interpreted to reach two divergent outcomes.

In days past, there was a significant financial advantage in the avoidance of a novation — the standard novation agreement relieves the government of any obligation to reimburse cost increases arising directly or indirectly from the transaction. This provision was generally viewed as rendering unallowable any post-transaction increase in the valuation of company assets for the purposes of allowable depreciation charges. A transfer "by operation of law" avoided this contractual cost limitation. With the promulgation of FAR 31.205-52, however, such cost increases are unallowable independent of any specific preclusion in a novation agreement. Nonetheless, there are reasons to evaluate the utility of an "operation of law" exception.

First, the FAR requires the contractor to gather detailed information with respect to the contracts at issue, to compile the appropriate corporate documentation and approvals, to provide the audited financial information of both the transferrer and transferee, to confirm that any security clearance requirements have been met, to secure the consent of any surety, and to obtain an opinion of legal counsel with respect to the transaction — tasks which in complicated corporate transactions could require the commitment of scarce corporate resources and the expenditure of significant corporate finances.

Second, the FAR does not contain a uniform time period within which the government must respond to a contractor's novation request. Although it is unlikely that the government would deliberately delay the novation process, it is conceivable that the government's definition of a quick "turnaround" would conflict with that of the parties.

Third, and perhaps most importantly, the government is not required to approve the novation, and the FAR specifically delegates discretionary authority for approving a novation to the contracting officer. Said differently, the FAR provides that the government may approve the novation when it is in its interest to do so. While the government, in our experience, will likely grant a novation agreement in most transactions, the risks associated with the uncertainty are nonetheless significant to the acquirer, and indeed, the transfer of the relevant government contracts may constitute the financial and economic basis of the entire transaction. If the government does not approve the transfer and novation of the contract(s), the contract(s) may be terminated for default if the original contractor does not perform the work. This may kill the deal, and possibly the contractor.

The existence of these risks should not lead a contractor to rely blindly on the "operation of law" exception and simply bypass the novation process. (After all, a novation agreement provides the acquiring company with the government's "stamp of approval" on the transfer of government contracts and obviates the risk of post-closing disputes with respect to the real party in interest under the contracts.) In many cases, structural alternatives to the transaction may be available that will obviate the need to seek novation altogether. In other cases, the government contractor might be best served by first engaging the designated contracting officer, on a formal or informal basis, in discussions on the topic. In yet other cases, the acquiring party may be comfortable with having to get the government's consent to novate the relevant contracts. But in all of these circumstances, it is essential that the government contractor seeks experienced and seasoned advisers familiar with the legal and regulatory terrain. Armed with these protections, the players will be best able to avert and mitigate any risks.

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