



When Deal Making and Government Consent Merge: The Who, What, When, Where, and Why of Novation Agreements

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Over the past year, there has been a tremendous amount of merger and acquisition activity, and the government contracting industry has been no exception. Along with the traditional concerns involved in the M&A world, companies holding federal government contracts face unique obstacles. In fact, government contractors seeking to scale their business through a merger or acquisition must take into account both traditional considerations and federal statutes and regulations that require the Government's consent for such transactions. These federal statutes are known as the Anti-Assignment Acts.

The Anti-Assignment Acts are made up of: (1) the Assignment of Contracts Act, which prohibits the assignment of government contracts, and (2) the Assignment of Claims Act, which prohibits the assignment of claims against the United States. Specifically, the Assignment of Claims Act provides that an assignment of a claim against the Government may be made only after the claim is allowed, the amount of the claim is decided, and a warrant for payment has been issued. 31 U.S.C. § 3727. Conversely, under the Assignment of Contracts Act, a "party to whom the Federal Government gives a contract or order may not transfer the contract or order, or any interest in the contract or order to another party. . . ." 41 U.S.C. § 6305. When deemed to be in its interest, however, the Government may waive the statutory prohibitions in the Anti-Assignment Acts. FAR 42.1204. Ordinarily, the Government waives such a prohibition on assignment, and thus consents to the transfer, by a contracting officer's execution of a novation agreement. FAR 14.1203(a). If, however, a prohibited transfer occurs without a novation, then "the original contractor remains under contractual obligation to the Government, and the contract may be terminated for reasons of default, should the original contractor not perform." FAR 42.1204(c).

The Federal Acquisition Regulations (FAR) not only dictate **how** the Government may waive the Anti-Assignment Acts, but also **when** the Government may waive the Anti-Assignment Acts. In order to understand **when** novation is required, it is crucial to first understand **why** novation is required. In *Tuftco Corp. v. United States*, the Court of Claims laid out the purpose of the Anti-Assignment Acts:

The statutes serve two purposes. They are primarily intended to prevent persons of influence from buying up claims against the United States, which might then be improperly urged upon officers of the Government. Second, it is inferred Congress sought to enable the United States to deal exclusively with the original claimant instead of several parties, thereby eliminating the

confusion of conflicting demands for payment and the chances of multiple liability.

614 F.2d 740, 744 (Ct. Cl. 1980) (quotations omitted). In addition, in *United Int'l Investigative Servs. v. United States*, the Court of Claims noted that the Anti-Assignment Acts “ensures that the government continues to receive the benefit of the management and financial responsibility for which it bargained for.” Put simply, the purpose of the Anti-Assignment Acts is to prevent fraud against the Government, to avoid the threat of multiple claimants against the Government, and to ensure that the Government knows who it is contracting with when it awards a contract. With the purposes of the Anti-Assignment Acts in mind, we will consider the transaction structures that a government contractor may consider, and the ramifications of such structures.

Asset Purchase

One way of structuring a transaction that includes the transfer of valuable government contracts is through an asset purchase. FAR 42.1204 provides that the Government may recognize a third party as a successor-in-interest to a government contract when the third party’s interest in the contract arises out of the transfer of all of the contractor’s assets or the entire portion of the assets involved in performing the contract. Examples of such transactions include: (i) sale of assets with a provision for assuming liabilities; (ii) transfer of assets incident to a merger or corporate consolidation; and (iii) incorporation of a proprietorship or partnership, or formation of a partnership. It is important to note that the regulations expressly contemplate transactions involving a transfer of all of a contractor’s assets, or all of the assets necessary to perform the contract. As such, the regulations seem to foreclose the possibility of simply transferring the contracts alone. See *Am. Gov’t Properties v. United States*, 118 Fed. Cl. 61 (2014).

Given the purposes of the Anti-Assignment Acts, requiring a novation for certain asset sales is fitting. For instance, when government contracts are included in asset deals, the acquirer is not the original party to the agreement, and it may not have the assets or experience required to adequately perform, which is contrary to what the Government originally bargained for. See, e.g., *Wyle Labs., Inc.*, B-408112.2, Dec. 27, 2013, 2014 CPD ¶ 16. Moreover, the possibility of fraud and multiple claims may exist as both the seller and the acquirer may later demand payment from the Government, without the Government fully knowing who owns the rights under the contract.

Stock Purchase

Another common way to structure a transaction is through the purchase of stock, partnership interest, or membership interest. As to these transactions, a novation will generally be unnecessary. In fact, the FAR expressly states that novation is not required “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 contract.” FAR 42.1204(b). Considering the purposes of the Anti-Assignment Acts, the exception from the novation requirement for stock deals is also fitting. For instance, when one acquires an interest in an entity holding government contracts, the contracts themselves are not being assigned to a different party. In fact, those contracts continue to be held by the same entity to whom the government awarded the original contract. Thus, a stock purchase is a viable transaction structure for those looking to buy or sell an interest in an entity holding federal government contracts, and is unlikely to require a novation.

Mergers, Consolidations and Reorganizations

For other corporate transactions, such as mergers, consolidations, and reorganizations, the

issue is much more complicated. In fact, case law has developed that excludes the need for government consent for assignments that occur by operation of law.^[1] For instance, in *Seaboard Air Line Ry. v. United States*, the Supreme Court recognized that mergers and consolidations functioned like other assignments by operation of law:

We cannot believe that Congress intended to discourage, hinder or obstruct the orderly merger or consolidation of corporations as the various states might authorize for the public interest. There is no probability that the United States could suffer injury in respect of outstanding claims from such union of interests and certainly the result would not be more deleterious than would follow their passing to heirs, devisees, assignees in bankruptcy, or receivers, all of which changes of ownership have been declared without the ambit of the statute.

256 U.S. 655, 657, 41 S. Ct. 611, 612 (1921). Although the Supreme Court and courts and administrative tribunals across the country have recognized this exception, the FAR requires consent for a transfer of assets “incident to a merger or corporate consolidation.” FAR 42.1204(a)(2)(ii). Further, even when courts do recognize the assignment by operation of law exception to the Anti-Assignment Acts, they have not always applied the exception with a reliable degree of consistency. Compare *NGC Inv. & Dev., Inc. v. United States*, 33 Fed. Cl. 459 (1995) with *United Int’l Investigative Servs. v. United States*, 26 Cl. Ct. 892 (1992). In addition, even the slightest change in a transaction structure may warrant opposing results. For example, reverse triangle mergers have been treated as stock purchases, rather than assignments by operation of law, whereas forward triangle mergers are assignments by operation of law. See *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, 62 A.3d 62, 83 (Del. Ch. 2013). Considering the complex case law concerning assignments by operation of law and the express requirements of the FAR, the possible need for novation should be given consideration in the planning of a deal structure that involves a merger or consolidation.

Given the inconsistent treatment of mergers and consolidations by courts and contracting officers alike, parties involved in deal-making with entities holding federal government contracts are well advised to consider early engagement with the Government regarding the possible obligation to seek novation. Although a contracting officer cannot execute a novation agreement until after the transaction has closed, early engagement with the contracting officer about such a possibility will allow the parties to set reasonable expectations and possibly help identify and address any Government concerns. Ultimately, the contracting officer is given a wide range of discretion in consenting to transactions in which he or she deems that Government consent is required. FAR 42.1203(b). Some contractors deal with the risk that the contracting officer may reject the novation request by subcontracting all of the work to the potential acquirer or to hold certain funds in escrow pending execution of the novation agreement. As such, it is best for the parties to be proactive in contacting the relevant contracting officers and always address in the transaction the possibility of a delayed or adverse action.

[1] “By operation of law” is simply “[t]he means by which a right or a liability is created for a party regardless of the party's actual intent.” OPERATION OF LAW, Black's Law Dictionary (10th ed. 2014).

Related People

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