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November 20, 2017

*Via Email to sec809@dau.mil*

Section 809 Panel

Ms. Diedre Lee, Chair

Mr. David Drabkin, Commissioner Team 4

1400 Key Blvd.

Suite 210

Rosslyn, VA 22209

**Re: Comments to Section 809 Panel; Improving Novations**

Dear Ms. Lee and Mr. Drabkin:

On behalf of the American Bar Association (“ABA”) Section of Public Contract Law (“Section”), I am submitting comments to assist the Section 809 Panel in reviewing acquisition regulations applicable to the Department of Defense (“DoD”) with a view towards streamlining and improving the efficiency and effectiveness of defense acquisition and defense technology advantage, along with achieving related goals.<sup>1</sup> The Section consists of attorneys and associated professionals in private practice, industry, and government service. The Section’s governing Council and substantive committees include members representing these three segments to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The views expressed herein are presented on behalf of the Section. They have not been approved by the House of Delegates or the Board of Governors of the ABA and, therefore, should not be construed as representing the position of the ABA.<sup>2</sup>

<sup>1</sup> Mary Ellen Coster Williams, Section Delegate to the ABA House of Delegates, and Marian Blank Horn, Kristine Kassekert, and Heather K. Weiner, members of the Section’s Council, did not participate in the Section’s consideration of these comments and abstained from the voting to approve and send this letter.

<sup>2</sup> This letter is available in pdf format at [http://www.americanbar.org/groups/public\\_contract\\_law/resources/prior\\_section\\_comments.html](http://www.americanbar.org/groups/public_contract_law/resources/prior_section_comments.html) under the topic “Transactions.”

## **I. INTRODUCTION**

The Section's comments for the Section 809 Panel focus in this letter on the Federal Acquisition Regulation ("FAR") Part 42.1204, Novation Agreements. Although the Section agrees that the Government should be advised when changes arise in the ownership and/or management of contractors, the Section submits that the current novation requirements are outdated, inconsistent with commercial practices, and often incongruent with market realities.

In the context of commercial mergers and acquisitions ("M&A"), for example, parties can "assign" contracts from the seller to the buyer in the time that it takes for the seller and buyer to negotiate the transfer. Often this effort involves contracts that contain provisions that prohibit the other contracting parties from "unreasonably" denying assignment requests. In contrast, under government novation requirements, contractors sometimes need years to finalize novation agreements, with agencies often requiring additional or different terms or simply refusing to accept the novation.

This dichotomy creates needless uncertainty for parties to corporate transactions, as well as inefficiencies for agency customers. For example, because the novation process can continue after a corporate transaction closes, the parties must arrange for temporary pass-through subcontracts to allow performance to continue pending completion and acceptance of the novation. These structures may be complex and confusing for all sides and do not serve anyone's best interests. The Section encourages the Section 809 panel to consider novation can be streamlined and clarified in terms of timing, substance, and personnel.

## **II. BACKGROUND ON FAR 42.1204**

The FAR Council established the novation process to create an exception to the Anti-Assignment Act, 41 U.S.C. § 6305.

The process allows the Government to recognize a third party as successor-in-interest to a government contract when there is a transfer of: (1) all of a contractor's assets, or (2) the entire portion of the contractor's assets involved in performance of the government contract. FAR 42.1204(a). The buyer in an asset transaction must complete this process to obtain approval to become the new prime contractor. A buyer in a stock purchase transaction may also be asked to furnish the same types of information and to obtain contracting officer approval as well.

Under the current process, both contractors (the buyer and seller) must send the Government copies of a proposed novation agreement after the transaction has closed, along with detailed information on all affected contracts, evidence of the transferee's capability to perform, and any other relevant information requested by the contracting officer. Each contractor must submit multiple specific documents, including: the bill of sale; board of directors' minutes authorizing the transfer; copies of corporate articles; opinion of legal counsel; balance sheets as of the date immediately before and after the transfer of assets; evidence of security clearances; and the consent of sureties, if required. These documents—an undertaking beyond what the actual commercial transaction required—are burdensome for contractors to prepare and for the Government to review.

The burden, delay, and uncertainty created by this process drives government contractors to avoid novation whenever possible, including by structuring many M&A deals as stock transactions.

### **III. COMMENTS ON SELECT PROVISIONS OF FAR 42.1204**

#### **A. Timing of Novation**

There are two significant problems with the timing of the novation process: (1) it must begin post-closing; and (2) it is not time limited and may sometimes take more than a year to complete. These problems combine to undermine certainty, create unnecessary and awkward subcontract arrangements, and limit the value of prompt agreement processing.

##### ***1. Requiring Novation Post-Closing Can Create Unexpected Results.***

Because novation can be requested only after a transaction has closed, parties must complete their transaction before they can formally ask the Government for permission to complete a transaction that was just completed. This back-loaded permission creates a gap between the transfer of personnel/assets (which occurs at closing to give a buyer the benefit of its bargain) and the contracts that those personnel/assets are performing (which cannot actually transfer until novation is approved). Parties bridge this awkward gap by implementing temporary subcontracts under which the buyer performs the seller's contractual obligations with buyer's newly acquired personnel and assets. In some instances, the seller exists only as a corporate shell entity for invoicing and payment until novation is granted. This arrangement is necessary because the current novation requirements elevate form over substance.

This "subcontract pending novation" arrangement causes both parties to incur additional costs and strips the Government of privity with the entity that performs the contractual requirements. The arrangement also puts the transactional parties at a disadvantage because they cannot discern whether the Government will, at some undisclosed time, object to the request to recognize the successor-in-interest. This necessary, but unfortunate, structure also creates a cumbersome payment process under which the prime contractor (seller) receives payment and the subcontractor (buyer) performs the work with seller's former employees. Even more challenging is the process by which the parties determine how the buyer of multiple-awardee contract can submit task- and delivery-order proposals under the contract it has purchased while the contract remains in the seller's name.

##### ***2. The Unlimited Time for Processing a Novation Creates Undue Uncertainty.***

The Government does not establish any deadlines by which it will finish processing a request for novation. Novation almost always takes many months, with some novations taking more than a year and others finishing only after the transferred contracts have expired. This lack of time limit and of consistency in timing introduces uncertainty. Not knowing when the novation may be granted puts the buyer at risk of knowing when—or if—it will realize the benefit of what it bargained for (i.e., the contracts and other assets necessary for the performance

of that contract). To address the risk of novation that lingers unapproved, transaction parties sometimes add an “unwind” or rescission provision to their purchase agreements. But even then, the transaction parties are never sure when the transaction will be complete, uncertainty that can, for example, make competing on future contracts more difficult.

The Section recommends two primary changes in the novation process and timing to increase certainty for contractors and to minimize disruption for the Government.

First, novation should occur before transaction closing. This change could be accomplished by allowing the review to occur before closing, just like the reviews offered under Hart-Scott-Rodino Act and by the Committee on Foreign Investment in the United States (“CFIUS”). Such a change would allow parties to close with certainty, avoid unwinding transactions, and make pass-through subcontracts a relic of the past.

Second, the Government should have incentives to timely process novations. The Government should be required to approve or disapprove novation applications within 90 days of the application’s submission. This timeline is similar to the deadlines established in the Hart-Scott-Rodino review and the review conducted by CFIUS. Both of those reviews apply to transactions involving government contractors, and both require the Government to act on an approval request within a prescribed time period, seek more time, or waive any objection to the approval request. In addition, this novation time period should include not just approving the novation, but also issuing all required modifications to the contract affected by the transaction.

These changes in the processing of novation applications would alleviate several burdens. For one, the Government would remain in privity with the entity that has the assets performing the prime contracts. In addition, the transactional parties could close the proposed deal with much more certainty. These changes would not increase risk for the Government: the novation agreement still requires the seller to continue to guarantee contractual performance after the Government agrees to recognize the successor-in-interest.

The current post-closing novation process can also lead to confusion, cost, and additional bid protests by competitors to the buyer in the M&A transaction. The novated contracts show the new prime contractor as of the date of the novation approval and modification, not the (earlier) date of the M&A transaction closing when the acquirer began performing the acquired contract. This disconnected timing leads to confusion in competitive bids because the M&A seller can continue to be the nominal prime contractor for a year or more after the transaction closes. This problem is heightened for novations of indefinite delivery/indefinite quantity (“IDIQ”) contracts and their task orders. The IDIQ contract continues to be held by the seller throughout the novation while the buyer must bid on new task and delivery orders under the seller/prime contractor’s name. These confusing steps create no benefits for the Government or industry and could be avoided with the changes described above.

**B. FAR 42.1204(b) – Change in Corporate Entity Structure (Conversions)**

Contractors are increasingly changing corporate form, whether to achieve tax advantages or obtain increased flexibility for outside investment. The Government has taken conflicting positions on whether novation is required for these conversions in form. In the Section’s experience, some officials have created specialized “conversion forms” that differ from the standard novation forms in the FAR. The Section recommends improving consistency in treatment of these conversions.

Novation agreements, together with the associated documentation, do not appear to apply to corporate conversions because no third party acquires any assets. The only parties to a corporate conversion are the entity undergoing the conversion and the Government. Further, a change in corporate form does not implicate any of the risks to be mitigated by novation—the assets of the contractor have not been transferred to a third party. Instead, they continue to exist, but in a different corporate form. As a result, novation is not needed for a corporate conversion in which a contractor simply changes its corporate form or state of incorporation.

The novation process, by its nature, must involve three parties to the agreement, and the package requires documents from the buyer (the successor-in-interest) seeking recognition from the Government. Accordingly, the Section recommends clarifying that the name-change requirements of FAR 42.1204(b) (not the novation requirements) apply to a corporate conversion.

**C. FAR 42.1204(e)-(f) – Contents of the Novation Package**

For the benefit of the Government and contractors, the Section recommends simplifying the novation package. The Government’s review for novation currently requires a multi-page flow chart with dozens of steps. Eliminating even some of the unnecessary documentation will shorten that process without increasing government risk. Further, simplifying the novation package submittal will decrease costs for contractors and increase the likelihood that novation packages are correct and complete when submitted.

The Section proposes a simplified novation package that includes the following: (i) a cover letter certifying that the novation packet is authentic and accurate; (ii) a novation agreement; (iii) a list of affected contracts; (iv) a statement of transferee’s capability to perform; (v) the purchase agreement; (vi) the opinion of legal counsel; (vii) evidence that classified security requirements have been met; and (viii) the consent of any sureties.

Other documents are superfluous and appear often times to not be reviewed by government personnel. For example, if an authorized person from the company has executed the purchase agreement and cover letter, and the agreement has been declared to be legal by counsel, other documents, such as board minutes approving the transaction, are unnecessary to protect the Government’s interests.

**D. FAR 42.1204(f)(6) – Audited Financials**

The Section also recommends eliminating the requirement for audited financials from before and after an M&A transaction. Although submission of audited financials is intended to address the risk of default or non-performance, the submission is cumbersome, outdated, and often waived. In almost all instances, the parties have only annual audited financials. If audited financials for shorter periods do exist, they are almost always outdated because the periods do not coincide with the transaction. Obtaining timely audited financials under the required timing may take weeks or months to perform and cost hundreds of thousands of dollars. Perhaps in recognition of this burden, the Government, in the Section's experience, often waives the requirement to submit audited financials and agrees to the novation request without receiving audited financials from either the buyer or the seller.

This requirement can be replaced, without any risk to the Government, with a requirement to provide financial evidence of the buyer's ability to perform in its capability statement. This is the risk at the heart of requiring audited financial statements. The parties should be able to provide the seller's most recently audited financials or other financial information that is part of the financial support required by bidders for government contracts generally. If the rule changes allow providing this information, the information should meet the Government's needs while avoiding unnecessary and costly novation-specific audited financials. In addition, the seller's (transferee's) continued guarantee of performance, which is a requirement in the novation agreement, provides a further security for the Government's interests in the event of a default.

**IV. CONCLUSION**

The FAR Part 42.12 novation requirements create unnecessary delays and add uncertainty in transactions to acquire a government contractor's assets. Several required supporting documents also create unnecessary regulatory burdens, impose costly obligations on the contractor parties, and delay the approval process. As detailed herein, there are modifications to the novation requirements that can be made to reduce the compliance burdens and streamline the process without increasing the risk borne by the Government.

The Section appreciates the opportunity to provide feedback to the Section 809 Panel to further its efforts to streamline the commercial item contracting process. The Section is available to provide additional information or assistance as you may require.

Sincerely,



Aaron Silberman  
Chair, Section of Public Contract Law

cc:

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November 20, 2017

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