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More Novation Complexity in Gov't Contracts M&A?

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Government contractors undergoing an asset transaction know all too well the peculiarity and uncertainty associated with the transfer of a U.S. government contract through the required novation process. In two recent decisions, the Government Accountability Office considered the impact of such transactions and the novation process on the pursuit of new task orders from the U.S. government, with disappointing results for the affected contractors.

GAO decisions underscore some of the challenges associated with the novation process and signal the possibility of even further complexity. We examine those decisions and offer perspective on the steps that sellers and purchasers can take to navigate the novation process in future M&A deals that contemplate the transfer of government contracts.

Background on the Novation Process

The Anti-Assignment Act generally prohibits the transfer of U.S. government contracts in the context of an asset sale.[1] However, the Federal Acquisition Regulation establishes an exception to this prohibition — known as the novation process — which allows the U.S. government to approve the transfer of a contract when it is in the U.S. government's interest.[2]

Contractors undergoing the novation process have experienced an array of practical and administrative challenges. For instance, the novation process typically begins only after the closing of a transaction — i.e., after the assets used to perform have transferred to the purchaser — which often leaves the parties to rely on a post-closing subcontract pending novation to ensure continued performance of the contract until novation is approved and to allow the purchaser to realize the revenue stream it just acquired. And, because the U.S. government controls both the timing of the novation process and the ultimate decision of whether to grant a novation request, the subcontract pending novation may remain in place for a significant period after closing.[3]

Recent Decisions Addressing the Novation Process

In recent months, the GAO addressed two separate bid protests involving procurements that were conducted in the wake of M&A transactions. In both cases, the seller had sought approval from the U.S. government to transfer a multiple award task order contract, or MATOC,[4] to the purchaser, and at the same time the seller and purchaser were collaborating on the pursuit of new task orders to be issued under the affected MATOC. The parties' efforts to compete for task order awards were foiled by the fact that the MATOC at issue had been the subject of a novation request.

Wyle Laboratories: Questions About Standing to Protest

In Matter of Wyle Laboratories Inc., the holder of a General Services Administration OASIS contract entered into an asset purchase agreement that transferred all assets and liabilities related to the OASIS contract to another government contractor.[5] The seller and purchaser had submitted a request for novation to the GSA, seeking approval for the transfer of the contract.

While the novation request was pending, the seller and purchaser worked together to submit a quotation that sought an OASIS task order to provide professional, technical and operational support services to the U.S. Department of Homeland Security's Office of Facilities and Asset Management. The seller, which held the MATOC, indicated in the quotation that it would "serve as the prime contractor until novation" and would then transfer its responsibilities to the purchaser, which was the incumbent contractor for the support services. The seller also indicated that regardless of the outcome of the novation, the purchaser would be performing all of the work under the homeland security task order.

The seller also filed a pre-award bid protest with the GAO to challenge the terms of the task order solicitation as unduly restrictive of competition. The seller maintained it had standing to protest because it would be the prime contractor unless and until the GSA granted the novation request. The GAO disagreed, concluding that the seller did not have a direct economic interest in the procurement because the seller had made repeatedly clear that it had no intention to perform any work under the task order. Thus, the GAO determined that the seller did not have standing to bring a bid protest.

Engility Corporation: Confusion About Who Submitted Proposal

Matter of Engility Corp. concerned a MATOC for logistic sustainment services in support of the U.S. Army.[6] Similar to Wyle, the MATOC holder entered an asset purchase agreement that transferred all assets and liabilities related to the contract to another contractor and had submitted a request for novation of the contract. A few weeks later, the seller and purchaser worked together to submit a proposal for a new task order under the contract.

The Army declined to approve the novation request and then rejected the task order proposal on the grounds that the proposal was submitted by the purchaser, which did not hold the proper MATOC. The seller protested the Army's decision to reject the task order, contending that it held a MATOC and properly submitted the proposal.

The GAO denied the protest, finding that while there were some elements of the record that supported the position that the seller and purchaser intended to jointly submit the proposal, numerous elements established doubt that the seller was intended to act as the prime contractor for this proposal. According to the GAO, the Army could reasonably conclude that the purchaser had submitted the proposal.

The GAO observed, for example, that the seller and purchaser had submitted cover letters speaking about an "administrative subcontract" but failing to identify the prime contractor. In addition, several volumes of the proposal stated that they were "PREPARED BY" the purchaser and all of the proposed team members identified in the proposal were associated with the purchaser. Finally, the proposal did not include any discussion regarding how the seller would remain the prime contractor in the absence of novation approval.

Interestingly, the Engility decision, which was issued two months after Wyle, never suggests that the seller might lack standing to bring the protest. This silence is particularly notable, as the seller represented that the purchaser would "perform 100 percent of the work" and, therefore, potentially suggests that Wyle may be an aberration or limited to its "unique circumstances."[7]

Takeaways

The Wyle and Engility decisions underscore some of the challenges that the novation process may present in M&A deals involving a government contractor. For instance, although novation requests are typically approved in due course, Engility demonstrates that approval remains at the discretion of the agency and, depending on the facts, may not be granted. Further, both decisions highlight the potential for business interruption following an M&A transaction, particularly where parties attempt to submit task order proposals, challenge the terms of a solicitation, or protest an award decision while the novation remains pending.

Minimizing the risk presented by the novation process requires careful planning and cooperation. This should begin as early as possible in the deal process, ideally well before a purchase agreement is signed by ensuring that each of the MATOCs that require novation approval is identified and assessed. As part of this assessment, parties should consider whether there are strategic or valuable pipeline opportunities tied to a MATOC and, if so, whether there are likely to be proposal submissions or proposal evaluations that occur while a novation request is pending.

If the risk to the value of the business created by the uncertainty of the novation process is too great, parties may consider altering the transaction timeline to allow the seller to pursue the key pipeline opportunity ahead of a novation request. Alternatively, if a transaction and subsequent novation must move forward without delay, a purchaser may be well advised to account for novation risk in its valuation of the key pipeline opportunity.

In addition to assessing the impact of the novation process during diligence, parties also should account for the challenges of this process in the transaction structure. For instance, it may be helpful to articulate in the purchase agreement or subcontract pending novation contingency plans if novation approval is substantially delayed or even denied.

In addition, although the seller typically should submit the task order proposal until a novation is approved, parties should be prepared to coordinate in developing the proposal and executing procurement strategy.

Finally, parties should have an agreement concerning the allocation of performance responsibilities under future task order pursuits and ensure that such allocation is consistent with the terms of each MATOC, including terms that may limit subcontracting.

The Wyle and Engility decisions suggest that when allocating responsibility, it is may be advisable for the seller to retain some responsibility for performance, at least until novation approval. For example, the seller could make clear that it inevitably remains responsible for task order performance and will oversee the work of the purchaser as a subcontractor until a novation is approved. The parties might also consider allowing the seller to remain responsibility for communications with the U.S. government customer and invoicing activities.

Each contract, task order and M&A transaction is different, and no solution will eliminate all risk involved in the novation of a MATOC. However, until meaningful changes are made to the current novation process to reflect commercial realities, government contractors and their counsel would be well advised to proceed with caution. They should continue monitoring the GAO's decisions involving contracts undergoing novation approval and be prepared to implement mitigating measures, such as those described above, when engaging in an asset transaction.

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[1] 41 U.S.C. § 6305; see also FAR 42.1204(a).

[2] FAR 42.1204(a).

[3] There have been cries from industry to reform the novation process, including recent comments from the American Bar Association Section of Public Contract Law to the Section 809 Panel, a panel charged by Congress with considering ideas to streamline and simplify the defense acquisition system. The Public Contract Law Section observed that "current novation requirements are outdated, inconsistent with commercial practices, and often incongruent with market realities" and presented opportunities to improve the novation process under FAR Part 42.1204. Yet, despite these efforts, there have been no substantive changes to the novation process since 1997.

[4] MATOCs are indefinite-delivery, indefinite-quantity contracts awarded to two or more contractors under a single solicitation. The selected contractors then compete for future task orders, as a government customer determines its specific needs. These awards have become particularly prevalent in recent years, and therefore represent significant opportunities for government contractors. A recent GAO report shows that more than $50 billion was obligated through MATOCs each year in fiscal years 2011 through 2015. See, Agencies Widely Used Indefinite Contracts to Provide Flexibility to Meet Mission Needs, Federal Contracts, GAO, https://www.gao.gov/assets/690/684079.pdf. Significantly, more than half of those obligated dollars involved the U.S. Department of Defense.

[5] Wyle Laboratories Inc., B-416528 (Sept. 7, 2018), https://www.gao.gov/assets/700/694563.pdf

[6] Matter of Engility Corporation, B-416650; B-416650.2 (Nov. 7, 2018), https://www.gao.gov/assets/700/695505.pdf

[7] The Wyle decision concludes with a paragraph that begins "In the unique circumstances presented here ... "