

Time To Reimagine The Novation Process For Gov't Contracts

By **Scott Freling, Nooree Lee and Emma Merrill-Grubb** (August 9, 2024, 4:36 PM EDT)

Last month, the Federal Acquisition Regulatory Council took action with a notice in the Federal Register to extend its existing authority to collect information from government contractors for novation requests. While this was a routine action, it is a reminder that the novation process is in need of serious attention.[1]

The notice addresses prior public comments echoing a long-standing sentiment that government contractors want a more streamlined, practical approach to novations — the procedure and requirements for which have remained substantively unchanged for nearly three decades.[2]

The FAR Council should heed commenters' suggestions — reimagine Subpart 42.12 of the Federal Acquisition Regulation and implement a novation process that functions better for the U.S. Government and its contractors.[3]

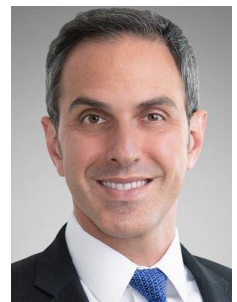
Current Requirements and Policy Foundation

FAR Subpart 42.12, in its current form, requires a contractor that is seeking to novate a contract to another entity, including a corporate affiliate, to assemble various documents, including three signed copies of the proposed novation agreement, a document describing the proposed transaction, a list of affected contracts and evidence of the transferee's capability to perform.

But the novation process does not end there. The contractor must gather a slew of other supporting documents, including some that typically are not available until after completion of the transaction.[4]

These various other documents include:

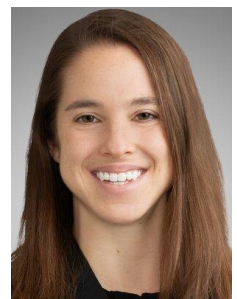
- An authenticated copy of the instrument affecting the transfer of assets;
- A certified copy of each resolution of the corporate parties' boards of directors authorizing the transfer of assets;
- A certified copy of the minutes of each corporate party's stockholder meeting necessary to approve the transfer of assets;



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- An authenticated copy of the transferee's certificate and articles of incorporation, if a corporation was formed for the purpose of receiving the assets involved in performing the affected contracts;
- Legal counsel opinions for the transferor and transferee stating that the transfer was properly affected under applicable law and the effective date of transfer;
- Balance sheets of the transferor and transferee as of the dates immediately before and after the transfer of assets, audited by independent accountants; and
- Evidence that any security clearance requirements have been met.

The FAR contemplates that after the contractor has packaged together all of this material, it will then submit the novation request to the responsible contracting officer. According to FAR 42.1203, the "responsible contracting officer" is responsible for examining the required documentation, soliciting feedback from the contracting officers for each of the affected contracts and determining on behalf of the government "whether or not it is in the Government's interest to recognize the proposed successor in interest" — i.e., to grant the novation request.

The FAR's novation process has important policy underpinnings. The government is obligated to contract with responsible contractors.[5] The novation process is designed, among other things, to ensure compliance with this requirement.

Similarly, novation functions as a government form of know-your-customer requirements in the commercial financial sector, whereby financial institutions and their employees must undertake reasonable diligence into their customers and associated risks.

Problems With the Existing Novation Process

The existing novation process at FAR Subpart 42.12 has a number of shortcomings. We provide a few examples below.

First, FAR Subpart 42.12 does not account for the range of corporate transactions a contractor may undertake. The current regime allows contracting officers to recognize a change in name of an existing legal entity through FAR 42.1205 and a transfer of a contract to a different legal entity through FAR 42.1204.

As these are the only mechanisms available, there is often confusion among contracting officers and industry on the applicable procedures for corporate transactions that do not fall neatly into one of these two buckets.

One example is the conversion of a legal entity to another form, such as from an S corporation into an LLC. There are often questions over whether this constitutes a name change or a novation, and this may lead contracting officers to adopt an overly conservative approach and require novation agreements. Of course, novation is not a clean fit either, as no assets are actually being transferred in most conversions.

Second, it creates unnecessary risk in asset-based transactions involving government contractors. Despite the requirement for a document describing a proposed transaction, in reality, parties typically are forced to sign and close asset-based transactions before the government will review a novation request.

As noted above, FAR Subpart 42.12 requires the submission of materials that generally are not available until after completion of an M&A transaction, like the instrument affecting the transfer of assets and legal opinions of both parties. Thus, parties typically must submit their novation packages only after the purchase price has changed hands.

The resulting uncertainty in whether and when the responsible contracting officer will approve the parties' novation request naturally makes transaction parties uneasy, and it may have the effect of disincentivizing some in the industry from pursuing deals structured as asset sales. It also makes asset-based deals more difficult.

The volume and variety of documents, not to mention the level of coordination between outside counsel, required to compile a complete novation package imposes an unnecessary — and avoidable — burden on such transactions.

Third, it creates inconsistent outcomes. Notably, the FAR lacks a defined timeline over which the responsible contracting officer must review the novation request, nor does it offer a transparent and objective framework under which the novation request will be evaluated. This can lead to inconsistent treatment of similarly situated contractors.

In addition, despite the explicit language in FAR 42.1203 requiring submission to a single responsible contracting officer, certain agencies and certain contracting officers will often insist on the submission of a separate novation package for contracts under its domain.

Recommendations for Improving FAR Subpart 42.12

What would a rewrite look like? To start, the FAR Council should create a formal process for preclosing engagement between the transferor, transferee and responsible contracting officer. A formal engagement process could help eliminate the uncertainty that contractors face in the current mergers and acquisitions landscape around when to reach out to the government, and shorten the time between closing and novation package submittal.

It also would presumably better protect the government's interests in the existing after-the-fact review and approval framework.

In addition, the FAR Council should establish a required timeline upon which the responsible contracting officer must review and approve novation packages. And, it should dispense with the unnecessary and burdensome documentation requirements, like audited financial statements.

Comments addressed by the FAR Council in its recent Federal Register notice represent a decent baseline for considering the ways to fix FAR Subpart 42.12. Among other ideas, commenters suggested:

- Defining time frames for the government's review of the novation package;
- Reserving the novation process for asset transfers between two completely unaffiliated legal entities;
- Conversely, permitting a streamlined process for asset transfers between two affiliated entities within the same corporate parent structure;

- Removing the requirement to provide the "approximate remaining unpaid balance" of contracts to be novated at FAR 42.1204(e)(2)(iv);
- Removing the requirement for a corporate seal or imposing a dollar threshold above which the corporate seal is required; and
- Replacing the listed documents at FAR 42.1204(f)(1)-(3) with certification that the required activities — registration, approval by the board, etc. — have been completed.

We also suggest some other ideas for consideration:

- Clarifying that electronic signatures are permitted;
- Providing clarity on the authority of responsible contracting officers to execute agreements on behalf of the entire government;
- Eliminating the requirement to submit audited financial statements, and replace it with guidance on acceptable alternative evidence of financial capability; and
- Creating an online government portal for submission of novation packages.

These are practical steps that could improve the novation process for both the government and industry. Even if a full scale rewrite of FAR 42.12 is unrealistic in the near term, the FAR Council should at a minimum scrutinize the comments received from industry and consider acting on at least some of them.

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[1] Submission for OMB Review; Novation and Change-of-Name Agreements, 89 Fed. Reg. 55595 (July 5, 2024).

[2] Comment Letters on Information Collection; Novation and Change-of-Name Agreements, (June 11, 2024), <https://www.regulations.gov/document/FAR-2024-0053-0011/comment>.

[3] FAR 42.12 (2024).

[4] See FAR 42.1204(e), (f).

[5] See FAR Subpart 9.103.