



**PREPARATION IS  
KEY TO A  
SUCCESSFUL  
INNOVATION**

WHAT CONTRACT MANAGERS CAN EXPECT IN THE NOVATION PROCESS.

BY **TODD R. OVERMAN**



**When a company wants to transfer its U.S. federal government contract to another party, it must engage in a complex process known as “novation.”**

**While the government may allow a company to sell or otherwise transfer its interest in a contract, the company must be careful to ensure that the new party to the contract can perform all of the obligations of the original contract.**

Putting together the voluminous package of information required by the government in the novation process typically falls to the contract manager, usually a non-lawyer, who is suddenly a key player in the contract transfer process. This article will offer guidance to the contract manager in what to expect in the novation process.

While one party to a commercial contract may usually have the ability to transfer its interest without the consent of another party to the contract, government contracts are different. The Anti-Assignment of Contracts Act<sup>1</sup> prohibits a contractor from transferring its interest in a government contract to a third party. Any attempt to transfer annuls the contract. Fortunately, the government may consent to a transfer to a successor in interest if the transfer is deemed to be in the government’s interest and all assets necessary to perform the contract have been transferred to the new party. The procedures are outlined in *Federal Acquisition Regulation (FAR)* 42.12.

### TIPS FOR A SUCCESSFUL NOVATION

Demonstrating capability of the new party to perform the contract is one of the keys to a successful novation. As part of the

novation process, the government requires the contractor to provide “evidence of the transferee’s capability to perform” the contract.<sup>2</sup> Basically, this means the government won’t allow a contract to be transferred, or novated, to a new party until it is satisfied that the new party has the capability to fulfill all of the terms. The burden of proof rests with the existing party to the contract, but requires involvement of the new party to ensure the government trusts that the new party has the capability to perform the contract.

One thing that is helpful to do is to prepare a “Capability to Perform Statement,” which explains to the government how great the new party is. This statement tells the government what sort of work the transferee does, how long they’ve been performing government contracts, and whether they have security clearances and the right accounting systems in place. A word of caution on this point: This is not just an empty exercise to placate the government—you should be satisfied yourself that the successor in interest is qualified to perform. Though it doesn’t occur often, the government could sue the original holder of the

contract to enforce the terms of the contract in a case where the successor in interest defaults on contract obligations. While that would seem to be at odds with the whole purpose of an approved novation, you should know that the government will always be determined to protect its interests. The lesson is to be sure the successor in interest really does have the capability to perform the contract.

Another key to a successful novation is to get qualified counsel involved when you be-



come aware of a possible novation. The minute you know of a possible novation situation, you need to get the right people involved who understand the novation process and will create the documents required by the *FAR* in connection with the asset transfer. Last-minute and unexpected requests for information can create speed bumps in the novation process, and ultimately delay novation approval.

While novation packages can be complex, the good news is that there have been no

recent changes to FAR 42.12. It's been over 17 years since the *FAR* first outlined the novation process. Still, the information requirements remain somewhat unpredictable because the *FAR* allows the administrative contracting officer—usually the main point of contact with the government—discretion in the types of information that can be requested.

For example, the government might unexpectedly ask for additional financial information from the acquirer, or it might ask a new

contractor to go through a financial capability assessment in order to determine whether it has the capital structure necessary to perform the contract it wants to assume. The government might also suspect there are other contracts that are still open, and it won't approve the novation until all of the unaccounted contracts are included in the novation agreement. I've also seen situations where the government challenged the adequacy of a legal opinion. If the government doesn't like the language in a legal opinion,





edits may be requested. That's often the case when legal opinions have caveats, as most do. All of these unexpected situations highlight the importance of getting qualified counsel involved early in the process.

Lastly, the parties to the transaction should carefully understand the contract requirements and how those requirements may become issues in the novation process. For instance, will the new contractor require access to classified information? If so, the new contractor needs to obtain or demonstrate that it has the appropriate security clearance before the novation will be approved. If it's a manufacturing contract, are there certifications or first article testing that won't transfer to the new contractor's manufacturing facility? The consequences of not anticipating the need to have these qualifications in place could place your government contract at risk. At minimum, you may hold up the novation approval or even the underlying transaction. At worst, a contract could be suspended or even terminated for default. Suspension of payments is also a possibility. Anticipating each of these issues ahead of time will expedite the transaction as well as the novation approval process.

### COMMON PROBLEMS IN THE NOVATION PROCESS

The following are some of the main problems that arise in the novation process and thoughts on how to overcome them.

#### Not Communicating with the Government Early on

To the extent you can do so, you need to reach out and explain to the appropriate contracting officer the exact transaction that is occurring. Make every effort to get the customer on your side from the beginning.

#### Lack of Understanding of When a Novation is Required

Some companies are caught off guard when the government requests a novation. Keep in mind that the FAR provides three situations where a novation is required:

- Sale of assets used in performing a government contract with a provision for assuming liabilities,
- Transfer of assets incident to a merger or corporate consolidation, and
- Incorporation of a proprietorship or partnership, or formation of a partnership.<sup>3</sup>

#### Lack of Substantive Response in the Novation Package

The FAR lays out specifically what you're supposed to provide, and any attempt to deviate from that list can lead to a contracting office rejecting your novation request. If there is a component on the list that is not applicable or not available, you need to explain that in your request. If you

have a substitute document, you should be able to provide it.

#### Be Sure You Have the Right Resources Available

Once the novation package is submitted, the process will go faster if you're prepared to answer questions and reach a resolution on the agreement itself. While the FAR doesn't allow any real negotiation on the requirements or novation agreement itself, you should be prepared to say, "What else do you need to see?"

#### Confirm that the Novation Agreement has the Appropriate Date and Contract Modifications are Issued

Once the novation agreement is approved, the official novation date becomes the asset transfer date—not the actual date you received approval. If you transferred assets to the new entity in March and then received novation approval in June, the effective date of the novation is March. All transferred contracts should then be modified to enter the name of the new contractor as of the asset transfer date identified in the novation agreement.

### IT'S A BACKWARD PROCESS

One surprise to those new to the novation process may be that assets must be transferred to the acquirer prior to approval of the novation. You cannot request that

the government recognize a successor in interest until you've transferred the assets underlying the performance of the contract. It's almost as if the process moves in reverse, in that you have to send all of the assets to the acquirer or the other corporate entity, and then ask the government to approve the transfer of the contract from the original contractor to the successor in interest. It would be great if you could go to the government ahead of time and ask it to approve the transfer before the assets are transferred, but that's not the way it works.

The reason the government doesn't do it that way is that it reserves the absolute right to not approve a novation. Even though the assets already may have been transferred and employees hired, the government can still refuse to approve the novation. Novations are disapproved infrequently, but the process may stretch out for many months if the government isn't satisfied early on. During the period between transfer and novation approval, it is recommended that parties enter into a subcontract pending novation.

This subcontract remains in place while the novation request is pending and requires the prospective new party to perform the obligations of the original contract. This situation is typically mutually beneficial because the interests of both parties are aligned—both have an economic interest in the new company handling the obligations properly so that the novation can go through.

Generally, there are no appeals of novation requests that are disapproved, but you may resubmit your novation request. If you receive pushback from the agency on a novation, the best course of action is usually to get agency legal counsel involved. I have worked through novation issues by asking agency counsel what they need to see in terms of financial capability or whatever issue they are concerned about. If the government does not approve the novation, the original contractor remains in privity with the government and must perform the contractual obligations—relying on the new party and the subcontract pending novation to meet those requirements. **CM**

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**ENDNOTES**

1. 41 U.S.C. 6305.
2. FAR 42.1204(e)(3).
3. FAR 42.1204(a).



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