Professional Perspective

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# Navigating the Acquisition of Distressed Government Contractors - Part 2

*Contributed by Steven S. Diamond, Michael D. McGill, and Thomas A. Pettit, Arnold & Porter*

Strategic or financial buyers looking to invest in or purchase assets from a distressed government contractor must navigate unique regulatory requirements applicable to federal government contracts. This article, the second in a three-part series, examines how the Anti-Assignment of Contracts Act (Anti-Assignment Act) restrictions on transferring any rights or interests in government contracts intersect with the bankruptcy process.

Part 1 discusses protections afforded to distressed government contractors through the bankruptcy process. Part 3 discusses due diligence considerations relevant to the acquisition of distressed government contractors.

A primary concern of any prospective acquirer of a government contractor or its assets is ensuring that government contracts transfer from the contractor to the acquirer or that the contractor retains the contracts following a reorganization. The Anti-Assignment Act, codified at 41 U.S.C. § 6305, generally prohibits contractors from assigning government contracts to third parties, stating that "[t]he 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."

There are exceptions to this prohibition, including government consent, such as through a novation, transfer by operation of law, and waiver. When a novation is required, the parties must consider how best to bridge the period between closing and the effectuation of the novation. Buyers and sellers, following notice to the contracting officer, may need to execute a transition agreement, typically some form of agency or subcontracting arrangement, pending approval of the novation. These arrangements often present their own challenges, which are compounded in the bankruptcy process.

## Scope of and Exceptions to the Anti-Assignment Act

Certain transactions are not subject to the Anti-Assignment Act's restrictions and Federal Acquisition Regulation (FAR) novation requirements. Stock purchases, for instance, do not involve the transfer of government contracts from one entity to another and thus do not implicate the act. While the contractor may be contractually required to inform the government of the change in ownership in connection with an equity sale, the Anti-Assignment Act prohibition on transferring government contracts does not apply. In other transactions, including asset sales, the government must consent to the assignment of contracts. The government can also implicitly waive the Anti-Assignment Act's restrictions by accepting the buyer's performance and paying invoices submitted by the buyer, but a contractor should not rely on the waiver exception.

To obtain the government's consent, the parties must comply with the novation process detailed in FAR 42.1204. This process requires the parties to submit a proposed tri-party novation agreement and certain supporting documentation to the cognizant contracting officer, which, in many cases, is an administrative contracting officer acting on behalf of all the contractor's agency customers. A complete novation package cannot be submitted to the government until a transaction has closed, due in part to documentation requirements. There are also certain types of transactions, such as mergers, that arguably fall within the operation of law exception to the Anti-Assignment Act prohibition, but which agencies often subject to a more limited novation process requiring less documentation, though they sometimes require some form of guaranty from the transferring entity.

There is no guarantee that an agency will consent to a transfer of a government contract. The decision to accept or reject a novation falls within the broad discretion of the contracting officer. Indeed, the Federal Circuit held in *Ordnance Devices, Inc. v. United States*, 50 F.3d 22 (Fed. Cir. 1995), that a buyer "ha[s] no right to have the contracts novated" and explained that the buyer "took a business risk when it purchased" the seller's assets because it "had no guarantee that the contracts would be novated." For an acquisition that will require the novation of one or more contracts, this creates significant risk for both the seller and the purchaser.

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Additionally, there is no prescribed timeline for the government to decide whether to accept or reject a novation request, which can delay the transfer for weeks or months. This is where contracting officer-approved transition arrangements come into play. Such arrangements, however, may not provide sufficient protection if the government ultimately withholds any required consent, including consent required under FAR 52.244-2, Subcontracts. It is prudent, therefore, to negotiate provisions in the purchase agreement for unwinding the transaction if the government fails to approve the novation for material contracts, or to otherwise provide for a reduction in the purchase price or other consideration.

Subcontracting arrangements may also be unattractive or infeasible when the prime contract is a small-business set-aside contract and the buyer is not a "similarly situated" business. Where applicable, FAR 52.219-14, Limitations on Subcontracting, requires the employees of the small business prime contractor to perform a specified portion of the work. For example, in non-service construction contracts, employees of the small business prime contractor, or a similarly situated subcontractor, must account for at least 50% of labor costs. A subcontractor is similarly situated if it has the same small business program status as the prime contractor, meaning, for instance, if the prime contractor is a service-disabled, veteran-owned small business, the subcontractor must also be a SDVOSB.

## Transferring Government Contracts in Bankruptcy

Transferring and assigning government contracts in the bankruptcy context is generally more complicated than transferring and assigning commercial contracts. One factor that bears on this issue is the venue in which the bankruptcy proceeding is pending; another concerns unique challenges in implementing subcontract transition arrangements pending approval of a novation.

### *Importance of Bankruptcy Venue*

The jurisdiction in which the bankruptcy is pending will affect the debtor's ability to assume, or to assume and assign, its government contracts. Section 365(f) of the Bankruptcy Code, which applies to Section 363 asset sales and Chapter 11 reorganizations, sets forth the general rule that a debtor may assume or assume and assign an executory contract or unexpired lease, notwithstanding a contractual provision that prohibits, restricts, or conditions assignment. Although the Bankruptcy Code does not define "executory contract," the Supreme Court clarified in *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652, 1657 (2019), that such a contract is one "that neither party has finished performing."

Assumption is a term of art in bankruptcy law and defined under the Bankruptcy Code. It does not refer to a debtor's mere continuation of performance under an agreement subsequent to a bankruptcy filing. Rather, assumption is the mechanism by which a debtor, upon notice to creditors, seeks authorization from the bankruptcy court to reaffirm its obligations under an executory contract. It requires the debtor to cure monetary and other defaults and to prove that it has the capability going forward to meet its contractual obligations.

The formal assumption of an agreement by a debtor during its bankruptcy proceeding is essentially equivalent to the debtor entering into a new agreement. The normal rule for commercial, non-government contracts, codified in section 365(f) of the Bankruptcy Code, is that once a debtor assumes a contract, it can generally override anti-assignment provisions and assign that contract to a third party.

Section 365(c) of the Bankruptcy Code provides that a counterparty may enforce a prohibition or restriction on assignment where applicable non-bankruptcy law would excuse the counterparty from accepting performance from, or rendering performance to, an entity other than the debtor, and the counterparty does not consent to such assumption or assignment. This is notwithstanding the broad authority of debtors, as debtors-in-possession (DIPs) or through trustees, to assume and assign contracts.

Nearly all jurisdictions consider the Anti-Assignment Act to be an applicable law. However, application of the Anti-Assignment Act varies across jurisdictions based on whether the jurisdiction where the case is pending applies the "actual test" or "hypothetical test." Courts applying the actual test hold that the Anti-Assignment Act applies only where the contractor seeks to assign a contract to a third party, but not to the debtor's assumption of the contract, through which the debtor essentially assigns the contract to itself. In hypothetical test jurisdictions, however, the contractor can neither assume nor assign a contract, including to itself as a DIP, without government approval.


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While it may seem that reorganizations or asset sales effected through a judicial order should fall under the operation of law exception to the Anti-Assignment Act, this is not the case in hypothetical test jurisdictions, which view the pre- and post-petition company as distinct entities. Thus, the pre- and post-petition companies are not considered to be essentially the same entity. Indeed, at least one bankruptcy court has held that section 365(c) is a "general non-transferability statute" that "precludes any assumption of the contract even where such an assumption might otherwise occur by operation of law."

Where an agency refuses to consent to an assumption, the contractor transferring the contract to a DIP will be deemed to have breached the contract. This could result in the government pursuing a termination for default. Even if the government were to consent to a debtor assuming its contracts, filing in hypothetical test jurisdictions imposes significant administrative burdens, because it guarantees at least one novation will be required. Where the debtor intends to assume and then assign its contracts to a third party, two novations will be required.

A distressed seller should consider these issues when selecting the venue in which to file its bankruptcy petition. Prospective acquirers should likewise consider implications of the chosen venue when deciding whether to pursue the transaction and, where possible, may seek to influence the seller's venue decision. Federal law allows debtors to file petitions in the U.S. district court for the district where the company had its principal place of business or maintained its principal assets for 180 days preceding filing the petition or, if they have not been limited to a single district for 180 days, the district in which the company had its principal place of business or held its principal assets "for a longer portion of such [180] day period."

When this analysis may result in multiple potential venues, government contractor debtors—and companies interested in acquiring the assets of distressed government contractors—should consider the impact of the venue on their ability to assume and assign government contracts through the novation process.

***Transition Agreements***

Subcontracts pending novation are commonly used to transfer certain performance obligations and financial benefits from a government contractor to its acquirer, while a novation request is pending. When the transferor is a debtor planning to dissolve, this waiting period presents unique challenges. Once the debtor sells all or substantially all its assets, the debtor will typically be little more than a shell company with only a chief restructuring officer remaining to wind-up the debtor's business.

Pending approval of the novation, however, the debtor must continue to serve as the prime contractor and perform, at a minimum, administrative tasks, including invoicing, maintaining a bank account to receive payments, and distributing payments to the subcontractor buyer to avoid termination for default. These obligations, and the buyer's interest in the debtor's continued existence to serve as the prime contractor, may conflict with the debtor's interest in dissolving.

To ensure the buyer's interests are adequately protected, a buyer must carefully draft the transaction documents, including any subcontracts, to provide that the seller contractor will continue to perform its prime contractor obligations, until the contracting officer issues the final decision approving the novation.

## Conclusion

Acquisitions of government contractors generally present questions related to novation requirements, which vary depending on the structure of the deal. For distressed government contractors involved in a liquidation, asset sales, or reorganization through the bankruptcy process, the parties must plan for and address an additional statutory overlay and court approval requirements. It is critical for government contractors and prospective buyers to understand the Anti-Assignment Act and how that law affects the acquisition of government contracts from distressed companies.


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