

CONTRACTING OFFICER'S GUIDE TO BANKRUPTCY

General Litigation Branch, Army Litigation Division, December 3, 2012

A local subcontractor performing construction on an important, high visibility project has threatened to walk off the job because the prime contractor hasn't paid the sub in months. While investigating the sub's allegations, you learn the prime has recently filed for bankruptcy. As if matters weren't complicated enough, you receive a copy of the complaint the sub sent its U.S. senator, questioning how the Government can sit idly by while a prime contractor stiffes a sub that's performing work on an Army base. Feeling pressure from the Directorate of Contracting to make this problem go away, you wonder whether you can solve this mess by expediting payments to the prime for completed work or—better yet—why not make payments directly to the sub for the remaining work.

First things first: Don't accept the contractor's word that the corporation has filed for bankruptcy. Always ask whoever¹ reports the bankruptcy to give you the date and location (court) of filing, and the case number assigned by the court. Provide this information and the name of the contractor to General Litigation Branch² and DFAS³ as set out in DoD Financial Management Regulation, Vol. 10, Sec. 1810, and FAR 42.9. If you can't verify that the contractor is in bankruptcy, call General Litigation Branch and we will search the bankruptcy database for you. A comprehensive list of contractors who have filed for bankruptcy are listed on the JAGCNET website under the FOIA/Public Access links.

Bankruptcy Code overview: The Bankruptcy Code is composed of five chapters. For the most part, you will see bankruptcies under Chapter 11 (reorganization of a business),⁴ with Chapter 7 (liquidation)⁵ bankruptcies a distant second. The other three types you

¹ If you are contacted by counsel for the debtor, remember to refer future calls to your servicing contracts attorney at the local legal office or to General Litigation Branch.

² General Litigation Branch, Army Litigation Center, 9275 Gunston Road, Fort Belvoir, VA 22060.

³ Office of General Counsel, DFAS-GS/CO, Defense Finance and Accounting Service, PO Box 182317, Columbus, OH 43218-2317.

⁴ Chapter 11 is often used by companies that plan to remain in business while repaying creditors under a court-approved reorganization plan. Under a plan, the debtor may get relief by paying a portion of its debts and discharging the rest, while restructuring for a fresh start. The plan must also address executory contracts—those where both parties have substantial performance remaining—and leases. Debtors will retain (assume) profitable contracts to perform or sell (assign) them, and will terminate (reject) burdensome or unprofitable contracts. Some debtors use Chapter 11 (as debtors in possession) to go out of business in an orderly manner, free from the control of a court-appointed trustee.

⁵ Companies and individuals alike may use Chapter 7, wherein a trustee—under the court's supervision—typically liquidates the estate by turning assets into dollars, and then distributes the money to creditors. Some property is exempt from liquidation, and creditors often receive only a percentage of what they are owed. For commercial debtors, the trustee becomes the company's manager and normally stops all business operations immediately. The trustee may simply reject ongoing (executory) contracts, or may assume them in order to sell them as estate assets. Performance of Government contracts rarely continues

could see—although it is much less likely—are Chapter 9 (bankrupt municipalities, such as Orange County, CA), Chapter 12 (bankrupt farmers), and Chapter 13 (reorganization of an individual, including sole proprietorship contractors who have not incorporated).⁶

Automatic stay: One of bankruptcy’s most important debtor protections is the automatic stay,⁷ which strictly limits actions (typically negative ones) creditors (including the U.S. Government) may take with respect to the contractor. As a general rule, check with your servicing contracts attorney before taking **any** action regarding a contract performed by a contractor that is in bankruptcy. While particular actions are discussed below, keep in mind that bankruptcy judges take a dim view of stay violations and the Army is not immune from contempt sanctions imposed by bankruptcy courts.

Show me the money: Once you establish that the contractor is in bankruptcy, gather information on all contracts your unit has with the contractor and any affiliated corporations that have also filed for bankruptcy. General Litigation Branch will need to know—for each contract—whether the contract is closed or ongoing, any money the Army owes the contractor, and—as sometimes occurs—any money the contractor owes the Army. Be sure to also advise General Litigation Branch of any existing or potential claims, either against or on behalf of the Government. Some possible claims may include environmental restoration work to be done by a contractor. All of this information allows General Litigation Branch to anticipate litigation, consider possible setoff or recoupment, and prepare the Army’s proof of claim (POC).

Where do I go from here? General Litigation Branch will also want to know what **you** want to do regarding each contract with the debtor(s). You will need to determine whether:

- The contractor's performance has been acceptable and if the contractor’s continued performance is desired.
- There is any contract default that must be cured.
- The contract should be terminated, either for default or for the convenience of the Government.
- It is acceptable for the contractor to transfer the contract—with Army approval—to another company, accompanied by a novation agreement.

While making these decisions, keep in mind that the Bankruptcy Code prohibits discriminating against a contractor based on either its status as a debtor in bankruptcy or its failure to pay a debt that was discharged in a bankruptcy proceeding. The Government *is* permitted to evaluate the contractor’s performance and the potential risk to contract completion presented by the contractor’s financial position. In short, both these and other decisions—such as whether to exercise an option to extend an ongoing

unless the trustee plans to sell the business as a “going concern,” rather than just selling the company’s assets.

⁶ You may see a Chapter 13 bankruptcy because some contractors are not incorporated and must file under Chapter 13 to reorganize. A Chapter 13 bankruptcy has some unique characteristics but is generally handled like a bankruptcy under Chapter 11, except on a shorter timeline.

⁷ 11 U.S.C. §362

contract or to award to an offeror that has filed for bankruptcy—will require evaluation of the factors normally considered when making such contract decisions.

Time line for a typical Chapter 11

- Day 1: Debtor (contractor) files the petition with the Bankruptcy court, automatic stay is immediately effective, whether or not you know the debtor has filed.
- Day 45: Creditors meeting must take place within 45 days from the date of filing. At this meeting the creditors get to ask the contractor/debtor questions about the assets and liabilities of the corporation and get some idea of its future intentions.
- Day 90: Average due date for a formal hearing on the disclosure statement. This is the document that is supposed to tell creditors all the information they need to know in order to vote on the plan of reorganization. Creditors get to show up and ask tough questions while the debtor is under oath.
- Day 120: This is the last day (unless the deadline is extended) for the debtor to file its plan of reorganization, obtain the necessary votes, and have a formal hearing on confirming the plan. After this date, any creditor may file a plan or seek to have the bankruptcy case dismissed or converted to a case under Chapter 7 (liquidation).
- Day 150: The plan goes into effect and creditors are paid as set out in the plan.

This timeline is based on how a case would proceed if there were no requests for extensions or delays, either of which might be sought for myriad reasons. The bankruptcy judge has great flexibility in extending the timeline.

The plan must pay creditors in order of their priority, according to the scheme laid out at 11 U.S.C. §527. Generally, this means that the debtor will pay administrative claims first, debts held by secured creditors second, and taxes third. Administrative claims may include subcontractor invoices for post-petition work. **Finally, once all of the higher priority claims are paid, general unsecured claims—including subcontractor claims for pre-petition work—can be paid.**⁸ Even under the best of circumstances, it would be unlikely for a sub to get paid for pre-petition performance within six months of the bankruptcy filing. Realistically speaking, it could take years for a sub to see any disbursement on its pre-petition claim, even if you insured that all of the contractor's invoices (both pre-petition and post-petition) were paid right away. Furthermore, when the debtor finally works its way down the priority list to general unsecured claims, the sub may receive only a fraction of the amount claimed or—worse yet—nothing at all, if the estate is totally depleted.

Why not just pay the sub directly? This “solution” will almost certainly cause more problems than it will solve. While your base understandably wants to keep the subcontractor on the job, both in the interests of fairness to the sub and for the more parochial reason of fulfilling the base's need, there are many problems associated with simply redirecting payments to the sub. Unilaterally making payments to the sub would be a breach of our contract with the prime; such action would likely result in the base

⁸ Unfortunately, this is where the Army often falls as creditor, particularly if we have given up what security we might have had by imprudently making payments that should have been withheld pending the discovery of Government claims against the debtor. The Government is permitted to withhold payments up to 120 days to determine if there are potential setoffs available.

having to pay twice for the same performance, the first payment to the sub being deemed a voluntary payment, and the second payment required by the bankruptcy court pursuant to the contract's terms.

Other issues: There are numerous other issues you will likely have to deal with throughout the course of a bankruptcy, potentially including contract assumption or rejection, recoupment and setoff, determination and assertion of the proof of claim, and recovery of Government property, just to list a few examples. This guide is designed to provide basic information for your initial response when dealing with bankruptcy. As soon as you notify them, your supporting contracts attorney and General Litigation Branch will assist you with each of the issues that arise throughout the bankruptcy.

Conclusion: The “fresh start” that debtors get in bankruptcy is almost always at the expense of their creditors, often including subcontractors and others down the line. The Army is interested both in completed contract performance and fair treatment of subcontractors, but we are not in a position to protect subs from the operation of the bankruptcy laws. A word to the wise: keep a ready ear for complaints from subs and suppliers claiming that they have not been paid by one of your contractors, and then promptly investigate such complaints and report your findings to General Litigation Branch as appropriate.