

# **BANKRUPTCY AND ITS RELATIONSHIP TO FEDERAL GOVERNMENT CONTRACTS**

(by Mackey Ives, Army Litigation Division, Fort Belvoir, VA, Feb 2014)

## **I. INTRODUCTION.**

## **II. REFERENCES.**

A. Army Regulation 27-40, *Litigation*, 1994

B. Title 11, U.S. Code

1. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Public Law 109-8, 119 Stat. 23, enacted April 20, 2005)

2. Federal Rules of Bankruptcy Procedure

C. "Adverse Impact of the Federal Bankruptcy Law on the Government's Rights in Relation to the Contractor in Default," Major Scott Ransick, Military Law Review, Volume 124, Spring 1989

D. Norton Bankruptcy Law and Practice 2d, William J. Norton, Jr., Author and Editor-in-Chief, Vols. 1-7

E. Collier's on Bankruptcy, Alan N. Resnick and Henry J. Sommer, editors, Volumes 1-6

F. American Bankruptcy Institute (ABI) ([www.abiworld.org](http://www.abiworld.org))

G. Points of Contact

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### **III. CONSTITUTIONAL AND STATUTORY BASIS**

A. Article I, Section 8 authorizes Congress to enact “uniform Laws on the subject of bankruptcies.”

B. The Bankruptcy Code is codified at Title 11, U.S. Code. It is divided into eight major chapters, with three general administrative chapters (1, 3, and 5), and five operative chapters (7, 9, 11, 12, and 13). It is designed to allow pre-existing state law as a starting point from which the bankruptcy court proceeds in exercising its federally based statutory and equitable powers. See Jaffke v. Dunham, 352 U.S. 280 (1957).

1. Broad equitable powers (11 U.S.C. § 105)
2. Can hear a variety of issues, e.g., tort case, contract disputes, environmental
3. Applies state law on many issues, e.g., whether a claim exists, priority of secured claims
4. The Federal Rules of Bankruptcy Procedure parallel the Federal Rules of Civil Procedure; provide guidance on how to effectuate the Bankruptcy Code

### **IV. COURT ORGANIZATION AND PROCEEDINGS.**

A. District Courts have original and exclusive jurisdiction over all cases under Title 11. 28 U.S.C. § 1334(a). The District Courts shall have original but not exclusive jurisdiction of all “civil proceedings” arising under, arising in, or related to bankruptcy. 28 U.S.C. § 1334(b).

1. Core Proceedings. All matters directly related to some provision contained in the Bankruptcy Code, and include, but are not limited to, matters concerning the administration of the estate, proceedings involving the automatic stay, proceedings to recover fraudulent conveyances, or determinations regarding the discharge of debts. The bankruptcy judge has authority to decide core matters. See 28 U.S.C. § 157(b)(2). Examples include allowance or disallowance of claims against the estate, order to turn over property of the estate, motion to modify the automatic stay, etc.

2. Non-core proceedings. Absent consent of the parties, a bankruptcy judge may only “hear” but not decide a proceeding that is not a core proceeding, but that is otherwise “related to” a bankruptcy case. 28 U.S.C. § 157(c)(1). In non-core proceedings, the bankruptcy judge may “hear” and propose findings but the final judgment must come from the District Court. The District Court must

issue the final order after conducting *de novo* review of the facts and law in noncore matters.

3. Contested matters (“routine matters”). Whenever there is an actual dispute, other than an adversary proceeding, before the bankruptcy court, the litigation to resolve the dispute is a contested matter. It includes matters which are contested but, for one unspecified or another, are not included in the class of adversary proceedings. Rule 9014 specifies that such proceedings shall be commenced by a motion. Examples of a contested matter include an objection to a filed proof of claim submitted by a creditor, motion for relief from automatic stay, motion to assume or reject an executory contract, objection to a disclosure statement, objection to confirmation of a plan under Chapter 11 or 13.

4. Adversary Proceeding. A lawsuit within a bankruptcy case initiated by the filing of a complaint. An adversary proceeding most resembles an ordinary lawsuit under the Federal Rules of Civil Procedure. They are governed by Part VII of the Bankruptcy Rules. Examples include a proceeding to recover money or property, determine the validity of a lien, object to or revoke a discharge, proceedings to determine the dischargeability of a debt. See Rule 7001, Bankruptcy Rules.

B. Jurisdiction Hearings. Bankruptcy cases are “*referred*” to the Bankruptcy Judge by the District Court. 28 U.S.C. § 157. The District Court may withdraw the “*reference*” *sua sponte* or upon motion. Generally, withdrawal of reference is mandatory only if “substantial and material consideration” of non-Code Federal statute is necessary to resolve proceeding. United Nat’l Ins. Co. v. Vicars ins. Agency, 96 F.3d 949, 952 (7<sup>th</sup> cir. 1996).

C. Appeals. Taken to the Bankruptcy Appellate Panel (BAP), if one exists, or to the District Court, and then, to the Circuit Court of Appeals. 28 U.S.C. § 158. Bankruptcy Appellate Panels exists in the 6<sup>th</sup>, 8<sup>th</sup>, 9<sup>th</sup>, and 10<sup>th</sup> Circuits

**V. CHAPTER 13 (wage earners) and CHAPTER 9 (municipality), CHAPTER 12 (family farmer)**

A. Chapter 13 is designed for individual debtors who have a regular source of income and pass the “disposable income test”.

B. For a debtor, Chapter 13 is preferable because it enables the debtor to keep valuable assets.

C. Chapter 13 debtor proposes a plan to repay creditors a reduced amount over time, normally 3-5 years. Receive “super-discharge” under § 1328. “Super discharge” has been reduced since passage of BAPCPA but can still discharge non-support obligations from divorce/separation and “willful and malicious injury” debts.

## **VI. CHAPTER 7 – LIQUIDATION.**

### **A. PURPOSE.**

1. Orderly liquidation of debtor's non-exempt assets. Chapter 7 deals with the complete liquidation of the debtor's estate. 11 U.S.C. § 726.
2. Filed voluntarily (11 U.S.C. § 301) or involuntarily (§ 303). An involuntary Chapter 7 may be filed by three or more creditors whose claims total \$13,475.

### **B. WHO MAY FILE?**

1. Individual debtors.
  - a. The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) was signed into law on April 20, 2005. This Act implemented a new “means test” to determine whether a debtor is eligible for Chapter 7 or must file under Chapter 13 (wage-earner repayment plan)
  - b. The BAPCPA certified entities to provide credit counseling that an individual must receive before filing bankruptcy and entities to provide the financial education required before discharging debts.
2. Partnership or corporation (§§ 101(41), 109)

### **C. FILINGS/COMMENCEMENT OF THE CASE.**

1. Schedules of Assets/Liabilities (Schedule A and B) (Federal Rules of Bankruptcy Procedure (FRBP) 1007(b))
2. Statement of Executory Contracts (Schedule G)
3. Statement of Financial Affairs (Schedule I)
4. Petition for Bankruptcy. This filing creates the “bankruptcy estate”. The estate technically becomes the temporary legal owner of the debtor's property, including all legal or equitable interests.
5. Schedule of Filings must be filed within 15 days after Petition for Bankruptcy filed. Normally, Schedules A-I are filed contemporaneously with the petition for bankruptcy (order for relief).

6. First Meeting of Creditors held within 30 days (“Sec. 341 Meeting”) after the order for relief (11 U.S.C. § 341). Debtors, creditors, and Trustee attend the meeting. Creditors may ask questions regarding debtor’s financial affairs (§ 343). Unsecured creditors must file claims within 90 days of the creditor’s meeting.

D. TRUSTEE.

1. Interim trustee appointed by United States Trustee Office. Interim trustee serves until selection of trustee at First Meeting of Creditors. Normally, trustees appointed are local attorneys, CPA’s on a standing list of qualified persons maintained by US Trustee’s Office. Generally, a Trustee is NOT appointed in a Chapter 11 Reorganization bankruptcy.
  - a. United States Trustee’s Office is a part of the Department of Justice that is responsible for overseeing the administration of bankruptcy cases and private trustees under 28 U.S.C. § 586 and 11 U.S.C. § 101, *et seq.* The U.S. Trustee’s Office appoints and supervises Trustees, monitors fee applications, and monitors cases for fraud.
  - b. The United States Trustee Program was created in 1978 and currently has 21 regional U.S. Trustee Offices nationwide and an Executive Office in Washington, D.C. Only Alabama and North Carolina do not have U.S. Trustee representatives. [see www.justice.gov/ust/](http://www.justice.gov/ust/)
2. Election of Trustee (11 U.S.C. § 702). Creditors either vote to “verify” interim Trustee or to select a new Permanent Trustee.
3. Duties (§ 704)
  - a. Trustee is a representative of the debtor’s estate, not the debtor. The Debtor generally retains private counsel to prepare and file the Chapter 7 bankruptcy. The Trustee has a fiduciary duty to the debtor’s estate and may pursue any legal interests that the debtor has that could accrue to the benefit of the trustee. The Trustee could file a lawsuit on behalf of the debtor to recover property or operate the debtor’s business for a short period of time to maximize income for the estate.

- b. Capacity to sue and be sued (§ 323)
- c. Authorized to operate the business for a limited time period and hire personnel to assist, e.g., CPAs, attorneys, appraisers (§ 721)
- d. Principal duty is to liquidate the debtor's non-exempt assets for distribution to the creditors (§ 725) and to terminate many of the debtor's executory contracts. (§ 365(a)). Focus of the proceeding is not about continuation of the business but evaluating claims made against the estate. Very few executory contracts, if any, will be assumed by a Chapter 7 trustee. About 75% of Chapter 7 cases are "no asset" cases- the debtor's have little or no assets or most of the property is exempt. The debtor is permitted to retain certain "exempt" property (defined under State Law) while the remainder of the estate is liquidated (SOLD).
- e. Trustee's primary job is to liquidate the estate. This may take time. Example: In re Precision Machining, Inc., No. 94-04377 (Bankr. N.D. Fla.) – pending sale of two properties since 1994.

## E. LIQUIDATION

1. Secured creditors often deplete the assets (banks, lien holders) such that unsecured creditors receive very little distribution from Trustee
2. Priority claims paid FIRST and in FULL (§ 507)
  - a. Administrative expenses (LAWYERS FEES!!)
  - b. Certain unsecured claims for wages and salaries
  - c. Certain unsecured claims for contributions to wages or salaries
  - d. Certain unsecured claims for contributions to employee benefit plans
  - e. Unsecured tax claims
3. Remaining Claims - Paid by Class (§ 726)
  - a. Unsecured claims (proof of claim holders) (this is generally where the United States Government/Agencies claims are positioned). In 1978, in amendments to the US Bankruptcy Act of 1898, the US Congress abolished the government's unsecured non-tax claim priority. See S.

Rep. No. 95-989, 95<sup>th</sup> Cong. 2d Sess. 16 (1978) reprinted in 1978 U.S. Code Cong. & Admin. News at 5792.

- b. Claims filed late
  - c. Claims for fines and penalties in excess of actual pecuniary loss
  - d. Claims for interest
  - e. Rule – If there is insufficient money to pay in full all of the claims in a particular class, the claims in that class are paid on a *pro rata* basis.
4. Assumption or Rejection of Executory Contracts. Debtor has 60 days to decide in a Chapter 7 case (§ 365)

#### F. DISCHARGE

1. **The GOAL of a Chapter 7 debtor!!! A discharge is a release of the debtor** from the personal liability for certain specific types of debts. The discharge operates as a permanent order directed to the creditors of the debtor that they refrain from taking any form of collection action on discharged debts.
2. Exceptions
  - a. Debts resulting from debtor's fraud, false pretenses, embezzlement, larceny, debts not listed on schedules are NOT discharged. (§ 523)
  - b. Taxes, Alimony, Child Support, and Student Loans are not discharged. (§ 523 and § 727)

### VII. CHAPTER 11 – REORGANIZATION

#### A. PURPOSE

1. Most significant form of bankruptcy. While the number of filings for Chapter 11 is significantly less than Chapter 7, approximately 75% of all liquidation (Chapter 7) cases are “no-asset” or nominal asset cases. A Chapter 11 proceeding allows the debtor to reorganize its business and administer the equitable distribution of payment of creditors. ABI statistics indicate that 84% of Chapter 11 filers don't make it to a confirmation hearing and most filers dissolve in five (5) years.
2. Intended to give debtor a FRESH START. (In re Talladega Steaks, Inc., 50 B.R. 42 (Bankr. N.D. Ala. 1985))

3. Intended to provide an orderly and ratable distribution to creditors. (*Pro rata* share with respect to similarly situated creditors)

## B. WHO MAY FILE?

1. Individuals (rarely)
2. Corporations, partnerships, sole proprietorship

## C. INITIAL PROCEDURES

1. Debtor files Petition (may be voluntary or an involuntary filing) (§§ 301, 303)
2. Automatic Stay IMMEDIATELY takes effect (§ 362)
3. Impact of Automatic Stay
  - a. The most powerful injunction in the law!!
  - b. Applies to all creditors, with or without actual knowledge of the filing
  - c. Permits the debtor to reorganize its affairs, provides “breathing room” for the debtor
  - d. Creditors prohibited from taking any adverse action against the debtor and its subsidiaries. Adverse action includes terminations, stop work orders, withholding payment to punish debtor, set-offs, actions to recover property, discriminating against the debtor, etc. (§ 362(a))
  - e. Does not apply to post-petition contracts
  - f. Does not apply to actions against the surety/insurer
  - g. Authority of Contracting Officer **BEFORE** Bankruptcy filed
    - (i) May terminate for default (FAR Part 49)
    - (ii) May terminate for convenience (FAR Part 49)
    - (iii) May decide NOT to exercise option (FAR Subpart 17.2)

- (iv) Actions to setoff debts against contract, suspend work, issue stop-work orders (FAR Subpart 42.13)
  - h. Authority of Contracting Officer **AFTER** Bankruptcy filed
    - (i) Terminate – LIFT STAY
    - (ii) Recover Inventory – LIFT STAY
    - (iii) Setoff – LIFT STAY
    - (iv) Not Exercise Option – Maybe (See In re Exquisito Services, Inc., 823 F.2d 151 (5<sup>th</sup> Cir. 1987))
    - (v) Retrieve Progress Payment Inventory – LIFT STAY
  - i. Relief from Stay granted if the debtor does not have equity in the property and such property is not necessary for an effective reorganization. In re Sun Valley Newspapers, Inc., 171 B.R. 71, 75 (B.A.P. 9<sup>th</sup> Cir. 1994)
  - j. Actions taken in violation of the stay are either void or voidable (depends on Circuit). Contempt citation and/or punitive damages can be imposed
4. Creation of the Estate (11 U.S.C. § 541)
- a. No Trustee is appointed for a Chapter 11 case unless **cause** shown (fraud, dishonesty, incompetence, and gross mismanagement) (§ 1104). U.S. Trustee’s Office will get involved in Chapter 11 Trustee appointment
  - b. Debtor becomes “debtor-in-possession” (DIP). The court allows the debtor to conduct its own business on a day-to-day basis during the attempted reorganization. Technically, the DIP is a different legal entity from the original debtor. See Bordewieck, **The Postpetition, Pre-Rejection, PreAssumption Status of an Executory Contract**, 59 Am. Bankr. L.J. 197, 198-200 (1985); NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984).
  - c. DIP has rights, powers, and duties of a reorganization trustee (§ 1106)
  - d. DIP has authority to operate the business (§§ 1101, 1107, 1108)

- e. The “estate” consists of all legal and equitable interests of the debtor as well as any interest acquired after the petition filing. (§ 541). Includes real property, personal possessions, bank deposits, accounts receivable, insurance proceeds, tax refunds, rights of action. Estate property is generally anything that could be perceived as being of value to the estate as a whole.
- 5. Debtor generally files “First Day Motions”
    - a. Motion to Assume Bank Accounts
    - b. Motion to Pay Critical Vendors
    - c. Motion Pay Employees
    - d. Motion for Interim Financing
  - 6. Debtor’s Required Filings.
    - a. File List of Creditors
    - b. Schedule of assets and liabilities
    - c. Statement of Financial Affairs (§ 521; FRBP 1007)

#### D. ADMINISTRATION OF THE CHAPTER 11 ESTATE

- 1. Committee of Creditors
  - a. U.S. Trustee appoints a committee of unsecured creditors (§ 1102(a)(1)). Other creditor committees appointed as necessary, e.g., Tort claimants, Foreign claimants, Environmental claimants.
  - b. Consists of the 7 largest unsecured creditors
  - c. U.S. Government and its agencies normally do not serve on such committees

2. Committee Tasks
  - a. Determines whether business should continue to be operated
  - b. Whether a Chapter 11 trustee should be appointed
  - c. Conduct an investigation of the financial affairs of the debtor
  - d. Consult with the DIP or trustee in the administration of the estate (§ 1103(c))
  - e. Participate in the formulation of the Plan of Reorganization (§ 1103(c)(3))
  
3. First Meeting of Creditors (§ 341)
  - a. Convened by U.S. Trustee within a *reasonable time* after the filing of the bankruptcy petition
  - b. Creditor's committee conducts its business, including selecting/nominating attorneys to represent the creditors
  - c. Opportunity for the unsecured creditors to query the debtor
  - d. DoD representatives normally do not attend. Occasionally, the Assistant U.S. Attorney (AUSA) will attend. (§§1102; 101(33))
  
4. Disclosure Statement (§ 1125) and Reorganization Plan (§ 1123)
  - a. Essentially a contract between the debtor and his creditors in which creditors are divided into classes
  - b. Must be filed within 120 days of petition filing (§ 1121(a))
  - c. Debtor has 60 days from filing of the Plan to get the Reorganization Plan approved, i.e., Debtor has total of 180 days to file and get Plan approved. (§1121(c)(3))
  - d. Creditors can reduce the debtor's period to file a plan (§1121(d))
    - (i) Courts consider size of the debtor

(ii) Difficulty of formulating a plan (In re Texaco, Inc., 76 B.R. 322 (Bankr. S.D.N.Y. 1987))

(iii) Whether a successful reorganization is possible (Matter of American Federation of Television and Radio Artists, 30 B.R. 772 (Bankr. S.D.N.Y. 1983))

(iv) Whether the extension would unreasonably delay the proceedings

- e. The Plan states which claims are “impaired” and “unimpaired” (§1123(a)(1)). “Impaired” claims are claims that receive a pro rata share (less than the claimed amount).
- f. Creditors in a given class must be treated in the same way unless consent to less favorable treatment is obtained. See In re Dow Corning Corp., 280 F.3d 648 (6<sup>th</sup> Cir. 2002).
- g. Adequate means for execution of the plan must be set forth in the Plan (§ 1123(a)(3))
- h. Before Plan can be executed, it must be accepted by the creditors and confirmed by the Court (§§ 1126, 1128, 1129). Normally, a hearing is held to determine whether the Plan should be accepted. The Plan is accepted if at least one impaired class of claims accepts the Plan and other creditors holding at least 2/3’s in dollar amount and ½ in number of allowed claims vote for the Plan.
- i. Confirmation of the Plan vests all property of the estate “free and clear of all claims of creditors” with the debtor. (§1141(c)). Confirmation of the Plan acts as a discharge of all preconfirmation debts and is tantamount to “settlement” in civil litigation. The debtor is obligated to execute the Plan with Court oversight (§ 1141; BR 2030(d))
- j. Confirmation of the Plan dissolves the Automatic Stay.
- k. Plan must address Executory Contracts (see below)
- l. If Plan not confirmed and debtor unable to reorganize, the Chapter 11 may be converted to a Chapter 7 liquidation

## 5. Objections to Disclosure Statements and Reorganization Plan

- a. Most common objection – Plan does not contain “adequate information” sufficient in kind and detail to make an informed

judgment about whether the Plan is “workable” and offers a reasonable prospect of success. In re Monnier Bros., 755 F.2d 1336 (8<sup>th</sup> Cir. 1985); In re Jartain, Inc., 44 B.R. 331 (Bankr. N.D. Ill. 1984)

b. “Adequate information” includes information regarding the directors and officers, their salaries and compensation, financial forecasts, all funding sources, the business’ pre-petition history and the intentions regarding key employees, a liquidation analysis, outstanding litigation, insider transactions, and tax consequences of the reorganization. See In re Beko Vending, 67 B.R. 234 (Bankr. D. Mass. 1986).

c. Objections must be filed with the court, served on the debtor, the trustee, and any creditor committees. FRBP 2002, 3016, 3017

d. U.S. Government representatives must review the Plan to ensure it addresses ongoing procurement actions and provides a reasonable expectation of success

e. The Court has authority to approve a Plan over the objections of a dissenting class of creditors if the Plan conforms to Section 1129 (Often called a “cram-down”)

f. Plan may not be confirmed if the ***Absolute Priority Rule*** violated (junior claim holder receives any property while a more senior unsecured claim holder receives less than his allowed amount). See Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988)

#### 6. Executory Contracts (§ 365)

a. Not defined by the Bankruptcy Code. Performance remains due on each side. (“A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Professor Vern Countryman, Executory Contracts and Bankruptcy: Part 1, 57 Minn. L. Rev. 439 (1973).

b. Contracts that are substantially performed are NOT executory. See Heartline Farms v. Daly, 128 B.R. 246, 250 (D. Neb. 1990)

c. What is a contract? Probably not “Task Orders” or “Delivery Orders” that are issued under a larger umbrella contract

- d. The Code allows the DIP (or Trustee) to “accept or reject” any executory contract prior to Plan Confirmation. (See N.L.R.B. v. Bildisco, 465 U.S. 513 (1984))
- (i) The DIP or Trustee may reject contracts that are “burdensome” (unprofitable).
- (ii) If the contract is in default (most of them are!!), the DIP must “CURE” any defaults and provide adequate assurance of future performance prior to assuming the contract(s)
- (iii) Subject to Court approval!!!
- e. “Bankruptcy No Man’s Land” - - What is the status of a Government contract between when the Petition is filed and the Plan Confirmed (180 days later?) (contract has neither been assumed nor rejected). See US v. Carolina Parachute Corp., 907 F.2d 1469 (4<sup>th</sup> Cir. 1990); NLRB v. Bildisco, 465 U.S. 513 (1984); In re Sharon Steel Corp., 161 B.R. 934, 937 (Bankr. W.D. Pa. 1994)
- f. “Assumption or Rejection”
- (i) U.S. Government may accelerate decision timeline (60 days for Chapter 7; Until Plan Confirmation for Chapter 11).
- (ii) Court’s consideration is limited to whether the proposed action will benefit the reorganization effort. See In re By-Rite Distributing, Inc., 47 B.R. 660, 668 (Bankr. D. Utah 1985)
- (iii) “Curing” defaults or compensation for pecuniary losses must be resolved by the Court prior to approving assumption (§ 365(b)(1))
- (iv) “Assumption” or “Rejection” of contract should be expressly approved by the Court to avoid “implied assumption doctrine.” (failure to notify counsel of bankruptcy filing and motion to assume contract may result in DOJ refusal to file motion to lift stay). The debtor must assume the contract in its entirety; it may not be assumed in part and rejected in part.
- (v) Claims arising from an “Assumed” contract constitute administrative expenses of the estate (higher priority ) (§§ 364, 507) [“A contract expressly assumed is considered a post-petition contract entitled to priority of payment under Sec. 507.”]. Contract

is assumed by debtor who then defaults post-petition, resulting in an administrative claim (higher priority).

(vi) The Anti-Assignment Act (31 U.S.C. § 3727; 41 U.S.C. § 15) precludes the DIP's assumption of an executory contract without the consent of the U.S. Government. See In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988)

(vii) "Rejection" constitutes a breach as the day before the petition date (prepetition claim) (§ 365(g)). The U.S. Government may recover costs under the "Default" clause and becomes prepetition unsecured claims.

(viii) Contract continues in force and effect if assumed. The Government gets an administrative expense priority claim for all obligations of the contractor arising under the assumed contract. See e.g., In re U.S. Metalsource Corp., 163 B.R. 260, 269 (Bankr. W.D. Pa. 1993)

(ix) Assignment. Anti-assignment Act generally prohibits but Government can waive protections of the Act. To assign executory contracts, debtor must assume contract and provide adequate assurance of future performance. Generally, a novation agreement is prepared by debtor and submitted to Government contracting officer.

7. Voidable Preferences. (§ 547). The Trustee may seek to recover payments made by the estate to creditors within 90 days of the bankruptcy petition being filed. Trustee will seek to have payments returned to the estate. Exceptions to "voidable preferences" exist, e.g. "new value defense" and payment made in the "ordinary course of business"
8. Closing of Cases. After the estate is fully administered, the court issues a final decree. (§ 350; FRBP 3022.)

## **VIII. CONTRACTING ISSUES IN BANKRUPTCY**

### **A. Notice of Bankruptcy Action.**

1. Clerk of Court required to notify government of bankruptcy if debt to US Government disclosed (FRBP 2002(j))
2. AR 37-103, chapter 13 requires commands to notify DFAS of bankruptcy and DFAS in turn notifies all procurement commands of the bankruptcy.

B. Automatic Stay Limitations.

1. Applies only to the 'bankrupt estate' (not surety and other non-debtors)
2. Does not apply to "police, regulatory actions." Example: Suspension and debarment actions could be regulatory actions designed to protect the public from dealing with non-responsible contractors. Test: Public policy v. pecuniary purpose? See In re Medicar Ambulance Co., Inc. 166 B.R. 918, 926-7 (Bankr. N.D. Cal. 1994)
3. Does not apply to postpetition contracts. See Gull Air, Inc., 890 F.2d 1255 (1<sup>st</sup> Cir. 1988)
4. Contracting Officer generally must obtain "relief" from the stay to take any adverse action
5. If you SUSPECT a contractor is going to file for bankruptcy, take IMMEDIATE action BEFORE they file!!
6. Contracting Officers have FAR authority PRIOR to bankruptcy and precious little authority afterwards.

C. Specific Contracting Issues (Top Ten Bankruptcy/Contracting Issues).

1. Filing Proof of Claim (§§ 502, 506)
  - a. Normally filed by DFAS on behalf of DoD
  - b. Have 180 days from petition date to file claim
  - c. "Claim" is broadly defined; any possible fact which may furnish the basis for a money claim against a debtor
  - d. Government takes a *pro rata* share as an unsecured creditor
2. Adverse Actions against debtor? Can the Government terminate a contractor before they file for bankruptcy? Afterwards?
3. Recoupment. An equitable defense that permits a nondebtor to withhold payments to recover overpayments arising from the same transactions (may recoup pre/post payments; no requirement to lift automatic stay because this is an accounting action not a collection action). See Brooks Shoe Mfg. Co., Inc. v. United Telephone Co., 39 Bankr. 980 (E.D. Pa. 1984); In re TLC Hospitals, 224 F.3d 1008 (9<sup>th</sup> Cir. 2000)

4. Payment? (May place an “administrative freeze” on payments). See Bank of Maryland v. Strumpf, 516 U.S. 16 (1993). Withholding payments due debtor pending bankruptcy court approval of setoff is allowable as long as setoff not actually effectuated. Three requirements for a setoff under § 553 are:
  - a. A debt owed by the creditor to the debtor which arose before the commencement of the Bankruptcy case; (pre-petition)
  - b. A claim of the creditors against the debtor which arose before the commencement of the Bankruptcy case; (pre-petition) and
  - c. The debt and the claim must be mutual obligations See IML Freight, 65 B.R. 788, 793 (Bankr. D. Utah 1986). There is no requirement that the debt and claim arise from the same transaction. This permits mutuality between different federal agencies for set off purposes. See e.g., In re Turner, 84 F.3d 1294 (10<sup>th</sup> Cir. 1996)(mutuality existed between the SBA and Department of Agriculture for setoff purposes).
5. Government Furnished Property? Title or Lien to property? Government has title to, and right to possession of parts, materials, inventory, and work in progress that is the subject of progress payments. See FAR § 52.232-12, 232-16; See In re Reynolds Manufacturing Co., 68 B.R. 219 (Bankr. W.D. Pa. 1986); In re Economy Cab and Tool Co., 47 B.R. 708 (Bankr. D. Minn. 1985); In re American Pouch Foods, 30 B.R. 1015 (N.D. Ill. 1983), Skip Kirchdorfer, Inc. v. United States, 6 F.3d 1573 (5<sup>th</sup> Cir. 1993). Seek abandonment by Trustee (§ 544), seek declaratory judgment, file complaint for turnover (§ 542), or file motion seeking adequate protection.
6. Should I do business with a bankrupt contractor? Can I discriminate against a bankrupt entity? (Cannot base a finding of non-responsibility based solely on the fact that a contractor has filed for bankruptcy). See In re Exquisito Services, Inc., 823 F.2d 151 (5<sup>th</sup> Cir. 1987) (under Section 525, held that the USAF could not deny option based solely upon the fact that contractor had filed bankruptcy)
7. Assumption / Rejection / Cure / Consent of US Government under Anti-Assignment Act . Under 41 U.S.C. § 15, the United States must consent to assignment of a government contract to non-debtor . If the debtor agrees to assume the contract, the debtor must promptly cure any existing defaults (late shipments, etc.) and provide appropriate guarantees of future performance. 11 U.S.C. § 365(b)(1). If the debtor rejects the contract, a breach occurs and the United States may file a damages claim for breach as if the contract had been terminated for default before the bankruptcy was filed. 11 U.S.C. § 365(g)

8. Taking care of Subcontractors. See FAR 49.402(b) (Termination in lieu of default?). Remember there is no privity with subcontractors. They may seek payment from Government once prime files for bankruptcy.
9. May I talk to the debtor?? Can my counsel talk to the debtor? Surety?? Recommend that you engage in communication with the debtor/trustee early to determine the status of your contract. i.e., whether it will be assumed, rejected, or assigned by the purchaser of the company.
10. Abstention. A judicially created doctrine, based upon the concept of comity to resolve conflicts between Federal and state courts . In the case of bankruptcy, the rule of abstention is statutory. 28 U.S.C. § 1334(c). Under § 1334(c)(1), a court may abstain from hearing a proceeding arising under Title 11 or arising in or related to a case under Title 11 in the interest of justice, or in the interest of comity. Examples include abstention from hearing a complex government contract matter pending before the Armed Services Board of Contract Appeals. In re American Pouch Foods, Inc., 30 B.R. 1015 (N.D. Ill. 1983); aff'd, 769 F.2d 1190 (7<sup>th</sup> Cir. 1985), cert denied, 475 U.S.. 1082 (1986).

## **IX. CONCLUSION**

