In light of the federal government budget crisis, sequestration and the recent government shutdown, it is likely bankruptcy filings will rise among those who do business with the government. A debtor seeking to reorganize faces unique challenges if it has important contracts with the federal government. This article provides an overview of U.S. Bankruptcy Code provisions that may interfere or affect the bankruptcy filing of a government contractor.

### Discrimination and Section 525

For a government contractor in bankruptcy, the key to an effective reorganization is likely the government’s willingness to award new contracts or renew existing contracts for goods or services. Section 525(a) of the bankruptcy code seeks to prevent such discrimination by the government and provides, in relevant part:

> (a) . . . a governmental unit may not deny, revoke, suspend or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to . . . a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor has been associated, solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act . . . or during the case but before the debtor is granted or denied a discharge, or has not paid a debt that is dischargeable in the case under this title or that was discharged under the Bankruptcy Act.”


Section 525(a) has the policy goal of promoting a fresh start for debtors in bankruptcy and to provide protection from discrimination on that basis. Though there is no mention of “contracts” in the code section, it is generally understood that the enumerated examples were not intended to be exclusive and that the section was intended to reach the grant or renewal of government contracts. See e.g. In re Exquisito Services, Inc., 823 F.2d 151 (5th Cir. 1987). The court in *Exquisito* held that the Air Force’s refusal to renew a contract solely on the basis of the debtor’s bankruptcy was a direct violation of section 525(a).

The practical protections of section 525(a) are limited, however, because of the plain meaning of the term “solely” in the statute, and the fact that the government is not prevented from considering issues other than those listed in the bankruptcy code when deciding not to award or renew a contract. Issues such as future financial stability and likelihood of the debtor to be able to perform on the contract may be considered, and if those reasons are stated, the refusal may not run afoul of section 525(a).
Still, the U.S. Supreme Court provided some flexibility to creditors seeking to challenge the government's actions on the basis of section 525(a) in FCC v. NextWave Personal Communications, Inc., 537 U.S. 293 (2003). The Supreme Court addressed the FCC's cancellation of certain licenses based on debtor's failure to make required payments post-petition. The Supreme Court held that even if the FCC had a valid regulatory motive for the cancellation, the debtor's bankruptcy filing and nonpayment was still the “proximate cause” of the cancellation, and therefore, it violated section 525(a).

Assumption and Assignment of Executory Contracts

One of the most powerful tools in bankruptcy is a debtor's right to reject, assume or “assume and assign” its unexpired contracts or leases under section 365(a) of the bankruptcy code. 11 U.S.C. § 365(a). In the case of a government contract, however, the federal Anti-Assignment Act generally prevents those who contract with the government from assigning their contract interest to a third-party. Further, section 365(c) prohibits the assumption or assignment of an executory contract or lease where “applicable law excuses a party to such contract or lease form accepting performance from . . . an entity other than the debtor or debtor in possession.” 11 U.S.C. § 365(c)(1).

Circuit courts are split in their interpretation of section 365(c) in light of the Anti-Assignment Act. Two tests have developed with regard to the assumption of government contracts: the “hypothetical” test and the “actual” test.

At least three circuits have adopted the hypothetical test, which construes the language “assume or assign” according to its plain meaning rather than construing the “or” as “and.” Courts applying the hypothetical test find that non-debtor parties do not have to accept performance from a debtor-in-possession on the reasoning that the debtor-in-possession is a separate entity from the debtor. Further, if a party is excused under applicable law from accepting performance from a non-debtor third-party, such that the debtor may not “assign” the contract, then the debtor is also precluded from assuming it. The 4th Circuit Court is among those circuits that have adopted the hypothetical test, which may potentially prevent many government contractors turned debtors in the Washington D.C. area from assuming their contracts. Courts in the 3rd Circuit and 9th Circuit have also adopted the hypothetical test.

By contrast, 2nd Circuit Courts have adopted the more liberal actual test when determining whether to permit the assumption of a contract by a debtor where the Federal Anti-Assignment Act or other “applicable law” would excuse the non-debtor contract party from accepting performance. Where the debtor-in-possession seeks to assume an executory contract but not assign it to a third party, a court applying the actual test will allow the assumption. One critique of the hypothetical test is that a debtor loses the benefit of a non-assignable contract vital to its business solely because it filed for bankruptcy, and such result is counter to the objectives of chapter 11 bankruptcy protection.

Non-bankruptcy courts have also addressed the “applicable law” exception of section 365(a) in the context of the sale of a debtor's assets free and clear of liens, claims, interests and encumbrances pursuant to section 363 of the bankruptcy code In Rel-Reeves, Inc. v. U.S., 606 F. 2d 949 (Ct. Cl. 1979), the court addressed the assignment of a patent claim (rather than contract) under the Federal Assignment of Claims Act, and held that a transfer of the claim by virtue of a corporate merger, inheritance, assignment to a bankruptcy trustee or “judicial sale” (such as a sale under section 363 of the bankruptcy code) is permissible despite the “applicable law” of the Assignment of Claims Act. Although bankruptcy courts have not addressed this issue head-on, the Rel-Reeves case is a preview of how bankruptcy courts may address an issue sure to reoccur in government contractor bankruptcies.

Note that, if the government consents, a debtor is free to assume and assign its interest in a government contract. Generally, this is accomplished with a tri-party novation agreement that must be approved by the bankruptcy court.
The Federal Government’s Setoff Rights

With certain exceptions, bankruptcy code section 553 preserves a creditor’s right to offset any mutual prepetition debt that would exist under non-bankruptcy law. To offset mutual debt, a party must move to modify the automatic stay imposed by the bankruptcy.

It is well established that, for the purposes of section 553, separate departments and agencies of the federal government (or a state government) are considered a single entity. This is distinct from the usually setoff practice, as the “mutuality” requirement would, by definition, preclude triangular, third-party setoffs. The federal government’s rights to setoff are exceedingly broad, although courts have noted that they are not unlimited. In United States v. Maxwell, 157 F.3d 1099 (7th Cir. 1998), the 7th Circuit Court allowed the United States Navy to avoid paying its debts to the estate for pre-petition construction services by setting off against loans owed to the Small Business Administration.

The federal government’s setoff rights may cause difficulty for a contractor seeking payments on accounts receivables due from the government post-petition to fund its ongoing operations. If the debtor owes on its federal taxes, a federal license or other federal debt, then the owing agency may be able to setoff. This has the potential to seriously hamper a debtor’s cash flow and budget during its bankruptcy case.