

Preserving Value for Government Contractors in Bankruptcy

Anti-Assignment Act dictates careful planning before Chapter 11

BY Edward H. Tillinghast, III & Blanka K. Wolfe / Sheppard Mullin Richter & Hampton LLP

The ability of a debtor in bankruptcy to retain valuable contracts while shedding burdensome ones is one of the greatest tools provided by the Bankruptcy Code. This power is critical to a debtor's chances of reorganizing successfully and extracting value from its assets, and is generally very broad. However, for government contractors, their ability to exercise this power to assume or assign their contracts with the government is limited. The Anti-Assignment Act prohibits the assignment of a government contract without the government's consent, and certain bankruptcy courts have interpreted this prohibition as extending to the debtor's assumption of its contracts. However, non-bankruptcy courts have recognized an exception to the Anti-Assignment Act for transfers

of government contracts that occur by "operation of law." This exception should permit a government contractor to preserve its value by transferring its contracts through a plan of reorganization without violating the Anti-Assignment Act. Government contractors, like the debtor in the recent Chapter 11 filing of Colt Defense, should carefully consider the assignability of their government contracts before beginning a Chapter 11 bankruptcy process.

Assumption and Assignment Generally

Generally, a debtor has the right to assume, assume and assign, or reject its executory contracts. 11 U.S.C. § 365. While the Bankruptcy Code does not define the term "executory," most courts have adopted the so-called Countryman definition, which states that an executory contract is one "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." Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 Minn. L. Rev. 439, 460 (1973). Thus, a government contract that requires performance by both the government and the debtor is executory.

However, the Bankruptcy Code contains an exception to the broad right of the debtor to assume and assign its executory contracts. Specifically, section 365(c) of the Bank-

Government contractors in bankruptcy risk losing valuable contracts.

ruptcy Code provides that the debtor "may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties if applicable law excuses a party, other

than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and such party does not consent to such assumption or assignment." 11 U.S.C. § 365(c). As a result, if non-bankruptcy law prohibits the assignment of a contract, the Bankruptcy Code will not permit the debtor to assign it without obtaining the counterparty's consent.

The Federal Anti-Assignment Act

One type of contract that is generally non-assignable under non-bankruptcy law is a contract with the federal government. Specifically, the Anti-Assignment Act provides, in pertinent part, that "[n]o contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order



Edward H. Tillinghast, III

Partner and co-chair of the firm's Finance & Bankruptcy Practice Group.

etillinghast@sheppardmullin.com



Blanka K. Wolfe

Associate in the Finance & Bankruptcy Practice Group in the firm's New York office.

bwolfe@sheppardmullin.com

transferred, so far as the United States is concerned.” 41 U.S.C. § 15(a). As a result, government contractors will generally be unable to transfer or assign their contracts.

There are two exceptions to the prohibition on the assignment of government contracts. First, the government can consent to the assignment and the substitution of the contract holder by entering into a tri-party novation agreement. FAR 42.1204. Second, a government contract can be transferred when the transfer occurs “by operation of law.” See *Johnson Controls World Servs., Inc. v. United States*, 44 Fed. Cl. 334, 343 (1999) (citing *See Seaboard Air Line Ry. v. United States*, 256 U.S. 655, 657, 41 S.Ct. 611, 65 L.Ed. 1149 (1921)). Transfers “by operation of law” include “transfers by intestate succession or testamentary disposition, judicial sale, the process of subrogation to an insurer, and where the assignment or transfer of a claim is effected through consolidation or merger.” *L-3 Communications Integrated Sys., L.P. v. United States*, 84 Fed. Cl. 768, 776-77 (Ct. of Fed. Cl. 2008) (discussing the parallel Assignment of Claims Act that bars assignment of claims against the federal government). Accordingly, the Federal Acquisition Regulation provides that “when there is a change in the ownership of a contractor as a result of a stock purchase, with no legal change in the contracting party, and when that contracting party remains in control of the assets and is the party performing the contract,” the government’s consent to the transfer is not necessary. FAR 42.1204. Essentially, transfers “by operation of law” are those “where in essence the contract continues with the same entity, but in different form.” *L-3 Communications Integrated Sys.*, 84 Fed. Cl. at 777. Thus, outside of bankruptcy, a government contractor will generally be able to transfer its contracts through a consolidation, merger or corporate reorganization.

Assumption of Government Contracts in Bankruptcy

In addition to requiring the government’s consent in order to assign a government contract, certain bankruptcy courts have held that if a contract is non-assignable

under non-bankruptcy law, it cannot even be *assumed* by the debtor. Specifically, under the so-called hypothetical test, a debtor cannot assume a government contract if “under the applicable law, the government [could] refuse performance from an ‘entity *other* than the debtor or debtor in possession.’ . . . Thus, the relevant inquiry is not whether [the Anti-Assignment Act] would preclude an assignment from [the prepetition debtor] . . . to [the debtor-in-possession], but whether it would foreclose an assignment from [the prepetition debtor] to another defense contractor.” *In re West Electronics Inc.*, 852 F.2d 79, 83 (3d Cir. 1988) (holding that debtor could not assume contract for manufacturing services with a defense contractor); see also *In re Plum Run Serv. Corp.*, 159 B.R. 496 (Bankr. S.D. Ohio 1993) (holding debtor could not assume a contract with the United States Department of Navy). Several circuits, including the Third and the Ninth circuits, follow the hypothetical test, and in those circuits, a debtor that is a party to a non-assignable contract will lose the benefit of that contract – regardless of how important it may be to its business – solely because it filed for bankruptcy protection.

Perhaps in recognition of the fact that barring a debtor from retaining its valuable government contracts runs counter to a goal of bankruptcy of providing debtors with a legal regime that allows it to maximize value and obtain a fresh start, other courts have rejected the hypothetical test and have instead applied the so-called actual test, which “contemplate[s] a case-by-case inquiry into whether the non-debtor party . . . *actually* was being ‘forced to accept performance under its executory contract from someone other than the debtor party with whom it originally contracted.’” *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997) (rejecting argument that debtor could not assume patent license pursuant to plan of reorganization that sold debtor’s stock to patent holder’s competitor); see *In re Am. Ship Bldg. Co.*, 164 B.R. 358 (Bankr. M.D. Fla. 1994) (holding debtor could assume government contract with the Navy notwithstanding the Anti-Assignment Act

and noting “[t]o accept the legal authority that espouses the hypothetical test to prevent a debtor from assuming its own contract is clearly not envisioned by the Bankruptcy Code and would be, at the least, a legal tautology.”).

In contrast to other corporate debtors, government contractors that file for bankruptcy protection risk losing their ability to retain their valuable contracts, particularly if they lack the planning and financial ability to consummate a plan of reorganization. Notwithstanding the “operation of law” exception to the Anti-Assignment Act, bankruptcy courts have consistently held that a debtor cannot assign its government contracts without the government’s consent and, in certain circuits, cannot even assume those contracts. Such a limitation severely impacts a government contractor’s ability to successfully reorganize and realize value. While assignment under section 365 of the Bankruptcy Code is not permitted, a government contractor may be able to transfer its contracts through a plan of reorganization. First, outside of bankruptcy, a government contractor generally does not violate the Anti-Assignment Act if its contracts are transferred pursuant to a corporate reorganization or merger. Second, in the analogous situation of intellectual property licenses (whose assignment is also limited by ‘applicable law’), the First Circuit approved the plan of reorganization of a debtor-patent licensee that sold the debtor’s stock to a competitor of the patent holder. See *Institut Pasteur*, 104 F.3d at 489. Thus, a financially troubled government contractor should be able to transfer its contracts pursuant to a plan of reorganization without the government’s consent.

Consequently, when a financially troubled government contracting company considers its restructuring options, it should carefully plan any Chapter 11 filing to maximize its ability to confirm a plan rather than simply liquidate through a Chapter 7 case or a sale of all its assets in a Chapter 11 case.