Professonal Perspective

Navigating the Acquisition of Distressed Government Contractors - Part 1

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Navigating the Acquisition of Distressed Government Contractors - Part 1

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

The Covid-19 pandemic and efforts to contain its impacts have upended the U.S. and global economies, leaving a wake of financial distress. Although the U.S. economy has shown signs of recovery, many companies, including government contractors, will continue to face significant challenges in the near term and potentially also in the medium and long term.

Government contractors and other companies facing financial distress may consider various options to maintain sufficient liquidity to remain solvent. In some cases, these options may not be viable or may not align with the company's objectives. In these instances, a sale of the company or its assets, bankruptcy, or a combination of the two, such as an asset sale under Section 363 of Bankruptcy Code, are the only realistic options.

Filing for bankruptcy protection can provide significant benefits. These include allowing debtors to reject unprofitable contracts and discharge pre-petition liabilities under Chapter 11 reorganizations and protecting debtors from judicial and administrative proceedings that could have been commenced prior to the bankruptcy petition. Small businesses, which are frequently targets of acquisitions, may find bankruptcy more attractive following Congress's enactment of the Small Business Reorganization Act.

The SBRA created Subchapter V within Chapter 11 and allows small business owners to retain an ownership interest in the company and generally eliminates creditors' committees, among other requirements. As discussed below, however, two of the standard protections associated with the bankruptcy process, the automatic stay and non-discrimination rules, may not be as effective for government contractors as they are for companies that do not perform government work.

These issues are not only relevant to government contractors but also to potential acquirers of distressed government contractors and their assets. Such acquisitions present challenges and opportunities not present in a standard acquisition. This three-part series highlights these unique issues, challenges, and opportunities. This article discusses protections afforded to distressed government contractors through the bankruptcy process. Part 2 discusses assignments and transfers of government contracts by distressed contractors. Part 3 discusses due diligence considerations relevant to the acquisition of distressed government contractors.

Automatic Stays

The automatic stay, a central tenet of the bankruptcy process, provides significant protections for the debtor. The Bankruptcy Code automatically enjoins creditors from taking unilateral action against the estate or debtor-in-possession (DIP) immediately upon the filing of the bankruptcy petition. The stay applies to all creditors, including federal, state, and local governments, and continues until certain events trigger its termination, such as resolution of the bankruptcy case or a court decision granting a creditor relief from the stay.

Although the stay applies to government contracts and claims, courts may grant governments relief from the stay under certain circumstances. Consistent with restrictions on assuming and assigning government contracts, courts in what are known as "hypothetical test" jurisdictions have signaled that they are more willing to grant governments relief from automatic stays because debtors cannot assume contracts without government approval. Courts have also indicated that they are comfortable with granting governments relief from automatic stays to recover property if title to that property is vested in a government. This may include government-furnished, contractor-acquired property and property where title has vested in the government.

Under the Bankruptcy Code, governments are exempt from the automatic stay when exercising their "police and regulatory power." Some courts, such as the Fourth Circuit, interpret this exception to the stay narrowly, while others, such as the Ninth Circuit, interpret this exception more broadly. The government may find that it is able to use this exception to enforce statutes and regulations such as the Service Contract Labor Standards, formerly known as the McNamara-O'Hara Service Contract Act. This statute requires contractors to, among other things, comply with prescribed wage standards and provide employees with certain minimum fringe benefits.

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False Claims Act (FCA) actions, which are the government's principal enforcement mechanism for violations of government contracts and compliance requirements, are also generally considered exempt from the automatic stay under this police and regulatory power exception, at least where the action is brought by the government and not a qui tam relator. This can make contractors and other companies vulnerable to the draconian remedies that the government, and potentially relators, can recover under that law.

Additionally, the government has broad rights to terminate contracts for convenience for nearly any reason at any time or to terminate in the event of a contractor's default. The automatic stay generally will not affect pre-petition terminations that have not finalized prior to the contractor filing the bankruptcy petition. However, it typically bars the government from terminating contracts for convenience or default, regardless of whether they were entered into before or after the petition, without court-ordered relief.

Anti-Discrimination Rules

Section 525 of the Bankruptcy Code prohibits the government from discriminating in many contexts against debtors solely because they filed for bankruptcy, including when issuing licenses, permits, and grants. The Supreme Court, in *F.C.C. v. NextWave Personal Commc'ns Inc.*, 537 U.S. 293 (2002), interpreted the word "solely" broadly as applying to government actions regardless of the government's motive. Although the Bankruptcy Code does not expressly preclude the government from declining to award a contract to a debtor that otherwise would receive the contract, certain courts have interpreted the Bankruptcy Code's prohibition on discrimination to extend to contract awards.

There is, however, a tension between this prohibition on discrimination and the concept of responsibility in federal government contracts. The government is required to determine whether the prospective contractor is responsible prior to awarding a contract to that entity.

When making responsibility determinations, agencies must consider, among other things, whether an offeror has, or has the ability to obtain, the technical and financial resources necessary to successfully perform the contract. Notwithstanding this tension, the government Accountability Office (GAO) and the Court of Federal Claims (COFC) have denied bid protests challenging agency non-responsibility determinations based on an offeror's bankruptcy. The Federal Circuit has also upheld a contracting officer's affirmative responsibility determination notwithstanding a contractor's bankruptcy declaration, indicating that bankruptcy is not an absolute bar to doing business with the government where the contracting officer is willing to conclude a company is otherwise responsible. This case law shows that a bankruptcy filing is something that a contracting officer can cite as a basis to decline to award a contract but it is not necessarily disqualifying.

Successor Liability

The type and structure of a transaction can impact whether a buyer inherits liabilities of the seller. Acquirers may attempt to exclude liabilities from an asset purchase or extinguishing liabilities through the bankruptcy process, such as through a Section 363 sale.

Out of Court Transactions

Out of court transactions include mergers, consolidations, stock purchases, and asset sales.

Mergers, Consolidations, and Stock Purchases

In mergers and non-bankruptcy stock purchases, the buyer generally assumes the seller's liabilities. However, the buyer often attempts to negotiate protections. For example, the parties can negotiate adjustments in the purchase price, indemnification from the buyer for certain liabilities, and exclusions of certain liabilities. Many of these options are not practicable when acquiring distressed companies. For instance, indemnification from a distressed seller is often not feasible. In some cases, the seller is dissolving, and even if it is not, the seller is unlikely to possess sufficient financial resources after paying creditors to satisfy indemnification commitments.

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Asset Sales

Buyers commonly attempt to exclude liabilities from asset purchases, but those attempts are not always successful. Determining whether an acquirer assumes the seller's liabilities through asset sales involves in-depth, fact-specific inquiries. The general rule is that buyers do not inherit the sellers' liabilities, but there are several exceptions to this rule, which can vary in substance or application across jurisdictions.

Express or Implicit Assumption

A purchaser expressly or implicitly assumes liabilities of the seller when the purchase agreement or the acts and representations of the parties demonstrate an intent to assume those liabilities.

Fraudulent Transfer

Courts will impute a seller's liability to a buyer when the seller intended "to hinder, delay, or defraud creditors." When assessing fraud claims, courts will consider both direct and circumstantial evidence of fraud, such as inadequate consideration, transfer to a spouse or relative, and benefits retained by the debtor. Courts may also find constructive fraudulent transfers, such as where consideration is grossly inadequate.

Mere Continuity and Substantial Continuity or Continuity of Enterprise Theories

Acquirers can be found to inherit the liabilities of sellers, if the buyer is merely a continuation of the seller or is substantially the same as the seller. The mere continuity theory applies when after the transfer of assets, only one corporation remains, and there is an identity of stock, stockholders, and directors between the two corporations.

The substantial continuity or continuity of enterprise doctrine, which is the expansion of the mere continuity test, considers a variety of factors. These include whether the buyer retains the seller's employees, the buyer's management is generally the same as the seller's management, the buyer's post-transaction operations and business goals are the same as the seller's pre-transaction operations and business goals, whether the name did or did not change, and whether the buyer represents itself as a continuation of the seller.

De Facto Merger

A transaction is treated as a de facto merger when the transaction was not structured as a merger but it is substantively indistinct from a merger or consolidation of the seller and purchaser. This doctrine generally applies when there is a continuity of the selling corporation, evidenced by the same management, personnel, assets and physical location, a continuity of stockholders, accomplished by paying for the acquired corporation with shares of stock, a dissolution of the selling corporation, and the assumption of liabilities by the purchaser.

Successor Liability under Bankruptcy Proceedings

In bankruptcy proceedings, successor liability generally depends on the transaction's structure and the type of liability. The standard successor liability doctrines discussed above can apply where assets are purchased through a Section 363 sale, but the Bankruptcy Code provides unique rules for discharging liability in Chapter 11 reorganizations.

False Claims Act Liability

At least one federal district court, in *U.S. ex. Rel. Ceas v. Chrysler Grp. LLC*, 78 F. Supp. 3d 869 (N.D. Ill. 2015), held that in Section 363 asset sales, successor liability under the FCA is the same as in out-of-court asset sales. In reorganizations, however, the question is whether the FCA liability was discharged, which is a fact-intensive inquiry that can vary across jurisdictions. Because of this uncertainty, due diligence on potential FCA liability is critical. This can be problematic, however, because a qui tam action could be pending, and the seller may not have knowledge of the suit. If a buyer has significant concerns about the seller's exposure to FCA liability, a 363 asset sale may place the buyer in a better position to avoid exposure to FCA liability.

In 2005, when Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). This statute amended 11 U.S.C. § 1141 to render non-dischargeable any corporate debt identified in Section 523(2)(A) or (2)(B) of the Bankruptcy Code, such as debts arising from fraud. It also excluded from discharge any debt "owed to a person as the result of an action filed under" the FCA "or any similar State statute."

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It is unclear whether section 1141's incorporation of Section 523 renders FCA liability per se non-dischargeable. Under section 523(a)(2)(A), which is the general fraud provision, a key question is whether the debtor's intent in committing fraud rose to the level contemplated by the Bankruptcy Code, actual knowledge or "gross recklessness as to its truth," as opposed to the lower level of scienter necessary for liability under the FCA, deliberate ignorance of the truth or falsity of the information or reckless disregard of the truth or falsity of the information.

Section 523(a)(2)(B), which specifically references the FCA and similar state statutes, has rarely been interpreted by courts. At least one court has held that Section 523(a)(2)(B) does not apply to the FCA because it refers to debts owed to a "person" and FCA claims belong to the government, which is not a person.

Given these complexities, companies considering acquiring debtors undergoing a reorganization should carefully assess the debtor's exposure to FCA liability and, if that liability is significant, either negotiate protections, possibly though representation and warranty insurance, or explore with the debtor the possibility of pursuing an asset sale.

Government Contracts Claims and Administrative Sanctions

Government contract claims in bankruptcy are generally treated in the same manner as private party claims. This equal treatment is grounded in the sovereign acts doctrine, which provides that when the government acts as a contracting party, it stands in the same shoes as any private party would in dealing with another private party. Not surprisingly, however, unique issues arise when resolving government contract claims during bankruptcy proceedings, including the forum for resolving those disputes, and contractual notice requirements that are necessary to discharge government claims.

Government contracts are governed by federal common law and a complex web of statutes, regulations, and judicial doctrines. These include the Contract Disputes Act (CDA), the Federal Acquisition Regulation, agency-specific FAR supplements, prescribed rules regarding deadlines for asserting rights to equitable adjustments that can pose jurisdictional bars to contractor claims, and the so-called "Christian doctrine," among other requirements.

Due to the complex, specialized nature of government contracts litigation, bankruptcy courts often defer to tribunals with expertise in adjudicating those disputes. Those tribunals are the Court of Federal Claims, Boards of Contract Appeals, and, on appeal, the U.S. Court of Appeals for the Federal Circuit. In certain circuits, bankruptcy courts are required to stay proceedings and defer to those tribunals absent good cause for doing otherwise. This can often result in delays as the bankruptcy court awaits adjudication of those claims.

As discussed above, liabilities in asset sales generally transfer through traditional successor liability theories. In Chapter 11 reorganizations, once the bankruptcy court confirms the reorganization plan, all debts—including government claims—are discharged, unless the Bankruptcy Code or the Plan deems them non-dischargeable. Although discharges preclude personal liability for those debts, the debts are not extinguished. Notwithstanding the government's inability to collect on that discharged debt from the contractor, the government "may recover on the claim from third parties possessing liability, such as guarantors, sureties, and insurers."

There is also a tension between limits on assumptions of liabilities, the Bankruptcy Code's discharge provisions, and FAR novation requirements. FAR 42.1204 states that the novation agreement "shall ordinarily provide in part that ... [t]he transferee assumes all the transferor's obligations under the contract." The standard novation agreement in the FAR further provides that it "may be adapted to fit specific cases and may be used as a guide in preparing similar agreements for other situations" but also states that "[t]he Transferee also assumes all obligations and liabilities of, and all claims against, the Transferor."

Bankruptcy cases may necessitate modifications to, or elimination of, this provision to avoid assuming liabilities extinguished through the bankruptcy process, though agencies may well push back on attempts to remove this assumption of liabilities provision from the standard agreement.

Importantly, discharges may be able to restrict more than just the government's ability to collect on a debt. At least one court has extended discharge protections to suspensions and debarment. For example, in *In re Pilgrim's Pride Corp.*, 564 B.R. 534 (Bankr. N.D. Tx. 2017), the bankruptcy court denied the Department of Labor's request that the debtor be excluded from conducting business with the government. The court denied the request to the extent it arose from pre-confirmation conduct that itself was a discharged claim. Notwithstanding this lone decision, there is no reason to believe that suspension and debarment officials will generally defer to bankruptcy courts.

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Conclusion

The bankruptcy process may offer attractive benefits to a distressed government contractor and its potential acquirer, based on the structure of the deal and specific factual circumstances. The next installment of this three-part series will examine assignment and transfers to be addressed by the parties to a potential acquisition.

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