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CLIENT ALERT

Guidance for the Federal Contractor in Dealing with a Financially-Distressed Subcontractor During and After the COVID-19 Pandemic

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The ongoing COVID-19 crisis has caused unprecedented harm to nearly all industries, including those involved in federal government contracts. This article provides information and guidance to prime contractors (and higher-tier subcontractors) who might be dealing with subcontractors devastated by COVID-19. A contractor may find that a subcontractor's financial problems not only jeopardize subcontract performance but also threaten an otherwise profitable project and the contractor's own reputation. Consequently, and especially in the COVID-19 era, contractors must monitor the financial affairs of their subs and be prepared to act decisively when a subcontractor's deteriorating financial condition becomes apparent.

Know the Terms of Subcontract:

Subcontracts should be reviewed with attention paid to provisions triggered by the inability to perform due to causes beyond a sub's control, including frustration of purpose, material adverse event, and impossibility/impracticality. For example, a subcontract may contain a clause addressing excusable delay similar to the standard *force majeure* clauses under the Federal Acquisition Regulation (FAR), which, among other things, permit extension of the delivery schedule if performance is disrupted due to causes beyond a contractor's control, including "quarantine restrictions." *See, e.g.,* FAR §§ 52.249-14, 52.212-4(f). In a memorandum dated March 20, 2020, the Office of Management and Budget (OMB) acknowledged that such excusable delay provisions may extend to quarantine restrictions due to COVID-19.

Communicate Proactively with Subcontractor:

Open and frequent communication between the contractor and sub is critical to identify immediate needs and formulate a strategy going forward. The contractor should be in touch with each potentially vulnerable sub and have a candid discussion about the sub's financial and performance status and needs, particularly with regard to disruption of work. The OMB memo urges that "agencies should be flexible in providing extensions to performance dates [due to] COVID-19 related interruptions[,]" and that "[a]gencies are encouraged to be as flexible as possible in finding solutions." To the extent practical, a contractor should have the same attitude in communicating with a troubled subcontractor.

In addition to discussing with the subcontractor a possible revision of the delivery schedule, the contractor should be prepared to explore other potential relief unique to the COVID-19 pandemic, such as several relevant provisions in the recently-passed Coronavirus Aid, Relief, and Economic Security (CARES) Act: (i) Sections 1102 and 1106(b) concerning Paycheck Protection Program (PPP) loans to small businesses, which may be forgiven; (ii) Section 3610 providing, with certain limitations, that a federal contractor may be paid by the government "to keep its employees or subcontractors in a ready state;" and (iii) Section 4003 addressing loans to distressed businesses.

Working early on with a subcontractor to explore solutions is a best practice to avoid termination of the subcontract or the sub taking more drastic action to survive, such as filing for bankruptcy.

Have a Backup Plan if Subcontractor is Unlikely to Survive:

Some subs may not survive the shutdown, in which case a contractor should be prepared with alternative and second sources of products and services. In addition, if the contractor ultimately determines that termination of the subcontract according to its terms is necessary for the good of the project, act sooner rather than later. As discussed further below, terminating a subcontract becomes more difficult if a financially-distressed sub files for bankruptcy.

Effect of Subcontractor's Bankruptcy on the Right to Terminate Subcontract:

A subcontractor's bankruptcy petition triggers an "automatic stay" of all actions against the subcontractor and its property, including a government subcontract. *See* 11 U.S.C. § 362(a). This means that a contractor could violate the stay by, for example, terminating the subcontract (whether for default or convenience), preventing the subcontractor access to the job site, or refusing to pay the subcontractor, without prior approval of the bankruptcy court. A willful violation of the stay could result in sanctions against the contractor for actual damages, including costs and attorneys' fees, as well as possible punitive damages. *See id.* § 362(k)(1).

Any delay in the right to terminate a subcontract poses problems for a contractor, particularly if the bankrupt sub has ceased or slowed its performance. Where time is of the essence to terminate the subcontract in order to bring in a replacement to finish the job, the contractor should consider filing an emergency motion for relief from the automatic stay, seeking the bankruptcy court's authority to terminate the subcontract immediately.

Because the subcontract may be the most valuable asset of a subcontractor, a bankruptcy court may be reluctant to grant relief from the stay early in the bankruptcy process, especially if allowing termination would effectively end any chance the subcontractor has to reorganize. However, the following factors may favor granting relief from the stay early in the case: (i) the subcontract permits termination for convenience, (ii) the government joins the prime in requesting relief, or (iii) the subcontract involves national security concerns or other sensitive matters.

If the subcontract includes a "title vesting" provision, then the contractor's motion for relief from the stay to terminate the subcontract should also request relief to take possession of covered property, which might, for example, include inventory, work in progress, tools, test equipment, plans, drawings or other property the subcontractor has acquired or produced that are chargeable to the subcontract.

Final Note: Distressed Subcontractors May Take Advantage of Newly-Passed Bankruptcy Benefits for Small Business:

New legislation aimed at extending a bankruptcy lifeline to small business may appear attractive to subcontractors trying to weather the pandemic. The Small Business Reorganization Act (SBRA) became effective on February 19, 2020, mere weeks before COVID-19 shuttered the country.

The SBRA, codified as the new Subchapter V of Chapter 11 of the Bankruptcy Code, allows a small-business debtor to retain control over its business operation while reorganizing and enjoying bankruptcy protections (such as the automatic stay,

discussed above), with the added benefits of a streamlined process and less cost than in the typical Chapter 11 reorganization. The SBRA originally limited eligibility to the small-business debtor with an aggregate non-contingent liquidated debt of no more than $2,725,625; however, as part of the CARES Act, Congress increased the cap to $7.5 million for the next year (after which the cap reverts to the original amount).

Conclusion:

Now is the time for contractors to be on top of their subcontractors' financial health and available options to navigate this trying time. The earlier a contractor can assist a sub to achieve stability, the less likely the struggling sub will consider more desperate measures like bankruptcy. Even if a subcontractor does seek bankruptcy relief, however, the contractor has options to mitigate the damage and delay.

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