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Government Contracts And The Risks Of Bankruptcy In The Current Environment

*By Frederick (Rick) Hyman, Michael E. Samuels, and Christian N. Curran**

The Trump Administration has introduced policies that are likely to have significant, long-lasting effects on the U.S. economy. Many of these policies—most prominently broad tariffs, grant terminations, and tightening federal government spending—will impose new and unexpected costs on government contractors. For many contractors, these policies are already being felt in the form of swift, unilateral contract terminations. Material terminations include contracts with the U.S. Agency for International Development, the Department of Education, the Department of Agriculture, and the Department of Commerce. For other contractors, the impact may be on the horizon as tariff policies and the administration's priorities continue to take shape. The result may be an increase in bankruptcy filings by government contractors in 2025 and beyond. Accordingly, it is critical that both prime contractors and subcontractors understand certain basic concepts of bankruptcy law and refresh their familiarity with other issues that may be of particular importance in connection with the bankruptcy of a government contractor.[1]

Bankruptcy Of A Government Contractor

Most relevant for these purposes is Chapter 11 of the Bankruptcy Code.[2] In a Chapter 11 case, the debtor is provided an opportunity to restructure its obligations and reorganize its business. Generally, the debtor remains in charge of its operations and retains decisionmaking authority.[3] Chapter 11 may also be used as an effective means of consummating an orderly sale of the debtor's assets as a going concern or otherwise.[4]

Automatic Stay Generally

A central tenet of bankruptcy is the "automatic stay."[5] The filing of a bankruptcy petition operates as a stay of most adversarial acts against the

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debtor and provides a breathing spell during which the debtor can effect a liquidation or reorganization. For practical purposes, common commercial actions taken by contractual counterparties, including payment demands, exercise of termination rights, effecting a setoff, or commencing (or continuing) legal action, are stayed absent relief from the Bankruptcy Court.[6] Creditors must take care to avoid any action (or in some cases, inaction) that might be deemed a breach of the automatic stay. Any knowing and willful violation may expose a creditor to actual, and perhaps punitive, damages.[7]

Contractor Performance

Due to the restrictions imposed by the automatic stay, non-debtor prime contractors and subcontractors will often be required to continue performance under their contracts. If a debtor elects to continue the effectiveness of a contract following a bankruptcy filing, it must perform its obligations thereunder, including making any required payments. As long as the debtor remains administratively solvent, i.e., has sufficient assets to pay its post-petition obligations, counterparties are generally paid in the ordinary course for their post-petition efforts. The Bankruptcy Code allows debtors broad discretion to choose to assume or reject "executory contracts."[8] This right is a key feature in many Chapter 11 bankruptcy cases. Generally, executory contracts are those in which the obligations of the parties are ongoing such that the failure of one to perform would constitute a material breach excusing performance by the other. Most ongoing operating contracts of a prime contractor or subcontractor will fall into this category and will be critical to any restructuring. A debtor's ability to choose to assume those contracts that are critical to its operations, and to reject those that have become uneconomic and burdensome can often mean the difference between a successful reorganization and a failed liquidation.

Risks Of Termination By The Government

As noted above, the automatic stay generally prohibits the termination of a contract by the non-debtor party without relief from the stay from the Bankruptcy Court.[9] This broad prohibition applies equally to the government in connection with a governmental contract but with some important limitations. Absent relief, the debtor is free to choose to continue to perform under the contract and the government must make timely payment, among other things. This is true despite contractual provisions that imply otherwise. In general, the government has the right to terminate contracts for convenience (i.e., for any or no reason)[10] or for default if the contractor has failed to correct an identified breach or otherwise is failing to perform.[11] Government contracts regularly include *ipso facto* clauses that permit the termination of a contract if a counterparty files for bankruptcy. These *ipso facto* clauses are unenforceable in bankruptcy.[12] Courts and government contracts tribunals have typically found that the government must still show "cause" to terminate contracts in contravention of the automatic stay, despite the presence of the Federal Acquisition Regulation (FAR) termination provision in such contracts.[13]

If the government wishes to terminate a contract, it must have proper grounds for termination (other than the mere fact that the debtor filed for bankruptcy) that will justify a lifting of the stay (e.g., a contractor's inability to perform and/or its continued performance would jeopardize the government's mission or create national security risk).

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Importantly, the automatic stay does not shield the debtor from the government's enforcement of its regulatory or police powers. When terminating a contract with, or pursuing remedies against, a debtor constitutes such enforcement, the automatic stay does not apply.[14] The concept of regulatory and police powers is not static and recent initiatives of the Trump Administration may provide new and expanded opportunities for the government to rely on when exercising its purported police powers. For example, recently issued (1) Executive Order 14275, "Restoring Common Sense to Federal Procurement" (signed April 15, 2025)[15] and (2) Executive Order 14271, "Ensuring Commercial Cost-Effective Solutions in Federal Contracts" (signed April 15, 2025),[16] along with a release titled "Revolutionary Federal Procurement Overhaul" (issued April 16, 2025),[17] together with the outcomes of the same, may provide additional avenues for the government to argue that its actions fall within the regulatory or police powers exception.

Treatment Of The Contract In Bankruptcy

As noted above, a debtor can exercise its business judgment to assume or reject its executory contracts.[18] Most courts apply a "business judgment" test to the debtor's decision. To assume a contract, a debtor must cure monetary defaults and provide assurance of future performance. In most contexts, a debtor can assume, and then assign, a contract without the consent of the other party.[19] To do so, the debtor must provide "adequate assurance of future performance."[20] A debtor also can chose to reject an executory contract.[21] Rejection is tantamount to a breach, giving the non-debtor party a pre-petition claim for damages (and an administrative expense claim for any post-petition damages).[22]

Generally, a debtor may assign an executory contract even if it prohibits or restricts assignment.[23] Many Chapter 11 cases in recent years are premised upon the sale of all or substantially all of a debtor's assets and the assignment of many of its executory contracts to preserve going concern value. If, however, applicable law excuses the non-debtor party from accepting performance from, or rendering performance to, a third party, then an executory contract cannot be assigned.[24] The Anti-Assignment Act[25] has been found to constitute "applicable law" for such purposes and can present an insurmountable hurdle absent government consent. The Anti-Assignment Act provides, in pertinent part: "The party to whom the Federal Government gives a contract or order may not transfer the contract or order, or any interest in the contract or order to another party. A purported transfer in violation of this subsection annuls the contract or order so far as the Federal Government is concerned, except that all rights of action for breach of contract are reserved to the Federal Government."[26] As a result, the government often plays an outsized role in determining the success or failure of a debtor.

The Anti-Assignment Act ensures that the government has knowledge of its counterparty. Violation of the Anti-Assignment Act can constitute a material breach of a government contract and grounds for termination. To assign a direct federal contract, parties must undergo a novation process, which involves the submission of a package of supporting documentation to the government for review and approval.[27]

Notably, a novation package will not be approved until sometime after the closing of a transaction because it must include the final documentation evidencing the transfer of assets from transferor to transferee.[28] Contractors often provide pre-closing novation packages to the government in hope of obtaining some level of comfort that approval is likely. Government approval can take many months, and the parties will typically have a transition services agreement and/or subcontract pending novation in place that govern the performance of the transferor's government contracts during the period where the transferor remains the named contract party but the transferee holds the assets used to perform the contracts.[29]

In bankruptcy, the federal circuit courts are split as to which test—the so-called "hypothetical test" or "actual test"—should be applied when evaluating whether the debtor can assume a government contract.[30] Under the hypothetical test, courts consider whether, "hypothetically," a debtor could be prohibited from assigning its contract absent consent under the applicable law. Courts consider whether the government could refuse to accept performance of a contract from any assignee because the Anti-Assignment Act deems such contract unassignable as a matter of law. Courts that apply this test do not consider whether or not the debtor actually *intends* to assign the contract but merely whether it *could* assign it.[31]

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Under the actual test, courts focus on whether the debtor intends to assign a contract or is instead intending to perform thereunder. Under this test, courts view the debtor as a continuation of the pre-petition contractor and, therefore, find that no assignment has occurred unless it actually intends to assign the contract.[32] Given the consequences of the hypothetical test, contractors will take care to file, if possible, in a jurisdiction that is most accommodating to their restructuring goals.

Federal government contractors looking towards the bankruptcy process should also be mindful of the restrictions imposed by the Assignment of Claims Act.[33] The Act prohibits not just the transfer of contracts without government consent, but also "any interest" in such contracts. This can pose an obstacle to, for example, having payments from government contracts deposited directly into the bank account of a lender or even the implementation of a deposit account control agreement on the account into which payments are received. However, the Assignment of Claims Act, unless expressly forbidden by the terms of an individual contract, does allow for the assignment of such payments to a "bank, trust company, or other financing institution," as long as certain prescribed notice is provided to individual contracting officers.[34]

FAR Issues

A bankruptcy filing by a contractor will not escape the attention of the government for long and will likely come under enhanced scrutiny. Under the FAR, a contractor has certain obligations to notify the government of its bankruptcy filing.[35] A contractor in bankruptcy must provide written notice of the bankruptcy within five days of the filing to the contracting officer responsible for administering the contract. Notice must include specific information, including "a listing of Government contract numbers and contracting offices for all Government contracts against which final payment has not been made."[36] Further, once notice has been provided to the contracting officer, agencies must "take prompt action to determine the potential impact of a contractor bankruptcy on the Government in order to protect the interests of the Government."[37]

Recent Executive Orders appear to focus on limiting bureaucratic red tape and eliminating waste from procurement, including directing the government's focus on commercially available products and services.[38] While the implementation of these directives remains uncertain, it is fair to question whether government contractors that file bankruptcy will be more likely to face government opposition with an overhaul of past practices.

Subcontractor Concerns Upon Bankruptcy Of Prime Contractor

Upon the bankruptcy of its prime contractor, a subcontractor must address its ongoing obligations in respect of the project and protect its ability to be paid for completed work. These include the consequences of the automatic stay, the unenforceability of *ipso facto* provisions, and the broad rights of a prime contractor to assume and assign the subcontract. In the case of each, assuming the importance of the subcontract to the restructuring narrative, the subcontractor may be hard-pressed to extract relief despite the hardships that may be caused by the filing. To test this, the subcontractor may choose to proactively seek a declaration that the debtor chooses to assume or reject the contract at an early stage in the case.

Subcontractors must be aware of any particular mechanics' or materialmen's lien rights available to them under applicable state law. There are exceptions to the automatic stay that allow for the filing of a notice of such liens in the bankruptcy case but attention must be paid to time limitations.[39] To the extent that a statutory lien exists, a subcontractor will have greater leverage in a restructuring and enjoy a superior right to repayment of all or a portion of its claim. Depending on when any such liens are deemed to have arisen, those secured claims may be senior, but more likely junior, to the secured claims of lenders.

Payment bonds are required on many federal projects and allow subcontractors to make claims directly against the bond for unpaid work that is within scope and up to the bond cap. Coverage may vary depending on whether a subcontractor is a first, second, or later-tier contractor. Time limitations apply under typical bonds, and careful attention must be paid to the applicable timeframes. In the current environment, and prior to any issues in connection with a project, subcontractors should review their payment bonds and determine where improvements or supplements may be needed. In certain circumstances, a

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subcontract may require the subcontractor to pursue a "sponsored appeal" against the government as a prerequisite to any recovery from the prime. Because such sponsored appeals must be brought in the name of the prime contractor, this raises issues concerning the automatic stay and whether the proceeds of any appeal constitute property of the estate.

While joint or dual checks may be a reasonable pursuit outside of the government context in order to gain an extra level of protection, it is a difficult task in connection with government contracts (although some states allow this). Where joint checks are not feasible, a subcontractor should focus on segregation of receipts and prompt notice of payments.

Avoidance Actions

Avoidance actions are, generally, those brought by a debtor or trustee to recover certain transfers of property made by the debtor to non-debtor parties prior to the filing while the debtor was insolvent (or rendered insolvent thereby). A "preferential transfer" is a transfer (1) by the debtor to a creditor that is made within the 90-day period prior to the bankruptcy filing (or one year if made to an insider), (2) on account of an "antecedent debt," and (3) that enables the creditor to receive more than the creditor would have received if the debtor's estate had been liquidated, generally.[40] A "fraudulent transfer" is a transfer of property made before the bankruptcy filing that has the effect of improperly placing assets outside the reach of other creditors and may include both actual and constructive fraud.[41] Constructive fraudulent transfers are generally those that are made for less than reasonably equivalent value within two years prior to the filing. Where the federal statute of limitations has passed, debtors may also look to state fraudulent transfer laws that have similar elements but with longer statutes of limitations.[42]

For purposes of a contractor, preferential transfers are likely to be more relevant. Understanding and monitoring current (and usually building) receivables aging is critical to understand and take steps to reduce preference exposure in the event of an obligor's bankruptcy filing. Depending on the debtor's financial situation, there may be time for a counterparty to manage receivables and to react quickly to avert slippage as they grow. Changing payment terms, for example, to "charge on delivery," may reduce or eliminate preference exposure by skirting the requirement that payments be on account of antecedent debt.

Common defenses to preference actions include that the payment was made in the ordinary course of business and may not be avoided and recovered. Receivables aging reports and histories will be useful to support any such defense. A preferential payment may also be defended to the extent that the creditor, after such preference payment, gave new value to or for the benefit of the debtor or where the payment was intended by the parties to be a contemporaneous exchange for new value given to the debtor (and the payment was a substantially contemporaneous exchange). Other important defenses exist and should be considered when faced with a challenge. From a practical perspective, preferential transfer challenges often lead to a negotiated settlement between the parties.

National Security/Facility Clearance Concerns

Another issue that can arise with regard to government contractors in bankruptcy relates to the maintenance of a facility security clearance required to perform classified contracts and, in some cases, store classified materials at the contractor's facility.[43] The Defense Counterintelligence and Security Agency (DCSA) or other cognizant security agencies must monitor cleared contractors for issues related to foreign ownership control or influence (FOCI).[44] If bankruptcy will result in changes to the ownership or control of the contractor, particularly with regard to foreign ownership, this will need to be reported to DCSA (or other cognizant agency) and in some cases could jeopardize the contractor's clearance if not handled correctly or if the ownership/control changes present, from DCSA's perspective, too great a risk of unmitigated FOCI. Further, certain employees, including the Senior Management Official (typically the contractor's CEO/President), chairman of the board, and facility security officer must all maintain clearances at the level of the contractor's facility security clearance.[45] To the extent that a bankruptcy might result in turnover, any replacements must also hold the requisite clearance (and such changes must be promptly reported to DCSA). If the novation of cleared contracts results from a bankruptcy process, the transferee contractor must hold the level of

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FCL required for those contracts, or else novation will not be approved until the transferee has obtained the requisite FCL, which can be a lengthy process.

Other Considerations

Subject to certain exceptions, a contractor must file a timely "proof of claim" in order to receive a distribution on a claim.[46] A proof of claim properly filed in accordance with the Bankruptcy Rules and local rules constitutes *prima facie* evidence of the validity and amount of the claim (but may be objected to by the debtor). Creditors must attach documentation to the official proof of claim form in support of their asserted claim. If a creditor fails to file a timely proof of claim, that creditor jeopardizes its right to payment. The deadline for filing is typically found in a "bar date" order entered on the bankruptcy court's docket.

In most larger cases, the U.S. Trustee (UST) will appoint certain unsecured creditors to serve on an official committee of unsecured creditors (or UCC) to represent the interests of the body of unsecured creditors.[47] A UCC will be able to retain legal and financial professionals that are paid for by the estate and will guide the UCC through the process. Participation on the committee requires a time commitment but also provides an opportunity to have some impact on the outcome of the case not otherwise available to unsecured creditors. Subcontractors with large pre-petition claims may have an opportunity to participate on a UCC in its prime contractor's case but should consider whether the nature of their claims differentiates their interests from those of other unsecured creditors.

Bonds or other forms of credit security, such as letters of credit, guarantees, or collateral, are sometimes provided as assurance of payment. Security in the form of collateral would become property of the bankruptcy estate and protected by the automatic stay. However, other forms of security, such as obligations owing under a letter of credit or from non-debtor parties under a guarantee, generally are not subject to the automatic stay.

Where progress payments are being made under FAR 52.232-16(d), the government takes title to property when the property is or should have been allocable or properly chargeable to the prime contract. Such "property" includes parts, materials, inventories, and even work in progress.[48] Such property is owned by the United States and will not become property of the debtor's estate. Accordingly, remedies otherwise available to an unpaid subcontractor against a prime, such as obtaining materialmen's liens or asserting reclamation rights, may not be available. If the government has taken title, the debtor is left with fewer assets to distribute to creditors, including subcontractors.

Conclusion

In the current economic climate, government contractors and their creditors face unprecedented challenges due to shifting policies and financial uncertainties. The threat of unanticipated financial distress is a reality that government contractors must prepare for, navigating the complex commercial and legal landscape with diligence and foresight. Understanding bankruptcy law and strategically managing contracts are essential steps to mitigate risks and maximize recovery. Perhaps more than ever, it is crucial for contractors to stay informed, proactive, and adaptable, ensuring they are well-equipped to handle the evolving dynamics of government contracts and safeguard their business interests.

Practical Guidelines

These *Guidelines* are intended to assist you in understanding the risks of bankruptcy for government contractors in the current economic and political environment. They are not, however, a substitute for professional representation in any specific situation.

1. *Understanding Chapter 11*: In the current uncertain economic and political environment, government contractors should familiarize themselves with the risks and benefits of Chapter 11 of the Bankruptcy Code. This knowledge is crucial as it provides opportunities for contractors to manage unexpected financial distress and preserve value.

2. *Automatic Stay Implications*: The automatic stay is a key feature of bankruptcy that prevents most adversarial actions against the debtor absent relief from the court. Contractors must understand the stay's broad scope, and where necessary, consider taking action prior to a filing.

3. *Role of the Government*: Contractors should be aware of the outsized role that the government will often

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play in the bankruptcy of a contractor. Limitations on a debtor contractor's ability to assume and assign government contracts and exceptions from the automatic stay in favor of the government provide it with leverage to influence the path of a contractor's bankruptcy case.

4. *Executory Contracts and Business Judgment*: Contractors should understand the debtor's ability to assume or reject executory contracts, which can significantly impact restructuring efforts. The business judgment test applied by courts highlights the importance of strategic decision-making in contract management during bankruptcy.

5. *Navigating the Anti-Assignment Act*: Specifically, the Anti-Assignment Act presents challenges for assigning government contracts in bankruptcy. Contractors must be prepared for the novation process and understand the implications of the Act to avoid breaches and ensure contract continuity.

6. *Subcontractor Considerations*: Subcontractors must be vigilant about their rights and obligations when a prime contractor files for bankruptcy. Understanding mechanics' lien rights, payment bonds, and the impact of the automatic stay is essential for protecting their interests and ensuring payment for completed work.

ENDNOTES:

[1]Note that the government has also terminated real property leases for many locations across the country that were housing employees of the Centers for Disease Control and Prevention and the Centers for Medicare and Medicaid Services, among many other agencies. Landlords for these locations will face many of these and other issues particular to real estate bankruptcy cases.

[2]11 U.S.C.A. §§ 1101 et seq.

[3]See 11 U.S.C.A. § 1107.

[4]See 11 U.S.C.A. § 1123(a)(5)(B), (D). A contractor with little opportunity to reorganize may instead choose a Chapter 7 filing. See 11 U.S.C.A. §§ 701 et seq. Unless successfully contested, this results in a liquidation of the debtor under the management and control of a Chapter 7 trustee. The trustee is appointed by a division of the Department of Justice, the Office of the United States Trustee. See 28 U.S.C.A. § 586.

[5]11 U.S.C.A. § 362.

[6]See 11 U.S.C.A. § 362(d).

[7]See 11 U.S.C.A. § 362(k).

[8]See 11 U.S.C.A. § 365.

[9]11 U.S.C.A. § 362.

[10]See, e.g., FAR 52.249-2, "Termination for Convenience of the Government (Fixed-Price)"; FAR 52.249-6, "Termination (Cost-Reimbursement)."

[11]See, e.g., FAR 52.249-8, "Default (Fixed-Price Supply and Service)"; FAR 52.249-6, "Termination (Cost-Reimbursement)."

[12]11 U.S.C.A. § 365(e)(1).

[13]See, e.g., U.S. Coating Specialty & Supplies, LLC, ASBCA No. 58245, 17-1 BCA ¶ 36,710.

[14]11 U.S.C.A. § 362(b)(4).

[15]90 Fed. Reg. 16447 (Apr. 18, 2025) (directing the Administrator of the Office of Federal Public Procurement Policy to "take appropriate actions to amend the FAR to ensure that it contains only provisions that are required by statute or that are otherwise necessary to support simplicity and usability, strengthen the efficacy of the procurement system, or protect economic or national security interests").

[16]90 Fed. Reg. 16433 (Apr. 18, 2025) (purporting to ensure the procurement of "commercially available products and services, including those that can be modified to fill agencies' needs, to the maximum extent practicable, including pursuant to the Federal Acquisition Streamlining Act of 1994").

[17]The White House explained that "the FAR Council will rewrite the FAR in plain English, eliminate non-statutory and duplicative regulations, remove DEI and wokeness, and add buyer guides in place of burdensome and outdated requirements." White House, https://www.whitehouse.gov/briefings-statements/2025/04/white-house-announces-revolutionary-federal-procurement-overhaul/. See https://www.acquisition.gov/far-overhaul.

[18]See 11 U.S.C.A. § 365.

[19]In the context of government contracts, however, a debtor prime contractor is restricted from assuming and assigning a contract in certain circumstances. Such restrictions can ultimately impact the debtor's ability to reorganize.

[20]11 U.S.C.A. § 365(f).

[21]11 U.S.C.A. § 365(a).

[22]11 U.S.C.A. § 365(g).

[23]11 U.S.C.A. § 365(f)(1).

[24]11 U.S.C.A. § 365(c)(1)(A).

[25]41 U.S.C.A. § 6305.

[26]41 U.S.C.A. § 6305(a).

[27]See FAR 42.1204.

[28]See FAR 42.1204(e), (f).

[29]Contractors must be mindful that the transferee must have in place the requisite compliance infrastructure

applicable to the transferor's government contracts, including items such as SAM registrations and CAGE codes, acceptable contractor business systems such as accounting, estimating, or purchasing systems, compliant IT systems, and clearances required for performance.

[30]The Third, Fourth, Ninth and Eleventh Circuits apply the hypothetical test and the First and Fifth Circuits apply the actual test.

[31]See, e.g., In re West Elecs., Inc., 852 F.2d 79 (3d Cir. 1988); In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); In re Catapult Ent., Inc., 165 F.3d 747 (9th Cir. 1999); In re James Cable Partners. L.P., 27 F.3d 534 (11th Cir. 1994).

[32]See, e.g., Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997); In re Mirant Corp., 440 F.3d 238, 247 (5th Cir. 2006).

[33]31 U.S.C.A. § 3727; 41 U.S.C.A. § 6305.

[34]31 U.S.C.A. § 3727; 41 U.S.C.A. § 6305; FAR subpt. 32.8; FAR 52.232-23.

[35]See FAR subpt. 42.9; FAR 52.242-13.

[36]FAR 52.242-13.

[37]FAR 42.901.

[38]See Exec. Order No. 14275, "Restoring Common Sense to Federal Procurement" (Apr. 15, 2025), 90 Fed. Reg. 16447 (Apr. 18, 2025); Exec. Order No. 14271, "Ensuring Commercial Cost-Effective Solutions in Federal Contracts" (Apr. 15, 2025); 90 Fed. Reg. 16433 (Apr. 18, 2025).

[39]See 11 U.S.C.A. § 362(b).

[40]11 U.S.C.A. § 547(b).

[41]11 U.S.C.A. § 548.

[42]11 U.S.C.A. § 544(b).

[43]See 32 C.F.R. pt. 117.

[44]See 32 C.F.R. § 117.11.

[45]32 C.F.R. § 117.7.

[46]See 11 U.S.C.A. § 1111.

[47]See 11 U.S.C.A. § 1102.

[48]FAR 52.232-16(d)(2)(i).

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