The Utah Banker

January/February 2009

INSIDE:

Government Receivables as Collateral? Proceed with Caution!

By Brian D. Cunningham and Nicole W. Skorupka, Snell & Wilmer, L.L.P.

Current economic troubles have caused bankers to closely examine the quality of their borrowers' accounts receivable that secure asset based loans. As account debtors delay paying invoices and the overall financial strength of account debtors weakens, borrowing base availability under a bank's typical commercial loan documents declines and the overall value of the bank's collateral diminishes.

Bankers are routinely finding that foreclosing upon accounts in the current environment provides the bank with far less of a return than was originally contemplated.

As part of the overall review of a borrower's accounts, if the borrower has receivables from the United States Government, it is imperative that the banker ensure that the loan and loan documents comply with the Federal Assignment of Claims Act (Act). The Federal Assignment of Claims Act is often misunderstood. The Act, found at 41 U.S.C. § 15, applies to all obligations owing by the federal government or any agency or department of the federal government. It is supplemented by the Federal Acquisition Regulations (FAR) found in Title 48 of the Code of Federal Regulations. The Act only governs notices of assignment and payment instructions. If the Bank does not comply with the Act, it may still have a valid assignment or security interest and prevail against junior security interests, judgment creditors and bankruptcy trustees. *However, if a bank does not comply with the Act and the government agency pays someone other than the bank, the bank has no claim against the government agency.*

The Framework

Prior to 1940, federal law prohibited the assignment of accounts receivable from contracts with the federal government, which greatly diminished the value of such receivables as loan collateral. Although these anti-assignment laws were implemented to protect the government from the administrative burden of investigating the validity of each assignment and any corresponding claim, the laws effectively reduced the ability of private contractors that supply goods or services to the federal government to secure financing by granting lenders an interest in their accounts receivable. The Act addressed the impact of the anti-assignment laws by exempting certain assignments to "financing institutions." When financing government contractors, banks must proceed with care when navigating the extensive statutory and regulatory framework applicable to assignments of proceeds from contracts with the federal government.

The Act encourages lenders to finance government contractors by permitting the contractors to assign the right to payment from receivables as loan collateral. Despite the name of the Act (The Assignment of Claims Act), permissible assignments only capture the right to receive payments due under the contract rather than the contract itself or claims other than for payment arising under the contract. In short, if the bank complies with the Act, the government will pay contract payments directly to the bank.

Conditions and procedures for assignments under the Act are prescribed in the FAR and are supplemented through regulations promulgated by federal agencies contracting under the Act. Under those rules, an assignment of money due or to become due under a government contract as security for a loan is <u>valid</u> if:

- The contract specifies payment of at least $1,000;
- The contract does not prohibit an assignment;
- The assignment is made to a bank, trust company or other financing institution (i.e., institution that deals in money as the primary function of its business activity);
- Unless otherwise expressly permitted in the contract, the assignment:
    - Covers all unpaid amounts payable under the contract;
    - Is not subject to further assignment;
    - Is made to one party, and such party participates directly in the financing, except that any assignment may be made to one party as agent or trustee for two or more parties participating in the financing of the contract; and
- Lender sends an original plus three copies of the notice of assignment and a true copy of the assignment instrument to (a) the administrative contracting officer performing all contract administrative functions, (b) any surety on bonds applicable to the contract, and (c) the disbursing officer authorized under the contract to make payments.

The administrative contracting officer is given a reasonable time after receipt of the notice of assignment to determinate if the assignment is valid.

There may be additional requirements applicable to assignments of amounts owing by certain federal departments or agencies. The provisions of the Code of Federal Regulations for the applicable department or agency should be reviewed in each instance.

The Risks and Rewards

Even after full compliance with the Act and FAR, lenders' collateral may be exposed to certain claims from sureties or the contractors' employees. Pursuant to the Miller Act, contractors must furnish certain payment and performance bonds for federal government contracts pertaining to the construction, alteration or repair of a public building or public work. A lender taking an assignment of proceeds from such contract is imputed with knowledge of the Miller Act's bond requirements. Any surety required to perform under a bond will have superior rights to proceeds from the underlying contract, regardless of an earlier assignment. Additionally, a lender's rights to assigned payments may be suspended if a contractor fails to comply with certain federal laws protecting employees, such as federal wage and hour statutes.

It should be noted that some courts have held that the Act requires that the bank must show that it loaned money or at least made money available for the performance of the government contract.

Regardless of the foregoing, financing government contractors may still be attractive to banks because of the continuous stream of timely payments available to pay down any outstanding balances. The federal government is subject to the Prompt Payment Act, which incentivizes the government to make payments when due by applying interest to late payments at a rate set by the Secretary of the Treasury. Additionally, with the federal government as the account debtor, lenders do not assume risk of non-payment due to insolvency as with non-government account debtors. Unless payments were made as a result of fraud, the federal government may not recover proceeds once paid to lenders.

How to Proceed

Thoroughly review government contracts. Government contracts must meet the conditions prescribed by FAR. Check to ensure that assignment is not prohibited by the contract. Additionally, the contracts should contain a "no-setoff" commitment to prevent the federal government from reducing assigned receivables to setoff the contractor's indebtedness to the government.

Take care drafting assignment instruments. Assignment instruments must grant the lender ownership in the proceeds; a collateral assignment granting a security interest

Proceed with Caution - continued on page 12

Proceed with Caution - continued from page 11

will be insufficient. Additionally, the assignment should only cover "moneys due or to become due" under the contract and should identify the contract by number. Blanket assignments capturing all assignable rights under the contract are not permitted under the Act and may be rejected by the administrative contracting officer.

Confirm appropriate form and delivery instructions for notices of assignment. Lenders must strictly comply with the notice requirements prescribed by FAR, including the form of the notice. Courts have consistently invalidated assignments for non-compliance with the notice requirements.

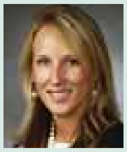
Perfect security interest in accounts receivable. Security interests must be perfected in accordance with the Uniform Commercial Code as is done when financing a non-government contractor. The Act does not apply to disputes between private parties (i.e., lenders and their borrowers) so compliance with the Act does not perfect a security interest and vice-versa.

Ensure compliance with applicable state laws. This article summarizes federal laws regarding assignments of claims. If the contract is with a state agency or department, lenders must review and comply with any applicable state assignments of claims' laws.

Although the foregoing article is not a comprehensive summary of the Act, lenders should be able to begin assessing whether credit facilities secured in whole or in part by government receivables are feasible and can be administered in a cost efficient manner. With careful consideration of the risks and rewards, and diligent observation of the legal framework, lending against government receivables may provide lenders with a substantial source of business.

ABOUT THE AUTHORS:

Brian D. Cunningham is a partner with the Salt Lake City office of Snell & Wilmer L.L.P. His practice is concentrated in banking law, secured lending, letters of credit and payment systems, general commercial and consumer finance, and creditors' rights. Brian can be contacted at bcunningham@swlaw.com or 801-257-1954.



Nicole W. Skorupka is an associate with the Denver office of Snell & Wilmer L.L.P. Her practice is concentrated in real estate and commercial finance, including construction lending, asset based lending, mezzanine lending, loan participations and syndications, workouts, and reorganizations. Nicole can be contacted at nskorupka@swlaw.com or 303-634-2128.

U.S. Treasury's Go Direct Campaign Urges Banks to Stand Up and Be Recognized for Promoting Direct Deposit

Whether your bank serves a small town, a large city or an entire region, customers in your community look to you for sound advice about their money. The U.S. Department of the Treasury's **Go Direct** campaign is announcing a new recognition program for financial institutions that go the extra mile in promoting direct deposit to senior citizens, people with disabilities, veterans and other members who receive federal benefits.

The six-month **Go Direct** Community Ambassadors Program launches in January and is aimed at community- and medium-sized financial institutions. The program is simple to implement and provides banks with a flexible way to demonstrate their commitment to the community's financial health while gaining recognition from Treasury's **Go Direct** campaign. All banks are invited to register online at www.GoDirect.org by January 31, 2009.

Banks that successfully participate in the Community Ambassadors program will receive a letter of recognition and certificate from **Go Direct.** Participating banks will be offered a variety of options for sharing information about the benefits of direct deposit with their customers, including ordering free **Go Direct** materials.

The simple act of switching to direct deposit can have a meaningful, positive impact on the lives of your customers and on your community. Consider the following:

- Direct deposit is safer and easier than paper checks—in fact, when there is a problem with a Social Security payment, nine times out of 10 it is with a paper check, not a direct deposit payment.
- Direct deposit also provides "green" benefits by reducing the paper and energy required to distribute checks.
- And direct deposit saves taxpayers money. Since it was launched in 2005, the **Go Direct** campaign has generated more than two million enrollments in direct deposit representing significant savings to taxpayers in printing, mailing and other costs.

Raising awareness about the benefits of direct deposit is a community effort. More than 1,200 **Go Direct** partner organizations engage in direct deposit education efforts across the country—including financial institutions, non-profits, and community-based groups.

For more information about the Community Ambassadors program or **Go Direct,** call 952-346-6055, or visit www.GoDirect.org.