

Lending on Government Receivables and Contracts

BY CAROL APICELLA AND RICHARD POLLAK

Government contractors' performance and lending requirements can change with the slightest turn due to financial regulations, acts of nature and geopolitical occurrences. Knowing you are secure in lending to, or financing, government contractors starts here.



Government contractors' stressors, including, among others, their financial performance, successful contract award, and building the infrastructure to complete the effort, combined with fulfillment of the contract, create pressures much like those when a diamond is created.

But even diamonds have flaws. Some flaws may be readily visible, while others need the aid of magnification to be brought to light. The lender must use its knowledge to identify those flaws that may impact its secured position vs. those that are not harmful to the lending relationship.

Relationships in lending include analysis of borrowers' past and present business operations as well as understanding requirements linked to successfully perform on contracts.

Contract awareness includes, though not limited to, the contract being:

- Fully executed by all parties
- Appropriated for the full contract amount (Base year plus Option years)
- Track appropriations-Purchase Orders (PO), Task Orders (TO), Work Orders (WO)
- Verify Periods of Performance
- Terms of Billing and Payment
- Billing vehicles (i.e., WAWF, IPP, Tungsten, etc.)

Familiarity with the contract terms, preparedness for the plethora of government acronyms, and lender vigilance in understanding the borrower's obligations are all important before wading into the world of government contract finance.

Is Your Institution Properly Secured?

Whether a bank or a finance company in an ABL relationship or purchasing invoices in a factoring relationship, the collateral will be tied to services rendered and/or goods delivered and typically all business assets.

Perfecting the lender's first lien position under the Uniform Commercial Code ("UCC") and taking an assignment as allowed by the Federal Assignment of Claims Act ("FACA") on prime government contracts where applicable, are two action items necessary to being secured.

Under the Uniform Commercial Code (UCC), a secured creditor perfects its security interest in accounts receivables (accounts) by obtaining a security agreement and filing a financing statement in the appropriate jurisdiction. Perfection in this manner works for both commercial accounts and accounts which are subject to the Federal Assignment of Claims Act (FACA). If this is the case, then why should a lender comply with the FACA?

Under the UCC, if a borrower defaults on a loan secured by accounts, the lender has the right to notify the borrower's

customers (account debtors) of the lender's security interest in the accounts and direct them to make future payments to the lender – not the borrower. If an account debtor ignores the notice from the secured party and continues to make payments directly to the borrower, the account debtor remains liable to the lender for the full amount owed to the borrower. In other words, the payments which the account debtor makes after receiving notice does not discharge the debt unless the account debtor makes those payments directly to the lender.

These same rules do not work on a government contract. In the government contractor industry vertical, the future is most important as successful performance on a contract potentially will lead to other opportunities, which in turn will lead to additional lending requirements. After reviewing the financial snapshot of the borrower, a lender's initial focus should immediately commence with a deep dive into the borrower's contract of engagement with the government agency or prime contractor with whom they are doing business. It is important to never lose sight of the fact that the contract is the roadmap that governs the contractor's business cycle process from expectation to fulfillment to creation of invoice to final payment.

Under federal law, the government will make payments in accordance with the directions it has received from the borrower. Subsequent instructions to direct payments to the lender will not be honored by the U.S. government. Further, unlike the commercial account debtor who continues to make payments at its own peril, if the federal government makes payments to the borrower after notice from a secured party, the debt paid is discharged.

Here is where the FACA is needed. If a lender complies with the requirements of the FACA, payments from a government contract will be directed by the government directly to the



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lender until such time as the lender releases the assignment. The borrower cannot give the government new payment directions or divert the funds to another financial institution unless the lender consents.

The assignment is limited to the monies due under the contract, not performance under the government contract. In other words, the government permits the contractor to assign the payments due from the government, but does not permit the contractor to assign its obligations to a third party.

The Steps

After the Lender takes the initial steps of perfecting its security interest in accounts, the lender needs to take several additional steps to take an effective assignment under the Act.

The lender should obtain a copy of each government contract. It is important to have counsel review the contract.

The contract will provide (i) the contract number and date and describe the nature of the goods or services being provided to the government, (ii) the government agency which is contracting with the Borrower and (iii) most importantly, the name and addresses of the contracting and disbursing officers on the contract.

With this information the lender can prepare two documents needed to comply with the Act: the assignment of the monies due under each contract and the notices of assignment.

There are slight variations on the form but, the form of assignment has been in use for 80 years. To complete the assignment, the lender needs the information from the contract. Once the assignment is complete the borrower signs the assignment. The assignment provides the government with specific directions on where payments should be made. This is almost always a deposit account with the lender.

Then the assignment is sent to both the contracting officer and disbursing officer with the prescribed form of notice. The contracting officer is the person who awarded and oversees the contract, the disbursing officer is the person who makes payments on the contract. It is possible at times for one

person to be both the contracting and the disbursing officer.

Both the contracting and disbursing officers must separately acknowledge the assignment and return the acknowledged assignment to the lender. Once acknowledgement happens, payments will be automatically directed to the deposit account with the lender until such time as the lender releases or terminates the assignment by filing a release with the contracting and disbursing officers.

This is the entire process for compliance with the FACA.



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Practice Pointers

Both the contracting and disbursing officers need several true correct and complete copies of the notice form, along with a true copy of the assignment document. Read the notice form and follow the instructions.

The lender should always take responsibility to deliver the notices to the government along with return envelopes addressed to the lender – preferably by FedEx. Don't hand it to the borrower and ask them to do this.

In all cases, prior to the assignments and notices being sent out, the borrower should first contact the contracting

and disbursing officers to tell them the assignment is coming. This avoids any confusion and delay.

As a lender, you should always consider which contracts you are going to have assigned, particularly if the borrower has a large number of contracts. Set thresholds based on the dollar amount and remaining term of the contracts. In other words, only take assignments of contracts which have remaining payments in excess of a certain amount.

Finally, the market on compliance with the FACA has shifted over time like a pendulum. Years ago, assignments were done routinely without any real objection. In today's market, rather than requiring compliance with the Act many lenders are taking several different approaches.

One approach is to simply provide the lender with the right at any time to require the assignments. On its face, this seems like a flexible way to protect the lender, but in reality it becomes very difficult to require the assignments absent some significant change in the borrower's condition – and then the

borrower is unlikely to cooperate. If the borrower is already in a default of some kind, an additional default for failure to provide the assignments won't really leverage the borrower.

A second approach is to either only take the assignments after an event of default has occurred or to have them signed at closing, but hold them and only file them upon a trigger event – an event of default or a covenant violation. Both of these approaches are problematic because the contracts you have assigned may no longer have much value or have been replaced by new contracts. Second, it is very unlikely that after an event of default the borrower is going to provide the lender with assignments unless the lender agrees to waive or forbear from the default.

Successful government contractors frequently enter into new contracts, meaning you need to have mechanisms in your loan documents for the borrower to periodically (quarterly with a compliance certificate) notify you of any new contracts and if you are taking assignments, provide you with the notice and assignment forms.

A Few Other Risks

A federal contractor can be suspended or debarred from contracting with the government. These are remedies the government has for contractors who fail to perform under contracts or for whom audits reveal accounting and other issues.

Suspension means that the contractor may not be allowed for some specific period to enter into new contracts with the government. This is the less-onerous punishment.

Debarment means a company cannot continue to enter into any contracts with the government and may impact the existing contracts the company has.

In the ever-evolving world of government contracting, financial institutions must remain vigilant and adaptable to mitigate risks effectively. By following the prescribed steps and staying informed about regulatory changes and industry trends, lenders can secure their positions and build successful relationships with government contractors. In this intricate realm, thorough understanding and proactive measures are the keys to long-term financial stability and success. 🏠



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