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LEGAL lines

Financing Government Receivables:
State Governments Subject to Notification Like Other Account Debtors

BY JEFFREY A. WURST

Assigning payment rights is a basic concept that enables borrowers to obtain working capital. However, matters can be more complex when working with government departments. Jeffrey Wurst explains a recent decision in a Florida appellate court that requires state government departments to make payments when the debt has been reassigned to a factor if proper procedures have been followed.

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The right to reassign property interests is a basic concept in western jurisprudence. Simply, secured lenders are allowed to make advances to their borrowers, relying on the borrowers' assignment to the lender of property rights. Without these assignments, many borrowers would be unable to secure working capital and the overall economy would suffer.

Of course, there are risks in accepting assignments. Consider, for example, the sale of property leased to a third party. The purchaser is not obtaining a present right to use the premises because the tenant has a contractual right to use it during the lease period. The seller might retain the payment rights under the lease, leaving only the remainder to the buyer. The same issues exist with transfers of personal property, especially intellectual property. Consider a licensed patent or copyright. Although the licensee has rights to use it, he or she does not own the patent or copyright and may not transfer or assign it. The license agreement may also prevent assignment of the license, patent or copyright.

Contracts containing prohibitions against assignments are common, for understandable reasons. Imagine contracting with someone to manufacture your product. You have shopped around and carefully selected a manufacturer to assure the quality and service will be of the highest caliber. Then you discover that carefully chosen manufacturer sold your contract to a company you already considered and rejected. Your desire to prohibit that kind of assignment makes perfect sense, so your contract includes a prohibition against assigning any and all rights under your contracts:

> This agreement and the rights provided for hereunder may not be assigned by any party hereto without the prior written consent of the non-assigning party.

Traditionally, federal anti-assignment law made it impractical for a lender or factor to make advances against federal government accounts. As the U.S. was preparing to enter World War II, it became necessary to ease these restrictions to allow government contractors to obtain the necessary financing to manufacture products needed to support the war effort. The federal Assignment of Claims Act of 1940 was amended from 1951 through 1996 and was ultimately repealed and replaced with more practical provisions in 2011.

But can that manufacturer assign his payment rights? He still manufactures your product, but instead of paying him, you pay his assignee. Does that fly in the face of the non-assignability clause of your contract?

Payment Rights Are Different

Payment rights are a different creature. Although contracts often prohibit assignments of any kind, the drafters of the Uniform Commercial Code separate payment rights from other rights. In 9-406(d), the UCC provides:

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> …a term in an agreement between an account debtor and an assignor or in a promissory note is ineffective to the extent that it
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> (1) prohibits, restricts, or requires the consent of the account debtor or person obligated on the promissory note to the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in, the account, chattel paper, payment intangible or promissory note

This provision enables factors and lenders to put account debtors on notice and enables them to recover, even when the contract prohibits assignments.

But the UCC falls under state law and is not binding on the federal government or its divisions. And the U.S. has historically been unreceptive to assignments of its contracts absent its prior consent. In general, federal anti-assignment statutes prohibit assignments, in part, to minimize susceptibility to fraud and to protect its rights of set off.

Federal Anti-Assignment Law Revised

Traditionally, federal anti-assignment law made it impractical for a lender or factor to make advances against federal government accounts. As the U.S. was preparing to enter World War II, it became necessary to ease these restrictions to allow government contractors to obtain the necessary financing to manufacture products needed to support the war effort. The federal Assignment of Claims Act of 1940 was amended from 1951 through 1996 and was ultimately repealed and replaced with more practical provisions in 2011. Section 6305 of the present act provides:

> 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.
>
> …Notwithstanding … amounts due from the federal government under a contract may be assigned to a bank, trust company, federal lending agency or other financing institution.

The assignment must be for a contract in excess of $1,000, may not be made if the contract expressly forbids the assignment and must be for all amounts due under the contract. Multiple assignments are not permitted (e.g. no subordinated interests). The assignee must file written notice and a copy of the assignment with the government agency that is a party to the contract, with the surety on any bond, if any; and with the disbursing officer, if any, designated to make payment. Section 3727 of the act has other provisions that must be observed.

The rules are specific and require total compliance to ensure that the lender or factor can collect assigned accounts from the federal government.

The takeaway is that state governments are subject to notification like any other account debtor, other than the federal government. The key is following the procedures proscribed in the Assignment of Claims Act.

But what about financing or factoring receivables owed by state governments or their sub-divisions? If an account debtor that is a unit of a state government receives notification under UCC 9-406 to make payment to a factor, is it obligated to honor such notification? Section 9-109 of the UCC addresses the scope of Article 9: "[t]his chapter does not apply to … [a]ny transfer by a government or governmental unit." A Florida appellate court recently addressed that issue.

A basic principle in commercial finance law is the right to place account debtors on notice and to rely on the effectiveness of such notice. Account debtors that fail to abide by the notification remain obligated to the assignee of the account — the secured party.

Factor Provided Notification

In the Florida case, the debtor provided roadside assistance to the Florida Department of Transportation. The factor provided the department with notification that the debtor's accounts had been assigned to the factor and that all future payments should be made to the factor. The notification stated that payment to any other party would not discharge the department's obligations on the accounts.

Section 9-406 provides in part:

> [A]n account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.

Although it received the notices, the department nonetheless continued to pay the debtor and refused to pay the factor. The department claimed that > >

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governmental account debtors were outside the reach of 9-406. It noted that 9-109(4)(n) provided: "[T]his chapter does not apply to … [a]ny transfer by a government or governmental unit."

The department argued that because its payments on the accounts receivable involved transfers of money by a governmental unit, the so-called government-transfer exception in 9-109(4)(n) prevented 9-406 from regulating how it may discharge its contractual obligation for the services rendered by the debtor.

The court noted that if the provisions of 9-406 could be read to apply to a transfer by a governmental unit where the governmental unit was merely an account debtor making a payment to the assignee of an account receivable rather than the assignor of that account, then the department's argument would be correct. But the court explained that the plain language of 9-109 excluded this construction.

The court went on to consider whether an account debtor's payments on accounts receivable in accord with 9-406 are transfers to which Article 9 is being applied. Put differently, the question was whether an account debtor's payments on accounts receivable are objects of 9-406.

The court determined the statutory text showed the transfer to which the statute applies is a transfer of accounts, chattel paper or payment intangibles and not a transfer of money as payment to satisfy an account debtor's obligation on one of those items.

The court concluded that the government-transfer exception created by section 9-109(4)(n) "by its own terms, is not implicated by the mere fact that the government happens to be an account debtor required to make a payment on an account, chattel paper, or payment intangible that has been assigned."

The court went on to note that it would have reached a different conclusion had the government sold such assets:

Article 9 generally applies to such sales, and the sale of an account, chattel paper or payment intangible by a governmental body would be a transfer of that asset, which would be a transfer by a governmental unit within the meaning of [9-109(4)(n)]. That circumstance, however, is not what the facts of this case present. Here, the accounts receivable were sold [to the factor], and the department, as the governmental account debtor, was owed notice of the sale under the statute for the purpose of sending the same payments it always owed.

Ruling — factor wins and the department was subject to a double pay.

Assignees of state government receivables can take comfort in this ruling as it protects the integrity of their 9-406 (and 9-607) notifications to state government divisions.

The takeaway is that state governments are subject to notification like any other account debtor, other than the federal government. The key is following the procedures proscribed in the Assignment of Claims Act. abfj

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