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Federal Assignment-Backed Securities (FAst-BackS): Financing Federal Accounts Receivable through Securitization

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**FEDERAL ASSIGNMENT-BACKED SECURITIES
(Fast-Backs): FINANCING FEDERAL ACCOUNTS
RECEIVABLE THROUGH
SECURITIZATION**

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I. INTRODUCTION

I only know that if a man lives long enough he can trace a thing through the Circumlocution Office of Washington and find out, after much labor and trouble and delay, that which he could have found out on the first day if the business of the Circumlocu-

*tion Office were as ingeniously systematized as it would be if it were a great private mercantile institution.*¹

The federal government purchases large quantities of goods and services each year. The government² does not pay for these purchases in advance,³ so contractors⁴ need funding to acquire the labor and materials required for production. Contractors frequently secure such funding by assigning their accounts receivable, arising from government's purchases, to banks and other financial intermediaries.⁵ Financial intermediaries, however, may be an expensive source of funding.⁶ An intermediary obtains funds at a "wholesale" rate and advances those funds at "retail" rates to its customers. From the customer's perspective, it is cheaper to obtain funding at the intermediary's wholesale rate.

Securitization allows organizations to bypass intermediaries and obtain lower-cost financing.⁷ It enables companies with quality assets to sell securities, backed by those assets, directly to investors.⁸ At a minimum, the organization raising funds through securitization saves on the cost of the intermediary's overhead and profit margin.⁹ There can be

1. MARK TWAIN, *The Facts in the Great Beef Contract*, in THE COMPLETE SHORT STORIES OF MARK TWAIN 40, 45 (Charles Neider ed., Bantam Books 1971) (1957).

2. This Comment uses the terms "government" and "federal" to describe all federal agencies. The financial markets do make credit distinctions between different agencies because the "full faith and credit" guarantee does not extend to all agencies. See MARCIA STIGUM, THE MONEY MARKET 41-42 (3d ed. 1990). Although this may be relevant to the pricing of a specific transaction, it is not critical to this general discussion.

3. See, e.g., 48 C.F.R. §§ 32.903, 52.232-.25 (1992) (setting out due dates for contract payments).

4. The term "contractor" describes a party that provides goods or services for a price. See BLACK'S LAW DICTIONARY 326 (6th ed. 1990).

5. For an excellent discussion of lending against federal receivables, see Heidi M. Schooner & Steven L. Schooner, *Look Before You Lend: A Lender's Guide to Financing Government Contracts Pursuant to the Assignment of Claims Act*, 48 BUS. LAW. 535 (1993).

6. See Steven Pearlstein & Jerry Knight, *Banks Lose Out as Depositors Go Elsewhere: Many Options Available for Saving, Borrowing, Investing*, WASH. POST, Aug. 22, 1993, at A1 (noting bank share of credit market declines due to more efficient alternatives). In one report, an Arlington, Virginia contractor found that it was less expensive to speed up payments by hand delivering invoices to a payment processor in Philadelphia than to borrow against receivables. Jill Andresky Fraser, *Account Receivables: Faster Government Collections*, INC., Apr. 1993, at 43, 43.

7. Stephen I. Glover, *Structured Finance Goes Chapter 11: Asset Securitization by Reorganizing Companies*, 47 BUS. LAW. 611, 615 (1992) (stating securitization reduces costs by tapping markets directly).

8. See Steven Pearlstein, *Recycling Money: How the New System Works: With 'Securitization' the Never-Ending Buying, Selling of Loans Benefits Consumers*, WASH. POST, Aug. 22, 1993, at A12.

9. See Pearlstein & Knight, *supra* note 6, at A12 (noting conduits need half of bank's spread to profit).

additional savings if the assets merit a higher credit rating than the organization selling those accounts.¹⁰ Thus, at a time when securitization is common,¹¹ government contractors should exploit ways to securitize their federal accounts receivable and reduce financing costs.¹²

The potential for federal assignment-backed securities (FAst-BackS)¹³ is staggering. For example, the Department of Defense spends roughly \$150 billion on procurement, operations, and maintenance annually.¹⁴ To the extent these expenditures create receivables on the books of government suppliers, they could give rise to a comparable level of securitization. Considering that private industry securitizes around thirty-five billion dollars of receivables each year,¹⁵ government receivables represent a significant new market.

This Comment explains why the securitization of federal accounts receivable makes sense. As a framework, Part II reviews asset securitization and discusses how a recent Tenth Circuit Court of Appeals decision impacts the future of these transactions. Part III introduces the Assignment of Claims Act of 1940 (ACA),¹⁶ a prerequisite¹⁷ to using federal accounts receivable in a financing, and compares the rights of assignees under the ACA with those of commercial and consumer assignees. Part IV examines statutory requirements and concludes that the ACA permits securitization. Part V addresses some of the issues faced in structuring

10. See Glover, *supra* note 7, at 615 (asserting that higher credit rating contributes to lower costs). For example, Advanta Corporation's senior debt is rated B2, whereas the Advanta Credit Card Master Trust is rated Aaa. 2 MOODY'S INVESTORS SERV., MOODY'S BANK & FINANCE MANUAL 5352, 5601 (1993). An investment rated B2 "generally lack[s] the characteristics of [a] desirable investment," while the Aaa rating is given to bonds with "the smallest degree of investment risk." Moody's Investors Serv., MOODY'S BOND RECORD, Mar. 1993, at 3. There could be more than a 1% difference in interest cost between Aaa and B2 securities. See ECONOMIC REPORT OF THE PRESIDENT, Jan. 1993, at 428 tbl. B-69 (evidencing more than 1% average spread between Aaa and Baa securities).

11. See Pearlstein & Knight, *supra* note 6, at A12 (noting 80% of mortgages, 50% of college loans, and 15% of car loans are securitized).

12. Securitization has the reputation of being a cost effective form of financing. See, e.g., Pearlstein, *supra* note 8, at A12 ("[S]tudies have shown that the process has reduced the price of home mortgage loans by up to a half-percentage point.").

13. Recognizing that the success of any capital markets product may depend upon a snappy acronym, this Author proposes "FAst-BackS"—Federal Assignment-Backed Securities.

14. OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1993 pt. Two-5 (Supp. Feb. 1992) (National Defense Outlays by Function and Program).

15. See Michael Liebowitz, *Can Corporate America Securitise . . . Itself?*, INVESTMENT DEALERS' DIG., Jan. 27, 1992, at 14.

16. Ch. 779, § 1, 54 Stat. 1029 (codified at 31 U.S.C. § 3727 (1988) and 41 U.S.C. § 15 (1988)).

17. Compliance with the ACA may not be an absolute prerequisite. See *infra* note 228.

Fast-BackS transactions and Part VI suggests why and how government should facilitate this financing alternative.

II. SECURITIZATION

A. Background

1. The securitization model

Securitization allows parties to finance their assets directly in the capital markets. The technique has been described as the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.¹⁸

In short, by selling investment interests in the cash flow generated by a segregated pool of assets, securitization turns those assets into marketable securities.¹⁹ From an investor's perspective, the purchaser of a securitized interest becomes a partner in the proceeds generated by that asset pool without exposing itself to the credit risks of either the asset pool's originator²⁰ or some other organization.

To securitize accounts,²¹ a sponsor²² sells selected accounts²³ to a bankruptcy remote entity (BRE)—a trust, corporation, or partner-

18. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1374-75 (1991).

19. See, e.g., *Asset Securitization and Secondary Markets: Hearing Before the Subcomm. on Policy Research and Insurance of the House Committee on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. 40 (1991) [hereinafter *Secondary Market Hearings*] (statement of Donald G. Coonley). Some, like Mr. Coonley, emphasize that securitization involves "illiquid assets." See *id.* This is not completely accurate. Before the United States Treasury began selling zero coupon bonds (STRIPs), Wall Street synthesized zero coupon bonds through securitization. See STIGUM, *supra* note 2, at 690-91 (discussing menagerie of zero coupon bonds—CATs, TIGRs, and LIONS). Although the underlying treasury securities were highly liquid, it was profitable to "repackage" these securities because of an investor preference for zero coupon instruments. *Id.*

20. An originator creates, or is the original owner of, the asset.

21. This Comment provides only an overview of the process. For more detailed discussions, see, for example, TAMAR FRANKEL, *STRUCTURED FINANCING, FINANCIAL ASSETS POOLS, AND ASSET-BACKED SECURITIES* (1991); Steven L. Schwarcz, *Structured Finance: The New Way to Securitise Assets*, 11 CARDOZO L. REV. 607 (1990); Shenker & Colletta, *supra* note 18. An overview also appears in STIGUM, *supra* note 2, at 1095-97.

22. A "sponsor" is the organization that is raising funds through securitization. Shenker & Colletta, *supra* note 18, at 1376 n.25. A sponsor may be a seller or an originator.

23. This Comment uses the terms receivable, account, and accounts receivable interchangeably. See U.C.C. § 9-106 (1990). While this text refers to the sale of accounts, a trans-

ship.²⁴ A servicer is appointed to manage the collection and administrative functions of the BRE.²⁵ To fund its purchase of the accounts, the BRE sells to investors securities that are backed by the projected stream of payments—cash flow—that the accounts will generate.²⁶ The cash flow from the assets will be passed through the BRE to repay investors.²⁷

Since actual cash flow may vary from projections, investors demand protection against payment deficiencies—that is, credit enhancement.²⁸ Credit enhancement, which protects against the risk of loss, can be provided internally or purchased from third parties. It may include purchase discounts, reserve accounts, holdbacks, cash collateral accounts, letters of credit, or insurance bonds.²⁹ Whatever method, or combination of methods, is used, the sponsor provides credit enhancement in an amount that is several times greater than a potential cash flow deficiency.³⁰ This structure is supposed to compensate investors for their risk of loss.³¹ It protects investors from deviations in the expected cash

action's prospectus may refer to the sale of a receivable in an account. This distinguishes the dollar balance from the account relationship, which is perceived to have its own economic value. In most transactions, only the receivable is being securitized. *See, e.g., Secondary Market Hearings, supra* note 19, at 281 (MBNA credit card prospectus).

24. Shenker & Colletta, *supra* note 18, at 1378. "Bankruptcy remote" means that the purchasing entity will not be substantively consolidated with the seller in the event of a bankruptcy. *See* Schwarcz, *supra* note 21, at 613, 616. Generally, bankruptcy remote entities, special purpose vehicles, and account "purchasers" are equivalent terms.

25. *See* Shenker & Colletta, *supra* note 18, at 1376. A sponsor or seller can also function as servicer. *See, e.g., Secondary Market Hearings, supra* note 19, at 256, 285, 293 (MBNA credit card prospectus). While securitization can involve a cast of administrative characters, this Comment assumes that all administrative functions are performed by the servicer.

26. *See* Schwarcz, *supra* note 21, at 609.

27. *See Secondary Market Hearings, supra* note 19, at 145 (Moody's Investor Service materials). This process is more complicated for noninterest bearing receivables, which must be discounted to allow for the time value of money. *See* Liebowitz, *supra* note 15, at 16 ("How it works"). Due to the uncertainty of the discounting period, the time to payment, interest bearing assets are more attractive for securitization. It is advantageous that outstanding federal accounts accrue interest. *See* Schooner & Schooner, *supra* note 5, at 536.

28. Shenker & Colletta, *supra* note 18, at 1376.

29. FRANKEL, *supra* note 21, §§ 9.1-9.

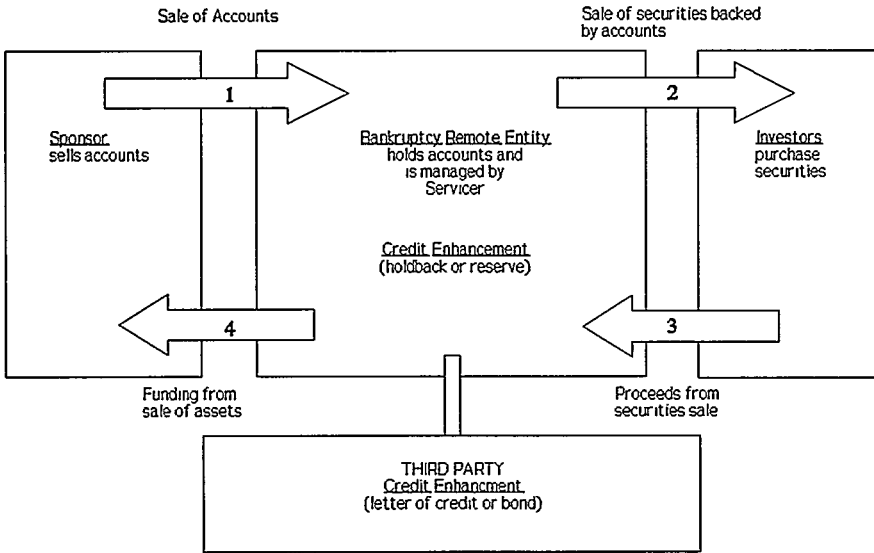
30. *See, e.g., Secondary Market Hearings, supra* note 19, at 26 (statement of Clifford Griep) ("[C]urrent credit support levels provide loss coverage, which is about three to four times higher than current receivable loss experience.").

31. Some are concerned that securitization allows sellers to dispose of risky assets. *See, e.g., Secondary Market Hearings, supra* note 19, at 227, 235, 240 (concerning securitization of "risky" assets). However, because investors demand that the sponsor provides credit enhancement, the "more risky the loans are the more costly it will be to securitize them." FRANKEL, *supra* note 21, § 2.7, at 57. In effect, the sponsor, through credit enhancement, *compensates* the investor for accepting risk. *See id.* Since credit enhancement is based upon *projected* losses, it may be more accurate to say that securitization allows a sponsor to avoid extraordinary losses—losses that exceed the level of credit enhancement.

flow, and it insulates investors from the credit declines of third party organizations.

The following diagram depicts a typical transaction:

SECURITIZATION MODEL



2. Account securitization depends upon cash flow

Because a securitized offering is designed to protect the expected cash flow of an asset pool, “cash flow securitization” may be the most accurate way to describe these financings.³² Consider, for example, the securitization of accounts that Associated Grocers Inc. (Associated) completed in 1988.³³ The underlying assets consisted of retail groceries.³⁴ Although the securities were dubbed “grocery-backed bonds,” it is hard to imagine that investors believed that, upon a default, levying upon retail groceries would provide a dependable source of repayment. In-

32. See Schwarcz, *supra* note 21, at 608; cf. Shenker & Colletta, *supra* note 18, at 1376 n.27 (“It is conceivable, though much less likely, that a non-income-producing asset (e.g., raw land) might be securitized.”).

33. Associated Grocers, Inc. is a grocery wholesaler that supplies independent grocers in the Northwest. See *Green Stamps Not Included*, ASSET SALES REP. (American Banker, Inc., New York, N.Y.), Feb. 16, 1988, at 1. Usually, trade receivables are securitized through commercial paper conduits. See Liebowitz, *supra* note 15, at 14-15. This was one of the first transactions to use trade receivables in a term financing. See *id.* (noting that Mattel, Inc. completed first term offering in September 1987).

34. See *Green Stamps Not Included*, *supra* note 33, at 1.

stead, investors were betting that the strong historical payment relationship between Associated and its customers would continue into the future.³⁵ Cash flow, as opposed to liquidation value, made the transaction possible.

Given the importance of cash flow, one would expect investment bankers to prepare extensive cash flow analyses as a guide to structuring a transaction. In this regard, many writers have observed that statistical analysis plays a large role in securitization.³⁶ Statistical analysis is popular because it provides an objective means of measuring historical payment relationships which, in turn, are used to estimate future cash flows. Investors favor asset pools with a large number of diversified borrowers because these characteristics are supposed to improve statistical reliability.³⁷

While statistical analysis is valuable, it is important to understand that the measurement of past performance does not guarantee future performance.³⁸ Fundamentally, there are some types of cash flow risk that cannot be measured or controlled using statistical methods.³⁹ Therefore, a common sense understanding of the business that gives rise to the subject cash flows may be the best guide for estimating risk.⁴⁰ Intuitively, an established business in a stable industry is likely to possess the cash flow

35. *See id.* at 5.

36. *E.g.*, *Secondary Market Hearings*, *supra* note 19, at 157 (Moody's Investor Service materials) (stating Moody's considers likely loss scenario and potential variability of loss); Schwarcz, *supra* note 21, at 610 (stating number of obligors must be large enough so that risk of loss can be statistically determined); Shenker & Colletta, *supra* note 18, at 1377 (stating delinquency and loss experience should support statistical analysis).

37. *Secondary Market Hearings*, *supra* note 19, at 209 (Moody's Investors Service materials) (reviewing rating methodology for portfolio characteristics); Schwarcz, *supra* note 21, at 610-12; Shenker & Colletta, *supra* note 18, at 1376-77 & n.29.

38. *Secondary Market Hearings*, *supra* note 19, at 263 (MBNA credit card prospectus) (stating sponsor "is unable to determine and has no basis to predict whether, or to what extent, social, legal or economic factors will affect future card use or repayment patterns").

39. *See, e.g.*, *Firms Scramble to Unload CMO Inventories as Managers Rebel*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Nov. 22, 1993, at 1, 11 (stating investors "have lost confidence in the Street's ability to evaluate payment schedules and cash flow risks embedded in structured mortgage-backed").

40. PAUL A. VATTER ET AL., *QUANTITATIVE METHODS IN MANAGEMENT* 262 (1978).
[D]ecision makers must specify which data are useful and which are reliable, and in doing so, use their own judgement and knowledge about the decision situations. . . .
[Using] past data as an indication of what is likely to happen in the future . . . is advisable only when the decision maker is convinced that the particular data being used are a good guide for the future.

Id. Predicting social and economic trends is difficult because the many factors that generate these trends are constantly in flux. *See* RICHARD VON MISES, *PROBABILITY, STATISTICS AND TRUTH* 11 (Hilda Geiringer ed., Dover Publications 1981) (1957) ("[P]robability calculus [] applies only to problems in which either the same event repeats itself again and again, or a great number of *uniform* elements are involved at the same time.") (emphasis added).

characteristics that favor securitization. In the Associated financing, getting investors to understand that a retail grocer must pay its wholesaler to stay in business may have been more meaningful than any statistical analysis.

This technical distinction is important to the securitization of accounts. Account transactions are different from mortgage, auto loan, or lease-backed securities, which are likely to consist of a single pool of obligations that are identified in advance of the offering. In account securitization, the underlying accounts have short maturities.⁴¹ A vendor might expect an account to be paid within ninety or so days. To obtain financing for any length of time, the receivable pool must be replenished with new receivables until the desired maturity is achieved.⁴² Rather than identifying specific obligations in advance, accounts are being created over the term of the financing. Because a receivables pool is constantly "rolling over," an understanding of the sponsor's *continuing* ability to provide quality receivables may be more important than the historical record.⁴³ Notably, although securitization is supposed to insulate investors from the risks associated with other organizations, an investor in a receivable-backed security has ongoing exposure to the sponsor's⁴⁴ continuing ability to supply quality receivables to the pool.

B. The True Sale Issue

1. A true sale is a requirement

Securitization focuses on cash flow. That focus has little value if the structure of a securitized offering does not preserve cash flow for the benefit of investors. To preserve cash flow, transactions are structured to legally separate the sponsor or originator from the assets used in the financing.⁴⁵ While this may not insulate investors from the risks associated with a servicer's or originator's continuing operations,⁴⁶ this

41. Cardholders may pay off their bills within 30 days, whereas a credit card receivable-backed security could have a maturity of several years. See *Secondary Market Hearings, supra* note 19, at 257-58 (MBNA credit card prospectus) (indicating certificateholders receive scheduled return of principal 3 1/2 years after issuance).

42. *Id.* at 162-63 (MBNA credit card prospectus) (noting credit card receivables are "revolving," "continually being repaid and renewed"); *id.* at 163-64 (Moody's Investors Service materials) (stating it is "possible to structure note programs to accommodate [trade] receivables"); see also Liebowitz, *supra* note 15, at 16 ("How it works").

43. *Secondary Market Hearings, supra* note 19, at 163-64 (Moody's Investors Services materials) (preparing credit rating includes evaluation of issuer's operations).

44. If the sponsor is not the originator, there is ongoing exposure to the originator's operations as well.

45. Schwarcz, *supra* note 21, at 608.

46. See *supra* note 43 and accompanying text.

separation minimizes the risk that a related party's bankruptcy would impair or delay the investor's right to receive cash flow.⁴⁷

A "true sale" of the assets from the originator to the BRE performs this legal separation.⁴⁸ In the absence of a true sale, a court might conclude that the assets were merely collateral for a loan.⁴⁹ As collateral, the assets would be part of the sponsor's bankruptcy estate,⁵⁰ payments to investors would be stopped by the automatic stay, and the trustee could use the assets as cash collateral.⁵¹ Without a true sale, the investor has little bankruptcy protection.⁵²

It is surprising, then, that account securitization can take place when there is no way to guarantee the existence of a legal sale:⁵³ "[T]here has not been any specific legal determination that the sale of [a sponsor's] assets to a bankruptcy-remote, wholly owned, special-purpose vehicle typically used in [securitization] constitute[s] a true sale."⁵⁴ In the sale of accounts, where a seller can be characterized as continuing to yield significant control over the assets,⁵⁵ there is reason to question whether a sale has actually occurred. In practice, courts will determine whether a true sale has occurred by applying a balancing test that weighs the practices, objectives, activities, and overall relationship of the seller and purchaser of the assets.⁵⁶ In the absence of any guarantees, parties rely upon legal opinions for the assurance that a specific transaction will be treated as a true sale.⁵⁷

47. Schwarcz, *supra* note 21, at 613 ("The source of payment must be *separated* from the originator in the event the originator becomes troubled or bankrupt.").

48. *Id.* at 618-19.

49. *Secondary Market Hearings*, *supra* note 19, at 172 (Moody's Investors Service materials); Schwarcz, *supra* note 21, at 619-21.

50. Schwarcz, *supra* note 21, at 620.

51. *Id.*

52. Because the seller could retain a perfected security interest in the assets, the seller still has some protection vis-a-vis other creditors.

53. Schwarcz, *supra* note 21, at 621.

54. *Secondary Market Hearings*, *supra* note 19, at 235 (quoting Andrew Silver). Notably, nine months earlier a federal court authorized a true sale of a debtor's credit card accounts to a bankruptcy remote entity. *See In re Federated Dept. Stores, Inc.*, No. 90-00132, 1990 Bankr. LEXIS 2453, at *8-*9 (S.D. Ohio Nov. 21, 1990). In its order the court held that the special purpose vehicle was the sole owner of the receivables and that neither the sponsor nor any of its creditors had any ownership rights in the receivables. *Id.*

55. The seller's control could be demonstrated through servicing activities, continuing business relationships with account debtors, and a perceived ability to control the quality of new receivables. *See* Schwarcz, *supra* note 21, at 623.

56. A thorough discussion appears *id.* at 621-24. *See also* *Major's Furniture Mart v. Castle Credit Corp.*, 602 F.2d 538, 544-46 (3d Cir. 1979) (discussing balancing test).

57. *Secondary Market Hearings*, *supra* note 19, at 131 (testimony of Clifford Griep); *id.* at 172 (Moody's Investors Service materials).

2. *Octagon Gas Systems, Inc. v. Rimmer*
rejects the true sale of an account

Despite the lack of any legal guarantee, it seems fair to assume that the issue is not whether the law prohibits the sale of an account, but whether the requirements of a sale have been met for a specific transaction. In *Octagon Gas Systems, Inc. v. Rimmer (In re Meridian Reserve, Inc.)*,⁵⁸ however, the Tenth Circuit recently rejected the possibility that there could be a legally binding sale of an account.⁵⁹ The court determined that the purchaser of an account⁶⁰ is, for all purposes, a secured party.⁶¹ It expressly rejected the notion that a purchaser takes title of an account and relieves the seller of all ownership interests.⁶²

The *Octagon* decision threatens financial securitization in two ways. First, it rejects the concept of the "true sale" of an account.⁶³ The true sale to a BRE is the primary source of bankruptcy protection.⁶⁴ Second, it endorses a broad definition of the bankruptcy estate.⁶⁵ By doing so, *Octagon* further exposes securitized assets to the bankruptcy of a selling or servicing organization. Since securitization is supposed to avoid payment interruptions and other uncertainties that arise in the course of a third party's bankruptcy, broad acceptance of the *Octagon* decision would effectively bar account securitization. Therefore, if the securitization of federal accounts is to be feasible, it is necessary to evaluate *Octagon's* impact on future account transactions.

a. *the Tenth Circuit takes a narrow view of*
Uniform Commercial Code Article 9

In *Octagon*, the Tenth Circuit held that a "sold" account remains the property of the seller's bankruptcy estate and the "purchaser" of an account could never be more than a secured creditor.⁶⁶ The court reasoned that the policies underlying Uniform Commercial Code (UCC) Article 9 support its holding.⁶⁷ Referring to Official Comment 2 to UCC

58. 995 F.2d 948 (10th Cir.), *cert. denied*, 144 S. Ct. 554 (1993).

59. *Id.* at 957.

60. The subject of this dispute was a royalty interest and not an account receivable. The court determined that this interest was an account under Article 9. *Compare id.* at 954-55 with *id.* at 960 (Seth, J., dissenting) (asserting definition of "account" is not appropriate).

61. *Id.* at 955.

62. *Id.* at 956.

63. *Id.* at 955.

64. *See supra* part II.B.1.

65. *See* 11 U.S.C. § 541 (1988).

66. *Octagon*, 995 F.2d at 957 & n.9.

67. *Id.* at 956.

section 9-102, the court noted that "the distinction between a security transfer and sale is blurred, and a sale of such property is therefore covered by [9-102(1)(b)] whether intended for security or not."⁶⁸ Presumably to avoid "secret liens," the court concluded that the "buyer of an account is treated as a secured party, his interest in the account is treated as a security interest, the seller of the account is a debtor, and the account sold is treated as collateral."⁶⁹

It is questionable whether, as the court asserted, UCC section 9-102 intended to invalidate any transfer of title in the sale of an account. In laying out rules for its interpretation, the UCC emphasizes the importance of preserving freedom of contract.⁷⁰ While a contractual provision cannot destroy UCC-created rights,⁷¹ there seems to be no harm in allowing title to pass provided that an account purchaser takes title subject to superior Article 9 interests. In fact, this result may be preferable because, in the spirit of UCC section 1-102, it does no damage to a freely negotiated contract.⁷²

Arguably, Article 9 is less concerned with regulating title and more concerned with regulating security interests.⁷³ Professor Gilmore⁷⁴ explained that prior to the UCC, lenders could materially alter their rights depending upon whether they were described as a beneficiary or an assignee.⁷⁵ Since it did not make sense for a mere "label" to determine a lender's rights, Article 9 provided that, whether the lender "describes himself as assignee, third party beneficiary, Supreme Exalted Potentate, Lord of the Three Worlds or whatever,"⁷⁶ UCC rules apply if the transaction "creates a security interest."⁷⁷ A security interest was defined to include "any interest of a buyer of accounts or chattel paper,"⁷⁸ so that the "label" for a transaction could not defeat a previously arising right in such collateral. Allowing an account purchaser to take free of any previously arising interest simply because the account was "sold" invites

68. *Id.* at 955 (citing Official Comment 2 to OKLA. STAT. ANN. tit. 12A, § 9-102 (West Supp. 1993)) (emphasis omitted).

69. *Id.* at 954-55 (footnote omitted).

70. U.C.C. § 1-102 cmt. 2 (1990) ("Subsection (3) states affirmatively at the outset that freedom of contract is a principle of the Code . . .").

71. *Id.*

72. *Id.*

73. *Id.* § 9-101 cmt.

74. Professor Gilmore was the reporter for the Article 9 project. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY at x (1965).

75. See Grant Gilmore, *The Assignee of Contract Rights and His Precarious Security*, 74 YALE L.J. 217, 223-34 (1964) (discussing third party beneficiary "caper").

76. *Id.* at 226.

77. *Id.* at 227 (emphasis added).

78. U.C.C. § 1-201(37).

abuse.⁷⁹ Therefore, even a purchaser of an account should be required to comply with Article 9.⁸⁰

However, while section 9-202 states that title to collateral is immaterial,⁸¹ that does not mean that title is immaterial for all purposes. In fact, the Official Comment to section 9-101 states that

[t]his Article does not determine whether "title" to collateral is in the secured party or in the debtor and adopts neither a "title theory" nor a "lien theory" of security interests. Rights, obligations and remedies under the Article do not depend on the location of title (Section 9-202). *The location of title may become important for other purposes . . . and in such a case the parties are left free to contract as they will.*⁸²

Furthermore, the Official Comment to section 9-202, the section that expressly notes title as "immaterial," acknowledges that

[Article 9] in no way determines which line of interpretation . . . should be followed in cases where the applicability of some other rule of law depends upon who has title. . . . [T]his Article does not attempt to define whether the secured party is a "legal" owner Other rules of law or the agreement of the parties determine the location of "title" for such purposes.⁸³

While Article 9 may be indifferent to title, that Article does not oppose a transfer of title. For example, assume that Article 9 *intended* to invalidate the transfer of title. If one *attempted* to sell an account to secure a debt, then the "seller" would retain any surplus between the value of the account and the associated debt. The "seller" retains the surplus because the account was never really "sold." UCC section 9-502(2), however, operates in exactly the opposite manner. It states that "if the underlying transaction was a *sale* of accounts,"⁸⁴ it is presumed that the debtor does not have any rights to the surplus.⁸⁵ Here, the UCC expressly acknowledges the possibility of a sale and creates a unique re-

79. Rimmer argued that because the account was "sold," the bankruptcy estate could not have an interest in the account because the account did not belong to the seller. *Octagon*, 995 F.2d at 955.

80. Alternatively, the circuit court could have achieved the same result by leaving title to the account with Rimmer and making his unperfected interest subject to the interests of the bankruptcy estate.

81. *See* U.C.C. § 9-202 (stating provisions of Article 9 apply whether secured party or debtor holds title).

82. *Id.* § 9-101 cmt. (emphasis added).

83. *Id.* § 9-202 cmt.

84. *Id.* § 9-502(2) (emphasis added).

85. *Id.*

sult to accommodate a sale.⁸⁶ This distinction would not be necessary if Article 9 invalidated sales.⁸⁷ Official Comment 4 to section 9-502 justifies this result on the grounds of "freedom of contract"⁸⁸ and "recognizes that there may be a true sale of accounts."⁸⁹

Thus, there is a compelling alternative to the Tenth Circuit's conclusion that Article 9 invalidates the sale of an account. The UCC's policy to preserve freedom of contract, its acknowledgement that title may matter outside Article 9's scope of determining priorities, its admission that Article 9 does not decide matters of title, and the express recognition within Article 9 that a true sale of accounts could exist suggest that the legal sale of an account is possible but that the purchaser takes title subject to previously perfected interests.

b. Octagon takes a broad view of the bankruptcy estate

Under *Octagon*, an account "seller" retains a property interest in the account⁹⁰ because Article 9 does not provide for a transfer of title. Accordingly, the Tenth Circuit concluded that the sale of an account does not "place that account beyond the reach of the bankruptcy trustee"⁹¹ because the property of the bankruptcy estate includes "all legal or equitable interests of the debtor in property."⁹² In doing so, the court does not limit the reach of the bankruptcy trustee, allowing the trustee to recover property without regard to the nature of the debtor's interest. *Octagon*, therefore, places assets within reach of the bankruptcy trustee even if the debtor does not have an economic interest in the asset.⁹³

To support this position, the court relied heavily upon *United States v. Whiting Pools, Inc.*⁹⁴ *Whiting Pools*, however, did not deal with the sale of an account but rather with a situation in which a creditor took possession of property to satisfy a lien.⁹⁵ The debtor never alienated this property and the property otherwise would have been available to reha-

86. See also *Major's Furniture Mart v. Castle Credit Corp.*, 602 F.2d 538, 543-46 (3d Cir. 1979) (acknowledging possibility of account sale and describing attributes of sale).

87. Alternatively, Article 9 would be redefining the term "sale" as a bundle of rights that does not include the transfer of title. Why not call this a security interest? See U.C.C. § 1-201(37).

88. *Id.* § 9-502 cmt. 4.

89. *Id.*

90. See *Octagon*, 995 F.2d at 956.

91. *Id.*

92. 11 U.S.C. § 541(a)(1) (1988).

93. *Octagon*, 995 F.2d at 956.

94. 462 U.S. 198 (1983).

95. *Id.* at 199-200.

bilitate the debtor.⁹⁶ It held that a trustee can prevent either a secured or unsecured creditor from seizing a debtor's assets.⁹⁷ In that same opinion, the Court explained that Congress did not intend to include in the bankruptcy estate "property of others in which the debtor had some minor interest such as a lien or bare legal title."⁹⁸ There is no authority for the trustee to take property in which the debtor does not have a real economic interest⁹⁹ and the bankruptcy estate cannot create an interest that was never there.¹⁰⁰ Even if the sale of an account does not qualify as a true sale, that account, contrary to *Octagon*, might not become property of the estate because the seller would not retain an economic interest in the sold account.¹⁰¹

3. Securitization after *Octagon*

Although *Octagon* threatens securitization, there is reason to believe that this decision should not weigh heavily on a properly structured transaction. Notably, rating agencies¹⁰² have downplayed the decision: Standard & Poors believes that the decision is "inconsistent with the purpose and intent of the UCC";¹⁰³ Fitch Investor Service calls it "contrary to existing precedent and unlikely to be followed";¹⁰⁴ and Duff & Phelps suggests the case was wrongly decided.¹⁰⁵ With the exception of transactions that take place in the Tenth Circuit, the rating agencies have not made material changes to their ratings requirements.¹⁰⁶

96. *Id.* at 201.

97. *Id.* at 203-04.

98. *Id.* at 204 n.8.

99. *Id.* at 206 n.12 (stating no turnover required when "property is of inconsequential value or benefit to the estate"); see also *In re Paoella*, 79 B.R. 607, 609-10 (Bankr. E.D. Pa. 1987) (stating property should be abandoned if estate lacks equity).

100. See *Belisle v. Plunkett*, 877 F.2d 512, 516 (7th Cir.) (indicating estate only gets what debtor could convey), *cert. denied*, 493 U.S. 893 (1989); *Vineyard v. McKenzie (In re Quality Holstein Leasing)*, 752 F.2d 1009, 1013 (5th Cir. 1985) ("Congress did not mean to authorize a bankruptcy estate to benefit from property that the debtor did not own").

101. *National Bank v. Erickson (In re Seaway Express Corp.)*, 912 F.2d 1125, 1127-28 (9th Cir. 1990) (equitable interests held by others are excluded from property of estate).

102. See *Secondary Market Hearings*, *supra* note 19, at 149 (Moody's Investors Service discussion of ratings).

103. *Rating Agencies Assess Consequences of Octagon Decision*, ASSET SALES REP. (American Banker, Inc., New York, N.Y.), Sept. 27, 1993, at 10.

104. *Id.* at 11.

105. *Id.*

106. *Rating Agencies Downplay Ruling*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Oct. 4, 1993, at 4.

The volume of securitized offerings¹⁰⁷ subsequent to the *Octagon* decision indicates that issuers and investors have also chosen to downplay the decision.¹⁰⁸ Since *Octagon* was decided, such well-known names as American Express, Chrysler, Citicorp, Ford Credit, First Chicago, General Motors, John Deere, Mitsubishi, and Toyota have come to market with over \$5.5 billion in auto loan-backed and \$7.6 billion in credit card receivable-backed offerings.¹⁰⁹ In short, it appears that *Octagon* has not chilled the flow of offerings within its reach.¹¹⁰

107. This is reflected in the volume of trade receivable, credit card receivable, and auto loan offerings since *Octagon* was decided. See *infra* note 109. *Octagon* impacts transactions governed by Article 9. See *supra* part II.B.2.a. Trade receivable and credit card receivable offerings are, by definition, account transactions under Article 9. See U.C.C. § 9-102(1)(a) (1990). Auto loans, which would be considered chattel paper, are also treated like an account under UCC Article 9. See *id.* §§ 9-105(1)(b), 9-102(b).

108. This may have been influenced by the availability of ratings. Ratings directly affect the pricing and marketability of securities. See FRANKEL, *supra* note 21, §§ 9.16-17.

109. See *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), July 19, 1993, at 10 (Ford Credit—\$1.1 billion in auto loans); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Aug. 23, 1993, at 7-8 (First Chicago—\$700 million in credit card receivables; MBNA—\$750 million in credit card receivables; Toyota—\$467 million in auto loans); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Aug. 30, 1993, at 9 (Citicorp—almost \$800 million in credit card receivables); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Sept. 6, 1993, at 10 (USAA—over \$200 million in auto loans); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Sept. 13, 1993, at 8 (Household Affinity Credit Card Trust—\$900 million in credit card receivables); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Sept. 20, 1993, at 8 (American Express—\$600 million in credit card receivables; GMAC—\$1.3 billion in auto loans; Chrysler—more than \$1 billion in auto loans); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Oct. 4, 1993, at 8 (Signet—over \$1 billion in credit card receivables); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Oct. 11, 1993, at 9 (John Deere—over \$600 million in equipment loans); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Oct. 18, 1993, at 9-10 (First USA—\$1.25 billion in credit card receivables; Mitsubishi Motors—almost \$350 million in auto loans); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Oct. 25, 1993, at 7 (Capital Auto Receivables Asset Trust—roughly \$1.3 billion in auto loans); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Nov. 8, 1993, at 11 (Navistar—over \$300 million in truck receivables); *Financing Record*, BONDWEEK (Institutional Investor, Inc., New York, N.Y.), Nov. 22, 1993, at 8-9 (Advanta Credit Card Master Trust—\$400 million in credit card receivables; Dean Witter—almost \$1.2 billion in Discover card receivables).

110. See, e.g., *Slight Increase Predicted in Asset-Backed Issuance*, ASSET SALES REP. (American Banker, Inc., New York, N.Y.), Dec. 27, 1993, at 3 (noting that market increased 20% over 1993 and was expected to grow through 1994).

This does not mean, however, that *Octagon* should be ignored.¹¹¹ Despite an apparent conflict between the circuits,¹¹² the Supreme Court has denied a petition for certiorari on this issue.¹¹³ The decision is good law in the Tenth Circuit and it might influence courts in other jurisdictions. Therefore, investors and rating agencies will probably be taking a closer look at the credit strength of securitization sponsors.¹¹⁴ If the sponsor does not seek bankruptcy protection, *Octagon* is not an issue. As a result, without halting securitization, *Octagon* may have increased the importance of a sponsor's credit to future deals. If so, the decision has dampened smaller and less creditworthy organizations' ability to access this market.

C. Securitization Has Risks

To review, securitization is a financing technique that uses the cash flow generated by a segregated pool of assets to create marketable securities. Asset cash flow is the primary source of repayment for these securities, and investors are attracted to the expected reliability of the underlying assets' cash flow. Although securitization is supposed to minimize the investor's risk of loss, investors are still exposed to analytical, business, and legal risks.

First, investors face the risk that the statistical methods used to measure cash flow reliability are not a reliable barometer of future change.¹¹⁵ Second, investors have exposure to the financial health of the originator and the servicer. To the extent the originator's financial health fails,¹¹⁶ there may be an incentive to reduce credit standards in favor of achieving sales objectives. As the servicer's health declines,¹¹⁷

111. See Paul E. Weber & R. Kenneth MacCallum, *Rating Agencies Offer Response to Octagon*, N.Y. L.J., Oct. 12, 1993, at 11 (acknowledging securitization may be uneconomical or impossible in Tenth Circuit); *Issuers Begin to Disclose 'Octagon' Decision in Prospectuses*, ASSET SALES REP. (American Banker, Inc., New York, N.Y.), Sept. 27, 1993, at 3 (observing issuers likely to disclose potential consequences due to *Octagon* in all ABS prospectuses).

112. See *In re Contractor's Equip. Supply Co.*, 861 F.2d 241 (9th Cir. 1988) (distinguishing between sales and security interests in account transactions); *Major's Furniture Mart v. Castle Credit Corp.*, 602 F.2d 538 (3d Cir. 1979) (recognizing sale with recourse may not convert to security interest).

113. *Octagon Gas Systems, Inc. v. Rimmer*, 126 L. Ed. 2d 455 (1993).

114. See Weber & MacCallum, *supra* note 111.

115. See *supra* note 40 and accompanying text.

116. See *Secondary Market Hearings*, *supra* note 19, at 162-64 (Moody's Investors Services materials) (acknowledging third party risks in credit card and trade receivables programs).

117. *Id.* at 174-75. In many transactions, investors have the right to replace the servicer. See, e.g., *id.* at 293 (MBNA credit card prospectus) (discussing servicer default). It is questionable whether this right has any practical significance. See Liebowitz, *supra* note 15, at 18-19 (discussing servicing risk).

staff reductions or reorganizations might distract from collection activities. Furthermore, account obligors might withhold payment if they perceive that either the originator or servicer has suffered a financial setback.¹¹⁸ Finally, there is some legal risk in account securitization. Recalling that a true sale to a BRE would provide protection against a third party's bankruptcy,¹¹⁹ there is no way to guarantee the legal sale of an account¹²⁰ and the Tenth Circuit has directly attacked the proposition that a true sale could exist.¹²¹

In short, while securitization is supposed to compensate investors against risk, these transactions involve business, legal and, to some extent, cash flow risks that cannot be measured with mathematical accuracy. It is, therefore, impossible to know whether the level of credit enhancement accompanying a securitized transaction has adequately provided for these contingencies. Because securitization continues in volume, however, it appears that investors have some tolerance to less than perfect protection. Investors may be willing to accept these risks because the businesses that securitize receivables are familiar to them and that familiarity underlies a subjective assessment of safety.¹²² Therefore, to the extent that investors can develop a subjective comfort with the government contracting industry, they should be receptive to a security backed by federal accounts receivable, provided that the sale of those accounts is not otherwise prohibited by law.

III. THE ASSIGNMENT OF CLAIMS ACT

A. Background

As a first step in securitizing federal accounts receivable, a contractor would sell its government receivables to a BRE. There is, however, a long standing policy against recognizing the transfer of claims against the

118. This might occur because the obligor either perceives an opportunity to negotiate a discount or has concerns about ongoing contract obligations—that is, future shipments and warranty obligations.

119. See *supra* notes 47-48 and accompanying text.

120. See *supra* note 54 and accompanying text. While beyond the scope of this Comment, it should be noted that there is no guarantee that a court would consider the entity purchasing assets a BRE. The legal determination that an entity is a BRE is also a balancing test. See Schwarcz, *supra* note 21, at 616.

121. See *supra* part II.B.2.

122. This is not to say that investment in securitized instruments is reckless. On the contrary, investors' familiarity with the nature of the commonly securitized receivables allows them to make a very rational, subjective evaluation. See, e.g., Schwarcz, *supra* note 21, at 611 (making subjective evaluation of risks related to sale of goods and services).

federal government.¹²³ This policy¹²⁴ is designed to protect the government from secret assignment arrangements, to prevent possible multiple claims,¹²⁵ and to block parties from accumulating claims which would enable them to exert undue influence over government.¹²⁶ Accordingly, an assignment of a claim against the federal government is presumed invalid.¹²⁷

There is an exception to the antiassignment rule. During World War II, defense contractors were having difficulty financing the projects they had undertaken in support of the war effort.¹²⁸ While the government could have provided direct funding to contractors, Congress passed legislation to induce private parties to finance contractors who supplied goods and services to the government.¹²⁹ The Assignment of Claims Act of 1940 (ACA)¹³⁰ helped government contractors finance their operations by allowing them to assign federal payment obligations to a "financing institution" to secure funding.¹³¹ By lifting the government's ban on assignments, the ACA opened the door to using federal payables as a means of inducing investors to finance government contracts.¹³²

B. *A Valid Assignment Meets Express and Implied Requirements*

1. Express requirements

To qualify as a valid assignment under the ACA, the transfer must meet express and implied requirements. The express requirements are fairly straightforward. The federal receivable must be (1) part of an obligation where total payments exceed \$1000; (2) assigned to a "financing institution"; and (3) made to only one person, or a single party acting as

123. This policy was traced to "an act to define the Pay and Emoluments of certain Officers of the Army, and for other Purposes. Act of July 17, 1986, ch. 200, § 14, 12 Stat. 594." Vincent J. Belusko, Note, *Government Contracts—Assignments—Federal Contracting Officer Possesses the Requisite Authority to Waive the Requirements of the Anti-Assignment Act*, 41 U.S.C. § 15, and to Bind the Government to an Assignment of a Federal Contract—Tuftco v. United States, 614 F.2d 740 (Ct. Cl. 1980), 49 GEO. WASH. L. REV. 167, 170 n.22 (1980). See generally Schooner & Schooner, *supra* note 5, at 537-39 (providing background on antiassignment policy).

124. See 31 U.S.C. § 3727 (1988); 41 U.S.C. § 15 (1988).

125. American Nat'l Bank & Trust Co. v. United States, 22 Cl. Ct. 7, 14-15 (1990).

126. United States v. Shannon, 342 U.S. 288, 291 (1952).

127. 31 U.S.C. § 3727.

128. Gilmore, *supra* note 75, at 218.

129. *Id.*

130. Ch. 779, 54 Stat. 1029 § 1 (amending antiassignment provisions of 31 U.S.C. § 203 (recodified as 31 U.S.C. § 3727) and 41 U.S.C. § 15).

131. The ACA amended the antiassignment provisions of existing law to permit assignments to financing institutions. See 31 U.S.C. § 3727(c); 41 U.S.C. § 15.

132. See Gilmore, *supra* note 75, at 218.

trustee for a group "participating in the transaction."¹³³ To comply with the express provisions of the ACA, the assignee only has to provide notice to certain parties,¹³⁴ and the assignment is perfected upon government's receipt of proper notice.¹³⁵ Because government requires strict adherence to these requirements,¹³⁶ there are concerns about compliance and at least one writer suggests that the notice requirement is impractical for commercial transactions.¹³⁷ Notice, however, is a mechanical procedure that is spelled out in federal regulations.¹³⁸ The ACA has always required notice and financial institutions—with some exceptions—have managed to comply.

133. 31 U.S.C. § 3727(a) provides that the prohibition against the assignment of claims is lifted where the assignment is made to

a financing institution of money due or to become due under a contract providing for payments totalling at least \$1,000 when—

- (1) the contract does not forbid an assignment;
- (2) unless the contract expressly provides otherwise, the assignment—
 - (A) is for the entire amount not already paid;
 - (B) is made to only one party, except that it may be made to a party as agent or trustee for more than one party participating in the financing; and
 - (C) may not be reassigned; and
- (3) the assignee files a written notice of the assignment and a copy of the assignment with the contracting official or the head of the agency, the surety on a bond on the contract, and any disbursing official for the contract.

31 U.S.C. § 3727 (1988). Similarly, 41 U.S.C. § 15 lifts the prohibition on the assignment of contracts where

the moneys due or to become due from the United States or from any agency or department thereof, under a contract providing for payments aggregating \$1,000 or more, are assigned to a bank, trust company, or other financing institution, including any Federal lending agency: *Provided*,

1. That in the case of any contract entered into prior to October 9, 1940, no claim shall be assigned without the consent of the head of the department or agency concerned;
2. That in the case of any contract entered into after October 9, 1940, no claim shall be assigned if it arises under a contract which forbids such assignment;
3. That unless otherwise expressly permitted by such contract any such assignment shall cover all amounts payable under such contract and not already paid, shall not be made to more than one party, and shall not be subject to further assignment, except that any such assignment may be made to one party as agent or trustee for two or more parties participating in such financing;
4. That in the event of any such assignment, the assignee thereof shall file written notice of the assignment together with a true copy of the instrument of assignment with (a) the contracting officer or the head of his department of agency; (b) the surety or sureties upon the bond or bonds, if any, in connection with such contract; and (c) the disbursing officer, if any, designated in such contract to make payment.

41 U.S.C. § 15.

134. See 31 U.S.C. § 3727(c)(3); 41 U.S.C. § 15(4).

135. *Reliance Ins. Co. v. United States*, 15 Cl. Ct. 62, 66 (1988).

136. See *Schooner & Schooner*, *supra* note 5, at 544.

137. See Reade H. Ryan, Jr., *Trade Receivables Purchases—A Primer* 41 (Feb. 4, 1993) (unpublished manuscript, on file with *Loyola of Los Angeles Law Review*).

138. See 48 C.F.R. § 32.805 (1992) (providing procedure for assignment).

Significantly, the government cannot reject a properly completed assignment.¹³⁹ As the Court of Claims stated in *Produce Factors Corp. v. United States*:¹⁴⁰

If an assignment permitted by the [ACA] is executed by the parties, and notice given the Government, as required by the terms of the [ACA], nothing in the law suggests that the Government could arbitrarily refuse the assignment. Such action would be in derogation of the obvious intent of Congress that the [ACA] serve as a vehicle to encourage private financing of Government contracts.¹⁴¹

Therefore, strict adherence with the ACA's requirements is rewarded by an unconditional recognition of an assignment.

2. Implied requirements

In addition to its express provisions, the ACA includes the implied requirement that the proceeds of an ACA financing are used to complete work on government contracts.¹⁴² Although one writer describes this requirement as "a club in a closet . . . used as another reason not to pay a contractor the government really doesn't want to pay,"¹⁴³ the restriction is not unreasonable. The purpose of the ACA is to finance government contracts with private capital.¹⁴⁴ Suppose that a contractor uses the proceeds of a loan obtained under a government assignment for a nongovernment project. Having expended those funds, the contractor may not have sufficient funding to complete the government contract.¹⁴⁵ This defeats the purpose of the ACA.¹⁴⁶ Accordingly, some restrictions on the use of proceeds are appropriate.

139. *Produce Factors Corp. v. United States*, 467 F.2d 1343, 1351 (Ct. Cl. 1972).

140. *Id.*

141. *Id.*

142. *American Nat'l Bank & Trust Co. v. United States*, 22 Cl. Ct. 7, 16-17 (1990); *Manufacturers Hanover Trust Co. v. United States*, 590 F.2d 893, 896-97 (Ct. Cl. 1978); *First Nat'l City Bank v. United States*, 548 F.2d 928, 934 (Ct. Cl. 1977).

143. Joseph H. Levie, *Assignee's Rights to Proceeds of Government Contracts*, N.Y. L.J., May 2, 1991, at 6. Notably, Mr. Levie represented the plaintiff in *First National City Bank*, 548 F.2d at 931. The plaintiff's claim was rejected because it did not meet the use-of-proceeds requirement. *Id.* at 935.

144. *Produce Factors Corp.*, 467 F.2d at 1348; *Coleman v. United States*, 158 Ct. Cl. 490, 496 (1962).

145. See *American Nat'l Bank & Trust Co.*, 22 Cl. Ct. at 10.

146. This explanation for the limitation on the use of proceeds is consistent with the Court of Claims in *Coleman*, 158 Ct. Cl. at 496 ("The [ACA] was designed to make funds available to a contractor with which he could complete his government contract. If the loan is used for another purpose, the objectives of the [ACA] are not satisfied."). Cf. *First Nat'l City Bank*,

In *First National City Bank v. United States*,¹⁴⁷ the Court of Claims restricted the ACA to a financing that "was used, or was available for use," in the contract that gave rise to the assignment.¹⁴⁸ It added that the "statutory concept is that of financing a specific government contract, not of the financing of government contracts in general or across-the-board, or the financing of all of a contractor's contracts as a lump."¹⁴⁹ This holding seems to impose the very restrictive requirement that the funding obtained through the assignment of receivables may only be used to complete the contract that gave rise to those receivables. If a contractor held multiple government contracts, it seems that the contractor would be required to enter into separate financing transactions for each contract or, at a minimum, be required to trace the flow of funding from each assignment to a specific contract. In practice, however, this requirement has been loosely construed to facilitate pooled financings such as revolving credit agreements as long as proceeds are applied to complete government work.¹⁵⁰

What happens, however, if the contractor misappropriates proceeds without the financial institution's knowledge? The Court of Claims, in *Coleman v. United States*,¹⁵¹ while emphasizing that financings under the ACA should be used to complete government contracts, stated that

if lending institutions know that the validity of an assignment turns upon the use to which the funds are put, they would, to say the least, be reluctant to rely upon the security of contract assignments. We note, therefore, that if the loans are made directly to a contractor by a financial institution, the use to which the funds are put will not defeat the validity of the assignment.¹⁵²

Accordingly, a financing institution will not be penalized for a contractor's misapplication of funds unless the financial institution "had reason

548 F.2d at 934-35 (attributing use requirement to "participating in such financing" language found in ACA).

147. 548 F.2d at 928.

148. *Id.* at 934.

149. *Id.*

150. See *Continental Bank & Trust Co. v. United States*, 416 F.2d 1296, 1301 (Ct. Cl. 1969) (citing 97 CONG. REC. 4350 (1951)) (allowing use of "pools" for revolving credit facilities). Notably, blanket assignments used to secure lines of credit without a showing that financing proceeds would be used for government work have been held invalid. See *Environmental Protection Agency*, 68 Comp. Gen. 216, 217-18 (1989).

151. 158 Ct. Cl. at 490.

152. *Id.* at 496.

to know in advance that the loan proceeds could not be used in completing [government contracts].”¹⁵³

This reason-to-know standard prohibits the assignment of receivables under completed contracts.¹⁵⁴ Stated simply, if the underlying contract has been completed, the lender has reason to know that the proceeds of a subsequent financing could not be used to complete that contract.¹⁵⁵ Therefore, an assignment under a completed contract may be rendered invalid.¹⁵⁶ Even though the court in *First National City Bank* accepted the proposition that loans do not have to be tied to specific contracts,¹⁵⁷ the Comptroller General has definitively stated that “if the proceeds of the loan secured by the assignment were not used *or available for use* by the assignor *in performing the contract that was assigned*”¹⁵⁸ the assignment would be invalid.¹⁵⁹ Thus, the assignment of a receivable under a completed contract will not be valid.

This absolute bar to making a valid assignment under a completed contract makes an ACA financing appear backwards. In financing accounts receivable, a commercial enterprise generally assigns its receivables *after* a contract has been completed. The ACA, on the other hand, requires that receivables must be assigned *before* the contract has been completed. While this does not prevent the assignment for financing purposes,¹⁶⁰ it may raise some additional concern about the assignor’s ability to perform. If the contractor does not perform, the obligor may not have an obligation to pay.

153. *First Nat’l City Bank*, 548 F.2d at 928. Although an assignee could appoint a “disbursing agent” to monitor the flow of funding, this is probably an unnecessary expense. See *Central Bank v. United States*, 345 U.S. 639, 647 (1953) (stating assignee should not be required to police assignor’s accounting and payment systems).

154. *First Nat’l City Bank*, 548 F.2d at 935.

155. Notably, an assignment that is perfected prior to contract completion remains valid subsequent to completion. *Continental Bank & Trust Co.*, 416 F.2d at 1302.

156. See Reconsideration of 60 Comp. Gen. 510 (1981) Involving Set-Off Authority of Government When Contract Contains a “No Set-Off Clause,” 62 Comp. Gen. 683, 687 (1983) (holding assignment made after contract fully performed should make lender aware that money will not be applied to performance of contract); cf. *Bamco Mach., Inc.*, 55 Comp. Gen. 155, 157 (1975) (invalidating assignment completed after contractor ceased operations).

157. 548 F.2d at 935.

158. 62 Comp. Gen. at 688-89 (emphasis added).

159. *Id.*

160. Notably, the assignment of a receivable under an executory contract is not that unusual. Building contractors frequently assign receivables under executory contracts for working capital loans. Dan T. Coenen, *Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform*, 45 VAND. L. REV. 1061, 1068 & n.30 (1992). In practice, there seems to be little difference between the assignment of an account under an executory contract and the common practice of granting a security interest in receivables arising in the future. See *id.* at 1068 & n.31.

Finally, there is an issue as to whether a refinancing¹⁶¹ could satisfy the use-of-proceeds requirement. The Court of Claims invalidated an assignment used to refinance a contractor's debt without a showing of a direct benefit to a government project.¹⁶² This implies that the government should receive some benefit from a refinancing. The simple showing that a refinancing is intended to repay the debts incurred in funding a government contract, however, may satisfy this requirement.¹⁶³

C. Consequences of a Valid Assignment

*I began to think it was a curious kind of a government. It looked somewhat as if they wanted to get out of paying . . .*¹⁶⁴

1. Assignments under the ACA, like commercial assignments, are subject to setoff

Even if an assignment is properly completed, there is no guarantee that the account obligor will be legally obligated to pay the assignee. A contractor cannot use an assignment of its rights under contract to evade its obligations or liabilities under contract. Both the common law and the UCC protect an account debtor's payment defenses subsequent to an assignment and, as an overriding principle, the assignee cannot succeed to rights that are superior to those of the assignor.¹⁶⁵ Therefore, under both common law and the UCC, an assignee's rights to receive payments may be set off by claims that the obligor has against the assignor.¹⁶⁶

An assignee's claims against an assignor may come from two sources: circumstances related to the contract¹⁶⁷ and circumstances unrelated to the contract.¹⁶⁸ The obligor has the right to set off claims related to the contract at any time and has the right to set off any unrelated claims that "arise" or "accrue" prior to the assignment.¹⁶⁹ Notably, the obligor's right to setoff is not dependant upon having knowledge

161. A refinancing simply replaces existing financing with new funding.

162. *American Nat'l Bank & Trust Co. v. United States*, 22 Cl. Ct. 7, 16 (1980).

163. *Manufacturers Hanover Trust Co. v. United States*, 590 F.2d 893, 897-98 (Ct. Cl. 1978) (dictum).

164. *TWAIN*, *supra* note 1, at 42.

165. *Gilmore*, *supra* note 75, at 228. "[T]he assignee stands in the assignor's shoes." *Id.*

166. *Id.*; see U.C.C. § 9-318 cmt. 1 (1990).

167. The claim could be a fraud related to the contract or a performance issue.

168. This could be a performance issue on another contract, the settlement of a debt, a tort claim, et cetera.

169. See *Gilmore*, *supra* note 75, at 228-30. An exception exists when the account debtor waives its rights against the assignor. See U.C.C. § 9-206(1).

of a claim or providing the assignee with any notice at the time of the assignment.

Government, as an account obligor, has the same general rights to set off as any other account debtor.¹⁷⁰ The government can set off contract-related claims¹⁷¹ as well as unrelated claims if the "liability existed at the time notice of the assignment was received even though that liability had not yet matured so as to be due and payable."¹⁷² Government's setoff rights are intimidating because they extend to any government agency,¹⁷³ including the Internal Revenue Service (IRS).¹⁷⁴ As long as the liability existed at the time of the assignment, the assignee takes subject to the government's claim. For example, an assignee would take subject to an IRS claim that "existed" at the time of the assignment even if no tax lien has been filed,¹⁷⁵ no notice of assessment has been issued,¹⁷⁶ and the assignee had no knowledge of the claim.¹⁷⁷

170. *Schooner & Schooner*, *supra* note 5, at 548 ("As a general rule, the government possesses the same right as any other creditor to offset claims.") (footnote omitted); *see also* Priority between a Federal Tax Lien and an Assignment Under a Government Contract, 60 Comp. Gen. 510, 515 (1981) ("[U]nder our theory of the assignment . . . [assignor] cannot transfer a greater right against the government than he possessed at [the time of assignment].").

171. 31 U.S.C. § 3727(d)(2) (1988) (stating no-setoff protection does not include "an amount that may be collected or withheld under, or because the assignor does not comply with, the contract"); 41 U.S.C. § 15 (1988) (noting no-setoff protection "does not include amounts which may be collected or withheld from the assignor in accordance with or for failure to comply with the terms of the contract"); *see also* *Industrial Bank v. United States*, 424 F.2d 932, 935 (D.C. Cir. 1970) (stating assignee is not entitled to "funds if needed by the Government to complete the contract").

172. 48 C.F.R. § 32.803(e) (1992). This has been interpreted to be consistent with the common-law right to set off claims that "arise" as of the time of the assignment.

[G]overnment is entitled to set off against the [assignee] any of its claims against the [assignor] which had matured prior to the assignment. . . . However, under the common law applicable to assignments, debts of the assignor which mature after an assignment is made may not be set off against payments otherwise due the assignee. *Cascade Reforestation, Inc.*, 56 Comp. Gen. 499, 503 (1977).

173. Note that the drafters of the Code of Federal Regulations used the term "Government" and not "Agency." 48 C.F.R. 32.803(e). The government sees itself as a "unit" and the contractor is perceived as doing business with the entire government and not just a particular agency. 60 Comp. Gen. at 513.

174. *See, e.g.*, 56 Comp. Gen. at 503 (citing *South Side Bank & Trust Co. v. United States*, 221 F.2d 813, 814 (7th Cir. 1957)).

175. Arguably, a tax claim should only have priority if the tax lien was perfected prior to a filing that perfected the assignment. *See* U.C.C. § 9-301(1)(b).

176. An IRS claim may not arise until an assessment letter is posted because a tax lien does not arise before "demand." *See* I.R.C. § 6321 (1991). Formerly, the Comptroller General gave priority to a tax claim as of the date of the assessment letter. *See* 56 Comp. Gen. at 503.

177. 60 Comp. Gen. at 512-13.

2. Government, like a commercial obligor,
can waive its rights to setoff

As a practical matter, no asset-based financier wants exposure to an obligor's right to setoff. An open-ended setoff right makes an assigned asset impossible to value. Therefore, organizations that use their receivables to secure funding will typically get account debtors to waive their rights to assert defenses against the assignee.¹⁷⁸ Similarly, government contractors can protect assignees by obtaining a no-setoff commitment in their contracts.¹⁷⁹ The no-setoff commitment provides that the government cannot reduce its payment obligation for (1) any of the contractor's liabilities that arise independently of the contract and (2) selected liabilities that are contract-related.¹⁸⁰

Rather than stepping into the assignor's shoes, a no-setoff commitment improves an assignee's position relative to the assignor.¹⁸¹ For example, though federal law provides that "[a] claim against the United States shall be forfeited to the United States by any person who corruptly practices or attempts to practice any fraud against the United States,"¹⁸² a no-setoff commitment has protected the innocent assignee from the

178. See U.C.C. § 9-206 cmt. 1. An account debtor's agreement not to assert defenses against an assignee is not a waiver of its claims against the assignor.

179. 48 C.F.R. § 32.803(d).

180. This includes fines, penalties, fees, taxes, and withholding taxes. *Id.* § 32.804.

181. See *Franklin E. Penny Co. v. United States*, 524 F.2d 668, 679 (Ct. Cl. 1975) ("[T]his protection against a diminution in contract proceeds is a limited benefit and one that runs exclusively to the assignee."). With regard to specific protections, the Federal Acquisition Regulation provides

(a) No payments made by the Government to the assignee under any contract assigned in accordance with the [ACA] may be recovered on account of any liability of the contractor to the Government. This immunity of the assignee is effective whether the contractor's liability arises from or independently of the assigned contract.

(b) Except as provided in paragraph (c) below, the inclusion of a no-setoff commitment in an assigned contract entitles the assignee to receive contract payments free of reduction or setoff for—

(1) Any liability of the contractor to the Government arising independently of the contract; and

(2) Any of the following liabilities of the contractor to the Government arising from the assigned contract:

(i) Renegotiation under any statute or contract clause.

(ii) Fines.

(iii) Penalties, exclusive of amounts that may be collected or withheld from the contractor under, or for failure to comply with, the terms of the contract.

(iv) Taxes or social security contributions.

(v) Withholding or nonwithholding of taxes or social security contributions.

48 C.F.R. § 32.804 (1992).

182. 28 U.S.C. § 2514 (1988).

fraudulent acts of the assignor.¹⁸³ A no-setoff commitment also protects against federal tax claims.¹⁸⁴ In sharp contrast to contracts without a no-setoff commitment, even where an assignment takes place *after* a tax lien arises, the assignee's rights are not subject to setoff.¹⁸⁵ Under the plain language of the Federal Acquisition Regulation, this protection extends to any federal claim including those for withholding, wage underpayments, and pension obligations.¹⁸⁶

Because the government's no-setoff protection is limited with regard to performance-related claims,¹⁸⁷ it may appear that a private account debtor could offer an assignee greater protection through waiver. The UCC allows a party to waive "any claim or defense."¹⁸⁸ This difference, though, does not hold much practical significance. First, it is not entirely clear that the UCC intended to allow an obligor¹⁸⁹ to waive performance-related defenses under Article 2.¹⁹⁰ Second, individual jurisdictions may

183. *Chelsea Factors, Inc. v. United States*, 181 F. Supp. 685, 690 (Ct. Cl. 1960) ("We see no reason why a banker, or those for whom he acts in financing a Government contract, should forfeit their security because of fraudulent acts of another person in which they did not participate."); *see also* *United States v. Peoples Bank & Trust Co. (In re Gulf Apparel Corp.)*, 140 B.R. 593, 598 (M.D. Ga. 1992) (holding that fraud in inducement will not impair assignee's rights where contract has been properly performed). Even where a contract does not contain a no-setoff commitment, courts have been reluctant to set off against an innocent assignee. *See Arlington Trust Co. v. United States*, 100 F. Supp. 817, 819 (Ct. Cl. 1951) ("[W]e think it could not have been intended by Congress that the bank which loaned the money should take the risk that its collateral might, in an instant, be rendered worthless by the act of the contractor in committing fraud.").

184. 48 C.F.R. § 32.804(b)(2)(iv)-(v).

185. *Priority to Contract Proceeds*, 65 Comp. Gen. 554 (1986); *Reconsideration of 60 Comp. Gen. 510 (1981) Involving Set-Off Authority of Government When Contract Contains a "No Set-Off Clause,"* 62 Comp. Gen. 683 (1983); *cf. supra* notes 172-79 and accompanying text.

186. *See* 48 C.F.R. § 32.804(b)(1) (stating protection extends to "[a]ny liability of the contractor to the Government"). Nothing prevents the government from asserting its claim against the assignor.

187. *See* 48 C.F.R. § 32.804(b). Note that the regulation uses the term "loan." *Id.* § 32.804(c)(1). Since securitization is a sale of assets and not a loan, it is arguable that the securitized financings do not qualify for no-setoff protections. It appears, however, that this wording is merely an oversight as no-setoff protection is available to factoring transactions. *See* the general discussion *infra* part IV.A., noting that the ACA is not limited to lending transactions.

188. U.C.C. § 9-206(1).

189. The account obligor would be a buyer of goods. Although the UCC does not apply to the sale of services, U.C.C. § 9-318 does not materially change prior law. *Id.* § 9-319 cmt. 1.

190. *See* U.C.C. § 9-206 cmt. 3 ("[W]arranty rules for sales are applicable."). It would be unconscionable to obligate a purchaser to pay the purchase price of goods that were never delivered or for which performance was wholly unacceptable. *Contra id.* § 3-305 cmt. 2 (stating that buyer's fraud defense arising from nondelivery cannot be asserted against holder in due course). Even though the UCC protects the "holder in due course," plaintiffs have prevailed under a theory that the financing intermediary was "too intimately involved" in the

have legislation that invalidates such waivers.¹⁹¹ Third, it is unlikely that a sophisticated commercial purchaser would waive its defenses without a reasonable assurance of performance.¹⁹² For these reasons, the protections of a no-setoff commitment are, at a practical level, at least as good as the protections available under a commercial waiver. Given a no-setoff commitment's broad protection against government action, the assignee of a federal claim is arguably better off than its commercial counterpart.

No-setoff commitments should be available for a large number of contracts.¹⁹³ Although the ACA states that this protection is only available in time of war or national emergency,¹⁹⁴ the statute provides that a national emergency applies for all Department of Defense contracts¹⁹⁵ and the Federal Acquisition Regulation stipulates that "there should be special considerations to justify a determination that *exclusion* of a no-setoff commitment is in the Government's interest."¹⁹⁶ Therefore, there could be as much as \$150 billion of receivables with no-setoff protection generated annually.¹⁹⁷

In summary, government accounts receivable, like commercial and consumer receivables, are subject to setoff. Despite setoff, accounts receivable continue to be used to secure financings. While the assignment of government receivables raises some unique issues, there is reason to

transaction to be considered a mere holder in due course and, as a result, free of defenses or counterclaims. See Gilmore, *supra* note 75, at 231 n.29.

191. For example, before the adoption of the Commercial Code in California, state law invalidated any waiver of defense. See CAL. COM. CODE § 9206 cmt. 2 (West 1993). Admittedly, state law may focus on protecting consumers and leave commercial parties to negotiate as they will. See *id.*

192. Admittedly this assurance might be as simple as trusting in the assignor's business reputation.

193. No-setoff commitments have been used in purchase contracts for a wide variety of goods and services. See, e.g., *Fine Fashions, Inc. v. United States*, 328 F.2d 419, 422 (2d Cir. 1964) (involving Air Force nurses' uniforms); *First Nat'l City Bank v. United States*, 548 F.2d 928, 931 (Ct. Cl. 1977) (involving preparation and update of Navy technical manuals); *Franklin E. Penny Co. v. United States*, 524 F.2d 668, 671 (Ct. Cl. 1975) (involving shock mounts for Terrier missile containers); *Priority to Contract Proceeds*, 65 Comp. Gen. 554, 555 (1986) (involving construction of swimming pool for Army Corps of Engineers); *Reconsideration of 60 Comp. Gen. 510* (1981) Involving Set-Off Authority of Government When Contract Contains a "No Set-Off Clause," 62 Comp. Gen. 683 (1983) (involving trucking services for U.S. Army); *Bamco Machine, Inc.*, 55 Comp. Gen. 155 (1975) (involving 160 "air flasks" for U.S. Navy).

194. 31 U.S.C. § 3727(d) (1988); 41 U.S.C. § 15 (1988).

195. See 50 U.S.C. § 1651 (1988).

196. See 48 C.F.R. § 32.803(d) (emphasis added); see also 65 Comp. Gen. at 555 n.1 (stating no-setoff authorization was extended "because of its importance in financing government contracts").

197. See *supra* note 14 and accompanying text.

prefer transactions involving government accounts. Fundamentally, the government obligor will not default.

IV. FEDERAL ACCOUNTS RECEIVABLE CAN BE SECURITIZED

A. *Securitization, Like Factoring, Is an Acceptable Form of Financing Under the ACA*

The ACA was intended "to encourage the participation of banks in the financing of Government contractors."¹⁹⁸ General discussions of "financing" tend to focus on banks or lending¹⁹⁹ and this, in turn, suggests that the ACA might be narrowly tailored to facilitate bank lending. Even the Federal Acquisition Regulation refers to financing in the context of lending.²⁰⁰ Therefore, it might be assumed that the ACA only applies to bank lending and excludes other forms of financing.

Lending, however, is not the only way to finance government contracts. As opposed to taking a loan, a contractor can factor its accounts receivable. In factoring, a contractor sells its accounts to a third party, a "factor," in exchange for cash.²⁰¹ This can be distinguished from lending where accounts are pledged as collateral for a loan. Notably, government contractors have been factoring their accounts receivable since the ACA was enacted²⁰² and factoring is recognized as an acceptable form of financing under the ACA.²⁰³

Account securitization closely resembles factoring. Like factoring, securitization involves the purchase and assignment of accounts. The only real difference between the two techniques is the manner in which account purchases are funded.²⁰⁴ The factor already has the funding to purchase accounts whereas the BRE in securitization sells securities to

198. See *Schooner & Schooner*, *supra* note 5, at 539 (quoting S. REP. NO. 217, 82d Cong., 1st Sess. (1951), *reprinted in* 1951 U.S.C.C.A.N. 1414) (emphasis added).

199. See *id.* at 535-36 (discussing ACA in context of lending); Gilmore, *supra* note 75, at 218 (explaining origin of ACA in terms of banks and lending).

200. See, e.g., 48 C.F.R. § 32.804(c)(1) (1992) (stating no-setoff commitment does not extend to situations where assignee has not made a "loan").

201. See Coenen, *supra* note 160, at 1066 & n.19, 1067-68.

202. The ACA was enacted in October 1940 and as early as January 1941 the Comptroller General made it clear that factoring was an acceptable form of financing under the ACA. See 20 Comp. Gen. 415, 417-18 (1941) (discussing *Municipal Factors Co.*).

203. See *Scarborough v. Berkshire Fine Spinning Assocs.*, 128 F. Supp. 948, 951 (S.D.N.Y. 1955) ("The legislative history of the Federal Assignment of Claims Act shows that a factor is a financing agent within the meaning of the word as used in the [ACA]."); *Alanthus Peripherals, Inc.*, 54 Comp. Gen. 80, 83 (1974) (recognizing validity of financing "effected through the purchase and assignment of accounts receivable").

204. While Liebowitz, *supra* note 15, at 20, suggests that the factor always assumes servicing, this is not accurate. See Coenen, *supra* note 160, at 1066-68.

fund a specific purchase.²⁰⁵ Because these two forms of financing are so closely related, it has been suggested that the term "securitization" is only used to avoid the negative connotations of factoring.²⁰⁶ Given this close similarity, it appears that securitization, like factoring, would be an acceptable form of private financing, provided that a given transaction otherwise met the express and implied requirements of the ACA.

B. A Bankruptcy Remote Entity Can Be a "Financing Institution"

While securitization is, in concept, acceptable, a given transaction must still conform to the ACA's requirements. Under the ACA, a government claim must be assigned to a financing institution. Securitization requires that the assignment is made to a BRE.²⁰⁷ This raises the issue of whether a BRE can qualify as a financing institution. In defining a financing institution, the Comptroller General has said that

the term "financing institution" was not meant to include every business organization that might find it convenient or necessary in the course of its business dealings to extend credit Rather, a "financing institution" may be defined in a general way as an individual, partnership, or corporation dealing in money as distinguished from other commodities as a primary function of its business activity.²⁰⁸

Whether an entity meets the definition of a financing institution, therefore, is really determined by the function of that entity. An entity that extends credit in support of its sales operations may not qualify as a valid assignee.²⁰⁹ Though it "deals in money," its operation may be viewed as incidental to the manufacturing or distributing activities of its parent. This presents a hurdle to wholly owned finance subsidiaries of manufacturing corporations²¹⁰ if their financing activities are viewed as incidental to the manufacturing operation. This also presents a hurdle to leasing companies, which might be viewed as "equipment dealers" as op-

205. Given that the BRE's investors fund a *specific* purchase and the factor's investors fund the factor's purchases *generally*, it is questionable whether this difference is substantive.

206. See Liebowitz, *supra* note 15, at 20.

207. Issues such as taxes, credit enhancement, and management requirements will influence the choice of this vehicle.

208. Assignment of Contract Payments—Interpretation of Term "Financing Institution," 22 Comp. Gen. 44, 45-46 (1942).

209. *Id.* at 46.

210. It is hard to justify why a third-party factor can qualify as a financing institution while a wholly owned subsidiary could not. The profit that a factor extracts for its services could be used to reduce a manufacturer's costs. It appears that this distinction actually costs the government money.

posed to “money dealers.”²¹¹ In fact, with limited exceptions, leasing companies would not qualify as financing institutions.²¹²

Although there are some obstacles to having a BRE qualify as a financing institution, these obstacles are not insurmountable. Principally, the BRE should be formed as an independent organization and not as an instrument of a parent organization. Provided that the BRE is an independently owned organization, which sells no merchandise and holds itself out to the public as being in the business of extending credit, it is likely that the BRE will qualify.²¹³

C. *Investors, Individually, Do Not Have to Be “Financing Institutions”*

It is clear that the ACA allows multiple party financings, but it is questionable whether investors, who hold the BRE’s securities, must also qualify as “financing institutions.” While the ACA prohibits multiple assignments, it permits assignments to a single party acting as a trustee or agent for a number of parties participating in the financing.²¹⁴ Therefore, following the model for securitization,²¹⁵ federal accounts receivable could be sold to a BRE, which would fund the purchase by selling securities to a large number of investors.

The ACA is not clear, however, as to whether the “parties participating in the financing”²¹⁶ also need to be “financing institutions.” The Comptroller General has, however, validated an assignment of federal lease payments to a bank acting as a trustee for bondholders.²¹⁷ Noting that ineligible assignees could not evade the ACA by designating a bank

211. The Comptroller General does not view “leasing” as equivalent to “financing.” See *Sanco Leasing Corp.*, 1991 U.S. Comp. Gen. LEXIS 1549, at *5 (noting *Sanco* listed “leasing” as its primary business purpose and not “financing”).

212. *Compare id.* (leasing subsidiary is not financial institution) with *Alanthus Peripherals, Inc.* 54 Comp. Gen. 80, 84 (1974) (allowing leasing company to qualify as financing institution because rapid product obsolescence in computer peripheral industry does not favor government purchasing such equipment). Notably, the Comptroller General may have been more willing to recognize the assignment in *Alanthus* since the arrangement was perceived to contribute to the performance of the government contract. 54 Comp. Gen. at 83.

213. *Id.* (distinguishing case from 20 Comp. Gen. 415 (1941)). Naturally, the structure of a BRE must be consistent with other requirements of law. For instance, it might be desirable to select a trust as a BRE because trusts are expressly recognized as a financing institution under the ACA. See, e.g., 41 U.S.C. § 15 (1988). Even so, it would be important for the trust to qualify as a business trust as opposed to a collateral trust because only a business trust could become a debtor under the Bankruptcy Code. See 11 U.S.C. § 101(9)(B)(v) (1988); *In re Secured Equipment Trust of Eastern Airlines*, 153 B.R. 409 (Bankr. S.D.N.Y. 1993).

214. 31 U.S.C. § 3727(a)(2)(B) (1988); 41 U.S.C. § 15(3) (1988).

215. See *supra* part II.A.1.

216. These would be investors in a securitized transaction.

217. See *Birmingham Trust National Bank*, 52 Comp. Gen. 462, 465 (1973).

trustee, the Comptroller General has explained that when the beneficiaries acted as a group to provide financing to a government project, they would be a financing institution under the ACA.²¹⁸ Similarly, investors who purchase securities backed by federal assignments would not need to qualify as financing institutions provided that the investors, as a group, acted to finance a government project.²¹⁹

D. *Securitization Is Consistent with the ACA*

It cannot be said that the ACA contemplated the securitization of federal accounts receivable. The ACA became effective in 1940,²²⁰ and securitization did not become popular until *the federal government promoted* the development of mortgage-backed securities in the 1970s.²²¹ The ACA's text, however, is not limited to financing techniques that were popular in 1940 and the ACA is not limited to lending transactions. Securitized offerings, like factoring transactions, can be structured to conform with the express and implied requirements of the ACA.

Securitization is also consistent with the principles behind the ACA. The Supreme Court has noted that "the [ACA] should be construed so as to carry out the purpose of Congress to encourage the private financing of government contracts."²²² Securitization invites the participation of a broad field of private investors. The Court of Claims has interpreted the ACA as "intend[ing] to facilitate the financing of Government contracts by private capital in the way in which private capital normally operates in financing the country's economy."²²³ Given that government is already a large presence in the securitization market and it continues to develop programs that endorse the use of securitization,²²⁴ it is hard to

218. *Id.*; Russel, 50 Comp. Gen. 613 (1971).

219. Furthermore, it would not appear that secondary market trading of securitized interests would violate the prohibition against multiple assignments. First, in securitization, there is only one assignment—from the contractor to the bankruptcy remote entity. Second, 52 Comp. Gen. 462 expressly authorized the assignment to a bank as trustee for bondholders. Bonds are negotiable, so the Comptroller General's validation of this assignment implies that secondary market trading would not be a violation of the prohibition on multiple assignments.

220. See *supra* note 133 and accompanying text.

221. Schwarcz, *supra* note 21, at 609.

222. *Central Bank v. United States*, 345 U.S. 639, 646 (1953).

223. *Continental Bank & Trust Co. v. United States*, 416 F.2d 1296, 1302 (Ct. Cl. 1969) (quoting *Chelsea Factors, Inc.*, 181 F. Supp. 685, 690 (Ct. Cl. 1960)).

224. The Federal Home Loan Mortgage Corporation and the Government National Mortgage Association either issue or provide guarantees for a large volume of securitized offerings. FIRST BOSTON, HANDBOOK OF SECURITIES OF THE UNITED STATES GOVERNMENT & FEDERAL AGENCIES & RELATED MONEY MARKET INSTRUMENTS 92 (34th ed. 1990). Notably, there has been considerable legislative attention paid to creating a federally sponsored agency to securitize small business loans. See *Legislative Proposals to Facilitate the Small Business*

believe that Congress intended to penalize contractors by prohibiting them from taking advantage of this widely-used financing tool.²²⁵ Fundamentally, the ACA is not intended to penalize contractors for doing business with the federal government.²²⁶

V. FAST-BACKS DO REQUIRE THOUGHTFUL STRUCTURING

Although the ACA permits securitization of federal accounts receivable, compliance with the ACA will not guarantee an investment market for FAsT-BackS. To promote the marketability of FAsT-BackS, issuers need to immunize investors against the risks that are inherent in these transactions.

A. *Not All Federal Accounts Receivable Are Created Equal: Setoff Impacts Investment Quality*

While it is appealing to think of FAsT-BackS as federally-backed securities, setoff implies that a government receivable is only as good as the performance of the contracting party. This makes the contractor, and not the account obligor, the primary source of risk in FAsT-BackS. The degree to which investors are impacted by the contractor's performance is determined by the terms of the contract that govern the assignment. There is less risk in a contract with a no-setoff commitment than there is in a contract that does not contain a no-setoff commitment.²²⁷ While the presence or absence of a no-setoff commitment might not be the only factor in deciding whether a transaction is feasible,²²⁸ it should be an important consideration in structuring transactions.

For example, although assignments arising from contracts that contain no-setoff commitments offer the greatest legal protection, the right to

Loan Incentive Act of 1993: Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, 103d Cong., 1st Sess. 119 (1993) [hereinafter Proposals] (Statement of Patricia A. Jehle); S. REP. NO. 169, 103d Cong., 1st Sess. 2 (1993) (encouraging securitization of small business loans).

225. Securitization has been called "one of the most significant financial innovations of the last twenty years." Shenker & Colleta, *supra* note 18, at 1371 & n.4 (listing multiple sources in support of this statement).

226. *Central Bank v. United States*, 345 U.S. 639, 643 (1953).

227. A discussion of setoff appears *supra* part III.C.1.-2.

228. For example, compliance with the ACA is not an absolute prerequisite to securitizing federal accounts because disputes between private parties would be determined under state law. The drawback for noncompliance, however, is that the federal government will not recognize a noncomplying assignment. Therefore, the assignee's right to receive payment will bear a higher degree of bankruptcy and setoff risk. While noncomplying assignments may not be ideal, a transaction could be feasible if the assignor-contractor had financial health, a good reputation for performance, and the transaction compensated investors for this subjective risk through either a higher level of credit enhancement or a higher investment yield.

collect on that receivable is still subject to the performance risks related to the underlying contract. Notwithstanding the fact that a contract to provide an advanced weapons system to the Air Force would carry no-setoff protection, it might be more desirable to securitize receivables arising from a contract to provide pink erasers to the General Accounting Office which does not have setoff protection. The lower level of performance risk attributable to the delivery of pink erasers could compensate for the lack of setoff protection. Naturally, contracts which have both low performance risk and setoff protection—for example, providing drab green t-shirts to the Army—would be the most attractive candidates for securitization. Consequently, as an issuer considers securitizing federal accounts receivable, it should balance considerations such as the setoff protections offered by the contract, the contractor's financial health, the contractor's reputation for performance, and the difficulty in performing the underlying contract to arrive at an appropriate structure.

In considering how transactions may be brought to market, it seems that FAsT-BackS, like any other receivables transaction, could be structured as a note or commercial paper program.²²⁹ A given program could accommodate single or multiple sellers of receivables.²³⁰ Due to the unique issues impacting FAsT-BackS, however, it may be preferable to develop multiple seller programs, structuring FAsT-BackS with pools of receivables purchased from several contractors. A "conduit," representing multiple sellers and multiple contracts, reduces performance risks through diversification.²³¹

Aside from diversification, there are other advantages to a multiple seller program. Instead of being controlled by a single contractor, a conduit would be organized and administered by a third-party sponsor.²³² Given that these transactions are sophisticated, an independent, third-party sponsor would increase investor confidence in the due diligence, asset selection, and structuring process. Furthermore, an independently owned financing conduit appears to be more like a "financing institution"²³³ as defined by the ACA. For these reasons, a multiple seller con-

229. *Secondary Market Hearings*, *supra* note 19, at 164.

230. *Id.*

231. For example, if a pool of receivables represents multiple contracts, the transaction is less dependant upon an individual contract within that pool. Given that the top 200 government contractors share \$80 billion of purchases, *Top 200 Government Contractors*, GOVERNMENT EXECUTIVE, Aug. 1993, available in LEXIS, News Library, Curnws File, it appears that the industry is sufficiently diversified to support a conduit program.

232. A third-party sponsor would be responsible for organizing and administering the securitization program on behalf of several originators.

233. See *supra* part IV.B.

duit may be more attractive than a single issuer program because the conduit's operation hedges against FAsT-BackS inherent risks.

B. Competing Priorities Could Be Determined Under Federal or State Law; The Assignee Protects Itself By Perfecting Under Both

1. The ACA does not determine disputes between private parties

Compliance with the ACA does not guarantee the assignee's rights against other parties. The ACA is for the convenience of the government.²³⁴ "Its focus is not on the perfection of liens and security interests, but rather the establishment of procedural requirements of assignees planning to assert claims against the government."²³⁵ Thus, an assignee must still comply with state law to ensure that its interest in purchased receivables will be valid against private third parties.²³⁶ Federal accounts receivable should be accounts under the UCC because they represent a "right to payment for goods sold or leased or for services rendered . . . whether or not it has been earned by performance."²³⁷ Consequently, to protect the assignee against private interests, a securitization of federal obligations should comply with UCC Article 9.²³⁸

2. State law may not always determine priorities between private parties

Where a priority dispute involving a federal receivable is strictly between private parties, state law will probably govern.²³⁹ If, on the other hand, a dispute involves the government, there is no guarantee that state law will apply.²⁴⁰ The Comptroller General has taken the position that

234. See *Schooner & Schooner*, *supra* note 5, at 548.

235. *In re Robert E. Derecktor, Inc.*, 142 B.R. 29 (Bankr. D.R.I. 1992).

236. *Cf.* Priority between a Federal Tax Lien and an Assignment under a Government Contract, 60 Comp. Gen. 510, 513 (1981) ("The Comptroller General does not express any position on whether the assignment of a claim under a Government contract should be viewed as perfected without filing in accordance with State law when the dispute only involves competing private claims.").

237. U.C.C. § 9-106 (1990).

238. Note that UCC § 9-104(a) states that Article 9 does not apply "to [an] interest subject to any statute of the United States, to the extent that such statute governs the rights of parties to and third parties affected by transactions in particular types of property." *Id.* § 9-104(a). Taken literally, Article 9 should *not* apply. However, Official Comment 1 to UCC § 9-104 explains that the UCC should not apply to the extent that federal statute governs: "Thus if the federal statute contained no relevant provision, [Article 9] could be looked to for an answer." *Id.* cmt. 1.

239. *In re Palmetto Pump & Irrigation, Inc.*, 81 B.R. 109, 112 (Bankr. M.D. Fla. 1987).

240. See *Ambassador Factors, Div. Fleet Factors Corp. v. First Am. Bulk Carrier Corp.* (*In re Topgallant Lines, Inc.*), 125 B.R. 682, 688-91 (Bankr. S.D. Ga. 1991) (discussing applicability of state law under different levels of federal involvement).

the provisions of the UCC are preempted by the ACA as far as the government is concerned.²⁴¹ "If the contracting agency is bound to acknowledge the assignment, a sister agency may not disavow it."²⁴² Even if an assignee fails to perfect a claim under state law, a properly completed assignment will continue to be valid against any government agency.²⁴³

The split between applying state and federal rules creates priority problems when a dispute involves both private parties and the government. Suppose that an assignee of a federal account under a no-setoff commitment properly complies with the ACA but does not perfect its interest under state law. Consider the priority conflict when a tax lien arises prior to the assignment and some other creditor obtains a perfected interest in the accounts subsequent to the assignment. Under state law, the tax lien would have priority under the general first-in-time principle. Under the ACA, however, the assignee has priority because the assignment is valid against the government. On the other hand, the creditor should prevail because it perfected its interest under state law and the assignee did not. Still, it was already decided that the government's tax lien was superior to the creditor's lien. Who should win? If the ACA does not decide the dispute between the assignee and the creditor, the creditor will prevail at the government's expense. In the absence of a clear governing doctrine,²⁴⁴ it is hard to tell when government's interest in the outcome will be strong enough to warrant the setting aside of state-created priorities.

An interesting question also arises as to whether the ACA determines the rights between private parties under bankruptcy proceedings. As Congress controls both the right to assign claims and bankruptcy adjudication, it seems that bankruptcy courts should protect the federal assignee against private creditors²⁴⁵ even if the assignee has not perfected its interest under state law. In *Cascade Reforestation, Inc.*,²⁴⁶ the Comptroller General stated that where "the assignee has filed its assignment . . . in accordance with the Assignment of Claims Act . . . it will have perfected the assignment to the extent that the assignment cannot be at-

241. 60 Comp. Gen. at 513.

242. *Id.*

243. *Id.*

244. Rather than "giving up" its position, perhaps courts should preserve government's position for the benefit of the assignee in the same way that the Bankruptcy Code preserves an avoidable lien for the benefit of the bankruptcy estate. See 11 U.S.C. § 551 (1988).

245. Naturally, the bankruptcy court could still avoid the transfer if it was a preference. See 11 U.S.C. § 547.

246. 56 Comp. Gen. 499 (1977).

tached by the trustee in bankruptcy."²⁴⁷ The Comptroller General, however, relied on *Scarborough v. Berkshire Fine Spinning Associates*²⁴⁸ to reach that decision. Although the *Scarborough* court suggested that an ACA filing was sufficient to protect against a bankruptcy trustee, New York did not require filing to perfect the assignment of an account receivable at that time.²⁴⁹ Moreover, federal bankruptcy power must be distinguished from "the adjudication of state-created private rights."²⁵⁰ Given that the ACA is not supposed to determine priorities between private parties,²⁵¹ it also seems reasonable that the ACA should not be given greater weight in a bankruptcy forum. Again, without a clear doctrine, it is difficult to say when federal rules will govern.

3. Government may not recognize the assignment

A valid assignment must meet the ACA's express and implied requirements. While the government cannot reject a properly completed assignment,²⁵² there is always some risk that the government will contest the validity of an assignment.²⁵³ An assignment's validity impacts investors in two ways. First, an invalid assignment will not carry any protections of the ACA.²⁵⁴ Without ACA protection, there is greater risk that the receivable will be set off against other obligations. Second, if the government determines that an assignment is invalid, it will continue to pay the assignor. As long as the assignor takes possession of these payments, the investor has increased exposure to the assignor's bankruptcy. While there may be little that an assignee can do to protect against the loss of the ACA's protection,²⁵⁵ the assignee can, at minimum, protect its inter-

247. *Id.* at 503-04.

248. 128 F. Supp. 948 (S.D.N.Y. 1955).

249. *Id.* at 951.

250. *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 71 (1982).

251. *See supra* note 235 and accompanying text.

252. *Produce Factors Corp. v. United States*, 467 F.2d 1343, 1351 (Ct. Cl. 1972).

253. *See, e.g., supra* note 143 and accompanying text.

254. *Manufacturers Hanover Trust Co. v. United States*, 590 F.2d 893, 897 (Ct. Cl. 1978).

255. The potential loss of statutory protection may be less troublesome to an assignment-based lender because a lender may take other recourse. In securitization, however, the underlying accounts are being sold. Recourse is not suited to securitization because it makes the transaction look more like a loan and less like a true sale. *See supra* note 55 and accompanying text. Although the presence of recourse does not preclude a legal sale, *see Major's Furniture Mart v. Castle Credit Corp.*, 602 F.2d 538, 544 (3d Cir. 1979), it also makes investors more reliant on the seller's credit instead of the asset's credit. It would be impractical to substitute a different form of credit enhancement for seller recourse because it is impossible to value an appropriate level of enhancement for unforeseeable claims. *See supra* notes 28-29 and accompanying text. Therefore, the securitization of federal accounts receivable might be restricted to transactions involving issuers whose financial health and reputation for performance limit performance-related concerns. This may not be a particularly burdensome constraint

est subject to government claims and defenses. By perfecting its interest under state law, the assignee protects its interest in the funds that the assignor receives.²⁵⁶

Summarizing, it is possible that a priority dispute involving a federal receivable will be determined under state law because the government found reason to invalidate the assignment.²⁵⁷ Additionally, if a priority dispute is between private parties, there is a "good chance" that the dispute will also be determined under state law.²⁵⁸ Therefore, in structuring financing transactions, even though perfection under the ACA protects an assignment against the government, the assignee maximizes its protection by perfecting the assignment under both the ACA and state law.²⁵⁹

C. A Properly Structured Fast-BackS Offering Would Be Competitive with Commercial and Consumer Receivable-Backed Offerings

1. Federal accounts receivable are suitable for securitization

The government has an interest in protecting its relationship with private industry because it needs a source of goods and services to perform its functions. Contractors do business with the government because there is an opportunity for profit. Although federal agencies may be "notoriously slow payers,"²⁶⁰ they eventually pay their bills. If government did not pay, there would not be a government contracting industry. Given that the assignment of federal accounts receivable has been used to secure funding for the past fifty years,²⁶¹ it appears that federal accounts are valuable assets.²⁶²

because account securitization, as a technique, is already sensitive to an issuer's and servicer's credit and performance characteristics. See *supra* notes 43-44, 114, 116-18 and accompanying text.

256. This circumstance is similar to the situation faced by an intended assignee when a court determines that the proposed sale of an account does not qualify as a true sale. See *supra* part II.B.1.

257. Reconsideration of 60 Comp. Gen. 510 (1981) Involving Set-Off Authority of Government When Contract Contains a "No Set-Off Clause," 62 Comp. Gen. 683, 686 (1983).

258. See *Arthur Pew Constr. Co. v. Lipscomb*, 965 F.2d 1559, 1576 (11th Cir. 1992).

259. See *Freeman v. Ritner*, 489 F.2d 431, 433 (9th Cir. 1973). Notably, these results are not dramatically different from commercial and consumer securitization transactions which are perfected under state law in the event that the underlying assignment does not qualify as a true sale. See *Secondary Market Hearings*, *supra* note 19, at 262 (MBNA credit card prospectus).

260. *Fraser*, *supra* note 6, at 43.

261. See 41 U.S.C. § 15(2) (1988) (stating effective date).

262. Apparently, this practice predates the use of assignments in commercial finance. Professor Gilmore credits the ACA for popularizing assignment-based financings in private industry. Gilmore, *supra* note 75, at 218.

In addition to being valuable assets, the assignment of a federal account receivable favors true sale treatment.²⁶³ Noting that there is no way to guarantee that a legal sale has occurred,²⁶⁴ government has always interpreted the “assignment of a claim on a Government contract as an outright and absolute sale of all of the assignor’s rights and property interest under the contract, and not as a more limited transfer of a security interest.”²⁶⁵ Although the ACA leaves the adjudication of rights between private parties to state law,²⁶⁶ the state should have relatively small interest in who possesses title provided that the transfer is perfected under state law. The federal government, however, does have an interest in protecting the true sale characterization since it facilitates the financing of government contracts. Therefore, government’s interest in encouraging private financing should support treating the assignment of an account under the ACA as a true sale and it may make such a characterization possible in spite of a state law prohibition. In short, federal accounts receivable are not only valuable assets, but they may be particularly suited to securitization because the assignment of a federal account favors true sale treatment.²⁶⁷

2. Credit risks associated with FAsT-BackS are comparable to commercial and consumer offerings

Unlike other forms of securitization, there is no borrower risk for FAsT-BackS because the government will not default.²⁶⁸ In this regard, FAsT-BackS have an advantage over other transactions because commercial entities and consumers can default.²⁶⁹ Still, there is an important distinction to be drawn between a federally backed security and a federal *assignment-backed* security. Federal securities are a direct obligation, whereas FAsT-BackS represent account obligations. Direct obligations are unconditional whereas account obligations are subject to payment defenses. These defenses arise from the contractor’s failure to perform.

263. A true sale to a BRE provides the primary source of bankruptcy protection in securitized transactions. *See supra* part II.B.1.

264. *See supra* note 54 and accompanying text.

265. Priority between a Federal Tax Lien and Assignment Under a Government Contract, 60 Comp. Gen. 510, 513 (1981).

266. *See supra* part V.B.1.

267. It might also be mentioned that the standardization of government contracts as a result of the Federal Acquisition Regulation would also facilitate asset servicing.

268. STIGUM, *supra* note 2, at 38.

269. While default risks are supposed to be “diversified” away, there is no guarantee. *See Secondary Market Hearings, supra* note 19, at 263 (MBNA credit card prospectus) (explaining that social, legal, and economic factors may alter payment patterns).

Therefore, in FAsT-BackS transactions, it is the contractor—the account seller and not the account obligor—that is the key source of risk.

Seller-related risks, however, are common to all assignment-based financings.²⁷⁰ Investors in commercial and consumer receivables securitization have exposure to the ongoing operations of the originator and servicer,²⁷¹ and their rights to receive payment can be diminished through either setoff²⁷² or a variety of statutory protections.²⁷³ Commercial and consumer securitization offerings are feasible because investors subjectively accept these risks as being remote.²⁷⁴ While there may be some additional concern over seller risk in FAsT-BackS transactions because the receivable is assigned *prior* to contract completion, careful structuring can minimize this concern. First, all federal receivables are not created equal and the careful selection of receivables can minimize performance-related problems.²⁷⁵ Second, the securitization may be restricted to contractors who have good financial health and a reputation for performance.²⁷⁶ Third, while the issuer must assign the receivable prior to *contract* completion, the issuer might delay the assignment until the *work associated with that receivable* has been performed. Fourth, investors should have fewer concerns about performance because the ACA requires financing proceeds to be applied to contract completion.²⁷⁷ In short, to the extent that FAsT-BackS offerings protect investors against seller risks, they should be comparable to commercial or consumer receivable transactions. Indeed, FAsT-BackS may be more attractive because the ultimate obligor—the United States government—is not subject to default.

270. It is questionable whether FAsT-BackS have greater performance risk relative to other receivable-backed transactions. Even so, it is arguable that even a marginally greater performance risk in FAsT-BackS would be offset by the absence of credit exposure to the borrower.

271. See *supra* part II.C.

272. See *supra* part III.C.1.

273. A detailed discussion of these risks is beyond the scope of this Comment. As an example, however, consider credit card securitization where investors have exposure to consumer protection laws. See, e.g., *Secondary Market Hearings*, *supra* note 19, at 262. Additionally, if a bank originated the securitized accounts, investors would also face the possibility of having their interest subordinated under federal banking laws. *Id.*

274. See *supra* note 122 and accompanying text.

275. See *supra* part V.A.

276. This may not be a particularly burdensome constraint because account securitization, as a technique, is already sensitive to an issuer's and servicer's credit and performance characteristics. See *supra* notes 43-44, 114, 116-18 and accompanying text.

277. See *supra* note 154 and accompanying text. Note that if the purchasing agency is doing its job, the government would have established that the contractor is capable of performing *before* entering into the contract. To some degree, the government is screening the contractor on behalf of investors.

D. If FAsT-BackS Are a Good Idea, Why Are No Deals Being Done?

Alexander Pope once cautioned his readers:

Be not the first by whom the new is tried

Nor yet the last to lay the old aside.

*With respect to [investment] practices, the first piece of advice is, on the whole, sounder than the second.*²⁷⁸

The ACA permits the securitization of federal accounts receivable. Federal accounts are valuable assets and suited to securitization. Given that securitization is a widely accepted form of financing, it is troublesome that a FAsT-BackS market has not already developed.

1. The DynCorp transaction

There has been only one reported transaction involving the securitization of federal payment obligations.²⁷⁹ In December 1991, DynCorp²⁸⁰ circled²⁸¹ a \$100 million offering that was privately placed by the investment banking firm of Donaldson, Lufkin and Jenrette.²⁸² Because the transaction was privately placed, there is limited information on the terms of that offering.²⁸³ However, it was reported that *most* of the underlying receivable pool represented billables to the United States government for work *completed*²⁸⁴ on military maintenance contracts.²⁸⁵ The notes were expected to be rated "single-A."²⁸⁶ The financing was structured as a note program with a five-and-one-half-year maturity,²⁸⁷ so it may be assumed that the program was designed to reinvest collected receivables to carry the program to term. Though a company official stated that the transaction was "not technically"²⁸⁸ part of a refinancing,

278. Gilmore, *supra* note 75, at 260.

279. Search of LEXIS, News Library, Curnws and Arcnws Files (Feb. 5, 1994) (search for record containing "government" and "receivables" and "securitization").

280. DynCorp, a provider of aircraft-related maintenance and consulting services, was ranked as the 164th largest domestic private company in 1993. *The 400 Largest Private Companies in the U.S.*, FORBES, Dec. 6, 1993, at 170, 190.

281. To "circle" an offering is to line up investors. See Michael Liebowitz, *DLJ Circles Structured Deal Backed by Trade Receivables*, INVESTMENT DEALER'S DIG., Dec. 9, 1991, at 15.

282. *Id.*

283. *Id.* A private placement is exempt from registration under § 4(2) of the Securities Act of 1933. 15 U.S.C. § 77(d) (1988).

284. Liebowitz, *supra* note 281.

285. *Id.* The other portion of the receivables represented work on corporate contracts. *Id.*

286. *Id.*

287. *Id.*

288. *Id.*

it was reportedly related to the company's \$261.9 million leveraged buyout.²⁸⁹

According to the *Investment Dealer's Digest*, the deal was tough to place.²⁹⁰ Reportedly, investors were concerned with (1) the government's right to setoff and (2) the possibility that the government would not recognize the assignment.²⁹¹ It is not, however, immediately clear why investors should have been concerned about setoff. Because these were military contracts, the receivables should have benefitted from no-setoff protection. As long as the underlying assignments were valid, no-setoff protection would have prevented tax setoffs.²⁹²

Investors' concerns may have stemmed from a perception that the government could challenge the validity of the DynCorp assignments. Principally, the ACA requires a contractor to apply refinancing proceeds to completing its government contracts.²⁹³ In DynCorp's circumstance, the financing may have been too closely related to the company's leveraged buyout. Moreover, by pooling government accounts with commercial receivables, it might be easier to characterize the transfers as a "blanket" or "lump" assignment as opposed to a financing that is tied to funding government projects.²⁹⁴ Finally, since DynCorp apparently owned the BRE, it might not qualify as a "financing institution."²⁹⁵ While these observations are speculative, these issues may have created uncertainty in the minds of investors. In financial terms, uncertainty translates to risk. Accordingly, investors who were unfamiliar with both government accounts receivable and the contracting industry may have been discouraged from participating.

2. The future for FAsT-BackS

Despite reported difficulties in selling the deal, the DynCorp transaction is a very positive signal. DynCorp, a single-B rated issuer,²⁹⁶ was able to use its accounts receivable to obtain funding at a single-A²⁹⁷ rate

289. *Id.*

290. See Liebowitz, *supra* note 15, at 14.

291. *Id.* at 19-20.

292. See *supra* part III.C.2.

293. It is assumed that when the company assigned receivables on *completed work* it was not assigning receivables on *completed contracts*, which, on its own, would render the assignment invalid. See *supra* part III.B.2.

294. See *supra* notes 149-51 and accompanying text.

295. See *supra* notes 212-16 and accompanying text.

296. Steve Quickel, *The ABS Market Catches a Second Wind*, INSTITUTIONAL INVESTOR, Dec. 1993, special sponsored section at 3.

297. Liebowitz, *supra* note 281.

of interest.²⁹⁸ This improvement in credit quality translated into roughly a three percent²⁹⁹ savings in the interest rate that DynCorp would otherwise have paid for financing, a cash savings of approximately three million dollars per year.³⁰⁰ Investors were also rewarded; it appears that the investment has performed.³⁰¹ While future transactions might be more accommodating of the financing institution and use-of-proceeds requirements, the DynCorp transaction proves that the concept works.

It is, however, troublesome that two years have passed since the DynCorp transaction closed and there have been no reported subsequent transactions.³⁰² The absence of a FAsT-BackS market may reflect investor reluctance to participate in any transaction that allows a sometimes arbitrary government to delay or offset payments. If investors can be shown that the contracting industry is sound, they should be receptive to FAsT-BackS. After all, if investors will purchase "grocery-backed bonds,"³⁰³ they should be willing to invest in government receivables.³⁰⁴

While a FAsT-BackS market has yet to emerge, the rise in commercial receivables transactions suggests that a market is forthcoming. In fact, it was recently announced that a company has been formed for the express purpose of purchasing and securitizing federal receivables.³⁰⁵

298. As noted earlier, securitization is particularly attractive when the underlying assets merit a higher credit rating than the selling organization. *See supra* note 10 and accompanying text.

299. Quickel, *supra* note 296.

300. Considering that DynCorp earned eight million dollars in 1993, a three million dollar savings is significant. *See The 400 Largest Private Companies in the U.S.*, *supra* note 280.

301. There are no reports of any problems with this transaction. Search of LEXIS, News Library, Curnws and Arcnws Files (Jan. 22, 1994) (search for record containing "DynCorp").

302. It was reported that DLJ attempted to market another transaction involving federal accounts receivable for Wang Laboratories in June 1992. *See Michael Liebowitz, DLJ Shops Wang Receivables in Private Market Attempt*, INVESTMENT DEALER'S DIG., June 1, 1992, at 11. A search of the LEXIS database does not confirm that such a transaction closed. Search of LEXIS, News Library, Curnws and Arcnws Files (Jan. 22, 1994) (search for record containing "Wang").

303. *See supra* notes 33-35 and accompanying text.

304. Although this Comment recognizes federal account securitization as a unique market, it is interesting to note that DLJ commingled, or planned to commingle, federal receivables with commercial receivables in both the DynCorp and proposed Wang transactions. This suggests that DLJ either (1) does not distinguish federal accounts as a unique market, (2) believes that commingling improves transaction marketability, or (3) could not accumulate a sufficient volume of receivables to merit a separate federal offering.

305. Pearlstein & Knight, *supra* note 6, at A13. Although it is reported that, as of August 1993, the company, Federal National Payable, Inc., has purchased \$20 million of receivables, there is no evidence that it has placed a securitized offering. *Id.* It is interesting to note that in purchasing the receivables, the company is planning to hold back 20% of the receivable's value as credit enhancement in addition to charging an interest rate that is several points above prime. *Id.* Intuitively, this appears to be a fairly "rich" deal. Therefore, one can assume that the company is targeting smaller contractors who are having difficulty in obtaining funding.

New players are bound to follow. Notably, the specialization associated with government contracting suggests that some organizations have a unique advantage in sponsoring FAsT-BackS programs. While banks with experience in lending against government receivables are an obvious choice,³⁰⁶ nonbank financial companies with experience in securitization and government contracting—General Electric, Chrysler, Westinghouse—are uniquely suited to developing programs.³⁰⁷ Presently, the challenge is to develop a benchmark structure for FAsT-BackS transactions to drive future issuances and develop a trading market for these securities.

VI. GOVERNMENT SHOULD PROMOTE THE SECURITIZATION OF FEDERAL ACCOUNTS RECEIVABLE

A. *Securitization Saves Money*

Government does not borrow from banks or other financial intermediaries.³⁰⁸ As a “default-free” borrower,³⁰⁹ it borrows less expensively through the direct sale of treasury securities in the capital markets.³¹⁰ Why, then, does government insist upon borrowing through its suppliers? Government’s obligation to pay for its purchases is a form of borrowing.³¹¹ Given its borrowing power, supplier-credit is an inefficient source of funding—particularly when government does business with smaller or less creditworthy suppliers. Although the cost of this borrowing may be hidden in the price of the goods and services purchased,³¹² government still pays these costs and they can be “shockingly high.”³¹³ Because government agencies are “notoriously slow pay-

306. A lender might even consider securitizing its portfolio of loans secured by government accounts receivable.

307. See, e.g., Pearlstein & Knight, *supra* note 6, at A12 (“The second-largest lender in the country is . . . a division of General Electric . . .”). These nonbank financial companies would be ideal as sponsors or providers of credit enhancement programs.

308. Financial intermediaries include banks, insurance companies, and other credit providers. See STIGUM, *supra* note 2, at 15.

309. *Id.* at 38.

310. This explains why corporate securities are priced as a “spread” over the government yield curve. See MOODY’S BOND RECORD, *supra* note 10, at 620 (referring to graph of “spread” between corporate composite rate and long term Treasury securities since 1946).

311. See RICHARD D. LEHMBECK, SUCCESSFUL CASH MANAGEMENT IN YOUR BUSINESS 150-51 (1984).

312. *Id.* at 152 (stating “vendor has undoubtedly built a financing factor into the price”).

313. Chelsea Factors, Inc. v. United States, 181 F. Supp. 685, 693 (Ct. Cl. 1960).

ers,³¹⁴ interest costs add up. The government, like a commercial enterprise, should examine whether this use of credit is cost-effective.³¹⁵

While federal payment practices merit examination,³¹⁶ there is a quick way for government to realize lower implied³¹⁷ interest costs. As long as securitization provides the contractor with savings, the contract bidding process is likely to return some portion of those savings to the federal government. Assuming that the contracting process is competitive, a contractor will use some portion of its cost savings to make itself more attractive relative to other bidders. Therefore, the government benefits from account securitization because it shares in a contractor's interest savings through lower acquisition costs.

B. Securitization Supports the Prompt Payment Act

Under the Prompt Payment Act (PPA),³¹⁸ Congress provided government agencies with incentives to pay invoices in a timely fashion.³¹⁹ The PPA requires agency heads to implement policies to "foster prompt payment to contractors" and to adopt procedures consistent with that policy.³²⁰ To the extent that agencies fail to complete payment, they are required to pay interest penalties.³²¹

Although securitization is not a perfect substitute for payment, a contractor may view the sale of an account receivable as roughly equivalent to payment.³²² From this perspective, promoting the use of securitization may be a more effective means of carrying out the objectives of the PPA. Government agencies are not profit-oriented organizations and may be insensitive to the cost penalties implied by the PPA. As a result, the PPA may have mandated interest penalties without effecting a significant change in payment delinquencies. By promoting the wider use of securitization, market forces will promote the prompt return of capital to government contractors.

There is, however, a more compelling argument favoring securitization. Under the PPA, the government pays the Renegotiation Board In-

314. Fraser, *supra* note 6, at 43.

315. LEHMBECK, *supra* note 311, at 152.

316. Consider the discussion of the Prompt Payment Act, *infra* part VI.B.

317. Financing costs are "implied" in the price of goods and services.

318. 31 U.S.C. § 3901 (1988).

319. Schooner & Schooner, *supra* note 5, at 536.

320. 48 C.F.R. § 32.904 (1992).

321. 48 C.F.R. §§ 32.903, 52.232-25(a)(3), 52.25(a)(5)-(6) (1992).

322. Once the contractor has received cash and the account receivable is off its books, it has no reason to be concerned about whether or not the government has paid.

terest Rate on delinquent accounts.³²³ This rate is calculated "by taking into consideration current private commercial rates of interest for new loans maturing in approximately five years."³²⁴ This obligates the government to pay a relatively high rate of interest. For example, the Renegotiation Board Interest Rate for the period July 1993 to December 1993 was set at 5.63.³²⁵ In early July, the rate on a three month Treasury bill was 3.07% and the rate on a *ten year* Treasury note was 5.83%.³²⁶ In other words, the government committed itself to pay Treasury bond rates on what was essentially a short-term obligation. In short, economic efficiency suggests that government should pay a rate of interest that more closely approximates the period of time that government, in essence, borrows the money. By establishing a program to directly reimburse contractors for their costs of securitization, contractors would obtain a prompt return of capital and government would dramatically reduce its interest expense.³²⁷

323. 41 U.S.C. § 611 (1988); *Schooner & Schooner*, *supra* note 5, at 564 & n.193. While the Renegotiation Board was terminated in 1979 pursuant to Pub. L. No. 95-431, § 501, 92 Stat. 1043 (1978), the Renegotiation Board rate of interest continues to be published since several agencies are required to use interest rates that are determined under these criteria. *See Renegotiation Board Interest Rate*, 58 Fed. Reg. 36,511, 36,511-12 (1993).

324. Pub. L. No. 92-41, § 2 (a)(3), 85 Stat. 97 (1971).

325. *Renegotiation Board Interest Rate*, 58 Fed. Reg. 36,511, 36,511-12.

326. *Key Interest Rates*, WALL ST. J., July 27, 1993, at C20. The Renegotiation Board Interest Rate was also high relative to commercial borrowings. *Id.* During that same period, 90 day commercial paper was priced at 3.19% and six month certificates of deposit were priced at 3.35%. *Id.*

327. There are several creative ways in which government could develop a program. By leaving the securitization of federal receivables completely in private hands, government could simply reimburse contractors for verified financing costs. Alternatively, the government might sponsor its own financing conduit. The difficulty with government sponsorship, however, is that to the extent government guarantees the receivable-backed securities, it insures the contractor's performance for investors. While investors would undoubtedly find this attractive, a government guarantee reduces the effectiveness of government's payment defenses. To balance government protections against investment marketability, government might choose to guarantee the payment of interest but not the payment of principal on sponsored securities.

A government-assisted program might be most appropriate to facilitate securitization by smaller contractors that, for several reasons, would have greater difficulty in making use of securitization. This would help fulfill one of the ACA's statutory objectives which is "to broaden the base of competitive bidders to include small companies." *See Schooner & Schooner*, *supra* note 5, at 539 (quoting *Continental Bank & Trust Co. v. United States*, 416 F.2d 1296, 1299 (Ct. Cl. 1969) (citing H.R. REP. No. 2925, 76th Cong., 3d Sess. 2 (1940))). Notably, recent legislative proposals to foster capital formation for small businesses through loan securitization missed the opportunity to address the unique needs of the small government contractor. *See Proposals*, *supra* note 224.

C. *There Is Room for Government Action*

Government can save money though the securitization of federal accounts receivable. The potential savings³²⁸ is an incentive to take action. To promote securitization and maximize savings, government should take steps to make FAsT-BackS more marketable.

1. Minimize the difference between FAsT-BackS and government securities

Minimizing the difference between FAsT-BackS and federal securities would improve marketability. Accordingly, FAsT-BackS would be priced more closely to federal securities and there would be a corresponding reduction in interest costs. As the cost of FAsT-BackS decline, the incentive to securitize would increase. As contractors securitize to realize lower interest costs, government would realize some reduction in purchasing costs.

Minimizing the difference between FAsT-BackS and government securities can be accomplished by extending the setoff protections on account obligations. By shifting performance risk from the investor to government, FAsT-BackS look more like a direct obligation. Short of removing all setoff defenses, the ACA could be amended to extend no-setoff protection under circumstances where the government buyer has less performance risk. What may be a nominal concession on government's part could be a significant improvement in the minds of investors. Notably, even though government would be giving up its rights against assignees, it would preserve its rights against the assignor. In short, the government needs to evaluate the benefit of preserving payment defenses against assignees relative to its potential benefit from lowering acquisition costs.³²⁹

328. To get an idea of the savings potential, consider that the Department of Defense spends roughly \$90 billion a year on procurement. OFFICE OF MANAGEMENT AND BUDGET, *supra* note 14. DynCorp saved 3% on its interest costs. Quickel, *supra* note 296. Assuming that the defense contracting industry could earn a generous 15% net margin and realize an average 1.5% savings through securitization, the defense contracting industry could save roughly \$100 million for each month that securitization is used to replace traditional sources of funding.

329. Although several years old, an excellent approach to such an analysis appears in PROGRAM ANALYSIS DIV., GENERAL ACCOUNTING OFFICE, U.S. DEP'T OF COMMERCE PUB. NO. PB-281 791, FEDERAL CREDIT ASSISTANCE: AN APPROACH TO PROGRAM DESIGN AND ANALYSIS (May 31, 1978).

2. Simplify compliance

While the ACA is supposed to encourage private financing,³³⁰ the ACA can be less than encouraging. Contractors and investors are more likely to accept securitization if government removes the uncertainties in compliance. Requirements such as notice, the use-of-proceeds,³³¹ and the assignment to a "financing institution"³³² should be simplified and set out in published guidelines. While some transactions may purposefully "push the edge of the envelope," published guidelines will give rating agencies and investors some reference in estimating the legal risks of a transaction.³³³

3. Make efficiency a priority

There is little reason to make financing available under the ACA if that financing is not economically advantageous. In establishing guidelines for compliance, some of the arbitrary standards that the Comptroller General and the federal courts use to decide matters under the ACA should be relaxed for the sake of efficiency. For example, there is little reason to limit a financing institution to an entity that "primarily deals in money."³³⁴ The important issue is whether that vehicle reduces the cost of providing goods and services to the government. Similarly, there should be no prohibition against the assignment of receivables on completed contracts because the probable difficulty in financing receivables that do not qualify for ACA protection ultimately increases costs to the government buyer.³³⁵

In summary, although it is healthy to debate government's spending priorities, the need for efficiency in administering spending programs cannot be denied. Efficient financing increases the size of the government

330. *Central Bank v. United States*, 345 U.S. 639, 646 (1953) ("[I]t is urged that the [ACA] should be construed so as to protect the United States. The short answer to this is that the [ACA] should be construed so as to carry out the purpose of Congress to encourage the private financing of government contracts.").

331. *See supra* part III.B.2.

332. *See Alanthus Peripherals, Inc.*, 54 Comp. Gen. 80, 84 (1974).

333. In addition to compliance guidelines, the government could publish payment statistics on various categories of procurement contracts. This would educate investors on government's payment record and provide some benchmark to evaluate an individual contractor's performance. This would also serve as a tool in rating and pricing transactions.

334. *See* 54 Comp. Gen. at 84.

335. This may explain why government is required to pay high interest rates under the Prompt Payment Act. *See supra* part VI.B.

purse. It makes more money available for all programs. Accordingly, the ACA should be applied with an eye towards saving money.³³⁶

VII. CONCLUSION

The securitization of federal accounts receivable has the potential to rival the emerging market in securitized trade receivables.³³⁷ While issuers must take care in structuring these offerings,³³⁸ federal accounts receivable reflect several characteristics that favor securitization: They are the product of a long-established industry; the social, economic, and legal environments that drive that industry are not prone to radical change; government, the ultimate obligor, is stable; and these receivables have a proven track record evidenced by over fifty years of use in related financings. Fundamentally, government accounts receivable are valuable assets and properly structured FAsT-BackS offerings should be just as attractive as commercial and consumer receivable-backed deals. While the present lack of a market for FAsT-BackS raises some concerns, this is most probably due to a general misunderstanding of the business and regulation of government contracting as opposed to any technical obstacles in structuring transactions.

Securitization is a financing tool that is reshaping the way that manufacturing and service organizations fund their operations. Government contractors, holding uniquely valuable assets, are free to exploit this opportunity. The failure to take advantage of securitization is waste at the public's expense. It is time for the government contracting industry to become "as ingeniously systematized as . . . a great private mercantile institution."³³⁹

*Kirk Cypel**

336. *Central Bank*, 345 U.S. at 646-47 (explaining that the ACA should be construed to "encourage the private financing of government contracts" in manner that does not create risk for assignee, make financing more difficult for assignor or increase cost).

337. See Liebowitz, *supra* note 15.

338. *Schooner & Schooner*, *supra* note 5, at 565.

339. TWAIN, *supra* note 1, at 45.

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