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The Comptroller General  
of the United States

Washington, D.C. 20548

## Decision

Matter of: Environmental Protection Agency--Priority of  
Payment--Assignment of Claims

File: B-231107

Date: February 3, 1989

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### DIGEST

1. Order of priority for the payment of remaining contract proceeds held by EPA, the contracting federal agency, is first to the IRS for the tax debts owed by the contractor and the remaining funds to the trustee in bankruptcy.
2. Since the assignee of amounts retained by contracting agency did not render any financial assistance to specifically facilitate the performance of the government contract, the assignment is invalid against the government. Accordingly, the assignee is not entitled to any of the remaining contract proceeds held by a contracting federal agency.
3. The government's right of set-off is affected by the filing of a bankruptcy petition. Under the bankruptcy law, although a party's right to set-off is preserved, 11 U.S.C. § 553, the automatic stay provision does not allow the exercise of that right unless the creditor obtains relief from the bankruptcy court. 11 U.S.C. § 362(a)(7). Therefore, before the government can exercise its right of set-off against the remaining contract proceeds of a bankrupt contractor, it must apply to the bankruptcy court to have the automatic stay lifted.

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### DECISION

Pursuant to 31 U.S.C. § 3529, the Comptroller of the United States Environmental Protection Agency (EPA), has asked for our opinion concerning the order of priority of payments among three claimants of the remaining \$35,978.22 proceeds of a contract between the EPA and ESEI, Inc. (EPA Contract No. 68-04-5017). The claimants are the Internal Revenue

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Service (IRS), the First of America Bank-Ann Arbor (Bank), as the contractor's assignee, and the trustee in bankruptcy. As explained below, we find the assignment to the Bank invalid as against the government. Therefore, the assignee Bank is not entitled to payment out of remaining proceeds of the contract. We also find that the tax debts asserted by IRS may be set off against the retained amount. We agree, however, with the IRS that before the offset is taken it needs to be approved by the bankruptcy court. See, e.g., United States v. Reynolds, 764 F.2d 1004 (4th Cir. 1985). After set-off is completed, the remaining contract funds should be paid to the trustee for the benefit of the contractor's creditors.

#### BACKGROUND

On September 30, 1982, EPA's Chicago Regional Office awarded the contract for the preparation of environmental impact statements and studies to ESEI, Inc.<sup>1/</sup> (ESEI/Delstar). It was a 1-year Fixed Rate-Indefinite-Quantity-Labor-Hour type contract which provided for delivery orders to be issued by EPA up to a maximum amount. Through contract modifications, the period of performance was extended through September 30, 1984. Delivery orders issued prior to that time could be extended 6 months beyond the date of contract expiration (March 31, 1985).

ESEI/Delstar encountered financial difficulties during the course of the contract. One of its subcontractors, Limno-Tech, Inc. (LTI), refused to continue its performance on delivery order No. 20 unless ESEI/Delstar assured payment. To satisfy LTI's demand, the contractor entered into an assignment agreement with the First of America Bank-Ann Arbor, the subcontractor's bank, on April 26, 1985. In addition, ESEI/Delstar requested, and EPA on March 29, 1985 agreed to, extend the period of performance for delivery order No. 20 until April 30, 1985. LTI completed performance and delivery order No. 20 was delivered the first week of May 1985, thereby completing contract performance.

On February 23, 1987, Delstar, Inc. filed a petition for relief under chapter 7 of the Bankruptcy Code. As of the bankruptcy petition date, IRS claimed three tax debts totaling \$7,061.53 (including interest to that date).

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<sup>1/</sup> In April 1984, ESEI, Inc. merged with two other corporations to form Delstar, Inc.

Under the payment clause of the contract, EPA was authorized to retain up to \$50,000.00 at the rate of 5 percent of each invoice. At the time of final audit, EPA had withheld \$35,978.22. EPA has asked us to determine how this money should be disbursed.

#### LEGAL DISCUSSION

##### The Assignee

The First of America Bank-Ann Arbor entered into an assignment agreement with Delstar, Inc., on April 26, 1985, covering "all retained percentages payable under the [EPA] contract." We conclude that this assignment is invalid against the government since the Bank did not render any financial assistance to specifically facilitate the performance of the government contract. The Assignment of Claims Act of 1940, as amended, 31 U.S.C. § 3727, 41 U.S.C. § 15 (the Act), permits an assignment to a bank, trust company or other financial institution, of money due or to become due from the United States under a contract providing for payments aggregating \$1,000 or more under certain conditions. The purpose of the 1940 Act was to facilitate the financing of individual government contracts by private capital. In this way, the contractor would be free to receive financial help in performing the government contract in reliance on the security of the expected government payments from that contract. See First National City Bank v. United States, 548 F.2d 928, 934-935 (Ct. Cl. 1977); Chattanooga Wheelbarrow Co. v. United States of America, Civil Action No. 4755 (E.D. Tenn. March 1, 1967).

Although the financial assistance from the bank does not have to pass directly from the assignee to the assignor, courts have held that for an assignment to be effective against the government, financial assistance actually has to have been rendered that facilitates the contractor's performance of the government contract. First National City Bank v. United States, above; see also Coleman v. United States, 158 Ct. Cl. 490 (1962). We have interpreted this to mean that the assignee must have a financial interest in the contractor's operations under the contract in question. Generally, this means that an assignment is valid only if it secures a loan which the assignee has made to the assignor to finance the assignor's performance. 65 Comp. Gen. 554, 555 (1986). Thus, blanket assignments usually do not meet the Act's requirements.

Delstar, Inc. entered into the assignment agreement with the First of America Bank-Ann Arbor in order to assure it's subcontractor, LTI, that LTI would be paid. LTI, a bank

customer since 1980, had refused to continue its work on delivery order No. 20 until a payment schedule with Delstar, Inc. could be worked out. The contractor could not directly assign the proceeds of the contract to LTI since the subcontractor was not a qualified party under the Assignment of Claims Act, 31 U.S.C. 3727. (As pertinent here, the Act only authorizes assignments to a bank, trust company, or other financial institution. See Uniroyal, Inc. v. United States, 454 F.2d 1394 (Ct. Cl. 1972) and cases cited therein). Instead, Delstar, Inc., assigned to LTI's bank the proceeds of the contract retained by EPA. In a separate agreement between LTI and its Bank, the Bank agreed to apply all proceeds from the Delstar assignment to LTI's outstanding loan balance on its line of credit.

The Bank did not provide direct funding to LTI to enable it to complete delivery order No 20. Rather, the Bank used the assignment to substantiate the Delstar receivable and thereby increase LTI's collateral base for its line of credit. LTI's line of credit was substantially increased in October 1985, when the Bank and LTI entered into a security agreement based, in part, on the Delstar assignment.

In Chattanooga Wheelbarrow Co., supra., a case very similar to the one at issue here, the court concluded that an assignment of monies due on a government contract to an assignee bank acting as disbursing agent for a subcontractor did not constitute a valid assignment. The fact that the subcontractor subsequently granted the assignee bank a security interest in his account receivable to secure outstanding loans owing to the bank did not validate the assignment. The court stated that such action was:

" . . . insufficient to validate the assignment, so far as the Government is concerned. There is no showing of any financial assistance rendered by the Bank which facilitated the performance by [the contractor] of this particular contract with the Government. Rather, for all that appears, the only financial assistance rendered by the Bank was to the plaintiff [the subcontractor] for the general operation of its business. Under these circumstances the Court is of the opinion that the assignment is not valid insofar as the defendant [the government] is concerned. . . ."

We recognize that LTI completed its work under the contract in anticipation that it would eventually receive the benefit of the assignment. The Bank, however, provided no financial assistance either to the contractor or to LTI to facilitate

the performance of the contract. The only financial assistance rendered by the Bank was to support LTI's general business operations. Accordingly, the assignment is invalid against the government.

Finally, we note that even if the Bank had provided a direct loan to LTI, it is questionable whether it could have been used to facilitate contract performance due to the timing of the assignment. The assignment was not received and acknowledged by EPA until after LTI had performed and delivered the last remaining work product under the contract.<sup>2/</sup> Under these circumstances, the assignment is invalid against the government and the assignee Bank is not entitled to any of the remaining contract funds under the assignment. LTI will have to look to the bankruptcy court for relief.

The IRS and the trustee in bankruptcy

It is well-settled that the government has the same right belonging to every creditor to apply undisbursed moneys owed to a debtor to fully or partially extinguish debts owed by the debtor to the government. United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947). Thus, absent a "no set-off" clause in a contract, the government may satisfy by set-off any tax claim it has against a contractor, notwithstanding that all or part of the tax claim does not

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<sup>2/</sup> LTI's attorney sent a notice of the assignment together with a copy of the assignment to EPA's contracting officer on May 2, 1985. No copies were sent to the contract's disbursing officer. EPA's contracting officer did not immediately acknowledge the assignment because she first had to substantiate that Delstar, Inc. had succeeded to the rights of ESEI, Inc. under the contract. LTI's attorney provided the necessary documentation on May 22, 1985, at which time the contracting officer acknowledged the assignment. Subsequently, the contracting officer forwarded a copy of the assignment and supporting corporate documents to the disbursing officer, where it was received on June 27, 1985. LTI made delivery of its work product during the first week of May. Clearly, performance and delivery occurred before the assignment was acknowledged by the contracting officer and prior to any notification to the disbursing officer being received. Under these circumstances, we are unable to discern how the assignment can be said to have facilitated performance. See First National City Bank v. United States, 548 F.2d 928 (Ct. Cl. 1977).

pertain to the contract under which the parties are contesting payment. The EPA contract did not contain a "no set-off" clause. Accordingly, IRS is entitled to set off the tax debts of the contractor against the retained contract proceeds.

However, as the IRS has indicated, the government's right of set-off is affected by the contractor's filing of a bankruptcy petition. Although, under the bankruptcy law, a party's right to set-off is preserved, 11 U.S.C. § 553, section 362(a)(7) of title 11, United States Code automatically stays the exercise of that right unless the creditor obtains relief from the bankruptcy court. See United States v. Reynolds, 764 F.2d 1004 (4th Cir. 1985). Therefore, before set-off can be completed, IRS would need to have the automatic stay lifted. Any funds remaining after the set-off belong to the contractor. In view of the contractor's bankruptcy, however, once the set-off is completed, the remaining funds should be forwarded to the trustee in bankruptcy for the benefit of the contractor's creditors.



Acting Comptroller General  
of the United States