DECISION THE COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

26395

FILE: B-201164 **DATE:** September 29, 1983

MATTER OF: Reconsideration of 60 Comp. Gen. 510 (1981) Involving Set-Off Authority of Government When Contract Contains a "No Set-Off Clause"

DIGEST:

1. Under the Assignment of Claims Act, now codified at 31 U.S.C. § 3727, a lender is not protected against set-off by the presence of a no set-off clause in the assigned contract unless the assignment was made to secure the assignee's loan to the assignor and only if the proceeds of the loan were used or were available for use by the assignor in performing the contract that was assigned. To the extent that our holdings in 49 Comp. Gen. 44 (1967), 36 Comp. Gen. 19 (1956), and other cases cited herein are not consistent with this decision they will no longer be followed. 60 Comp. Gen. 510 (1981) is clarified.

2. When a contract containing a no set-off clause is validly assigned under the Assignment of Claims Act, now codified at 31 U.S.C. § 3727, to an eligible assignee who substantially complies with the statutory filing and notice requirements, the Internal Revenue Service cannot set off the contractor's tax debt against the contract proceeds due the assignee, even if the tax debt was fully mature prior to the date on which the contracting agency had received notice of the assignment. B-158451, March 3, 1966, and B-195460, October 18, 1979, are modified accordingly. 60 Comp. Gen. 510 (1981) is clarified.

This decision is in response to a request from the Internal Revenue Service (IRS) for us to reconsider and modify our holding in 60 Comp. Gen. 510 (1981) concerning the set-off authority of the IRS when a Government contract containing a "no set-off clause" is assigned.

In that decision we considered the relative priority of a Federal tax lien against a Government contractor and the claim of the bank to which the contractor had assigned his rights under the contract in accordance with the provisions of the Assignment of Claims Act, formerly 31 U.S.C. § 203, now codified at 31 U.S.C. § 3727. The bulk of that decision dealt with the situation that existed when the contract involved did not contain a no set-off clause. We held that in the absence of a no set-off provision, a claim by the IRS or other Federal entity that arose before the assignment became effective could be set-off against the amount otherwise payable to the assignee under the assigned contract. The IRS is not asking us to reconsider that portion of our decision.

However, our decision in that case also addressed the matter of priority when the Government contract did contain a no set-off clause. In this respect we said the following:

> "It is well settled that the presence of a no set-off clause in a contract prohibits IRS or any other Government agency from making any claims to the monies due the assignee under the contract."

Similarly, one of the digests in the decision states that:

> "If Government contract contains a no 'set-off' clause, Government cannot set-off tax debt of assignor under any circumstances."

The IRS is now requesting us to reconsider our holding regarding the priority question when a no set-off clause is contained in an assigned contract, particularly as that holding would apply to the facts of a specific case described in the IRS request (which is discussed at greater length below). Specifically, the IRS requests us to adopt the position that our holding concerning the protection afforded assignees by the no set-off clause should be narrowed so that it only applies (1) if the assignee files a proper notice of assignment that satisfies the statutory requirements prior to the IRS tax levy or request for set-off and (2) if the proceeds of the loan secured by the assignment were used or at least were available for use by the assignor in the performance of the assigned contract.

For the reasons set forth hereafter, we agree with the IRS' second point that the no set-off clause does not prohibit set-off when the underlying loan is not used or available for

use by the assignee in performing the assigned contract.[1] However, we do not concur with IRS' first contention that notwithstanding the presence of a no set-off clause, set-off is permissible if the IRS tax claim arises before the assignee notifies the contracting agency of the assignment.[2]

The specific case that appears to have prompted the IRS to request us to reconsider our earlier decision was summarized as follows in the IRS letter and accompanying attachments. In July, 1973, Ward La France Trucking Corporation (Ward La France) entered into a defense contract with the United States Army. The contract contained the standard no set-off clause authorized by 31 U.S.C. § 203 (now codified at 31 U.S.C. § 3727) and section 7-103.8 of the Armed Services Procurement Regulation. Subsequently, on August 3, 1978, Ward La France assigned the contract to Marine Midland Bank (Marine) "in order to secure new operating capital loans." At the time of the assignment, Ward La France had already completed performance of the assigned contract. Moreover, IRS states that the "loans secured by the assignment were not used in Ward La France's performance of the subject defense contract." The IRS further states that it "levied on the contract proceeds prior to the filing of the notice of the assignment with the defense contract disbursing officer and the Army contracting officer."[3]

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[1] Set-off is also permissible, notwithstanding the presence of a no set-off clause, if the assignment was not made to secure the assignor's indebtedness to the assignee or to the extent the contract proceeds exceed that indebtedness.

[2] In our 1981 decision which held that if the contract does not contain a no set-off clause the IRS can set-off a tax claim that arises before notification of the assignment is received, we took the position that set-off was permissible if the tax debt of the assignor was in existence even if not yet due (mature) before notification.

[3] While the IRS letter goes on to state that the disbursing officer's files do not contain any record of the assignment notice, IRS does not argue that the notice was legally insufficient under the Act. Moreover, it appears that the contracting officer did receive formal written notice of the assignment and that the disbursing officer did receive "actual" notice. Accordingly, the adequacy of the notice received by the IRS was not considered to be an issue in this case.

In order to facilitate payment of the uncontested monies due under the assigned contract and to preserve the rights of the parties pending litigation, an escrow agreement dated August 24, 1981, was entered into between Marine and the IRS. The agreement preserved the set-off claims, tax liens, or other statutory claims of the Government and also the contractual and statutory claim of Marine in the $625,000 escrow fund. We also note that paragraph 7 of the escrow agreement specifically provides that if the parties are unable to reach a satisfactory agreement as to the disposition of the escrow account "then the respective rights of the parties to such account shall be submitted to a federal court of competent jurisdiction, for adjudication as to the relative priority status and validity of all competing setoffs, liens, and claims."

As explained at greater length hereafter, it is our view that since Marine's loan to Ward La France was made after Ward La France had already completed performance on the contract, Marine was not protected against set-off by the presence of the no set-off clause in the assigned contract.

The matter at issue here turns on the proper interpretation and application of a provision, contained in certain federal contracts, that is commonly referred to as a "no set-off clause". In this respect 31 U.S.C. § 3727 4/ reads as follows:

> "(d) During a war or national emergency proclaimed by the President or declared by law and ended by proclamation of law, a contract with the Department of Defense, the General Services Administration, the Department of Energy (when carrying out duties and powers formerly carried out by the Atomic Energy Commission), or other agency the President designates may provide, or may be changed without consideration to provide, that a future payment under the contract to an assignee is not subject to reduction or setoff. A payment subsequently due under the contract (even after the war or emergency is ended) shall be paid to the assignee without a reduction or setoff for liability of the assignor--

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4/ Prior to the revision and codification of title 31, United States Code by Pub. L. No. 97-258, 96 Stat. 877, September 13, 1982, this provision was set forth in 31 U.S.C. § 203 in essentially the same terms.

> (1) to the Government independent of the contract; or
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> (2) because of renegotiation, fine, penalty (except an amount that may be collected or withheld under, or because the assignor does not comply with, the contract), taxes, social security contributions, or withholding or failing to withhold taxes or social security contributions, arising from, or independent of, the contract."

As stated above, in 60 Comp. Gen 510 we said that the presence of a no set-off clause in a contract prohibits the Government from setting off the assignor's tax debts against the monies due the assignee under the assigned contract. While that statement and the related digest may have been somewhat broader than was necessary (or perhaps advisable), we believe that when read and considered in the context of the entire decision, our intended meaning should not be unclear. That is, in making that broad statement we assumed that the contract involved was validly and properly assigned to an eligible assignee in accordance with all of the statutory requirements contained in the Assignment of Claims Act. For example, in digest 1 of the decision we said the following:

> "Assignment of claim to proceeds under Federal Government contract must be recognized by contracting agency and all other Federal Government components including * * * IRS, <u>if assignee complied with filing and other requirements of Assignment of Claims Act</u> * * *." (Emphasis added.)

Since the validity of the assignment under the Assignment of Claims Act was not at issue in 60 Comp. Gen. 510, that decision did not address the statutory requirements that must be satisfied in order for an assignment to be deemed valid.

Clearly, we would agree that if a contract is assigned improperly or if the assignor or assignee does not fulfill all of the statutory requirements, the assignment would be invalid and would not be recognized by our Office. In that case, the presence of a no set-off clause in the assigned contract would not provide the assignee with any protection against set-off by the Government. See 58 Comp. Gen. 619 (1979); 55 Comp. Gen. 155 (1975); 54 Comp. Gen. 137 (1954);

49 Comp. Gen. 44 (1969); B-171063, February 14, 1971; and cases cited in the decisions.

The IRS' second contention (which we have considered first since it is dispositive of the instant dispute between Marine and the IRS) is that an assignment is not valid under the Assignment of Claims Act unless the assignment was made to secure a loan whose proceeds were used or were available for use by the contractor in the performance of the contract. The decisions of our Office have consistently upheld the view that an assignment of a Government contract, and any no set-off clause contained therein, is only valid if the assignment was made to secure a loan made by the assignee to the assignor and only then to the extent that the assignor remains indebted to the assignee. B-177648, December 14, 1973; B-176905, November 1, 1972; B-175670, May 25, 1972; B-171063, February 16, 1971, B-159320, July 7, 1966; B-137321, October 13, 1958; 37 Comp. Gen. 9 (1957); 35 Comp. Gen. 104 (1955). Also see Beaconwear Clothing Co., v. United States, 174 Ct. Cl. 40, 355 F. 2d 583 (1966). Therefore, even if a no set-off clause is present, it always has been and remains our position that whether or not the Government's claim arises before notice of the assignment is received, the Government can set-off the assignor's debts to the extent the contract proceeds exceed the assignor's remaining indebtedness, if any, to the assignee.

However, as to whether a loan must be made for a particular purpose relating to the performance of Government contracts by the assignor in order for the assignment to be recognized as valid, our decisions have reflected a somewhat different interpretation of the Assignment of Claims Act over time. Initially, our Office took the position that a validly executed assignment of a contract containing a no set-off clause could defeat the Government's set-off claim even if the loan secured by the assignment was not made for the purpose of financing the assignor's Government contract work. See 36 Comp. Gen. 19 (1956); B-131183, March 13, 1958; B-138974, May 23, 1969; and B-142275, March 26, 1965. Thereafter, we modified our prior interpretation and held that the no set-off clause did not preclude set-off "unless the outstanding indebtedness represents loans made to the assignor for the purpose of carrying out contracts with the Government." See 49 Comp. Gen. 44 (1967) and 54 Comp. Gen. 80 (1974).

In 1974 we adopted our current position in this respect. In 54 Comp. Gen. 137 (1974) we considered a case in which the loan secured by the assignment was made after performance of the assigned contract was completed. After analyzing several judicial opinions interpreting the Assignment of Claims Act, we said the following:

> "We take these cases, therefore, to affirm a policy of encouraging the financing of Government contracts by not limiting to the initial amount loaned the no set-off protection of parties which lend a contractor several sums for the performance of a contract. However, * * * [none of these cases] stand for the proposition that parties which lend money to a firm having both completed (from the contractor's point of view) and on-going contracts are protected against setoff under the completed contract.
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> "First National City loaned Trilon $250,000 believing that the subject contract was fully performed. It therefore quite reasonably anticipated that no further funds would flow to Trilon from this contract. Yet, when funds did become available the bank asserted a claim against them.
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> "* * * the bank's entitlement is secondary to the setoff rights of the Federal Government. And, since we conclude that the Assignment of Claims Act does not extend no setoff protection to First National City Bank in this instance, the Government may properly exercise its right of setoff to the $54,369.37 in question."

Thus, in 54 Comp. Gen. 137, we held that the presence of a no set-off clause in the assigned contract does not preclude set off by the Government if the loan secured by the assignment is made after the contract has been fully performed, presumably making the lender assignee aware that "the money lent will not be applied to performance of the contract." Our Office interpreted the Assignment of Claims Act in a similar manner to reach a similar result in 55 Comp. Gen. 155 (1975). As stated above, this interpretation of the Act and the no set-off clause represents our current position in this respect. It is entirely consistent with the most recent judicial interpretation of the Act and the no set-off clause.

The leading court case in this respect is First National City Bank v. United States, 212 Ct. Cl. 357, 548 F. 2d 928 (1977), which IRS cited and relied upon in its request to us for reconsideration. In that case the court considered the same factual situation that we had addressed previously in

54 Comp. Gen. 137. While the court's disposition of the case was not entirely consistent with that of the Comptroller General (differing in some respects that are not at issue here), the court did concur in our view that an assignment was not valid against the Government unless the proceeds of the loan secured by the assignment were available for the performance of the contract. In this respect the court held as follows:

> "The objective of the 1940 Act was to authorize the financing of individual government contracts in the sense that Congress wished the holder of such a pact to be free to receive financial help in performing his agreement in reliance on the security of the expected government payments from that contract. At the same time Congress did not, we think, wish to eat into the Government's normal right of setoff against the assignor more than would be necessary to induce such monetary aid in performing. Where a contract has been fully completed, further aid is not needed for that contract and there is no occasion to give up the right of setoff.
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> "This view does not mean that loans must be tied to particular contracts nor does it go counter to the endorsement of the revolving-credit plan in Continental Bank & Trust Co. v. United States, 416 F. 2d 1296, 189 Ct. Cl. 99 (1969). In all of our prior cases, including Continental Bank, which have upheld the financing institutions' right to recover free of setoffs, the loans were made before the completion of the particular contract and were available to help in the performance of that work--even though the loans may not have been tied to, or designated as directed to, a or the specific contract * * *. It is only where the contract has been fully performed before the loan is made that the institution cannot call upon that right [of no setoff] under that particular contract.
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> "For these reasons, we hold that plaintiff does not belong within the class of assignees

> or of those 'participating in such financing' under the 1940 Act, and has no rights under that statute." (Emphasis added.)

Subsequently, in Manufacturers Hanover Trust Co., v. United States, 590 F. 2d 893 (Ct.Cl. 1978), the Court of Claims reaffirmed its holding in First National City Bank that "in order for a lending institution to achieve the status of an assignee under the Assignment of Claims Act of 1940, it had to be shown that the monies which that institution had advanced to the contractor were actually used in, or at least made available for, the performance of the contract(s) in question". Also, see 58 Comp. Gen. 619 (1979), in which we cited the court's holding in First National City Bank as standing for the same proposition at least when the issue is, as it is here, whether an assignee bank is protected by a no set-off clause in the assigned contract.

Thus, we concur in the IRS's second contention that under the Assignment of Claims Act a lender is not protected against set-off by the presence of a no set-off clause in the assigned contract, 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. Our decision in 60 Comp. Gen 510 (1981) is clarified in accordance with our position as set forth herein. Moreover, to the extent that any of our prior decisions, cited above, have taken a contrary position they will no longer be followed by our Office.

Applying our position in this respect to the instant case, we would advise the IRS as follows in connection with its negotiations with Marine under the terms of the August 24, 1981, escrow agreement mentioned above.

Based on the information contained in the IRS submission, it appears that the contract proceeds were assigned Marine after the contract had been fully performed, in order to secure new operating loans. Obviously therefore, these new loans could not have been used or available for use by Ward La France in performing the already completed contract. Accordingly, it is our view that the presence of the no set-off clause in the assigned contract would not prevent IRS from setting off the contractor's tax debts against the contract proceeds otherwise payable to the assignee.

While the foregoing is dispositive of the specific case involved here, we note that the IRS request for us to reconsider our decision in 60 Comp. Gen. 510 also asks that we rule on its other contention. Accordingly, in order to clarify our

position in this respect, and since it is not unlikely that this issue could arise again in the future, we have addressed the IRS' other contention as well.

IRS contends that a lender is not a valid assignee under the Act, and is therefore not entitled to the protection provided by the no set-off clause, if "the notice provisions imposed upon an assignee by the statute were not carried out prior to the Internal Revenue Service's levy and set-off actions." In this respect, 31 U.S.C. § 3727(a)(3) (formerly set forth in substantially the same terms in 31 U.S.C § 203), provides that assignments to financing institutions are valid if:

> "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."

In accordance with this provision, it has consistently been held by our Office (and the courts) that an assignee who does not at least substantially comply with the notice and filing requirements would not have any enforceable rights against the Government under the assignment. 58 Comp. Gen. 619 (1979); B-185962, April 7, 1976; 20 Comp. Gen. 424 (1941); Uniroyal Inc. v. United States, 197 Ct. Cl. 258, 454 F. 2d 1394 (1972); and other cases cited therein. As a necessary corollary of that rule, it is also recognized that an assignment does not become effective until the contracting agency (through the contracting or disbursing officer) receives formal written notice of the assignment. 60 Comp. Gen. 510, supra; B-197648, December 14, 1973; and 29 Comp. Gen. 40, supra.

The position of the IRS in this respect, however, would require an unwarranted extension of the foregoing principles. That is, the IRS states where a no set-off clause is included in the contract, a financing institution would "not qualify as an assignee within the meaning of 31 U.S.C. § 203 * * *" if it does not notify the contracting agency of the assignment before the tax levy is filed. We disagree. The Assignment of Claims Act does not specify any period of time within which the contracting officer and disbursing officer must be notified of the assignment. 22 Comp. Gen. 520 (1942). There is absolutely no basis, in our view, for holding that an otherwise proper assignment to an otherwise eligible assignee under a contract containing a no set-off clause is invalidated because the notice of the assignment was not received by the agency officials prior to the filing of a claim by IRS. That

is not to say that the "timing" of the notice is irrelevant where a no set-off clause is not present. As stated above, the assignment does not become effective until proper notice is received by the contracting agency. Therefore, if the Government has a competing claim against the contract proceeds, the date on which the agency receives notice, while not affecting the basic validity of the assignment, may determine which claim will have priority. However, our Office has consistently held that this is only true if the contract involved does not contain a no set-off clause. For example in 56 Comp. Gen. 499 (1977), we said the following in this respect.

> "In regard to the priority between the IRS and the assignee, both the courts and this Office have held that in the absence of a no set-off provision in the contract, the Government, i.e., the IRS, is entitled to set-off against the assignee-bank any of its claim against the assignor-contractor which had matured prior to the assignment." (Emphasis added.)

See also, B-177648, December 14, 1973; B-170454, August 12, 1970; B-157394, October 5, 1965; B-152008, September 10, 1963, 37 Comp. Gen. 318 (1957); and numerous other cases cited in those decisions.

Conversely, we have consistently held that when a no set-off clause is included in the assigned contract, neither the IRS or any other Government agency can set-off amounts due from the assignor against the contract proceeds owed to the assignee even if the IRS claim matures prior to the date on which the assignment becomes effective, i.e., the date on which notice of the assignment is received by the contracting agency. Our decision in 37 Comp. Gen. 318, supra, is precisely in point. In that decision we said the following:

> "But for the no set-off provisions of the Assignment of Claims Act, as amended, we would perhaps agree with the position of the Internal Revenue Service. We think it is clear, however, that that part of the act expressly nullifies the effect of section 6321 of the Internal Revenue Code of 1954, Title 26, in the present case.

* * * * *

"Other provisions of the Assignment of Claims Act permit the assignment of moneys due under a Government contract which theretofore was prohibited. If the act had permitted only this, without the no set-off provision, an assignee's rights would be governed by common law. Indeed, this is the situation where the contract does not include a no set-off provision. In such case, the assignee stands in the shoes of the assignor and the Government may set off against the assignee any claims of the Government against the assignor which had matured prior to the assignment. South Side Bank & Trust Co. v. United States, 221 F. 2d 813. 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. 20 Comp. Gen. 458, 459, and cases cited there.

"These principles are applicable to a Federal tax indebtedness owed by a Government contractor, apart from any lien which may exist. Where the contract does not contain a no set-off provision it may well be that the lien created by section 6321 of the 1954 Internal Revenue Code would prevent the effective assignment of moneys thereafter becoming due the taxpayer under a Government contract. If the assignment of the contract proceeds was made before the tax became due, there would be no property or right to property owned by the taxpayer to which the lien could attach, at least to the extent of the assignee's entitlement to such proceeds.

"It is clear that the no set-off provision of the act operated to reduce the Government's common law right of set-off against an assignee. As was stated in Central Bank v. United States, 345 U.S. 639, 643:

> '* * * The Act authorized the War and Navy Departments to limit the Government's previous rights of set-off. * * *
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> 'The Assignment of Claims Act of 1940 was evidently designed to assist in the

> national defense program through facilitating the financing of defense contracts by limiting the Government's power to reduce properly assigned payments. Borrowers were not to be penalized in security because one contracting party was the Government. Contractors might well have obligations to the United States not imposed by the contract from which the payments flowed, as for example the contractor's income tax for prior earnings under the contract. The taxes here involved are another illustration of the dangers to lenders.'
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> "While no mention is made in the Central Bank case of tax debts which might have accrued prior to the making of a Government contract, and as to which a tax lien might have arisen, it is plain that such debts would pose an even greater danger to prospective lenders than tax debts arising during the course of performance of the contract."

In that decision we held that even though the contractor's tax debt arose long before the assignment, and even the execution of the contract, the no set-off clause precluded the IRS from setting off any of the contractor's tax debts against the contract proceeds (except for any portion of the contract proceeds that may have exceeded the assignor's indebtedness to the assignee). Our Office has reached a similar conclusion in a number of other cases, including the following: B-176905, November 1, 1964; B-166531, November 10, 1969; B-156781, August 4, 1965; B-153171, October 8, 1964; and B-138974, May 23, 1960.

To conclude that whether or not a no set-off clause is present the Government's set-off authority is to be determined solely on the basis of which claim arose, or became effective first, would nullify the effect and meaning of the no set-off clause in our view. Accordingly, it remains our position that where a no set-off clause is present in a contract that is validly and properly assigned to an eligible assignee who substantially complies with the statutory filing and notice requirements, the IRS cannot set-off the contractor's tax debt (whether arising under or independently of the assigned contract), against the contract proceeds due the assignee, even if the tax debt was fully mature prior to the date on which the contracting agency received notice of the

assignment.[5]/This of course, would not prohibit set-off if the contracting agency had not been notified of the existence of the prior assignment before the set-off was made (assuming payment was already due under the assigned contract). In this case the contracting agency could not be bound by an assignment of which it was unaware.

We note that B-158451, March 3, 1966, and B-195460, October 18, 1979, in apparent reliance on the conclusion reached in a case in which the contract at issue did not contain a no set-off clause (37 Comp. Gen 808 (1958)), concluded that a no set-off clause did not overcome a Government claim which arose prior to receipt of the notice of assignment. Those decisions are modified to conform to our holding in this case.

for Milton J. Socolar
Comptroller General
of the United States

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[5]/ We note that this only applies with respect to tax debts, whether arising under or independently of the contract, or other debts that arise independently of the assigned contract. In accordance with the express language of the Assignment of Claims Act, the no set-off clause does not protect the assignee against set-off by the Government of any non-tax debt that arises under the assigned contract. Moreover, our Office has held that where the claim to be set-off is acquired "under the same transaction or contract, the prior notice of assignment does not defeat the right of set off" by the Government. See 46 Comp. Gen. 441, 546 (1966) and 30 Comp. Gen. 98 (1950). This is true whether or not the assigned contract contains a no set-off clause.