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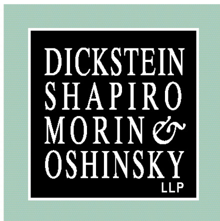

Legal Innovators

Our attorneys guide clients through the maze of regulations to maximize a company's ability to secure government contracts. If you would like more information on this issue or any other government contracts issue, please contact us.

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A Faltering Economy: Friend or Foe for the Government Contractor

It is virtually impossible to ignore the signals of the marketplace over the past 12 months as we begin the second quarter of 2001. The year 2000 produced events unfamiliar to the modern market, spawning heightened concerns about credit quality and causing investors and financial institutions alike to pull back the credit reigns and revisit underwriting guidelines. Overzealous market conditions of the late 1990s, fueled by highly leveraged or inappropriately structured credit facilities to meet extremely competitive financing demands, have already begun to dampen growth prospects, strain existing bank/customer relations, and limit the availability of leveraged financing.

As the economy experiences more stress, financial institutions will focus closely on credit quality in seeking a safe haven in today's volatile marketplace. New financing opportunities will be closely examined, and there will be little appetite for the promise of greater returns from yet-to-be proven company successes or those types of financings poised to be repaid through asset sales or capital market transactions (i.e., going public or subordinated debt issuances). Companies in basic, less-cyclical industries with good financial performance, proven business plans, and acceptable collateral packages may find themselves being courted by financial institutions eager to develop more secure business relationships in this time of economic uncertainty.

Government contractors may well become a sought-after commodity. They may find themselves in the driver's seat for financing opportunities, not only because their business is less prone to stagger through faltering economic times, but also because government contractors are uniquely positioned to offer collateral that has historically withstood the test of a faltering economy: government contract receivables. Unlike real estate, inventory, and most other types of collateral, government contract receivables rarely suffer drops in value that might otherwise be triggered by a depressed economy.

Financing performance under contracts with federal or state governments, and leveraging government receivables to obtain such financing, may not be appropriate for all contractors, but it does have certain benefits. Government contract financing arrangements have proven to be an attractive means to accomplish

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any of the following objectives:

- stabilizing cash flow to meet general working capital needs when liquidity might be tight due to seasonal, cyclical, or growth-related reasons;

- establishing good credit, developing sound borrowing practices, and creating opportunities to take advantage of other bank-provided services;

- implementing growth and development strategies; and/or

- reducing the costs and expenses of suppliers and service providers who offer discounts for early payment.

Many contractors obtain lines of credit secured by government contract receivables, not so much because these contractors have an immediate need for additional capital, but instead to provide a sense of security, an insurance policy of sorts, for those times when they might face unexpected cash or liquidity needs. Just like insurance policies have premiums, commercial lines of credit also carry a cost, usually in the form of a "commitment" fee or an "unused availability" fee (charged on that portion of the line of credit not used by a contractor in order to compensate lending institutions for keeping credit available to the contractor). Relatively speaking, however, the cost to have the financial security of an available line of credit is minimal compared to the potential cost that could be incurred, and other ramifications that could result from cash or liquidity shortfalls.

Even if your company has already leveraged its government contract receivables for existing lines of credit or other financing, now or the approaching months may be an appropriate time to reevaluate your financing arrangements and explore alternatives. As the faltering economy triggers heightened competition among banks and lending institutions seeking to focus their attention on the more conservative, less volatile asset-based lending market, government contractors might see more borrowing opportunities at a reduced cost. Nevertheless, you will rarely find lenders eager to establish asset-based loans or lines of credit for less than $500,000, simply because of the high cost of monitoring such loans (which entails regularly reviewing books and records to determine the validity and value of the contractor's accounts receivables, and is generally the same whether the financing arrangement is large or small). Smaller loans or lines of credit may be available through private capital firms, but contractors should expect to encounter higher borrowing costs (i.e., commitment fees, unused fees, origination fees, etc.) from such lenders to offset their own monitoring costs and expenses.

Before opening your company's doors to lending officers anxious to pitch the benefits of their particular products, review your accounts receivable track record. It is critical that your company's books and records are in order and reflect a disciplined billing practice and payment history. You should also review your contracts with federal and state governments to confirm that the payments thereunder can be assigned to a bank or financial institution as collateral for a loan (generally, while the payment stream or receivable can be assigned, the contracts themselves cannot). Only then will you be in a strong enough position to offer what might be viewed as a "golden egg," in exchange for financing arrangements designed to meet your company's business objectives.

Matthew S. Bergman is an attorney in the Corporate & Finance Group of Dickstein Shapiro Morin & Oshinsky LLP, specializing in representing both lenders and borrowers in documenting, negotiating, and closing asset-based lending transactions. The Firm's government contracts clients represent a broad spectrum of the industry - large and small companies, domestic and international, in both defense and civilian arenas. Aside from the Firm's government contracts clients, representative lender clients of the Firm include First Union's Leveraged Finance Group, Bank of America, N.A., Mellon Corporate Financing, and Branch Banking and Trust Company.

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