

RECENT DEVELOPMENTS IN THE RIGHT OF SURETIES IN DEFAULTED FEDERAL CONSTRUCTION CONTRACTS

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A dispute as to who is entitled to receive undisbursed contract proceeds frequently arises when a federal construction contractor who is bankrupt, or who has assigned his contract to a bank or who owes taxes or is otherwise indebted to the government defaults and a Miller Act¹ surety is called upon to complete performance under the performance bond or make payment under the payment bond. Generally speaking, except where it conflicts with tax liens or setoffs of the United States, the position of such sureties is progressively being recognized as superior to the rights of trustees in bankruptcy and assignee banks.

Historically, sureties have assumed great risks and have thus felt it their basic right to be subrogated on a priority basis to the full interests of a principal. Bond premium costs, in order to be within the means of the average contractor, have to be predicated upon the surety's being able to look to a responsible principal and his being able to secure guarantees and indemnification agreements, as well as rights of subrogation. The absence or weakening of any of these elements can only be reflected in the reluctance of sureties to accept further risks and the actuarially calculated charges for premiums and in stricter requirements for indemnification, collateral or other guarantees. However, with the space age advances in construction methods and the increases in the dollar volume, magnitude and complexity of federal contracting, sureties' risks and problems have correspondingly increased.

In the past twenty-five years, the sureties' traditional position of subrogation has been challenged more and more. For instance, since 1940, when the Federal Assignment of Claims Act² was amended to permit assignment of government contracts to financial institutions to facilitate financing,³ there has been a succession of conflicts with assignee banks. The problems of the courts have been complicated by the fact that both banks and sureties frequently have substantial, though conflicting, equities in a default situation.

The interests of the government often clash with the rights of the sureties, for the modern federal tax system requires that a con-

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¹ 49 Stat. 793 (1935), 40 U.S.C. § 270(a) (1958).

² 12 Stat. 596 (1862), as amended, 41 U.S.C. § 15 (1958).

³ 54 Stat. 1029 (1940), 41 U.S.C. § 15 (1958).

tractor pay his own social security and unemployment taxes, as well as withholding his employees' income taxes. In addition, the sureties' position may be further confused by the government's claims on other contracts and transactions which the bonded contractor may have undertaken for the government. Finally, there is the traditional controversy between sureties and the trustees in bankruptcy for a defunct principal.

The case law bearing on these problems has been based on overall equities, usually substantial on all sides, major questions of legislative intent and statutory interpretation.

For purposes of discussion here, in each instance, let us assume a set of circumstances where:

(a) a contractor has a construction contract with the United States and has furnished standard performance and payment bonds under the Miller Act;⁴

(b) the contractor has defaulted and the surety has been called upon and has made payment under the payment bond or completed the work under the performance bond, or both and

(c) the United States has undisbursed contract proceeds on hand.

What then are the relative rights and priorities of:

- (1) The surety v. the trustee in bankruptcy?
- (2) The surety v. the assignee bank?
- (3) The surety v. a United States Government tax lien?
- (4) The surety v. a United States Government claim for setoff arising out of the principal's other contracts or transactions?

Surety v. Trustee in Bankruptcy

The United States Supreme Court has recently reaffirmed the position that a surety is entitled to precedence over a trustee in bankruptcy for a defunct contractor in *Pearlman v. Reliance Ins. Co.*⁵ Although there was a division with respect to the theory, eight members of the Court joined in the holding, four of whom concurred in the opinion of Mr. Justice Black that the surety was entitled to the fund on the basis that it was subrogated to the claims of the contractor or the laborers and materialmen to the extent of monies disbursed to them. Three Justices, including Mr. Justice Clark, believed that the surety was only entitled to the fund because it was standing in the shoes of the United States and that, unless overruled, *United States v. Munsey Trust Co.*,⁶ precluded the holding of the majority and re-

⁴ See U.S. Standard Forms 25 & 25A, 49 Stat. 793 (1935), 41 U.S.C. App., §§ 54.15-16 (1958).

⁵ 371 U.S. 132 (1962).

⁶ 322 U.S. 234 (1947).

quired that the basis for the decision be subrogation to the rights of the United States since the laborers and materialmen had valid claims against the surety itself under the payment bond. Mr. Justice White dissented in silence!

The United States Court of Claims carefully followed *Pearlman* in *United Pac. Ins. Co. v. United States*⁷ allowing summary judgment in favor of a surety as against a trustee. However, the right of the United States to offset a tax claim ahead of both was stipulated.

Actually, in every instance, Supreme Court decisions have favored the surety. As early as 1896, in *Prairie State Bank v. United States*,⁸ the Court held that a surety completing work under a performance bond was subrogated to the rights of the United States and was therefore entitled to receive the ten per cent retention fund in the possession of the United States, saying with respect to the surety:

[The surety's] right of subrogation, when it became capable of enforcement, was a right to resort to the securities and remedies which the creditor (the United States) was capable of asserting against its debtor Sundberg & Company, had the security not satisfied the obligation of the contractors, and one of such remedies was the right based upon the original contract to appropriate the ten per cent retained in its hands.⁹

In 1908, in *Henningsen v. U.S.F. & G. Co.*,¹⁰ the Supreme Court recognized the surety's priority right to contract funds as a result of disbursements made under a payment bond.

These two cases dealt with bonds furnished under the Heard Act¹¹ which, after several amendments, was ultimately replaced by the Miller Act. The principal difference between the two is that the Miller Act requires the furnishing of separate performance and payment bonds whereas a single one covering both requirements was called for by the Heard Act. In addition, the Miller Act contains certain procedural provisions to avoid a multiplicity of litigation in different jurisdictions.

Two factors apparently led the Supreme Court to again consider an issue which many people felt had already been completely resolved by the *Prairie State Bank*¹² and *Henningsen*¹³ cases. First, questions were raised as a result of the enactment of the Miller Act in 1935 and its amendment in 1958. Second, the Supreme Court seemed to want to

⁷ 319 F.2d 893 (Ct. Cl. 1963).

⁸ 164 U.S. 227 (1896).

⁹ Id. at 232.

¹⁰ 208 U.S. 404 (1908).

¹¹ 28 Stat. 278 (1894).

¹² Supra note 8.

¹³ Supra note 10.

review the reasoning in *United States v. Munsey Trust Co.*¹⁴ in which it held that laborers and materialmen have no enforceable right against the United States as such but rather have rights exclusively under the payment bond.

Today, the question of relative priority as between a surety and a trustee in bankruptcy seems to have been put to rest by the Supreme Court. However, because of the differences of opinion expressed by the Court itself in the *Pearlman* case, the fascinating and most difficult question still remains: "to whom is the surety subrogated?"

In *Pearlman*, the majority indicates that the surety is subrogated to the rights of the materialmen and laborers which it has paid. However, Mr. Justice Clark's separate opinion states that, since the majority expressly denied that it was overruling *United States v. Munsey Trust*,¹⁵ which states that the laborers' and materialmen's rights are limited to claims under the bond, the majority opinion is contradictory in that the subrogation can only be based upon the right to subrogation to the rights of the United States. Either line of reasoning can easily lure one onto a merry-go-round from which it is difficult to dismount.

For instance, where does this leave such questions as the right of the United States to set off independent claims, the obligations to assignee banks who have in good faith advanced moneys induced by the language of the Assignment of Claims Act,¹⁶ the prohibition against setoffs and recoupments established in the Act based on other rights and, of course, inevitably the claims for various types of tax obligations? If the surety is subrogated only to rights of the United States, the banks can make a powerful claim to priority on the basis of this Act.

These and other problems will be considered in sections which follow.

Surety v. Assignee Bank

Prior to 1940, the federal government prohibited all assignments of claims; although it is true that under some circumstances claims were recognized on the part of assignees due to special equitable considerations. In some instances the United States simply said that the prohibition against assignment in the prior acts was a defense in bar which it could assert or not within its discretion, in effect as a matter of sovereign grace.¹⁷

Essentially, the current Assignment of Claims Act¹⁸ was passed

¹⁴ Supra note 6.

¹⁵ Ibid.

¹⁶ Supra note 2.

¹⁷ II McBride & Wachtel, Government Contracts, ch. 16 (1963).

¹⁸ Supra note 2.

to enable assignments for the purpose of funding the war effort during World War II. A 1951 amendment had the express objective that, except in cases of fraud, a bank or financing institution receiving payments pursuant to an assignment thereunder would not be subject to later recovery by the government of amounts received.¹⁹

Thus, a situation has developed in which banks are encouraged to lend money to public contractors. Federal law apparently recognizes that all assignments are "a valid assignment for all purposes" and that they are not subject to any setoff or reduction for obligations arising out of other matters. It would appear that the lenders are not to be subjected to any exposure for recoupment of payments received except in cases of fraud.

At first blush it would thus appear that a bank holds a preferred position and indeed this is the view of all federal courts except the Court of Claims which consistently rules that the surety has priority over the bank.²⁰ This is particularly important because the Court of Claims, through one means or another, has emerged as the forum in which most of these controversies are decided. It has determined that it has jurisdiction in every instance where there are funds in the hands of the government, and it thus far sits secure in the fact that the Supreme Court has denied certiorari in the cases involving this issue. However, as has been pointed out previously, the sureties recognize the precedence of the United States to set off tax obligations as was done in *United Pac. Ins. Co. v. United States*,²¹ and thus we have the anomaly of a bank having a preference over independent claims of the United States and a surety having preference over the bank.²²

In any event, approaching this issue of relative priority from the standpoint of decided authorities, a substantial line of Court of Claims cases headed by *Royal Indem. Co. v. United States*²³ and followed recently in *National Union Fire Ins. Co. v. United States*²⁴ holds that, notwithstanding the removal of the statutory bar upon assignment, the assignee can acquire no greater rights than the assignor and the assignor's rights are subject to the subrogation rights of a surety.

The contrary theory, followed by the federal courts, has as its cornerstone *Coconut Grove Exch. Bank v. New Amsterdam Cas. Co.*,²⁵ which gave priority to the bank, holding it to be a valid assignee. This doctrine was extended somewhat in *Bank of Arizona v. National Sur.*

¹⁹ S. Rep. No. 217, 82d Cong., 1st Sess. (1951).

²⁰ Speidel, "Stakeholders" Payments Under Federal Construction Contracts: Payment Bond Surety vs. Assignee, 47 Va. L. Rev. 640 (1961).

²¹ Supra note 7.

²² Supra note 17.

²³ 117 Ct. Cl. 736, 93 F. Supp. 891 (1950).

²⁴ 304 F.2d 465 (Ct. Cl. 1962).

²⁵ 149 F.2d 73 (5th Cir. 1945).

*Corp.*²⁶ which held that if the money lent by the bank (within reason) was used in the discharge of the contractor's obligations, and hence for the purpose of fulfilling the contract, unless the funds were diverted the surety's exposure was consequently reduced and therefore, in equity, as well as in a literal reading of the law, the bank was entitled to priority as assignee.²⁷

It should also be noted that the Court of Claims' position on jurisdiction has not been constant. In *Arlington Trust Co. v. United States*,²⁸ it rejected jurisdiction, but *Maryland Cas. Co. v. United States*²⁹ overruled *Arlington Trust*. Also there have been numerous dissents, for instance, by Chief Judge Jones and Judge Madden in *Royal Indemnity*³⁰ and Judge Larramore in *Maryland Casualty*.

One type of situation which has never been finally resolved in the Court of Claims arises where a bank has been induced to make the loan by a surety who was fully cognizant of the obligations to the bank at the time of writing the bonds or who participated in the establishment of the overall relationship between contractor, bank and surety.

To recapitulate, the situation is this: (1) The surety's position has evolved over a period of time as a consequence of the desire on the part of the government and the courts to treat all concerned with equity and fairness. (2) The position of the bank is a creature of statute. (3) The question of who has the fund will control the outcome since if there are still funds in the hands of the government the case will be heard in the Court of Claims with all parties called in and the surety will be given a preference. Otherwise, the bank will prevail.³¹ (4) The Supreme Court has refused certiorari in *National Sur. Corp. v. United States*,³² a holding which follows *Royal Indemnity*. The Court cited *Royal Indemnity*³³ in a note to *Pearlman v. Reliance Ins. Co.*³⁴ with an implication of approval.

It should also be noted that the Court of Claims bases this third party practice on the Contract Settlement Act of 1944.³⁵ However, this writer feels that the jurisdiction of the Court of Claims in cases not involving contract termination has been fully set out by a statute which was considered thoroughly by Congress and rewritten in 1953 and

²⁶ 237 F.2d 90 (9th Cir. 1956).

²⁷ Sadler, *Governments Contracts—Rights of Assignee and Surety*, 24 Geo. Wash. L. Rev. 708 (1956).

²⁸ 134 Ct. Cl. 251, 139 F. Supp. 556 (1956).

²⁹ 135 Ct. Cl. 428, 141 F. Supp. 900 (1956).

³⁰ *Supra* note 23.

³¹ *Supra* note 20.

³² 132 Ct. Cl. 724, 133 F. Supp. 381, cert. denied, 350 U.S. 902 (1955).

³³ *Supra* note 23.

³⁴ *Supra* note 5.

³⁵ 58 Stat. 663 (1944), 41 U.S.C. § 114(b) (1958). See *supra* note 29; *Seaboard Sur. Co. v. United States*, 144 Ct. Cl. 686, cert. denied, 359 U.S. 1001 (1959).

revised in 1954.³⁶ No express extension of the Court of Claims jurisdiction was provided by Congress therein. This, it is felt, indicates that the Court of Claims should not be concerned with these essentially private controversies where the United States is a mere stakeholder and a nominal party in interest. They should be settled in the regular federal courts.

Further, no decision has ever adequately answered the argument that assumption of jurisdiction by the Court of Claims denies private litigants the right of a jury trial, a constitutional privilege which should transcend any statute. Certainly the court's statement in *Maryland Casualty*³⁷ that the acceptance of an assignment constitutes an acquiescence to jurisdiction is most difficult to follow. Some of these issues arose in *Newark Ins. Co. v. United States* in the Court of Claims and the court ruled on two motions.³⁸ However, the case was settled without a final determination.

Meanwhile, with the law in the stage that it is at the present, banks, surety companies and contractors would be well advised at the very inception, prior to the arising of any controversy, to enter into agreements among themselves which would forestall any disputes and establish between them rights of priority. In considering such agreements it would also be well to keep in mind the superior position a bank enjoys under the provisions of the Assignment of Claims Act, with respect to independent obligations and recoupment by the United States as previously mentioned.

Legislation has been suggested and, of course, efforts have been made to bring the priority conflict to the United States Supreme Court, to date unsuccessfully. In view of the inescapable logic of the several lines of reasoning offered and the dilemma resulting from their application, it would appear that legislation dealing with the entire subject would be the best ultimate solution.

Meanwhile, in the absence of any agreement, as suggested above, perhaps the most practical solution would be a proceeding in the nature of an interpleader in a federal district court, as was suggested in Professor Speidel's article,³⁹ where at least a jury trial is available. Understandably, sureties could not view this plan with any enthusiasm!

Surety v. United States Tax Lien

At last we have come to an area in which the law is perfectly clear. The United States, asserting a tax lien, is entitled to set off this sum

³⁶ 28 U.S.C. §§ 1491-1505 (1958).

³⁷ *Supra* note 29.

³⁸ *Newark Ins. Co. v. United States*, 144 Ct. Cl. 655, 169 F. Supp. 955 (1959), assignee's motion to dismiss government's cross-claim denied, 149 Ct. Cl. 170, 181 F. Supp. 246 (1960).

³⁹ *Supra* note 20.

against a surety who is claiming a right to the contract proceeds. In *United States v. Munsey Trust Co.*,⁴⁰ the surety on a payment bond undertook to say that, being subrogated to the rights of laborers and materialmen who had something in the nature of a lien, it had superior rights. The Court pointed out, however, that the bonds provided for payment to the laborers and materialmen and that there was a general right of setoff in the United States. Prior cases which hold, in effect, that the surety's right of subrogation cannot operate contrary to the rights of the United States are *United States v. National Sur. Co.*⁴¹ and *Globe Indem. Co. v. United States*.⁴² *Standard Acc. Ins. Co. v. United States*⁴³ and *General Cas. Co. v. United States*⁴⁴ follow *Munsey Trust* and extend the general rights of setoff on the part of the United States to tax claims. Recently, sureties do not appear to have contested the priority of tax liens.

As mentioned previously, in 1963 in *United Pac. Ins. Co. v. United States*⁴⁵ with respect to a counterclaim therein for federal taxes "the parties have conceded that this claim is a valid offset against the claims of the Surety and the Trustee."⁴⁶ Note, however, that *Central Bank v. United States*⁴⁷ holds that the anti-setoff provisions give a bank priority over United States tax liens, even those involving withholding taxes on the subject contract, on the theory that this was the express intent of Congress. Thus, we have the anomalous situation of sureties in the Court of Claims coming ahead of banks but behind the United States on a tax claim while the bank is ahead of the United States on a tax claim. Further, if the theory of the recent *Pearlman*⁴⁸ decision is followed, it may re-open the arguments asserted in the *Munsey Trust* and *Standard Accident* cases that on this basis sureties have a prior claim to the proceeds of the contract itself.

Surety v. United States Government Claims for Setoffs From Other Transactions

Little need be added on the general rights of the United States to setoff in addition to what has been mentioned in the prior section. In fact, the foundation for the holdings in the various tax lien cases lies in the basic tenet that the United States has the same rights as a private party to setoffs, *McKnight v. United States*.⁴⁹ In *Munsey Trust*, the

⁴⁰ Supra note 6.

⁴¹ 254 U.S. 73 (1920).

⁴² 84 Ct. Cl. 587, cert. denied, 302 U.S. 707 (1937).

⁴³ 119 Ct. Cl. 749, 97 F. Supp. 829 (1951).

⁴⁴ 130 Ct. Cl. 520, 127 F. Supp. 805, cert. denied, 349 U.S. 938 (1955).

⁴⁵ Supra note 7.

⁴⁶ Id. at 894.

⁴⁷ 123 Ct. Cl. 237, 105 F. Supp. 992 (1952), rev'd, 345 U.S. 639 (1953).

⁴⁸ Supra note 5.

⁴⁹ 98 U.S. 179 (1878).

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setoff represented the amount of damage sustained as a result of the default of the contractor in connection with another job which it bid and did not perform. There the excess above the amount deposited with the contractor's bid was allowed as a setoff. Since that decision the law on this subject has been firmly established.⁵⁰ Further, by statute⁵¹ the Court of Claims is expressly given jurisdiction over setoffs asserted by the United States, so the question of a proper forum does not exist here.

Conclusion

It is suggested that the ultimate solution to these controversies should come from legislation; first, definitely establishing an order of priority in the rights to contract proceeds and second, resolving the jurisdictional controversy.

Meanwhile, as stated, contractors, banks and sureties would be well advised to agree among themselves, when their commitments are originally made, upon their relative rights and priorities.

⁵⁰ Supra note 17.

⁵¹ 28 U.S.C. § 1503 (1958).