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## Suretyship-Subrogation-Rights of Surety to Funds Withheld Under A Government Contract

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SURETYSHIP—SUBROGATION—RIGHTS OF SURETY TO FUNDS WITHHELD UNDER A GOVERNMENT CONTRACT—Petitioner surety, under the terms of its payment bond, paid laborers and materialmen of a government contractor, who was later adjudicated bankrupt. The Government paid to the trustee in bankruptcy funds it had retained but which had been earned prior to termination of the contract. The district court<sup>1</sup> reversed the referee's ruling denying the surety's petition for an order directing the trustee to transfer the retained funds to the surety. On appeal, *held*, affirmed. The surety was entitled to the funds, in preference to the trustee in bankruptcy, by subrogation to the laborers' and materialmen's equitable priority in the retained payments. *In the Matter of Dutcher Constr. Corp.*, 298 F.2d 655 (2d Cir.), *cert. granted sub nom. Pearlman v. Reliance Ins. Co.*, 82 Sup. Ct. 936 (1962).

The Miller Act<sup>2</sup> requires a government contractor to furnish two bonds, one guaranteeing performance of the contract and the other guaranteeing payment of laborers and materialmen. When a surety fulfills the terms of either or these bonds, it becomes subrogated<sup>3</sup> to the rights of the laborers and materialmen<sup>4</sup> or of the Government.<sup>5</sup> In such a case the surety's right to funds retained by the Government has usually been preferred to the

<sup>1</sup> *In the Matter of Dutcher Constr. Corp.*, 197 F. Supp. 441 (W.D.N.Y. 1961).

<sup>2</sup> 49 Stat. 793 (1935), 40 U.S.C. § 270a-d (1958).

<sup>3</sup> Subrogation is the equitable doctrine under which the surety, by fulfilling the duties owed to the obligee, is entitled by substitution, to the rights and interests which the obligee had as security for the obligor's performance. RESTATEMENT, SECURITY § 141 (1941).

<sup>4</sup> *United States Fid. & Guar. Co. v. Sweeney*, 80 F.2d 235 (8th Cir. 1935); *Street v. Pacific Indem. Co.*, 79 F.2d 68 (9th Cir. 1935), *cert. denied*, 297 U.S. 718 (1936); *Hadden v. United States*, 132 F. Supp. 202 (Ct. Cl. 1955).

<sup>5</sup> *Prairie State Bank v. United States*, 164 U.S. 227 (1896); *In re L. H. Duncan & Sons*, 127 F.2d 640 (3d Cir. 1942); *National Sur. Corp. v. United States Fid. & Deposit Co.*, 133 F. Supp. 381 (Ct. Cl.), *cert. denied*, 350 U.S. 902 (1955).

claims of the general creditors<sup>6</sup> and assignees<sup>7</sup> of the contractor. However, in *United States v. Munsey Trust Co.*,<sup>8</sup> the Supreme Court stated that "laborers and materialmen do not have enforceable rights against the United States for their compensation."<sup>9</sup> The Ninth and Tenth Circuits have extended this language to its logical conclusion: if laborers and materialmen have no enforceable rights against the United States, they have no enforceable rights against funds held by the United States—consequently they have no superior rights to which the surety can be subrogated.<sup>10</sup> However, in the principal case, the Second Circuit limited *Munsey* to cases in which the Government claims an interest in the retained funds.<sup>11</sup> Since the Government acts as a mere stakeholder here, the court held that laborers and materialmen had an "equitable priority" in the funds, based upon the premise that the Government has an "equitable obligation," albeit unenforceable, to see that the laborers and materialmen are paid.<sup>12</sup>

In the absence of statute,<sup>13</sup> a person supplying services or materials pursuant to an agreement with a contractor cannot recover in quasi-contract<sup>14</sup> or by way of equitable lien<sup>15</sup> from an owner whose property has been improved thereby. A fortiori, these remedies would not be available

<sup>6</sup> E.g., *In re L. H. Duncan & Sons*, *supra* note 5; *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 271 Fed. 144 (6th Cir. 1921); *In re P. McGarry & Son*, 240 Fed. 400 (7th Cir. 1917); *In re Cummins Constr. Corp.*, 81 F. Supp. 193 (D. Md. 1948).

<sup>7</sup> E.g., *Henningsen v. United States Fid. & Guar. Co.*, 208 U.S. 404 (1908); *Prairie State Bank v. United States*, 164 U.S. 227 (1896); *Hadden v. United States*, 132 F. Supp. 202 (Ct. Cl. 1955).

<sup>8</sup> 332 U.S. 234 (1947).

<sup>9</sup> *Id.* at 241.

<sup>10</sup> *American Sur. Co. v. Hinds*, 260 F.2d 366 (10th Cir. 1958); *Phoenix Indem. Co. v. Earle*, 218 F.2d 645 (9th Cir. 1955).

<sup>11</sup> In *Munsey* the surety paid the laborers and materialmen of an otherwise completed contract. The contractor had breached another, unrelated contract. The Supreme Court upheld the Government's claim to set-off the damages sustained under the latter contract against the funds withheld under the former.

<sup>12</sup> Principal case at 658. The premise that the Government is under an "equitable obligation" to see that the laborers and materialmen are paid is based upon language in *Henningsen v. United States Fid. & Guar. Co.*, 208 U.S. 404, 410 (1908), as interpreted in *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 271 Fed. 144 (6th Cir. 1921). The *Henningsen* case, however, did not hold specifically that the laborers and materialmen had a prior right to the funds, but only that the surety's rights under its invalid assignment were prior in time to the bank's rights under another invalid assignment.

<sup>13</sup> In most states, persons furnishing labor and materials in construction contracts have a statutory lien upon the improved property to insure their being paid. E.g., FLA. STAT. ANN. § 84.02 (1943); MICH. COMP. LAWS § 570.1 (1948); N.Y. LIEN LAW § 3. However, no lien can be acquired on property of the federal government. *Armstrong v. United States*, 364 U.S. 40, 41 (1960); *Hill v. American Sur. Co.*, 200 U.S. 197, 203 (1906).

<sup>14</sup> *Alexander v. Alabama W. Ry.*, 179 Ala. 480, 60 So. 295 (1912); *Trimmer v. Sells*, 87 Kan. 647, 125 Pac. 42 (1912); *Cahill v. Hall*, 161 Mass. 512, 37 N.E. 573 (1894); *Cascaden v. Magryta*, 247 Mich. 267, 225 N.W. 511 (1929); *Green v. Messing*, 236 App. Div. 107, 258 N.Y. Supp. 82 (1932).

<sup>15</sup> *Van Stone v. Stillwell & Bierce Mfg. Co.*, 142 U.S. 128 (1891); *Davis Estate v. West Clayton Realty Co.*, 338 Mo. 69, 89 S.W.2d 22 (1935); *Reynolds v. Griswold*, 152 Wis. 144, 139 N.W. 727 (1913). See Kerley, *Rights of Parties in Funds Withheld Under Government Construction Contracts*, 20 U. CINC. L. REV. 494 (1950).

against the Government, as no judicially recognized means exist whereby the laborers and materialmen can require the Government to pay the withheld funds directly to them.<sup>16</sup> Although laborers and materialmen may be said to have a "moral right" to the funds retained by the Government, this right is not sufficient to confer a priority on one class of creditors in a bankruptcy proceeding.<sup>17</sup> If the laborers and materialmen have no enforceable rights in funds still in the hands of the Government, whatever enforceable interests they do have can arise only after the funds are paid to the bankrupt contractor and become a part of his estate. If these rights accrue within four months of the filing of bankruptcy, they are vulnerable as illegal preferences under section 60 of the Bankruptcy Act.<sup>18</sup> On the other hand, only the laborers' wages earned within three months of the commencement of the bankruptcy proceedings qualify for the statutory priority conferred in section 64(a)(2).<sup>19</sup> Thus, arguably the laborers and materialmen are entitled to neither an enforceable lien nor any priority in the retained funds to which the surety can be subrogated.

It seems, however, that the surety does have a prior right to these funds by subrogation to the rights of the Government.<sup>20</sup> Most government contracts contain a provision that the contractor will pay the laborers and materialmen;<sup>21</sup> and, even if the contract itself does not so state, the terms of the bond are to be read as a part of the contract and binding upon the contractor.<sup>22</sup> Since the contract requires payment of the laborers and materialmen, failure to pay them constitutes a material breach, and the Government has the right to retain any funds owing under the contract until the breach is rectified.<sup>23</sup> By paying the laborers and materialmen,

<sup>16</sup> However, there is one ground upon which the laborers might claim a right to the retained funds superior to the claims of the general creditors of the contractor. Congress has authorized and directed the Comptroller General to pay any wages that are due directly to the laborers from any accrued payments that are withheld under the contract. Wage Rates Act (Public Buildings), 49 Stat. 1011 (1935), 40 U.S.C. § 276a-2 (1958). Although this right is unenforceable against the Government [see *Veader v. Bay State Dredging & Contracting Co.*, 79 F. Supp. 837 (D. Mass. 1948)], it is a right to be paid from the funds before they become a part of the bankrupt's estate (see note 25 *infra*). If the laborers are paid by the Comptroller General, the payment might not be an illegal transfer of the *bankrupt's* property which could be avoided under the Bankruptcy Act § 60, 64 Stat. 24 (1950), 11 U.S.C. § 96 (1958).

<sup>17</sup> "Section 64 of the Bankruptcy Act provides a hard and fast categorical classification of claims against a bankrupt estate, and the order in which said claims are to be paid. This order of priorities cannot be varied or departed from." *In re Penticoff*, 36 F. Supp. 1, 2 (D. Minn. 1941). See 3 COLLIER, BANKRUPTCY § 64.02 (1961).

<sup>18</sup> See note 17 *supra*.

<sup>19</sup> Bankruptcy Act § 64(a)(2), 52 Stat. 87A (1938), as amended, 11 U.S.C. § 104(a)(2) (1958).

<sup>20</sup> See note 5 *supra*.

<sup>21</sup> Congress has required that every government contract exceeding \$2,000.00 "shall contain a stipulation that the contractor or his subcontractor shall pay all mechanics and laborers." 49 Stat. 1011 (1935), as amended, 40 U.S.C. § 276a (1958). Many government contracts also require that materialmen be paid.

<sup>22</sup> *Martin v. National Sur. Co.*, 300 U.S. 588, 598 (1937).

<sup>23</sup> *Ibid.*; *In re L. H. Duncan & Sons*, 127 F.2d 640 (3d Cir. 1942); *Hartford Acc. & Indem. Co. v. Coggin*, 78 F.2d 471 (4th Cir.), *cert. denied*, 296 U.S. 620 (1935).

the surety discharges a duty owed to the Government and becomes subrogated to the Government's right to retain payments until the terms of the contract are fulfilled.<sup>24</sup> Therefore, the surety has a right to the retained funds before they are ever due to the contractor or his trustees,<sup>25</sup> and his right to the funds is superior and prior to the rights of the general creditors of the contractor.

It is submitted that the Second Circuit reached the correct result in the principal case: a surety who fulfills the terms of his payment bond has a right in the retained funds superior to the general creditors of the contractor. However, it would appear that this superiority should be based upon subrogation to the rights of the United States rather than the more tenuous rights of the laborers and materialmen.

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<sup>24</sup> Furthermore, when the laborers and materialmen sue the surety to enforce the payment bond, they may do so in the name of the United States. Miller Act, 49 Stat. 793 (1935), 40 U.S.C. § 270a-d (1958). The payment of the laborers and materialmen in the name of the United States is further evidence that the surety is fulfilling an obligation owed to the Government even though the actual benefit goes to others.

<sup>25</sup> When the Government has sought to impose a tax lien upon the retained funds, it has been held that the contractor had no property in the funds to which the lien could attach. *E.g.*, *Massachusetts Bonding & Ins. Co. v. New York*, 259 F.2d 33 (2d Cir. 1958); *Fidelity & Deposit Co. v. New York City Housing Authority*, 241 F.2d 142 (2d Cir. 1957); *Aetna Cas. & Sur. Co. v. United States*, 4 N.Y.2d 639, 152 N.E.2d 225 (1958); *United States Fid. & Guar. Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 74 N.E.2d 226 (1947). *Contra*, *Phoenix Indem. Co. v. Earle*, 218 F.2d 645 (9th Cir. 1955).