

DECISION



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

FILE: B-186206

DATE: July 1, 1976

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MATTER OF: Request by United States Department of Agriculture
(Forest Service) for collection action against
Capitol Indemnity Corporation

DIGEST:

Where notice of contractor's default is received by contracting officer prior to receipt of IRS setoff request and performance bond surety's refusal to enter into takeover agreement is based on refusal by Forest Service to make available, free from setoff, funds retained under defaulted contract, surety may not be subsequently proceeded against in debt collection action.

Department of Agriculture's (Forest Service) request that our Office institute debt collection action on a defaulted contract presents the issue of whether performance bond surety should be proceeded against where:

1. Surety's refusal to enter into a takeover agreement is based on the Government's refusal to make available, free from setoff by the IRS, funds retained under the defaulted contract;

2. Notice of contractor's default is received by the contracting officer prior to his receipt of IRS setoff request.

Contract 01-2370 (Brush Creek Road No. 1417) called for construction of 2.03 miles of roadway in the Chequamegon National Forest, approximately 16 miles northwest of Medford, Wisconsin. The contract was awarded by the United States Forest Service on May 3, 1971, in the amount of \$85,307.20 to the Midwestern Pacific Corporation (Midwestern).

On August 22, 1972, Midwestern declared itself in default and requested that the unpaid balance of the contract (retainage) be paid to its payment and performance bond surety, Capitol Indemnity

Corporation (Capitol). This letter was received by the contracting officer on August 29, 1972. There is substantial evidence indicating that Midwestern's unstable financial condition was known to the contracting officer at least 2 months prior to default.

On August 31, 1972, the Forest Service sent a directive to the contracting officer requesting compliance with an IRS setoff request, dated August 24, 1972, for the amount of Midwestern's tax liability (\$39,533.06). Responding to this request, the Forest Service paid the IRS \$18,311.76 in a check issued October 2, 1972. Capitol, upon learning of the payment to the IRS, repudiated its performance bond on November 6, 1972. Prior to this date the Forest Service and Capitol were in the process of negotiating a takeover agreement and Capitol had located a contractor who was willing to complete the contract for \$35,500. The only apparent reason for Capitol's decision not to execute a takeover agreement was the refusal by the Forest Service to make available to it money from the retained funds. During the period of negotiations (September-November 6, 1972) the Forest Service had apparently failed to inform Capitol of the payment to the IRS.

The record indicates that Capitol was willing to honor its performance bond and complete the contract provided that the retainage be released to the contractor and surety. In its letter of November 6, 1972, Capitol acknowledged that the monies available from the retainage would be decreased by the amount due under the Miller Act as well as the liquidated damages. Capitol's approach to this matter was fully in accord with the procedure set forth in § 1-18.803-6 (1964 ed. amend 48) of the Federal Procurement Regulations (FPR) concerning dealings with surety takeover agreements.

Following completion of the contract by a successor contractor the Forest Service sent Capitol a bill of collection summarized as follows:

Excess Cost for Reprocurement	\$3,811.72
Liquidated Damages	7,125.00
Excess Administrative Costs	<u>2,472.23</u>
Total	\$13,408.95

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On February 14, 1975, Capitol disclaimed responsibility for the costs and damages and refused to pay. The Forest Service referred the claim to the Department of Justice which declined, on the same legal grounds as do we, to prosecute the claim.

It is well established that a performance bond surety acquires a right to withheld funds when it undertakes to complete performance of a contract upon default of the contractor. Prairie State National Bank of Chicago v. United States, 164 U.S. 227 (1896); Trinity Universal Insurance Co. v. United States, 382 F.2d 317 (5th Cir. 1967), cert. denied 390 U.S. 906 (1968). In Security Insurance Co. of Hartford v. United States, 428 F.2d 838 (Ct. Cl. 1970) the Court of Claims stated that "[W]hen a performance bond surety and the Government enter into a formal take-over agreement, a set-off is not to be permitted against the retained funds claimed by the performance bond surety." 428 F.2d at 843.

This rule is in accord with the Government's interest in allowing the surety to complete the defaulted contract. See FPR § 1-18.803-6(b). As the Fifth Circuit observed in Trinity, the performance bond surety who elects to complete the contract confers a benefit on the Government by relieving it of the task of completing performance itself. 382 F.2d 320. See also American Employers' Insurance Company, Completing Surety for Mike Bradford, Incorporated, under contract NBy 65761, B-180267, February 4, 1974, 74-1 CPD 51. Moreover, the benefit to the Government is enhanced, we think, when the takeover by the completing surety occurs in a swift and orderly fashion. Although the surety's rights to the retained funds are formally created only upon the execution of the takeover agreement, it would be contrary to the overall purpose of § 1-18.803-6 of FPR as well as the reasoning in Trinity and Security to permit a depletion of those funds during the period in which the agreement is being negotiated. Because a workable takeover agreement necessarily requires that the parties negotiate in good faith and with some degree of certainty as to the availability of the retained funds, it is in the interest of the

Government not to honor an IRS setoff request during the period of negotiations following default.

Therefore, to avoid the possibility of jeopardizing the execution of a takeover agreement, it will not be appropriate for the contracting agency to honor an IRS setoff request that is received by the contracting officer after his receipt of the notice of default. There may be circumstances, however, when the contracting officer, after consultation with the surety, will be satisfied that to honor such a request would not undermine the ability of the surety to complete performance of the contract.

In light of the foregoing, our Office will not undertake to initiate a debt collection action against Capitol Indemnity Corporation.

Concerning the question of what steps are available to the Forest Service to obtain a refund from IRS, it must be observed that while our Office has been called upon in the past to decide controversies arising under agreements between two Federal agencies, here there is no agreement and we know of no legal basis under the circumstances of this case by which IRS could be required to refund the monies in question.


Deputy Comptroller General
of the United States