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**DECISION**



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

**FILE:** B-212130

**DATE:** August 20, 1984

**MATTER OF:** Army Request for Advance Decision

**DIGEST:**

Where the unpaid balance due under a government contract is claimed by the contractor's bank as assignee, the payment bond surety, and the Internal Revenue Service (IRS), payment should be made to the IRS because the surety's claim is superior to that of the bank and the government may set off its claim for taxes owed by the contractor against an amount that otherwise would be due the surety.

The Finance and Accounting Officer at Fort Devens, Massachusetts, requests an advance decision as to whom the final payment under contract No. DAKF31-80-D-0244 should be made. For the reasons stated below, we conclude that the funds should be paid to the Internal Revenue Service (IRS).

On September 30, 1980, the Army awarded a fixed-price contract to Diamond Construction, Inc. to install insulation and siding and to paint windows on 38 buildings at Fort Devens. As required under the Miller Act, 40 U.S.C. §§ 270a-270d (1982), Diamond executed payment and performance bonds on which the Aetna Casualty and Surety Company agreed to act as surety. Also on September 30, Diamond assigned all payments that would become due under the contract to the Pelham Bank and Trust Company. The bank notified the contracting officer of the assignment, as the Assignment of Claims Act, 31 U.S.C. § 3727 (1982), requires; the record does not show that the bank complied with the Act's requirement that it also give notice to the surety and to the disbursing officer. After an increase in the contract price for additional work, and a decrease for work that the contractor did not complete, the total due under the

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B-212130

contract is \$307,343.36. Of this amount, the Army is holding a balance of \$15,086.92 pending resolution of the following demands for payment:

- On November 2, 1981, the IRS served a Notice of Levy on the Finance and Accounting Officer demanding payment of \$30,210.12 for unpaid taxes and statutory additions to the tax which had been assessed against the contractor in September and November of 1981.
- By letter of May 7, 1982, the surety informed the Army that it had received claims from unpaid creditors of Diamond, some of whom had filed suit against the surety under the payment bond. Aetna requested that no further payments be made to Diamond and stated that, as the payment bond surety, it was entitled to have the Army apply any remaining funds against those claims. In a subsequent submission to this Office, Aetna states that it incurred a loss under the payment bond of \$56,836. Aetna also has informed us that it does not know of any suppliers or laborers of Diamond who remain unpaid at this time.
- The bank maintains that its assignment is still in effect and that Diamond's indebtedness to the bank exceeds the remaining funds due under the contract.

Certain rules for establishing an order of priority among these conflicting claimants are well-established. As between the IRS and a payment bond surety, the IRS is entitled to priority because, although a surety who pays laborers and materialmen may have a right to contract funds retained by the government, Pearlman v. Reliance Insurance Co., 371 U.S. 132 (1962), the government nevertheless may satisfy by setoff any tax claim it may have against the contractor. Aetna Ins. Co. v. United States, 456 F.2d 773 (Ct. Cl. 1972), citing United States v. Munsey Trust Co., 322 U.S. 234 (1947). As between the IRS and an assignee bank, the Assignment of Claims Act provides that if, as here, the contract contains a no-setoff clause, and other requirements of the Act have been satisfied, payments shall be made to the assignee without reduction or setoff for any

liability of the contractor for taxes, withholdings, social security contributions, or penalties. See 62 Comp. Gen. 683 (1983). Thus, it appears to us that if the bank has priority over the surety, the bank would be entitled to the funds since its claim would not be subject to setoff by the IRS. On the other hand, if the surety has priority over the bank, the IRS would be entitled to the funds since it may set off its claim for taxes against the funds remaining in the hands of the government.

The matter of priority between the surety and the assignee, however, has not been entirely free of doubt. The consistent position of the United States Court of Claims had been that a surety who has paid on behalf of its principal debts owing to unpaid laborers and materialmen has an equitable interest in contract funds held by the government that is superior to the interest of an assignee bank. See, e.g., Great American Ins. Co., v. United States, 492 F.2d 821 (1974); Royal Indemnity Co. v. United States, 93 F. Supp. 891 (Ct. Cl. 1950).<sup>1/</sup> The apparent rationale is that an assignee can acquire no greater right to a fund than its assignor had, and the assignor's right to payments under a government contract is subject to the surety's right to be reimbursed for amounts paid on the contractor's behalf to laborers and suppliers. On the other hand, the United States Court of Appeals for the Fifth Circuit has said that the bank should prevail, at least where amounts due under the contract have already been paid to the bank as opposed to being held by the government. Coconut Grove Exchange Bank v. New Amsterdam Cas. Co., 149 F.2d 73 (5th Cir. 1945). This case has generated uncertainty in this area and has accounted for our practice in these assignee versus payment bond surety cases to recommend that payment be made to no one pending either an agreement among the parties or a judicial determination. See, e.g., Air Force Request for Advance Decision, B-198100, Dec. 16, 1980, 80-2 CPD ¶ 433.

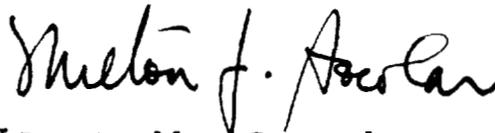
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<sup>1/</sup>Although the United States Claims Court, the successor to the Court of Claims, has not yet, to our knowledge, had occasion to consider this issue, it has adopted as binding precedent the decisions of the Court of Claims. United States Claims Court, General Order No. 1, October 7, 1982.

B-212130

We reviewed again the authorities in this area and are now convinced that our prior cases gave too much weight to the views expressed in Coconut Grove. We believe that the holding in Coconut Grove should be limited to its facts, that is, where contract funds have been paid to the bank, the Assignment of Claims Act establishes in the bank an unqualified right to retain them notwithstanding the competing claims of others. Where the funds have been paid to no one, however, the equitable right of the surety to have the funds applied against its claim is superior to the claim of the assignee bank.

Since the surety's claim is superior to that of the bank, this contest for the funds might appear to create a situation of circular priorities--the bank beats the IRS, which beats the surety, which beats the bank. This problem is resolved, however, by recognizing that the bank is entitled to the protection of the no-setoff clause only if it first can establish that it is otherwise entitled to the funds. It cannot do this here as long as the surety is maintaining its claim. In this situation, we think the IRS may properly exercise its right of offset over the claim of the surety.



Acting Comptroller General  
of the United States