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

FILE: B-217167 **DATE:** August 13, 1985

MATTER OF: Priority of Payment from Remaining Contract Proceeds

DIGEST:

1. Order of priority for the payment of remaining contract proceeds held by a contracting Federal agency are to the surety on its performance bond, including the taxes required to be paid under the bond, the IRS for the tax debts owed by the contractor, the surety on its payment bond, and the assignee.

2. As the remaining contract proceeds held by a Federal contracting agency are not, and will not, become the property of the defaulting contractor, the trustee in bankruptcy would have no right to them.

3. Since the owner-operator laborers performing work on a Federal contract have been paid, and the question of priority of payment of remaining contract proceeds held by Federal contracting agency does not depend on determining whether the laborers are covered by the Davis-Bacon Act, 40 U.S.C. § 276a, the question of whether they are covered by that Act is moot and need not be answered.

A contracting officer with the Department of Agriculture's Forest Service has asked us to determine the order of priority of payment among several claimants of the remaining $36,500 proceeds of a contract between the United States Forest Service and Scott Construction Co. (Contract No. 50-9JHA-2-216). The claimants are the Internal Revenue Service, Reliance Insurance Co., as surety on performance and payment bonds, the Bank of America as the contractor's assignee, and a trustee in bankruptcy. He also asks whether certain owner-operator laborers who performed work for Scott Construction are covered by the Davis-Bacon Act, 40 U.S.C. § 276a.

For the reasons given below, we find the order of priority to be first, Reliance on its performance bond, second, the Internal Revenue Service (IRS) for the tax debt,

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third, Reliance on its payment bond, and last, the Bank of America. As the laborers have all been paid by the payment bond surety, we think the Davis-Bacon Act issue is moot.

BACKGROUND

The contract in question was awarded to the Scott Construction Co., on August 28, 1982, for $271,780.40. On September 28, 1982, performance and payment bonds were executed between Scott Construction and the surety, the Reliance Insurance Co., consistent with the contract provision making the Miller Act, as amended, 40 U.S.C. §§ 270a-270d, applicable to the contract. The Miller Act requires performance and payment bonds on various kinds of Government contracts exceeding $25,000. On May 27, 1983, Scott Construction assigned all monies due or to become due on the contract to the Bank. Proper notice of the assignment was received by the Forest Service contracting officer on June 13, 1983, in compliance with the Assignment of Claims Act, 31 U.S.C. § 3727. We understand that at the time of the assignment, the assignee knew that Scott Construction Co. had secured performance and payment bonds with Reliance. The assignment does not have a "no setoff" clause.

The IRS has informed us that Scott Construction failed to pay required taxes arising from the contract for the second, third and fourth quarters of 1983. The first notice of tax lien was filed with the Forest Service on October 25, 1983. Not all of the delinquent taxes, however, which exceed $250,000, pertain to the Forest Service contract. On October 26, 1983, David Scott, representing the Scott Construction Co., filed a chapter 11 petition for bankruptcy in the United States Bankruptcy Court for the Eastern District of California. In re Scott, No. 283-04392-W-11.

The Forest Service terminated the contract with Scott Construction Co. for default on November 7, 1984. Soon thereafter, pursuant to its performance bond, the surety, Reliance, elected to complete the remaining contract work. The takeover agreement states that the estimated total cost for the work is $10,000. Reliance has also paid $15,449.50 to the IRS in partial payment of Scott Construction's tax liability arising from the contract under its performance bond. Pursuant to its payment bond obligations, Reliance has paid all contract obligations incurred by its principal, including the claims for wages of four owner-operators who performed work on the contract.

Reliance contends that it has first priority for reimbursement on the retained contract funds pursuant to its performance bond, both for amounts incurred in completing work on the project and for the $15,449.50 paid to the IRS for the contractor's delinquent taxes. Furthermore, in reliance on Henningsen v. United States Fidelity and Guaranty Co., 208 U.S. 404 (1908), Reliance claims that it also has priority rights to reimbursement from the retained funds for satisfying its payment bond obligations. These rights, it contends, are equal to its performance bond rights, and thus superior to the interest of both the IRS and the assignee Bank of America.

The IRS states that all of its claims, whether for taxes pertaining to the contract or other taxes, have priority over all competing claims to the remaining contract proceeds, with the possible exception of the performance bond surety for its expenses in completing the contract. The Service argues that its claims arose prior to those of the Bank of America because the taxes were assessed prior to full performance of the work which gave rise to the assigned account receivable.

LEGAL DISCUSSION

1. Performance Bond Surety vs. All Others

It is well established that a surety who completes performance of a contract or pays funds needed for completion of a contract, becomes entitled to remaining contract proceeds in the hands of the Government as the Government's subrogee. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 139 (1962); Trinity Universal Ins. Co. v. United States, 382 F.2d 317, 320 (5th Cir. 1967), cert. denied 390 U.S. 906 (1968). It also is established that a surety completing a defaulted contract under a performance bond has a right to reimbursement from the unexpended contract balance for the expenses it incurs, free from setoff by the Government of the contractor's debts to the Government. 62 Comp. Gen. 498, 500-01 (1983). Thus, the performance bond surety's priority over the Government's right to set off tax debts "avoids the anomalous result whereby the performance bond surety, if set-off were permitted, would frequently be worse off for having undertaken to complete performance." Security Ins. Co. of Hartford v. United States, 428 F.2d 838, 844 (Ct. Cl. 1970). It follows that a performance bond surety who stands in the contracting agency's shoes has priority over an assignee of contract proceeds, who is entitled to such proceeds only to the extent that the assignor would have been entitled had the assignment not been made. Prairie State Bank v. United States, 164 U.S. 227, 239-40 (1896); Trinity Universal Ins. Co. v. United States, 382 F.2d at 320.

Consistent with these principles, we think Reliance has first priority to receive the unexpended contract proceeds for its performance bond obligations. This priority includes not only the expenses for carrying out the work on the contract but also for payment of any employment taxes covered by the performance bond. In this regard, we have held that a surety who pays the withholding taxes required to be paid under a performance bond is entitled to be reimbursed for the amount of those taxes free from set-off for any other debts of the contractor. B-189679, September 7, 1977; see United States v. United States Fidelity and Guaranty Co., 328 F. Supp. 69 (E.D. Wash. 1971), aff'd, 477 F.2d 567 (9th Cir. 1973). This is consistent with section 1 of the Miller Act, as amended, 40 U.S.C. § 270a(d), which requires every performance bond to "specifically provide coverage for taxes imposed by the United States which are collected, deducted, or withheld from wages paid by the contractor in carrying out the contract with respect to which such bond is furnished." The contract between Scott Construction and the Forest Service makes the Miller Act applicable to the contract.

2. Payment Bond Surety, IRS, and Assignee

With respect to the other claimants, the priorities are more complicated. The doctrine of subrogation allows a payment bond surety who pays the debts of his principal to assert all the rights of the creditors who were paid, in order to enforce the surety's right to be reimbursed. Pearlman v. Reliance Ins. Co., 371 U.S. at 136-37. For example, when a surety meets its obligations on a payment bond by paying claims of laborers and materialmen, as happened in this case, it is subrogated to whatever rights the contractor and laborers and materialmen had in undisbursed contract funds. Id. at 141. The surety's right has been held to relate back to the date of the surety bond, entitling it to priority over all subsequent lienholders and general creditors. Western Casualty and Surety Co. v. Brooks, 362 F.2d 486, 489-90 (4th Cir. 1966).

As an assignee can acquire no greater right to contract proceeds than its contractor-assignor had, and an assignor's rights to payment under a Government contract is subject to the surety's right to be reimbursed for amounts paid on the contractor's behalf, a payment bond surety would have priority over an assignee. 63 Comp. Gen. 533, 535 (1984).

In this instance, pursuant to its payment bond obligations, Reliance paid the four operator-owners mentioned above, who did the actual work under the contract. Moreover, the payment bond was executed some 9 months before the assignment was made, and, in any event, the assignee had notice of the surety's bond obligations. Thus, Reliance has priority over the Bank on its payment bond.

It is well-settled that the Government has the same right belonging to every creditor to apply undisbursed moneys owed to a debtor to fully or partially extinguish debts which he owes to the Government[1]. United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947); Gratiot v. United States, 40 U.S. (15 Pet.) 336, 370 (1841); B-214905.2, July 10, 1984. Thus, absent a "no set-off" clause in a contract, the Government may satisfy by set-off any tax claim it has against a contractor, notwithstanding that all or part of the tax claim does not pertain to the contract under which the parties are contesting payment. The Government's right of set-off has been held to be superior to that of a payment bond surety who has paid the claims of laborers and materialmen, United States v. Munsey Trust Co., 332 U.S. at 239-44, and to that of an assignee so long as the tax debt arose before the assignment was made. 60 Comp. Gen. 510, 513-15 (1981).[2] Accordingly, the IRS would have priority over Reliance on its payment bond and the Bank of America as assignee on the tax debts that arose before the assignment was made.

We reach the same result in the present case for the tax debt that arose after the notice of assignment was filed with the Forest Service, but on different grounds. It is true that as mentioned above, in the absence of a no set-off provision in a contract, an assignee has priority over the IRS for tax debts accruing after an assignment is made. 60 Comp. Gen. at 513-14. This is based on the common law principle that the debts of an assignor that mature after an assignment is made may not be set off against payments otherwise due the assignee. Id. Nevertheless, if we hold in this case that the Bank of America has priority over the

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1/ Of course, the Government also has a right to enforce its tax lien. 26 U.S.C. §§ 6321, 6322.

2/ When a validly assigned contract does contain a no setoff clause, the IRS may not set off a tax claim against the assignor regardless of when it arose or became mature. 62 Comp. Gen. 683, 690-693 (1983).

IRS for the tax debts of the contractor that arose after the notice of assignment was received by the Forest Service, we would create a tautology that admits of no solution. The IRS would have priority over the payment bond surety, the surety over the assignee, and the assignee over the IRS.

A similar problem was considered and resolved in 63 Comp. Gen. 533, 536 (1984), in which the assignment did have a no set-off clause. There we held that the assignee bank was entitled to priority over the IRS only if it could establish that it otherwise was entitled to the funds. Since the payment bond surety had priority over the assignee, the assignee was not "otherwise" entitled to the funds, and therefore it could not have priority over the IRS. Thus, we found the order of priority to be the IRS, the payment bond surety, and last, the assignee bank. We think the same principle should apply here. In other words, since Reliance on its payment bond obligations has priority over the Bank, the Bank would be precluded from maintaining its priority over the IRS.

3. Trustee in Bankruptcy vs. All Other Claimants

With regard to the trustee in bankruptcy, the Supreme Court has held that property interests in a fund not owned by a bankrupt at the time of adjudication are not a part of the bankrupt's property and do not vest in the Trustee. Pearlman v. Reliance Ins. Co., 371 U.S. at 135-36. In Pearlman, the Court said that the Bankruptcy Act "simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors." Id. at 135-36. As the remaining contract proceeds are not, and will not be, owned by Scott Construction Co., or by Mr. Scott, the Trustee has no right to them.

As a final matter, since the four owner-operator laborers, described earlier, were paid by Reliance pursuant to its payment bond obligations, and the answer to the priority question does not depend on determining whether they were covered by the Davis-Bacon Act, 40 U.S.C. § 276a, the question about their coverage is moot and need not be answered.[3]

Milton J. Fowler
for Comptroller General
of the United States

[3] Consistent with the Department of Labor's informal comments to us, however, we do point out that the salient factor for determining Davis-Bacon coverage is not the contractual relationship between the contractor and the individual, but whether the individual is performing the duties of a laborer or mechanic. 29 C.F.R. § 5.2(o).