J Cunningham Proc I

DECISION

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

8837

FILE: B-189183 DATE: January 12, 1979

MATTER OF: Robert L. Singleton; Capital City Construction, Inc., et al.

PLG 00570

DIGEST:

1. GAO will not question indebtedness owed by 8(a) subcontractor to Small Business Administration (SBA), notwithstanding allegations of fraudulent inducement to debt and alleged breach of collateral agreement by SBA, since allegations are unsupported and are contradicted by SBA.

2. Where surety has paid only fraction of outstanding claim under its payment bond, surety will not be permitted to share in retainage held by Government despite assertion that SBA advance payment to contractor was improper.

3. Right of set-off as to debts owed is inherent ~~in United States~~ and extends to debts owed as result of loan by SBA to 8(a) subcontractor. SBA's capacity as Government agency could not be disregarded by courts.

4. SBA was not authorized to subordinate its interest to surety in view of dollar amount of contract.

5. Pearlman v. Reliance Insurance Company, 371 U.S. 132 (1962), does not affect Government's right to priority to contract retainage against surety which has completed payments under payment bond.

6. Attorney's liens are not recognizable against United States.

~~003216~~

The Singleton Subcontract

On August 23, 1972, the Small Business Administration (SBA) and the Federal Aviation Administration (FAA) entered into contract No. DOT-FA73-SO-7071 for expansion and modernization of the Jacksonville Air Route Traffic Control Tower at Hilliard, Florida, in the amount of $2,455,366. On the same date, SBA entered into a subcontract--under so-called "8(a)" contracting authority--with Robert L. Singleton to do the work. FAA reports that "SBA delegated to FAA the responsibility of administering the [subcontract] * * * [and that] Reliance Insurance Company was the Miller Act payment and performance bond surety [for Robert Singleton]."

On May 29, 1974, SBA and Singleton entered into a modification of the subcontract which provided for the making of an advance payment by SBA to Singleton in the amount of $150,000. This agreement, in part, provided:

> "The final $150,000 due and payable by the U.S. Government (DOT/FAA) on this contract shall be withheld and used to liquidate this advance payment."

The advance and agreement were made without the knowledge or consent of Reliance.

Singleton completed the subcontract, but was unable to pay his laborers and materialmen. FAA reports that Reliance paid these creditors $9,000 and is being sued for another $142,946 under its payment bond. FAA reports that it is holding $150,000 under this contract to pay all claims relating to the contract.

Singleton contends that the $150,000 payment received from SBA was not a loan but an outright "grant or gift" and that for SBA to insist otherwise

means that the SBA fraudulently induced Singleton to sign the documents evidencing the purported loan. Moreover, Singleton alleges that SBA is indebted to the company because of its failure to deliver promised funds under other agreements for which failure Singleton is "presently preparing to file suit." Singleton therefore urges that the SBA cannot properly lay claim to the retainage.

Reliance argues that the prepayment by SBA to Singleton was improper as a "prepayment to a contractor by the Government without the consent or knowledge of the surety." Reliance urges that it has a right to the retained amount because of payments made to laborers and materialmen under its payment bond. Consequently, Reliance argues that it is "entitled to the retained fund, not as a creditor and subject to set off, but as a subrogee having the same rights to the fund as the government."

The Capital Subcontract

On August 17, 1972, SBA and FAA entered into contract No. DOT FA73-RM-0203 (price $2,925,478) for modernization and expansion at the Longmont, Colorado, air traffic control center. On the same date, SBA entered into subcontract No. SB830-8(a)-73-C-001 with Capital City Construction, Inc., to do the work.

FAA reports that Capital had difficulty securing appropriate bonding but that Aetna Insurance Company "eventually provided Miller Act performance and payment bonds." FAA further reports that "Aetna asserted that [bonding was provided] because SBA agreed to subordinate its interest in the contract to Aetna in return for Aetna's cooperation." Nevertheless, FAA reports that it "cannot ascertain the accuracy of [Aetna's] allegation."

SBA made several advances to Capital, the unliquidated balance of which is $268,515.

FAA terminated Capital, partly for default and partly for convenience. Aetna declined to complete the job on its performance bond, but paid laborers and materialmen $691,358 on its payment bond. FAA also reports that the "Internal Revenue Service (IRS), meanwhile, asserted a $38,261 tax lien for withholding taxes not paid by Capital, and Capital's law firm asserted an attorney's lien for $22,461 in attorney's fees." FAA retains $333,532 to pay all claims relating to the contract.

SBA's position in these matters is as follows:

> "SBA made substantial advance payments to both subcontractors which have not been fully repaid. SBA has made demand upon FAA for payment to SBA of the unliquidated balance of such advance payments from monies in FAA's possession which it is withholding from payments due the subcontractors. FAA has declined to make payment to SBA and has, indeed, even suggested the possibility of filing an interpleader suit to determine who is entitled to payment.
>
> "It is our unequivocal opinion that SBA, having made advance payments of U.S. Government funds to the subcontractors, is entitled to repayment of the unpaid balances thereof from any monies due the subcontractors in the possession of FAA and that SBA's claim takes priority over the claims of other Government agencies, sureties, and any and all other claimants.
>
> * * * * *
>
> "It is our understanding that only claims of the Miller Act payment bond surety are involved in connection with the Singleton subcontract. Accordingly. * * * the claim of SBA (a Government agency) for funds advanced by it to an 8(a) subcontractor is superior to any claims by a payment bond surety.

* * * * *

"With respect to SBA's claim for unliquidated advance payments made to Robert L. Singleton, it is submitted that it is wholly immaterial that such advance payments were made pursuant to modification to the subcontract between SBA and Singleton without the consent of the surety since both the payment bond (Standard Form 25-A) and the performance bond (Standard Form 25) expressly provide that the surety undertakes obligations under the contract and '* * * any and all modifications of said contract that may hereafter be made, notice of which to the Surety(ies) being hereby waived * * *' (Emphasis supplied)"

"[FAA] stated * * * that the surety (Aetna) provided payment and performance bonds to the Capital City Construction Co., Inc. (an 8(a) subcontractor) '* * * because SBA agreed to subordinate its interest in the contract to Aetna in return for Aetna's cooperation * * *' and that if Aetna could demonstrate the existence of such an agreement, it would defeat SBA's claim.

"Pursuant to Section 411 of the Small Business Investment Act of 1958, as amended, 15 U.S.C. 694b., SBA may '* * * guarantee and enter into commitments to guarantee any surety against loss, as hereinafter provided, as the result of the breach of the terms of a bid bond, payment bond, or performance bond by a principal on any contract up to $1,000,000 in amount * * *' (Emphasis supplied). Since the contract between SBA and FAA which was subcontracted to Capital City was over twice that amount, SBA had no authority to, and could not and did not, guarantee or enter into any commitment to guarantee Aetna against loss as the result of breach of the term of any bonds upon which Aetna was the surety in connection with the contract.

* * * * *

"[Moreover,] it does not appear that the surety under the performance bond in this case is a 'completing surety' and acquired any rights * * *.

FAA's analysis is as follows:

"The [relevant] legal rules * * * derive from a quartet of Supreme Court decisions. Prairie State Bank v. United States, 164 U.S. 227 (1896), concerned a dispute between a bank which had advanced money to a contractor and the surety who completed the job under a performance bond after the contractor defaulted. The Court found that the surety's subrogation arose at the time the bond was issued, and was therefore prior to the bank's equitable lien, which arose at the time it made its advance. The Court held that the surety was entitled to the percentage of the contract price which had been retained by the Government pending the completion of the contract. Hennigensen v. U.S. Fidelity and Guaranty Co., 208 U.S. 405 (1908), expanded the Prairie State Bank holding.

* * * * *

"Read together, Prairie State Bank and Hennigensen gave sureties on either performance or payment bonds a clear preference to contract funds retained by the Government over the claims of private lenders or assignees. They did not deal with the question of whether sureties held a like preference over claims of the United States to retained funds. United States v. Munsey Trust Co., 322 U.S. 234 (1947), resolved this question in the Government's favor.

* * * * *

"As Pearlman v. Reliance Insurance Co., 371 U.S. 132 (1962), makes clear, the Munsey rule is limited to cases where the Government

itself is a claimant.* * * Pearlman, however, also contained language which appeared (see concurring opinion, 371 U.S. at 142) to contradict the statement in Munsey that laborers and materialmen have no rights vis a vis the Government. The Court said that:

> 'the Government had the right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it. (371 U.S. at 141)'"

"The Comptroller General has held that when it is not possible administratively to determine conclusively the rights of all parties to retainages held by an agency, the agency holding the funds should not make payment to any of the contending parties until these rights are determined by agreement or court order (B-158142, Feb. 14, 1966).

"We believe that the Comptroller General should rely on this rule and decline to decide the cases in question. There is considerable legal uncertainty in both cases concerning the relative rights of SBA and the surety. SBA argues that as a government agency, it is entitled to set off its claim against the contractor against the retainage held by FAA, per the Munsey rule. If this argument prevails, the equitable claim of the surety to the retainage based on its payment to laborers and materialmen is unavailing. On the other hand, SBA's functional role

in the transaction is that of an assignee: SBA made a 'loan' to the contractor and the contractor 'assigned' to SBA the right to receive from FAA a certain part of the contract price. * * * Moreover, relying on the statement in Pearlman * * * that the Government has the right (if not the obligation) to pay laborers and materialmen from the retained fund, the surety could argue that equity favors doing so with respect to their subrogee in these cases. The cases would appear to turn on the question of whether the court viewed the SBA's status as a government agency or its functional role as an assignee as more significant. In a type of case in which equitable considerations are important, it is not a foregone conclusion that SBA's status would control.

"There are additional uncertainties. In the Denver case, the relative priority of SBA and IRS is problematical. Munsey and its progeny held that the Government, as an entity, may set off claims against retainages. Tax liens are among the items subject to set off.* * * Should there be insufficient money to pay the claims of both [SBA and IRS] this question would have to be resolved. Second, Aetna has asserted that SBA agreed to subordinate its interest in the contract to Aetna in return for Aetna's agreement to bond what it viewed (correctly, as it turned out) as a poor risk. If Aetna could demonstrate the existence of such an agreement, it could defeat SBA's Munsey claim, even if that claim would otherwise prevail. In the Florida case, the effect upon the parties' rights of the failure of SBA and Singleton to obtain Reliance's consent to the advance is a potential problem.

"Because of these uncertainties, a decision by the Comptroller General directing FAA to pay SBA could involve this Department in double liability. Therefore, we request that you do not decide the merits of the conflicting claims for payment, but rather direct SBA to negotiate with FAA and the other parties concerning the disposition of the funds and, failing agreement, to cooperate in an interpleader action to resolve the issues."

Analysis

Singleton Subcontract

In the absence of a judgment against the United States, the right of set-off as to debts owed is inherent in the United States and extends to debts owed as a result of separate and independent transactions. As we said in Bonneville Power Administration, B-188473, August 3, 1977, 77-2 CPD 74:

"* * * Where a person is both creditor and debtor to the Government, the accounting officers are required by law to consider both the debts and credits and set off one indebtedness against the other, and certify only the balance. * * *

"This Office has held that the Government may setoff the estimated amount of claims due the United States by withholding amounts due under Government contracts. Metro Machine Corporation, B-187178, October 7, 1976, 76-2 CPD 323; Nabisco Inc., B-184506, October 29, 1975, 76-1 CPD 189. Set-off of the amount of estimated debts is authorized notwithstanding the absence of final resolution of a contract dispute underlying the debt. * * *"

Although Singleton contests the validity of the $150,000 indebtedness owed to SBA, based on the record before us we do not question that indebtedness for the following reasons: (1) the record evidences the signed

document of Singleton's indebtedness to SBA; (2) the unsupported allegations of fraudulent inducement are contradicted by SBA's apparent position that the debt was not fraudulently induced; and (3) because Singleton insists that it will be filing suit in court over the alleged failure of SBA to honor other supposed financial commitments, it would be inappropriate for our Office to consider that the alleged SBA failure now affects the $150,000 indebtedness owed here.

Based on the record before us, Reliance has paid only a fraction ($9,000) of the claims ($142,946) under its payment bond and is being sued for the rest. It is well established, however, that until a surety undertakes to pay all of the outstanding claims owed by the contractor, the surety will not be permitted to share in retainage still held by the Government even if the surety, as here, asserts that a Government payment was made in violation of its rights.

As stated by the Court of Claims in United States Fidelity & Guaranty Co. (USF&G) v. United States, 475 F.2d 1377, 1381-1385 (1973):

> "Under the facts in this case, it is also quite clear that the surety has no claim of priority to the fund unexpended under this contract. Even though the surety was not required to make any payments on its performance bond, it did deposit the full value of its payment bond in the Massachusetts District Court. As it turned out, the payment bond was insufficient to cover all of the subcontractors' claims, so there still remains $43,657.57 in debts incurred by the prime contractor which were not and have not been paid. * * * Until this surety undertakes to pay all of the outstanding claims owed by Premier, it will not be permitted to share in retainages still held by the Government.

* * * * *

> "However, even if the court would allow evidence to be received which clearly proved that the contracting officer abused his discretion in making the progress payment after being given notice by the surety of the contractor's default in paying the subcontractors, we would be powerless under the authorities cited, supra, to require that the Government make a payment of $29,000 to the surety when it is clear that the surety has not paid these subcontractors in full."

In the event Reliance should pay all the claims in question, there is still no evidence in the record that FAA's contracting officer could be accused of an abuse of discretion in approving the disbursements of advance payments. (The advance payment agreement specifically required the FAA's contracting officer--charged with administering the 8(a) subcontract--to approve an advance payment prior to it being made.)

Under the facts of record, there seems to be no question that SBA is owed a valid debt by Singleton arising out of action taken by SBA in its status as a Government agency under authority of 41 U.S.C. § 255 (1976) which permits any executive agency to make advance payments to contractors under certain conditions. Contrary to FAA's view, we do not agree that a court could disregard SBA's governmental status in these circumstances.

Further, as to FAA's concern about the prospect of "double liability" should it pay SBA's claim and judgment later be entered against the United States for a like amount, it is sufficient to point out that the concept of "double liability" applies only to recovery of amounts for the same debt from a Government agency by two private parties. The concept is not for application when another Government agency asserts a governmental claim against funds which one or more private parties also claim.

Because of our views, we conclude that the SBA is entitled to the funds retained by the FAA under the Singleton 8(a) subcontract.

The Capital Subcontract

Here the only objection raised to the validity of the underlying debt is FAA's statement that SBA agreed to subordinate its interest in the contract to Aetna in return for Aetna's cooperation. Aetna itself, however, in comments filed with our Office has not raised this argument.

In any event, we cannot question SBA's position that 15 U.S.C. § 694(b)(a) (1976) prevented any SBA official from properly authorizing a "subordination" agreement for this multimillion dollar contract. On this point, it is well settled that the United States is not bound by the unauthorized acts of its agents. Alabama Rural Fire Insurance Company v. United States, No. 332-76, slip op. at page 15 (Ct. Cl. February 22, 1978), and cases cited in text.

As to the FAA's argument that the Supreme Court's decision in Pearlman, supra, somehow undercut the admitted holding of the Munsey Trust decision, supra, (namely: a payment bond surety which pays the contractor's laborers and materialmen is a mere creditor of the Government and is subject to any Government claims), we note that this argument has been consistently rejected by the courts under differing approaches.

For example, in Trinity Universal Insurance Company v. United States, 382 F.2d 317 (5th Cir. 1967), involving the Government's right of set-off against a surety who completed the contract under its performance bond, the court, at page 320, insisted that the Pearlman decision did not affect the Government's right of set-off against a payment bond surety as follows:

"In Pearlman v. Reliance Insurance Co., 1962, 371 U.S. 132, 138, 83 S.Ct. 232, 236, 9 L.Ed.2d 190, the Supreme Court recognized the well-established doctrine that 'a surety who completes a contract has an "equitable right" to indemnification out of a retained fund.' Munsey did not disturb this rule, for as the Court noted in Pearlman:

> 'We held that the Government could exercise the well-established common-law right of debtors to offset claims of their own against their creditors. This was all we held. * * * We hold that Munsey left the rule in Prairie Bank and Henningsen * * * undisturbed.' 371 U.S. at 140, 141, 83 S.Ct. at 237.

The rights of the surety in Munsey were those of a subrogee of the contractor. Whoever, be it the contractor or his surety, pays the laborers and materialmen would be a creditor of the government insofar as the retained funds are concerned. Pearlman at p. 141, 83 S.Ct. 232. Of course, however, the government has a right to set off claims against its creditors. [Emphasis supplied.]

"A different situation occurs when the surety completes the performance of a contract. * * *"

In Security Insurance Co. of Hartford v. United States, 428 F.2d 838 (Ct.Cl. 1970), also involving the Government's right of set-off against a surety who completed the contract under its performance bond, the court simply asserted that the Pearlman decision (involving the resolution of priorities between private parties only) did not apply to a case, where, as here, the Government's right of set-off is involved. As stated by the Court of Claims at page 842:

> "Subsequent to Munsey, in Pearlman v. Reliance Ins. Co., 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962), the Supreme Court held that Munsey left 'undisturbed' the 'established doctrine,' as set forth by the Court in Prairie State National Bank of Chicago v. United States, 164 U.S. 227, 17 S.Ct. 142, 41 L.Ed. 412 (1896), that 'a surety who completes a contract has an "equitable right" to indemnification out of a retained fund.' 371 U.S. at 138, 141, 83 S.Ct. at 237. The Miller Act was also held not to have changed the law as declared in Prairie Bank. 371 U.S. at 139, 83 S.Ct. 232. Pearlman, however, was a suit to determine the priority in right to a retained fund of the surety on a Government contract and the trustee in bankruptcy of the contractor, and is thus factually distinguishable from the instant case." (Emphasis supplied.)

In USF&G, supra, involving the Government's right of set-off against a payment bond surety, the court "reconciled" the asserted discrepancy between the Munsey and Pearlman decisions by finally concluding that the Pearlman decision did not confer standing to sue on laborers and materialmen, who "might have superior equitable rights to the retainage," or on sureties who might be subrogated to their rights. USF&G at page 1382. Moreover, the court, at page 1383, approved the Government's right to set-off against a payment bond surety, as follows:

> "* * * A surety that pays on a performance bond in order to complete the subject contract has priority over the United States to the retainages in its hands. A surety that pays on its payment bond, however, does not have priority when the United States is asserting a tax or other obligation owed by the prime contractor. Since the surety in this case paid only on its payment bond, it falls in the latter category, and must claim the retainage subject to the tax claim of the United States.* * *"

We therefore conclude that Pearlman does not affect the Government's right to priority against a payment bond surety which has paid laborers and materialmen. Thus, even if the surety here has paid all laborers and materialmen, the Government claims have priority over the surety's claim.

Consequently, and because of our above views rejecting the "double liability" specter and the suggestion that the courts could disregard SBA's governmental status, it is our view that the SBA is entitled to set-off for the amount of its advances, $268,515, even if the surety has paid all claims.

We realize there are two Government claims asserted--the SBA's claim for $268,515 and the IRS tax lien of $38,261--the sum of which is $306,776, or $26,756 less than the $333,532 retained by the FAA. Since the amount of the two Government claims is less than the amount currently retained by FAA, we do not perceive the need to determine priority between the SBA and the IRS.

Therefore, it is our view that the IRS is also entitled to set-off in the amount of its lien, $38,261.

Finally, although there is $26,756 remaining after set-off of the SBA claim and IRS lien, the attorney's lien is not for settlement from that amount, since such liens are not recognizable against the United States. B-179424, November 13, 1973; Pittman v. United States, 116 F. Supp. 576 (Ct.Cl. 1953). In the event the surety has actually paid all the outstanding claims, it would be entitled to the remaining balance.

R. F. Keller

Deputy Comptroller General
of the United States