DECISION

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

FILE: B-219463

DATE: October 22, 1985

MATTER OF: Priority of payment of unexpended contract balances on contract between United States Fish and Wildlife Service and Yu Corporation

DIGEST:

1. The order of priority for the payment of remaining contract balances held by a contracting Federal agency are first, the surety on its performance bond, including taxes required to be paid under the bond, minus any liquidated damages owed the Government as provided in the contract; second, the IRS for the tax debt owed by the contractor; and, last, the surety on its payment bond.

2. As there was no formal takeover agreement between the performing surety and the contracting Federal agency providing therefore, the surety's priority over the Government to unexpended contract balances for satisfying its performance bond obligations would not include unpaid earnings due the contractor that accrued prior to the surety taking over performance of the defaulted contract.

A contracting officer with the United States Fish and Wildlife Service, Department of the Interior, has asked us to determine the order of priority of payment of approximately $155,000 of remaining proceeds of a contract between the Service and the Yu Corporation (Contract No. 14-16-00005-82-025). The parties are the Internal Revenue Service and the surety, the Fidelity and Deposit Company of Maryland, on its performance and payment bonds. For the reasons given below, we find the order of priority to be the surety on its performance bond, the IRS, and the surety on its payment bond.

BACKGROUND

The record shows that the contract in question was awarded to the Yu Corporation on May 12, 1982 for $570,485. The contract was to be completed by September 18, 1982. Subsequently, the contract was modified to increase the contract price to $600,041.65, and to extend performance time to November 11, 1982. Consistent with the Miller Act, 40 U.S.C. §§ 270a-270d, performance and payment bonds were issued by the Fidelity and Deposit Company of Maryland. The

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bonds were executed on May 21, 1982. On November 19, 1982, Yu Corporation assigned monies due under the contract to Guaranty-First Trust Company of Waltham, Massachusetts. By trust agreement of December 23, 1982, the assignee bank agreed to the surety's priority for payments the surety made on its bond obligations.

Apparently work did not progress well on the contract and problems arose regarding nonpayment of subcontractors and suppliers. To further complicate matters, on February 9, 1983 the contracting officer was served with an IRS Notice of Levy stating that Yu Corporation owed the IRS $52,263.88. The tax liabilities arose in 1980, 1981 and 1982. Several months later, the United States Department of Labor requested withholding of $2,971.24 from contract monies for violation of the Davis-Bacon Act, 40 U.S.C. § 276a. Subsequently, the surety instituted an interpleader action in the United States District Court for the District of Massachusetts, Fidelity and Deposit Co. v. A.J. Concrete Service, Civ. Action No. 83-1822-K (D.C. Mass. June 23, 1983), listing claims from subcontractors and suppliers. As a result of satisfying its payment bond obligations, by Order of November 30, 1984, the surety was discharged from liability for making further payments under the payment bond.

On March 30, 1983, the contract with Yu was terminated for default. (In this regard, the contract provided for liquidated damages to the Government at $400 per day for each calendar day of inexcusable delay.) Several weeks later the Fidelity and Deposit Company agreed to complete the project. The contracting officer informs us that in view of the diverse claims to remaining contract funds no formal takeover agreement was executed with the surety. The contracting officer subsequently informed us that the surety has completed the project.

As of December 20, 1984, Fidelity and Deposit Company claimed it had made payments of $400,229.82 on its performance and payment bonds, but did not provide specific totals for its payments on each of the bonds. It is estimated that as of May 13, 1985, the remaining contract proceeds totalled $155,000.

Based on the facts described, the Fish and Wildlife Service asked us to render an advance decision about the appropriate distribution of remaining contract funds. Several weeks later the service informed us that we should limit our consideration to the priorities between the IRS and the surety on its performance and payment bonds.

LEGAL DISCUSSION

It is established that when a surety completes performance of a contract, the surety is not only a subrogee of the contractor but also a subrogee of the Government and entitled to any rights the Government has to the retained funds. Trinity Universal Ins. Co. v. United States, 382 F.2d 317, 320 (5th Cir. 1967), cert. denied 390 U.S. 906 (1968); Security Ins. Co. of Hartford v. United States, 428 F.2d 838, 841-43 (Ct. Cl. 1970), overruling in pertinent part, Standard Accident Ins. Co. of United States, 97 F. Supp. 829 (Ct. Cl. 1951); B-217167, Aug. 13, 1985, 64 Comp. Gen. ___. Thus, 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 (Security Ins., 428 F.2d at 842-43), less any liquidated damages to which the Government is entitled under the contract. B-192237, Jan. 15, 1979. We have held that the surety's expenses, for which it is entitled to be reimbursed, include payments of withholding taxes required to be paid under a performance bond.1/ B-189679, Sept. 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). The surety's priority avoids the anomalous result whereby if setoff were permitted the surety frequently would be worse off for having undertaken to complete performance. Security Ins., 428 F.2d at 844; B-217617, 64 Comp. Gen. ____, supra.

When there is a takeover agreement between the Government and the surety, the money available to the surety generally would include all funds remaining in the hands of the Government under the contract, including withheld percentages and progress payments, whether earned prior to or subsequent to the original contractor's default, less any liquidated damages to which the Government is entitled under

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1/ Section 1 of the Miller Act, as amended, 40 U.S.C. § 270a(d), 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. See B-192237, Jan. 15, 1979.[2] Absent a formal takeover agreement providing therefore, however, a performing surety is not entitled to recover free from setoff, amounts earned by, but not paid to, the contractor before the date the surety took over performance of the contract. In this situation a surety is limited to payment from all other retained contract balances. Security Ins., 428 F.2d at 844.

Consistent with these principles, after the Fish and Wildlife Service deducts the liquidated damages owed it, we think Fidelity and Deposit Company, as a performing surety, would have first priority to the unexpended contract proceeds up to the amount it expended for satisfying its performance bond obligations, including payment of the withholding taxes it was required to pay under its performance bond. The priority over the IRS for the unexpended contract proceeds would include priority to all retained percentages and progress payments except those earned by Yu prior to Fidelity and Deposit taking over performance of the contract. The IRS has priority to the unpaid earnings due the Yu Corporation because there is no formal takeover agreement providing that these proceeds also would be paid to Fidelity and Deposit.

Unlike the priority on its performance bond, Fidelity and Deposit does not have priority over the IRS for expenditures made under 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 owed the Government.[3] 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 setoff" clause in a contract, the Government may satisfy by setoff

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2/ In situations where there is a formal takeover agreement the Federal Acquisition Regulation provides that "unpaid earnings of the defaulting contractor, including retained percentages and progress estimates for work accomplished before termination, shall be subject to debts due the Government by the contractor, except to the extent that such unpaid earnings may be required to permit payment to the completing surety of its actual costs and expenses incurred in the completion of the work * * *." FAR § 49.404(e)(1) (Apr. 1, 1985).

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

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 to setoff 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. Thus, a payment bond surety is subrogated to the rights of a contractor, rather than to the rights of the Government, and, as subrogee of the contractor cannot claim rights the contractor did not have. Security Ins., 428 F.2d at 841. Accordingly, the IRS has priority over Fidelity and Deposit, for payments the surety made to laborers and materialmen on its payment bond, to the unexpended contract proceeds in the amount of the $52,264 tax debt owed by Yu Corporation to the United States.

In sum, we conclude that after deducting liquidated damages owed the government, the remaining unexpended contract balance should be distributed first to Fidelity and Deposit for its performance bond payments, then to the IRS to satisfy Yu Corporation's $52,204 tax debt and, if anything remains, to Fidelity and Deposit for its payment bond disbursements. As the record only provides a total sum for the monies spent by the surety on both its bonds, and that as of December 20, 1984, the Fish and Wildlife Service will have to determine the precise amounts paid out on each of the bonds so that it can make the proper distributions consistent with the described priorities.

for Milton J. Socolar
Comptroller General
of the United States