DOCUMENT RESUME

03031 - [A2163274]

[Priority to Funds Withheld under Six Separate Contracts]. B-189137. August 1, 1977. 7 pp. + 2 enclosures (2 pp.).

Decision re: M. C. & E. Service & Support Co., Inc.; by Robert F. Keller, Deputy Comptroller General.

Issue Area: Federal Procurement of Goods and Services (1900).
Contact: Office of the General Counsel: Procurement Law I.
Budget Function: National Defense: Department of Defense - Procurement & Contracts (058).
Organization Concerned: Department of the Air Force; Travelers Indemnity Co.
Authority: Service Contract Act (41 U.S.C. 351-356). Miller Act (40 U.S.C. 270a-e). Davis-Bacon Act (40 U.S.C. 276a). (P.L. 89-719; 80 Stat. 1125). B-174488 (1971). B-169264 (1971). B-175222 (1973). B-178198 (1973). B-161460 (1967). B-170784 (1971). 55 Comp. Gen. 744. United States v. Munsey Trust Co., Receiver, 332 U.S. 234 (1947). Wheeler v. United States, 340 F.2d 119 (1965). United States v. Phoenix Indemnity Company, 231 F.2d 573 (1956). United States v. Seaboard Engineering Corp., 125 F. Supp. 918 (1954).

The Acting Assistant Secretary of the Air Force, Financial Management, requested a decision regarding priority to funds withheld under six separate contracts between a contractor and the Air Force. The Internal Revenue Service's claim for unpaid taxes and the Air Force's claim for reprocurement costs have priority over surety's claim for moneys spent to pay the withholding taxes for the contractor's employees. Claims by the workers who were underpaid are given priority over the Air Force's claims for reprocurement cost at the request of the Air Force. Contracts for services covered by the Service Contract Act are not subject to the Miller Act. (Author/SC)

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DECISION

THE COMPTROLLER G[illegible] L
OF THE UNITED S[illegible] S
WASHINGTON, D.C. [illegible]

FILE: B-189137 DATE: August 1, 1977

MATTER OF: M.C.&E. Service & Support Co., Inc.

DIGEST:

1. Amount expended by surety to pay withholding taxes for contractor's employees for period immediately prior to surety's takeover is part of surety's obligations under payment bond, rather than the performance bond, since this amount did not represent money expended to complete performance of contract. This being case, Government, under reasoning followed in United States v. Munsey Trust, 332 U.S. 234 (1947), can offset its claims against amount withheld from monies owed contractor under contract. Thus, the IRS claim for unpaid taxes and Air Force's claim for reprocurement costs would have priority over surety's claim.

2. Claims by workers underpaid under Service Contract Act given priority, at request of Air Force, over Air Force's claims for reprocurement costs.

3. Contracts for services covered by Service Contract Act, 41 U.S.C. §§ 351-358, are not subject to Miller Act, 40 U.S.C. § 270a-e (1970), which requires contractors to furnish bonds where contract is for construction, alteration, or repair of public buildings or public works of United States.

By letter dated May 6, 1977, the Acting Assistant Secretary of the Air Force, Financial Management, requested a decision by our Office in regard to priority to funds withheld under six separate contracts between the M.C.&E. Service & Support Co., Inc. (MC&E), and the Air Force.

According to the record six Air Force installations entered into separate contracts with MC&E for the furnishing of dining hall services. During the period March through May 1976, MC&E defaulted on four of the contracts and MC&E's surety, The Travelers Indemnity Company (Travelers Indemnity), took over performance on

the remaining two contracts. Initially the Air Force withheld payments totaling $75,705.03 due MC&E under these contracts. Pursuant to a settlement agreement between the Air Force and MC&E in connection with the Duluth International Airport contract (F21603-75-90083) the sum of $7,832.15 was retained by the Air Force to cover reprocurement costs and $1,609.04 was paid to the Internal Revenue Service (IRS) in partial satisfaction of a $219,453.14 tax lien against MC&E. Also, $13,633.15 was paid to the Department of Labor (DOL) for wages due MC&E employees for work performed on the George Air Force Base contract No. F04609-76-90010. The Air Force is presently holding $52,630.69, all or part of which is claimed by the Air Force, DOL, IRS and MC&E's surety, Travelers Indemnity.

Due to the continuous need for dining hall services, it was necessary to reprocure these services at four installations, Duluth International Airport, Minnesota; Cannon Air Force Base, New Mexico; George Air Force Base, California; and McChord Air Force Base, Washington. Air Force excess reprocurement costs at the latter three installations totaled $37,281.57. As pointed out earlier, $7,832.15 was retained by the Air Force to cover reprocurement costs under the Duluth International Airport contract.

The Assistant Secretary, in his letter of May 6, 1977, states that DOL, by letter of May 7, 1976, requested that the Air Force withhold all funds available under the contract(s) to cover Service Contract Act (SCA), 41 U.S.C. §§ 351-358 (1970), violations. A figure of $44,823.72 was established for the underpayments. This amount was to be transferred to DOL for payment to MC&E employees at Duluth, Cannon, George, McChord, and Davis Monthan. We note that in a mailgram of May 7, 1976, Peterson Air Force Base was also notified of DOL's request to have MC&E funds withheld.

The IRS levy in the amount of $219,453.14 was filed for unpaid Social Security and employee income taxes. The notice of levy was served on April 27, 1976. The $1,609.04 paid to IRS under the Duluth settlement agreement was made on this levy. Finally, the surety, Travelers Indemnity, claims the amount of $3,838.85 for amounts expended by it to cover withholding taxes for the period immediately prior to the surety's assumption of performance of contract No. F02601-75-C-0158 at Davis Monthan Air Force Base and contract No. F05604-75-90131 at Peterson Air Force Base.

The question of who has priority to the funds, as between the IRS and the surety, presents the most difficult issue with which we have to deal. We were unable to find any court cases or Comptroller General decisions which specifically address this question in connection with contracts covered by the SCA. While both the courts and our Office have dealt with the question in connection with construction contracts, which are covered by the Miller Act, 40 U.S.C. § 270a-e (1970), we are not convinced that these cases are completely valid precedent. However, to the extent that the Miller Act cases are based on general suretyship principles we will apply their rationale and reasoning to the present case. In the Miller Act cases it has been held, both by the courts and our Office, that a surety has a right to withheld funds when the surety completes performance of a contract upon default by the contractor. Trinity Universal Insurance Company v. United States, 382 F.2d 317 (1967); Security Insurance Company of Hartford v. United States, 428 F.2d 838 (1970); Aetna Casualty and Surety Company v. United States, 435 F.2d 1082 (1970); Home Indemnity Company v. United States, 376 F.2d 890 (1967); and B-175222, April 4, 1973. The rationale for these cases is that when the surety completes the performance of a contract, it is not only a subrogee of the contractor, and therefore a creditor, but also a subrogee of the Government and entitled to any rights the Government has to the retained funds. Thus, the Government cannot exercise the common law right accorded all debtors to offset claims of their own against their creditors. It is the surety's contention that it paid the $3,838.85 under its performance bond and under the authority of the above-cited cases has priority to the withheld funds to that extent.

It should be pointed out that all of the contracts in the above cases were completed by the surety under a performance bond, but where funds are expended by a surety under a payment bond, the courts, as well as our Office, have taken a different view. The court, in United States v. Munsey Trust Co., Receiver, 332 U.S. 234 (1947), held that notwithstanding claims of a surety on a payment bond for reimbursement for sums paid to laborers and materialmen, the Government may set off against percentages of progress payments withheld by it and due the contractor on the construction contract, a debt owed to it by the contractor as a result of a separate and independent transaction. This view was affirmed in Security Insurance Company of Hartford v. United States, supra, where the court held that the surety was subrogated to the rights of the contractor, and, as a subrogee of the contractor, would be a creditor of the Government insofar as the retained funds were concerned, but the Government would have a right to set off claims against the surety as a creditor.

See B-174488, December 29, 1971. This, of course, would not have been the case had the surety completed the contract under a performance bond since in that situation the surety would have been not only a subrogee of the contractor, but a subrogee of the Government having the same rights as the Government.

The present law covering construction contract bonds (40 U.S.C. § 270a(d) (1970)) requires that the performance bond 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." This provision of the law was added by Public Law 89-719, 80 Stat. 1125, November 2, 1966. The legislative history of this provision indicates that the reason the provision was enacted into law was that prior to its enactment bonds issued under the Miller Act did not guarantee the payment of Federal withholding taxes. See Proposed Amendments to Internal Revenue Code of 1954 With Respect to The Relative Priority and Effect of Federal Tax Liens and Levies Over the Interest of Other Creditors: Hearings on H.R. 11256 and H.R. 11290 Before the House Committee on Wage and Means, 89th Cong., 2d Sess. section 105, page 53. See Wheeler v. United States, 340 F.2d 119 (1965), wherein the court stated:

> "* * * This court has held that claims for taxes are not labor and material within the meaning of the ordinary Miller Act bond and therefore the Government cannot recover on the bond from the surety for the contractor's unpaid taxes. United States v. Zschach Const. Co., 10 Cir., 209 F.2d 347; United States Fidelity & Guaranty Co. v. United States, 10 Cir., 201 F.2d 118. Other circuits have held likewise. United States v. Maryland Casualty Company, 5 Cir., 323 F.2d 473; United States v. Crosland Construction Company, 4 Cir., 217 F.2d 275."

Also, see United States v. Seaboard Engineering Corporation, 125 F. Supp. 918 (1954), and United States v. Phoenix Indemnity Company, 231 F.2d 573 (1956), for contrary views, i.e., that surety bonds do cover withholding taxes. However, there is no indication that the holding in the Wheeler case and cases cited therein affected the Government's common law right of setoff if there happened to be, as in the present case, a retainage.

In the present case, General Services Administration (GSA) Standard Form 25 was used for the performance bond. This form provides, in essence, that the surety is liable for payment of taxes imposed by the Government which are collected, deducted, or withheld from wages paid by the principal, but only if the contract is subject to the Miller Act. The Miller Act only requires the contractor to furnish a performance bond where the contract is for the construction, alteration, or repair of public buildings or public works of the United States. The contracts in the present case are not of this type, but are for services covered by the SCA. Therefore, we must conclude that they are not subject to the Miller Act. However, we do not believe that we are required in this case to reach the harsh conclusion suggested by the cases cited in the Wheeler case, i.e., that the surety bonds do not cover withholding taxes. Those cases were based on an interpretation of the Miller Act and its application to construction contracts. We know of no court cases which state that surety bonds for SCA contracts do not cover withholding taxes. Until a court of competent jurisdiction decides otherwise, we will act on the premise that since the withholding taxes in question are required by law to be withheld from the employees' wages, they constitute a portion of the employees' wages.

Since there is no statutory provision similar to 40 U.S.C. § 270a(d) requiring that SCA performance bonds cover tax withholdings, we are of the view that those Miller Act cases, which hold that the Government cannot offset its tax claims against the retainage since withholding taxes are covered by the performance bond, are valid precedents in the present case only to the extent that the surety expends the funds to complete the contract. Our reasoning is based on the equitable principle that where the surety completes a contract, it performs a benefit for the Government and is entitled to any retained funds. If the Government is allowed to set off the amount of the unpaid taxes when the surety has completed the contract, the surety would, in fact, be forced to work for less than the contract price, which is an unfair result. See Trinity Universal Insurance Company, supra. In the case of a performance bond, the surety guarantees performance at a specific price (undiminished by tax setoffs) and should the Government incur any costs in excess of this price, the surety is liable for this amount. Thus, the issue that must be resolved in this case is: was the $3,838.85 expended for the purpose of completing the contract? Since in the present case there was no actual default by the contractor or a takeover agreement by the surety, it is unclear as to what the excess costs actually were. (See B-169264, June 10, 1971, where we took the position, in connection with a Miller Act case, that the surety's

right to withheld funds without a Government setoff is limited to situations where the surety entered into a specific agreement to complete the contractor's performance following a default.) Therefore, we must look at this case from another perspective. Had the contractor defaulted and had the Government paid another contractor to perform the contract, MC&E's tax indebtedness, which matured prior to default, would certainly not be considered part of the completion costs, whereas, the taxes withheld after default would be part of the completion costs. Thus, we fail to understand why the surety should be in a more advantageous position merely because it refused to sign a takeover agreement and MC&E did not actually default. It is our opinion that the tax withholdings in question would more properly be covered by the payment bond. This being the case, the Government's right of setoff is superior to the surety's claim, which is under the payment bond. We reach this conclusion on the basis of the reasoning and rationale of the Munsey case. Also, on the basis of the rationale of Munsey, we conclude that the Air Force's claim for reprocurement costs would have a superior priority to that of the surety's claim.

Regarding the priority to the funds as between the Air Force for reprocurement costs at the four installations where there was no surety and DOL for payment of underpaid workers, the Air Force states in its letter of May 6 that first priority should be given to the Department of Labor to satisfy unpaid wages to employees under the SCA. We have no objection to this recommended priority since in B-178198, August 30, 1973, we held as follows:

> "Here, the record shows that funds were retained to insure completion of the work under the contract. However, in B-161460, May 25, 1967, copy enclosed, we recognized that a contracting agency may apply such funds to satisfy wage claims under the Service Contract Act before it satisfies its own claim for excess reprocurement costs. * * *"

Concerning the priority to the funds as between DOL for payment of underpaid workers and the IRS for unpaid withholding taxes, we have on past occasions given priority to workers underpaid under the SCA over the IRS. B-161460, May 25, 1967, and B-170784, February 17, 1971. Also, see Richard T. D'Ambrosia d.b.a. Ambrosia Construction Company, 55 Comp. Gen. 744 (1976), 76-1 CPD 68, wherein we held that as between the IRS and workers underpaid under the Davis-Bacon Act, 40 U.S.C. § 276a (1970), the priority of the underpaid workers to the withheld funds was superior to that of IRS.

Accordingly, the withheld funds may be applied first to the workers who were unpaid under the SCA and the balance against Air Force's excess reprocurement costs.

Deputy Comptroller General
of the United States

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

IN REPLY REFER TO B-189137

August 1, 1977

The Honorable
The Secretary of the Air Force

Dear Mr. Secretary:

We refer to a letter dated May 6, 1977, from the Acting Assistant Secretary of the Air Force (Financial Management), requesting that our Office render a decision concerning the priorities to be accorded various claimants to funds withheld from monies due M.C.&E. Service & Support Co., Inc. (MC&E), under six Air Force contracts.

Enclosed is a copy of our decision of today in which we gave first priority to the workers who were underpaid in violation of the Service Contract Act and second priority to the Air Force for reprocurement costs. However, it is suggested that the sum of $3,838.85, the amount claimed by MC&E's surety, be retained since the surety has indicated that it might file an action in the United States District Court in the event of an adverse decision by our Office.

Sincerely yours,

Deputy Comptroller General
of the United States

Enclosure

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

IN REPLY REFER TO: B-189137

August 1, 1977

The Honorable
The Secretary of Labor

Dear Mr. Secretary:

Enclosed is a copy of our decision of today concerning the priorities to be accorded the various claimants to funds withheld from monies due M.C.&E. Service & Support Co., Inc. (MC&E), under six Air Force contracts.

As you will note, two of these contracts were covered by both payment and performance bonds which were prepared on General Services Administration Standard Forms 25 and 25-A, which are forms intended primarily to be used in connection with construction contracts which are covered by the Miller Act, 40 U.S.C. § 270a-270e. Since we have ruled that the Miller Act is not applicable to contracts covered by the Service Contract Act, it is suggested, to avoid future difficulties, that prospective Service Contract Act contractors be advised that GSA Standard Forms 25 and 25-A are not appropriate for use in connection with Service Contract Act contracts.

Sincerely yours,

Deputy Comptroller General
of the United States

Enclosure