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DECISION

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

FILE: B-190181 DATE: December 8, 1977

MATTER OF: K.B.J. Engineering, Inc.

DIGEST:

Where funds withheld from bankrupt contractor, who completed contract but failed to pay materialmen and subcontractors, are claimed by (1) contractor, (2) insolvent surety who made no payments to materialmen and subcontractors, (3) SBA who agreed to guarantee payment of 90 percent of losses suffered by surety as result of contractor's failure to pay materialmen and subcontractors, and (4) unpaid materialmen and subcontractor, GAO will not authorize payment to any of claimants. If GAO were to authorize payment to any of claimants, other claimants could bring suit against Government, and since GAO decision is not res judicata, Government might have to make duplicate payment. Parties therefore left to remedies in courts.

By letter dated September 14, 1977, an authorized certifying officer for the Department of the Interior requested a decision by our Office regarding the disposition of $53,254.72 withheld under a contract between K.B.J. Engineering, Inc. (KBJ), and the Bureau of Reclamation.

The above contract was for the purpose of constructing inlet and outlet works along the Colorado River and was in the amount of $233,707.90. Pursuant to the requirements of the Miller Act, 40 U.S.C. § 270(a) (1970), performance and payment bonds were obtained from Summit Insurance Company of New York (hereafter the surety). The payment bond was in the amount of approximately $117,000. Regarding these bonds, the Small Business Administration, (SBA) pursuant to 15 U.S.C. §§ 694a and b (1970), entered into a guarantee agreement with the surety whereby the SBA guaranteed the payment of 90 percent of any loss that the surety might incur as the result of any breach by KBJ of the terms of the bonds. While KBJ did complete performance of the contract, it failed to discharge its obligations to several suppliers and subcontractors. Under ordinary circumstances, the

surety would discharge these obligations, at least up to the sum of the payment bond, i.e., approximately $11[illegible],000. However, the surety is now insolvent and under the control of the Commissioner of Insurance of the State of New York. It is our understanding that the surety did not pay any part of the claims prior to its insolvency. Prior to the completion of the contract, the contracting officer, after entering into a hold harmless agreement with the surety for the protection of the Government, withheld $39,142.60 due KBJ under the contract. Later, amounts allowed for additional compensation and remission of liquidated damages were added to this amount bringing the total withholding to $53,254.72. There are an excess of three dozen claimants and suspected claimants with claims or suspected claims of approximately $160,000. One of these claimants has obtained a Writ of Garnishment After Judgment from an Arizona State court while another claimant sued (in a United States District Court in California) under the Miller Act, and obtained a judgment against KBJ and the surety. By letter of June 10, 1976, to the Bureau of Reclamation, the SBA has filed a subrogation and setoff claim against the $53,254.72 held by the Bureau of Reclamation. The liquidator for the surety has also expressed an interest in the money, as well as KBJ, who we are advised is also insolvent.

The SBA, in support of its claim, states that there is no question as to the Government's right to the money since it has long been recognized that the surety acquires the right to withheld funds when it completes performance of the contract upon default by the contractor. The SBA cites Prairie State Bank v. United States, 164 U.S. 227 (1896); Trinity Universal Insurance Co. v. United States, 382 F.2d 317 (1967) as authority for this rule. SBA also stated that as between competing claimants a surety would have a right to the funds, citing Security Insurance Co. v. United States, 428 F.2d 838 (1970) and one of our decisions, American Employers' Insurance Company, Completing Surety for Mike Bradford, Incorporated, B-180267, February 4, 1974, 74-1 CPD 51. SBA concludes that since the surety is in receivership and SBA, by virtue of its guarantee of the surety's bonds, must pay the claimants, the Government stands in the shoes of the surety and can claim a right of setoff. SBA cites Gratiot v. United States, 40 U.S. 336 (1841); McKnight v. United States, 98 U.S. 179 (1878); Barry v. United States, 229 U.S. 47 (1913), and United States v. Munsey Trust Co., 332 U.S. 234 (1947) in support of the latter rule.

While, of course, we do not disagree with the holdings of the above cases, we do question the applicability of at least the first group of cases (Prairie State, Trinity, Security Insurance and American Employers' Insurance) to the present situation, since all of these cases deal with the surety's right to withheld funds where the surety has completed the contract under the performance bond. In this situation there is no question that the surety is entitled

to the funds free from setoff, which is not the case where the payments by the surety are under the payment bond. See United States v. Munsey Trust Co., supra. Also, see Security Insurance Co., of Hartford, supra, which discusses and compares rights to withheld funds under both the performance and payment bonds.

In the present case, the contractor did not default on its performance of the contract, and thus, there was no liability under the performance bond. The last group of cases (Gratiot, McKnight, Barry and Munsey Trust) all stand for, among other things, the well-established rule that the Government has a common law right of setoff.

SBA's rationale appears to be that the surety has first priority to the funds (citing as authority cases dealing primarily with the surety's rights to the funds after completion of the contract under the performance bond) and since SBA by virtue of its guarantee must pay the claimants, the Government stands in the shoes of the surety and can claim a right of setoff, which the Government only has in connection with the payment bond. Thus, it appears that SBA on one hand is claiming as a subrogee to the rights of the surety, while on the other hand it is claiming as a Government agency holding funds owing to the contractor which are subject to offset by the Government.

Concerning SBA's claim as a subrogee to the rights of the surety, it has been held that in cases, such as we have here, involving the question of priority to funds in connection with the payment bond, the surety is required to show that it has fully paid the claims of laborers and materialmen arising out of the contract before it (the surety) can share in the unexpended sums retained under the contract. American Surety Co. v. Westinghouse Electric Manufacturing Co., 296 U.S. 133 (1935); United States Fidelity & Guaranty Co. v. United States, 475 F.2d 1377 (1973). We are unaware of any exception to this rule. This being the case, the surety would have no entitlement to the funds since it has not paid all of the claims of the materialmen and subcontractors. It should be pointed out that even had the surety discharged all of its obligations under the payment bond, it still would not be entitled to the funds since the amount of the payment bond is less than the amount of the outstanding claims. United States Fidelity & Guaranty Co., supra. Since SBA has guaranteed the payment of 90 percent of any losses suffered by the surety as a result of default by KBJ of its obligations to materialmen and subcontractors, it would appear that SBA would be subrogated to the rights of the surety. However, since the surety

is not entitled to the funds, SBA, who "stands in the surety's shoes," would not be entitled to the funds. In light of this conclusion, it does not appear that we need discuss the question of SBA's right of setoff.

Since the contractor has performed the contract and, to our knowledge, the Government has no further claims against the contractor, the Government would appear to be a mere stakeholder of the funds to which KBJ would be entitled had it paid all of its obligations to materialmen and subcontractors. The courts have held that when the Government is in the position of a stakeholder, it is not free simply to pay the contractor where, as in this case, it had adequate notice of competing claims to the fund. Fireman's Fund Insurance Company v. United States, 421 F.2d 706 (1970); Home Indemnity Company v. United States, 376 F.2d 890 (1967).

Regarding the claims by those firms that furnished goods and services to the contractor, it has been held that laborers and materialmen do not have enforceable rights against the United States for their compensation. See Munsey Trust Co., supra, and cases cited therein. It was because laborers and materialmen have no enforceable rights against the Government that the Miller Act was enacted requiring that a surety guarantee their payment.

Judging from the above, it does not appear that any of the claimants, who might have standing to sue, has established entitlement to the funds at this time. The Government's sole concern is to obtain a good and valid acquittance for the money in its possession and it does not appear that any of the claimants would be able to do this. Thus, payment to any of the claimants would not prevent suit by the other claimants against the Government. Since our Office is an administrative agency and not a judicial body, our decision would not render the matter res judicata, and the Government might well be required to make a duplicate payment. See 46 Comp. Gen. 389 (1966). Thus, under the circumstances and in the absence of agreement between the parties, we do not feel that we can properly authorize payment to any of the claimants except pursuant to an order from a court of competent jurisdiction. We are of the view that the best course of action would be an interpleader action. However, we are advised that such a course of action was suggested to the Department of Justice when the United States was sued by the materialmen (United States v. K.B.J. Engineering, Inc., CV-75-1544-WMB, U.S.D.C. Central District of California) but that the Department of Justice decided that a defense of sovereign immunity was in the best interests of the Government. Apparently, this was the basis on which the suit was dismissed. But in any event, the rule is well

settled that claims of doubtful validity should be disallowed by the accounting officers of the Government and the claimants left to their remedies in the courts. See Charles v. United States, 19 Ct. Cl. 316, 319 (1884); Longwill v. United States, 17 Ct. Cl. 288, 291 (1881).

Accordingly, the funds should be retained pending a binding agreement of the parties or a disposition by a court of competent jurisdiction.

Deputy Comptroller General
of the United States