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DECISION

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

FILE: B-221519 **DATE:** *July 1, 1986*

MATTER OF: Payment to the Fidelity and Deposit Company of Maryland

DIGEST:

Consistent with Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136-37 (1962), the surety has priority over trustee in bankruptcy to contract retainage funds held by agency where funds never became the property of the contractor.

A contracting officer with the United States Department of the Interior, Bureau of Indian Affairs (BIA), asks whether it is proper to pay the contract surety, Fidelity and Deposit Company of Maryland, or the trustee in bankruptcy, $197,600 representing monies remaining to be paid out on a contract between the BIA and L.R. Foy Construction Co., Inc. For the reasons given below, we find that the surety should be paid the $197,600.

BACKGROUND

The record shows that L.R. Foy Construction Co., Inc. contracted with the BIA to construct a middle school located on the Navajo Indian Reservation in Rough Rock, Arizona. The contract was entered into on September 29, 1982 for a price of $3,083,318. The Fidelity and Deposit Co. of Maryland executed performance and payment bonds on October 11, 1982. Under the terms of the contract, the United States was authorized to retain and hold 10 percent of the estimated contract amount until final completion and acceptance of the contract work.

The contractor did complete the work. Prior to the Government making final payment, however, the contractor filed a chapter 11 petition for bankruptcy in the United States Bankruptcy Court for the District of Kansas. In re L.R. Foy Construction Co., Inc., Case No. 85-40798 (D. Kan. July 18, 1985). The agency indicates that there remains a total of

$197,600 in contract proceeds to be paid out on the contract; however, as a result of the bankruptcy, the contracting officer has withheld final payment and execution of the release of claims. The facts show that as yet there has been no adjudication of the bankruptcy proceeding.

The surety, the Fidelity and Deposit Co. of Maryland, in a letter dated February 28, 1986, maintained that it had paid out some $268,286[1] to subcontractors and suppliers on its payment bond obligations and seeks the remaining contract proceeds. Subsequently, Fidelity submitted copies of checks to this Office that show that its payment bond payments exceeded $197,600. In reliance on Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962), the surety contends it has a priority to the contract proceeds over the trustee in bankruptcy.

LEGAL DISCUSSION

The doctrine of subrogation allows a payment bond surety such as Fidelity and Deposit, which pays the debts of its principal, to assert all the rights of the creditors that were paid to enforce its right to be reimbursed. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136-37 (1962).

In Pearlman, the Supreme Court held that property interests in a fund not owned by a bankrupt at the time of adjudication are not part of the bankrupt's property, and do not vest in the trustee. Thus, it 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; see 64 Comp. Gen. 763, 767-68 (1985). Consistent with these principles the Court held that a payment bond surety had priority over a trustee in bankruptcy to contract retainage funds. Had the contractor made the payments it, and thus the trustee, would have been entitled to the funds; however, since the surety made the payments, it was entitled to be reimbursed.

We think the same result should occur here. The contract retainage funds never became property of the L.R. Foy Construction Co. since the contractor did not make the necessary

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1/ The surety subsequently informed us that as of June 12, 1986, it had paid out some $367,286.

payments entitling it to those monies. Thus, those funds should not become part of L.R. Foy's bankrupt estate. Since Fidelity and Deposit Co. made payments, under its payment bond, that would have been made by the contractor, it is entitled to the funds to the extent of its payments. As those payments exceed $197,600, Fidelity and Deposit should be paid the entire $197,600 retained.

for Milton J. Socolar
Comptroller General
of the United States