R. Seldon

The Comptroller General
of the United States

Washington, D.C. 20548

Decision

Matter of: Priority to Remaining Proceeds of Contract Between Veterans Administration and Kathy's Kranes Corporation.

File: B-225115

Date: February 20, 1987

DIGEST

The performance bond surety under a Veterans Administration contract has priority over the United States Army Corps of Engineers to remaining contract proceeds but only to the extent of the surety's actual costs and expenses in completing the contract. A direction in a takeover agreement between the surety and the Government that the surety be paid amounts that become progressively due in the same fashion and at the same times as sums otherwise would have been paid to the contractor does not alter applicable law that the surety not recover more than the actual costs and expenses it incurs in completing the contract. Furthermore, since the takeover agreement does not delineate what rights the surety and Government would have should there be conflicting claims to the remaining contract proceeds, it should not be construed as altering the general rules governing priority.

DECISION

The Veterans Administration (VA) asks about proper distribution of proceeds under contract no. V101C-1169 between the VA and the Small Business Administration (SBA) and subcontract No. 58320716 between the SBA and Kathy's Kranes Corporation. For the reasons given below, we find that the performance bond surety, St. Paul Fire and Marine Insurance Co., has priority to amounts equal to its costs and expenses in completing work on the contract. The remaining amounts should be paid to the Army Corps of Engineers (Corps) in full or partial setoff of a $29,729.79 debt Kathy's Kranes owes the Corps on another contract.

BACKGROUND

In May 1983, the VA entered into a prime contract with the Small Business Administration for development of 14,800 gravesites and additional facilities at Fort Snelling National Cemetery, Minneapolis, Minnesota. The parties agreed that Kathy's Kranes Corporation, the subcontractor, would perform all the contractual requirements in place of the Small Business Administration. The contract required both performance and payment bonds. Several weeks later a performance bond for the contract was executed by the surety, St. Paul Fire and Marine Insurance Co.

On December 19, 1984, the VA contracting officer informed Kathy's Kranes that it was terminating the described contract for default, the only work remaining to be done essentially being completion of punchlist items. On the same day, the VA transmitted a notice of termination and demand for completion to the surety.

In May 1985, the surety executed a takeover agreement forwarded by the VA contracting officer. The takeover agreement stated that the surety would perform and procure performance of all work remaining to be completed on the contract. It also directed that the VA pay to the surety "such amounts that become progressively due in accordance with the provisions of . . . [the] contract, as well as all retained amounts, in the same fashion and at the same times as the sums would otherwise have been paid to the original contractor." (Emphasis added.) The surety has fulfilled its obligations under the performance bond and the takeover agreement.

About the same time that the VA contract with Kathy's Kranes was progressing, a problem arose on an Army Corps of Engineers contract with the same contractor. Apparently, the Corps mistakenly made a $29,729.79 contract payment directly to Kathy's Kranes instead of to its assignee, the Norwest Bank of Mankato, Minnesota, which had an assignment to all contract proceeds.[1/]

[1/] The Norwest Bank has brought suit against the Army Corps of Engineers in the United States Claims Court for $29,729.79 plus interest, costs and fees. Norwest Bank Mankato v. United States, File No. 687-86C (U.S. Cl. Ct. Oct. 29, 1986).

As the Corps was unable to recover the payment from Kathy's Kranes, in September 1984 it requested the VA to set off $29,729.79 from proceeds of the VA contract with Kathy's Kranes. As the setoff was not effected, several times in early 1986 the Corps renewed its request.2/

On May 30, 1986 the VA contracting officer informed the surety that it intended to honor the Corp's offset request. The surety protested and asked to be paid all remaining contract funds. In July 1986, the VA changed its position, concluding that the surety was entitled to priority over the Corps to the remaining contract proceeds as a result of carrying out its performance bond obligations. Soon thereafter the Corps asked the VA to refer the dispute to this Office.

In support of its position, the Corps maintains that the takeover agreement, which it asserts did not conform to applicable regulations, specifically affords the surety only the same rights to the remaining contract proceeds that the contractor would have had. Since the Corps properly could invoke its right to setoff in an amount equal to the $29,729.79 it mistakenly paid Kathy's Kranes against payments that might be due Kathy's Kranes or its assignee on the VA contract, it can do so against the surety as well. The Corps also contends that if the surety does have priority, it is only to the costs and expenses the surety incurred in completing the VA contract.

The VA contracting officer informs us that a little more than $30,000 remains to be paid out on the contract. The record, however, does not indicate how much the surety expended in completing the contract work.

LEGAL DISCUSSION

It is well-established that when a surety completes performance of a contract, it is not only a subrogee of the contractor, but also a subrogee of the Government entitled to any rights the Government has to the retained funds. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 139 (1962); Trinity Universal Ins. Co. v. United States, 382 F.2d 317, 320 (5th Cir. 1967), cert. denied 390 U.S. 906 (1968). Thus, a surety completing a defaulted contract under a performance

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2/ Initially the VA was concerned that the Corps had not complied with requirements of the Debt Collection Act, 31 U.S.C. § 3716. Subsequently, the Corps indicated it had complied.

bond has a right to reimbursement from the unexpended contract balance of the expenses it incurs, free from setoff by the Government of the contractor's debts to the Government, less any liquidated damages to which the Government is entitled under the contract. Security Ins. Co. of Hartford v. United States, 428 F.2d 838, 841-43 (Ct. Cl. 1970); 64 Comp. Gen. 763, 765 (1985).

In many instances, when a surety undertakes to complete performance of a contract in satisfaction of its performance bond, the surety enters into a takeover agreement with the Government. Under such takeover agreements, the money available to the surety generally would include all funds held by the Government on the contract, including withheld percentages and progress payments, whether earned prior to or subsequent to the contractor's default, less any liquidated damages to which the Government is entitled under the contract. 65 Comp. Gen. 29, 31 (1985). However, the amounts paid to the surety generally may not exceed the actual costs and expenses the surety incurs. See 65 Comp. Gen. 29, 31 (1985); B-192237, Jan. 15, 1979; 31 Comp. Gen. 103, 108 (1951).

The Federal Acquisition Regulation established procedures for surety takeover agreements. Federal Acquisition Regulation, § 49.404, 48 C.F.R. § 49.404.[3]/ Among other things, it states that such agreements shall provide that the surety complete the contract work pursuant to the terms of the contract, and that the Government pay the surety the balance of the contract price unpaid at the time of default, but not in excess of the surety's cost and expenses. Id. § 49.404(e).

In this instance, the takeover agreement is somewhat ambiguous and it is not clear that it conforms to applicable law and regulations. For example, it does not specifically limit recovery by the surety to its actual costs and expenses. Moreover, the Army Corps of Engineers suggests it only grants the surety the same right to contract proceeds as the contractor. Since 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

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[3]/ The provisions of the Federal Procurement Regulations which still were applicable when the takeover agreement was executed were substantially the same. 41 C.F.R. § 1-18-803.6(c)(1984), cited in Security Ins. Co. of Hartford v. United States, 428 F.2d 838, 843 (Ct. Cl. 1970).

extinguish debts owed the Government, United States v. Munsey Trust Co., 332 U.S. 234, 239 (1947), if the surety is only a subrogee of Kathy's Kranes, as the Corps suggests, the Corps would have priority over the surety for the $29,729.79 it asserts Kathy's Kranes owes the Corps.

We do not, however, construe the takeover agreement as being in conflict with applicable law and regulations. Thus, in our view, the direction in the takeover agreement that the VA pay the surety such amounts that become progressively due in the same fashion and at the same times as the sums otherwise would have been paid to the contractor merely describes the manner of payment to the surety. It did not alter the requirement that the surety not recover more than the actual costs it incurred in completing the contract. This requirement, which is embodied in regulations described above, was omitted from--but should have been included in--the takeover agreement. Furthermore, since the agreement does not delineate what rights the surety would have should there be conflicting claims to remaining contract proceeds, it should not be construed as altering the general rules governing priority.

Accordingly, we conclude that the surety does have priority over the Corps of Engineers, but only for the costs it incurred in completing the contract. As the particular amount has not been presented to us, before the VA pays out any monies to the surety it should require a full accounting of its costs. Any remaining amounts not paid to the surety in carrying out its performance bond obligations should be paid to the Corps in setoff of Kathy's Kranes' debt to the Corps.

The VA has informed us that the takeover agreement described has been used for other contracts. In view of the problems discussed, we suggest that in the future such agreements specifically state that payments to the surety in completing a contract under a performance bond not exceed the costs the surety incurs. Furthermore, the agreement might also include a provision indicating that the surety has priority to contract proceeds for the costs it incurs.

Milton J. Socolar

for Comptroller General
of the United States