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The Comptroller General
of the United States

Washington, D.C. 20548

Decision

Matter of: Priority of Payment under Small Business
Administration 8(a) Subcontract

File: B-229235.2

Date: February 27, 1989

DIGESTS

1. Order of priority for remaining contract funds held by the contracting agencies and Small Business Administration (SBA) is to the Army for any liquidated damages under its contract, the Surety on its performance bonds, the SBA and Internal Revenue Service (IRS) for debts owed by the contractor, and the Surety on its payment bonds.
2. In making advance payments to subcontractors, SBA's status is that of a government agency and not a contractor's assignee. Therefore, because the United States' right of set-off extends to debts owed as a result of loans by SBA to 8(a) subcontractors, SBA's claim to remaining contract proceeds is superior to that of a payment bond surety.

DECISION

We have been asked to determine the order of priority of payment among several claimants to the remaining proceeds of two Small Business Administration (SBA) subcontracts and other contract funds held by SBA. The requestors are: SBA, St. Paul Insurance Company (Surety), as surety on performance and payment bonds on two SBA subcontracts, and Wallace L. Bodlt, General Contractor, Inc., the Surety's guarantor.

The contracts were entered into between the SBA and the Department of the Army (Contract No. DACA63-86-C-0018), and between the SBA and the Department of the Navy (Contract No. N62467-81-C-0807). SBA subcontracted both contracts under its 8(a) program to Cal-Tom Construction Co., Inc. (Cal-Tom). Among the claimants, SBA claims priority to any remaining funds for the unliquidated balance of advance payments made to Cal-Tom by SBA under both subcontracts; the Surety claims an equitable lien against remaining funds in favor of subcontractors, materialmen and suppliers under both subcontracts; and the Internal Revenue Service (IRS)

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claims a lien on contract proceeds for unpaid back taxes, interest and penalties. Also, the Army may have a claim for liquidated damages under its contract.

For the reasons given below, we find the order of priority of payment to be, first, the Army for any liquidated damages that may be applied to its contract; second, the Surety for any performance bond payments it may have made; third, SBA and IRS for the unliquidated balance of advance payments and for the tax debt; and last, the Surety on its payment bonds.

BACKGROUND

In September 1985, SBA and the Naval Facilities Engineering Command, Department of the Navy (Navy), entered into a contract for the construction of a child care center at the Naval Air Station, Chase Field, in Beeville, Texas, in the amount of \$489,000. In January 1986, SBA and the Army entered into a contract for the construction of an addition to the NCO Club at Fort Sam Houston in San Antonio, Texas, in the amount of \$1,182,059. Under its 8(a) program, SBA subcontracted both contracts to Cal-Tom (Subcontract Nos. SBA 6-86-2-7008, SBA 6-86-2-7023). In early 1986, performance and payment bonds were executed under both subcontracts between Cal-Tom and the Surety, St. Paul Insurance Company, to satisfy the requirements of the Miller Act, as amended, 40 U.S.C. §§ 270a-270d.

In July 1986, SBA modified both subcontracts to permit advance payments by SBA to Cal-Tom in amounts up to \$125,000 for the Navy contract and \$250,000 for the Army contract. See 15 U.S.C. § 637(a)(2) and 41 U.S.C. § 255. Under the terms of the modifications and an agreement among SBA, Cal-Tom, and Texas Bank, advance payments to Cal-Tom were deposited in special accounts at Texas Bank in San Antonio, Texas.

Beginning in April 1987, claims by subcontractors, suppliers, and materialmen were filed with Cal-Tom, the Surety, and its Surety's guarantor. In October 1987, Donald E. Barnhill, the Surety's attorney, sent letters to the Navy, the Army, and SBA which included lists of subcontractors, suppliers, and materialmen who had made demands on the Surety as to payments due from Cal-Tom. The Surety's attorney also gave notice of competing claims to any remaining contract funds under Navy and Army control, and demanded that both the Navy and the Army withhold payment of those funds pending resolution of such claims.

On October 14, 1987, the Surety and its guarantor filed a request that our Office determine the priority of payment

under both subcontracts. Shortly after this request was filed, we asked the Navy and the Army to withhold any remaining contract funds pending our decision. According to SBA, the Navy presently holds \$49,965.45, and the Army holds \$140,107.00.

By letter of November 24, 1987, SBA requested that Texas Bank close the special accounts and forward to SBA any funds remaining in the accounts. Based on this request, SBA received a cashier's check in the amount of \$2,800 from the Navy account, and \$63,709.15 from the Army account. SBA is holding both checks pending our decision.^{1/}

With respect to the Navy contract, by letters of December 14, 1987 and May 5, 1988, SBA made demands on Cal-Tom for payment of \$45,000, the amount of unliquidated advance payments, i.e., the amount of outstanding advance payments not recovered by repayment from Cal-Tom or by deductions from payments from the Navy. According to SBA, interest began to accrue on the unpaid balance as of May 12, 1987, the date on which SBA found Cal-Tom to be in default of its repayment obligation under the modification to the Navy subcontract. Beginning on February 18, 1988, the Surety began making payments to subcontractors, suppliers and materialmen under its payment bond obligation. As of March 25, 1988, the Surety contended that it had paid out \$47,564.67 under the payment bond. As of August 30, 1988, the Navy subcontract has been completed and accepted. As noted above, the final payment of \$49,965.45 remains outstanding and currently is in possession of the Navy. With respect to the Army contract, SBA made demand on Cal-Tom for payment of \$170,000, the amount of unliquidated advance payments, by letters of December 14, 1987 and April 22, 1988. According to SBA, interest began to accrue on the unpaid balance as of June 15, 1987. Beginning on March 2, 1988, the Surety began making payments to subcontractors, suppliers and materialmen under its payment bond obligation. As of March 25, 1988, the Surety contended that it had paid out \$45,625.67 under the payment bond. According to the Surety's attorney, on October 11, 1988, the Army subcontract was completed and accepted.

On May 16, 1988, the Surety's attorney filed findings of fact and legal arguments with our Office in furtherance of

^{1/} SBA is also holding a check in the amount of \$59,000 which Cal-Tom delivered to SBA in December 1987, for partial payment of the unliquidated advances under the Army contract.

his request that we determine the priority of payment under these subcontracts. The facts outlined above are consistent with the facts submitted by both the Surety and SBA. On October 19 and 25, 1988, the Surety's attorney filed additional legal arguments on the questions before this Office.

On October 7, 1988, SBA submitted its factual statements and legal arguments. In its filing, SBA notes that IRS also has a claim on contract proceeds under both the Army and Navy contract, and that it filed a lien against Cal-Tom in 1987. According to SBA, IRS filed a request with SBA on February 23, 1988, to offset the Army subcontract to recover \$7,680.67 in unpaid back taxes, interest and penalties through March 31, 1988.

The Army and Navy also filed statements with our Office. In its letter of December 8, 1987, the Army stated that, at that time, it had assessed \$65,550 in liquidated damages against Cal-Tom for late completion of the contract. The Navy has made no claim to contract proceeds.

LEGAL DISCUSSION

Standing of Surety under Payment Bond

As a preliminary matter we will address the issue raised by the SBA concerning the Surety's standing to assert its claim. SBA argues that the Surety lacked standing when the Surety initially filed its request with our Office on October 14, 1987. At that time, the Surety had not yet paid any of the claims filed by Cal-Tom's subcontractors, suppliers, or materialmen under either the Army or Navy subcontracts. SBA contends that the Surety still does not have standing because, although it began to pay claims on the Army subcontract on February 18, 1988, and on the Navy subcontract on March 2, 1988, it has yet to pay all outstanding claims. SBA maintains that

"the Surety will not have standing until the Surety, under its payment bonds on both the Army and Navy subcontracts, undertakes to pay all the outstanding claims owed by Cal-Tom, the Surety's principal under both payment bonds."

To support its argument, SBA cites American Surety Co. v. Westinghouse Elec. Mfg. Co., 296 U.S. 133, 137 (1935), United States Fidelity & Guaranty Co. v. United States, 475 F.2d 1377, 1381 (Ct. Cl. 1973), and 64 Comp. Gen. 763, 766 (1985). We disagree with SBA's reading of these decisions. In American Surety, the controversy was between

the materialmen and the surety, rather than the surety and a government agency or a contractor's assignee. Moreover, the court merely held that the materialmen's claims took priority where the surety was liable for only part of the debt of the principal. American Surety at 137. In United States Fidelity, the court held that the surety must only show that it had fully paid any existing claims, and not all potential claims, as SBA apparently argues, of the laborers and materialmen arising out of the contract. Although the facts presented by SBA and the Surety on the amount of the claims paid by the Surety in this case are not entirely clear, we accept the Surety's contention that as of October 19, 1988, it had paid all the claims it has been called upon to pay. Therefore, and following the reasoning in 64 Comp. Gen. 763, 766, we find that at this time, the Surety has standing to assert all the rights of the creditors who have been paid in order to enforce the Surety's right to be reimbursed. See Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136-37 (1962).

Priority of Payment

1. Army

Notwithstanding the extensive arguments presented by both SBA and the Surety, we think that the priority of payment rules are well established as they apply to this case. The government is first entitled to recover any liquidated damages under the contracts. 65 Comp. Gen. 29 (1985); B-192237, Jan. 15, 1979. In its letter of December 8, 1987, the Army claimed that \$65,550 was being held as liquidated damages. However, in an affidavit of an SBA official sent to our Office on October 18, 1988, the official stated that the Army had agreed to forego the assessed liquidated damages if the contract could be completed by a certain date. Whatever the status of this agreement is at present, it is our understanding that the Army is still asserting \$60,030.00 in liquidated damages under the contract. If the Army retains a claim for liquidated damages, it has first priority to any remaining contract proceeds under the Army contract.

2. Performance Surety

If the performance bond surety completed either subcontract in this case, the performance bond surety would have next priority with respect to performance bond payments. 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 remaining 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. den. 390 U.S. 906 (1968). 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 set-off by the government of the contractor's debts to the government, less any liquidated damages to which the government is entitled under the contract. 65 Comp. Gen. 29, 31 (1985); 62 Comp. Gen. 498, 500-501 (1983). The performance bond surety's priority over the government

"avoids the anomalous result whereby the performance bond surety, if set-off were permitted, would frequently be worse off for having undertaken to complete performance."

Security Ins. Co. of Hartford v. United States, 428 F.2d 838, 844 (Ct. Cl. 1970).

In its October 14, 1987 request, and its May 16, 1988, submission of facts and legal arguments, the Surety claimed priority over SBA based on its status as a payment bond surety. The Surety further stated that no payment was due on a performance bond. In its more recent submissions, made on October 19 and 25, 1988, however, the Surety apparently argues that it has made payments under its performance bond. Based on the facts presented by SBA and the Surety, we cannot determine to what extent the Surety actually made payments under its performance bonds. In light of the above decisions, however, the Surety would be entitled to be reimbursed for the amount of any payments growing out of its performance bonds after any liquidated damages under the contracts have been paid.

3. SBA

The principal dispute between SBA and the Surety concerns whether SBA has priority over a payment bond surety. We think this issue is well settled. In Robert L. Singleton; Capital City Construction, Inc., et al., B-189183, Jan. 12, 1979, 79-1 CPD ¶ 17, SBA also was owed a debt by the contractor as a result of advance payments made under the advance payment statute, 41 U.S.C. § 255. We there held, apparently in the absence of a "no set-off" clause in the contract, that SBA had priority over a payment bond surety based on its right of set-off as a government

agency.^{2/} In support of our decision, we relied on United States v. Munsey Trust Co., 332 U.S. 234, 239-44 (1947), which held that the government's right of set-off is superior to that of a payment bond surety who had paid the claims of laborers and materialmen.

In Singleton we held that in making advance payments to subcontractors, SBA's status is that of a government agency. Accordingly, we refused to view SBA in a functional role as a contractor's assignee. We find no reason to conclude otherwise in this case. Since neither contract or subcontract had a "no set-off" clause, SBA's claims through set-off are superior to those of the payment bond surety in this case. The SBA has the right of set-off to the extent of the outstanding unliquidated advance payments under both subcontracts.

4. IRS

In 64 Comp. Gen. 763 (1985), we held that the government's right to set-off IRS's tax claims is superior to the claims of a payment bond surety. We there concluded that, absent a "no set-off" clause in a contract, the government may satisfy by set-off 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. See 63 Comp. Gen. 534 (1984). In United States Fidelity & Guaranty Co. v. United States, 475 F.2d 1377, 1383 (1973), the Court of Claims also upheld the priority of the government's right to set-off a tax debt over a payment bond surety.

Therefore, we conclude that the tax claims of IRS are superior to those of the payment bond surety, and that IRS has the right to set-off the amount of its tax liens under both subcontracts. We agree with SBA that we do not need to decide the issue of which claim, as between the two government claims of the IRS and SBA, takes priority since sufficient funds appear to exist to satisfy the claims of both IRS and SBA.

^{2/} This right has been grounded in statute since the Debt Collection Act of 1982, 31 U.S.C. § 3716 (1982), and no longer depends upon the common law right in the case of persons covered by the Act.

5. Payment Surety

Finally, after the above claims have been paid, the Surety has the right to be reimbursed for any payments made under its payment bond obligations.

Surety's Contentions

The foregoing notwithstanding, the Surety maintains that the rights of a payment bond surety are superior to those of a contractor's assignee, and that SBA is merely Cal-Tom's assignee under the facts presented here. The Surety argues that SBA should not be treated as a government agency because, in this case, it performed a function normally performed by the private sector.^{3/} We think our holding in Singleton forecloses this argument. On facts very similar to those presented here, we concluded that in making advance payments to subcontractors, SBA's role is that of a government agency, not a contractor's assignee. We continue to adhere to this view.

The Surety also argues that SBA wrongfully diverted contract proceeds in the special bank accounts when, on November 24, 1987, SBA requested that Texas Bank close the accounts and forward any remaining funds to SBA. The agreements establishing the accounts provided that two out of four named SBA officials must authorize the withdrawal of any account funds. The Surety argues that, in violation of the agreements, only one of the two officials that requested the bank to release account funds was so authorized. Citing Coconut Grove Exchange Bank v. New Amsterdam Casualty Co., 149 F.2d 73 (5th Cir. 1945), the Surety contends that

"where a Surety can show a wrongful diversion of funds, it has an equitable right in the money wrongfully repaid to the Contractor's assignee."

To counter the Surety's argument, SBA maintains that its decision to withdraw account funds was based on its belief

^{3/} In addition, the Surety argues that SBA did not comply with the Assignment of Claims Act, 31 U.S.C. § 3727, 41 U.S.C. § 15 and therefore, did not even achieve the status as the contractor's assignee. Because we do not view SBA as the contractor's assignee, we see no need to address the Surety's contention that the Assignment of Claims Act controls the order of priority in this case.

in November 1987 that

"the contract proceeds would be more secure if they were no longer held in the two Special Accounts, where Cal-Tom might obtain access to the funds."

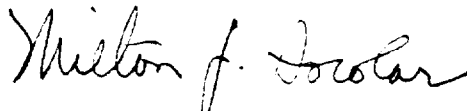
In addition, SBA argues that SBA was within its rights to withdraw account funds because the agreements specifically provided that SBA was the "owner" of any payments deposited into the accounts. Moreover, SBA maintains that the Surety has not alleged any harm, nor has the Surety been harmed, by SBA's custody of the funds.

We think that the court's decision in Coconut Grove supports SBA's position. Although the court dealt in that case with funds supposedly diverted to an assignee bank rather than a government agency, the court held that there was no superior equity in a surety unless the surety alleged and proved an actual diversion of money and an injury from such diversion. We agree with SBA that the account funds have not been diverted, that is, applied to liquidate any unpaid advance payments. Rather, SBA is merely the custodian of such funds, ready to remit the funds based on our decision in this case. Since the Surety has not proven any diversion of such funds or injury resulting from SBA's holding of the funds, we reject the Surety's claimed equitable right to such funds.

Finally, the Surety contends that it has the right under the Equal Access to Justice Act, 5 U.S.C. § 504, to be reimbursed for attorney fees and interest

"based on the conduct of the SBA in removing joint funds to the ultimate detriment of the laborers, materialmen and suppliers on the two contracts."

The Equal Access to Justice Act provides for the award of fees and expenses to the prevailing party when an agency conducts an adversary adjudication. 5 U.S.C. § 504(a)(1). Since our Office has not conducted an "adversary adjudication" within the meaning of the Act in this matter, we have no basis upon which to make such an award even if we found merit in the Surety's contentions. See 5 U.S.C. §§ 504(a)(1), (b)(1)(c) and 5 U.S.C. § 554 (1982).



Acting Comptroller General
of the United States