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Suretyship—Subrogation—Assignment of Claims Act—Assignee Bank's Right to Progress Payments Superior to That of Sureties on Government Contractor's Bonds.—American Fidelity Co. v. Nat. City Bank of Evansville.

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Suretyship—Subrogation—Assignment of Claims Act—Assignee Bank's Right to Progress Payments Superior to That of Sureties on Government Contractor's Bonds.—*American Fidelity Co. v. Nat. City Bank of Evansville.*[1]—A corporation entered into a construction contract with the federal government. The contract conformed to the requirements of the Miller Act[2] by providing for two surety bonds, one conditioned on the completion of the work within the contract period and the other on the payment of those furnishing labor and material to the contractor. Subsequent to the execution of the contract, the corporation entered into an agreement with the appellee bank which provided for a loan to the contractor and an assignment[3] to the bank of all progress payments.

Prior to the contractor's default, the government made three payments to the bank. At default the government was withholding retained percentages[4] and part payment for work completed. As a result of the default, the appellant sureties paid the United States the cost of completion of the construction by another contractor. The retained percentages and the withheld payment for work already performed by the original contractor were applied against the actual completion cost and the sureties paid the difference.

The bank as assignee of the progress payments brought suit against the sureties in the U.S. District Court for the District of Columbia seeking recovery of an amount equal to the retained percentages and the value of the payment due for work completed prior to the default.[5] The sureties filed a counterclaim seeking recovery of the three progress payments made to the bank prior to the default.[6] Both the claim and the counterclaim were dismissed and the sureties appealed[7] from the denial of their counterclaim.

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1 266 F.2d 910 (D.C. Cir. 1959).

2 Act of Aug. 24, 1935, c. 642 §§ 1, 2, 4, 49 Stat. 793-794 (1934), 40 U.S.C. §§ 270a-270d (1958).

3 The assignment was authorized by and perfected in compliance with the Assignment of Claims Act, 54 Stat. 1029 (1940), as amended, 31 U.S.C. § 203 (1958) and 41 U.S.C. § 15 (1958). The sureties acknowledged notice of the assignment "without prejudice to any and all rights and with reservation thereof."

4 Art. 16(b) of 41 U.S.C. App., § 54.13 (1958), shows a 10 percent retainage in the standard government contract. These withheld payments are usually paid by the government upon completion of the job, but the government has the right, under the contract to refuse payments until presented with a waiver of all claims arising under the contract (including presumably the claims of laborers and materialmen). See 41 U.S.C. App. § 54.13 (1958) Art. 16(d); 41 U.S.C. App. § 54.13 (1958) Art. 17(a).

5 The government had withheld $10,593.26 pending satisfactory completion and the contracting corporation had performed work worth $13,520. for which no payment had been made. The bank contended that it was entitled to these sums because the government's retention of them had relieved the sureties of liability thereof to the government.

6 The sureties had instituted a suit in the U.S. District Court for the Southern District of Indiana seeking the same recovery sought in the counterclaim and on agreement of the parties the actions were consolidated in the U.S. District Court, District of Columbia.

7 The sureties argued on appeal that the bank received the payments impressed

The Court of Appeals for the District of Columbia affirmed, HELD: the sureties could not recover the progress payments as subrogee of the United States, the laborers and materialmen or the contractor, since none of these had any right to recover against the bank as assignee of the contractor. The United States under the Assignment of Claims Act of 1940, as amended,[8] clearly had no right to the progress payments which had been made, absent proof of fraud;[9] the laborers and materialmen had no right against the bank for unpaid wages or claims but only against the contractor and the sureties; and the contractor could not recover the payments from his assignee since he had for a full consideration effectively assigned the progress payments to the bank.

Upon his payment of the principal's obligation, the surety, as subrogee of the creditor, steps into his shoes.[10] The rights of the subrogated surety sometimes called "equitable liens" relate back to the date of the bond[11] and are, therefore, superior to any conflicting claims thereafter asserted.

The question in the present case was whether, upon being forced to pay after the contractor's default, the sureties had a right to recover progress payments from the assignee bank superior to any right of the bank to retain assigned payments made prior to the contractor's default.

That segment of the sureties' right which was based upon the government's interest in the proceeds was dependent on construction of the Assignment of Claims Act of 1940, as amended. Prior to the 1951 amendment, payments made to the assignee of a government contract could be recovered by the United States[12] when the assignor was liable to it under or apart from the assigned contract. The instant case comes within the purview of the amendment[13] forbidding the government to recover progress payments

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with an equitable lien in their favor to the extent they had been forced to pay under the bonds.

[8] §§ 3477 and 3737 of the Revised Statutes (Anti-Assignments Act), as amended by the Assignment of Claims Act of 1940, and the amendment thereto, 65 Stat. 41 (1951), are codified in 31 U.S.C. § 203 (1958) and 41 U.S.C. § 15 (1958), respectively.

[9] The sureties' charge that the bank wrongfully diverted the loan proceeds to a partnership (operated by the same individuals who were the contracting corporation's only stockholders) which did not devote them to the Corporation's contract was, essentially, a charge of fraud. The court said that since the crediting of the partnership account was at the request of the contractor—tantamount to drawing a check to the partnership for the loan proceeds—the bank as assignee was not required to look to the application of the loan proceeds. Until the default occurred the bank had a right to trust the contractor just as the sureties did. The latter could have but did not require joint control. It was incumbent upon the sureties to sustain that allegation by proof that the partnership did not use the money for the intended purpose. They did not do so. See Central Bank v. United States, 34 U.S. 639 (1953); Coconut Grove Exchange v. New Amsterdam Casualty Co., 149 F.2d 73 (5th Cir. 1945).

[10] This position entitles the surety to enjoy any advantage the creditor had. United States v. Munsey Trust Co. of Wash., D.C., 332 U.S. 234 (1947); Restatement, Security § 141 (1941).

[11] E.g., Moran v. Guardian Casualty Co., 76 F.2d 438, 439 (D.C. Cir. 1935).

[12] A surety who had been forced to pay to or for the United States could also recover. Thus, in effect, an assignee bank became surety for the surety to the extent of its collection.

[13] See note 8 supra.

once made, unless the payments had been induced by fraud.[14] The Court's conclusion agrees with prior case law.[15]

The cases[16] relied upon by the sureties recognize a right in unpaid laborers and materialmen or in the surety who had paid them, to contract proceeds. These cases, however, were either decided prior to the amended Assignment of Claims Act and are therefore no longer controlling, or involved controversies over proceeds in the possession of the United States after default. It is difficult from the cases to determine the exact nature of this recognized right of recovery of the laborers, materialmen and the surety.[17] Generally, however, they are to the effect either that the government may, or has a moral obligation to,[18] apply the contract proceeds in its possession at the time of default and termination, to the claim of laborers and materialmen. Further since, the surety upon payment of these claims is subrogated to this right or obligation of the government, the surety can recover the contract proceeds in the government's possession. Inasmuch as the present controversy concerned itself exclusively with the progress payments paid to the assignee bank prior to default, it is evident that the Court of Appeals correctly distinguished the authority[19] relied upon by the sureties in support of their equitable lien theory.

The result reached by the case seems correct and is certainly desirable. A strict adherence to the reasoning of the decision will aid contractors in securing loans to finance national defense contracts—the expressed purpose of the 1940 Act.[20] Certainly a bank, trust company or other financial institution or federal lending agency will be more inclined to loan money to a government contractor in consideration of an assignment of progress payments under the contract, when it is assured that a surety on the contractor's payment and performance bonds will not be able to reach the progress payments collected under the assignment before default. As for the surety, he is voluntarily engaged in a risky business and it is not believed that the legislation is needed to protect him.

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14 See note 9 supra.

15 United States v. Hadden, 192 F.2d 327 (6th Cir. 1951).

16 Martin v. National Surety Co., 300 U.S. 588 (1934); Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404 (1908); Richards Brick Co. v. Rothwell, 18 App. D.C. 516 (1901); Moran v. Guardian Casualty Co., 76 F.2d 438 (D.C. Cir. 1935); Town of River Junction, Fla. v. Maryland Casualty Co., 133 F.2d 54 (5th Cir. 1943); Royal Indemnity Co. v. United States, 117 Ct. Cl. 736, 93 F.Supp. 891 (1950); National Surety Corp. v. United States, 132 Ct. Cl. 724, 133 F. Supp. 381 (1955).

17 The language and reasoning of this group of cases is discussed in detail in Bank of Arizona v. National Surety Corp., 237 F.2d 90, 93 (9th Cir. 1936).

18 The case of United States v. Munsey Trust Co., 332 U.S. 234 (1947) has denied the existence of any duty or moral obligation owing to laborers and materialmen by the government. Under the standard government construction contract the government does not agree to pay them, and the fact that the government by means of the Miller Act has gratuitously required bond protection for them, should not create any duty or moral obligation running from the government to the laborers and materialmen.

19 Cases cited note 16 supra.

20 See note 8 supra.