Boston College Law Review

Volume 4 | Issue 3 Article 20

4-1-1963

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Forrest W. Barnes

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Recommended Citation

Forrest W. Barnes, *Bankruptcy—Conflicting Interests in Security—Status of Miller Act Surety.— Pearlman v. Reliance Ins. Co.*, 4 B.C.L. Rev. 748 (1963), http://lawdigitalcommons.bc.edu/bclr/vol4/iss3/20

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Bankruptcy—Conflicting Interests in Security—Status of Miller Act Surety.—*Pearlman v. Reliance Ins. Co.*[1]—A contractor entered into a contract with the United States to perform certain work on the St. Lawrence Seaway project. Respondent surety executed the two bonds required of the contractor by the Miller Act,[2] one to guarantee performance of the contract and the other to guarantee payment to laborers and materialmen. As part of the surety agreement, the contractor assigned all its rights arising out of the contract to the surety, conditional on default by the contractor. Pursuant to the terms of the contract, the United States retained certain percentages of estimated amounts due monthly to the contractor, which were to be paid to the contractor upon final completion and acceptance. The contractor encountered financial trouble, the contract was terminated, and the work was completed by another contractor. The surety was compelled to pay about $350,000 to laborers and materialmen under the payment bond. After final acceptance and payment, the United States still held nearly $88,000 in retained percentages which would have been due and owing the original contractor had it carried out its obligation to pay laborers and materialmen. This fund was turned over to the now bankrupt contractor's trustee in bankruptcy, whereupon the surety filed a petition alleging ownership of the fund and seeking an order directing the trustee to pay it over to the surety. The referee ruled that the surety had no superior rights in the fund but must share equally with general creditors. The District Court for the Western District of New York reversed the referee, granting the surety a priority over general creditors.[3] This decision was affirmed by both the Second Circuit[4] and the Supreme Court. HELD: A surety has a right by way of subrogation to such a fund. The Government had a right to use the retained fund to pay laborers and materialmen; the laborers and materialmen had a right to be paid out of the fund; the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.

Certiorari was granted in an attempt to clarify conflicting holdings with respect to the surety's rights in such a fund. Most courts have granted the surety, who met his obligation under either the performance or payment bond, a priority over the rights of the defaulting contractor's trustee in bankruptcy and creditors having conflicting security interests in the same contract rights.[5]

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1 371 U.S. 132 (1962).

2 49 Stat. 793 (1935), 40 U.S.C. § 270a (1958).

3 In re Dutcher Constr. Corp., 197 F. Supp. 441 (W.D.N.Y. 1961). The referee's ruling is reported in 35 Ref. J. 81 (1961).

4 In re Dutcher Constr. Corp., 298 F.2d 655 (2d Cir. 1962), noted, 61 Mich. L. Rev. 402 (1962).

5 See Martin v. National Sur. Co., 300 U.S. 588 (1937); Belknap Hardware & Mfg. Co. v. Ohio River Contract Co., 271 Fed. 144 (6th Cir. 1921); In re Cummins Constr. Corp., 81 F. Supp. 193 (D. Md. 1948); National Sur. Corp. v. United States, 133 F. Supp. 381 (Ct. Cl. 1955), cert. denied sub nom. First Nat'l Bank v. United States, 350 U.S. 902 (1955); Royal Indem. Co. v. United States, 93 F. Supp. 891 (Ct. Cl. 1950); United States Fid. & Guar. Co. v. Triborough Bridge Authority, 297 N.Y. 31, 74 N.E.2d 226 (1947).

However, recent decisions in the Ninth and Tenth Circuits[6] have denied that sureties have a prior claim to retained percentages by mere payment to laborers and materialmen. These cases have relied on the following dictum in *United States v. Munsey Trust Co.*:[7]

> But nothing is more clear than that laborers and materialmen do not have enforceable rights against the United States for their compensation. . . . They cannot acquire a lien on public buildings . . . and as a substitute for that more customary protection, the various statutes were passed which require that a surety guarantee their payment.
>
> [I]t is elementary that one cannot acquire by subrogation what another whose rights he claims did not have.[8]

In fact, the question of the surety's right to subrogation was not in issue in the *Munsey* case. Rather, that case decided that the United States had the right to set off its own claim against the contractor out of the retained fund. When the instant case was before the Second Circuit, that court interpreted the *Munsey* dictum as follows:

> [W]e think the quotations from Munsey in the opinions in Phoenix and Hinds[9] have been misconstrued. If the Supreme Court intended to make any comment with respect to the situation now before us, it was merely to say that they held the point open for decision in the future. Of course, if the surety failed to pay materialmen and laborers, the surety 'would have done nothing to earn subrogation.' Moreover, the fact that 'laborers and materialmen have no enforceable rights against the United States,' 260 F.2d at page 368, is beside the point. *The question is not whether the laborers and materialmen have rights enforceable against the Government, but whether they have an equitable priority in the retained payments.*[10] (Footnotes and emphasis supplied.)

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6 See American Sur. Co. v. Hinds, 260 F.2d 366 (10th Cir. 1958); Phoenix Indem. Co. v. Earle, 218 F.2d 645 (9th Cir. 1955). But cf. United States v. Chapman, 281 F.2d 862 (10th Cir. 1960).

7 332 U.S. 234 (1947).

8 Id. at 241-42.

9 Supra note 6.

10 Supra note 4, at 658. See also National Sur. Co. v. United States, supra note 5, at 384, where the court states:

> In United States v. Munsey Trust Co. . . . the Supreme Court said that the United States was not legally liable to laborers and materialmen, but it did not say that laborers and materialmen could not assert an equitable claim to moneys in the hands of the United States payable under the contract. We think they can. To permit them to do so in no way interferes with the full exercise of the sovereign powers of the United States. It does not subject the . . . [United States] to liability beyond the amount it has in its hands confessedly due and owing to somebody.

Other courts have held that the *Munsey* decision is limited to situations in which the United States is more than a mere stakeholder. See United States Fid. & Guar. Co. v. Triborough Bridge Authority and In re Cummins Constr. Corp., supra note 9. The Supreme Court in *Munsey* stated (332 U.S. at 240):

> From *Prairie State Bank v. United States*, 164 U.S. 227 [1896], to *American*

The majority of the Supreme Court in *Pearlman,* relying on *Prairie State Bank v. United States*[11] and *Henningsen v. United States Fid. & Guar. Co.*[12] for the principle that "there is a security interest in a withheld fund like this to which the surety is subrogated,"[13] decided either expressly or by necessary implication that laborers and materialmen have at least an equitable right to be paid out of such retained percentages held by the United States as a mere stakeholder, and that the surety is entitled to that right after it has paid the laborers and materialmen. The surety is therefore given an equitable lien on retained percentages which has priority over the claims of the contractor's trustee in bankruptcy and general creditors.[14]

A proper understanding of the issues involved in the case requires a consideration of traditional suretyship law. At common law, a surety who has been compelled to complete performance of a contract or to pay laborers and materialmen has several distinct remedies available. He has a direct right against the principal debtor for *indemnity* or *reimbursement.* This

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> *Surety Co. v. Sampsell,* 327 U.S. 269 [1946], we have recognized the peculiarly equitable claim of those responsible for the physical completion of building contracts to be paid from available moneys ahead of others whose claims come from the advance of money. *But in all those cases, the owner was a mere stakeholder and had no rights of its own to assert.* (Emphasis supplied.)

11 164 U.S. 227 (1896). The surety in this case had been compelled, under a performance bond, to complete a government contract after the contractor's default. The Court held that the percentages retained by the United States could be used by it to protect itself and that the surety, by asserting the right of subrogation, could protect itself out of the fund by resort to the same securities and remedies which had been available to the United States for its protection against the contractor.

12 208 U.S. 404 (1908). Here the surety had paid laborers and materialmen under a combination performance and payment bond. The Court held that the same equitable principles as in the *Prairie State Bank* case operated to entitle the surety to subrogation to any right of the United States Government arising through the building contract.

13 Pearlman v. Reliance Ins. Co., supra note 1, at 137.

14 Counsel for the trustee in bankruptcy in the *Pearlman* case apparently relied on both §§ 70a and 70c of the Bankruptcy Act, 30 Stat. 565 (1898), as amended, 11 U.S.C. §§ 110a & c (1958), although this is by no means clear from the opinion. The Court's only reference to § 70 is at 83 Sup. Ct. 233 where the Court states that the Government turned the fund over to the trustee "who held it on the assumption that it had been property of the bankrupt at the time of adjudication and therefore had vested in the trustee 'by operation of law' under § 70 of the Bankruptcy Act." It is possible to construe the Court's opinion as based on the exceedingly narrow ground that the fund never vested in the trustee under § 70a, leaving for future determination the question whether or not the trustee had any superior rights under § 70c, which provides:

> The trustee, as to all property . . . upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all the rights, remedies, and powers of *a creditor then holding a lien thereon* by such proceedings, whether or not such a creditor actually exists. (Emphasis supplied.)

However, it is inconceivable that the several courts which considered this controversy on the petition of the surety after numerous arguments of eminently qualified counsel would have deprived the trustee of the fund in its possession on so narrow a ground without full consideration of the trustee's rights. Note that at the argument before the Second Circuit two amicus curiae briefs were submitted in support of the trustee's contentions in addition to the brief of the trustee's counsel. Since no issue was made of this point and since the Court cited § 70, it is submitted that all of the trustee's rights under that section, including § 70c, were considered.

remedy is purely equitable and is similar to restitution.[15] The surety also has a right of *subrogation* to all the rights of laborers, materialmen or other creditors of the principal debtor that the surety has been compelled to pay under the suretyship agreement. This right is also equitable and may involve the right to recover under the creditor's contract with the principal, the right to enforce liens of the creditor, including statutory mechanic's liens, or other remedies. A different right exists where, as in the instant case, the surety has received as part of the suretyship agreement an *assignment* of all the principal's rights under its contract with a third party, here, the Government. Such an assignment gives the surety the legal right, in the event of the principal's default, to receive all sums due and owing under the contract to the extent of all payments made under the bond and any expenses incurred in completing the contract. Finally, the surety also has certain rights prior to making any payments under the suretyship agreement. These include the equitable right of *exoneration* which enables the surety to bring suit against the principal and obtain an order directing the principal to pay the creditors to whom the surety is liable on the bond. A right of *reverse exoneration* has been recognized in some states, by statute or judicial decision, which enables the surety, by bringing suit against the creditor, to force the creditor to sue the principal debtor to enforce payment of the debt on which the surety is liable, thus reducing the surety's risk.[16]

The majority opinion appears to have confused these various remedies, lumping them together, discussing *reimbursement* as though it were the same as *subrogation*,[17] and not mentioning the surety's rights under the assignment from the contractor. The opinion cites the *Prairie State Bank* and *Henningsen* opinions for the proposition that the surety is subrogated to the rights of the United States in such a retained fund and then concludes that the surety is subrogated to the rights of laborers and materialmen and that they have a right to the fund, citing *Martin v. National Sur. Co.*[18] as reaching a similar result.

As stated in the minority concurring opinion in the instant case, the *Martin* case did not reach such a broad conclusion. In that action the surety, which became insolvent during the proceedings, brought a suit in the nature of exoneration against an assignee of certain funds of the contractor. The assignee took his assignment with knowledge of a prior assignment to the

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[15] The right to reimbursement is one of the major differences between a surety contract and an insurance contract.

[16] This is the "Doctrine of Pain v. Packard," 13 Johns. R. (N.Y.) 174 (1816). See generally Simpson, Suretyship 165-253 (1950).

[17] See 371 U.S. at 136, 137, where the Court states that the question is

> whether the surety had, as it claimed, ownership of, an *equitable lien* on, or a prior right to this fund before bankruptcy adjudication.
>
> . . . Traditionally sureties compelled to pay debts for their principal have been deemed entitled to *reimbursement*, even without a contractual promise such as the surety here had [citing a footnote which states, "The right of *subrogation* is not founded on contract."]. And probably there are few doctrines better established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be *reimbursed* . . . generally known as the right of *subrogation*. (Emphasis supplied.)

[18] 300 U.S. 588 (1937), affirming, 85 F.2d 135 (8th Cir. 1936).

surety. The purpose of the suit was to protect laborers and materialmen to whom the surety was obligated under the bond. On the surety's becoming insolvent, it renounced all its rights in the fund in favor of the laborers and materialmen. The Court, in an opinion written by Mr. Justice Cardozo, merely held that the laborers and materialmen were entitled to the fund by virtue of the prior assignment to the surety. It declined to rule on the Eighth Circuit's holding in the same case that the proceeds of a building contract are chargeable with an equitable lien in favor of laborers and materialmen, the proposition for which the majority opinion in the instant case cited it.

In the concurring opinion in *Pearlman,* three justices took the view that the majority had given laborers and materialmen rights against the Government which "might jeopardize the rights of the United States and have serious consequences for its building operations."[19] Exactly what these rights might be is by no means clear, especially since the majority opinion merely gives the laborers and materialmen equitable rights in a fund held by the United States as a stakeholder. If the United States is more than a stakeholder, as in *Munsey,* then certainly different rules apply as that case demonstrates. The minority opinion clarifies the *Prairie State Bank* and *Henningsen* decisions, which held that the surety should be subrogated to the rights of the United States rather than to the rights of laborers and materialmen. Such a holding would permit a similar recovery by the surety on the theory that the United States has a right to use retained percentages to pay laborers and materialmen; the surety has paid them; and, being subrogated to the rights of the United States, can reimburse itself out of the fund to the extent of such payments. However, the minority opinion, citing the *Martin* case for its actual holding, concluded that the surety's rights to the fund should be determined on the basis of its contract with the contractor. Since under the contract all sums due to the contractor after default "were assigned to the surety to be credited against any loss or damage it might suffer thereby,"[20] the surety could recover the entire fund without the necessity of deciding whether or not the laborers and materialmen had rights against the United States, an equitable lien on retained percentages, or any of the many other factors which caused so much confusion in the majority opinion. It is submitted that this is the better basis for the Court's decision.

The Court expressly limits its decision to a situation where "there is no statute which expressly declares that a surety does acquire a property interest in a fund like this under the circumstances here."[21] The case having been decided in a jurisdiction in which the Uniform Commercial Code is not yet in effect,[22] the question arises whether the Code will have any effect upon the surety's rights. Two recent Pennsylvania decisions under the Code have rejected the claims of sureties to prior interests in retained percentages under government contracts. In *United States ex rel. Greer v. Fleetwood & Co.,*[23] the court ordered the retained percentages paid over to a bankrupt subcon-

[19] Supra note 1, at 142.

[20] Id. at 143.

[21] Id. at 136.

[22] The Uniform Commercial Code will become effective in New York September 27, 1964.

[23] 165 F. Supp. 723 (W.D. Pa. 1958).

tractor's trustee in bankruptcy, denying that the surety on a performance bond had prior rights in the fund since it had not complied with the filing requirement of UCC section 9-302(1). The court stated that the surety, "therefore, must be relegated to the stature of a general creditor."[24] The court did not discuss the possibility of other rights of the surety such as subrogation. This decision seems to reject completely the holding in the *Prairie State Bank* case.[25]

In *Hartford Acc. & Indem. Co. v. State Pub. School Bldg. Authority*,[26] the contractor had assigned all its accounts receivable, present and future, to a bank in exchange for financing. The bank filed a financing statement, thus "perfecting" its security interest under the Code.[27] After default by the contractor, the surety also filed a financing statement. In denying the surety's claim to priority, the court's reasoning indicates that the bank, having filed first, was entitled to priority, and that *the surety, by filing, in effect, waived its admitted rights to subrogation.*

It would seem that these courts were correct in treating the interest of the surety under the assignment from the contractor as a "Security Interest" governed by Article 9 of the Code. The assignment is intended to secure reimbursement to the surety in case the contractor defaults, and is therefore intended to create a security interest under UCC section 9-102(1), which brings the interest within the scope of Article 9.[28] Under the Code, the surety, by taking certain steps,[29] can insure that it has an enforceable legal

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24 Id. at 725.

25 Supra note 11.

26 26 Pa. D. & C. 2d 717 (1961), annotated in, 4 B.C. Ind. & Com. L. Rev. 123 (1962).

27 See UCC §§ 9-204(1), 9-302(1).

28 UCC § 9-102(2) states, "This Article applies to security interests created by contract including . . . assignment . . . ." Comment 1 to this section states:

> Except for sales of accounts, contract rights and chattel paper, the principal test whether a transaction comes under this Article is: is the transaction intended to have effect as security?

UCC § 1-201(37) defines "Security Interest" as "an interest in personal property or fixtures which secures payment or performance of an obligation."

The assignment to the surety is conditional and does not become enforceable unless and until the contractor defaults, at which time the surety's obligation of performance and/or payment to laborers and materialmen also becomes unconditional. There is nothing in Article 9 that excludes security transactions merely because they are conditional.

29 The required steps are described in Coogan, How to Create Security Interests Under the Code—And Why, 48 Cornell L.Q. 131 (1962), which contains an excellent treatment of the subject. The steps are as follows:

(1) There must be agreement that the security interest attach;

(2) Value must be given. "Value" is defined in UCC § 1-201(44), which provides:

> Except as otherwise provided with respect to negotiable instruments and bank collections . . . a person gives 'value' for rights if he acquires them
>
> (a) in return for a binding commitment to extend credit . . . ;
>
> . . .
>
> (d) generally, in return for any consideration sufficient to support a simple contract.

Such value is given by the surety on the date the surety contract is executed;

(3) The debtor (contractor) must have rights in the collateral. This requirement is fulfilled on the date of execution of the government contract.

security interest which will have priority over the trustee in bankruptcy of a defaulting contractor and over nearly all the other creditors claiming security interests in the same collateral.[30] If the surety files a financing statement[31] at or before the time the surety contract is executed, its security interest will have priority over the trustee in bankruptcy,[32] and over any secured creditor having a security interest in the same collateral who filed a financing statement at a later time. The only conceivable situation in which a prior security interest could exist is if the contractor had previously assigned his future contract rights under a continuing financing arrangement and if a proper financing statement had been filed at an earlier date. This could be ascertained by the surety by checking the filing records. If such a prior interest existed, the surety could still take steps to protect itself in case of default. For example, it could obtain an agreement from the bank that the surety's claim would have priority, or an agreement establishing pro rata distribution between the bank and the surety, or by simply charging a higher surety premium before undertaking the bond obligation.

What effect, then, will the Code have on the surety's other rights, especially that of subrogation? It is conceivable that the Supreme Court could rule that the surety's right of subrogation is superior to any other conflicting interest regardless of how created. Certainly, the *Pearlman* case does not support that result, as the majority opinion gives the surety an equitable lien only. Moreover, such a result would conflict with the Government's policy of encouraging small contractors to undertake government work.[33] A second

When these three steps are satisfied, the security interest "attaches" under UCC § 9-204(1).

(4) The surety must file a "financing statement," required by UCC § 9-302(1) to perfect a security interest in such collateral if it represents a significant part of the assignor's contract rights.

Upon completion of these four steps, the security interest is "perfected" under UCC § 9-303(1).

(5) Finally, the security agreement must be in writing, signed by the debtor, and contain a description of the collateral.

See Coogan, supra at 139, where the author states:

> As a minimum, one must think not in terms of the three steps that cause a security interest to attach nor even of the four steps that cause it to be perfected, but in terms of at least the five steps necessary to create a perfected and enforceable security interest—namely, compliance with the provisions of 9-203, 9-204, and 9-303.

See also Coogan, A Suggested Analytical Approach to Article 9 of the Uniform Commercial Code, 63 Colum. L. Rev. 1 (1963).

[30] The most important of the steps in point of time is the requirement of filing. UCC § 9-312(5) provides that as to conflicting security interests perfected by filing, order of filing governs priority, and not order of perfection.

[31] See supra note 29, step (4).

[32] UCC § 9-301 gives the trustee in bankruptcy priority over an unperfected security interest. See Coogan, A Suggested Analytical Approach to Article 9 of the Uniform Commercial Code, 63 Colum. L. Rev. 1, 28 (1963), where the author states:

> The inferences to be drawn from . . . [UCC § 9-301(1)(b)] are that an unperfected security interest is good against a lien creditor with knowledge, and a perfected security interest is good whether or not the subsequent lien creditor has knowledge.

See Bankruptcy Act § 70c, quoted supra note 14.

[33] This policy is evidenced by the Federal Assignment of Claims Act of 1940, 54

alternative would be to rule that the surety can elect to stand on his rights of subrogation; or to file a financing statement, thereby waiving his rights of subrogation, as held in the *Hartford Acc. & Indem. Co.* case, and electing to stand on his legal rights under the Code. A third alternative, and one with much to commend it, is for the court to hold that there is no need to look beyond the statute to determine the surety's right. The Code has provided an adequate legal remedy by which sureties, by following proper procedures, can establish legal security interests having absolute priority over the trustee in bankruptcy and almost certain priority over all other creditors of the defaulting contractor. It would seem that the "equitable subrogation" doctrine, designed to provide the surety with a remedy where none was previously provided by common law or statute, is superfluous.[34]

The *Pearlman* case provides an uncertain basis for granting the surety "equitable subrogation" in retained percentages which the United States holds as a stakeholder in jurisdictions in which the Uniform Commercial Code is not in effect. In Code jurisdictions, no reason is apparent why the "equitable subrogation" doctrine should not be abandoned.

FORREST W. BARNES

Communications—FCC—Unfair Competition by Community Antenna Service.—*Cable Vision, Inc. v. KUTV, Inc.*[1]—In an action commenced on antitrust grounds by a community antenna operator, the defendant, a local television station, filed a compulsory counter-claim and applied for a preliminary injunction against plaintiffs. The defendant station alleged that it had exclusive contract rights to the "first run" of major network programs in the Twin Falls, Idaho area. It further alleged that the activities of the plaintiff community antenna operator, in picking up and distributing these programs to its subscribers at the same time they were broadcast by the station, constituted tortious interference with these contract rights and was a means of unfair competition. HELD: The contractual arrangements made by the local station with the television networks which granted the limited right of first call exclusively upon the programs of the latter is a valuable property right, protectable by injunction from the tortious interference and unfair compe-

Stat. 1029 (1940), as amended, 31 U.S.C. § 203 (1958), which authorizes the assignment of the contractor's contract claims against the Government to a bank or other financial institution as security for the extension of the financing necessary to enable small contractors to undertake government contracts. Such assignments were previously null and void as against the United States. Financing institutions would be increasingly reluctant to extend such credit if the major source of security in the event of default and bankruptcy of the contractor, i.e., the retained percentages, is held to belong to the surety regardless of whether it has taken the steps necessary to perfect its interest, which would have served to put the bank on notice of that interest.

[34] A similar policy is found in the analogous provisions dealing with "preferred creditors" in Bankruptcy Act, § 60a(6), 30 Stat. 562 (1898), as amended, 11 U.S.C. § 96a(6) (1958), which provides: "The recognition of equitable liens where available means of perfecting legal liens have not been employed is declared to be contrary to the policy of this section."

[1] 211 F. Supp. 47 (D. Idaho 1962).