Financing on Construction Contracts Under the Uniform Commercial Code

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Building contractors commonly assign future payments under their contracts as security for working capital loans. If the various obligations of the contractor are secured by the undertaking of a surety, the assignee bank is likely to come into conflict with the surety in the event of the contractor's default, since the surety will seek these assigned payments for reimbursement of the loss which it incurs when it either completes the job, responds in damages or pays labor and material claims. The surety's claim will be based either on a theory of subrogation or on an assignment included in the bond application. A large number of cases involving these disputes have reached appellate courts, but this volume of litigation has produced remarkably little in the way of clear and satisfactory law. This is certainly true for the mass of decisions taken as a whole, and it seems about equally true for most jurisdictions considered individually. The only possible generalization is that while the surety generally wins, assignee banks prevail just often enough to maintain the flow of litigation.

Lawyers who are concerned with these problems must now give consideration to the Uniform Commercial Code in those states where it has been adopted. At the outset there is probably some question as to whether the Code applies in these cases at all and, if so, whether it applies with respect to both the assignee bank and the surety. So far as the assignee bank is concerned, the assigned payments would seem to be "contract rights" as that term is defined in the Code, and the assignment would therefore constitute a "security agreement" in Code terminology. With respect to the surety's assignment in the bond application, the situation is not so clear. Since it is not given to secure an extension of commercial credit, it falls outside the general class of transactions with which the Code is principally concerned.

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1 Jordan, The Rights of a Surety Upon the Default of Its Contractor-Principal, 41 Ore. L. Rev. 1, 4-14 (1961).

2 Uniform Commercial Code § 9-106. Building contract payments are mentioned in the comment to this section as an illustration of contract rights. Citations to the Code are to the 1958 Official Text, with Comments. Hereinafter the Code will be cited as UCC.

3 UCC § 9-105(b). The Code will apply even though the assignment is outright rather than for security (UCC § 9-102(1)(b)). This is only a technical distinction since either form may be used to finance on future payments.

4 See Comments to UCC § 9-104, especially paragraph 3, which refers to the field of labor and material liens as being, "far removed from ordinary commercial financing." As will be seen the position of the contractor's surety is often closely related to these lien claimants.
Furthermore, it is at least arguable that it is expressly excluded. Section 9-104 states that the Code does not apply to "a transfer of a contract right to an assignee who is also to do the performance under the contract." Since the surety on a building contract customarily has the right to complete the work on the contractor's default, the quoted section would seem to raise a considerable question. It has been suggested that it excludes only payments earned after default and after the surety has taken over, and that the surety's rights to payments earned prior to default are governed by the Code. The Federal District Court for the Western District of Pennsylvania has held that the assignment to a surety is governed by the Code. However, the surety did not take over the project and thus the question raised by Section 9-104 was not considered. More recently, a lower Pennsylvania state court likewise held that the surety's assignment is governed by the Code. In that case the surety did take over the project, but the amount involved had been earned by the contractor prior to default. The court in the latter case put considerable emphasis on the fact that the surety, by filing a financing statement, indicated its understanding that the Code applied.

It is interesting to note that the 1952 version of the Code included a provision expressly covering the sort of conflict between a surety and assignee bank with which we are concerned. This provision would apparently have given the assignee bank priority in almost every instance, and it was eliminated in 1953 because of the protests of the Association of Casualty and Surety Companies. Neither of the cases referred to above considered this bit of history in determining the applicability of the Code. More will be said of this provision and the possible significance of its elimination later in this discussion.

Even though it is concluded that one or both of the assignments are governed by the Code, there is a further question as to whether filing is necessary for perfection. Section 9-302 exempts from the filing requirements, "an assignment of . . . contract rights, which does not, alone or in conjunction with other assignments to the same assignee, transfer a significant part of the outstanding . . . contract rights of the assignor." If a given bank customarily finances all the

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5 Spivack, Secured Transactions (Under the Uniform Commercial Code) 64 (1960). This analysis, if correct, does not treat the problem in an entirely satisfactory manner. For example, what is the status of a final payment which consists of retained percentages earned by both the contractor and surety?


jobs of a particular contractor, this exemption would clearly be unavailable. Presumably, the same conclusion would be reached if the same surety company wrote all of the contractor's bonds. In both of the cases discussed above, the courts held that filing was necessary to perfect the sureties' assignment, without considering the possible application of the quoted provision from Section 9-302.

For the balance of this discussion, it will be assumed that both the assignment to the bank and the assignment to the surety come under the provisions of the Code and that filing is required for perfection in both cases. These conclusions, however, only serve to introduce the more perplexing questions which the Code raises in this area.

In order to consider the impact of the Code, it seems desirable to first outline the principal features of the prior law on the subject, and this in turn requires a short explanation of some of the usual provisions of construction contracts and contractors' bonds. The typical contract provides for two types of payments. So-called progress payments are generally made monthly as the work progresses and each payment, depending upon the contract, is between eighty and ninety-five per cent of the value of labor and materials added during the previous month as determined by the architect. The final payment is made after the building is complete and has been accepted by the owner and equals the difference between the contract price and the total progress payments. Included in the final payment are the so-called retained percentages which have, in a sense, been accumulated by paying the contractor less than one hundred per cent of value in the progress payments. The distinction between progress payments and retained percentages has been of considerable significance in cases of the sort under consideration.

It is likewise necessary to pay brief attention to the more or less standard types of contractors' bonds. In every case there will be a bond which, in effect, secures the owner against the failure of the contractor to complete the building and otherwise fully perform the contract. This is called a performance bond. There may also be a payment bond under which the surety assumes liability for the payment of labor and material claims and on which the labor and material suppliers have a direct right of action. Although payment bonds are sometimes used in private construction, they are, in a sense, redundant because under the performance bond the surety will be obligated to pay labor and material claims in order to protect the owner against liens. On the other hand, payment bonds are commonly required by statute for public construction in order to provide a substitute security for the laborers and materialmen who are precluded from asserting a lien on the public improvement. While separate payment and per-
formance bonds are frequently written, it is about as common to include both obligations in a single undertaking. For our purpose this distinction is not significant.

A further more or less standard feature of these cases is that the bond application executed by the contractor generally includes a provision which purports to assign to the surety for indemnity all amounts becoming payable under the contract after the contractor’s default.

In analyzing the cases, then, it is necessary to make a three-way classification: first, on the basis of whether the amount in dispute consists of retained percentages or earned, but unpaid, progress payments; second, on whether the contract is for private or public construction and lastly, on whether the surety is relying upon the assignment in the application or upon a theory of subrogation. This is not to say that other distinctions are unimportant.

The law is most clear with respect to retained percentages. Under any view, and regardless of whether the contract is for public or private construction, the retained percentages serve as security to the owner that the project will be completed. If then, the contractor fails to complete the work in accordance with the contract, and the surety takes over and completes performance, the surety’s right to the retained percentages as against the contractor’s assignee is clear on the theory of subrogation to the owner. If the surety responds in damages instead of taking over performance, its rights with respect to the retained percentages will be basically the same. It will be entitled to have them applied in mitigation of damages rather than paid to the assignee bank. The subordinate position of the assignee in these cases can be most easily explained by the well established proposition that the rights of an assignee can be no greater than those of his assignor.

A somewhat different analysis is necessary with respect to retained percentages in cases where the contractor has completed the construction but left labor and material bills which the surety has been required to pay. In private construction the retainage can properly be considered security to protect the owner from the liens which would result from such unpaid claims, and the paying surety can therefore predicate his claim to priority over an assignee bank on subrogation to the owner. However, since liens are not possible in the case of public construction, no very strong argument can be made

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for this type subrogation in such cases. Nevertheless, if the laborers and materialmen have enforceable rights to the retained percentages, the surety will logically prevail on the theory of subrogation to them. This seems to be the usual result so far as state and local construction are concerned. In New York, however, it has been recently held that the state or other public contracting body has no right to use retained percentages to pay labor and material claims and that the surety, therefore, cannot prevail by subrogation to such claimants. The cases involving federal contracts are somewhat confusing. For some purposes it has been held that laborers and materialmen have no right to the retained percentages, and that therefore the surety cannot claim such amounts on the basis of subrogation to the labor and material suppliers it has been required to pay. But in cases of the type now under consideration, where the dispute is between the paying surety and an assignee bank, the federal courts have consistently held that the laborers and materialmen have a sufficient equitable or inchoate interest in the retainage to support the surety’s claim to priority on the theory of subrogation.

With respect to retained percentages, then, the surety has generally been able to prevail on some theory of subrogation and has not had to rely on its assignment. There is presently nothing in the Code which expressly denies or limits the surety’s rights by subrogation. It would therefore seem proper to conclude that the enactment of the Code has not changed the law so far as retained percentages are concerned. As previously mentioned, the 1952 draft of the Code included a provision giving an assignee bank priority as to all amounts payable under the contract, so long as the bank’s advances were

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14 United States v. Munsey Trust Co., 332 U.S. 234 (1947) held that the federal government could set off a separate debt owed to it by the contractor against the retained percentages on a government contract as against the surety who sought such retainage to reimburse itself for amounts paid to laborers and materialmen. Considerable doubts as to the scope of the Munsey Trust case are raised by the Supreme Court’s recent decision in Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962), which held that the surety has a better right to the retained percentages on a government contract than the contractor’s trustee in bankruptcy. According to a concurring opinion this result was reached by the majority on the theory of subrogation to labor and material claims.  
16 See UCC § 1-103 which preserves all general principles of law and equity unless displaced by particular provisions of the Code. While subrogation is not expressly mentioned, the similar equitable doctrines of estoppel, fraud, duress and mistake are specifically included.
designated for use in the performance of the contract. The Association of Casualty and Surety Companies convinced the draftsmen that this provision was contrary to the majority view under the case law and it was therefore eliminated. This seems to indicate that the draftsmen would agree with the conclusion, stated above, that the Code does not alter the surety's priority when based on subrogation.

However, a recent decision of a Pennsylvania trial court apparently holds otherwise. In Hartford Acc. & Indem. Co. v. State Pub. Sch. Bldg. Auth., the surety and an assignee bank were contesting for a progress payment earned by the contractor but unpaid at the time of default. The assignee bank prevailed since it had first perfected its security interest by filing. The court apparently felt that, under the Code, such a security interest could not be displaced on any theory of subrogation. This seems to miss the whole point of subrogation. The bank undoubtedly had priority as to the subject matter of the assignment. That, however, was only the contractor's right to the payment, and the surety, by subrogation, was asserting the owner's right to refuse to make the payment because of the contractor's default. But it should be recognized that there has been a tendency on the part of the courts to consider the surety's right of subrogation in terms of priority. Thus in the leading Prairie State Bank case, the Supreme Court of the United States found that the surety's equitable rights under the doctrine of subrogation came into existence on the date of the contract and bond and thus had priority over the bank's later assignment. The Pennsylvania court in the Hartford Accident case followed the same line of reasoning, but held for the assignee bank because, under the Code, its priority dated from the time of filing the financing statement which was prior to the contract.

17 Supra note 8.
18 Supra note 9.
19 Supra note 7.
20 This distinction finds support in the cases involving priority as to retained percentages between materialmen or sureties on the one hand and federal tax liens on the other. The basic rule is that the question as to whether the taxpayer has a property interest to which the tax lien can attach is to be determined by state law, while questions of priority of lien are to be decided by federal law. Aquilino v. United States, 363 U.S. 509 (1960). The cases have generally held that, under the applicable state law, the defaulting contractor has no rights in the retained percentages to which the tax lien can attach. The surety, on the other hand, can reach the retainage either by subrogation to the owner or to the labor and material claims which it has paid. General Ins. Co. of America v. Ted Price Constr. Co., 175 F. Supp. 261 (D. Idaho 1959); Wolverine Ins. Co. v. Phillips, 165 F. Supp. 335 (N.D. Iowa 1958). See also United States v. Chapman, 281 F.2d 862 (10th Cir. 1960). By way of contrast the tax lien prevailed when the surety based its claim entirely on the assignment in the bond application. United States v. Ball Constr. Co., 355 U.S. 587 (1958).
22 See Goodwin, Significant Decisions Interpreting Article 9 of the Uniform Commercial Code, 18 Bus. Law. 777, 788 (1963) which interprets the Hartford Accident case
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In the writer's opinion, as previously indicated, subrogation does not involve any such question of priority. Before leaving the Hartford Accident case it should be pointed out that, since it involved a progress payment rather than retained percentages, it was perhaps decided correctly for reasons which will be discussed below.

In recent cases in Washington and Arkansas, the assignee banks argued for priority on the basis of recently enacted accounts receivable statutes. Both courts held that the perfection of the bank's assignment against third parties under the statute did not in any way alter or lessen the surety's rights by subrogation. Since the accounts receivable statutes, which were enacted in the wake of Corn Exch. Nat'l Bank & Trust Co. v. Klauder, can be considered as the forerunners of the Code in this area, these cases would seem closely in point.

In the case of progress payments earned but unpaid at the time of default, the prior law is not so clear. Logically the surety's claim to priority by subrogation to the owner seems strong. After default the owner is not obligated to make any further payments to the contractor until the construction has been completed and the owner's damage claim thereby liquidated. Nor is there any reason for making an exception to this for earned but unpaid progress payments, since the contract obviously cannot be considered divisible merely because of the provision for monthly payments. The surety, then, regardless of whether it elects to complete performance or to respond in damages, would seem equally entitled by subrogation to have these amounts used in completing the construction. The shortcoming of this analysis is that it ignores equitable considerations even though subrogation is basically an equitable doctrine. In any event assignee

as denying subrogation because the surety had constructive notice of the bank's prior claim from the filed financing statement. See also Goodwin, Selected Practical Considerations Under Article 9, B.C. U.C.C. CO-ORD. 555, 559-62 (1963). Cf. Comment, 4 B.C. Ind. & Com. L. Rev. 748, 753 (1963) which interprets the case as holding that the surety by filing a financing statement waived its claim by subrogation.


318 U.S. 434 (1943).

The Arkansas statute was of the so-called "validation" type while the Washington statute requires the filing of a notice to perfect the assignment and is thus more analogous to the Code.

See Scarsdale Nat'l Bank & Trust Co. v. United States Fid. & Guar. Co., 264 N.Y. 159, 190 N.E. 330 (1934). In this case the contract gave the owner the right to use all unpaid amounts to complete the job in event of the contractor's default. O'Neil Eng'r Co. v. First Nat'l Bank, 222 S.W. 1091 (Tex. Comm'n of App. 1920) reached the same result without such express provisions.

banks have frequently prevailed over sureties with respect to earned but unpaid progress payments.

In some of these cases, the courts appear to have simply ignored the possibility of subrogation and treated the question as one of priority of assignment. But in a few, the courts have expressly found subrogation to be unavailable for one reason or another. Thus it has been held, with respect to public construction, that the surety’s only right to subrogation was to the labor and material claimants, and therefore to the retained percentages. Under the facts of one case, the court found that the owner assumed a direct obligation to the assignee bank and, therefore, had no rights with respect to the progress payments in question to which the surety could be subrogated. In another case the progress payment was not made when due because of the owner’s lack of funds, and for this reason the court apparently felt that the rights of the assignee bank should not be affected by the contractor’s later default.

The greatest disagreement, in cases involving progress payments, has been over the significance to be given to the fact that the bank’s advances have been used to pay expenses incurred in the particular construction. Some courts have found this sufficient reason to hold for the assignee bank, while others have stated that it is wholly immaterial. A third group holds that this is relevant only if such application is required by the contract between the bank and the contractor. This disagreement is not surprising since it is difficult to fit this factor into the logical pattern of subrogation. Clearly such application of the assignee’s advances would not impair the right of the owner, as against the contractor’s assignee, to use all unpaid amounts to complete the project. If the surety’s position by subrogation is in all respects equivalent to that of the owner, then this factor would likewise be immaterial so far as the surety is concerned. However, since subrogation is an equitable doctrine, it seems proper to

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31 Town of River Junction v. Maryland Cas. Co., 110 F.2d 278 (5th Cir. 1940).
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take into account the fact that in these circumstances the bank’s advances have inured to the benefit of the surety who would otherwise have been called upon to pay these claims.\(^{35}\)

On the subject of progress payments, special mention should also be made of the cases involving federal construction, because of the apparent significance of the Federal Assignment of Claims Act.\(^{36}\) In its original version, this statute in effect nullified assignments of claims against the government except when they were executed subsequent to the issuance of a warrant or payment. In 1940 this was amended to permit assignments to banks, trust companies and other financing institutions.\(^{37}\) The amendment included the following statement: “Notwithstanding any law to the contrary governing the validity of assignments, any assignment pursuant to this section, shall constitute a valid assignment for all purposes.” The significance of this language is obscure in cases where the surety is relying on subrogation. In two cases before the Court of Claims involving retained percentages, the surety has prevailed over an assignee bank that had perfected its assignment under the statute.\(^{38}\) On the other hand, the Fifth Circuit has relied heavily on this statute in two cases holding for assignee banks as to unpaid progress payments.\(^{39}\)

It appears, then, that cases involving progress payments will frequently arise in which, for any one of a variety of reasons, the surety will not be able to prevail on any theory of subrogation and must, therefore, rely upon the assignment in the bond application. In these cases the Code will undoubtedly have a substantial impact. In considering the Code provisions, it will be helpful to examine concurrently the case law on priority of assignment. This is considerably more prolific than the foregoing discussion would indicate, because in numerous instances the courts have chosen to comment on the

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\(^{35}\) See Town of River Junction v. Maryland Cas. Co., supra note 31, in which the court held that the assignee bank was subrogated, as against the surety, to the labor and material claims paid by its loan. But see Johnson v. Maryland Cas. Co., 225 Ark. 224, 280 S.W.2d 398 (1955) stating that such subrogation is available only if the loan was in some way induced by the surety. Cf. American Employers Ins. Co. v. School Dist., supra note 34 in which the court, in holding for the surety, pointed out that even though the surety in a sense had the benefit of the bank’s advances it was not unjustly enriched since it had been required to pay further claims.


question of priority even though the actual basis for decision has been subrogation.

The assignment to the surety in the bond application is invariably conditioned upon default. While there is some variation in language, these provisions usually purport to assign only those amounts becoming payable after default. Quite a number of courts have held that, for purposes of priority, these assignments become effective only at the date of default and generally are, therefore, junior to the assignments to lending banks. On the other hand, at least as many courts have held that the conditional feature is immaterial and have given the surety's assignment priority from the date of the construction contract. A similar split of authority exists as to whether notice to the owner is necessary for priority. These factors become completely immaterial under the Code if one or both of the parties perfects his assignment by filing a financing statement. Under the Code, priority between conflicting security interests is determined by the order of filing regardless of when the security interests actually attach. Therefore, if the assignee bank files first, it will prevail even though the interest of the surety is considered as attaching upon the execution of the construction contract. The Hartford Accident case, previously discussed, appears to be authority for this proposition even though the court did not base its decision squarely on the "first-to-file" rule. Conversely, the surety will prevail if it files first, regardless of the fact that its interest might be held to attach only upon the contractor's default.

In the same connection, a further possibility deserves mention. If a particular bank customarily finances all the jobs of a given contractor, then it will no doubt have a financing statement in effect at

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41 Gray v. Travelers Indem. Co., 280 F.2d 549 (9th Cir. 1960); O'Neil Eng'r Co. v. First Nat'l Bank, supra note 26.

42 First Nat'l Bank v. Monroe County, supra note 27 (notice necessary); American Employers Ins. Co. v. School Dist., supra note 34 (notice not necessary).

43 UCC § 9-312(5).


45 The court relied on UCC § 9-312(3) of the 1952 draft of the Code which gives priority to after-acquired collateral from the date of the originally perfected security interest. The court considered the original security interest to date from the general contract between the bank and the contractor for accounts receivable financing, although it does not appear that any accounts were actually assigned thereby or any advances made at that time. The court cited, but did not discuss UCC § 9-312(1) which stated the 1952 version of the "first-to-file" rule. In any event the matter is considerably clarified in the 1958 draft both by a more explicit statement of the "first-to-file" rule and by the removal of the after-acquired property provision from UCC § 9-312.
all times which will serve to perfect all assignments made during the effective period of the statement. Under such circumstances, no surety for a particular project could obtain priority of assignment regardless of how promptly it filed. A surety could, of course, have a financing statement in effect at all times with respect to a particular contractor but this does not seem so likely.

There is another type of case in which the surety must rely on its assignment and in which, for different reasons, the Code will apparently make considerable changes. Occasionally a surety has attempted to recover amounts already paid to the assignee bank. For the most part, these attempts have been unsuccessful. Subrogation avails nothing in these cases since it has generally been held that the owner himself cannot recover such payments from the assignee even though, under the particular facts, the payment could have been recovered had it been made instead to the contractor. Absent any relevant statute the surety's position is not much better under its allegedly prior assignment. The general rule has been that a junior assignee who receives payment in good faith may retain the payment as against a prior assignee. While the question is not covered expressly by the Code, it seems clear that this last rule is changed. If the first assignee has perfected his assignment by filing and has priority under the provisions of the Code, then he will apparently be able to recover amounts already collected by the junior assignee. In the type of case

46 UCC §§ 9-303, 9-403.


48 Restatement, Contracts § 173 (1932). This rule was apparently followed in the federal cases cited in the preceding note since the courts, in considering the question of priority of assignment, emphasized that the assignee banks had no notice of the assignment to the surety in the bond application. In Aetna Cas. & Sur. Co. v. Harvard Trust Co., supra note 47, the court cited § 173 and related Massachusetts' cases. In United States Fid. & Guar. Co. v. Bank of Brewton, 4 F. Supp. 272 (S.D. Ala. 1933), the court found the bank had notice because it knew of unpaid bills. The surety recovered the payments from the bank apparently on the ground of subrogation to the materialmen.

49 This seems to follow from UCC § 9-312 which makes priority between conflicting security interests depend upon the order of filing or perfection. UCC § 9-318(3) authorizes payment by the account debtor to the assignor until notice of the assignment, but this does not seem relevant to the rights of a junior assignee receiving payments. In Aetna Cas. & Sur. Co. v. Eastern Trust & Banking Co., 156 Me. 87, 161 A.2d 843
under consideration, this means that if the surety files first, the assignee bank may not even be able to keep amounts already collected. This is probably not quite so serious as it first appears since the surety’s assignment, by its terms, will usually reach only amounts becoming payable after default.

In a number of cases, the surety has sought to recover payments becoming due on one contract to reimburse itself for losses sustained on another bond for the same contractor. Since the assignment in the bond application is invariably conditioned on default, this possibility is available only if there has been a default on the contract giving rise to the payments, and the surety has been able to complete it for less than the amount remaining unpaid at the time of default. The terms of the assignment are generally broad enough to cover losses on other bonds and the courts have given them effect, in the circumstances outlined, as against assignee banks. Under the Code, the rules governing priority of assignment, as discussed above, will apply to these cases, but otherwise the Code will apparently make no changes in this area.

From the foregoing discussion it seems evident that, not only has the prior case law in this area been largely unsatisfactory, but also that the enactment of the Code, rather than improving the situation, has added to the uncertainty. When the draftsmen eliminated the 1952 provision favoring assignees they apparently intended that the Code should thereafter be neutral in these disputes between assignee banks and sureties. However, the Pennsylvania experience indicates that the Code will definitely be a factor in these cases although its impact is presently unpredictable. The difficulty with the Code in this area is that, while it clearly governs the relative rights of the parties as assignees, it leaves the rights of the surety by subrogation in a state of uncertainty. Lawyers and judges will be reluctant to recognize that the Code provides only partial coverage of what is, after all, a single question. The Hartford Accident case is significant principally as an illustration of the difficulties and confusion which will result.

Additional statutory coverage is apparently indicated, not only to clear up the confusion which has resulted from the Code, but also to replace the arbitrary and frequently conflicting rules of the prior case law. While there are presently a number of statutes on the books

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(1960), the Maine court allowed the surety to recover progress payments already received by the assignee bank on the basis of Maine’s “validation” type accounts receivable statute, which expressly provides that a junior assignee receiving payment “shall be a trustee and shall be accountable . . . to the original assignee therefore.”


51 Supra notes 8 and 9.

of various jurisdictions which touch on the problem, none of these seems to provide a satisfactory solution. For example, the various amendments to the Federal Assignment of Claims Act have obviously been intended to facilitate financing on government contracts and to strengthen the position of assignee banks. While it is by no means clear that Congress intended to enhance thereby the position of assignees as against sureties, this has apparently been the result.

New York has a rather complex statutory scheme, as a part of its mechanics lien law, to insure that amounts received by contractors under building contracts are used to discharge obligations incurred in the performance of the contract, and these provisions are made applicable to amounts advanced on assignments of such contracts. However, the assignee will prevail over subsequent labor and material claims, including those of subcontractors, only to the extent that its advances are actually used in the project and then only if a proper "notice of lending" has been filed. The California provisions, which are also included in the mechanics lien law and which are equally complex, give labor and material claimants a prior right to all amounts becoming payable under the contract over the contractor's assignee regardless of whether the latter's advances have been used in the project. Both of these statutes illustrate a strong tendency to give labor and material suppliers a preferred position with respect to contract funds. However, neither makes any special provisions for sureties, and they must therefore come into the picture as subrogues of labor and material claimants. In a sense this is unrealistic since, at least in public construction, the laborers and materialmen are always amply protected by the payment bond, and the dispute, when it occurs, will generally involve the assignee bank and the surety. Whether the position of the surety, a professional risk taker, should be fully equated to that of labor and material claimants is open to question.

The 1952 provision of the Code at least attempted to deal expressly with the relative rights of sureties and assignee banks. However, its subsequent eliminations would indicate that the solution it provided was not an acceptable one. That provision, it will be recalled, gave the assignee priority over the surety as to all amounts payable under the contract so long as the assignee's advances were made for use in the performance of the contract. This seems objectionable primarily because it fails to distinguish between retained percentages and progress payments.

Retained percentages are a species of security and for this reason

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53 N.Y. Lien Law §§ 70-79.
54 N.Y. Lien Law § 73.
the surety's claim to them by subrogation is intrinsically strong. Beyond that there would seem to be very few situations in which the use of retained percentages for collateral would serve any legitimate financial need of the contractor. Since the contractor will ordinarily pay subcontractors and material suppliers on the same basis on which he is being paid by the owner, it should ordinarily not be necessary for him to assign the retained percentages to secure a working capital advance for the particular job. Moreover, the subcontracts will usually have provisions for retained percentages similar to the prime or general contract. If the general contractor assigns his retained percentages and uses the proceeds of the loan for other projects or purposes, he is likely to be without funds to pay the subcontractors their retained percentages when the time comes. Finally, since the contractor is in effect anticipating future profits when he assigns the retained percentages, such an assignment would seem to defeat the purpose of the retainage from the point of view of the owner. It will no longer provide an inducement to the contractor to complete performance. It would appear therefore that, for a variety of reasons, the case law is correct in generally giving the sureties priority over assignee banks.

On the other hand, financing on the assignment of specific progress payments seems to be a reasonable method for meeting the working capital needs of contractors. Such financing does not impair any legitimate interest of the surety since, at the time of assuming its obligation, the surety cannot very well count on the possibility of an earned but unpaid progress payment at the time of default. Furthermore, sureties must frequently rely on the availability of such financing, since without it the contractors would be unable to undertake the construction at all. It has been suggested that the proper solution to the difficulties in this area is a prior agreement under which the surety could subordinate its claim if it decides that the financing is desirable in the particular circumstances. However, such agreements are apparently quite rare, probably because a surety company is an extremely difficult


67 In this connection UCC § 9-318 should be noted. This section invalidates any provision of a contract prohibiting assignment. In the case of construction contracts this seems unfair to the owner. Under the prior law the owner, when requested to consent to an assignment, has been able to consider its probable effect under the particular circumstances, on future performance. In spite of a valid provision prohibiting assignment a sort of "non-notification" financing was apparently possible if the bank cared to risk it. See McLaughlin v. New England Tel. & Tel. Co. —Mass. —, 188 N.E.2d 552 (1963).

68 This was the suggestion of the Association of Casualty and Surety Companies in opposing the 1952 provision, see note 9, supra.
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entity with which to communicate during the interval between the
writing of the bond and the default.50

In the writer’s opinion, a statute based on the distinction between
retained percentages and progress payments would give fair recogni-
tion to the reasonable expectations of both sureties and lenders and
would be much better, both in terms of certainty and of policy, than
either the incomplete coverage of the Code or the prior case law. Most
of the cases have involved public contracts, and it should be relatively
easy to draft such a statute for public construction, since the terms of
both the contracts and bonds are themselves established in large part
by statute. There might be some practical difficulties in drafting such a
statute so as to make it applicable to contracts for private construction,
even though, in practice, the payment provisions and the bonds are
generally similar to those used in public contracts. In view of the
local interests involved with respect to public construction, and also
in view of the unfortunate experience with the 1952 provision, it may
not be feasible to attempt such a statutory solution by amendment of
the Code. In that case it would be better to completely supersede the
Code in this area.

50 The principal difficulty is illustrated by Seaboard Sur. Co. v. First Nat'l Bank
& Trust Co., 121 F.2d 288 (8th Cir. 1941), in which the bank relied on a consent
to the assignment executed by a representative of a general agency of the surety who
signed as “Attorney-in-fact.” The principal purpose of the power of attorney naming
such agents is, of course, to authorize them to execute bonds, and in this case the
surety company contended that the agent had no authority to execute the consent.
The court held otherwise on a somewhat doubtful interpretation of the power of at-
torney. Nonetheless, the decision appeals to the writer because, in his limited experience,
any inquiry or request of this sort which is addressed to the home office of a surety
company will be referred back to a general agent for handling.