Surety Bonds on Federal Construction Contracts: Current Decisions Reviewed

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SURETY BONDS ON FEDERAL CONSTRUCTION CONTRACTS: CURRENT DECISIONS REVIEWED

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I. INTRODUCTION

THE essential principle upon which a mechanic's lien rests is that of unjust enrichment. Mechanics' liens have been created by statute in every state of the Union because of the legislative realization of the equity in favor of the mechanic resulting from an enhancement in value due to the expenditure of work or the employment of materials upon property without payment therefor. Since the security has been enhanced in value, the creditors are not prejudiced by the existence of the lien.1

Customarily, in a construction contract between private parties, laborers and materialmen have a lien on the building to secure payment of their claims; hence, if a contractor fails to pay laborers and materialmen, the owner of a private building has the right to use any money owing to the contractor to discharge his obligation to the laborers and materialmen. However, a building erected for the United States is not subject to a mechanic's lien. The Government is under no legal liability to pay laborers and materialmen but it is under an equitable obligation to do so.2

A public body has a moral obligation to see that the persons who furnished labor and material required in the construction of a public project are paid in full.3 Prior to the passage of the Act of 1894, the United States endeavored to fulfill this obligation and to protect unpaid subcontractors, materialmen, and laborers by various methods.4 Congress, by the Act of August 13, 1894,5 commonly called the Heard Act,

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1. Member of the Philadelphia and District of Columbia Bars.
3. National Surety Corp. v. United States, 132 Ct. Cl. 724, 133 F. Supp. 331, cert. denied, 350 U.S. 902 (1955). To discharge this equitable obligation, Congress passed the Miller Act, 40 U.S.C.A. §§ 270(a)-(c), carrying forward prior acts and enlarging them, which required the execution of a performance bond and a separate payment bond payable to the United States as a condition precedent to the letting of a Government contract. Under such payment bond, the surety guarantees the payment of laborers and materialmen, and, upon performance of this obligation, it relieves the United States from its equitable obligation to see that the laborers and materialmen are paid.
5. 28 Stat. 278.
required any person entering into a formal contract with the United States for the construction or repair of any public building or public work to execute: "the usual penal bond, with good and sufficient sureties, with the additional obligation that such contractor or contractors shall promptly make payments to all persons supplying him or them labor and materials in the prosecution of the work provided for in such contract. . . ."

The Heard Act failed to protect the United States. A few subcontractors instituted suit thereunder before the completion of the building, and the payment of their claims tended to exhaust the penal sum of the bond and thus prejudice the United States. Jurisdictional problems also arose. Whereupon Congress, by an amendment of 1905, sought to remedy these defects by assuring to the United States adequate opportunity to enforce its demands against the contractor's surety, and the priority of such demands. This purpose was accomplished by requiring other creditors to refrain from suit on the bond for a period of six months after completion of the contract and final settlement thereunder, and providing that, if the United States had a claim on the bond, it should have priority in distribution over all other claimants.

The Miller Act of August 24, 1935, eliminated procedural problems raised by the Heard Act of 1894 as amended in 1905. The separation


8. 33 Stat. 811. The Act was further amended by substituting for the words "Circuit Court" as set forth in the Act, the words "District Court." 36 Stat. 1167 (1911).

9. Illinois Surety Co. v. United States to the Use of Peeler, 240 U.S. 214 (1916). In 1905, the Treasury Department was not only in charge of a considerable portion of the federal building projects, but was in charge of the auditing of accounts thereof. The official in charge of construction would certify that the building was completed, a letter would be prepared setting forth the contract price, the additions and deductions, if any, and payments on account, and recommending that a final voucher for the sum therein specified be drawn to the order of the contractor. The date of the administrative approval of this "final settlement letter" by the Treasury Department was held to be the date of final settlement within the meaning of Heard Act. See also note 50 infra.

10. While this amendment of 1905 was somewhat ambiguous, the courts construed it so as to give full effect to its obvious purpose and avoid injustice or absurd results. London and Lancashire Indemnity Co. v. Smoot, 287 Fed. 952 (D.C. Cir. 1923).


12. MacEvoy v. United States for the Use and Benefit of the Calvin Tompkins Co., 322
of the dual obligation of performance and payment of labor and material claims into separate instruments executed simultaneously followed the Pennsylvania practice.\(^{13}\)

The Miller Act provides that before any contract exceeding $2,000 in amount for the construction, alteration or repair of any public building or public work of the United States is awarded to any person, such contractor shall furnish to the United States: (1) a performance surety bond in such amount as the officer awarding the contract shall deem adequate for the protection of the United States, and (2) a separate payment surety bond for the protection of certain suppliers of labor and material in a penal sum equal to one-half of the contract price, when the total amount payable by the terms of the contract is not more than one million dollars, and such a bond in a smaller fraction of the contract price where the total amount payable, by the terms of the contract, is more than one million dollars.

II. Definitions

Public Work

The term "public work" is required to be understood in its plain, obvious and rational sense, and includes any work in which the United States is interested, and which was done for the public, and for which the United States was authorized to expend funds.\(^{14}\)

It includes a vessel constructed under contract for the United States,\(^{15}\) the work of raising a sunken towboat from a canal,\(^{16}\) and work on a railroad roadbed and tunnel on a flood control project.\(^{17}\) Public works generally are fixed or movable property the title to which is vested in the United States.\(^{18}\)

Labor and Material

The term "labor and material" has been liberally construed. For illustration, the bond has been held to cover groceries and provisions required

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\(^{13}\) The problems sought to be corrected in Pennsylvania, and a review of the Pennsylvania legislation will be found in two articles by the writer, New Pennsylvania Bond Laws, 36 Dick. L. Rev. 69 (1932), and Recent Decisions and Trends in Building Construction Law, 9 Temp. L.Q. 125 (1935).

\(^{14}\) United States to the Use of Noland Co. v. Irvin, 316 U.S. 23 (1942); Peterson v. United States for Use of Marsh Lumber Co., 119 F.2d 145 (6th Cir. 1941).

\(^{15}\) Title Guaranty & Trust Co. v. Crane Co., 219 U.S. 24 (1910).


\(^{17}\) Peterson v. United States for Use of Marsh Lumber Co., 119 F.2d 145 (6th Cir. 1941).

\(^{18}\) 35 Comp. Gen. 454 (1956).
for a construction camp distant from a built up area, and freight. Recovery has been allowed for the fair rental value of equipment while in use on a construction project and necessary parts and appliances wholly consumed in the performance of the work, but not for such rental while the equipment is idle. There is now pending in the Sixth Circuit a question growing out of the following facts: The Federal Government had undertaken simultaneously the construction of two buildings on an engineering job under two separate contracts. A subcontractor having subcontracts for earth moving work on both contracts, leased earth moving equipment on one project, then moved the equipment to the second project, and after discontinuing such use on the second project permitted the equipment to stand idle at or near that job site. A number of days later he removed the equipment to the first project for the resumption of work there. The District Court held the prime contractor for the second project obligated under the Miller Act to the lessor of such equipment for the rental value thereof for the period the equipment was standing idle at or near the second project and not actually used thereat.

Recovery has been allowed where the transaction was found to be a rental and not a sales agreement.

Several courts, under exceptional circumstances, have recently allowed recovery for materials which were not actually used in the performance of a contract. In *Commercial Standard Ins. Co. v. United States for Use of Crane Co.*, pipe procured under priority or allocation order restored to inventory to replace identical material fabricated to meet the specifications of the contract and incorporated into the work was held to be within a liberal construction of the Miller Act. On the authority of this case recovery was allowed for stock-piled material, although much of the shipped material was not physically used on the job in question but went to replace electrical equipment stock actually used on the job. Recovery was denied for materials which went into a stock-pile, which included similar items purchased from other suppliers, where there was

22. United States for Use of Edward E. Morgan Co. v. Maryland Cas. Co., 147 F.2d 423 (5th Cir. 1945).
25. 213 F.2d 106 (10th Cir. 1954).
SURETY BONDS

There is no evidence of any record to show which material had actually been used in the performance of the public work and which had been used for work on other contracts.27

It is not essential to a recovery by a materialman on a payment bond required under the Miller Act that the material furnished to a subcontractor, being delivered at the site of the work, be thereafter actually incorporated into the project. However, the materialman must prove not only that he furnished the material but also that the material furnished was in accordance with his contract with the subcontractor, which called for material conforming with the specifications of the principal contract.28

Labor and material does not include premium on Workmen's Compensation Insurance29 or Workmen's Compensation awarded for injuries.30 In recent years a number of our courts have also held that there is no liability under a payment bond taken pursuant to the Miller Act for federal taxes owed by a contractor or subcontractor.31

While the Government has now accepted the conclusion of the various appellate courts that the liability of an employer to pay over to the Government amounts deducted and withheld from employees' wages is a tax liability rather than a wage liability, it has by no means abandoned

28. United States ex rel. Purity Paint Products Corp. v. Aetna Casualty & Surety Co., 56 F. Supp. 431 (D. Conn. 1944). Here recovery was allowed for paint which was found to have the chemical content conforming to the specifications. The manufacturer's affidavits as to quality, as required by the specifications, were accepted and approved. The containers were labelled as required.

Where paint which has been made especially for use in the construction of an air base warehouse met all specifications required by the contract and had the Area Engineer's approval, the general contractor who had refused to accept the paint after authorizing shipment thereof was held liable to the paint manufacturer for the difference between the contract price and the present market value of the paint. Judgment was entered against the contractor and his surety on the Miller Act bond. United States for the Use and Benefit of Morris Paint & Varnish Co. v. Watson, 129 F. Supp. 573 (D. Neb. 1955).
the fight. The Government was successful in *United States v. Phoenix Indemnity Co.*,\(^3\) under the following circumstances:

The Housing Authority of the City of Fayetteville, North Carolina, entered into a contract for the construction of a low cost housing project. This construction contract provided that the contractor should "... provide and pay for all materials, labor ... taxes legally collectible because of the work and all other services and facilities of every nature whatsoever necessary to execute the work under the contract." A single surety bond was given which combined the obligations and performance and payment of labor and material claims. Approximately one year after commencing work the contractor acknowledged it was in default and the surety agreed to undertake completion of the project. During the period when the contractor was engaged in performance it employed diverse individuals on the work and as a result thereof the Commissioner of Internal Revenue made certain assessments upon the contractor as employer, representing taxes, penalties and interest due for Federal Unemployment taxes and for the employer's portions of the Federal Insurance Contributions Act taxes. In addition to these taxes the Commissioner assessed a substantial sum against the employer for withholding taxes and for the employee's portion of the Federal Insurance Contributions Act taxes for the same period. The lower court held the surety was not liable for the taxes composing these latter assessments. The Fourth Circuit held that the surety was liable under the bond for all the taxes mentioned and the judgment of the District Court was accordingly modified. It held its conclusion not to be at variance with its decision in *United States v. Crosland Constr. Co.*,\(^3\) and the line of cases therein discussed. It stated that in each of those cases suit had been brought on a surety bond given by the contractor to insure the performance of the contract work and the condition of the bond related to the obligation of the contractor to make payment to persons supplying labor and material to the work and did not refer to an obligation of the contractor to pay taxes due the Government. The bond and contract in the *Phoenix Indemnity Co.* case construed together were distinguished, the court stating that the bond in this suit covered not only the obligation of the employer to pay the wages earned by his employees, but also to pay the taxes collectible because of the work, and that there could be no doubt that the sums of money sued for were either taxes payable directly by the employer to the United States, or moneys withheld by him from the wages of his employees under the federal tax statutes which had become taxes due the Government in his hands. The bond here guaranteed the performance of all covenants

\(^3\)231 F.2d 573 (4th Cir. 1956).

\(^3\)217 F.2d 275 (4th Cir. 1954).
and agreements undertaken by the contractor in the contract. These covenants and agreements included the agreement to pay all the taxes collectible because of the work, a provision held to be broad enough to cover not only the taxes payable by the employer, such as unemployment taxes and the employer's portion of the Federal Insurance Contributions Act taxes, but also the withholding taxes which were credited on the income taxes due by the employees and the employees' portion of the Federal Insurance Contributions Act taxes. While the United States was not a party to this Housing Authority contract or the bond, it was held that the bond was made for the Government's protection and that it was entitled to sue thereon as a third party beneficiary.24

If the Supreme Court of the United States continues to adhere to its recent terse rulings and Congress does not change the law, it would appear that under Title 26 of the United States Code, section 3670, a lien that is specific and choate under state law, no matter how diligently enforced, can never prevail against a subsequent federal tax lien short of reducing the lien to final judgment. A dissenting opinion states that this is a new doctrine not warranted by the decisions of the Court.25

A claim for contribution due from a bankrupt employer to a union welfare fund is not a wage claim entitled to priority in bankruptcy proceedings.26 The Ninth Circuit has held that a suit may not be prosecuted under the Miller Act against the surety for sums required to be paid by the contractor into a health and welfare fund under a collective bargaining agreement entered into by the contractor with an employees' organization.27

Subcontractor

The Miller Act makes no attempt to define the word subcontractor. The Supreme Court, in substance, has defined a subcontractor under

34. In American Fidelity Co. v. Delaney, 114 F. Supp. 702 (D. Vt. 1953), it was held that a highway contractor's Performance bond and Wages and Material bond, posted pursuant to a state public works contract, did not render the surety liable to the Government for withholding taxes and Social Security taxes withheld by the principal from the employees' wages, but not paid to the United States, where the United States failed to comply with the state statutory requirements to establish a claim against the principal under such statutory Wages and Material bond.28


37. United States for the Benefit and on Behalf of Sherman v. Carter, 229 F.2d 645 (9th Cir.), cert. granted, 351 U.S. 917 (1956), distinguishing an action upon a bond required by a state statute from a case involving a Miller Act bond. See Sherman v. Achterman, Civil No. 2369, Cal. App. Dep't, May 18, 1955, in which the surety was held liable.
the Miller Act as one who performs for and takes from the prime contractor a specific part of the labor or materials required in the original contract, thus excluding ordinary laborers and materialmen. 38 MacEvoy v. United States 39 decided that one who sells building materials to another for resale to the contractor for use on a Government project was not entitled to recover under a payment bond furnished by a contractor pursuant to the Miller Act. The Supreme Court reasoned that Congress cannot be presumed, in the absence of express statutory language, to have intended to impose liability on the payment bond in situations where it is difficult or impossible for the prime contractor to protect himself. It is easy for a prime contractor to secure himself against loss by requiring the subcontractors to give security by bond or otherwise for the payment of those who contract directly with the subcontractor. However, this method of protection was deemed generally inadequate to cope with remote and undeterminable liabilities incurred by an ordinary materialman who may be a manufacturer, a wholesaler or a retailer. To impose unlimited liability under the payment bond in favor of submaterialmen and laborers, it was held, would create a precarious and perilous risk on the prime contractor and his surety.

In a recent case the contractor entered into an agreement with a supplier to furnish and deliver to the job site all millwork as required by the contract documents. Among the items specifically mentioned were certain doors which this supplier ordered from the plaintiff. These doors were manufactured in accordance with the specifications referred to in the principal contract and were delivered to the principal contractor. A motion to dismiss the complaint on the ground that the supplier was not a subcontractor within the meaning of the Miller Act, but merely a materialman, was dismissed, the District Court holding that by contracting with the general contractor to supply specific items to be manufactured in accordance with the specifications of the prime contract, and in so doing taking over a part of the prime contract itself by specific reference thereto, the supplier became a subcontractor in the technical sense. 40

III. Notice

A person having a direct contractual relationship with a subcontractor, but no contractual relationship, express or implied, with the principal contractor, must give written notice to the contractor within ninety days after the date on which such claimant performed the last of the labor or supplied the last of the material for which the claim is made.\(^{41}\) This provision is intended to give immunity to the contractor from undisclosed claims of materialmen where the contractor withholds payment to the subcontractor for ninety days.\(^{42}\) If no notice is given by the claimant under a subcontractor within the ninety day period, the materialman has no right of action on the bond.\(^{43}\)

A written notice received by the contractor within the statutory period is sufficient, although not sent by registered mail.\(^{44}\) The Fifth Circuit has held that the statute is sufficiently complied with if the proof shows convincingly that knowledge has been brought home to the principal contractor. It is not necessary that the writing relied on be signed by the supplier. It is sufficient that there exists a writing from which, in connection with oral testimony, it plainly appears that the nature and state of the indebtedness was brought home to the general contractor. When this appears, the object of the statute, to assure that the contractor will have notice, is attained and the statute is complied with.\(^{45}\)

A materialman wrote a letter to the contractor regarding an unpaid bill of a subcontractor. The contractor answered suggesting that the materialman communicate with the bonding company and advise the contractor in about ninety days of the result of his appeal to the bonding company. It was held that by not protesting the first notice, there was either a conditional waiver or modification of the notice obligation, and the materialman was allowed to recover.\(^{46}\) Furthermore, where the contractor guarantees payment of the materialman's claim, this relieves the

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41. 40 U.S.C.A. § 270(b).
materialman of the obligation of notice under the Miller Act. The requirement of notice may be waived.

IV. TIME FOR SUIT

Each claimant institutes a separate action in the District Court for any district in which the contract was to be performed, and not elsewhere, at any time after the expiration of ninety days after the date on which the last labor was performed or the last material was furnished or supplied by him, for which such claim is made. Such action must be commenced within one year after the date of final settlement of the principal contract with the United States. Final settlement has been defined as the administrative determination by the Government of the sum found to be due the contractor. It may antedate final payment. The Comptroller General's certificate of the date of final settlement is conclusive and may not be questioned by either the contractor or his surety in the absence of fraud or mistake.

Where a subcontractor fully complied with the terms of the contract and was in no way responsible for the delay in final payment by the Government, as where such delay occurred because the principal contractor became insolvent, resulting in the taking over and the completion of the job by the surety, a provision in the subcontract that final payment thereunder should not be due until the principal contractor received final payment from the Government must be construed in the light of the Miller Act, giving the subcontractor a right to sue on the payment bond. Hence, a subcontractor's suit, instituted more than ninety days after the final settlement but prior to the expiration of one year from final

47. United States for Use of W. E. Foley & Bro., Inc. v. United States Fidelity & Guaranty Co., 113 F.2d 888 (2d Cir. 1940).
49. 40 U.S.C.A. § 270(b).
51. United States for Use and Benefit of Tobin Quarries, Inc. v. Glasscock, 27 F. Supp. 534 (E.D. Mo. 1939). The certificate of the Comptroller General as to the date of final settlement must be supported by substantial evidence. In determining whether the decision of the Comptroller General is supported by substantial evidence, the record as a whole, and not merely the evidence on which the official based his decision, was reviewed in United States ex rel. Bangor Roofing and Sheet Metal Co. v. Cunningham, 141 F. Supp. 205 (D. Me. 1956). The court held that the date of final settlement, as certified, was not supported by substantial evidence and directed that judgment be entered in favor of the claimant on the contractor's surety bond. This case also holds that the burden is upon the claimant to establish that it has satisfied the condition imposed by the Miller Act of bringing suit within a year after the date of final settlement, but that no more than a preponderance of the evidence is required to sustain this burden.
settlement, was held not to be premature, notwithstanding the fact that
the contractor had not been paid by the United States Government.\textsuperscript{52}
Since the Miller Act vests exclusive jurisdiction in the District Court for
the district where the contract is to be performed, and not elsewhere, a
suit in the state court will be dismissed.\textsuperscript{63}

V. AMOUNT RECOVERABLE BY SUBCONTRACTORS

The amount recoverable by subcontractors under the Miller Act bond
is ordinarily the unpaid portion of the contract price.\textsuperscript{64} The interpretation
of the original plans and specifications of the prime contract, as made
by the Government Engineer, was held binding on the subcontractor so
that the subcontractor could not, in a Miller Act suit, collect for work
which the subcontractor considered to be extras but which the Govern-
ment Engineer considered as being included in the original plans and
specifications.\textsuperscript{65}

Where a subcontractor, because of unanticipated soil conditions, has
done work other than soil moving and compacting contemplated by
the subcontract, he may recover in quantum meruit for work done, notwith-
standing that the change order agreed to by the United States and the
contractor provided that the subcontractor should do such work without
further compensation.\textsuperscript{66}

Where a prime contractor for rehabilitation work on Government
camps materially breached a subcontract for plumbing and heating work,
the subcontractor was entitled to recover under the Miller Act bond on

\textsuperscript{52.} United States for the Use of Ackerman v. Holloway Co., 126 F. Supp. 347 (D.N.M.
1954); United States for Use of Bailey v. United Pacific Ins. Co., 122 F. Supp. 43 (D.N.M.
1954).

\textsuperscript{53.} Pierce Contractors, Inc. v. Peerless Cas. Co., 31 So. 2d 747 (Fla. 1955). A sub-
contractor under a federal project may sue the general contractor directly on the sub-
contract wherever he can get proper service. Such a suit is not an action on the Miller
Act bond and is not required to be brought in the Federal District Court in an area in
which the work was done, and can be maintained in a state court. Veelz v. Milgram Con-
tracting Co., 75 N.W.2d 305 (Wis. 1956), citing Western Cas. and Surety Co. v. Biggs, 217
F.2d 163 (7th Cir. 1954). On July 28, 1956 the Fifth Circuit held that in view of the
difference in the action authorized under the Miller Act from that contemplated under the
Hear Act, the provision in the Miller Act limiting the place of suit is a restriction only
on venue rather than on the power of a federal court to entertain the suit and a statutory
provision which could be waived by the failure of a defendant to move by timely motion
to attack the venue. Texas Constr. Co. v. United States for Use of Caldwell Foundry and
Machinery Co., — F.2d — (5th Cir. 1956).

\textsuperscript{54.} Lee E. Morris, Inc. v. United States for the Use and Benefit of Roberts, 219 F.2d
541 (10th Cir. 1955).

\textsuperscript{55.} United States for the Benefit and on Behalf of Lanehart v. United Enterprises, Inc.,
226 F.2d 359 (5th Cir. 1955).

\textsuperscript{56.} United States for the Use of T. M. Page Corp. v. Hensler, 125 F. Supp. 887 (S.D.
Cal. 1954). See also Continental Cas. Co. v. Schaefer, 173 F.2d 5 (9th Cir. 1949).
a quantum meruit basis. Recovery was also allowed following an oral rescission of a contract.

In one case two government contractors engaged a single subcontractor, who in turn purchased materials from the plaintiff. It was held that the plaintiff could apply to either prime contractor an amount paid by the subcontractor, without direction, from his personal funds, and the first prime contractor was not entitled to have this payment apply to discharge its liability in the proportion in which the plaintiff had previously allocated payments between the prime contracts.

If a subcontractor who receives from the contractor a check together with an accompanying letter of transmittal containing a breakdown of the total amount, including a specified sum for work done pursuant to change orders, protests by telephone to the contractor, but nevertheless deposits the check, there is an accord and satisfaction and the subcontractor may not maintain a civil action on the contractor's Miller Act bond. However, the mere retention of the check tendered as payment for all obligations in connection with the contract does not evidence a clear indication that the payment was accepted as satisfaction for extra work not required by the contract.

VI. WAIVER OF BOND RIGHTS

Waivers of rights of subcontractors under statutory public work bonds are not favored by the law, and will not be implied or enforced without a showing of a clear intent to relinquish such rights. However, if it appears that the subcontract was awarded to the subcontractor on the reliance of the materialman's representation that if the general contractor would award the subcontract to this subcontractor and waive a performance bond from him, the materialman would furnish all materials to the subcontractor and save the general contractor harmless from claims for


60. United States for the Use of Glickfeld v. Krendel, 136 F. Supp. 276 (D.N.J. 1955). This case also holds that a claimant may maintain a suit on the bond for extras ordered verbally notwithstanding a state statute, which in effect, provides that a written contract, containing a provision that it cannot be changed orally, may not be lawfully changed by an executory agreement unless such agreement is in writing, and signed by the party against whom enforcement of the change is sought.

material, there appears a contractual relationship between the material-
man and the general contractor whereby the materialman waived his
rights under the Miller Act bond.62

Where a Government contractor did not furnish a payment bond be-
cause the provisions of the Miller Act were waived pursuant to an execu-
tive order issued by the President, as authorized by the First War Pow-
ers Act, a supplier who furnished labor and material to a subcontractor
was not entitled to recover payment from the Government contractor.63

Bonds are again required on construction contracts. It is submitted that
such a waiver is not in the public interest.

VII. ADVANTAGES OF BOND PROTECTION

Much can be written in detail of the advantages of requiring, in com-
petitive bidding, a performance and a labor and materialman's bond. Tersely stated, the advantages may be tabulated as follows:

A. Advantages to owner and architect.
   1. In effect a prequalification service, through the medium of the
      surety industry's nationwide experience, organization, and sound under-
      writing.
   2. The availability to the Government of the surety industry's
      extensive records relating to contractors and the key officials behind the
      corporate contract name.
   3. Organization of joint ventures in order to increase the number
      of responsible bidders.
   4. The refusal to bond certain applicants enables the award of
      the contract to be made to the lowest responsible bidder deemed qualified
      for the contract by a surety willing to assume the risk of loss.

B. The performance bond assures:
   1. Lowest available market price.
   2. Elimination of pressure upon officials who make the award.
   3. Fair and equitable treatment of all bidders, under the demo-
      cratic principles of free enterprise, which inspires public confidence by
      the elimination of fraud and favoritism, and creates the desired large pool
      of qualified contractors in bidding.
   4. The elimination of delay, as examination of the low bidder's
      qualifications has been made by the surety prior to the letting date.
   5. A confirmation and check of the contracting officer with re-

62. United States for the Use and Benefit of Continental Lumber Co. v. Embrey, 130
spect to the qualifications of the low bidder, thus relieving him of criticism in default situations when they occur.


C. *When trouble develops:*

1. The loss preventive activities of the surety often avert defaults in performance, thus expediting completion. Sureties can, and do, render technical assistance, financial aid, and eliminate disputes between contractor and subcontractor.

2. The bond assures against loss through diversion or misapplication of funds by the contractor or his employees; through the use of defective materials and workmanship; through improper installation resulting from inexperience or other failure to adhere to plans and specifications; and through the death or disability of experienced personnel.

3. The shifting of the risk to the surety assures completion of the contract or defrayment of the Government's costs within the bond penalty, thus permitting a definite fixation of the Government's cost at the contract price.

4. The bond also assures compliance with the plans and specifications, thus affording protection against defective workmanship or materials.

D. *Advantages to suppliers of labor and material; the payment bond assures:*

1. Prompt payment to subcontractors and to furnishers of labor and materials.

2. Elimination of loading charge for credit hazard resulting in lower over-all cost.

3. Greater competition among subcontractors and furnishers of materials which brings further reduction in over-all cost.

4. Acceleration of the progress and completion of the contract, because the bond enhances a flow of materials to the extent that materialmen can act more promptly by reason of the reduced credit risk.

5. Preferment of deliveries to bonded contractors by suppliers when labor and materials may be in short supply.

VIII. WHERE THE GOVERNMENT CONTRACTOR DEFAULTS

Where the surety has determined that there is a reasonable basis for the Government terminating the agreement of the contractor the surety has bonded by reason of this contractor's default, the surety usually has
two alternatives, i.e., to undertake completion, or to waive its right to completion.

Among the factors which the surety will consider are the following:

(a) Whether it can use the defaulted contractor's organization or whether it will have to find a new contractor.
(b) The rights, if any, of the bank to whom the contractor may have assigned current estimates.
(c) Whether the subcontractors are responsible and qualified.
(d) The sums which it must immediately pay subcontractors and materialmen to induce them to complete.
(e) Whether there is a risk of a loss greater than the amount of the performance bond.

Where, as sometimes is the case, there is a one-sided provision in the contract of a type which the Court of Claims has rightly condemned, such as have existed in recent cases, the surety cannot be blamed for being unwilling to assume a hazardous uncertain obligation.

The surety's burden has been made serious by decisions to the effect that the United States has the right to withhold from the surety sums payable by the contractor for taxes, and that this right exists whether it be a completing surety or its obligations arose out of payments for labor and material due by the defaulting contractor, or whether these taxes grew out of the bonded job or arose from tax obligations of the contractor having no relationship to the bonded job. The General Accounting Office has ruled that the effect of the decision holding that the Government can set off the contractor's unpaid taxes as against a completing surety, can be avoided if before assuming the completion, the surety enters into an agreement with the Government by the terms of which the Government agrees to pay it, as completing surety, such a portion of the unpaid contract price as equals the surety's completion.

64. Ozark Dam Constructors v. United States, 130 Ct. Cl. 354, 359, 127 F. Supp. 187, 195 (1955). With true insight of the basic problem, Judge Madden wrote:

"A contract for immunity from the harmful consequences of one's own negligence always presents a serious question of public policy. That question seems to us to be particularly serious when, as in this case, if the Government got such an immunity, it bought it by requiring bidders on a public contract to increase their bids to cover the contingency of damages caused to them by the negligence of the Government's agents. Why the Government would want to buy and pay for such an immunity is hard to imagine. If it does, by such a provision in the contract, get the coveted privilege, it will win an occasional battle, but lose the war."


costs. The Comptroller General has held that the surety's agreement to complete the contract, regardless of cost, is an additional obligation sufficient to constitute legal consideration to the Government for the Government's promise to make the payment to the surety, since prior to the agreement the surety was not obligated to complete the contract.67

A few months after this opinion, the Comptroller General held that a surety was not entitled to moneys earned by a contractor prior to a default, including retained percentages, if the surety merely limited its assumption of completion by the bond penalty. The Comptroller General held that there was no consideration running to the Government sufficient to afford a legal basis for awarding this fund to the completing surety.68

The contractor who enters into an agreement with the surety to complete the work of another contractor who defaulted should scrutinize his agreement to ascertain whether it is an agreement to complete a certain portion of the work or is an absolute agreement for the prosecution to completion of the previous construction contract.69 Of course, if the surety declines to complete its obligation it is liable for the cost of work substantially similar to that which the defaulting contractor obligated himself to perform.70

The Assignment of Claims Act as amended,71 was enacted to enable a contractor to obtain money to finance his contract with the United States. The Court of Claims held the equity of the surety to be superior to the rights acquired by the bank under a valid legal assignment.72

A surety who has paid the Government construction contractor's debts to laborers and materialmen has been held entitled to reimbursement out of amounts due on the contract at the time of the contractor's default despite the contractor's assignment of contract payments to a bank.73 The Fifth Circuit has held in favor of the bank where the borrowed moneys were used in relief of the surety's obligation under the contractor's bonds.74

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67. 31 Comp. Gen. 103 (1951).
68. Comptroller General's opinion B-104219, November 7, 1951 to the Travellers' Indemnity Co.
70. United States v. Warsaw Elevator Co., 213 F.2d 517 (2d Cir. 1954).
74. General Cas. Co. v. Second Nat'l Bank, 178 F.2d 679 (5th Cir. 1950); Cocoanut Grove Exchange Bank v. New Amsterdam Cas. Co., 149 F.2d 73 (5th Cir. 1945).
On August 25, 1955, the Comptroller General ruled that any excess of the amount owed by the contractor to the assignee bank could be seized by the Government to satisfy the contractor's tax indebtedness. This opinion seeks to distinguish a recent Court of Claims decision.\(^7\)

An assignment of the proceeds of a contract which contained a no set-off clause, to a bank pursuant to the Assignment of Claims Act of 1940, at a time when the contractor was delinquent in its deliveries under the contract, may not defeat the right of the Government to declare the contractor in default, to purchase the defaulted items from other sources, or to hold the contractor liable for damages, and, therefore, any amounts due under the contract were available as a set-off against the contractor's indebtedness arising out of the default.\(^8\)

**IX. Recovery on Bond of Subcontractor**

A materialman has been held to have a right of action on the bond of his subcontractor, construed to be conditioned for the payment of labor and material claims.\(^7\) New York is in accord.\(^7\) A New Jersey District Court, following state court decisions, has denied a sub-subcontractor the right to sue on a subcontractor's performance bond, holding that the presence of rights under the Miller Act precludes a finding that the parties to the subcontractor's bond at the time of its execution intended to benefit unpaid labor and materialmen.\(^7\)

The surety of a subcontractor is liable on its bond to the general contractor for an unpaid bill for material used in the work under the sub-

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75. 35 Comp. Gen. 104 (1955). However, the office of the Comptroller General in Case No. B-128375, July 9, 1956, decided that the purpose of the loans to the contractor has no bearing on the assignee's rights. The department which had requested a ruling on this point contended that the assignee was required to prove that its advances to the contractor had been used in performing the assigned contract. The Comptroller General ruled that the legislative history of the 1951 amendment to the Assignment of Claims Act supports the conclusion that the validity of an assignment is not dependent upon the purpose for which loans secured by the assignment are made, and that the act negates any inference that the no set-off protection is restricted to advances made for performance of the particular contract containing a "no set-off" clause. In commenting upon the decision reported in 35 Comp. Gen. 1042 (1955), the Comptroller General states in this latest decision that the earlier case did not involve the question whether loans secured by the assignment were made to assist the contractor in performing government contracts.

76. 35 Comp. Gen. 149 (1955).


A contractor may bring in a subcontractor and subcontractor’s surety as proper parties in a suit by an electrical supplier against the prime contractor, the subcontractor and their sureties. Further, he has no obligation to serve notice on a subcontractor’s surety of any default on the part of the subcontractor (in the absence of any provision in the bond expressly requiring such notice), prior to the failure of the subcontractor to supply needed material.

X. Arbitration

Where a federal court has jurisdiction by reason of the diversity of citizenship of the litigants, and there exists in the state in which the federal court is located an arbitration statute substantially similar to the Uniform Arbitration Act, and suit has been instituted on a bond accompanying a contract which calls for arbitration, the litigation will be stayed pending arbitration. The right to arbitration is a right which a federal court must regard as substantive, and must, therefore, apply the law of the state in which it sits. An order denying a motion to compel arbitration is an interlocutory decision and is not appealable. It is not within the purview of the statute to give the Courts of Appeals jurisdiction of appeals from said interlocutory decisions.

XI. Bankruptcy

Where the contractor has been adjudicated a bankrupt, a creditor is not prejudiced in his separate bond action either by refraining from filing a proof of claim in the bankruptcy proceedings, or by filing a proof of

81. Glen Falls Indemnity Co. v. United States ex rel. Westinghouse Co., 229 F.2d 370 (9th Cir. 1955). See also Indemnity Ins. Co. v. Browning-Ferris Machinery Co., 227 F.2d 804 (9th Cir. 1955); United States to Use and for Benefit of Wheeler Corp. v. American Surety Co. of New York, 142 F.2d 726 (2d Cir. 1944).
86. Fidelity & Cas. Co. v. Lackland, 175 Va. 178, 8 S.E.2d 306 (1940), and cases cited therein.
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claim in the bankruptcy proceedings. The creditor with bond rights is not compelled to wait for the termination of the bankruptcy proceedings to ascertain the amount of dividend, if any. He is entitled to recover from the surety immediately the amount due on his claim, and the corporate surety, as this creditor's assignee, looks to the bankruptcy proceedings for salvage. Any other view of the law would, in effect, be in derogation of the established legal principle that suit may be instituted against a surety on a joint and several bond without joining the principal.

Where the surety has deposited the full penal sum of its bond in court, but this is insufficient to pay suppliers of labor and material in full, the surety may not compete with these unpaid materialmen for such portion of the construction fund as is required to effectuate payment in full.

XII. CONCLUSION

In the two decades which have passed since the enactment of the Miller Act, it has become more and more apparent that the separation of the rights and obligations of the owner and contractor from that of third party beneficiaries, by the device of executing two separate and distinct surety bonds, is sound and wise. Every state of the Union, as well as the federal government, now requires contractors on certain public works to furnish a bond for the protection of labor and materialmen. Three states, Kentucky, Maine, and South Carolina, however, lack express surety bond legislation, but as a matter of policy a bond protecting labor and materialmen is required by the State Highway Department in each of these three states. There is nothing ultra vires or contrary to the public policy in this requirement. It is the right, as well as the interest of the public body, to secure good work upon its contracts for public improvements, and there is no better policy toward that end than to satisfy owners, their competent workmen, and subcontractors and materialmen, that they can rely on being paid. The requirement of such a bond attracts a superior grade of subcontractors and materialmen to public work.

Among the states which have followed Pennsylvania and the Federal

87. United States for Use of John Davis Co. v. Illinois Surety Co., 226 Fed. 653 (7th Cir. 1915).
Government by adopting the two-bond system are: Alabama,\textsuperscript{92} California,\textsuperscript{93} Connecticut,\textsuperscript{94} Vermont,\textsuperscript{95} and Wisconsin.\textsuperscript{96} Georgia adopted such a two-bond system effective April 1, 1956 with respect to contracts awarded subsequent to that date.\textsuperscript{97}

The enactment of the two-bond system has resulted in most instances in the prompt payment of legitimate claims for labor and material and is now regarded favorably not only by the suppliers of material and subcontractors, but also by bonding company executives who joined in sponsoring a broad form of coverage and simplified procedure acceptable to the American Institute of Architects as its Form 107, intended for private work. Year after year, interested groups advocate the enactment of the two-bond system in the several states. The greater the uniformity of coverage and simplicity of procedure, the more the legislation is in the public interest.

\textsuperscript{92} Ala. Code § 2931 (9) (Supp. 1936).
\textsuperscript{96} Wis. Stat. c. 289, § 289.16 (1953).
\textsuperscript{97} Amending Ga. Code c. 23-17, § 23-1705 (1933).