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THE RIGHTS AND STATUS OF SURETIES IN BANKRUPTCY CASES OF CONTRACTORS

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CONTROVERSIES arising over the rights of sureties upon the default of contractors, particularly on public work projects, have plagued the courts for many years. There is a tremendous amount of case law on the rights, inter se, of contractors, sureties, federal and state governments, and assignees of contractors. In many instances, the defaulting contractors have trustees in bankruptcy whose rights also become involved in this litigation. Indeed, trustees have been drawn into litigation on occasions where it was ascertained ultimately that nothing was due the bankrupt estates. With the increasing number of governmental contracts, litigation can only increase, and it is rare indeed that the legal and practical complications arising from the default of a contractor may be resolved readily. While this article discusses several decisions adjudicating such problems and, in particular, analyzes the problems as they reach the bankruptcy court, a consideration of the rights of the respective parties in bankruptcy litigation necessarily requires some consideration of their rights as determined in non-bankruptcy cases. It must be borne in mind, of course, that, in considering the respective rights of bankruptcy litigants, state law controls the nature and extent of a taxpayer's property rights and the validity of liens, whereas the Federal Bankruptcy Act governs the distribution of assets of a bankrupt estate.

I. THE OBLIGATION OF THE SURETY

Attendant to almost every substantial construction contract, whether the obligee be a governmental body or a private corporation, is the requirement that the contractor furnish the obligee with a surety bond or bonds. A single project may be covered by both a payment bond for the protection of laborers and materialmen and a performance bond warranting completion within the contract period for the protection of the obligee; the Miller Act requires both for federal government work.

4. Miller Act § 1(a), 49 Stat. 793 (1935), 40 U.S.C. § 270a(a) (1964). In some instances a single document may combine both functions. Prior to this statute, although only one bond

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Prior to the surety's issuance of the bonds, the contractor generally is required to sign an application containing many conditions; this writing becomes part of the agreement between the surety and the contractor. The construction contract, which is the subject of the surety's bond or bonds, is regarded as part of the surety's undertaking. Accordingly, sureties are certain to protect themselves, so far as possible, by indemnity agreements. Upon the contractor's default, the surety itself may complete the contract, or it may employ others to do so, in order to protect itself against the claims of the obligee. In each case the rights of the respective parties depend to a great extent upon the wording of the obligation. For example, where the bond is a payment bond conditioned upon the payment of laborers and materialmen, significant authority indicates that, as against unpaid laborers and materialmen, the surety is not entitled to monetary amounts accrued in current operations and retained by the obligee. In addition, the priority of laborers and materialmen in such a case usually obtains even where the contractor has assigned his rights in the accrued amounts to the surety.

II. THE RIGHT OF SUBROGATION

When a default occurs because the contractor either voluntarily or involuntarily has ceased to perform, the obligee may be holding two characteristically different funds. Most contracts provide for the obligee to withhold a certain amount of the contract price, termed the retained percentage or the retainage, in order to assure completion of the contract. In addition, since most contracts provide for periodic payments to be made during the progress of the construction, it is not unusual for the obligee, at the time of the default, to be holding a certain amount of unexpended moneys currently accrued. When a contractor becomes a

was required, both performance and payment had to be covered. Act of Feb. 24, 1905, ch. 778, 33 Stat. 811.

5. "It is a fundamental rule of construction that where the contract which is the subject of the performance bond is referred to in the latter . . . the contract is to be regarded as a part of the undertaking of the surety under the bond." Home Indem. Co. v. F. H. Donovan Painting Co., 325 F.2d 870, 874 (8th Cir. 1963). See Prairie State Bank v. United States, 164 U.S. 227, 231 (1896); Triangle Elec. Supply Co. v. Mojave Elec. Co., 234 F. Supp. 293, 308 (W.D. Mo. 1964).


bankrupt, the trustee, invested with title to rights of action arising upon contracts, may be expected to make a claim for all amounts then owing to the contractor.

When the contractor defaults, leaving obligations owing and unpaid, or work to be completed and paid for in the future, or both, the surety is faced with existing and future obligations to the obligee and, hence, has what is generally termed a right of subrogation to the retainage and to the money currently owing.

Subrogation has been defined as "the substitution of another person in the place of the creditor, to whose rights he succeeds in relation to the debt." It is difficult, however, to apply the textbook definition so as to protect the surety in those cases in which it is entitled to protection, and this has resulted in the use of such terms as "equitable right through subrogation," "equitable lien," "equitable assignee by subrogation," and "trust or equitable claim." Sustaining the rights of the surety according to the standard definition of subrogation leads to many difficulties. For example, it certainly cannot follow that the surety is merely subrogated to the claims of the contractor, since a defaulting contractor ordinarily has no claim. Nor can it be said that the surety in every case is subrogated to the rights of the laborers and materialmen, for, under the Miller Act, such parties can assert no claim against the

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4. "That a stipulation in a building contract for the retention, until the completion of the work, of a certain portion of the consideration, is as much for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed; that it raises an equity in the surety in the fund to be created ... is amply sustained by authority." Prairie State Bank v. United States, 164 U.S. 227, 233 (1896).
5. See text accompanying notes 30-32 infra.
11. This is particularly true in situations involving tax liens. E.g., Phoenix Indem. Co. v. Earle, 213 F.2d 645 (9th Cir. 1955) (subordinating surety's claim to Government's perfected tax lien).
Moreover, it cannot be said that in every instance the surety must rely upon a claim against the obligee, since the obligee, recognizing its obligation, may have paid the fund to the trustee in bankruptcy or into the registry of the court. Difficulties also arise in cases where the surety is making a claim for the purpose of protecting itself against funds to be paid out in the future. The doctrine of subrogation, applied strictly, entitles the claimant only to reimbursement for funds already expended; therefore, if the surety waits until the funds have actually been disbursed, it may suffer a loss against which it should be protected at the time of the default.

When the contractor becomes the subject of a bankruptcy proceeding, the duty may devolve upon the trustee, either because the funds are within the jurisdiction or control of the bankruptcy court, or because of the remote possibility that the bankrupt estate may have some equity in the funds, to assist the court in adjudicating the rights of the respective parties. The Bankruptcy Act itself does not provide clarification of the various subrogation problems that may be involved in the proceeding. The sole reference in the act is a provision for the subrogation of the claim of a secured creditor under certain conditions, but this only gives

19. State statutes provide similar governmental immunity. E.g., Md. Ann. Code art. 90, § 11 (1957); R.I. Gen. Laws Ann. § 37-12-1 (1956). "If the [Government] ... were obligated to pay laborers and materialmen unpaid by a contractor, the surety who discharged that obligation could claim subrogation. But nothing is more clear than that laborers and materialmen do not have enforceable rights against the [Government] ... for their compensation." United States v. Munsey Trust Co., 332 U.S. 234, 241 (1947).

20. Ordinarily, however, where the surety performs the balance of the contract, its right of subrogation is "a right to resort to the securities and remedies" which the obligee could assert against the contractor if the retainage does not satisfy the contractor's obligation. One such remedy is the right to appropriate the retainage. Prairie State Bank v. United States, 164 U.S. 227, 232 (1896).

21. See, e.g., Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962). Of course, the obligee may have rights of its own to assert against the contractor, such as set off claims, even though the completed work has been accepted by the obligee. E.g., United States v. Munsey Trust Co., 332 U.S. 234 (1947); see note 41 infra.


23. "Whenever a creditor whose claim against a bankrupt estate is secured, in whole or in part, by the individual undertaking of a person, fails to prove and file that claim, that person may do so in the creditor's name, and he shall be subrogated to the rights of the creditor, whether the claim has been filed by the creditor or by him in the creditor's name, to the extent that he discharges the undertaking except that in absence of an agreement to the contrary, he shall not be entitled to any dividend until the amount paid to the creditor on the undertaking plus the dividends paid to the creditor from the bankrupt estate on the claim equal the amount of the entire claim of the creditor. Any excess received by the creditor shall be held by him in trust for such person." Bankruptcy Act § 571, 76 Stat. 570 (1962), 11 U.S.C. § 93(i) (1964). See 3 Collier, Bankruptcy §§ 57.21 (14th ed. 1964).
a right to file a general claim and, for practical purposes, affords no substantial relief.

A. The Prairie State Bank Case

Seventy years ago, the Supreme Court, in *Prairie State Bank v. United States*, was confronted with a dispute between a surety and a bank for the retainage held by the Government as security for the full performance of a building contract. The contractor assigned its rights in the fund to the bank to secure past and future advances. Upon the contractor's default, the surety, pursuant to its obligation on its performance bond, assumed the contractor's obligations and completed the contract. The Court held that the surety had an equitable right of subrogation, based upon the rights which the Government might assert against the retainage for the purpose of completing the contract, to indemnify itself against loss, and that this right was superior to the assignee bank's claim arising out of the attempted transfer of the fund. The Court stated that the contractor had attempted to transfer to the bank a right which he did not possess since a claim against the Government, *i.e.*, the contractor's right to reclaim the retainage upon full performance, is not transferable.

25. No statute then existed requiring a payment bond for the benefit of laborers and materialmen on federal government work. *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 271 Fed. 144, 146 (6th Cir. 1921); see note 4 supra and accompanying text.
26. See note 20 supra.
27. See note 9 supra.
28. "[I]t is manifest that if the transaction ... by which the Prairie Bank acquired its alleged lien on the fund possessed the effect contended for by the bank, it would necessarily operate to alter and impair rights acquired by the surety under the original contract. [The contractor] ... could not transfer to the bank any greater rights in the fund than [he himself] ... possessed. [His] ... rights were subordinate to those of the United States and the sureties." 164 U.S. at 239-40.
29. Id. at 230; see Rev. Stat. § 3477 (1875), as amended, 31 U.S.C. § 203 (1964); *Martin v. National Sur. Co.*, 300 U.S. 585, 594 (1937); *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 271 Fed. 144, 148-49 (6th Cir. 1921). Recognizing that such a claim could not be transferred, the Prairie State Bank had based its claim on an equitable lien theory. The Court ruled not only that the surety, which had no knowledge of the attempted transfer to the bank, was subrogated to the Government's rights in the retainage, but also that the surety's rights arose upon entry into the contract rather than upon assumption of the contractor's obligations; accordingly, the surety's rights were superior to whatever equity the bank may have acquired. 164 U.S. at 230.

Where a surety takes an assignment of the contractor's claim for the fund against the Government, the assignment, though invalid against the Government, would entitle the surety to prevail in a contest with the contractor. *United States v. Munsey Trust Co.*, 332 U.S. 234, 237 n.1 (1947).
B. The Henningsen Case

Not too many years thereafter, the Supreme Court, in *Henningsen v. United States Fid. & Guar. Co.*, applied the same doctrine in a case involving a payment bond. The Court held that, because the surety, by making payment upon the contractor's default, released the contractor from his obligation to pay the workers and materialmen and "to the same extent released the Government from all equitable obligations to see that the laborers and supply men were paid," the surety was subrogated to the right of the contractor to reclaim the fund upon performance of his contract. The Court, as in *Prairie State Bank*, made pointed reference to the fact that the surety company was contractually obligated to make the payments, whereas the claimant-bank was a "mere volunteer" in lending money upon the security of an assignment and, therefore, was not subrogated to the contractor's rights in the retainage. In *Prairie State Bank*, it was the voluntary aspect of the transaction entered into by the bank that would have defeated a claim by the bank to subrogation of the Government's rights in the retainage. The cases have been contrasted on the basis that in *Prairie State Bank* the surety had completed the contract and thereby became entitled to the retainage held as security by the Government; whereas in *Henningsen* the contractor himself had finished the work, and therefore the surety was subrogated to the rights of the laborers and materialmen in the fund rather than to

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30. 208 U.S. 404 (1908).
31. Id. at 410.
32. 164 U.S. at 232.
33. Almost 80 years ago, the Supreme Court stated: "One of the principles lying at the foundation of subrogation in equity, in addition to the [principle] . . . that the person seeking this subrogation must have paid the debt, is that he must have done this under some necessity, to save himself from loss which might arise or accrue to him . . . ." *Aetna Life Ins. Co. v. Middleport*, 124 U.S. 534, 547-48 (1888).
34. 208 U.S. at 410, 411.
35. However, in a later case, the Supreme Court did not discuss voluntariness (it was not in issue), stating: "From *Prairie State Bank v. United States* . . . 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." *United States v. Munsey Trust Co.*, 332 U.S. 234, 240 (1947). (Italics omitted.) (Citations omitted.) See *American Sur. Co. v. Hinds*, 260 F.2d 366, 368 (10th Cir. 1958).
36. *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 271 Fed. 144, 148-49 (6th Cir. 1921). In discussing the Henningsen case, the Belknap court stated: "We are constrained to think that the decision necessarily rests upon the existence of this right, as one entitling these [laborers and materialmen] . . . to priority in payment out of the fund, and therefore as entitling the surety, as their equitable assignee by subrogation, to the same priority." Id. at 149.
the Government's right of security. It is doubtful, however, that courts today would accord significant weight to this difference.

C. The Munsey Trust Co. Case

In 1947, the Supreme Court, in *United States v. Munsey Trust Co.*, held that the Government, despite the asserted rights of a surety under its payment bond, could set off a claim bearing no relation to the contract in issue against the contractor's claim for the retainage held by the Government.

Pursuant to statute, the surety had given both a payment and a performance bond. The contractor completed performance of his contract but defaulted in payments to the laborers and materialmen. The surety, in compliance with its obligation on the payment bond, paid the balance owing to the workers and materialmen and, therefore, sought to apply the retainage against the amount it had disbursed; the Government intended to apply the fund against damages suffered from a subsequent default of the contractor on an independent transaction. The Court reasoned that the surety could not be subrogated to the rights of the laborers and materialmen on the basis of the payment bond since, when the laborers and materialmen were as yet unpaid, they had no enforceable rights against the Government, and the fact that, subsequently, they were paid by the surety certainly did not provide them with rights not previously in existence. In addition, the Court stated that the only motive in retaining the fund was to assure completion of the contract on time, and, since it had been so performed, the surety had no right

37. Once the contractor had completed his performance, the element of security no longer existed; accordingly, if there is no right to be transferred, there can be no right transferred by subrogation. Id. at 148-49; see note 29 supra and accompanying text.

38. "The fact that the contractor may ... fail to complete the contract is entirely beside the point and does not alter, change, add to or modify the law of suretyship." United Pac. Ins. Co. v. First Nat'l Bank, 222 F. Supp. 243, 249 (D. Ore. 1963).


41. The contractor has the right to reclaim the retainage upon full performance of his obligations, but, here, the independent claim would simply be set off against the contractor's claim. United States v. Munsey Trust Co., 332 U.S. 234, 239, 241 n.4 (1947).

42. The purpose of such a bond contravenes the surety's contention. "[T]he statutory provisions requiring a separate bond for payment of laborers and materialmen were enacted for their benefit, not to the detriment of the government. It is the surety who is required to take risk. We have no warrant to increase risks of the government." Id. at 243-44. See American Sur. Co. v. Hinds, 260 F.2d 366, 368 (10th Cir. 1958).

43. See note 19 supra.

44. 332 U.S. at 241-42.

45. Id. at 243. At one point, the Court had acceded to the surety's assumption that the retainage was as much to assure the Government that the contractor would perform his
which could be based on its performance bond to the Government's rights in the retainage.\footnote{46}

In reasoning that the Government was a secured creditor with the right to retain the fund for its set off claim\footnote{47} so that the surety never became entitled to the retainage,\footnote{48} the Court used language which was broader than the facts or finding required, thus fostering considerable confusion.\footnote{49} Doubt centered on whether the surety would be relegated to its subordinate position if the Government were "a mere stakeholder and had no rights of its own to assert."\footnote{50} Some courts sought to limit the \textit{Munsey} holding to the narrow extent of its facts,\footnote{51} whereas the decision has also been applied in situations where the Government was not a claimant.\footnote{52}

\section*{III. Priority Between Surety and Trustee}

In 1962, the Supreme Court, in \textit{Pearlman v. Reliance Ins. Co.},\footnote{53} attempted to resolve the confusion.\footnote{54} The surety and a trustee in bankruptcy of the defaulting contractor vied for a fund which the Government had turned over to the trustee. Since performance was completed by a second contractor, the surety's claim was based on the payment bond under which it had paid the original contractor's debts to the laborers and materialmen. The majority seemed to subrogate the surety's rights contract by paying the laborers and materialmen as by completing the work within the contractual period. Id. at 241. However, this assumption was permitted solely for purposes of the contention, which the Court negated, that the surety was subrogated to the rights of the laborers and materialmen. Id. at 243. \footnote{46}

46. Here the Court discarded the assumption that the retainage was to assure performance of all the contractor's obligations, see note 45 supra, and reasoned that, since performance was completed on time, no rights in the fund accrued to the surety on the basis of its payment bond. See 332 U.S. at 243. In 1958, the Tenth Circuit Court of Appeals also subordinated a claim by a surety under its payment bond, but the court did not consider whether the surety's position would be the same if it were claiming under its performance bond. American Sur. Co. v. Hinds, 260 F.2d 366, 368 n.5 (10th Cir. 1958).

47. 332 U.S. at 240.

48. "[W]e are not prepared to apply law relating to security to unappropriated sums which exist only as a claim." Id. at 243.


50. 332 U.S. at 240.


54. Differing results among some circuit courts of appeals prompted the Court to hear this appeal. Id. at 135.
to the Government's right to use the retained fund\textsuperscript{55} to pay laborers and materialmen,\textsuperscript{56} although it appeared that the Government's obligation was moral rather than legal.\textsuperscript{57} The Court recognized the difference between a surety incurring loss by paying the contractor's debts rather than by completing performance of the contract,\textsuperscript{58} but stated that the same rules should apply to both situations.\textsuperscript{59} In reaffirming the principles of \textit{Prairie State Bank} and \textit{Henningsen},\textsuperscript{60} the Court limited its holding in

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55. The Court stated that it was “an already established doctrine that a surety who completes a contract has an ‘equitable right’ to indemnification out of a retained fund such as the one claimed by the surety in the present case.” Id. at 138. However, the Court did not seem to regard as significant the fact that the Government no longer had possession of the fund, although the concurring opinion did mention this factor. Id. at 143.

Although Bankruptcy Act § 64, 52 Stat. 574 (1938), as amended, 11 U.S.C. § 104 (1964), does not prescribe priority to a surety’s claim, the Court agreed with the contention of the surety that, prior to adjudication, it had a property interest in the fund so that title did not vest in the trustee. “Ownership of property rights before bankruptcy is one thing; priority of distribution in bankruptcy of property that has passed unencumbered into a bankrupt’s estate is quite another. Property interests in a fund not owned by a bankrupt at the time of adjudication, whether complete or partial, legal or equitable, mortgages, liens, or simple priority of rights, are of course not a part of the bankrupt’s property and do not vest in the trustee.” 371 U.S. at 135. See United States v. Durham Lumber Co., 363 U.S. 522 (1960); Security Mortgage Co. v. Powers, 278 U.S. 149 (1923).

56. “We . . . hold . . . that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.” 371 U.S. at 141. (Footnote omitted.) However, the concurring opinion stressed the fact that the Government was not legally obligated to pay the laborers and materialmen and treated the majority opinion as subrogating the surety to the rights of such laborers and materialmen. Id. at 142; see note 63 infra. In fact, subrogating the surety to the Government’s rights appears inconsistent with the Court’s reiteration of the doctrine 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.” 371 U.S. at 137. (Footnote omitted.)

57. See text accompanying notes 17-19 supra.

58. 371 U.S. at 138.

59. “The same equitable rules as to subrogation and property interests in a retained fund . . . exist whether a surety completes a contract or whether, though not called upon to complete the contract, it pays the laborers and materialmen.” Id. at 139. See Henningsen v. United States Fid. & Guar. Co., 208 U.S. 404 (1908); Prairie State Bank v. United States, 164 U.S. 227 (1896); Martin v. National Sur. Co., 85 F.2d 135 (6th Cir. 1936), aff’d, 300 U.S. 588 (1937).

60. 371 U.S. at 139-41. The Court stated: “[T]he equitable rights of a surety declared in the Prairie Bank case as to sureties who complete the performance of a contract were expressly recognized and approved in Munsey, and the Henningsen rule as to sureties who had not completed the contract but had paid laborers was not mentioned. Henningsen was not even cited in the Munsey opinion. We hold that Munsey left the rule in Prairie Bank and Henningsen undisturbed. We cannot say that such a firmly established rule was so
Munsey Trust Co.: “We held that the Government could exercise the well-established common-law right of debtors to offset claims of their own against their creditors. This was all we held.”

Three concurring Justices, after stating that Prairie State Bank and Henningsen might not apply where the Government has relinquished the fund to the court, asserted that the instant decision should have been grounded on the theory of an equitable lien based upon the assignment of moneys contained in the indemnity agreement. However, sustaining the surety on the basis of an assignment is not always readily amenable to support.

The concurring Justices, without mentioning the word “trust,” seemed to conclude that the fund, even in the hands of the trustee, was subject to a trust arising out of the moral obligation of the Government to see that the laborers and materialmen were paid. Following such reasoning, the Justices agreed with the majority that the surety was entitled to the entire fund because the debts owing to the laborers and materialmen constituted an amount greater than the existing retainage.

One writer believes that the Pearlman case has settled problems between Government and surety, with the caveat that leading cases today seem to spring from Miller Act or Capehart bonds. But this is wishful thinking.

casually overruled.” Id. at 140-41. (Italics omitted.) (Footnotes omitted.) The concurring opinion stated that consideration of the Prairie State Bank and Henningsen cases was not even necessary to a determination of the Munsey case. Id. at 143.

Mr. Justice Clark wrote the opinion, with Justices Douglas and Brennan joining in the concurrence.

Id. at 143 (concurring opinion). As previously stated, the concurring Justices treated the majority’s opinion as subrogating the surety to the rights of the laborers and materialmen, see note 56 supra, and pointed out that neither in Prairie State Bank nor in Henningsen did the Court find that these persons had any rights against the Government. 371 U.S. at 143; see note 66 infra.

See 371 U.S. at 143 & n., 144 (concurring opinion). The concurring Justices agreed with Mr. Justice Cardozo in Martin v. National Sur. Co., 300 U.S. 588 (1937), that Prairie State Bank and Henningsen should not be enlarged and that the “narrower” ground of assignment was the better course. 371 U.S. at 144.

See text accompanying notes 88-90 & 96-98 infra.

See 371 U.S. at 143-44 (concurring opinion). Mr. Justice Clark, relying on Munsey Trust Co., explicitly rejected any contention that the Government was legally obligated to the laborers and materialmen and stated that, “since the laborers and materialmen have no right against the funds, it follows as clear as rain that the surety could have none.” Id. at 142 (concurring opinion).

See id. at 141-42; id. at 144 (concurring opinion).


A 1963 Court of Claims case, involving payment and performance bonds given under the Miller Act, followed the Pearlman decision. Upon the contractor's default, the surety completed the work, and the trustee in bankruptcy of the contractor intervened in the dispute between the surety and the Government and claimed the balance held by the Government. The trustee maintained that the surety had no claim under the payment bond, on the theory that a prerequisite to the right of subrogation is that all payments have been made, and, here, at least one claim had not been settled. However, the amount of the withheld balance was considerably less than the sums already expended by the surety. The surety prevailed on the ground that its equities were greater than the trustee's even though the surety had not completely fulfilled its obligations to the laborers and materialmen. There are holdings, however, to the effect that the surety's right to subrogation depends upon the total completion of payments required under the bond, but that obligations arising after the date of the bond impose no bar to subrogation.

Although laborers and materialmen merely have the status of general creditors and are not in a position to assert priority claims in the bankruptcy court, the surety is not thereby deprived of its right of subrogation and of priority over the trustee. This was decided on the theory that the Government is unwilling to have laborers and materialmen go unpaid, and that the Government, by retaining the fund, can insure such payment. It may be assumed that, where the Government relinquishes

71. The trustee contended first that the surety induced the contractor, through a "business arrangement," to default and that this wrong defeated the default. The court found this allegation to be contrary to the facts and stated that, even if it were true, the contention was "of no legal significance." Ibid.
72. An alleged materialman had filed suit on the bond in the district court. The court of appeals recognized that this claimant, if successful, could collect on his judgment only from the surety. Since the surety's motion for summary judgment was granted, the court obviously did not deem significant the fact of whether or not an unpaid materialman did, in fact, exist; therefore, the surety had a right of subrogation for the amounts already paid to the laborers and materialmen, to the extent that the retainage would satisfy such disbursements. See id. at 365-66, 319 F.2d at 595-96.
74. In the Matter of Buildice Co., supra note 73.
75. Materialmen have no right to assert a claim based upon subrogation in the bankruptcy court, since their claim is on the bond. In re Flotation Sys., Inc., 65 F. Supp. 698, 701-02 (S.D. Cal. 1946).
76. Continental Cas. Co. v. United States, 145 Ct. Cl. 99, 103, 169 F. Supp. 945, 947 (1959). The Government, in exacting the contractor's promise to pay the laborers and materialmen and in requiring a payment bond, "acquired a right against the contractor that they should be paid." Ibid. The court suggested that the bondsman's insolvency would allow
the fund to the trustee, the same result will be reached.\textsuperscript{77} There is no valid reason for treating amounts already paid by a surety on a different basis than amounts which the surety is obligated to pay; this is particularly true where it appears that the amounts available will be insufficient for complete reimbursement. In fact, in \textit{Pearlman}, the Court seemed to assume that the Government still retained the fund, although, in fact, it had already been turned over to the trustee.\textsuperscript{78}

In light of the foregoing problems, perhaps a new definition of the term "subrogation" is needed. It may be, as suggested by one writer, that definitive legislation in this field, such as we have in bankruptcy law, is required;\textsuperscript{79} but the difficulty is that, after almost every amendment to the Bankruptcy Act, we have been plagued with new problems and perplexing decisions.

Subject to certain limitations, the right of subrogation should extend to amounts currently withheld, as well as to retainages, to the extent necessary to reimburse the surety,\textsuperscript{80} although some cases have emphasized that the right to the retainage originates from the date of the contract,\textsuperscript{81} when the claim to current funds later withheld is not in existence.\textsuperscript{82} Of course, in the rare event that an amount in excess of the surety's claim

the Government to pay the laborers and materialmen out of the withheld moneys, id. at 103, 169 F. Supp. at 947 (dictum); therefore, the surety, by paying the laborers and materialmen, satisfied the contractor's obligations to these persons as general creditors and to the Government as a preferred creditor "because of its possession of funds which could be used as an offset against the contractor," and it was satisfaction of this latter obligation that entitled the surety to be subrogated to the funds held as security by the Government. Id. at 103, 169 F. Supp. at 947.

78. See note 55 supra.
80. Lacy v. Maryland Cas. Co., 32 F.2d 48 (4th Cir. 1929). The court reasoned that the surety's equity arises because of his obligation to perform upon the contractor's default, and that, upon performing, the surety is subrogated by equity to the obligee's rights against the contractor. Since the obligee is entitled to apply the amounts withheld towards completion of the contract, "it necessarily follows that the surety . . . is entitled to the moneys unpaid so far as necessary to reimburse his loss." Id. at 51. The court supported its reasoning by relying on the principles of the surety's subrogation to the "securities and remedies" of the obligee in Prairie State Bank, see note 20 supra, despite recognition of the fact that only a retained percentage was there involved. 32 F.2d at 51. The court also noted that, in granting recovery to the surety in the Henningsen case, the Supreme Court made no distinction between retainage and current amounts withheld. Id. at 52.
81. Gray v. Travelers Indem. Co., 280 F.2d 549, 552 (9th Cir. 1960); United States Fid. & Guar. Co. v. United States, 201 F.2d 118, 121 (10th Cir. 1952); see note 29 supra.
should develop in the retainage and current account funds, that surplus belongs to the trustee of the bankrupt contractor, and on that ground the bankruptcy court may retain control of the funds.\(^{53}\)

**Restriction on Subrogation**

There is a definite restriction on the surety’s right of subrogation. Not only does the doctrine offer no protection to the surety against the claims of those whom its bond was written to protect, but also the surety’s rights under the doctrine cannot share on a parity with such claims.\(^{54}\) The courts feel that success of such a claim in bankruptcy would effectuate the result “that the statutory security be whittled down” in contravention of the bond’s purpose.\(^{55}\) However, this does not deprive the surety of its rights to priority as an assignee of wage priority claimants,\(^{56}\) with the reservation that amounts paid by the surety after default and abandonment by the contractor, not being obligations of the bankrupt, cannot be allowed as priority wage claims.\(^{57}\)

**IV. Surety’s Rights Under Assignments**

**A. Against the Trustee**

In the contract between the contractor and the surety, it is indeed rare that there are no clauses assigning to the surety the contractor’s rights to moneys due under the contract and to the equipment that the surety will require to complete the contract upon the contractor’s default. In addition, the contractor usually agrees that, upon default, the surety may use the contractor’s premises if necessary to the completion of the contract. These clauses raise various problems when bankruptcy intervenes.

The position of sureties who rely upon assignments is ordinarily far weaker than the position of those who rely upon their right of sub-

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84. American Sur. Co. v. Sampsell, 327 U.S. 269, 272-73 (1946); Home Indem. Co. v. F. H. Donovan Painting Co., 325 F.2d 870, 874-75 (8th Cir. 1963); In re Flotation Sys., Inc., 65 F. Supp. 698, 702 (S.D. Cal. 1946); see cases cited notes 6 & 7 supra and accompanying text. The Supreme Court, in Sampsell, relying upon American Sur. Co. v. Westinghouse Elec. Mfg. Co., 296 U.S. 133 (1935), reasoned that the surety, by paying some of the obligations, should not be allowed to claim subrogation or indemnification for such payments, because the bond was intended to protect all the laborers and materialmen since they would have been paid if the contractor had not defaulted; therefore, until all are paid in full, the surety’s claim will be postponed. 327 U.S. at 273, 274.


rogation. Therefore, in situations where intervening assignments to banks or others have been properly perfected under state law prior to perfection by the sureties, the rights of the sureties are subject to the rights of such intervening creditors. In Uniform Commercial Code states, bankruptcy courts will be required, most assuredly, to determine the respective priorities of secured creditors to a greater extent than they have in the past.

As might be expected, occasions have arisen where assignments provided for in the original agreements between contractors and sureties, and perfected according to state recordation statutes, have not resulted in payments to the sureties until sometime within the four month period preceding bankruptcy; and, accordingly, bankruptcy trustees have claimed that such payments constitute recoverable preferences. This theory is untenable.

A chattel mortgage or other security given to a surety company within four months prior to bankruptcy to strengthen its position as against an insolvent contractor is voidable where all the elements of a recoverable preference are present, even though the surety was otherwise protected by a general assignment of assets in the bond application. Although Section 60a(6) of the Bankruptcy Act, which covers the subject of preferences, states: "The recognition of equitable liens where available means of perfecting legal liens have not been employed is hereby declared to be contrary to the policy of this section," it is clear that this provision does not make voidable the rights of a surety under the doctrine of subrogation. Under the holdings that equitable liens arise at the time of the contract, there is, under the theory of subrogation, no recoverable preference as to payments obtained by the surety within the four month

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88. In re L. H. Duncan & Sons, 127 F.2d 640 (3d Cir. 1942) (by implication). Where the surety pays claims of laborers that are priority claims under Bankruptcy Act § 64a(2), 70 Stat. 725 (1956), 11 U.S.C. § 104(a)(2) (1964), and takes an assignment of those claims, there is no problem. Shropshire, Woodliff & Co. v. Bush, 204 U.S. 186 (1907); see text accompanying notes 86 & 87 supra. However, when a surety is claiming superior rights both through subrogation and under an assignment, if he is not entitled to recovery on the subrogation theory, he will have to establish that the alleged assignment has been perfected according to applicable state law. See Danais v. M. De Matteo Constr. Co., 102 F. Supp. 874, 877 (D.N.H. 1952) (dictum).


93. Case cited note 82 supra; see note 29 supra.
And where a contractor, within the four month period, executes contracts in an attempt to complete a pending project, the surety on the bond does not obtain a recoverable preference by acquiring, at the time, a security interest.  

Some trustees have asserted rights superior to the rights of ordinary assignees of the bankrupt contractor, basing their claims on Section 70c of the Bankruptcy Act, the so-called "strong arm clause." Only if the surety's rights have been perfected in accordance with state law, both as to property covered by the assignment and as to after-acquired property, will the surety prevail over the trustee. It is clear that, when a surety is compelled to rely upon an assignment, whether it be of money or property, compliance with state law governing the perfection of assignments must be shown.

Sureties seek to protect themselves in their contracts by clauses which authorize them to apply surplus funds acquired on completion of one project to their losses on another project. Such an attempt must rest strictly upon orthodox contract law; it cannot be bottomed upon subrogation. Nor in this instance will the assignment theory prevail against a trustee in bankruptcy, for it is rare that the surety's rights under assignment have been protected to this extent. Ordinarily, a payment so applied by a surety within four months prior to bankruptcy will constitute a recoverable preference.

A further contractual device by which sureties seek to protect themselves in the event of the contractor's default is a clause providing the


95. Ibid.

96. "The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitation, statutes of fraud, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee, as to all property, whether or not coming into possession or control of the court, 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." Bankruptcy Act § 70c, 66 Stat. 430 (1952), 11 U.S.C. § 110(c) (1964).


surety with the right to use the plant, plant equipment, machinery, and tools of the contractor. Without considering the surety's position where bankruptcy does not intervene, it does not seem that the right thus outlined can be enforced in bankruptcy proceedings. The terminology of such a clause is too general to constitute an agreement to lease, and, even if this were not so, the trustee, endowed with the power to reject executory contracts, can so reject.

In some cases, the Federal Assignment of Claims Act occupies a controlling position. A 1910 case held that an assignment of a claim in violation of that act was null and void, and that the contractor, therefore, still owned the claim at the time of his bankruptcy, with title to such claim passing to the trustee. Yet, later cases tended to hold that the act was intended to benefit the Government only, rather than to regulate the equities of other parties between themselves. This necessarily assumes, of course, that the assignment has been perfected under state law. Without question, the Government can successfully raise the point if its rights are involved.

B. Against the Government

It is not surprising that the bankruptcy court is frequently called upon to determine the priority claim of a surety vis-à-vis the United States. The Munsey case dealt with the Government's claim to set off, and on that point the decision was not affected by the Pearlman case. Trouble-some questions arise where the surety bases its claim upon an assignment of current funds due; the Supreme Court, in a five-to-four per curiam decision, has held that such an assignment cannot be construed as a mortgage within the meaning of the Internal Revenue Code, that the surety's rights rest upon an inchoate lien and are, therefore, inferior to a federal tax lien dating subsequent to the assignment. The result

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may be different where the assignment relates to the retainage, particularly where the amount is so determined that it cannot be construed as inchoate.

V. The Trustee’s Injunctive Remedy

Consideration of the respective rights of the trustee of the bankrupt contractor’s estate and of the surety involved in the bankrupt’s projects would be incomplete without reference to the trustee’s right, if any, to enjoin the surety from the pursuit of his rights in tribunals other than the bankruptcy court.

After adjudication, the bankruptcy court is invested with exclusive jurisdiction, dating from the filing of the petition, over all of the property of which the bankrupt at the time of bankruptcy had possession, actual or constructive; and such exclusive jurisdiction gives to the court the right and the duty to determine the persons entitled to that property. Such determination may be made in a summary proceeding. This rule cannot be applied to funds, such as funds in trust, to which the bankrupt had no right of possession. Since the bankruptcy court has such jurisdiction, unless it is voluntarily relinquished, the judge has the power to enjoin the surety’s prosecution of actions to recover funds in the class of cases that have been under discussion; and whether the actions were instituted before or after the commencement of the bankruptcy proceeding is not material. Some courts, upon the entry of an order of adjudication, have ordered the funds under their immediate control to be transmitted to the trustee. It is not difficult to foresee that in similar cases some courts may refuse to do this, thus resulting in unfortunate conflicts. However, it is also true that, when a valid lien has been acquired more than four months prior to bankruptcy, the trustee will be foreclosed from attacking it.

VI. Conclusion

In spite of the mass of accumulated case law applicable to the respective rights of trustees in bankruptcy, sureties, federal and state governments, and other parties in interest, it appears that many existing

107. In re Weston, 68 F.2d 913 (2d Cir. 1934); American Sur. Co. v. Owens, 66 F.2d 190 (D.C. Cir. 1933).
problems want of solution. Perhaps a theory supporting the concept of subrogation will soon be evolved upon which all can agree. Assuredly, new causes of litigation will be arising constantly. The impact of the Uniform Commercial Code is certain to be substantial and, while its statutory provisions are generally uniform, diversity of decisions is not a difficult prediction. The future will be awaited by the surety companies with some measure of trepidation, and by referees and trustees in bankruptcy with a considerable measure of perplexity.