

## GOVERNMENT CONTRACTS: THE FEDERAL TAX LIEN ACT OF 1966 AND THE SURETY'S PRIORITY TO RETAINAGES

THE Federal Tax Lien Act of 1966<sup>1</sup> amended the Miller Act<sup>2</sup> to require that obligatory performance bonds on government construction contracts include coverage for contractor default in withholding tax payments. Treasury Department figures, urged in support of enactment, indicated that the construction industry, which accounts for only a small portion of withholding tax revenue, was responsible for twenty-six percent of the defaults in payment of tax actually withheld.<sup>3</sup> According to government testimony before the House Ways and Means Committee, collection of these taxes had been greatly frustrated by judicial holdings that taxes are not wages or materials, and thus not covered by Miller Act bonds.<sup>4</sup> The Government alleged that these decisions had stimulated "net payroll financing," whereby the surety pays only "after tax" wages, through the insolvent contractor, to the unpaid workmen, which further reduces tax revenues.<sup>5</sup> Collection could not be made from the laborers, as they had already "paid"; nor from the surety, as the taxes were not covered by the bond; and the contractor remained insolvent. Though the surety industry protested that the practice was not common,<sup>6</sup> Congress responded to the Government's requests and, essentially, shifted the collection problem to the surety.<sup>7</sup> Surprisingly, the surety industry did not strenuously object,<sup>8</sup> but did insist upon a reasonable notice requirement and a limit to the time within which suit could be instituted on the bond.<sup>9</sup> These sug-

<sup>1</sup> Federal Tax Lien Act of 1966, § 105 (b), 40 U.S.C. § 270a (d) (Supp. II, 1965-66).

<sup>2</sup> 40 U.S.C. §§ 270a-d (1964).

<sup>3</sup> *Hearings on H.R. 11256 and H.R. 11290 Before the House Comm. on Ways and Means*, 89th Cong., 2d Sess. 40, 42-44 (1966) [hereinafter cited as *Hearings*].

<sup>4</sup> *Id.* at 39; see, e.g., *Nickell v. United States ex rel. Texas Vitrified Pipe Co.*, 340 F.2d 117 (10th Cir. 1965); *United States v. Maryland Cas. Co.*, 323 F.2d 473 (5th Cir. 1963); *United States Fidelity & Guar. Co. v. United States*, 201 F.2d 118 (10th Cir. 1952).

<sup>5</sup> *Hearings* 39. See also Gallagher, *The Good and the Bad for Surety Companies Under the Federal Tax Lien Act of 1966*, 34 INS. COUNSEL J. 214, 218 (1967).

<sup>6</sup> *Hearings* 226.

<sup>7</sup> See Gallagher, *supra* note 5.

<sup>8</sup> *Hearings* 221.

<sup>9</sup> *Id.* at 221-23.

gestions were incorporated into the statute, which provides that no suit may be brought on the bond unless notice of taxes remaining unpaid is given the surety within ninety days after the contractor files a return, or within one hundred and eighty days from the required filing date if a timely return has not been filed. In all cases, suit on the bond must be commenced within one year from the date of filing the required notice.<sup>10</sup>

Controversy between the United States and a Miller Act surety has often involved the question of whether a surety has a right to retainages, withheld by the United States under the terms of a construction contract, free from setoff of government claims against the contractor. In *Prairie State Bank v. United States*<sup>11</sup> and *Henningsen v. United States Fidelity & Guaranty Company*,<sup>12</sup> the Supreme Court established that a surety to a federal contract who is called upon to pay on his bond has an equitable right to indemnification out of the retainages, by subrogation to the Government's position. The Court observed in *Prairie State*, a performance bond case, that payment made to the Government under compulsion of the contract of suretyship subrogates the surety to all the rights and remedies which the Government is capable of asserting against its debtor-contractor, including indemnification out of retainages.<sup>13</sup> Without detailing its analysis, the Court, in *Henningsen*, applied *equitable* subrogation to reach the same result in a payment bond case. Later cases applying *Henningsen* have interpreted the Court's rationale to be that, since there is no legal relationship between the United States and the laborers and materialmen, the payment bond surety becomes subrogated to the laborers' and materialmen's equitable right to be compensated, and the corresponding equitable obligation of the Government to ensure payment.<sup>14</sup> The statutory requirement of a payment bond on government contracts has been viewed as congressional recognition of these equitable rights and duties.<sup>15</sup> Both *Prairie State* and *Henningsen* involved the United States as stakeholder in a controversy between the

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<sup>10</sup> Federal Tax Lien Act of 1966, §105 (b), 40 U.S.C. § 270a (d) (Supp. II, 1965-66).

<sup>11</sup> 164 U.S. 227 (1896).

<sup>12</sup> 208 U.S. 404 (1908).

<sup>13</sup> 164 U.S. at 231-33.

<sup>14</sup> See, e.g., *National Sur. Corp. v. United States*, 133 F. Supp. 381, 383-84 (Ct. Cl.), *cert. denied*, 350 U.S. 902 (1955).

<sup>15</sup> Cf. *Western Cas. & Sur. Co. v. Brooks*, 362 F.2d 486, 491 n.23 (4th Cir. 1966).

surety and other claimants to the retainages. The surety's subrogative rights, arising with the contract of suretyship, were said to take precedence over later claims of general creditors and assignees of the contractor.<sup>16</sup> A subsequent case, *United States v. Munsey Trust Company*,<sup>17</sup> pitted the Government against a surety asserting the priority of his claim. The Supreme Court, ignoring its earlier reliance on equitable subrogation, held that there was no legal relationship between the laborers and the United States to which the surety could become subrogated. The surety, as subrogated to the position of the contractor, was, in the Court's view, a creditor against whom the United States could offset claims of its own, an exercise of the well established right of a debtor to offset his own claim against that of his creditor.<sup>18</sup> Some fifteen years later, in *Pearlman v. Reliance Insurance Company*,<sup>19</sup> the Court held that *Munsey* had not disturbed *Prairie State* and *Henningsen*, and that the surety does have an equitable right to indemnification out of the retainages.<sup>20</sup> However, the Court did not indicate whether the surety's right was superior to the right of the United States to offset its claims.

Some courts have allowed, and others denied, tax debt setoffs against retainages without consideration of the subrogation question.<sup>21</sup> The Court of Claims, though concluding that the surety has an equity superior to claimants other than the Government,<sup>22</sup> has, since 1951, unwaveringly held that the United States may offset taxes owed by the contractor against the retainages, reasoning that since *Munsey*, the Supreme Court has not placed the equitable rights of the surety in a superior position to the right of the United States

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<sup>16</sup> See *National Sur. Corp. v. United States*, 133 F. Supp. 381, 384 (Ct. Cl.), cert. denied, 350 U.S. 902 (1955).

<sup>17</sup> 332 U.S. 234 (1947).

<sup>18</sup> *Id.* at 241-44.

<sup>19</sup> 371 U.S. 132 (1962).

<sup>20</sup> *Id.* at 140-41.

<sup>21</sup> See, e.g., *United States v. Maryland Cas. Co.*, 323 F.2d 473, 475 (5th Cir. 1963); *United States v. Phoenix Indem. Co.*, 231 F.2d 573, 574-75 (4th Cir. 1956); *United States v. Zschach Constr. Co.*, 209 F.2d 347 (10th Cir. 1954); *United States Fidelity & Guar. Co. v. United States*, 201 F.2d 118, 121 (10th Cir. 1952); *United States v. American Employer's Ins. Co.*, 192 F. Supp. 873, 878 (D.N.D. 1961). But see *United States v. Seaboard Sur. Co.*, 201 F. Supp. 630, 634-36 (N.D. Tex. 1961); *United States ex rel. Gregg v. Seaboard Eng'r Co.*, 125 F. Supp. 918, 919 (E.D. Va. 1954).

<sup>22</sup> *Royal Indem. Co. v. United States*, 371 F.2d 462, 464 (Ct. Cl.), cert. denied, 389 U.S. 833 (1967); *National Sur. Corp. v. United States*, 133 F. Supp. 381, 383-84 (Ct. Cl.), cert. denied, 350 U.S. 902 (1955).

to offset contractor-owed debts against retained funds.<sup>23</sup> A few courts have found, in the manner of *Prairie State* and *Henningsen*, that the surety becomes subrogated to the rights of the Government upon discharge of the contractor's obligations under the construction contract. They reason further that the surety's rights relate back to the bonded contract, arise prior to the tax lien, and thus are superior to it.<sup>24</sup> A recent case, *Trinity Universal Insurance Company v. United States*,<sup>25</sup> adopts still another rationale.

Trinity Universal Insurance executed the bonds required under the Miller Act for Dallas Building, Inc., which had been awarded a million dollar contract for construction of a nuclear warfare laboratory. When the contract was substantially completed and most of the progress payments had been made, Dallas Building defaulted. At that time, \$39,906.96 in retainages and \$67,276.16 in funds appropriated for the completion of the contract remained unpaid. Trinity Universal elected to complete the contract, expending \$116,623.37 in so doing. The remaining appropriated funds were paid to Trinity Universal. Against the retainages, however, the Government asserted a \$6495.07 setoff for payroll taxes owed by Dallas Building, and that amount was deducted from the retainages paid to Trinity. In a suit brought to recover these funds, the district court denied recovery, concluding on the basis of *Munsey* that the Government had the right to setoff its tax claims against contract retainages.<sup>26</sup> The Court of Appeals for the Fifth Circuit reversed, unconvinced that the Government should have a right to retainages superior to the rights of the surety. While *Munsey* established that the Government could offset its tax claims against retainages where the Government has been forced to recontract, at additional expense, for completion of the project, the Fifth Circuit also found in *Munsey* a recognition that a surety completing construction might be entitled to retainages, as well as to progress payments. *Pearlman*

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<sup>23</sup> See *Royal Indem. Co. v. United States*, 371 F.2d 462 (Ct. Cl.), cert. denied, 389 U.S. 833 (1967) (surety paid damages due under bond); *Barrett v. United States*, 367 F.2d 834, 838 (Ct. Cl. 1966) (surety paid laborers and materialmen on completed contract); *Standard Accident Ins. Co. v. United States*, 97 F. Supp. 829 (Ct. Cl. 1951) (surety completed contract).

<sup>24</sup> See, e.g., *United States Fidelity & Guar. Co. v. United States*, 201 F.2d 118, 121 (10th Cir. 1952); *Glenn v. American Sur. Co.*, 160 F.2d 977, 982 (6th Cir. 1947); *New York Cas. Co. v. Zwerner*, 58 F. Supp. 473, 476 (N.D. Ill. 1944).

<sup>25</sup> 382 F.2d 317 (5th Cir. 1967).

<sup>26</sup> *Id.* at 319.

lent support to this distinction, the Fifth Circuit observed, since it explicitly stated that *Munsey* had not quashed the completing surety's right to indemnification established by *Prairie State*. The surety who completed the contract was not only a creditor of the Government, by subrogation to the rights of the contractor, but was also, by virtue of performance of his suretyship guarantees, subrogated to the rights and remedies of the Government against the contractor, including indemnification from retainages, and enjoyed a position superior to the tax lien.<sup>27</sup> The court felt that to hold otherwise would be to require the surety to work for less than the contract price. The court further noted that "[i]f the government undertook to complete the contract, the surety would be liable for costs exceeding the contract price, but not for taxes owed by the contractor."<sup>28</sup> Since the surety relieves the Government of a substantial burden by completing the project, an equity court should not penalize him for doing so, the Fifth Circuit concluded.

The amendment to the Miller Act, as a practical matter, adopts the result obtained in the Court of Claims. The requirement of specific coverage for withholding tax default will permit the Government to recover contractor tax deficiencies from the surety, without consideration of the subrogation problems which arise absent the statute. However, should the Government fail to observe the notice requirement or limitation period, no suit may be commenced on the bond. In such event, it seems likely that the Government will attempt to offset its claim against retainages on the priority rationale advanced by the Court of Claims, thus resurrecting problems existing prior to the recent Miller Act amendment. This prospect is clearly indicated by a memorandum from the Commissioner of Internal Revenue to the Assistant Secretary of the Treasury, included in the transcript of the Hearings on the Tax Lien Act, wherein the Commissioner stated that "nothing in this bill is intended to reverse *United States v. Munsey Trust Co.*"<sup>29</sup> While the amended Act deliberately bypasses the issue of priority raised in *Munsey* and *Pearlman*, and offers no attempt to reconcile them, the enactment of the amendment may well aid the Government in setoff litigation.

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<sup>27</sup> *Id.* at 320.

<sup>28</sup> *Id.* at 321.

<sup>29</sup> *Hearings* 48.

The variegated decisions prior to the Miller Act amendment seem to have been engendered by a conflict between the equitable principles of subrogation and the equitable doctrine allowing offset of debtors' claims against creditors. Viewed in these terms, the question is clearly one of priorities; *i.e.*, whether the tax lien, an equitable offset, takes priority over equitable subrogative rights. Logic would seem to dictate that the latter should prevail, as the offset is one of the Government's rights against the contractor to which the surety should become subrogated, thus extinguishing that right in the Government.<sup>30</sup> A different determination therefore should result only from a policy decision that the tax lien must prevail. Factors integral to a resolution of the problem might include the Government's need for revenue, the construction industry's bad record of tax default, the role of the surety as guarantor of complete performance, and the economic effect of the decision on the surety industry and on Government contract costs. Consideration of these factors is arguably rendered nugatory, however, if one views the enactment of the tax guaranty requirement as indicative of a congressional preference for superiority of the Government's interest. And while it may be argued that Congress provided the Government with an exclusive remedy in the amended Miller Act, the Treasury draftsmen of the legislation seem to have intended otherwise. When coupled with the statute's failure to expressly foreclose the possibility of setoff, these factors portend a more certain surety liability for contractor tax defaults.

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<sup>30</sup> See *Prairie State Bank v. United States*, 164 U.S. 227, 232 (1896).