

RIGHTS TO FUNDS WITHHELD FROM DEFAULTING GENERAL CONTRACTORS: SURETY v. TAX COLLECTOR*

A GENERAL contractor's default on a job undertaken creates many troublesome commercial problems. Among the most perplexing of these is the conflict between the claims of the contractor's surety¹ and the federal tax collector to funds retained by the owner.² Although the owner normally makes periodic payments for work completed, he retains specified percentages of each installment until completion. When the contractor defaults, the owner usually exercises his right to require the surety to complete, but withholds the balance of the contract price.³ Under the usual rule of subrogation a surety who satisfies the claims of his principal's creditors acquires the rights of those creditors and any security held by them;⁴ the surety accordingly claims that he is entitled to the

*Fidelity and Deposit Co. v. New York City Housing Authority, No. 24196, 2d Cir., Feb. 8, 1957, *reversing* 140 F. Supp. 298 (S.D.N.Y. 1956).

1. The commercial surety company undertakes, in a bond executed between it as surety and the contractor as principal, to protect the owner of the contemplated project from the loss he may suffer if the contractor fails to perform, to complete the actual work itself should the owner so request after the contractor's default, and to pay all claims of materialmen, laborers and subcontractors arising out of the work should the contractor leave these claims unsatisfied. The limit of the surety's liability in all cases is set by the so-called "penal sum" specified in the bond. *Bill Curphy Co. v. Elliott*, 207 F.2d 103 (5th Cir. 1953).

The surety thus functions as a general insurer of performance for the contract price. This makes practicable a highly competitive system of job-bidding, for the owner may accept the lowest competent bid with nearly full assurance of performance at that price. Cf. BACKMAN, SURETY RATE-MAKING 246 (1948); Haas, *The Corporate Surety and Public Construction Bonds*, 25 GEO. WASH. L. REV. 206 (1957).

2. Typically these claims stem from the contractor's failure to pay over both taxes withheld from his employees wages, see INT. REV. CODE OF 1954, §§ 3402-03 (imposing on employers the duty to withhold, and making them liable for, income tax from employees' wages), and taxes assessed directly against the contractor's business, see, *e.g.*, *id.* §§ 3111, 3301 (Federal Insurance Contributions Act taxes and employment taxes).

3. See Record on Appeal, p. 60, *Aetna Cas. & Surety Co. v. Horticultural Service*, 136 N.Y.L.J. No. 112, p. 7, col. 4 (N.Y. App. Div. Dec. 12, 1956), *reversing* 1 Misc. 2d 956, 147 N.Y.S.2d 422 (Sup. Ct. 1956) (reproducing New York City Housing Authority contract clauses). For a different type of payment clause also in general use, see PARKER & ADAMS, THE A. I. A. STANDARD CONTRACT FORMS AND THE LAW 25 (1954).

4. *Prairie State Bank v. United States*, 164 U.S. 227 (1896); *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 410 (1908); *Glenn v. American Surety Co.*, 160 F.2d 977, 981 (6th Cir. 1947); *Scarsdale Nat'l Bank & Trust Co. v. United States Fidelity & Guaranty Co.*, 264 N.Y. 159, 163, 190 N.E. 330, 332 (1934); *cf.* *United States Fidelity & Guaranty Co. v. Centropolis Bank*, 17 F.2d 913 (8th Cir. 1927). See also cases collected in Annot., 134 A.L.R. 738, 742 (1941). *But see* *Aetna Cas. & Surety Co. v. Horticultural Service*, 1 Misc. 2d 956, 147 N.Y.S.2d 422 (Sup. Ct. 1956), *rev'd*, 136 N.Y.L.J. No. 112, p. 7, col. 4 (N.Y. App. Div. Dec. 12, 1956).

The completing surety also acquires the owner's right of action against the contractor. This is as valueless as the surety's right of reimbursement from his principal for the contractor is generally insolvent or close to it at the time he defaults. The surety also

withheld portions of each installment and the balance of the contract price as security held by the owner.⁵ Countering this argument is the tax collector's claim to the funds for taxes arising both prior to and out of the bonded job.

As against claims for on-the-job taxes, the surety's contentions have long been sustained; the courts "related back" the surety's interest in the retained funds to the time the bond was executed.⁶ Then, applying a first-in-time-first-in-right theory, courts protected the surety from claims for taxes arising after the contract was signed as well as from those of the contractor's subsequent creditors.⁷ The federal government has usually prevailed over the surety on prior tax claims by asserting a lien under section 6321 of the Internal Revenue Code.⁸

may acquire the rights of subcontractors whose claims he has paid. However, as one of the main purposes of the surety's bond is to hold the owner harmless from these claims, he may not himself urge them as against the owner.

"Completion" in this context means either the performance of the physical work required by the contract, *Century Cement Mfg. Co. v. Fiore*, 264 App. Div. 475, 36 N.Y.S.2d 332 (3d Dep't 1942); *Henningsen v. United States Fidelity & Guaranty Co.*, *supra*, or the payment of all claims which the contract requires the contractor to pay, *United States Fidelity & Guaranty Co. v. Miller*, 143 F. Supp. 941 (W.D.N.C. 1956); *F. H. McGraw & Co. v. Sherman Plastering Co.*, 60 F. Supp. 504 (D. Conn. 1943); *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 74 N.E.2d 226 (1947).

5. See cases cited note 4 *supra*. Were there no surety bond involved the owner would by the terms of the contract have the right to apply the contract balance and retained percentages to the completion of the job after the general contractor's default. *McKnight v. United States*, 98 U.S. 179, 186 (1878); *Gratiot v. United States*, 40 U.S. (15 Pet.) 336, 370 (1841). And when the owner does elect to complete the job himself, his claim against the surety is reduced by the amount of the contract balance and retained percentages.

6. The fact that the surety's right has neither an ascertainable value nor is enforceable until he has completed payment or performance has never disturbed the courts. See, *e.g.*, *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404 (1908); *United States Fidelity & Guaranty Co. v. Sweeney*, 80 F.2d 235 (8th Cir. 1935); *National Surety Corp. v. United States*, 133 F. Supp. 381 (Ct. Cl. 1955).

7. Under the "first-in-time-first-in-right" theory the surety's subrogation interest is regarded generally as an "equitable lien." It accordingly has been held superior to subsequent statutory liens, see, *e.g.*, *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 37, 74 N.E.2d 226, 227 (1947) (federal tax lien), and consensual liens, see, *e.g.*, *Prairie State Bank v. United States*, 164 U.S. 227 (1896) (assignment of accounts receivable). See, generally, cases collected in Annot., 134 A.L.R. 738 (1941).

8. INT. REV. CODE OF 1954, § 6321: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

The lien arises at the time the assessment lists are received by the tax collector's office. INT. REV. CODE OF 1954, § 6322. It continues in effect until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time; the lien is invalid as against mortgagees, pledgees, purchasers and judgment creditors unless notice of the lien has been filed in accordance with the law of the state wherein the property subject to the lien is situated. For typical state requirements, see, *e.g.*, N.Y. LIEN LAW § 240 (Supp. 1956) (notice to be filed in the office of the county clerk, city register, or town

More recently, however, the government's argument was successful in a federal district court as to both prior and on-the-job taxes. In the recent case of *Fidelity & Deposit Co. of Maryland v. United States*⁹ the surety had given bonds securing performance of all work required by the contract and securing payment of all materialmen's and laborers' claims arising on the job.¹⁰ The contractor completed the work but failed to pay all outstanding claims. The surety completed payment of the claims covered by its bond. The federal government, seeking taxes owed by the contractor for the bonded and prior jobs, and the surety both claimed the fund retained by the owner.¹¹ The government argued, and the district court held, that the surety had no claim to the funds either in his own right or by subrogation to the rights of the materialmen and laborers or the owner.¹² Although, under the contract, the

or city clerk); CONN. GEN. STAT. § 7213 (1949) (notice to be filed in lands records office or office of town clerk). When the state makes no provision for filing, the lien may be perfected by filing in the district court. INT. REV. CODE OF 1954, § 6323.

9. No. 24196, 2d Cir., Feb. 8, 1957, *reversing* 140 F. Supp. 298 (S.D.N.Y. 1956).

10. 140 F. Supp. at 300. See also Record on Appeal, p. 60 (facing), *Aetna Cas. & Surety Co. v. Horticultural Service*, 136 N.Y.L.J. No. 112, p. 7, col. 4 (N.Y. App. Div. Dec. 12, 1956) (standard form of bond required by the New York City Housing Authority).

11. 140 F. Supp. at 301-03.

12. *Id.* at 301-03. In concluding that the surety was not subrogated to the rights of the owner, the court relied on *United States v. Munsey Trust Co.*, 332 U.S. 234 (1947). There the federal government was the owner. The Court held that the government was promisee of only the performance bond and that no retained percentages or other withheld monies may be considered as held as security for the payment of unpaid laborers and materialmen. *But see* *National Surety Corp. v. United States*, 133 F. Supp. 381 (Ct. Cl. 1955); *Martin v. National Surety Co.*, 300 U.S. 588 (1937); *Trinity Universal Ins. Co. v. Gray*, CCH 1957 STAND. FED. TAX REP. ¶ 9297 (M.D. Ga.).

The basis for the *Munsey* holding lies in the government's unique immunity from materialmen's and laborers' liens. The government is responsible only morally for payment, as no liens may be filed against federal projects. See, *e.g.*, *Equitable Surety Co. v. McMillan*, 234 U.S. 448, 455 (1914); *Hill v. American Surety Co.*, 200 U.S. 197, 203 (1906). See 49 STAT. 793 (1935), 40 U.S.C. § 270(a)-(d) (1952) (Miller Act). The private owner, however, has a very real liability for liens. He therefore requires the contractor to furnish a payment bond, and he should be treated as the promisee thereof. Admittedly, under the lien laws of some states, the owner's liability to unpaid subcontractors is extinguished if payment of the full contract price is made *before* the liens are filed. See, *e.g.*, N.Y. LIEN LAW § 4 (Supp. 1956); CONN. GEN. STAT. § 7220 (1949). *But see* MASS. ANN. LAWS c.254, §§ 1-4 (1956); OHIO REV. STAT. § 1311.02 (Supp. 1956). Under the installment payment system, however, since full payment is never made and liens may be filed immediately upon delivery of materials or performance of labor, this rule seldom comes into play. Nor does the notice provided by filing fully protect the owner. He may, after receiving notice of lien, protect himself from out-of-pocket loss by holding back funds in the amount of the lien. He then can either settle directly with the lienors or pay the money into court. See, *e.g.*, N.Y. LIEN LAW § 20 (Supp. 1956). But this may seriously curtail the flow of monies to the general contractor and therefore to the job. The owner runs the risk of subcontractor defaults and a breakdown of the building schedule in general. The government's freedom from liability permits it to continue channeling funds into the job, leaving the claimants to go against the surety. The owner of a non-federal job requires the corresponding protection offered him by the

owner's duty to pay the contractor arose only when the latter had paid all claims promptly, the court held that the contractor had a right to the retained percentages. It accordingly held that the federal tax lien attached to this "right to property" and awarded the entire fund to the government for past and current taxes.¹³

The Court of Appeals for the Second Circuit, however, reversed.¹⁴ It held that Congress did not intend by section 6321 of the Internal Revenue Code to confer power on the federal courts to decide whether a taxpayer has a property interest, but solely to examine whatever property interests are created by state law and to determine whether such interests are "property" or "rights to property" to which the statutory tax lien attaches.¹⁵ The existence of a property interest being a question of state law, the court felt itself bound by a New York decision. In *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*¹⁶ the New York Court of Appeals had held that as long as unsatisfied materialmen's and laborers' claims were outstanding and as long as the owner had the right to withhold and apply the fund, the contractor had no property interest to which the federal tax lien might attach. The Second Circuit further held, relying again on state decisions, that since the general contractor's failure to pay such claims was a material breach of contract, there was no property interest by way of right of recovery under a substantial performance theory.¹⁷ Consequently, the court denied the government any part of the fund.

payment bond. Further, the assurance of payment the bond offers the subcontractors benefits the owner by tending to lower initial bid-prices. Thus, for a variety of reasons foreign to the government-as-owner situation, the private owner is very definitely the promisee of the payment bond, and withheld funds may be properly deemed security for payment as well as performance.

13. 140 F. Supp. at 301-03. See also *Aetna Cas. & Surety Co. v. Horticultural Service*, 1 Misc. 2d 956, 147 N.Y.S.2d 422 (Sup. Ct. 1956), which reached an identical result, but by different reasoning. The court there rejected the relation back doctrine and held that the surety's interest was an "inchoate" lien and therefore inferior to the federal tax lien which was "choate" the moment the assessment lists were filed. This allowed recovery on all tax liens, including those arising prior to the job, during it, and after completion. Cf. *United States v. White Bear Brewing Co.*, 350 U.S. 1010 (1956), *reversing without opinion* 227 F.2d 359 (7th Cir. 1955); *United States v. Colotta*, 350 U.S. 808 (1955), *reversing without opinion* 79 So. 2d 474 (Miss. 1955).

14. *Fidelity and Deposit Co. v. New York City Housing Authority*, No. 24196, 2d Cir., Feb. 8, 1957, *reversing* 140 F. Supp. 298 (S.D.N.Y. 1956).

15. *Fidelity and Deposit Co. v. New York City Housing Authority*, No. 24196, 2d Cir., Feb. 8, 1957, at 582.

16. 297 N.Y. 31, 37, 74 N.E.2d 226, 227 (1947).

17. *Fidelity and Deposit Co. v. New York City Housing Authority*, No. 24196, 2d Cir., Feb. 8, 1957, at 586, citing *Jacob & Youngs v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921); *Dauchey v. Drake*, 85 N.Y. 407 (1881); *Spence v. Ham*, 163 N.Y. 220, 57 N.E. 412 (1900); *Cassino v. Yacevich*, 261 App. Div. 685, 27 N.Y.S.2d 95 (3d Dep't 1941); *Gompert v. Healy*, 149 App. Div. 198, 133 N.Y. Supp. 689 (2d Dep't 1912).

The government, however, has consistently urged that private contractual provisions—in this case making all performance a condition precedent to receipt of withheld percentages—cannot derogate the rights acquired by the government under the tax statutes.

The Second Circuit need not have felt bound by state law. The distinction between the creation of interests, governed by state law, and the classification of such interests as property rights by the federal courts was based on a Supreme Court dictum; the holding actually tends to contradict the Second Circuit's reasoning.¹⁸ The court might have concluded that in order to achieve uniformity in tax results¹⁹ the existence of property interests subject to tax liens should be decided under federal law. Alternatively, state law does not compel the conclusion that the contractor has no interest in the fund when he has defaulted and the surety completes his contract. *Triborough*, for example, negated the contractor's interest "so long as" material and labor claims were outstanding.²⁰ But once the surety pays these claims the contractor's right is no longer conditioned. State law then gives the surety a right *superior* to that of the contractor to implement the surety's right of reimbursement;²¹ consequently, since the tax collector can only claim against the contractor's rights, the surety prevails. The federal court could have concluded that since the litigation concerned federal taxes, the question of priorities became one of federal law and the surety's rights should have been subordinated.²² Because the

United States v. Kings County Iron Works, 224 F.2d 232 (2d Cir. 1955); United States v. Manufacturer's Trust Co., 198 F.2d 366 (2d Cir. 1952). It has therefore been urged that the contractor's interest in any funds which have been earned is a right to property subject to the tax lien, notwithstanding contractual provisions limiting the contractor's right to payment.

If successful, however, this argument might give the government monies which the contractor never actually earned. The contractor may pad the work estimate on which the owner's periodic payments are based. The payments actually received by the contractor before his default could then be equal to or even in excess of the full measure of his performance.

18. *Morgan v. Commissioner*, 309 U.S. 78 (1940). Plaintiff's decedent was the legatee of two powers of appointment over property held in two trusts created under her father's will. Since § 302(f) of the Internal Revenue Code of 1926, 44 STAT. 71, included only general, not special, powers of appointment within the category of rights subject to the estate tax, the issue was whether the powers were special or general. The Court stated that its task was one of classifying already existing interests, not of determining whether such interests existed. Then despite the fact that the state court had classified the power as special and had held that no general power existed, the Court held that the power was the type of interest Congress intended to tax as a general power. See also *Davies Warehouse Co. v. Bowles*, 321 U.S. 144, 155 (1944).

19. See, e.g., *Lyeth v. Hoey*, 305 U.S. 188 (1938); *Niagara Hudson Power Corp. v. Hoey*, 117 F.2d 414 (2d Cir. 1941); *Weil v. United States*, 115 F.2d 999 (2d Cir. 1940).

20. 297 N.Y. at 37, 74 N.E.2d at 227.

21. In *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, for example, the court would have reached the same result had it initially assumed that the contractor had a present unconditional right to the fund. Courts of equity may subordinate the contractor's right to the claim of a surety to whom the contractor owes a duty of reimbursement. See cases cited note 4 *supra*. All that was therefore essential to the court's decision was this rule of equity and a determination that the government's right was inferior to that of the surety. For similar state decisions see, e.g., *Fosmire v. National Surety Co.*, 229 N.Y. 44, 127 N.E. 472 (1920).

22. The question of relative priorities where a federal lien is involved has become a matter for exclusive federal determination. *United States v. Colotta*, 350 U.S. 808

circuit court could have concluded differently,²³ the main support for the decision must rest on the practicality of the results it reaches.

In effect, the decision prevents the government from asserting a "secret" lien—one that would be condemned in the hands of a private creditor.²⁴ Characteristically, in litigation between the tax collector and the completing surety, the government seeks to collect not only taxes which arose from the current job but also taxes that are due from the contractor's past jobs and have accumulated for several years prior to his current default.²⁵ The government had collection machinery available to it during this period; instead of deferring

(1955) (mechanic's lien); *United States v. Scovil*, 348 U.S. 218 (1955) (distress warrant); *United States v. Liverpool & London & Globe Ins. Co.*, 348 U.S. 215 (1955) (garnishment); *United States v. Acri*, 348 U.S. 211 (1955) (attachment); *United States v. New Britain*, 347 U.S. 81 (1954) (municipal tax liens, mortgages, and water rent liens); *United States v. Gilbert Associates, Inc.*, 345 U.S. 361 (1953) (municipal tax liens arising out of ad valorem assessments); *United States v. Kings County Iron Works*, 224 F.2d 232 (2d Cir. 1955) (mechanic's liens). *But see Karno-Smith Co. v. Maloney*, 112 F.2d 690, 692 (3d Cir. 1940); *F. H. McGraw & Co. v. Sherman Plastering Co.*, 60 F. Supp. 504 (D. Conn. 1943). For criticism of this rule, and the history of its development, see Kennedy, *The Relative Priority of the Federal Government*, 63 YALE L.J. 905 (1954).

23. See note 13 *supra* and accompanying text; *cf. American Radiator Co. v. New York*, 223 N.Y. 193, 119 N.E. 391 (1918). In the principal case the Second Circuit fails to draw any distinction between the different types of monies included in the contested fund. The consistent use of the term "balance" has tended to obscure the divided nature of the fund which may be comprised of retained percentages (earned but not due), sums fortuitously unpaid at default (earned and due but not paid) and finally, the actual balance of the contract price (unearned, not due and unpaid). The contractor's rights on default vary on each of these elements. See, *e.g.*, *Cassino v. Yacevich*, 261 App. Div. 685, 27 N.Y.S.2d 95 (3d Dep't 1941); *Venmar v. Scott Realty Co.*, 24 N.Y.S.2d 189 (Sup. Ct. 1940); *Nieman-Irving & Co. v. Lazenby*, 263 N.Y. 91, 188 N.E. 265 (1933). See also cases cited note 19 *supra* (federal tax questions should not be controlled by varying state determinations of property relationships).

24. See, *e.g.*, *Benedict v. Ratner*, 268 U.S. 353 (1925), 39 HARV. L. REV. 253; 1 WASH. L. REV. 47. See also Countryman, *The Secured Transactions Article of the Commercial Code and Section 60 of the Bankruptcy Act*, 16 LAW & CONTEMP. PROB. 76 (1951); Livingston & Kearns, *Commercial Financing and the Relation Between Secured and Unsecured Creditors in Bankruptcy*, 13 LAW & CONTEMP. PROB. 609 (1948).

25. See, *e.g.*, *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 297 N.Y. 31, 74 N.E.2d 226 (1947); *Aetna Cas. & Surety Co. v. Horticultural Service*, 1 Misc. 2d 956, 147 N.Y.S.2d 422 (Sup. Ct. 1956); *R. F. Ball Constr. Co. v. Jacobs*, 140 F. Supp. 60 (W.D. Tex. 1956); *cf. United States v. Colotta*, 350 U.S. 808 (1955).

26. INT. REV. CODE OF 1954, § 7403.

Further, the government could have instituted criminal proceedings against the delinquent contractor; INT. REV. CODE OF 1954, § 7203 (willful failure to file return, supply information or pay the required tax is a misdemeanor, punishable by a fine of not more than \$10,000 and imprisonment for not more than one year); *id.*, § 7202 (willful failure to collect or pay over any tax imposed is a felony subject to a maximum fine of \$10,000 and five years imprisonment); *id.*, § 7201 (any attempt to defeat or evade tax is a felony and subject to § 7202 penalties).

The statute of limitations is three years on criminal prosecutions and six years for criminal prosecutions of willful violations. INT. REV. CODE OF 1954, § 6531. See also

attempts to collect, it could have foreclosed its liens as they arose.²⁶ Such enforcement devices always involve the risk of precipitating the contractor's financial ruin, and consequently of reducing the chances that he will eventually be able to pay. The government, therefore, frequently gambles, waiting in the hope that the delinquent contractor will recover his footing.²⁷ But the government hedges its gamble at the expense of the surety and other creditors of the contractor. By filing its assessment lists in the collector's office, the government obtains a statutory lien under section 6321.²⁸ As a practical matter, the surety and creditors will seldom be able to learn of the lien.²⁹ If the contractor's financial condition worsens and he eventually defaults, the government then hopes that under a first-in-time-first-in-right theory, its lien will take precedence over unsecured claims.³⁰

It is, however, undesirable to bar the government, as both the Second Circuit and *Triborough* views do, from collecting taxes which arose on the construction job bonded by the surety. Admittedly, the surety has not contracted to pay these job taxes if the contractor fails to do so.³¹ But the surety, who is called upon to complete performance or payment, benefits from the contractor's

id., § 6502 (imposing a six year limit for civil actions). In addition, the statute begins to run when the initial assessment list is filed, and this may be done up to three years after the tax fell due. *Id.*, § 6501.

27. For an official, if not particularly recent, recognition of this fact see G.C.M. 4715, VII-2 CUM. BULL. 94 (1928), advising the tax collector to wait and keep on the alert as "a delinquent taxpayer may at any time prior to the expiration of the statutory period of limitations become possessed of property against which the lien may attach, thus making the tax liability enforceable through the lien."

Although the statement is not recent, it seems to be an accurate description of current policy. For examples of the numerous cases which can be explained, if not by inexcusable inefficiency, only in terms of this policy, see cases cited note 25 *supra*; and for very recent cases indicating that the policy persists, see *Colusa-Glenn Production Credit Ass'n v. Phoenix Ins. Co.*, 145 F. Supp. 844 (N.D. Cal. 1956); *United States Fidelity & Guaranty Co. v. Miller*, 143 F. Supp. 941 (W.D.N.C. 1956); *Damato v. Leone Constr. Co.*, 41 N.J. Super. 366 (App. Div. 1956).

28. See note 8 *supra*.

29. Assessment lists filed in the tax collector's office may be examined only if a power of attorney has been obtained from the contractor. INT. REV. CODE OF 1954, § 6103; T.D. 4929 § 463C.2, in 2 P-H 1954 FED. TAX SERV. ¶ 17902.

For a discussion of the practical difficulties of searching the tax collector's records and suggested remedies, see Rudolph, *Performance Bond Servicing of Government Contracts*, 19 INS. COUNSEL J. 171, 177 (1952).

30. See cases cited note 13 *supra*.

31. The bond does not include federal taxes among the enumerated claims for which the surety is responsible. See typical bond provisions, note 10 *supra*. In the absence of any express inclusion and an express intent to give the claim holder a cause of action, the government has no right of action on the bond. *United States v. Crosland Constr. Co.*, 217 F.2d 275 (4th Cir. 1954); *Great American Indemnity Co. v. United States*, 120 F. Supp. 445, 448 (W.D. La. 1954); *McGrath v. American Surety Co.*, 307 N.Y. 552, 122 N.E.2d 906 (1954); *cf. United States Fidelity & Guaranty Co. v. United States*, 201 F.2d 118, 120 (10th Cir. 1952). *But cf. United States v. Phoenix Indemnity Co.*, 231 F.2d 573 (4th Cir. 1956).

failure to pay job taxes as they fall due. In most cases the contractor's default is caused by a combination of inadequacy of capital and unexpected or miscalculated costs.³² Except in the unlikely event that the contractor's success in forestalling the tax collector encourages him to increase his non-business spending,³³ by deferring his tax payments the contractor increases his available capital. This increases the amount of performance he can complete before default and correspondingly decreases the loss incurred by the completing surety.

The best solution can be reached by a system of notice better calculated to give the surety immediate knowledge of a contractor's failure to pay taxes. The surety not only has a need for information regarding the contractor's skill, business acumen and financial condition at the time he undertakes the job, but properly informed, can best prevent losses. The surety is best able both to judge the contractor's ability to undertake a given project and, by virtue of his accumulated business experience, to evaluate the risks presented by the contemplated job. In deciding whether to bond a job, if the surety knows the amount of existing tax claims, he will be best able to determine whether the contractor has become too indebted to be capable of completing the job. And once the job is undertaken, if a point of excessive indebtedness is reached, the owner may be apprised of the situation, the contractor may be defaulted, and the job relet to a capable contractor.³⁴

32. The fact that the contractor is insolvent at least in the equitable sense is evident; if he had sufficient assets to pay his debts as they mature, the case would not arise. It may be true, of course, that insolvency merely coincides with a willful failure to complete the contract, or with some event (labor trouble, for example) which prevents the contractor, but not the surety, from completing. Such coincidence, however, would seem rare.

The contractor's insolvency does not necessarily mean that the government can assert its priority under REV. STAT. § 3466 (1875), 31 U.S.C. § 191 (1952). Legal insolvency must first be proven. For previously unsuccessful attempts by the government to use the priority argument see, *e.g.*, *In re Taylorcraft Aviation Corp.*, 168 F.2d 808, 809-10 (6th Cir. 1948); *United States v. Sampson*, 153 F.2d 731, 734 (9th Cir. 1946); *cf.* *New York Cas. Co. v. Zwerner*, 58 F. Supp. 473 (N.D. Ill. 1944); *In re Van Winkle*, 49 F. Supp. 711 (W.D. Ky. 1943). The contractor may be equitably insolvent but not legally insolvent. And even when he is proven insolvent for § 3466 purposes, the question still would arise whether the retained sums were part of the insolvent's estate which the statute devotes first to paying the government. See also, for criticism of the government's approach, Kennedy, *supra* note 22.

33. Since a willful failure to pay taxes may lead to criminal prosecution, see note 26 *supra*, it seems reasonable to infer that a contractor would only violate the statute out of necessity, *i.e.*, attempting to fulfill his contractual obligations.

34. Since a typical contract with the owner provides that the contractor will pay all lawful claims promptly, his tax delinquencies may constitute a breach. See note 3 *supra*. Distribution of the costs of risk protection through a rise in the premium rates is, however, unlikely. Even though the rates charged by a large part of the industry are influenced to a degree by the rating bureau device set up under the American Surety Association, competition is still keen. BACKMAN, SURETY RATE-MAKING 106 (1949). Rather than raise rates, most companies, particularly those not members of the American Surety Association, would probably prefer to absorb the risk, since they may expect that by

While section 6323(a) should be amended to require timely and effective notice,³⁵ existing doctrines can be construed to compel the same result. Since the surety and the contractor are in effect joint obligors under the general contract,³⁶ performance by either discharges the joint obligation.³⁷ The contractor then has an absolute right to payment as soon as either he or the surety performs all the requirements of the contract and the tax lien can attach to this right. The surety, however, can be protected against tax liens for past taxes by obtaining from the contractor the customary assignment of the contractor's rights under the general contract.³⁸ At the same time, the assignment arrangement can be construed to allow the government to collect

maintaining lower rates they can obtain larger volumes of business which will yield an increase in profit large enough to offset the new risk. Further, should the rates rise by any appreciable amount and the expense to the owner become too great, he may dispense with the surety bond altogether and employ alternative security devices. This has been done in the past by some states and municipalities, and by the federal government on certain types of contracts during the war, and it is still done frequently on smaller private jobs. *Id.* at 339-45. Fear of a repetition of such action serves as a continual and additional curb on premium rates.

35. INT. REV. CODE OF 1954, § 6323(a) should be revised to require the government to file all tax liens in the district court or with the appropriate state agency before the liens become effective as against the surety. Alternatively, or in addition, provision for direct notice to the owner and/or surety should be made. See also MACLACHLAN, *BANKRUPTCY* §§ 154-55 (1956) (discussion of notice provisions and priorities); Kennedy, *supra* note 22.

36. The surety generally does not join with the contractor in signing the main contract with the owner. He does, however, in his bond promise to pay the owner if the contract is not performed, and performance by either the contractor or surety discharges the surety on his bond. See SIMPSON, *SURETYSHIP* § 69 (1950); STEARNS, *SURETYSHIP* § 96 (4th ed. 1934).

Thus the surety promises to pay if the contractor and surety do not perform. Moreover, the surety promises in his bond that he will perform if the owner demands that he do so. Except for the fact that he places an upper limit on his liability, the surety therefore makes the same promise that he would make by signing the main contract. Had he done so, his status as a joint obligor would be clear. See 4 CORBIN, *CONTRACTS* §§ 923-42 (1951) (hereinafter cited as CORBIN). And the fact that the surety does limit his liability is irrelevant here, even when that limit becomes operative. A joint obligor can be liable for only part of the total performance. 4 *id.* § 926.

37. 4 *id.* §§ 928, 936-37.

38. See *R. F. Ball Constr. Co. v. Jacobs*, 140 F. Supp. 60 (W.D. Tex.), *aff'd*, 239 F.2d 384 (5th Cir. 1956), where surety holding an assignment of contractor's contract rights was held the equivalent of a mortgagee within the meaning of INT. REV. CODE OF 1954, § 6323(a), and notice of lien was therefore required before the federal tax lien could become effective as against the surety's interest. Filing of assessment lists in the collector's office is not sufficient for this purpose. See note 8 *supra*. See also *Alabama-Tennessee Natural Gas Co. v. Lehman-Hoge & Scott*, 122 F. Supp. 314 (N.D. Ala. 1954); *accord*, *In re Allied Products Co.*, 134 F.2d 725 (6th Cir.), *cert. denied*, 320 U.S. 740 (1943); *cf.* *Salem Trust Co. v. Manufacturers' Finance Co.*, 264 U.S. 182 (1924). However, even where the assignment is contingent on default, it may be argued that a present assignment has been made, subject to divestment on the occurrence of a condition subsequent (*i.e.*, successful completion).

on-the-job taxes as long as it gives prompt notice to the surety whenever the contractor falls behind in his tax payments.

Normally, at or before the time the owner-contractor agreement is signed, the surety takes an assignment of all the contractor's rights, privileges and properties under the contract, including the right to all monies due or to become due.³⁹ The assignment is, by its terms, a present assignment. In addition, by the terms of its bond, the surety also assumes liability for performance. Thus the surety in two steps acquires the same position as he would by taking a total assignment of the contract. The surety then in effect employs the contractor to perform the work required on the job.⁴⁰

Thus viewed in a double capacity—assignee and employer—the surety can be freed from liability for previous tax claims the contractor had incurred and yet made liable for on-the-job taxes of which the surety has notice. As assignee, he has, in effect, taken the contractor's rights under the contract in return for his promise to perform; the contractor's rights in the contract can be viewed as security for the surety's assumption of liability. As a security holder, the surety prevails over unrecorded tax claims existing at that time.⁴¹ But as employer, he is liable for the contractor's subsequent refusals to pay taxes, providing the surety has actual notice of the delinquency.⁴²

39. For an example of the conventional type of indemnity assignment agreement, see *Application for Contract Bond and Agreement of Indemnity* (The Aetna Casualty & Surety Co.), Clause four. *Record on Appeal*, p. 60 (facing), Aetna Cas. & Surety Co. v. Horticultural Service, 136 N.Y.L.J. No. 112, p. 7, col. 4 (N.Y. App. Div. Dec. 12, 1956).

40. A clause in the owner-contractor agreement requiring permission for any assignment does not militate against the suggestion in text. First, by consenting to the surety's promise to assume liability for performance, the owner has in effect waived any objection to the assignment. Secondly, the assignment is made in order to clarify the relationship between the surety and the contractor and does not alter the owner's rights. See 4 CORBIN §§ 869, 906.

If, however, the requirements of the federal notice statute, INT. REV. CODE OF 1954, § 6323(a), have been met prior to the execution of the assignment and the bond, the surety will have had such notice as is sufficient both under general assignment doctrine and *R. F. Ball Constr. Co.*, discussed in note 38 *supra*, to render it liable for the sums covered by such liens.

41. See note 38 *supra*.

42. Where conditions exist which raise the likelihood of on-the-job accidents and these conditions are known to the employer, a duty to inspect and hence constructive notice of any related improper or negligent acts of the independent contractor is often imposed. Foreseeability of the particular type of injury increases the need for inspection. See Annot., 30 A.L.R. 1502, 1531 (1924) (general discussion of liability for unlawful acts). Similarly, once the government has filed a notice of lien, the likelihood that the contractor's tax delinquency will continue in the future seems strong enough to warrant imposing on the surety a duty to inspect. The surety then may have actual knowledge of further failure to pay. For where the terms of the assignment are actually carried out, the surety will have access to the contractor's progress reports. He can tally the payroll and other payments, plus their correlative taxes, with the funds taken in. Additional powers to inspect the contractor's books and general credit standing should be made a prerequisite to granting the bond. See Rudolph, *supra* note 29. And the duty to inspect, coupled with the surety's ability through inspection to insure that current taxes are paid,

Adoption of the proposed theory will induce the government to give the surety prompt notice of any tax delinquencies, either by filing notice of its liens or by informing the surety directly.⁴³ And since, under the solution proposed, the surety's immunity from loss due to liens for past taxes is predicated on its taking a present assignment, the surety cannot escape liability for current taxes by deferring the effective time of the assignment.

Construing the customary assignment as creating an employer-independent contractor relationship will secure substantial advantages to all of the parties concerned. Under the present tax-lien statute, only this construction of the assignment provides the incentive for the federal government to give prompt notice of its lien. Notice in turn permits a comprehensive system of loss control which will guard all of the parties—owner, surety and tax collector—from loss caused by the contractor defaulting with large debts outstanding. And timely notice, by enabling the owner and surety to replace the contractor as soon as he becomes financially unstable, may avoid much of the costly interruption of the job which characteristically follows an unexpected default.

should be sufficient to charge the surety with constructive notice of any subsequent deficiencies. Thus any loss stemming from the first lien would fall upon the government, all subsequent loss on the surety, thereby putting a premium on prompt filing by the government.

Alternatively, the employer-surety may be held responsible under the general doctrine which imposes liability for any injury flowing from having hired or, after having notice of the contractor's condition, having retained a financially incompetent contractor. See Annot., 30 A.L.R. 1502, 1544 (1924) (financial irresponsibility of independent contractors generally); Morris, *The Torts of an Independent Contractor*, 29 ILL. L. REV. 339, 344 (1934); Steffen, *Independent Contractor and The Good Life*, 2 U. CHI. L. REV. 501, 505 (1935). Though usually considered only in relation to tort liability and, more particularly, to physical injury and property damage, employer liability for the acts of an incompetent (financially or otherwise) independent contractor has occurred in other areas as well. Person, *Liability of Employers for Misrepresentations made by "Independent Contractors"*, 3 VAND. L. REV. 1 (1949) (contract misrepresentation, false representations by brokers, incompetence of hired physicians and incorrect translations of newspaper articles).

43. The surety should not, however, be subject to any of the criminal penalties provided for in the federal tax statutes. See Annot., 30 A.L.R. 1502, 1531 (1924) (liability for unlawful acts limited to financial loss). The penalties imposed by the tax statutes, see note 26 *supra*, are discretionary with the court. Since tax liability here is imposed solely to prevent and to distribute loss, penal sanctions can serve no justifiable purpose.

Furthermore, the statutes are directed towards "willful" failure, "willful" evasion, etc.; that such "willfulness" could be attributed to the surety who is made liable only by virtue of an imposed duty to inspect after notice, real or constructive, seems doubtful.