

GOVERNMENT CONTRACTORS, COMMERCIAL BANKS, AND MILLER ACT BOND SURETIES— A QUESTION OF PRIORITIES

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INTRODUCTION

In recent years a sizeable volume of litigation¹ arising from the default of public works contractors has focused upon the relative priority positions of surety companies and commercial banks. With the continued growth of expenditures for federal public works²—the

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¹ A discussion of recent cases appears in the text at notes 103-05, 134-40 *infra*.

² Contract amounts for the construction of publicly owned projects (i.e., owned by federal, state, or municipal entities) have increased fivefold since 1950. The valuation, in millions of dollars, is: 1950—\$4,409; 1960—\$12,587; 1970—\$23,188. Department of Commerce, Business Statistics 51 (1971 ed.).

context in which most of the disputes arise—a satisfactory resolution of this problem becomes increasingly important.

In terms of legal theory alone the issues are exceedingly complex and subtle. They have generated a good deal of academic commentary.³ But perhaps because of their complexity, they have not yet been adequately analyzed in an empirical framework. There has been little research "in the field." Consequently we know little about the relationship between the theoretical and the real—specifically, about how well or poorly the developing law on this issue is responding to its commonly stated policy goals. The research reported in this paper has been undertaken both to explore that relationship, and to offer further critical commentary on matters of legal doctrine. Initially, however, we must look at the factual setting out of which the conflict arises.

As a condition to his being awarded a contract to construct, alter, or repair a federal public work, a successful bidder is required by the terms of the Miller Act to secure both performance and payment bonds from an acceptable surety.⁴ The *performance* bond, which runs directly to the United States, obligates the surety to complete the project or respond in damages if the contractor fails to perform satisfactorily.⁵ The United States is the nominal beneficiary of the *payment*

The most recent figures show public construction to be in excess of 25% of the total construction in the United States (figures are \$ millions):

	1970	1971	1972 (Jan.-Feb.)
Total Construction	\$68,160	\$80,590	\$11,841
Publicly Owned	21,977	22,626	3,771

See 52 Survey of Current Business S-10 (No. 4, April 1972).

Federal expenditures for civil public works alone have nearly doubled since 1960, from \$5.01 billion to \$10.01 billion in 1971. Of this, direct federal construction was \$3.46 billion in 1960, and \$4.6 billion in 1971. Department of Commerce, Statistical Abstract of the United States 1971, at 660.

³ A sampling would include: Speidel, "Stakeholder" Payments Under Federal Construction Contracts: Payment Bond Surety vs. Assignee, 47 Va. L. Rev. 640 (1961); Note, 71 Yale L.J. 1274 (1962); Comment, 31 Fordham L. Rev. 161 (1962); Rudolph, Financing on Construction Contracts Under the Uniform Commercial Code, 5 B.C. Ind. & Com. L. Rev. 245 (1964); Cushman, The Surety's Right of Equitable Priority to Contract Balances in Relation to the Uniform Commercial Code, 39 Temp. L.Q. 239 (1966); Brady, Bonds on Federal Government Construction Contracts: The Surety's View, 46 N.Y.U.L. Rev. 262 (1971); Withers, Surety vs. Lender: Priority of Claims to Contract Funds, 10 Washburn L.J. 356 (1971); 2 G. Gilmore, Security Interests in Personal Property §§ 36.1-8 (1965). It should be noted that most of these authors reach or advocate a pro-surety view.

⁴ 40 U.S.C. §§ 270a-d (1970). Projects of less than \$2000 in amount need not be bonded, although the contracting officer may require bonding even in these excepted cases. 40 U.S.C. § 270a(c) (1970). Similarly, the bonding requirement may be waived in cases of military or maritime construction, 40 U.S.C. §§ 270e, f (1970).

⁵ Standard Form 25: Performance Bond, 41 C.F.R. § 1-16.901-25 (1972). The surety's options include paying damages, hiring another contractor to complete the project, having the government contract for completion directly, or—and least likely—financing the original contractor to completion. See Brady, *supra* note 3, at 263-65.

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bond as well, although the surety's obligation on this is to satisfy the claims of any laborers and materialmen whom the contractor may have failed to pay.⁶ Unlike their counterparts in the private sector, who can rely upon materialmen's liens as a means of securing payment to themselves,⁷ these laborers and materialmen are unable to acquire a lien on public works,⁸ and have no other legal rights against the Government as "owner" of the project.⁹

Consequently, any serious default by a bonded contractor can expose his surety to potentially sizeable claims against either one or both of the bonds. The surety who actually suffers such a loss will in turn seek indemnification from its assured, the contractor.¹⁰ It often happens—not surprisingly, given that he has already defaulted in some respect—that the contractor is unable to indemnify the surety from its own assets. In such a case the only substantial fund that may be available to the surety is the amount the Government owes but has not yet paid under the contract. This fund typically includes contract retainages, a percentage (usually 10%) of the contract amount retained as security for full performance, and often includes earned but unpaid progress payments as well.¹¹ The zeal with which the surety will pursue these withheld funds, however, is matched or exceeded by that of the commercial lender, typically a bank, which has also made cash advances on the contractor's behalf and taken as security an assignment in the same funds.

A contracting firm which has involved itself in the burgeoning business of federal works construction often undertakes projects whose gross costs may exceed the firm's net capitalization by several orders of magnitude.¹² To procure the equipment, labor and materials

⁶ Standard Form 25-A: Payment Bond, 41 C.F.R. § 1-16.901-25A (1972). See *United States v. Magna Bldg. Corp.*, 305 F. Supp. 1244, 1246 (D. Ga. 1969): "The purpose of the Miller Act . . . is to protect materialmen and laborers . . ." See also *United States v. Williams*, 240 F.2d 561, 564 (10th Cir. 1957).

The laborers and materialmen who provided services to the project, but who were under contract not to the prime but to a first-tier subcontractor, may nevertheless take advantage of the prime contractor's payment bond. 40 U.S.C. § 270b (1970). It is for this reason that a general contractor will often require his subcontractors to procure bonds, with the prime contractor as beneficiary.

⁷ See, e.g., N.J. Stat. Ann. §§ 2A:44-71 et seq. (1952); *Shore Block Corp. v. Lakeview Apartments*, 377 F.2d 835 (3d Cir. 1967).

⁸ *United States v. Munsey Trust Co.*, 332 U.S. 234, 241 (1947).

⁹ *Id.*

¹⁰ The contract between the surety and the principal obligor inevitably contains a general indemnity agreement. See, e.g., *Fireman's Fund American*, Form 360124-11.65 ¶ 2.

¹¹ Progress payments are normally made monthly by the contracting agency involved. Ten percent of each payment is withheld until final completion, or until the dispensing officer elects to make full progress payments, usually after a substantial amount of the work has been completed. See Standard Form 23-A: General Provisions (Construction Contract) § 7(c), 41 C.F.R. § 1-16.901-23A (1972).

¹² While precise figures are elusive, and at present not available, some indication of

necessary to start the job, the contractor often requires significant outside financing. Since the contractor's largest (and potentially most liquid) source of collateral is the Government's obligation to pay the contract price, it is this "contract right" which he generally assigns to the bank from which he obtains the loan.¹³ Consequently, if the contractor defaults on one or both of its bonds and, as is likely, on its financing loan as well, it will leave the surety and the secured lender looking to the same fund for reimbursement. The determination of which party will be victorious depends, in a word, on priority. And although the surety, like the bank, may have taken an assignment of the contract rights for security, the problem is something more than the pedestrian issue of status among competing assignees. It represents, rather, a peculiarly murky intersection of the legal rights of the holders of otherwise unrelated legal statuses: assignee banks, and subrogee sureties. Moreover, little of the legal structure of either status has been concerned with the interactive effects one theory could have on the other. Thus while a plethora of distinctions and criteria have been suggested by the courts to deal with these problems, they have failed to coalesce into a comprehensive decisional framework.

In the pages to follow I shall attempt to develop the judicial reactions to this complex problem and critically examine these decisions from two dimensions: first, from a strictly doctrinal point of view, and then by reference to the impact these decisions have had on matters of policy. The discussion will reveal, first, that the courts have developed a line of decisional law favoring the surety. The doctrinal analysis which follows, however, will conclude that these decisions stand on weak foundations, and that, from a doctrinal viewpoint, the opposite result can be validly attained. The third section of the article will then examine the policy embodied in federal legislation and conclude that its goals—the vitality of small business contractors and a competitive public contracting market—can be pursued more adequately through

this can be seen in the ratios of revenue to working capital of typical contracting firms. This ratio is the gross annual revenue divided by the excess of total current assets over current liabilities. Robert Morris Associates, *Annual Statement Studies* vii (1972 ed.). The ratio for a sample of general building contractors is 11.6:1; 9.8:1 for non-highway heavy construction; and 9.5:1 for highway and street contractors. *Id.* at 146-47. "A low ratio may indicate unprofitable use of working capital while a very high ratio often signifies overtrading—a vulnerable condition for creditors." *Id.* at vii.

¹³ This "contract right" has become a significant element in construction financing since the enactment of the Assignment of Claims Act of 1940, 31 U.S.C. § 203 (1970), amended by 41 U.S.C. § 15 (1951). The purpose of the Act was to remove the ban on assignments of claims against the United States which had previously existed, and by making such assignments to financial institutions "valid for all purposes," to facilitate the entry of larger numbers of firms into the public construction market. See House Comm. on the Judiciary, *Permitting Assignment of Claims Under Public Contracts*, H.R. Rep. No. 2925, 76th Cong., 3d Sess. (1940); see also discussion of the legislative history in text at notes 210-16 *infra*.

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a reversal of the pro-surety line of cases. Section four consists of the results of a study conducted by this author directed toward an empirical determination of the effect of the present pro-surety status of the law regarding the financing of public works contractors, with particular emphasis placed on the federal policies noted above. Finally, I will offer a suggestion for a legal change which may correct this persisting empirical infelicity, and will point out some avenues worthy of further research.

I. DOCTRINAL RESPONSES: COURTS AND COMMENTATORS

A. *The Miller Act Priority Cases to 1950*

The theoretical—to say nothing of the practical—issues in this dispute which have been faced, or generated, by the federal courts have led even as astute a commentator as Grant Gilmore to remark in 1965 that “[d]espite more than sixty years of judicial analysis, the bank-surety priority problem may today be further than ever from a generally accepted solution.”¹⁴ Gilmore’s lament could stand correction in but one respect: as of today, the pot has been bubbling for seventy-seven years. The tale begins in 1896, with a victory for the surety.

In 1888 Charles Sundborg and Company had contracted with the United States to build a customhouse. When Sundborg defaulted on the project, his surety undertook to complete it, and spent considerable sums before learning that Sundborg had another creditor lurking about. That other was the commercial bank which had extended Sundborg an enabling loan. Because the United States was still in possession of the retained percentages, the race was on. The Court of Claims granted the fund to the surety,¹⁵ and in *Prairie State Bank v. United States*¹⁶ the Supreme Court affirmed. Justice White’s opinion did more than decide the outcome of a private dispute: it gave rise to a host of later difficulties.¹⁷

The bank in *Prairie State* had obtained its interest in the periodic disbursements of the contract proceeds through a power of attorney.¹⁸ Conceding that an assignment was not effective as such against the

¹⁴ 2 G. Gilmore, *Security Interests in Personal Property* § 36.1, at 949 (1965).

¹⁵ *Hitchcock v. United States*, 27 Ct. Cl. 185 (1892).

¹⁶ 164 U.S. 227 (1896).

¹⁷ The opinion pointed out, for example, that the Court of Claims did not find that the bank’s loans were in fact applied to the project in question. *Id.* at 229. But the opinion failed to state the relevance of that non-finding. Its importance was, if anything, denied by the more explicit rationale of the decision.

¹⁸ As to the contractor this “interest” was an assignment, but as to the United States the assignment was impermissible. Therefore, a power of attorney was used to collect the proceeds.

United States, the bank asserted an equitable lien against the retained percentages. The surety did likewise, but further argued that its lien on the fund had arisen when the bond was given, and accordingly was prior in time and therefore prior in right. Justice White, however, did not choose the simpler path of judging the competing priorities between assignees, but found instead that the surety might occupy an entirely different legal status: that of subrogee.

He then applied the suretyship doctrine that one who pays a debt due to a third party—here, the United States—*other than as a volunteer* is subrogated to that third party's rights as against a creditor. Specifically, in a case such as this the effect of the surety's subrogation would be to grant it the right to withhold funds from the debtor (contractor), and by hypothesis, from the debtor's assignee or attorney-for-collection. The surety, being obligated by its bond to pay, was not a mere volunteer. The bank, though, *was*.¹⁹ The Court was thus faced with the question of "whether the equitable lien, which the bank claims it has . . . is paramount to the right of subrogation which unquestionably exists in favor of [the surety]."²⁰ The issue turned on the date on which the surety's rights arose. That date, the court held, was the date the bond was given, and so the surety was first in right.

Because the surety is subrogated to the rights of the United States, including the Government's right to retain ten percent of the contract amount as security for full performance, this "timing" conclusion was necessary to give the subrogation practical effect. For example, if the subrogation were held to have dated from the time of the surety's payment on its bond, and if that payment removed the right of the United States to continue holding the retainages, there would be no useful right to which the surety could ever be subrogated.²¹ Furthermore, if the surety's rights existed at the time of the assignment to the bank, the bank could receive no greater interest in the security fund than the contractor had, *i.e.*, the bank would be subject to the surety's claim.

Prairie State thus established several principles which were to become both influential and troublesome in later years: (1) the surety is subrogated to the rights of the United States—specifically in this case, the right to withhold payment to the contractor upon default; (2) its

¹⁹ 164 U.S. at 231. On the assumption that the bond and the loan were both given in normal course, this distinction seems tenuous. Certainly the bank's loan was voluntary. But so was the giving of the bond. The court's distinction was probably good textbook law, ascribing the element of voluntariness to the act of payment rather than to the act of promising to pay later. But one might question whether such an artificial definition should ever be related to potentially consequence-producing legal statuses: subrogee or lienor.

²⁰ *Id.* at 232.

²¹ This circularity became manifest in *Munsey Trust*, discussed in text at notes 65-74 *infra*.

rights arise at the time the bond is given; (3) a bank which later takes an assignment takes subject to those rights; and (4) the retained percentages exist for the security of the United States *and* the surety. It should also be noted that the bond obligation involved in *Prairie State* was for performance and not for the payment of laborers and suppliers, and the funds in question were retainages, not progress payments. These additional factors were not to go unnoticed in the later cases. Finally, the question of the actual use or misuse of the loan proceeds in furthering a defaulted project was considered by the Supreme Court to be a factor worthy of mention, but unfortunately not worthy of much discussion. This distinction, briefly alluded to in *Prairie State*, later became determinative in the Fifth Circuit's analysis of the problem.²²

The first important application of *Prairie State* came in 1906 when the Ninth Circuit Court of Appeals decided *Henningsen v. United States Fidelity & Guaranty Co.*²³ The facts of *Henningsen* differed from those in *Prairie State* in two respects. First, the contractor's default in *Henningsen* was his failure to pay materialmen and laborers, not—as in *Prairie State*—failure to complete the project. And second, the fund in question had been “earned”²⁴ by the contractor. The opinion does not indicate whether the fund was earned-but-unpaid progress payments, or whether it was retained percentages “earned” by full performance. The more interesting point is that the court apparently did not consider the distinction important.

Citing *Prairie State*, Judge Ross upheld the distinction between lenders and sureties so far as subrogation was concerned. The bank, being a mere volunteer “and under no obligation to loan its money,” was not entitled to assert the equitable doctrine of subrogation,²⁵ the surety, on the other hand, by paying the laborers and materialmen was subrogated to their rights against the contractor. That subrogation again related back to the date of the bond, making the surety prior in right to the bank, to whom the contractor had made an assignment after the bond had been issued. However, despite the fact that Judge Ross noted when the surety's rights arose, he left only to implication what might appear to be the next step in reaching his holding, *i.e.*, that the decision as to priority actually turns on the relative timing of the competing interests. Furthermore, in the course of his opinion Ross mentioned what could well have been an independent basis for deciding the case: it had not been shown that the loan proceeds were

²² See discussion in text at notes 76-77 *infra*.

²³ 143 F. 810 (9th Cir. 1906).

²⁴ *Id.* at 812.

²⁵ *Id.* at 813.

actually applied to the instant project.²⁶ But this observation too was left in the air. Thus, a banker reading the *Henningsen* opinion would be unable to say whether or not he could attain the superior right regardless of the timing of his loan vis-à-vis the issuance of the surety bond by "policing" his loan disbursements, or whether, conversely, he could attain priority by making a loan prior to the date of the bond regardless of how the contractor then used the funds.

Judge Ross can be forgiven, at least in part, for his less than syllogistic style, for he had a troublesome theoretical difficulty which he may have felt constrained to avoid. Assume, as the judge apparently did, that "timing" is a determinative issue. If the surety is subrogated to the materialmen as of the date of its bond, then as of that date the surety is a creditor of the contractor. But he is a general creditor only. Since the materialmen have no legal right to the contract proceeds as distinguished from the other assets of the contractor, the surety by its subrogation succeeds only to their "generalized" rights. In contrast, as assignee of the contractor's contract rights against the Government the bank had an equitable interest in a *particular* fund and therefore was not a mere general creditor. Thus if timing is the key, so that the bank takes the contractor's interest subject to the already existing rights of the surety, the case for the surety's priority can be made certain only if the surety's rights attach to that particular fund or if the lender's rights were also "generalized." The clearest way to generalize the lender's interest is to find that the proceeds of the loan were not used solely for the project from which the disputed fund was generated. Although Judge Ross pointed out that it had not been shown that the funds were so used, he did not articulate this problem. Thus the decision left open for future courts the task of deciding whether in payment bond cases timing alone is determinative or whether the nature of the bank's right as generalized or particular—depending upon whether its loan was utilized in construction or not—is also in issue.

Not surprisingly the bank in *Henningsen* appealed; and in 1908 the Supreme Court, citing *Prairie State* as controlling, affirmed the surety's victory.²⁷ Justice Brewer's opinion clarified nothing.²⁸ Instead,

²⁶ Certainly the bank cannot be justly said to have any sort of equity to the entire sum of \$5,041.79, for it is not pretended that in making its loans to *Henningsen* it was understood that he was to use all of the money so loaned in the performance of the contract in question.

Id. at 813.

²⁷ *Henningsen v. United States Fidelity & Guar. Co.*, 208 U.S. 404 (1908). The opinion of the Court was written by Mr. Justice Brewer.

²⁸ "It seems unnecessary to again review the authorities. It is sufficient to say that we agree with the views of the Circuit Court of Appeals, expressed in its opinion, in the present case [that only the surety was entitled to subrogation]." *Id.* at 411.

it added to the haze the gratuitous dictum that the United States had an "equitable obligation to see that the laborers and supplymen were paid."²⁹ The dictum was out of place in *Henningsen*, but was a harbinger of bright days for the surety companies.

At this point we can skip to 1940, and a banker's victory in a case decided just before the passage of the Assignment of Claims Act in that year. In *Town of River Junction v. Maryland Casualty Co.*³⁰ the factual distinctions were sliced in yet another way. Here, as in *Prairie State*, the surety had made payment under its *performance* bond and was subrogated to the rights of the United States. The fund in question comprised both retained percentages and, unlike that in *Prairie State*, progress payments earned before the contractor's default. The Fifth Circuit Court of Appeals held that *Prairie State* was controlling with respect to the retainages, which exist for the protection of both the United States and the surety.³¹ Progress payments, however, were a different matter.³² So long as the contractor was not in default, he was entitled to use the progress payments as he wished, including assigning them to a commercial bank as collateral for a loan.³³ The distinction was premised on the general proposition that the surety has a beneficial interest in all collateral pledged to the creditor by the general debtor, that is, in the retained percentages reserved to the United States by the contractor, but (by implication) that he has no such interest in the debtor's other assets, that is, in progress payments made prior to default. Distinguishing the retained percentages from progress payments in this way not only made doctrinal sense but, in the court's view, made practical sense as well: without some such guarantee "banks cannot safely lend. . . ." Also, "[t]he whole matter of public contracts will be seriously affected."³⁴

After the denial of certiorari³⁵ in *River Junction* it appeared that at least some degree of predictability had been inserted into the financing of Government projects. But the querulous could still point to a few problems. First of all, in *River Junction* the Fifth Circuit had indicated that the surety "probably" had a right to insist that the proceeds not be diverted from the job it had bonded.³⁶ Yet at the same

²⁹ Id. at 410.

³⁰ 110 F.2d 278 (5th Cir.), cert. denied, 310 U.S. 634 (1940).

³¹ Id. at 281. The court added, however, that the timing of the competing interests is again crucial: "In these retained percentages the contractor can give no one a right superior to that of the surety, for the surety's right dates from the making of the contract which pledged them." Id.

³² In a strong dissent, Judge Hutcheson read the prior cases as making no such distinction. Id. at 285-86.

³³ Id. at 281.

³⁴ Id.

³⁵ 310 U.S. 634 (1940).

³⁶ 110 F.2d at 281.

time the court had said: "The surety cannot object [to an assignment of a particular progress payment] on the ground that the contractor might divert the money, for he has agreed to trust the contractor until he defaults."⁸⁷ Secondly, the notion that the retained percentages existed for the surety's benefit might no longer stand up in a situation involving *payment* bonds.

Prairie State had determined that the surety succeeded to the United States' rights against the contractor, and so also against the contractor's assignee. Because the United States has a right to withhold job funds if a default in performance occurs, according to *Prairie State* the surety's rights would exceed those of the financing bank. However, since the United States does not have a legal obligation to pay materialmen and laborers this conclusion does not necessarily follow where payment bonds are concerned. To obtain priority in a payment bond situation, the surety would have to rely on the dictum in *Henningsen* that the Government does have an "equitable obligation" to pay the materialmen and laborers.⁸⁸ Only if this "equitable obligation" dictum is interpreted to mean that the United States has the right to withhold funds if the contractor fails to pay his bills, can the surety have the same priority position after responding on its payment bond as it did on the performance bond.

A third problem arises from the fact that *River Junction* was a town. The bank's claim in the federal cases had been based on its equitable lien rather than on its assignee's rights only because assignments of debts owed by the United States were invalid. As against a town, in other words in municipal public works cases, assignments of funds owed by the governing body might well be valid. Finally, in *River Junction* the payments had already been made to the bank; the town was not (as the United States in prior cases had been) holding the funds as stakeholder. In short, the bank's victory in *River Junction* was probably not sufficient cause for bacchanalian revelries among commercial lenders everywhere.⁸⁹ But a statute passed in 1940 was good for at least a small party.

⁸⁷ *Id.*

⁸⁸ See text at note 29 *supra*.

⁸⁹ The same cause reappeared before the Fifth Circuit in 1943, *Town of River Junction v. Maryland Cas. Co.*, 133 F.2d 57 (5th Cir. 1943). Following the 1940 opinion, the case was remanded for trial. The lower court found that the progress payment had not been earned, because not all of the contractor's obligations had been satisfied. The lower court had also found that the loan proceeds had not been used exclusively for this project, and thus entered judgment for the surety. The Fifth Circuit agreed with the first finding but disagreed with the result. Even if the assignment was ineffective because it had not yet been fully "earned," the bank's payments had gone to pay laborers and material suppliers, and to that extent the bank had relieved the surety of potential claims against its bonds. The surety, having chosen an equitable remedy (subrogation), will not be allowed to force the bank to disgorge payments it has received in return for its relieving

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With the threat of war rapidly increasing in 1940, the United States began to consider its national defense. Defense construction and material would have to be contracted for with private industry; that in turn meant that some method of financing defense contractors had to be found. Direct Government participation was out of the question; administrative efficiency dictated that private capital be mobilized. It was Congress' idea that passage of a statute removing the ban on assignments of claims against the United States would facilitate the private financing of national defense contracts by allowing lending institutions some degree of safe collateral security.⁴⁰ In the words of Representative Hobbs: "Nor will any bank in the United States take any risk on making a loan under the terms of this bill. The assignments permitted by the bill we are talking about will be good security; they can be safely accepted."⁴¹ The bill Hobbs was referring to became the Assignment of Claims Act of 1940;⁴² in form it was an amendment to an act of 1846 which had forbidden assignments of unmatured contract rights against the United States.⁴³ After passage of the Act, assignments of claims against the United States of \$1000 or more, made to banks or other financing institutions, were "valid . . . for all purposes"⁴⁴ if certain minimal requisites were satisfied; these included a requirement that the bond sureties be notified by the assignee that the claim had been transferred.⁴⁵ On the face of the statute, a bankers' victory over the sureties seemed assured. Not only would a bank no longer have to rely on its rights as an equitable lienor as it had in *Prairie State* and *Henningsen*, but it could now lay claim to the *only* valid assignment—an assignment "valid for all purposes." Consequently, a bank might allege, the surety's priority through subrogation has been displaced by the bank's statutory right to its assignment.

the surety. *Id.* at 59. The case was commented on unfavorably. See Comment, 56 Harv. L. Rev. 1168 (1943).

⁴⁰ House Comm. on the Judiciary, Permitting Assignment of Claims Under Public Contracts, H.R. Rep. No. 2925, 76th Cong., 3d Sess. 2 (1940).

⁴¹ 86 Cong. Rec. 13135 (1940). As will be more fully argued later, see text at notes 211-12 *infra*, Congress was concerned with "small" contractors. See, e.g., the dialogue between Representatives Sumners and Youngdahl, *id.* at 12557.

⁴² Act of Oct. 9, 1940, 54 Stat. 1029 (codified at 31 U.S.C. § 203 (1970)).

⁴³ Act of July 29, 1846, 9 Stat. 41 (codified at 31 U.S.C. § 203 (1970)).

⁴⁴ 31 U.S.C. § 203 (1970).

⁴⁵ The limitations after October 9, 1940 were few:

- (a) a government agency could still prohibit assignment by including an appropriate clause in its contract;
- (b) a claim could be assigned to only one party, and could not be further assigned;
- (c) in addition to notifying the bond surety, notice must be given to both the contracting officer and the disbursing officer.

See 31 U.S.C. § 203 (1970).

The first major case to test this bankers' hope was brought to the Fifth Circuit, the same court that five years earlier had given a victory to the bank financing a municipal public work.⁴⁶ The case was *Coco-nut Grove Exchange Bank v. New Amsterdam Cas. Co.*;⁴⁷ the facts were paradigmatic. In *Coconut Grove* the surety had paid supplymen and laborers under a payment bond, and had been awarded the unpaid progress payments by the district court.⁴⁸ Basing its decision on the Assignment of Claims Act of 1940, the Fifth Circuit reversed, and held that the bank was entitled to the funds, which, incidentally had already been paid over to it by the disbursing agency.

Only the bank, the court held, was a "bank, trust company, or other financing institution" under the 1940 Act, and so only the bank could claim a valid assignment. Furthermore, the effect of the Act was to grant the bank a priority over other claimants; why else would the statute require notice to the surety? And unless the language "valid for all purposes" speaks to the issue of rights as against third parties, that clause too would become mere surplusage.⁴⁹ Of course "validity" and "priority" are not the same concept.⁵⁰ But in the absence of discussion of priority in the statute, reading "valid for all purposes" as meaning "prior to competing claims" is not at all outrageous; it is, arguably, consistent with the legislative purpose of providing safe collateral to financing banks.⁵¹ As to the surety's claim of priority through its rights of equitable subrogation, the court quite correctly held that to acquire an equity superior to the assignee's legal rights the surety must show injury, not benefit from its competitor.⁵² In other words the bonding

⁴⁶ See discussion of *River Junction* in text at notes 30-37 supra.

⁴⁷ 149 F.2d 73 (5th Cir. 1945).

⁴⁸ *Id.* at 75. The lower court had also considered and rejected an assertion that the bank's claim was within the protection of the surety's bond. Similar claims were made both before and after *Coconut Grove*, and have been similarly rejected. See *First Nat'l Bank v. American Sur. Co.*, 53 F.2d 746 (5th Cir. 1931) (private construction contract); *Bank of Auburn v. United States Fidelity & Guar. Co.*, 295 F.2d 641 (5th Cir. 1961); *Boka Elec. Constr. Co. v. W.M. Chappell, Inc.*, 262 F.2d 718 (D.C. Cir. 1958); and cases collected in Annot., 127 A.L.R. 974 (1940), and Annot., 164 A.L.R. 782 (1946). This result obtains even if the bank can establish that its loan funds went to pay the claims of suppliers who would have rights under the surety's bond. *First Nat'l Bank v. American Sur. Co.*, supra at 748-49.

⁴⁹ 149 F.2d at 77.

⁵⁰ Although not in effect at the time of this decision, the current state of the law with respect to the assignment of contract rights clearly separates validity from priority. See U.C.C. §§ 9-201 ("General Validity of Security Agreement"), 9-312 (on priorities).

⁵¹ See text at note 40 supra.

⁵² 149 F.2d at 78-79. In his dissent Judge Sibley did not disagree in principle; rather, he would have remanded the cause for further findings on two issues: (1) the bank, to attain the equity accorded the bank in *River Junction*, would have to prove the use of its loan; and (2) the bank would also have to show that the progress payment now in question was actually earned by the contractor, and *not* earned by the surety's payments under its bond. *Id.* at 80-81 (dissenting opinion).

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companies would have no superior equity unless they could show that the contractor had diverted the proceeds of the bank's loan away from the project.⁵³

Coconut Grove, however, did not provide a firm resolution of any of the manifold problems arising from the central priority issue. In addition two other Supreme Court cases, decided at about the same time as *Coconut Grove*, muddled the waters.⁵⁴ Not since *Henningsen* had the Court spoken directly to the issue of bank-surety priorities, but a dictum that the Court dropped in the first of these two cases was to become of great interest to the rival claimants even though the surety was not a party to that action.

In *McKenzie v. Irving Trust Co.*,⁵⁵ the competing parties were a financing bank and the contractor's trustee in bankruptcy. The contractor had assigned and then paid over to the bank certain progress payments, alleged by the trustee to have been unlawful preferences, and thus voidable under section 60 of the Bankruptcy Act.⁵⁶ The dispute was properly decided on the narrow holding that the payments in question had not been made within four months before bankruptcy and thus were not within section 60's preference period. Pointing out that the surety did not appear to be a creditor,⁵⁷ and in addition, was not a party to this suit, Justice Stone went on to add, in dictum, that *even* if the surety were a creditor, it did not appear that its lien would be prior to the bank's. First, the surety had not perfected its assignment as against a trustee in bankruptcy of the contractor;⁵⁸ and second, the bank had received the proceeds before receiving notice of the

⁵³ If the bank's funds had actually gone into the project, it would have reduced the surety's maximum risk by roughly that amount. The surety would thus have been benefited by the bank's presence. Equity should not then aid the surety in defeating the legal rights of the bank. Subrogation, an equitable doctrine, is therefore inappropriate to the extent that it favors the surety at the bank's expense.

⁵⁴ *United States v. Munsey Trust Co.*, 332 U.S. 234 (1947), rev'g 67 F. Supp. 976 (Ct. Cl. 1946); *McKenzie v. Irving Trust Co.*, 323 U.S. 365 (1945).

⁵⁵ *Id.*

⁵⁶ Under § 60, "a preference is a transfer . . . on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing [of bankruptcy] . . ." 11 U.S.C. § 96(a)(1) (1970). Any such preferential transfer can be set aside by the trustee, and the payment recouped for the benefit of the bankrupt's estate. 11 U.S.C. § 96(b) (1970).

⁵⁷ 323 U.S. at 372. Justice Stone's answer is not free from doubt. 11 U.S.C. § 96 (1970), unlike § 110(e), does not require the actual existence of a competing creditor. The transfer (payment) is complete when it is so far perfected that no creditor *could* acquire a lien. It is an issue of law, not of fact; the non-existence of such a creditor is unimportant. 11 U.S.C. §§ 96(a)(2), (3) (1970). And see § 96(a)(3): "The provisions of paragraph (2) . . . shall apply whether or not there are or were creditors who might have obtained such liens . . ."

⁵⁸ Nor could it have. The surety was not protected by the Assignment of Claims Act of 1940, since it was not a "bank, trust company, or other financing institution . . ." 31 U.S.C. § 203 (1970).

prior assignment to the surety. Justice Stone thus applied the basic rule governing priorities of successive assignees: since the surety and the bank are successive assignees, their rights are governed by the usual rules of priority. Receiving the proceeds of an assignment without notice of the competing assignee's claim gives the first recipient the higher equity.⁵⁹ However, Stone's dictum is obviously inadequate. It failed to consider the surety's peculiarly equitable claim to subrogation, and ignored the reasoning of both *Prairie State* and *Henningsen*. It treated the surety as an assignee with an invalid assignment, rather than as a subrogee, and by inference, without discussion, allowed the Act of 1940 to undo the mess that the courts had taken some forty-nine years to create. But if taken seriously, this unfortunate lapse of cerebration could create a problem as extensive as the one it seemed to resolve; the whole matter of priority might be decided on the fortuitous basis of the location of the disputed fund, for the bank would be protected by Justice Stone's dictum only if it had received the payments prior to receiving notice of the surety's claim.

With the "whole matter of public contracts" at stake,⁶⁰ the physical locus of the cash seems to be a signally ill-founded basis for decision. But exactly such a result was being caused by developments in another quarter. Under federal law the Court of Claims has jurisdiction in those cases in which the payments have *not* yet been paid over to any party, leaving the United States holding the funds as stakeholder.⁶¹ Less than a year before the *Coconut Grove* decision the Court of Claims, in *Maryland Casualty Co. v. United States*, had firmly placed itself in the surety's camp.⁶² This decision, like *McKenzie*, did not directly concern a bank-surety conflict but rather awarded a disputed fund to the surety as against the United States' attempt to set off unpaid taxes of the defaulting contractor. The Court of Claims felt that although the surety had undertaken the risk that the contractor would mismanage the funds, it had not undertaken the risk that it would be required to pay the "contractor's taxes or unrelated debts to the Government."⁶³ This and other like cases⁶⁴ made it very clear that sureties had friends in the Court of Claims, at about the same time *Coconut Grove* did the same for the banks in the circuit courts. Since

⁵⁹ For this rule Justice Stone relied on *Salem Trust Co. v. Manufacturers' Finance Co.*, 264 U.S. 182 (1924), which was *not* a public contracts case. It was a dispute between two assignees of one fund. According to *Salem Trust*, "If equities are equal, the first in time is best in right." *Id.* at 199.

⁶⁰ See text at note 34 *supra*.

⁶¹ Tucker Act, 28 U.S.C. §§ 1491, 1346(a)(2) (1970).

⁶² 53 F. Supp. 436 (Ct. Cl. 1944).

⁶³ *Id.* at 440.

⁶⁴ See especially *Royal Indem. Co. v. United States*, 93 F. Supp. 891 (Ct. Cl. 1950).

the choice of forum depends upon the location of the fund at the time of suit, it was this factor which, in effect, determined the result.

Shortly after *Coconut Grove* the Supreme Court again stepped into the fray, and by dictum created another relevant factual distinction: that the surety's priority position might well be limited to performance bond situations. In *United States v. Munsey Trust Co.*⁶⁵ the surety had made good on its payment bond obligation, and sought reimbursement from the retained percentages held by the United States.⁶⁶ The contractor, however, had breached another contract it had entered into with the United States, and the Government attempted to set off this amount against the retained percentages. Consistently with its prior holdings,⁶⁷ the Court of Claims held for the surety.⁶⁸ The Supreme Court reversed.⁶⁹ The surety in *Munsey Trust*, perhaps conceding that the United States had the right of set-off as against the contractor, argued that it was by its payments subrogated both to the laborers and materialmen whom it paid and to the United States.⁷⁰ Justice Jackson answered for the Court that laborers and materialmen do not have enforceable rights against the United States. Even if laborers and materialmen do have some equitable right, such as a lien on the retained percentages, the surety cannot win: if they have not been paid by the contractor the United States may retain the fund to continue to secure their payment as part of the contractor's performance of the contract. "In that case, how may the laborers and materialmen have a lien upon money which the United States may legally keep?"⁷¹ If they *are* paid, even if by the surety, their equitable right in any fund, including the retainages, evaporates, and so again the surety's subrogation to their rights yields the surety a fistful of dreams.⁷² As to the surety's subrogation to the rights of the United States, the Court noted that the retainages are kept only to insure completion of the work and not to secure the payment of the laborers and materialmen, a debt for which the United States is not liable. Since the security fund was not held to insure payment, the surety was not entitled to indemnification from that fund when it made good on the payment

⁶⁵ 332 U.S. 234 (1947), rev'g 67 F. Supp. 976 (Ct. Cl. 1946).

⁶⁶ Recall that even *Coconut Grove* had allowed the surety the higher priority in retainages, as opposed to progress payments, in a case involving a payment bond. See text at notes 47-50 *supra*.

⁶⁷ See *Maryland Cas. Co. v. United States*, 53 F. Supp. 436 (Ct. Cl. 1944).

⁶⁸ 67 F. Supp. 976 (Ct. Cl. 1946).

⁶⁹ 332 U.S. 234 (1947).

⁷⁰ *Id.* at 240.

⁷¹ *Id.* at 241.

⁷² *Id.* at 242.

bond.⁷³ This last conclusion appears unnecessary, especially in view of the Court's more direct holding that the bonds are required for the materialmen's benefit, not for the Government's detriment: "It is the surety who is required to take risk [sic]. We have no warrant to increase risks of the government."⁷⁴ Thus, unlike the surety whose rights inure on fulfillment of a performance bond, the payment bond surety has no rights of the United States to which it can be subrogated.

Anyone trying to understand the state of the law prior to 1950, and apply that law to a given set of facts, would have to keep a number of balls in the air all at once:

- a) Does the case involve a payment bond, or a performance bond?
- b) Does the disputed fund consist of retained percentages, or of earned progress payments?
- c) Were the loan proceeds used to further the contract, or were they dissipated?
- d) Has the fund been paid over to the bank, or is the United States still a stakeholder?
- e) Did either the bank or the surety have notice of the other's interest at the time it received a payment?

Each of these variables had been used, if not relied upon, in one or more of the reported cases. But even being able to provide answers to the five questions would not produce any sure result. Some cases which considered one of the issues important ignored the others, and some of the issues were the products of ill-considered Supreme Court dicta, the future of which is always shaky.⁷⁵

Some of these uncertainties jelled in two cases reported in 1950, at least enough for us to see where the battle lines would ultimately be drawn. In that year the Fifth Circuit, in *General Casualty Co. of America v. Second National Bank*,⁷⁶ reaffirmed its prior position expressed in *Coconut Grove*, that so far as progress payments were concerned the bank has the higher priority. The court explicitly relied, in this later case, on the fact that all of the loan proceeds had indeed been used in the project; however, it ignored the question of the sort of bond involved.⁷⁷ In the same year the Court of Claims reiterated *its* position, as firmly pro-surety as the Fifth Circuit's was pro-bank, in what

⁷³ Id. at 243.

⁷⁴ Id. at 244.

⁷⁵ A more important criticism, to which detailed attention is paid in the text at note 379 *infra*, is that none of these variables can be demonstrated to have any real relationship to what the results *ought* to be.

⁷⁶ 178 F.2d 679 (5th Cir. 1949).

⁷⁷ According to the opinion, the surety apparently made payment under both bonds. Id. at 679.

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was to become something of a landmark opinion: *Royal Indemnity Co. v. United States*.⁷⁸

Royal Indemnity involved a payment bond surety and an assignee bank squabbling over a retained percentage still in the hands of the United States. The Court of Claims held for the surety, noting that there was no evidence of the proper or improper use of the loans, and that because the bank is held to be aware of the Miller Act it had notice of the surety's interest under the bond contract. The bank cited the Assignment of Claims Act and its application in *Coconut Grove*, but without success. The Act, the court held, speaks only of validity, not of priority. Before the Act was passed in 1940 any assignment of an unliquidated claim against the United States was held to be null and void. The Act provided that a contract claim against the United States *could* be assigned before maturity for the purpose of securing credit. However, the long-standing principle that an assignee with notice of a prior assignment takes subject to it "was not legislated away by the 1940 Act."⁷⁹ Arguing further, the bank cited the *Munsey Trust* dictum that laborers and materialmen had no legal rights against the Government or in the job funds in the Government's hands, but again to no avail. The court concluded that the surety's priority awarded to it in both *Prairie State* and *Henningsen* was too firm to be overturned by a mere dictum. *Munsey* was explained away on its facts: there the Government had its own rights to assert when attempting the set-off; here the Government is a mere stakeholder in a case involving bank-surety priorities.

The Court of Claims was thus squarely in conflict with the federal courts, most notably with the Fifth Circuit.⁸⁰ The conflict was a more or less natural result of the peripatetic development the earlier cases had fostered: there were so many ways to slice the facts that it was almost inevitable that some courts would decide their cases by criteria thought unimportant by other courts. Despite the variety of approaches to the problem, however, the principal head-on collision that had occurred by 1950 was that involving the correct reading of the phrase "valid for all purposes" in the 1940 statute—the Fifth Circuit seeing in it a statement about priorities, and the Court of Claims seeing only a provision validating assignments of unliquidated claims against the United States, which assignments had theretofore been invalid. The

⁷⁸ 93 F. Supp. 891 (Ct. Cl. 1950).

⁷⁹ *Id.* at 895.

⁸⁰ Speidel has attempted a reconciliation of *Royal Indemnity* and *Coconut Grove*, and has done so brilliantly. I must, however, dissent from his conclusion, largely because of my own retracing of the steps which led to the conflict. See Speidel, "Stakeholder" Payments Under Federal Construction Contracts: Payment Bond Surety vs. Assignee, 47 Va. L. Rev. 640, 651-54 (1961).

other conflicts were less clear-cut. Indeed, it is fair to sum up the situation in 1950 by saying that there were still enough viable theories to provide almost anyone with a plausible argument for almost any set of facts. In 1951, however, Congress again enmeshed itself in the public contracts area by passing an amendment to the 1940 Act. This amendment was the focal point around which the next round of litigation arose.

B. *The 1951 Amendments to the Assignment of Claims Act, and Cases Since 1951*

With the onset of the Korean conflict, national defense again became a pressing need, and concomitantly, so did the need for financing government contractors. A number of obstacles had to be removed if the need were to be met. In 1949 and 1950 the Comptroller General of the United States had ruled that amounts due the United States for a contractor's unpaid taxes or other debts could be set off against the progress payments even if the payments had been validly assigned to the financing bank.⁸¹ Congress found that the value of the contract rights as collateral security was thereby severely reduced, deterring banks and other financing institutions from making loans to government contractors.⁸² The cure Congress provided was the 1951 Amendment to the Assignment of Claims Act, which provided that an assignee who had received a payment would be immune from making refund, restitution or repayment if the source of the assignor's liability was extrinsic to the particular contract in question.⁸³

The effect of this amendment was to support the district and cir-

⁸¹ No. B-79413, 29 Comp. Gen. 40, 42-46 (1949); No. B-95362, 30 Comp. Gen. 98, 99-101 (1950).

⁸² House Comm. on the Judiciary, Amending the Assignment of Claims Act of 1940, H.R. Rep. No. 376, 82d Cong., 1st Sess. 3 (1951). See also Senate Comm. on Banking and Currency, Assignment of Claims Act, S. Rep. No. 217, 82d Cong., 1st Sess. (1951).

⁸³ Act of May 15, 1951, 65 Stat. 41 (codified at 31 U.S.C. § 203 (1970); 41 U.S.C. § 15 (1970)). The bill was first proposed by the Board of Governors of the Federal Reserve System. In the Board's view,

Many defense contractors—especially the smaller manufacturers and producers—are presently unable to obtain necessary financing for the performance of their defense contracts because of the widespread reluctance of banks to make loans to them on the security of assignments of proceeds under their Government contracts. The reluctance of banks to provide such financing arises from the fact that certain recent rulings of the Comptroller General of the United States under the Assignment of Claims Act of 1940 have made it hazardous for private financing institutions to accept assigned contracts as collateral for loans. This situation has created a serious impediment to the success of the current V-loan program, authorized by the Defense Production Act of 1950, for the guaranteeing of loans by banks to defense contractors.

In order to meet this problem, the Board believes that the Assignment of Claims Act of 1940 should be amended to the extent necessary to remove the existing deterrent to participation by banks in the financing of defense contractors. Letter of Transmittal, reprinted at U.S. Code Cong. & Ad. Service 1414, 1416 (1951).

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cuit courts in a position that they had long held. In *American Fidelity Co. v. Nat'l City Bank*, decided in 1959, the Court of Appeals for the District of Columbia held that an assignee who had received progress payments in liquidation of its loan to the contractor would not be required to disgorge those sums to the performance bond surety.⁸⁴ By virtue of the 1951 amendment the United States could not recoup; consequently neither could the surety, who was subrogated to the United States' rights. As to payment bonds, the surety might still be subrogated to the rights of the supplymen, but they too had no right to recoupment from the funds actually paid to the assignee.

Predictably, the Court of Claims disagreed with this pro-banker holding.⁸⁵ The assignee is entitled under the amended 1940 Act only to money "due" under the contract. Since only those funds earned under the contract and not committed to payment for labor and materials could "become due," any payment to the assignee in excess of this amount is a payment made under "mistake of law," and the 1951 amendment does not cover such payments.⁸⁶ Thus, in the Court of Claims the timing of the payment determined the decision. If progress payments were turned over to the bank prior to the time that any default by the contractor occurred, the assignee could retain the funds,⁸⁷ but probably only if the proceeds of the assignee's loan had in fact been used by the contractor to reduce the surety's exposure, *i.e.*, had been applied to the project in question.⁸⁸ But as to funds *not* earned and paid prior to default (such as the retainages) the Court of Claims with great constancy awarded the surety priority, regardless of which bond was called on.⁸⁹ With respect to *payment* bonds, the circuit courts seemed to disagree with the Court of Claims. Relying sometimes on the amended 1940 Act, and sometimes on the strange reasoning of *Munsey Trust*, they failed to see how by subrogation to the rights of the supplymen—who under *Munsey Trust* had no rights—the surety could come up with anything resembling a solid claim.⁹⁰ The time was ripe for one final interjection by the Supreme Court.⁹¹

⁸⁴ 266 F.2d 910 (D.C. Cir. 1959).

⁸⁵ *Newark Ins. Co. v. United States*, 181 F. Supp. 246 (Ct. Cl. 1960).

⁸⁶ *Id.* at 248.

⁸⁷ *National Union Fire Ins. Co. v. United States*, 304 F.2d 465 (Ct. Cl. 1962).

⁸⁸ *Id.* at 468.

⁸⁹ See, e.g., *National Sur. Corp. v. United States*, 133 F. Supp. 381 (Ct. Cl. 1955).

⁹⁰ See *Phoenix Indem. Co. v. Earle*, 218 F.2d 645 (9th Cir. 1955) (surety vs. Internal Revenue Service); *American Sur. Co. v. Hinds*, 260 F.2d 366 (10th Cir. 1958) (surety vs. contractor's trustee in bankruptcy); and *American Fidelity Co. v. National City Bank*, 266 F.2d 910 (D.C. Cir. 1959).

⁹¹ The importance of the issue could hardly be ignored, at least if the volume of litigation is indicative of importance. The surety companies, for example, were being barraged with claims by materialmen and suppliers. The number of cases (*not* claims) in which they were involved was tabulated in 1956 by Stickells as follows:

*Pearlman v. Reliance Insurance Co.*⁹² was an appeal to the Second Circuit by the trustee in bankruptcy of a government contractor. The lower court had held,⁹³ and the Second Circuit agreed, that the surety, by subrogation to the rights of the laborers and materialmen whom it had paid, had acquired a preference to the earned contract funds. In so holding, the Second Circuit had knowingly deviated from the interpretation of *Munsey Trust* then current in the Ninth and Tenth Circuits,⁹⁴ and, if we can extrapolate from *Coconut Grove*, in the Fifth Circuit as well.⁹⁵ *Munsey Trust*, it was held, was limited to cases in which the United States asserted its own rights to the retained funds: "It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and subrogation"⁹⁶

Perhaps more to clarify its own prior meanderings than to resolve a conflict among the circuits, the Supreme Court granted certiorari.⁹⁷ Justice Black, writing the majority opinion, cited *Prairie State* for the proposition that the surety was entitled to the same rights the United States had in the contract retainages—namely, to hold them as security for full performance.⁹⁸ Black also recognized that the instant case con-

TABLE NO. 1
CIVIL CASES COMMENCED IN THE UNITED STATES DISTRICT COURTS DURING THE
FISCAL YEARS 1951, 1952, 1953, 1954 AND 1955 BY BASIS OF
JURISDICTION AND NATURE OF SUIT

Year	86 Districts	D.C.	Alaska, Canal Zone, Guam and Virgin Islands	Removed from State Courts	Total
1951	113	3	1	0	117
1952	243	0	2	0	245
1953	259	3	7	0	269
1954	419	8	13	2	440
1955	332	6	24	0	362
Totals:	1,366	20	47	2	1,433

Stickells, Bonds of Contractors on Federal Public Works—The Miller Act, 36 B.U.L. Rev. 499, 546 (1956). Stickells' discussion focused on the Miller Act. For contemporaneous general discussions of the Assignment of Claims Act, see Note, 68 Yale L.J. 515 (1959); Shnitzer, Assignment of Claims Arising Out of Government Contracts, 16 Fed. B.J. 376 (1956); and Nichols, Assignment of Claims Act of 1940—A Decade Later, 12 U. Pitt. L. Rev. 538 (1951).

⁹² 298 F.2d 655 (2d Cir. 1962). The case name before it reached the Supreme Court was *In Re Dutcher Construction Corp.*

⁹³ 197 F. Supp. 441 (W.D.N.Y. 1961).

⁹⁴ See note 90 *supra*.

⁹⁵ *Coconut Grove* was decided before *Munsey Trust*, but confirmed after, in *General Cas. Co. of America v. Second Nat'l Bank*, 178 F.2d 679 (5th Cir. 1950).

⁹⁶ 298 F.2d at 659.

⁹⁷ 369 U.S. 847 (1962).

⁹⁸ 371 U.S. 132, 138 (1962).

carried a payment, not a performance bond. As to that, *Henningsen*, wherein a result similar to *Prairie State* was reached, is decisive. *Munsey Trust* was characterized as a case wherein the Court had decided only the question of set-off; the dictum, which did not even cite *Henningsen*, certainly did not casually overrule such a venerable principle as the sureties' right to the suppliers' rights to the retained funds. It would seem, however, that Black's rereading of *Munsey Trust* is unconvincing, especially in view of the narrow holding of the case.

Notwithstanding the obscurity which the opinion may have cast on earlier issues, the holding was perfectly clear:

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.⁹⁰

Even though *Pearlman* did not concern itself with the more particular issue of sureties versus financing banks, its impact on that problem is unmistakable.¹⁰⁰ At least for retained percentages, the surety is subrogated to valuable rights, now under its payment bond as well as its performance bond. Presumably, *Pearlman* said nothing to the issue of earned progress payments paid to the assignee before default.¹⁰¹ On that item the Court of Claims and the federal courts agreed,¹⁰¹ so that too should be laid to rest. But other things to which *Pearlman* did not address itself, because no claim by an assignee was before it, were yet to be worked out. For one thing, would the surety's post-*Pearlman* rights attach also to earned but unpaid progress pay-

⁹⁰ Id. at 141. Justices Clark, Douglas and Brennan concurred in the result, but argued that the basis of the holding should have been the contractor's assignment of the fund (in the bond contract) to the surety, citing Justice Cardozo's opinion in *Martin v. National Sur. Co.*, 300 U.S. 588 (1937). Id. at 143-44 (concurring opinion).

On the issue of surety vs. assignee bank, *Martin* is obviously of no importance, especially after 1940 when only the bank could claim a valid assignment. If Clark's opinion had been the majority, and Black's the concurrence, *Pearlman* too would have been irrelevant on the priority issue. We can only speculate on the possibility that Black was aware of the effect his analysis would have on cases not then before him.

¹⁰⁰ *Pearlman* and *Dutcher* have been frequently commented upon. See, e.g., Note, 61 Mich. L. Rev. 402 (1962); Note, 9 N.Y.L.F. 226 (1963); Note, 24 Mont. L. Rev. 161 (1963); see also Note, 17 Rutgers L. Rev. 814, 821-22 (1963), noting that the majority opinion in *Pearlman*, unlike the concurrence, is so broad that it does not foreclose further development of the surety versus assignee bank situation.

¹⁰¹ See text at note 87 *supra*.

ments? If so, will the surety have a prior status over a perfected assignment? And if a bank is ever to win, must it prove that its loan proceeds were used to reduce the potential exposure of the surety? Finally, cutting across all of this, is the difference between payment and performance bonds to be continued for cases *not* involving retained percentages?

Clearly the pro-surety tendencies of the Court of Claims gained momentum, if not citable authority, from the Supreme Court's decision in *Pearlman*. It continued to hold that the Assignment of Claims Act governs only validity against the United States, not priority among rival claimants.¹⁰² To date, the surety has not lost a case in the Court of Claims.¹⁰³ For retained percentages, it is irrelevant that the loan funds were used in furthering the contract; nor does it matter what sort of a bond was involved.¹⁰⁴ The case is the same for progress payments not yet paid over, even if earned before default.¹⁰⁵ Thus, at this point in time, the Court of Claims will permit the assignee bank to retain only progress payments *earned and paid over* prior to default—and that position hardly connotes magnanimity on the part of the Court of Claims, since if the fund has been paid to the bank by the Government, the Court of Claims will not even have jurisdiction over the bank-surety dispute.¹⁰⁶ The case will, instead, be decided by the district courts and the circuit courts of appeal.

Moreover, although *Pearlman* did not speak directly to the priority issue, it has had its effect on those courts too, for recently the surety hasn't lost in the district¹⁰⁷ or circuit courts either. The Second Circuit, called upon to decide *Pearlman* a second time, in *In Re Dutcher Construction Corp.*¹⁰⁸ held that the reasoning of *Pearlman* should not

¹⁰² *United Pacific Ins. Co. v. United States*, 358 F.2d 966, 970 (Ct. Cl. 1966), citing *Royal Indemnity*.

¹⁰³ *Home Indem. Co. v. United States*, 433 F.2d 764 (Ct. Cl. 1970); *Fireman's Fund Ins. Co. v. United States*, 421 F.2d 706 (Ct. Cl. 1970); *Fidelity & Deposit Co. v. United States*, 393 F.2d 834 (Ct. Cl. 1968); *Home Indem. Co. v. United States*, 376 F.2d 890 (Ct. Cl. 1967); *Royal Indem. Co. v. United States*, 371 F.2d 462 (Ct. Cl. 1967), cert. denied, 389 U.S. 833 (1967).

¹⁰⁴ *Royal Indem. Co. v. United States*, 371 F.2d 462, 464 (Ct. Cl. 1967).

¹⁰⁵ *Fidelity & Deposit Co. v. United States*, 393 F.2d 834 (Ct. Cl. 1968).

¹⁰⁶ The court's jurisdiction derives from the Tucker Act, 28 U.S.C. § 1491 (1970), giving jurisdiction so long as the United States is a stakeholder, but not over what (after payment) is entirely a private dispute.

¹⁰⁷ *Compañia General de Seguros, S.A. v. First Nat'l City Bank*, 306 F. Supp. 1361 (D. Balboa, C.Z. 1969); *National Shawmut Bank v. New Amsterdam Cas. Co.*, 290 F. Supp. 664 (D. Mass. 1968). The surety is not, however, always successful as to assets of the contractor *other than* the contract funds. See *Aetna Cas. & Sur. Co. v. J. F. Brunken & Son, Inc.*, Civil No. 72-4036 (D.S.D., April 23, 1973), abstracted in 41 U.S.L.W. 2610 (D.S.D., May 15, 1973).

¹⁰⁸ 378 F.2d 866 (2d Cir. 1967).

be restricted to retained percentages.¹⁰⁹ Thereafter—although *Dutcher* did not directly involve a financing bank—its rule that the surety succeeded to the laborers' and materialmen's equitable rights to be paid from *all* earned funds remaining in the hands of the United States, had an echo in a case which *did*.¹¹⁰ Under such a rule, application of the loan proceeds to the contract becomes irrelevant,¹¹¹ as does *Coconut Grove* and its analysis of the Assignment of Claims Act,¹¹² for if the United States may withhold any sums from the contractor, it may do so from the contractor's assignee as well. Since *Pearlman*, then, the United States has been found to have an obligation to do just that whenever the materialmen and laborers are left unpaid, even though the fund in question may otherwise have been "earned" prior to the default.¹¹³ The surety, its subrogation reaffirmed by *Pearlman*, succeeds to these rights of the United States, and so has a higher claim than that of the contractor's assignee.¹¹⁴

The Supreme Court, while not squarely facing the bank-surety priority problem since 1906—when commercial financing and government contracting may have been far different from what they are today—has by dictum and tangential decision apparently limited the banks' victories to one narrow and unsatisfying case: when the bank has received and digested a progress payment actually earned, it may keep it. Otherwise, the collateral security seemingly guaranteed to it by the Assignment of Claims Acts of 1940 and 1951 isn't worth a nickel in a priority race against the contractor's surety. The path which led to this state of affairs has been tortuous. It has been plagued

¹⁰⁹ Id. at 870.

¹¹⁰ *National Shawmut Bank v. New Amsterdam Cas. Co.*, 290 F. Supp. 644 (D. Mass. 1968). See also *Industrial Bank v. United States*, 424 F.2d 932 (D.C. Cir. 1970).

¹¹¹ 290 F. Supp. at 665 n.1.

¹¹² 424 F.2d at 934-35.

¹¹³ In several cases the surety has successfully made claims against the government, which had paid sums over to the contractor or its assignee after being notified that materialmen or laborers were being unpaid. *Hanover Ins. Co. v. United States*, 279 F. Supp. 851 (S.D.N.Y. 1967); *Home Indem. Co. v. United States*, 313 F. Supp. 45, 48 (W.D. Mo. 1970).

¹¹⁴ I have found but one case which tends to the contrary. In *New Amsterdam Cas. Co. v. Manufacturer's & Trader's Trust Co.*, 330 F.2d 575 (2d Cir. 1964), the bank had failed to notify the surety of its assignment under 31 U.S.C. § 203, as required. The surety sued the bank for some \$300,000 in paid-over progress payments. The district court dismissed the claim under Fed. R. Civ. P. 12(b)(6) and the circuit court reversed: "Plaintiff should have an opportunity to prove, if it can, that it was prejudiced by lack of notice." 330 F.2d at 576. What the court may have had in mind in uttering this statement is quite impossible to tell. However, the court did indicate that the notice provisions of the Assignment of Claims Act should not be entirely ignored, especially when the possibility of "prejudice" is present. If "prejudice," then, is a key determinant, it may be only a short further step to preferring the lender when the facts show that the bank's loan was of *benefit*, not *prejudice* to the surety. Unfortunately, the case has not been reheard at the appellate level; thus, only speculation can remain about the potential impact of this opinion.

with uncertainty, contradictions, and subtle distinctions of the first order. But what is far worse is that it may also be affected with commercial irrelevance: if there is some purpose to be served, or some debility to be avoided by granting either bankers or surety companies safe haven, why should that purpose be furthered or retarded by the fortuitous circumstance of the timing of the Government's payments? What we may well have here is the creation of social policy through the ailment of default. As shall be seen, this ailment was not limited to the federal courts. The state courts were quick to contract it.

C. *Developments in the States—and the Uniform Commercial Code*

Today, every state requires contractors on public works to furnish bonds for the protection of laborers and materialmen,¹¹⁶ for as is the case with federal projects, most states disallow liens against public works.¹¹⁶ Because these state acts serve the same purpose as the Miller Act, there has been a strong tendency in the several states to follow closely the decisions of the federal courts in working out the priority problems.¹¹⁷ In fact, at times the "tendency" has been an abdication of state law to the rules generated by the Supreme Court for federal cases.¹¹⁸ Given the close affinity of the state and federal bond-

¹¹⁶ E. Cushman et al., *Bonds on Public Works* (1972), reprinted from National Association of Credit Management, *Credit Manual of Commercial Laws* 1972, at 652 (1971), and citations to statutes therein contained. For a listing of the bond amounts, coverages and other requirements by State, see R. L. Ager, *Summary of Problems under State and Local Public Works Bonding Statutes*, Proceedings of the ABA Section of Insurance, Negligence and Compensation Law 261, 270-71 (1963).

¹¹⁶ G. Ashe, *Law of Public Improvement Contractors' Bonds* 11 (1966).

¹¹⁷ E.g., *Broward County, Florida Comm'rs f/b/o General Elec. Co. v. Continental Cas. Co.*, 243 F. Supp. 118 (S.D. Fla. 1965) (surety vs. assignee bank, state construction project); *Home Indem. Co. v. United States*, 433 F.2d 764 (Ct. Cl. 1970); *Southern Sur. Co. v. Merchants' & Farmers' Bank*, 176 N.E. 846 (Ind. 1931) (surety vs. assignee bank, state project); *National Sur. Corp. v. State Nat'l Bank*, 454 S.W.2d 354 (Ky. 1970); *First Nat'l Bank v. McHasco Elec., Inc.*, 141 N.W.2d 491 (Minn. 1966) (surety vs. assignee bank, municipal project); and see *Fidelity & Cas. Co. v. Indiana Nat'l Bank*, 216 N.E.2d 857 (Ind. 1966); *Aetna Cas. & Sur. Co. v. Perrotta*, 62 Misc. 2d 252, 308 N.Y.S.2d 613 (Sup. Ct. 1970). But cf. earlier cases, *Western Cas. & Sur. Co. v. Brooks*, 362 F.2d 486 (4th Cir. 1966) (state project, surety vs. contractor's trustee in bankruptcy; the court cited *Pearlman* as controlling, inferring that the Ohio Supreme Court would agree, id. at 490); *State v. A. D. Ingalls, Inc.*, 105 N.H. 244, 197 A.2d 214 (1964) (bankruptcy case, relying on *Pearlman*); *State Bank v. Danbar Contracting Co.*, 12 App. Div. 2d 416, 212 N.Y.S.2d 386 (1961), aff'd, 12 N.Y.2d 804, 187 N.E.2d 19, 235 N.Y.S.2d 835 (1962); *Levinson v. Linderman*, 51 Wash. 2d 855, 322 P.2d 863 (1958) (municipal contract, surety vs. assignee bank), distinguished in *Guthrie Investments, Inc. v. Bennett*, 63 Wash. 2d 697, 388 P.2d 955 (1964). But compare two cases contra, *Aetna Cas. & Sur. Co. v. Eastern Trust & Banking Co.*, 156 Me. 87, 161 A.2d 843 (1960) (a rare instance of a state court applying state law in a Miller Act dispute); and *Reliance Ins. Co. v. First Mississippi Nat'l Bank*, 263 So. 2d 555 (Miss. 1972) (granting priority to the bank over the surety on a municipal project, and not citing any of the federal cases). These last two cases really are the exceptions which prove the rule.

¹¹⁸ *Butler v. Pacific Nat'l Ins. Co.*, 375 F.2d 518 (9th Cir. 1967) (state project, surety

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ing statutes, such a development is quite natural and, so far as uniformity is concerned, it is probably desirable. It rests, however, on the assumption that the federal decisions are "right."¹¹⁹

Private contracts, however, are quite another thing. Owners of contemplated construction projects may, and very often do, require bonds that run in their favor, so that they too may have a completed, lien-free project after the dust has settled. The important distinction is that with respect to privately owned projects most state statutes provide that the subcontractors, materialmen and laborers *can* acquire liens to secure their rights to payment.¹²⁰ If they choose instead to rely upon their rights under a surety bond,¹²¹ the relationships are contractual, not statutory. For example, it would be possible to argue that a private owner who had required a supplymen's bond from his prime contractor, and who presumably paid for that bond through a higher contract cost, has no further obligation to see that the supplymen are paid. Although there are arguments that can be made to the contrary,¹²² most reported opinions have not discussed them. What has happened is that lawsuits between bankers and sureties have come, even in the private construction cases, to be governed by a federal rule fashioned to implement a federal policy which might or might not hold water in a private case.¹²³

vs. contractor's trustee in bankruptcy; cites *Pearlman* as the correct application of Ariz. Rev. Stat. Ann. § 34-221, subsec. A, par. 3 (Supp. 1972), id. at 520-21; *Reliance Ins. Co. v. Alaska State Housing Authority*, 323 F. Supp. 1370 (D. Alas. 1971) (state project, surety vs. assignee bank; cites *Prairie State*, *Henningsen*, and *Pearlman* as controlling, id. at 1372); *Philadelphia Indus. Corp. v. Upper Dublin Twp.*, 169 F. Supp. 725 (E.D. Pa. 1959) (municipal project, surety vs. assignee; holding premised on *Prairie State* and *Henningsen*, id. at 729).

¹¹⁹ I reject this assumption. See text at note 218 infra.

¹²⁰ An excellent review of the statutes in every jurisdiction is given in National Association of Credit Management, *Credit Manual of Commercial Laws* 1972, at 288-349 (1971).

¹²¹ This can be done either by formal written waiver of lien, or by failing to file timely notice, or otherwise.

¹²² One such argument may be that the rights in question apply to the cost the owner has already agreed to pay, *not* to the completed project itself. It is only through the device of subrogation that the former rights may be related to the latter.

¹²³ *Canter v. Schlager*, — Mass. —, 267 N.E.2d 492 (1971); see also *United States Fidelity & Guar. Co. v. First State Bank*, 208 Kan. 738, 494 P.2d 1149 (1972). The case dealt squarely with the surety-bank conflict, with the fought-over funds held by a private party. In holding for the surety the court cited *Pearlman*, noting "[t]his holding [*Pearlman*] is squarely applicable here . . ." Id. at 744, 494 P.2d at 1154. The discussion in the case centered about the retelling of *Prairie State*, *Pearlman*, *Henningsen* and *Munsey Trust*, id. at 741-46, 494 P.2d at 1152-55. About these the court said: "From our examination of the numerous authorities cited to us we are convinced that the foregoing represents the general rule, accepted overwhelmingly if not universally throughout the various jurisdictions in this country." Id. at 745, 494 P.2d at 1154. All of the prior Kansas cases were then methodically distinguished away. Id. at 745-49, 494 P.2d at 1155-58.

One case of equally recent vintage *did* recognize and discuss the possibility of disparate policy referents between public and private works. It was resolved, however, that there

This notion of a "private dispute" obviously appealed to the commercial banking community, just as the creeping federalism of *Pearlman* in the state courts appealed to the sureties. When the Uniform Commercial Code (hereinafter U.C.C.) became widely enacted in the early 1960's, a fresh store of ammunition came to the banks, or so they thought. The bankers had scored an early victory in the drafting process of the U.C.C. Section 9-312(5) as it appeared in the 1950 Draft of the Code read as follows:

[I]f the obligation secured by the earlier perfected security interest is a surety's . . . such security interest is subordinate to a later perfected security interest given to a secured lender who . . . enable[s] the debtor to perform the obligation for which the earlier secured lender is liable secondarily as surety or otherwise.¹²⁴

Presumably to ensure that the salt was rubbed well into the suretys' wounds, the comment superfluously added: "The lender who enables the construction work to proceed is by subsection (5) given priority over the claim of a surety who claims security for his contingent claim."¹²⁵

This section appeared in the 1952 text as 9-312(7), and the comment was expanded: "Although prior law on this point was obscure, this provision is in accordance with commercial understanding among the parties involved. . . . Subsection (7) adopts the principle of Coconut Grove . . . and rejects the contrary holding in Royal Indemnity"¹²⁶ We can now only guess what prompted this move. Perhaps the draftsmen felt that state law should be conformed to their view of the "real" meaning of the Assignment of Claims Act of 1940 (*i.e.*, that adopted in *Coconut Grove*); or perhaps they felt that the federal rule itself should be based on state law principles.¹²⁷ Whichever it was, it didn't matter, for the entire section was dropped from the next draft at the insistence of the Association of Casualty and Surety Companies.¹²⁸ The official position of the U.C.C. Editorial Board in 1953 was that the existing case law "should not be disturbed."¹²⁹ While

were none. *Framingham Trust Co. v. Gould-National Batteries, Inc.*, 427 F.2d 856 (1st Cir. 1970).

¹²⁴ U.C.C. § 9-312(5) (1950 draft).

¹²⁵ U.C.C. § 9-312, Comment 7 (1950 draft).

¹²⁶ U.C.C. § 9-312, Comment 9 (1952 version).

¹²⁷ A third possibility exists: the draftsmen may have thought that they were drafting federal law. See, e.g., the introductory language in § 2-318 of the Official Text: "[i]f this Act is introduced in the Congress of the United States . . ." At some point, evidently, there was the thought that the Code as a whole might become a federal statute.

¹²⁸ Recommendations of the Editorial Board for Changes in the Text and Comments of the Uniform Commercial Code 25 (June 1, 1953).

¹²⁹ *Id.*

some commentators have concluded that after this deletion the U.C.C. became totally irrelevant to the issue,¹³⁰ others have suggested that the Code's usual rule of priority¹³¹ will govern the banker-surety claims —i.e., the first to file gets the preference.¹³² Inevitably, that dispute has become the focus of the most recent round of cases and comments.¹³³

Except for the first case to speak to the issue of the coverage of Article 9,¹³⁴ the trend has been all downhill so far as the banks are concerned.¹³⁵ The leading case is *National Shawmut Bank of Boston v. New Amsterdam Casualty Co.*,¹³⁶ a dispute between a surety and a bank over progress payments due from a federal construction project. Even admitting that the dispute should be governed by state law, and not by a federal rule,¹³⁷ the First Circuit awarded the fund to the surety on the grounds of equitable subrogation. The U.C.C., the court felt, simply did not apply. From this conclusion there have been no exceptions to date, whether the source of the funds be a federal,¹³⁸ state,¹³⁹ or privately-owned¹⁴⁰ project. The reasoning of *Shawmut*, which has been echoed in most of the succeeding cases, was premised very largely on the language and drafting history of the U.C.C. On that score there

¹³⁰ Withers, *Surety vs. Lender: Priority of Claims to Contract Funds*, 10 Washburn L.J. 356, 365 (1971).

¹³¹ U.C.C. § 9-312(5)(a).

¹³² See 2 G. Gilmore, *Security Interests in Personal Property* § 36.7 (1965).

¹³³ A sampling of the comments includes: Withers, *supra* note 130; Hoffman, *The U.C.C.: Has It Changed the Pre-Code Banker-Surety-Contractor Relationship?*, 50 J. Com. Bank Lending 2 (Jan. 1968); Note, 69 Dick. L. Rev. 172 (1965); Cushman, *The Surety's Right of Equitable Priority to Contract Balances in Relation to the Uniform Commercial Code*, 39 Temp. L.Q. 239 (1966); and Note, 65 Colum. L. Rev. 927 (1965).

¹³⁴ *United States v. G.P. Fleetwood & Co.*, 165 F. Supp. 723 (W.D. Pa. 1958).

¹³⁵ The very next case after *Fleetwood* also arose in Pennsylvania: *Jacobs v. Northeastern Corp.*, 416 Pa. 417, 206 A.2d 49 (1965). Although *Jacobs* made a passing attempt to distinguish *Fleetwood*, the opinion clearly implied that *Pearlman*, not *Fleetwood*, contained the governing principles. *Id.* at 53, 55 n.8. The most recent opinion on this issue restricted the non-applicability of Article 9 to the contract funds, and required that with respect to *other assets* of the contractor the usual filing requirements applied to the surety as well as to the bank. See *Aetna Cas. & Sur. Co. v. J. F. Brunken & Son, Inc.*, Civil No. 72-4036 (D.S.D., April 23, 1973), abstracted in 41 U.S.L.W. 2610 (D.S.D., May 15, 1973).

¹³⁶ 290 F. Supp. 664 (D. Mass. 1968), *aff'd*, 411 F.2d 843 (1st Cir. 1969).

¹³⁷ See *Eric R.R. v. Tompkins*, 304 U.S. 64 (1938).

¹³⁸ *National Shawmut Bank v. New Amsterdam Cas. Co.*, 290 F. Supp. 664 (D. Mass. 1968), *aff'd*, 411 F.2d 843 (1st Cir. 1969); *Home Indem. Co. v. United States*, 433 F.2d 764 (Ct. Cl. 1970).

¹³⁹ *General Elec. Supply Co. v. Epco Constructors, Inc.*, 332 F. Supp. 112 (S.D. Tex. 1971); *National Sur. Corp. v. State Nat'l Bank*, 454 S.W.2d 354 (Ky. 1970); *Aetna Cas. & Sur. Co. v. Perrotta*, 62 Misc. 2d 252, 308 N.Y.S.2d 613 (Spec. T. 1970).

¹⁴⁰ *Framingham Trust Co. v. Gould-National Batteries, Inc.*, 427 F.2d 856 (1st Cir. 1970); *United States Fidelity & Guar. Co. v. First State Bank*, 208 Kan. 738, 494 P.2d 1149 (1972).

were several points to be made, some or all of which found expression in *Shawmut* and its progeny.

First, the doctrinal development regarding the surety's rights to equitable subrogation in *Prairie State*, *Henningsen* and *Pearlman* demonstrates that those rights arise by operation of law; they are not creatures of contract so as to fall within the limited scope of Article 9.¹⁴¹ Second, the deletion of section 9-312(7) from the 1952 Draft clearly indicated that it was the draftsmen's intention to avoid disturbing the developing case law. Third, section 1-103 of the Code provides that "[u]nless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions."¹⁴² These "principles" of course are those developed by the Supreme Court from *Prairie State* to *Pearlman*. They have become "too hardly a plant to be uprooted by a Code which speaks around but not to the issue."¹⁴³

Very little hard thinking was done about whether the Code result would have been a *good* one:¹⁴⁴ whether the "first to file" rule of section 9-312(5)(a) would have a happier impact on the whole process of financing contractors than would the near-complete victory now guaranteed to the surety. Judge Coffin's concluding remarks in *Shawmut* characterize the historical development of the law of bank-surety priorities:

Our analysis has centered on the interpretation of the Code and of the doctrine of subrogation as developed by the cases [I]t may well be—although we express no opinion—that to subject sureties to the filing requirements of the

¹⁴¹ U.C.C. § 9-102(2): "This Article applies to security interests created by contract"

¹⁴² U.C.C. § 1-103.

¹⁴³ *National Shawmut Bank v. New Amsterdam Cas. Co.*, 411 F.2d 843, 849 (1st Cir. 1969). Those courts which have found the U.C.C. inapplicable have in effect ignored the fact that the "scope" provisions of Article 9 have not changed materially since 1952. By at one point having § 9-312(7) in the Code the draftsmen must certainly have thought that the surety would come within the purview of Article 9. Deleting § 9-312(7) from the 1952 Draft because, perhaps, it unfairly gave the banks a priority in every case regardless of the relative timings or equities of the positions, therefore does not establish present inapplicability. To the contrary, its one-time presence affirms it. Thus, Professor Rudolph's difficulty with § 9-104(f) evaporates, since at one point both §§ 9-104(f) and 9-312(7) existed in the same draft. Consequently, § 9-104(f) could not have been meant to exclude sureties. Rudolph, *Financing on Construction Contracts Under the Uniform Commercial Code*, 5 B.C. Ind. & Com. L. Rev. 245, 246 (1963).

¹⁴⁴ *Aetna Cas. & Sur. Co. v. Perrotta*, 62 Misc. 2d 252, 308 N.Y.S.2d 613 (Spec. T. 1970), is more or less typical. The court was more concerned with the policy of the Code and the legal characterization of the transaction within the Code definition of "security" than with the question of sound result. *Id.* at 257, 308 N.Y.S.2d at 618. See also *National Shawmut's* discussion of the U.C.C. § 1-201(37) definition of a security interest. 411 F.2d at 845-46.

Code would improve and rationalize the system of financing public contracts.¹⁴⁵

II. CRITICISMS OF LEGAL THEORY: A CRITIQUE OF PURE REASON

To the extent that it is symptomatic of a more general tradition of judicial decision-making, Judge Coffin's comment is disturbing. The fact that the Code was deemed "not compelling"¹⁴⁶ on its face, as to its coverage of the law of bank-surety priorities, points up the major flaw in the development of the law in this area: that traditional legal analyses have been insufficiently informed by considerations of practical impact and the furtherance of social policy.

It is therefore appropriate to critique¹⁴⁷ this seventy-seven year process from two points of view. One will test the rules as they are announced, by measuring them in terms of their effects on the real world. The other is a more traditional review of the lines of analysis, synthesis and exposition actually employed by the courts. The former is treated in a later section;¹⁴⁸ the latter, here.

A. *The Government's Obligation to Materialmen*

Of central importance to the current pro-surety fabric of the law are the propositions that (a) the laborers and materialmen have a right to be paid by the Government, and (b) the Government has a right to satisfy this obligation out of any funds not yet paid over to the contractor.¹⁴⁹ If either or both of these points is incorrect, then, at least in the payment bond situation, the surety's claim to priority as explicated in the cases lacks a convincing basis in law, since it is only by subrogation to these rights that the surety can support his claim to the retained funds. There are two sources from which these propositions could be derived. One source is the provisions in the Government's construction and bond contracts. The other is the Miller Act and its predecessor.

The clauses of a Government construction contract are standard and are dictated by Federal Procurement Regulations.¹⁵⁰ Those directly relevant here are Standard Forms 23 (Construction Contract),¹⁵¹ 23-A (General Provisions—Construction Contract),¹⁵² 21

¹⁴⁵ 411 F.2d at 848-49.

¹⁴⁶ Id. at 845.

¹⁴⁷ Not necessarily to criticize.

¹⁴⁸ See parts III and IV of text infra.

¹⁴⁹ See discussion and review of cases in text at note 113 supra.

¹⁵⁰ 41 C.F.R. §§ 1-16.900-903 (1972).

¹⁵¹ Id. at § 1-16.901-23.

¹⁵² Id. at § 1-16.901-23A.

(Bid Form—Construction Contract),¹⁵³ and 19-A (Labor Standards Provisions Applicable to Contracts in Excess of \$2,000).¹⁵⁴ It is in these required clauses that the Government's right or duty to withhold or set off payments must be found.

Form 23-A provides, "In making . . . progress payments, there shall be retained 10 percent of the estimated amount until final completion and acceptance of the contract work."¹⁵⁵ The purpose of the retainage is "for the protection of the government;"¹⁵⁶ *i.e.*, to compensate for the contractor's refusal or failure to complete the work,¹⁵⁷ or to compensate the Government for rejected materials, poor workmanship, or for breaches of warranty.¹⁵⁸ "Final acceptance" by the Government must be made as promptly as practicable after completion of the work required by the contract,¹⁵⁹ at which point the entire price must be paid to the contractor.¹⁶⁰ The only mention of materialmen and laborers in Form 23-A is a provision that if the surety becomes unacceptable the Government may require additional security for the supplymen's protection.¹⁶¹ More specifically, these contract clauses do not authorize the Government to withhold funds from the contractor who has completed the work but has failed to pay the supplymen. However, Form 23 obligates the contractor to abide by the provisions of Form-19A, one of which *does* permit the withholding of funds for the purposes of paying the contractor's *employees* their full wages and overtime.¹⁶² This clause, it should be noted, applies only to laborers, not to materialmen.¹⁶³ Thus, if the contractor's only default is his failure to satisfy the claims of materialmen, the United States may not withhold funds for their benefit. Ironically, it is materialmen who are most frequently left unpaid by the defaulting contractor.

The contract does, however, require the bidder to provide a payment bond,¹⁶⁴ which in turn obligates the surety to satisfy the materialmen if the contractor does not. While it is arguable that the terms of

¹⁵³ *Id.* at § 1-16.901-21.

¹⁵⁴ *Id.* at § 1-16.901-19A.

¹⁵⁵ *Id.* at § 1-16.901-23A, ¶ 7(c).

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at § 1-16.901-23A, ¶ 5(a).

¹⁵⁸ *Id.* at § 1-16.901-23A, ¶¶ 10(c), (f).

¹⁵⁹ *Id.* at § 1-16.901-23A, ¶ 10(f).

¹⁶⁰ *Id.* at § 1-16.901-23A, ¶ 7(e).

¹⁶¹ *Id.* at § 1-16.901-23A, ¶ 16.

¹⁶² *Id.* at § 1-16.901-19A, ¶ 6.

¹⁶³ It should also be noted that this clause did not exist during the early development of the law we have been discussing, but came into effect nearly three decades after the decision in *Henningesen*. The wage and labor standards which the clause is designed to enforce were enacted in 1935 by the Davis-Beacon Act, 40 U.S.C. §§ 276a to a-5 (1970), and in 1962 by the Contract Work Hours Standard Act, 40 U.S.C. §§ 327-33 (1970).

¹⁶⁴ 41 C.F.R. § 1-16.901-21 (1972). The bond itself is prescribed. See *id.* at § 1-16.901-25A.

the bond are thus incorporated by reference into the contract, such an argument does not carry us very far. The language is typical of penal bonds: "If the principal shall promptly make payment . . . then the above obligation [of the surety] shall be void and of no effect."¹⁰⁵ Incorporating such language into the primary agreement cannot obligate the contractor where previously he had not been obligated. So with the single exception of protecting the contractor's employees the Government does not have a right by contract to withhold payments earned by performance.¹⁰⁶ Thus, the proposition that the Government has an obligation to pay unsatisfied material suppliers cannot be derived from the Government's contract terms. The only other source for finding such an obligation is the statutory scheme as laid out in the Miller Act.

As early as 1894, two years before the *Prairie State* decision, the United States required its contractors to provide bonds for the protection of laborers and materialmen who would otherwise be without remedy.¹⁰⁷ The original statute, known as the Heard Act, required a

¹⁰⁵ *Id.* The Court of Claims has held that the terms of the bond are incorporated by reference, and therefore the contractor's failure to pay materialmen is a breach of the agreement between the contractor and the United States. *Fireman's Fund Ins. Co. v. United States*, 421 F.2d 706, 708 (Ct. Cl. 1970). See also *Continental Cas. Co. v. United States*, 169 F. Supp. 945, 946-47 (Ct. Cl. 1959). Such a view has been rejected. See, e.g., Comment, 31 *Fordham L. Rev.* 161, 162 (1962).

¹⁰⁶ This conclusion is buttressed by Federal Procurement Regulations § 1-30.524, 41 C.F.R. § 1-30.524 (1972): "The rights reserved . . . are for the purpose of protecting the interests of the Government . . ." The rights referred to do not include withholding for non-payment of materialmen.

¹⁰⁷ "The problem always is that the contractor has absconded or is hopelessly insolvent; so unless the surety can be forced to pay, subcontractors and materialmen have no hope of recovery." White, *The Miller Act, No More Tears for the Second-Tiers*, 74 *Com. L.J.* 41 (1969).

Wage-earners (laborers) have similarly scant protection, although they are granted a priority position among other creditors if the contractor is in bankruptcy by § 64(a)(2) of the Bankruptcy Act, 11 U.S.C. § 104(a). The priority is limited to \$600 per claimant, and can be asserted only for wages earned within three months preceding the commencement of the bankruptcy proceedings. In *re Sheik Products, Inc.*, 141 F. Supp. 463 (S.D.N.Y. 1956), *aff'd*, 242 F.2d 375 (2d Cir. 1957), *cert. denied*, 355 U.S. 833 (1957). This priority, however, is almost always illusory, for the greatest number of business bankruptcies are "no asset" cases:

	1946	1950	1960	1969
No asset cases	72%	72%	75%	70%
Nominal asset cases	13	10	12	15
Asset cases	15	18	13	15

Even in those 25% of all cases in which there are assets, the priority creditors typically receive about 35.5 cents to the dollar. Brookings Institution, *Bankruptcy, Problem-Process-Reform* 20-21 (1971).

As to contractors working specifically on public projects, the risk of insolvency is severe. "As most contracts for public work are awarded on the basis of competitive bid-

bond but did not in any way obligate the United States to make payment to the suppliers.¹⁶⁸ So far as the legislative intent of the original Act is concerned, there is no evidence that any obligation on the part of the Government—equitable or otherwise—was contemplated.¹⁶⁹ Neither did the later amendment to the Heard Act add anything to that effect.¹⁷⁰ The Miller Act, which replaced the Heard Act in 1935, is on its face similarly lacking in commentary on this issue.¹⁷¹ To the extent that the purpose of the statutory requirements can be gleaned from their legislative history, it is fair to conclude that little, if any, thought was given to the equitable or legal obligations of the United States.

The bond required by the Heard Act was unitary—it covered both the payment *and* performance obligations of the contractor. Consequently the statute required that all claims be brought in one action not earlier than six months after the entire contract had been performed or terminated.¹⁷² Frequently the process of adjudicating the claims took at least another six to twelve months. As a result, persons who had supplied materials or subcontract services during the early phases of construction would often have to wait for as long as two years before being paid. In recognition of that hardship, a significant number of contractors (and, some think, sureties as well) were able to compromise claims at substantial discounts, often turning the laborers and materialmen's profitable contracts into stinging losses.¹⁷³

ding and in most instances the prime contractor uses, and is required to use, the lowest responsible bidder in each of the subtrades, public work is normally carried on at a low profit margin [I]nsolvencies have [thus] not been infrequent." Burgess, A Commentary on the Miller Act, 42 B.U.L. Rev. 282 (1962). This fact has often been recognized by the building trades themselves. For an example of the level of interest credit managers of national materials suppliers have had in the enactment of bonding statutes in the several states, see Harms, *Where Do We Stand on Construction Payment Bonds?*, 74 Credit and Financial Management 18 (May 1972).

The United States needs protection only against default in performance, again because the suppliers have no possibility of acquiring mechanics' liens on public works. Prior to the Heard Act, ch. 280, 28 Stat. 278 (1894), the United States had as a matter of course required by contract that the contractor provide a penal bond going to performance. House Comm. on the Judiciary, Protection of Persons Furnishing Material and Labor for the Construction of Public Works, H.R. Rep. No. 97, 53d Cong., 1st Sess. (1893).

¹⁶⁸ Ch. 280, 28 Stat. 278 (1894), repealed by the Miller Act, 40 U.S.C. §§ 270a-d (1970).

¹⁶⁹ See, e.g., H.R. Rep. No. 97, *supra* note 167. Protection against an insolvent employer seemed "nothing more than just." *Id.* at 1.

¹⁷⁰ Ch. 778, 33 Stat. 811 (1905).

¹⁷¹ Actions against the surety are to be brought in the name of (*not* against) the United States, although the United States is not liable for the costs and expenses of any such suit. 40 U.S.C. § 270b(b) (1970).

¹⁷² Ch. 778, 33 Stat. 811 (1905).

¹⁷³ Letter from Acting Secretary of the Treasury Gibbons to Rep. J. M. Mead, Feb. 23, 1934. Hearings before the House Comm. on the Judiciary, Bonds of Contractors on Public Works, 74th Cong., 1st Sess. 38-39 (1935).

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By permitting suppliers to make their claims ninety days after *they* have finished rather than six months after the *project* is completed, the Miller Act attempts to correct this evil. That this was the purpose behind the Act's adoption is as readily demonstrated from its legislative history¹⁷⁴ as is the complementary conclusion that it was not the intention or perception of Congress that the United States, *as the owner of a construction project*, had an obligation to pay laborers and materialmen.¹⁷⁵ It was, rather, the intention of Congress that the United States *as a government* should recognize and remedy a commercial evil.

This separation of roles of the United States is important. In its capacity as a government it had the responsibility to pass laws which would preserve the orderly conduct of social affairs, regardless of who the interacting parties may have been. In its role as builder, however, it is acting with respect to contractors and their suppliers only as an owner, and as a party to commercial agreements. It is therefore not permissible to infer from the fact of passage of protective legislation that the United States in its role as a contracting party was assuming an obligation to further the protection it had in another capacity granted. This conclusion is further strengthened by the fact that as a party not involved in the contractor-materialmen transactions, the United States is not even governed by the legislation it had enacted,

¹⁷⁴ House Comm. on the Judiciary, Bonds of Contractors on Public Works, H.R. Rep. No. 1263, 74th Cong., 1st Sess. 1-2 (1935); Senate Comm. on the Judiciary, Bonds to Accompany Contracts for Government Building Construction, S. Rep. No. 1238, 74th Cong., 1st Sess. (1935) (adopting in toto H.R. Rep. No. 1263, *supra*); Hearings, *supra* note 173; 79 Cong. Rec. 11702 (1935). Two excellent general discussions are Note, The Application of the United States Arbitration Act to Miller Act Suits, 50 Va. L. Rev. 105, 122-26 (1964), and Stickells, Bonds of Contractors on Federal Public Works—The Miller Act, 36 B.U.L. Rev. 499, 501-07 (1956).

There was one other difficulty under earlier law which the Miller Act was designed to avoid. Under the Heard Act the materialmen could recover only for supplies "actually consumed" in the project. Currently, delivery ("expected consumption") is generally sufficient. Byrne & Costello, The Evolution of Coverage Under the Miller Act, 28 Fordham L. Rev. 287, 290-94 (1959). For additional commentary on the problems of coverage of the act, see Burgess, A Commentary on the Miller Act, 42 B.U.L. Rev. 282 (1962).

¹⁷⁵ The sole indication to the contrary appeared during final consideration in the Senate, 79 Cong. Rec. 13382 (1935):

Mr. WALSH. As I understand, the bill will require a contractor, in furnishing a bond, not only to be liable for default by reason of his inability to complete the contract or by reason of failing to meet the requirements and specifications as to material, but will require him to meet the claims of workers and employees who do not receive their compensation.

Mr. BURKE. That is the point exactly.

This exchange is in sharp contrast with the balance of the legislative history, and is most probably the result of a hurried attempt at passage, and a quick response to an obviously favorable inquiry. In spite of this exchange, it has been concluded elsewhere that the "obligation" of the United States, laid down in *Henningson*, is not dependent on the Miller Act. Comment, 31 Fordham L. Rev. 161, 168 (1962). See also Note, 9 N.Y.L.F. 226, 228-29 (1963), citing the above portion of the Congressional Record.

other than merely to require the contractor to provide the mandated protection (the bond) to the suppliers.

In summary, neither the "equitable obligation" to satisfy the suppliers and laborers, nor the right to withhold contract funds when a supplier is left unpaid, can be found in either the contracts into which the United States enters, or in the statutes it has enacted. How, then, did *Henningsen* find such an obligation, and *Pearlman* find such a right? Neither case gives any clue.

Saying that a party who has received a benefit for which it agreed to pay cannot retain the agreed price as against one who has conferred the benefit, is not only satisfying to the equitable instincts, it is also good law. If the disputes really were between the United States and the subcontractors and materialmen, it would be easy to conclude that if allowed to retain the fund, the United States would be unjustly enriched. Making restitution to the suppliers would then clearly be an "equitable obligation" of the United States.¹⁷⁰ Such a principle, however, has no application to the instant problem. The disputes are *not* between the United States and the unpaid materialmen.

The materialmen have in every relevant case been adequately compensated by their rights against the payment bond. Thus as against *them*, the United States is not unjustly enriched by retaining the fund; consequently it has no obligation to pay. The United States does, however, often retain a fund which should be paid to someone. If both the surety (by payment under its bond) and the bank (by application to the project of its loan proceeds) have made contributions to the project, then as against either or both of them, the United States may have a duty to effect restitution. What this analysis does *not* do, is to give any indication as to which of those two competitors should have a prior right.

But this analysis *does* lead to two salient points. First, the "equitable obligation" to pay materialmen and suppliers upon which the cases have ultimately come to rest cannot be demonstrated to have any solid legal foundation. And second, the issue of application of the loan proceeds—which some of the cases began to develop but which is now considered irrelevant—can be shown to be a crucial threshold issue. If, for example, the bank has *not* seen to it that its loan was used to further, or to free other funds to further, the instant project, then it should be summarily disregarded as a claimant if "equitable obligations" are deemed important. But if the bank has policed its

¹⁷⁰ Restatement of Restitution § 1 (1937). However, see *id.* at § 110: "A person who has conferred a benefit upon another as the performance of a contract with a third person is not entitled to restitution from the other merely because of the failure of performance by the third person."

customer's use of the loan in an appropriate way, then its claim to the equitable obligation is equally meritorious with that of the surety. Who should ultimately be favored in such a case cannot, it is suggested, be determined on these grounds. To resolve it we must look more directly at the surety's right to subrogation and the bank's statutory right to its assignment.

B. *The Theory of Subrogation*

The surety's right to the retained percentages and unpaid progress payments is predicated on its claim to subrogation. After *Pearlman*, sureties can be subrogated to the rights of the contractor, the United States, and the laborers and materialmen whom it has paid,¹⁷⁷ and, as has previously been indicated, the success of this equitable substitution could vary greatly, depending upon what claims have been satisfied under the bond.

If the contractor has failed to pay its employees or has defaulted on the performance of the contract, the United States has the right as against the contractor—and, arguably, against the contractor's assignee—to withhold further progress payments. However, the Government does not have a contractual or statutory right to stop its payments if the only default has been a failure to satisfy the claims of suppliers and subcontractors.¹⁷⁸ Thus, in the latter case, the surety by its subrogation to the United States should acquire no rights as against the financing bank. Nor in any case will subrogation to the contractor's rights to the fund be of any help to the surety, since the contractor has typically assigned its claims to the surety's competitor, the assignee bank.

The rights of the materialmen are only a bit more difficult to sort out. While these parties certainly have contract claims against the principal obligor, they do not have specific rights in the retained fund. They are, consequently, general creditors of the contractor. As against a party who has perfected a security interest in a particular asset, such as the contract proceeds, their claims are of subordinate status.¹⁷⁹ The surety who succeeds to these claims should thus also be subordinate to a creditor with a perfected assignment.

¹⁷⁷ See text at note 98 *supra*.

¹⁷⁸ The government *does* now have a right to stop payment if laborers are unpaid.

¹⁷⁹ U.C.C. § 9-201. The inapplicability of the U.C.C. to the surety's right of subrogation discussed in text at notes 134-40 *supra*, does not undercut the fact that state law still governs the rights of the parties to the assignment and of the general creditors. The non-applicability cases only held that the right of subrogation survived the enactment of the U.C.C. and that U.C.C. § 9-312 did not govern the priority question. The cases did not, however, disturb the fact that as state law, the Code nonetheless determines the nature of the underlying rights to which the surety lays claim.

This line of argument alone can provide little comfort to the financing banks, since it would secure a priority to them only in the instance of unpaid materialmen, but not for cases in which the surety has paid the contractor's employees, or—more importantly—when the surety has made good on its *performance* bond obligations. Thus, although all of the recent cases have come to ignore it, doctrinally speaking there is a distinct difference between the surety's status on its payment bond and on its performance bond obligations. But even with respect to defaults in performance, the surety's claims ultimately rest upon its equitable rights of subrogation.¹⁸⁰

Although there can be little argument that a Miller Act surety satisfies the usual criteria for entitlement to a right of subrogation, there are certain limitations imposed by the law of suretyship which should be pointed out. First, as an equitable remedy subrogation is available only if there is no adequate legal remedy. Second, subrogation as a creature of equity may only be granted under circumstances of conscience. And third, subrogation may be contraindicated when its application would affect the equal or superior rights of third parties. Each of these limitations merits exploration.

1. *Adequacy of the Legal Remedy*

The U.S. Supreme Court, both before and after its decisions in *Prairie State* and *Henningsen*, affirmed the general requirement of equity jurisdiction, that there be an "absence of a complete and adequate remedy at law."¹⁸¹ The existence of a legal remedy for the Miller Act surety, and its "adequacy," are therefore crucial to the instant problem.

In its contract with the obligor, the surety inevitably insists upon the contractual right of indemnity,¹⁸² and upon an assignment to it of the contractor's interest in the proceeds from the contract.¹⁸³ The question, then, is whether by this assignment the surety has acquired a right at law and, secondarily, whether that is "adequate." Before 1940, assignments of claims against the United States were unenforceable, *except* for claims which were fully matured and liquidated.¹⁸⁴ Thus by virtue of its indemnity contract the surety could as a prac-

¹⁸⁰ For an excellent description of the consequences of this reliance on subrogation, as well as some of the additional doctrinal difficulties it represents, see Note, 71 Yale L.J. 1274 (1962).

¹⁸¹ *Payne v. Hook*, 74 U.S. (7 Wall.) 425, 430 (1860). See also *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 478 (1961).

¹⁸² E.g., *Fireman's Fund American, General Indemnity Agreement* (Form No. 360124-11.65) ¶ 2.

¹⁸³ *Id.*, ¶ 5. With this clause the surety takes an interest not only in the contract rights, but in the contractor's machinery, tools, materials, and subcontracts.

¹⁸⁴ See discussion in text at notes 43-44 *supra*.

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tical matter lay claim to the liquidated retainages. But even though its right to subrogation related back to the date of its bond, the surety could not acquire possession of the funds until it had satisfied the Government's demands. At that point the payment was matured, and the surety could make application to the Government under its assignment with the contractor.

The issue of existence of a "legal remedy" can be debated on other grounds as well. As has been shown, a surety could not enforce an assignment against an unliquidated contract obligation of the United States. Since the surety is not a "bank, trust company or other financing institution,"¹⁸⁵ the Assignment of Claims Act of 1940 did not alter this disability, as it did for the assignee bank. The disability, however, applied only to the United States; it did not affect the validity of the assignment between the surety and its assured:

[The anti-assignment Act] affords no protection to the parties to the assignment; . . . [it] does not nullify the contractual rights of the parties thereto . . . neither party may resort to the protection of the statute as against the other.¹⁸⁶

The statute existed for the protection of the United States, and was not designed to affect the rights of any other parties to the transaction.¹⁸⁷ Clearly, then, the surety did have some quantum of legal remedy; that of any assignee against its assignor for failure of the assigned claim to materialize.

The only remaining question is whether it was "adequate." This question, it is submitted, cannot be answered in the abstract. Certainly as between surety and contractor adequacy is not a problem. The issue becomes troublesome only if we ask about competitors, such as a financing bank. If the surety's legal rights to the contract funds are "inadequate" in a dispute with the financing bank, it can only be because it would otherwise be subordinated to that rival. That, in turn, requires the finding that the surety *should not* be so subordinated. Thus the threshold question is one of policy: whether surety or assignee bank should be given the prior status.¹⁸⁸ Until that question is resolved the surety cannot make out a clear case for its own subrogation. Those cases which have seen the issue in terms of the priority of subrogation over assignment have therefore failed to perceive the threshold question.

¹⁸⁵ 31 U.S.C. § 203 (1970).

¹⁸⁶ *In re Webber Motor Co.*, 52 F. Supp. 742, 744 (D.N.J. 1943). See also *California Bank v. United States Fidelity & Guar. Co.*, 129 F.2d 751, 753 (9th Cir. 1942).

¹⁸⁷ *Bank of California v. Commissioner*, 133 F.2d 428, 432-33 (9th Cir. 1943). The United States could, therefore, waive the statute when its interests were not in peril. *Id.*

¹⁸⁸ See text at notes 232 et seq. *infra*.

This adequacy of legal remedy point is especially important because of the enactment of the Uniform Commercial Code.¹⁸⁹ Under Article 9 the surety *can* acquire a legal interest in the contract rights,¹⁹⁰ even though recent cases have uniformly held that it *need* not rely on that right alone when competing for a retained fund.¹⁹¹ If the surety did choose to rely on the Article 9 rights available to it, by the exercise of a minimal degree of diligence it could easily acquire *legal* rights superior to those of the financing bank.¹⁹² The point is simply this: if the adequacy of legal remedy can only be tested against the rights the legal remedy grants to a surety as against competing parties, the possibility of the surety's success under state law makes the legal remedy not inadequate. Consequently, the equitable doctrine of subrogation may not be available. Equity should not protect a party who has voluntarily foregone a legal right.¹⁹³ In the words of one commentator, "Since the Code has provided a *legal* remedy for sureties . . . resort to the doctrine of equitable subrogation is superfluous and should be abandoned."¹⁹⁴

2. *Demands of Justice*

As an equitable remedy, subrogation can be invoked only in those cases in which justice demands its application.¹⁹⁵ As between the Miller Act surety and a commercial lender whose extension of credit has actually gone to reduce the surety's exposure on its bonds, it is difficult at best to argue that justice demands the application of subrogation for the surety's benefit. Those cases which have held that *because* of subrogation the surety must be preferred, have put the cart before the horse.

¹⁸⁹ Louisiana is the only state which has not enacted the U.C.C.

¹⁹⁰ U.C.C. § 9-102. See 2 G. Gilmore, *Security Interests in Personal Property* § 36.7, at 97 (1965).

¹⁹¹ See cases listed in notes 134-40 *supra*.

¹⁹² U.C.C. §§ 9-312(5), 9-401, 9-302.

¹⁹³ Note, 69 Nev. L. Rev. 582, 593 (1969). Cf. Comment, 65 Colum. L. Rev. 927, 933 (1965); Hoffman, *The UCC: Has It Changed the Pre-Code Banker-Surety-Contractor Relationship?*, 50 J. Com. Bank Lending 2, 12 (Jan. 1968).

¹⁹⁴ Note, 69 Dick. L. Rev. 172, 177, 180 (1965). An example of an occasion when subrogation should be available to the surety is that of a contractor who has gone into bankruptcy, leaving wage earners to their rights against the bond. In such a case the surety's only possibility of adequate recoupment is its right to be subrogated to the employees' priority in bankruptcy, 11 U.S.C. § 104(a) (1970). See *In re Bessemer Materials, Inc.*, 225 F. Supp. 314 (N.D. Ala. 1963); cf. *Home Indem. Co. v. V.F.H. Donovan Painting Co.*, 325 F.2d 870 (8th Cir. 1963); 6 H. Remington, *Bankruptcy* § 2802 (5th ed. 1952); 31 U.S.C. §§ 191, 193 (1970).

In the case of unpaid employees, this priority in bankruptcy adds to the proposition that as against the financing bank the surety has a fair quantum of other rights available to it. For a general discussion, see Jordan, *The Rights of a Surety Upon the Default of its Contractor-Principal*, 41 Ore. L. Rev. 1 (1961).

¹⁹⁵ *J. G. Boswell Co. v. W. D. Felder & Co.*, 103 Cal. App. 2d 767, 230 P.2d 386 (Dist. Ct. App. 1951). G. Harris, *Law of Subrogation* § 6, at 8 (1889).

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This "demands of justice" requirement is the rationale behind another limiting feature of suretyship law: that one who pays the debt of another as a volunteer cannot be subrogated to the creditor's rights.¹⁹⁶ There are three classes of *non*volunteers: those who act under the necessity of self-protection; those who act at the request of the debtor and whose payments are favored by the public; and those who act in performance of a legal duty, arising either by express agreement or by operation of law.¹⁹⁷

Neither the surety nor the bank falls within the first class; both fall equally within the second class;¹⁹⁸ but the surety has the marginal edge in the third class. As to that last point, it suggests a distinction which has not been either raised or recognized in the reported cases. The surety is obligated by its bond, even though the giving of the bond was as voluntary as was the making of the bank's loan. Quaere, then, whether a bank which extends a loan to cover payroll costs is not doing exactly the same thing as is the surety which pays out on its bond, if the bank is obligated to make such a loan under a mandatory future advance clause.¹⁹⁹ In short, the surety's edge on this score is marginal.

3. *Third Parties*

The "demands of justice" point has yet another consequence. Generally, subrogation can be applied for the benefit of one party only when it can be done without disturbing the rights of others.²⁰⁰ This principle is of ancient vintage,²⁰¹ but of continued vitality.²⁰² Subrogation is thus unavailable if by its application the rights of parties of equal or higher rank would be affected.²⁰³ Thus, regardless of the source of the right, it can be enforced only *after* the surety's claim is balanced against the claim of the assignee bank.²⁰⁴

In short, the surety's right to equitable subrogation as against an assignee bank is not as solid a proposition as the surety-bank priority

¹⁹⁶ *Prairie State Bank v. United States*, 164 U.S. 227, 231-32 (1896).

¹⁹⁷ 5 J. Pomeroy, *Equity Jurisprudence* § 2344, at 5184 (1919).

¹⁹⁸ The legislative histories of the Assignment of Claims Act of 1940, and of the 1951 amendment, clearly indicate that the bank's loan is as much favored by the public as are the surety's bonds.

¹⁹⁹ Our survey reported herein established that many contractors have firm lines of credit with their banks.

²⁰⁰ Harris, *supra* note 195, § 6, at 8.

²⁰¹ E.g., *Appeal of D. E. Robeson*, 117 Pa. 628, 12 A. 51 (1888).

²⁰² "Subrogation will not be enforced to the prejudice of rights of equal or higher rank." *St. Johnsbury & Lamoille County R.R. v. Skeels & Weidman, Inc.*, 124 Vt. 25, 30, 196 A.2d 485, 488 (1963).

²⁰³ *Federal Ins. Co. v. Allen*, 92 Cal. Rptr. 125, 13 Cal. App. 3d 648 (Ct. App. 1970); *Castleman Constr. Co. v. Pennington*, 222 Tenn. 82, 432 S.W.2d 669, 676 (1968); *Credit Bureau Corp. v. Beckstead*, 63 Wash. 2d 183, 385 P.2d 846 (1963).

²⁰⁴ Cf. *Castleman Constr. Co. v. Pennington*, 222 Tenn. 82, 432 S.W.2d 669 (1968).

cases would have us believe. To the extent that this proposition can be shown to be unfounded, the conclusions based on this proposition can be shown to be equally unfounded.

Two points can be drawn from this discussion of equitable doctrines inherent in the law of suretyship. First, the discussion has not proven that the surety is never entitled to subrogation. Rather, it demonstrates that by reference to legal doctrine alone the subrogation feature is not an irrevocable and compelling conclusion. It has shown further that the right to subrogation should be awarded only *after* the question of priorities has been examined in a policy framework, not—as the courts have done—awarded as a premise from which the priority issue can be deduced. *Prairie State*, which first made this error, can at least be credited with having made one absolutely correct decision. Although all but ignored by the most recent cases, *Prairie State* was correct in saying that deciding the issue of subrogation *vel non* does not per force decide the issue of priority. For that, we must inquire into the arguments available to the assignee.

C. *The Assignment of Claims Act*

As previously noted,²⁰⁵ until 1940 neither the financing bank nor the surety could lay claim to an assignment that would be "valid" against the United States. The purpose of this original anti-assignment law was to protect the Government—specifically, to minimize two potential difficulties: (1) the possible embroilment of the United States in conflicting claims, with the resultant possibility of double payment; and (2) the use of improper influence against agents of the United States by parties who originally had no interest in the transaction.²⁰⁶

Although avoiding embroilment in multiple claims is of primary concern, that purpose of the anti-assignment law is not thwarted when the United States' role is only that of a stakeholder for the rival claimants. Peril to the United States' interest does not exist in such a case since it is discharged from liability irrespective of the outcome of the

²⁰⁵ See discussion in text at notes 40-43 *supra*.

²⁰⁶ *Seaboard Air Line Ry. v. United States*, 256 U.S. 655, 657 (1921). See also *Patterson v. United States*, *Northwestern Nat'l Bank*, 354 F.2d 327, 329 (Ct. Cl. 1965); *United States v. Aetna Cas. & Sur. Co.*, 338 U.S. 366, 371 (1949); *Martin v. National Sur. Co.*, 300 U.S. 588, 594 (1937). More recent cases have supported this view, while expressing it somewhat differently: "The purposes of the Assignment of Claims Act were [(1)] to secure the Government against embroilment in multiple claims and subjection to possible double liability; (2) to insure that the Government will be able to avail itself of rights to setoff or cross-claims against the original claimants; and (3) to prevent persons of influence from buying up claims against the United States, which might then be improperly urged upon officers of the Government." *United States v. Improved Premises*, 204 F. Supp. 868, 871 (S.D.N.Y. 1962). See also *In re Goodson*, 208 F. Supp. 837, 845-46 (S.D. Cal. 1962).

private dispute.²⁰⁷ Consequently, the Government should be unconcerned with the relative equities of the claimants.²⁰⁸ Thus, unless it can be established that Congress saw some federal policy to be served by regulating the priority issue there is no reason for the dispute to be of federal concern.²⁰⁹ Twice in the past thirty-three years Congress had the opportunity to examine the question. On both occasions—the one in 1940, the other in 1951—the exigencies of national defense prompted the legislative action.

The Assignment of Claims Act of 1940,²¹⁰ spawned in the environment of increasing defense expenditures, was unequivocally intended by Congress to stimulate the use of private capital for the financing of government contractors,²¹¹ particularly small business contractors.²¹² By changing the law to allow assignments of claims to banks, trust companies and other financing institutions, Congress hoped to facilitate the ability of these contractors to procure the financing they would need in order to participate in public works.

As finally enacted, the statute said nothing with respect to the issue of priorities among competing assignees or between an assignee and other types of claimants such as subrogees. It simply provided that the bank's assignment would be "valid . . . for all purposes."²¹³ Standing alone, such a phrase is, and was, subject to two possible interpretations.²¹⁴ First, one could agree with the Court of Claims that validity and priority are not the same concepts, and that the bank's "valid" assignment may nevertheless be subordinate to the surety's

²⁰⁷ Precisely such a position was adopted by Mr. Justice Cardozo in *Martin v. National Sur. Co.*, 300 U.S. 588, 595 (1937).

²⁰⁸ *Id.* See also Note, 35 N.Y.U.L. Rev. 857 (1960): "Thus, although the assignment is not enforceable against the United States, the statute does not affect rights between the parties to the assignment."

²⁰⁹ See text at notes 232 et seq. *infra*.

²¹⁰ 31 U.S.C. § 203 (1970) (originally enacted as Act of Oct. 9, 1940, ch. 779, 54 Stat. 1029).

²¹¹ 86 Cong. Rec. 12556, 12559 (1940) (remarks of Rep. Sumners); *id.* at 13135 (remarks of Rep. Hobbs). In 1940 there were some six billion dollars available for this purpose in the reserves of private banks, which were "frozen" by the anti-assignment statutes then in force. *Id.* at 12560 (remarks of Rep. Wolcott).

²¹² This concern for small business contractors was expressed during both the House and the Senate considerations. See 86 Cong. Rec. 12803 (1940) (remarks of Sen. Barkley): "The object of the proposed legislation is to make it possible for smaller contractors to go to a bank or trust company and put up their contract as collateral security and borrow the money necessary to enable them to go on with the work." Rep. Hobbs remarked, "It will put idle money to work and gives the little man a chance." *Id.* at 13122. This was, in fact, the reason why the limit of \$1000 was substituted for the \$3000 figure originally proposed in the bill. See *id.* at 12557-60, 12803.

²¹³ 31 U.S.C. § 203 (1970).

²¹⁴ See *Coconut Grove*, discussed in text at notes 47-53 *supra*; cf. *Royal Indemnity*, discussed in text at notes 78-80 *supra*. On the notice to surety point, see *New Amsterdam Cas. Co. v. Manufacturers & Traders Trust Co.*, 330 F.2d 575 (2d Cir. 1964).

right of subrogation. On the other hand, the federal courts could point to the fact that *only* the bank could be an assignee. Congress, presumably aware of the Miller Act, must have intended to validate the bank's interest alone. Furthermore, the statute must have been directed to the priority issue, if for no other reason than that it requires the financing bank to notify the surety of the assignment to it. This latter point finds scant, but some, support in the legislative history of the 1940 Act. During the debates in the House, Rep. Wolcott (then a member of the House Banking and Currency Committee) confessed:

I do not see any particular reason why an assignee should have to give notice to the contracting officer or head of his department or agency. *There may be some justification for giving notice to the surety on the bonds which the contractor has to put up.*²¹⁵

In Rep. Wolcott's view, the notice requirement was a matter of "protection."²¹⁶ What protection such notice would give to a surety which had already issued the bond is unclear. It would be dubious protection at best, possibly only reminding the surety that it should be more attentive to its assured's affairs than it might otherwise be. Aside from this one comment, the House and Senate debates are silent on the priority issue. Thus, even though this one comment is not convincing on the issue of priorities, it does minimally *tend* to support the banker's interpretation.

The only additional piece of relevant information is the fact that around the time when Congress was considering the legislation "[a]n allocation agreement was proposed and seriously considered for the purpose of equitably distributing such funds between banks and sureties but unhappily it never came to fruition."²¹⁷ Without knowing the now lost details of those discussions, we can only speculate as to the expectations the bankers and sureties may have had at the time the statute was first drawn.

In short, neither the statute's language nor its legislative history can be considered conclusive as to the meaning of "valid for all purposes." What was intended by Congress, however, was clear: commercial banks should be encouraged to participate in defense contractor financing. It would appear, therefore, that to argue the priority issue on the basis of linguistics, as the courts have done, is to miss the point. Since the language is ambiguous, the only rationale available is an

²¹⁵ 86 Cong. Rec. 12560 (1940) (remarks of Rep. Wolcott) (emphasis added).

²¹⁶ *Id.*

²¹⁷ Nichols, Assignment of Claims Act of 1940—A Decade Later, 12 U. Pitt. L. Rev. 538, 539 (1951).

extrapolation from the declared policy. If validating assignments was meant to encourage banks to lend, allowing those same banks only a subordinate position in the assigned fund would most probably interfere with the intended encouragement. Lenders care about collateral only because of the possibility of the borrower's defaulting on the loan. Otherwise, they look to repayment, not liquidation. It seems likely that those contractors who have defaulted on their construction work, so as to require the sureties to pay on their bonds, are the very contractors who will with the greatest frequency also be in default on their bank loans. Thus in the greatest number of problem cases a surety will be a competitor in the very situation where the bank most cares about its collateral security. Consequently, to hold that the bank has a position subordinate to that of the surety is probably to inhibit the very process Congress was trying to promote. Although this inhibiting factor is susceptible to factual verification or disproof,²¹⁸ it is nevertheless *the* question which should have been the crux of the post-1940 priority cases. That it was indeed an inhibiting factor can be established at least in part by the findings Congress made in 1951.

The 1951 Amendment to the Assignment of Claims Act of 1940²¹⁹ was also born in a time of national emergency but was a reaction to a more specific problem. In 1949 and 1950 the Comptroller General had ruled that a bank which had received payments pursuant to its assignment could be made to reimburse the Government if the assignor was indebted to the United States for taxes or otherwise.²²⁰ The 1951 amendment was a direct response to these rulings. It provided that for a limited class of contracts no set-off or recoupment would be available to the Government, other than for debts or damages arising from the contract that had been assigned.

Like the Act which it amended, the 1951 statute was, on its face, inconclusive as to the priority of conflicting claims. Arguably, the United States could still withhold any funds necessary to reimburse itself for the contractor's failure of performance.²²¹ The surety, by being subrogated to those rights, was therefore not foreclosed from participating in the fund by the language of the 1951 act,²²² except possibly for the case of earned progress payments actually delivered to the assignee bank.²²³ On the other hand, the purpose for which the

²¹⁸ See Section IV *infra*.

²¹⁹ 31 U.S.C. § 203 (1970); 41 U.S.C. § 15 (1970) (originally enacted as Act of May 15, 1951, ch. 75, 65 Stat. 41).

²²⁰ See text at note 81 *supra*.

²²¹ This was the position taken by the Comptroller General. See No. B-125305, 35 Comp. Gen. 149 (1955).

²²² See Comment, 31 Fordham L. Rev. 161, 173 (1962).

²²³ On this point the federal courts and the Court of Claims initially disagreed. Compare *American Fidelity Co. v. Nat'l City Bank*, 266 F.2d 910 (D.C. Cir. 1959), and

statute was drawn demonstrates the validity of the conclusion reached about the proper construction of the 1940 act: that commercial banks would be deterred from financing public works contractors unless their rights to the contract fund were uninterrupted. Following the adverse decisions of the Comptroller General in 1949 and 1950, the Board of Governors of the Federal Reserve System found that the possibility of set-off and recoupment had again inhibited commercial banks from financing contractors, especially small businesses, who were working on federal projects.²²⁴ Both houses of Congress, after holding hearings on the bill, agreed.²²⁵

The purpose of the "no set-off" clause,²²⁶ then, and the problems to which it was addressed, are beyond dispute. The encouragement which Congress had intended to give to the commercial banks in 1940 had been frustrated by factors which had removed some of the safety from government contract rights as collateral. Congress reacted in 1951 by reaffirming that encouragement through removing the impediments. On this clear purpose, however, two divergent arguments may conceivably be founded. On the one hand, Congress did *not* expressly disturb the pro-surety tendencies of the Court of Claims; in fact, it did not even mention them. Thus the case law should be left intact. On the other hand, Congress *had* restated its policy that financing was to be encouraged and had expressly found that the impairment of priority in the contract rights had an adverse effect on that purpose.²²⁷ To the extent that the surety's priority would have a similar effect, the pro-surety decisions of recent days are inconsistent with this established federal policy.

Bank of Arizona v. Nat'l Sur. Corp., 237 F.2d 90 (9th Cir. 1956), with *Newark Ins. Co. v. United States*, 181 F. Supp. 246 (Ct. Cl. 1960). The Court of Claims has since decided otherwise, see text at notes 105-06 *supra*, for progress payments earned and paid over prior to default. The *American Fidelity* opinion, *supra*, was consistent with the general proposition that "[a]n assignee of a non-negotiable chose in action who, having paid value therefor, has received payment from the obligor is under no duty to make restitution although the obligor had a defense thereto, if the transferee made no misrepresentation and did not have notice of the defense." Restatement of Restitution § 14(2) (1937). The *Newark* case, *supra*, has been commented on unfavorably. See, e.g., Note, 46 Va. L. Rev. 1014 (1960); Note, 35 N.Y.U.L. Rev. 857 (1960).

²²⁴ Letter of Feb. 13, 1951, reprinted in Senate Comm. on Banking and Currency, Assignment of Claims Act, S. Rep. No. 217, 82d Cong., 1st Sess. 4-5 (1951).

²²⁵ House Comm. on the Judiciary, Amending the Assignment of Claims Act of 1940, H.R. Rep. No. 376, 82d Cong., 1st Sess. (1951); S. Rep. No. 217, *supra* note 224.

²²⁶ See generally *Continental Bank & Trust Co. v. United States*, 416 F.2d 1296 (Ct. Cl. 1970); Silberfield, The "No Set-Off Clause" and Its Impact on the Financing of Government Contracts, 52 J. Com. Bank Lending 47 (Aug. 1970).

²²⁷ On the bank-surety issue specifically, Nichols reached a conclusion contrary to the one being argued here: "In any event the Act is serving its purpose as intended by Congress. It is not necessary to upset established and time-honored principles to carry out this purpose." Nichols, *supra* note 217, at 567.

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D. Summary of Legal Criticisms

What the preceding doctrinal critique has attempted to establish is that the leading bank vs. surety cases have virtually ignored substantial arguments and doctrinal responses which can be raised against them. Of course this result is not so astonishing when one considers the many fact-pattern variations which are possible. These variations include: (1) payment bond vs. performance bond; (2) retained percentages vs. progress payments; (3) "policed" loan proceeds vs. dissipated loan proceeds; (4) paid-over fund vs. stakeholder fund; and (5) timing vs. notice. Since it would be almost impossible for one case to present a complete "grid" of these variations, it is not surprising that no really comprehensive judicial reasoning came about. An additional complication facing the courts was the fact that banks were not the only competitors the sureties were litigating against. *Pearlman*, for example, involved not a bank but a bankruptcy trustee. As against such other rivals the surety could lay claim to quite different equities than those it might have in opposition to a financing bank.²²⁸

The basic flaw in the federal priorities cases, however, is that they do not take into consideration the policy that Congress had intended be carried out when they enacted the 1940 and 1951 Assignment of Claims Acts. In those situations where there is no "clear and substantial" interest of the federal government being impinged upon,²²⁹ or where there are no rights or duties of the United States at stake,²³⁰ a federal rule will govern only if the dispute is to be governed by the interpretation of a federal statute or if a "clear [and] emphatic" federal policy is involved.²³¹ The priorities problem is such a situation. Considering the fact that the Miller Act and the Assignment of Claims Acts did not compel a result on the issue of priorities, the courts should have examined the federal policy espoused by these Acts before attempting to fashion a federal rule by which the priorities issue could be resolved. Having committed themselves to the application of federal rather than state law, the courts could not then legitimately choose to ignore the federal policy which justified that choice. Nevertheless, that is precisely what they did. This approach is at best incon-

²²⁸ See *Pearlman's* own discussion of *Munsey Trust* in text at notes 94-99 *supra*.

²²⁹ *United States v. Yazell*, 382 U.S. 341, 352 (1966). See *Wallis v. Pan American Petroleum Corp.*, 384 U.S. 63 (1966). On Miller Act disputes specifically, compare *United States v. Henke Constr. Co.*, 157 F.2d 13, 24 (8th Cir. 1946), with *Liebman v. United States*, 153 F.2d 350, 352-53 (9th Cir. 1946).

²³⁰ *Bank of America v. Parnell*, 352 U.S. 29, 32-34 (1956). See also *UAW v. Hoosier Corp.*, 383 U.S. 696 (1966); *Wheeldin v. Wheeler*, 373 U.S. 647 (1963).

²³¹ *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 462 (1942).

sistent, for when the law does not compel a result, a clear articulation of policy must.

III. FEDERAL POLICY AND PRIVATE FINANCE

A. Policy Goals

The existence and nature of the relevant federal policy goals can be documented with little difficulty. In the broadest sense Congress has been concerned with the free enterprise system as a whole:

The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such *security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed.*²³²

This concern with the encouragement and vitality of small businesses²³³ has been repeated often in Congress,²³⁴ in such disparate contexts as defense appropriations²³⁵ and foreign assistance.²³⁶ Currently,

²³² Small Business Act § 2(a), 15 U.S.C. § 631 (1970) (emphasis added).

²³³ "For the purposes of this chapter, a small-business concern shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation." 15 U.S.C. § 632 (1970). When not otherwise indicated, this definition is what is meant by the use of "small business" throughout this paper. As a practical matter, however, it is possible to define "small business contractor" somewhat more specifically, as a firm with less than \$5 million in annual gross receipts. This \$5 million figure, used as one of the dividing lines in the survey described in section IV infra, can be supported by reference to the actual operations of the Small Business Administration. "Direct Basis" SBA financing is normally not available to contractors whose receipts exceed that sum, according to Mr. Stuart Rawlins, Chief of the Financing Division, SBA Los Angeles Regional Office. Five million dollars is also the high break-point for the Bureau of the Census data discussed in text at notes 246-47 infra. (Mr. Rawlins was extensively interviewed by the author in October, 1972. Information gathered from that conversation will hereinafter be cited as Rawlins Interview.)

²³⁴ See, e.g., Armed Services Procurement Act, 10 U.S.C. § 2301 (1970): "It is the policy of Congress that a fair proportion of the purchases and contracts made under this chapter be placed with small business concerns." 41 U.S.C. § 252(b) (1970): "It is the declared policy of the Congress that a fair proportion of the total purchases and contracts for property and services for the Government shall be placed with small business concerns." 41 C.F.R. §§ 1-1.702(a), (b)(1) (1972): "It is the policy of the Government to aid, counsel, assist, and protect, insofar as possible, the interests of small business concerns in order to preserve free competitive enterprise"

²³⁵ Defense Appropriation Act of 1971, Pub. L. No. 92-204, § 709, 85 Stat. 716: "Insofar as practicable, the Secretary of Defense shall assist American small business to par-

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with increased awareness of the need for minority group economic development, the policy has become even more insistent.²³⁷ Specifically with respect to contractors, the federal government has become concerned with the involvement of small business in federal procurement and public works construction.²³⁸ Furthermore, Congress has noted the causal relationship between this policy and the ability of small business contractors to procure financing. If adequate financial assistance is not available, the desired participation of small business cannot be successfully effectuated.²³⁹ The legislative histories of both the 1940 and the 1951 assignment of claims statutes reflect this finding while the statutes themselves attempt to further this concern.²⁴⁰

It is possible to discover in Congress' action two separate, but intermingled goals. One, and the most obvious one, is to foster small business enterprises for their own sake and for the sake of a competitive economy generally. The other is to provide for the United States, as a buyer of contracting services, a wide and competitive market of able sellers.²⁴¹ If inadequately financed contractors are permitted to

participate equitably in the furnishing of commodities and services financed with funds appropriated under this Act"

²³⁶ Foreign Assistance Act of 1961, Pub. L. No. 87-195, §§ 602(a), (b), 75 Stat. 424, as amended 22 U.S.C. § 2352 (1970).

²³⁷ Exec. Order No. 11625, 36 Fed. Reg. 19967 (1971).

²³⁸ See notes 234-35 *supra*. See also 41 C.F.R. § 1.1.702(b)(1) (1972). "Small business concerns . . . shall be afforded an equitable opportunity to compete for all contracts that they can perform." Armed Services Procurement Regulation [hereinafter ASPR] § 1-702(b), 3 Gov't Cont. Rep. ¶ 32,191 (1972).

²³⁹ Realistically, the Government cannot effectuate its policy of bolstering small-business participation in defense procurement merely by ensuring that a fair proportion of defense contracts is allocated to small business. Considering the complexity and the unique risks of defense procurement, as well as the serious economic consequences of a termination for default, financial assistance should be made readily available to the small-business contractor from the date of bidding for the contract to the time of final payment.

Speidel, Financial Inability and the Default Termination of Defense Supply Contracts: A Small Business Case Study, 44 Minn. L. Rev. 1055, 1078 (1960). The Government, apparently, agrees with Speidel: "Immediate and continuing attention must be given to insure that constructive measures will be taken to facilitate and accelerate necessary contract financing assistance to small business concerns." Federal Procurement Regulations § 1-30.204, 6 Gov't Cont. Rep. ¶ 66,881 (1971). In certain cases progress payments are handled differently for small business contractors. See ASPR App. E-504, 4 Gov't Cont. Rep. ¶ 35,693 (1972). Compare ASPR App. E-510.1 with ASPR App. E-510.2, *id.* at ¶¶ 35,699-.05.

²⁴⁰ For the 1940 Act, see 86 Cong. Rec. 12557, 12559, 12803, 13122 (1940), demonstrating concern for the "little fellow." For the 1951 amendment, see Sen. Comm. on Banking and Currency, Assignment of Claims Act, S. Rep. No. 217, 82d Cong., 1st Sess. 2 (1951): "[M]any of the smaller contractors having a large volume of Government contracts but a small net worth are presently unable to obtain the financing necessary to enable them to perform their contracts."

²⁴¹ See, e.g., Commission on Government Procurement, Pub. L. No. 91-129, § 1, 83 Stat. 269 (1969): "[I]t is hereby declared to be the policy of Congress to promote economy, efficiency, and effectiveness in the procurement of goods, services and facilities by and for the executive branch of the Federal Government. . . ."

undertake federal construction projects, these two goals could very easily become incompatible.²⁴² But if, on the other hand, financing is provided at a level sufficient to support small business firms' ventures into public works, it would serve to promote both goals: it would encourage the proliferation and growth of financially capable individual enterprises, and would thus enlarge the market out of which the United States must procure its services.

Both the bonding companies and the commercial banks can present good cases for their involvement in the furtherance of these goals.²⁴³ Sureties argue that their screening processes weed out those firms which would be incapable of providing satisfactory levels of service. The banks respond with an allegation that their efforts alone can provide the necessary financial support. Both claims have merit. Before inquiring into their specifics, however, it is necessary to describe the state of the contracting industry as it now exists, and the complementary state of the financing available from sources other than private commercial banks.²⁴⁴ The rival claims can be adequately assessed only against such a background.

The annual volume of public works construction in recent years has grown to very near the \$30 billion mark, or roughly thirty percent of all new construction attempted.²⁴⁵ However, only a quarter of all the construction firms in the United States participate in this enormous market.²⁴⁶ To envision what the competitive stature of the

²⁴² "If the participation of small businesses in defense procurement is to be effectively implemented, no small business should be awarded a contract until firm, adequate, financial arrangements have been obtained. Only at this level of administrative responsibility are the interests of both the Government and the small-business contractor adequately protected." Speidel, *supra* note 239, at 1066.

²⁴³ See sections III-C, D *infra*.

²⁴⁴ On the latter point, see section III-B *infra*.

²⁴⁵

NEW CONSTRUCTION
(Millions of Dollars)

Period	Total	Private—% of Total	Public—% of Total
1966	76,002	51,995 —68%	24,007 —32%
1967	77,503	51,967 —67%	25,536 —33%
1968	86,626	59,021 —68%	27,605 —32%
1969	93,368 ^r	65,404 ^r —70%	27,964 ^r —30%
1970	94,030 ^r	65,932 ^r —70%	28,098 ^r —30%
1971	109,399 ^r	79,535 ^r —73%	29,864 ^r —27%

^r revised.

Department of Commerce, Bureau of Domestic Commerce, 18 Construction Review 12 (July 1972).

²⁴⁶ The following table shows the number of firms "With Payroll" and the source of their gross revenues. Only 103,886 of the total 368,771 (or 28.2%) show any receipts from public works.

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market may be requires extrapolation from the following data for the construction industry as a whole, both public and private:²⁴⁷

Size of Establishment by Total Receipts	Number of Establish- ments	% of Total Establish- ments	Total Receipts (in thousands)	% of Total Receipts
\$2,500,000 or more	5,328	.7%	38,263,333	37.6%
\$1,000,000 to \$2,499,999	10,809	1.3%	16,556,135	16.3%
\$ 500,000 to \$ 999,999	17,456	2.2%	12,411,518	12.2%
\$ 250,000 to \$ 499,999	30,129	3.8%	10,821,538	10.6%
\$ 100,000 to \$ 249,999	70,746	8.9%	11,270,344	11.1%
\$ 50,000 to \$ 99,999	80,429	10.1%	5,688,418	5.6%
\$ 25,000 to \$ 49,999	97,602	12.3%	3,447,434	3.4%
\$ 10,000 to \$ 24,999	130,592	16.4%	2,115,712	2.1%
Less than \$10,000	351,747	44.3%	1,160,961	1.1%
Total	794,838	100%	101,735,392	100%

Over a third of the total revenues are earned by less than one percent of the contracting firms. Less than five percent of the firms do two-thirds of the business. On the other hand, the smallest outfits, which make up 83.1% of the total number, have a market share barely in excess of twelve percent. Unfortunately there is no mathematically certain way to stratify these figures for private and public construction separately. An indication of what such an extract for federal work alone would look like can, however, be seen from the results of the

Establishments with Receipts from Public Construction Only:	
Number of firms: 18,789	Receipts (in \$1,000) \$8,933,285
Establishments with Receipts from Both Public and Private Construction:	
Number of firms: 85,096	Receipts (in \$1,000) Public \$19,742,839 Private \$24,571,461
Private Only:	
Number of firms: 264,886	\$39,340,417
Totals	
Number of firms: 368,771	Total Receipts \$92,588,002 Public \$28,676,124 Private \$63,911,878

Bureau of the Census, Census of Construction Industries, 1967, in 1 Industry Statistics and Special Reports 1B-13, Table B7 (1971). These "With Payroll" firms, however, represent only 46.4% of the 794,838 construction firms in the country. The balance, of course, are the much smaller firms "Without Payroll." Our survey has indicated (see Appendix, Contractors' Questionnaire, Question 4, *infra*) that these smaller firms participate in public works to a significantly lower extent than do their larger competitors. As a result, if the table immediately above had included *all* firms, the proportion showing some receipts from public works would be measurably lower than the 28.2% there indicated, and in all probability below 25%.

²⁴⁷ These figures are derived from Bureau of the Census, *supra* note 246, at 1A-3, Table A2. The complementary data for "With Payroll" firms only are as follows:

survey undertaken in connection with this article and discussed below. Of those firms earning less than \$250,000 per year in gross incomes, 59% reported to us that they did *no* federal work whatsoever. For firms earning between \$250,000 and \$1 million, the ratio was 48%; it drops to 34% for those in the \$1-5 million range, and is only 27% for firms grossing in excess of \$5 million.²⁴⁸

It is fairly safe to conclude that the intensity of competition present in the federal construction market is far less than that prevailing in the construction industry generally; and the latter is itself not particularly good. Although the question of why this is the case will be deferred for a moment, it is nevertheless important to be aware of the phenomenon at this juncture. To the extent that federal contracts are, or could be, a source of profits, or an opportunity for market entry not requiring extensive good will and community reputation, the noncompetitive features of the market run contrary to the policy of furthering individual small business enterprise. If the difficulty can be traced in part to some impediment to small business financing, that impediment should be removed. And if that impediment to financing is a function of the trend of judicial law-making in cases dealing with surety-banker priorities, then those cases can well be subjected to empirical criticism. Stated the other way around, if federal policy is to be a decisional criterion, then the courts simply must

SHARE OF THE MARKET FOR ESTABLISHMENT WITH PAYROLL

Size of Establishment by Total Receipts	Number of Establish- ments	% of Total Establish- ments	Total Receipts (in thousands)	% of Total Receipts
Total	368,771	100%	\$95,925,449	100%
\$5,000,000 or more	2,033	.55%	26,825,796	28.0%
\$2,500,000 to \$4,999,999	3,282	.9%	11,382,491	11.9%
\$1,000,000 to \$2,499,999	10,692	2.9%	16,387,814	17.1%
\$ 500,000 to \$ 999,999	16,983	4.6%	12,093,307	12.6%
\$ 250,000 to \$ 499,999	28,600	7.75%	10,292,193	10.7%
\$ 100,000 to \$ 249,999	63,339	17.2%	10,149,144	10.6%
\$ 50,000 to \$ 99,999	68,490	18.6%	4,864,889	5.0%
\$ 25,000 to \$ 49,999	73,541	19.9%	2,627,623	2.7%
\$ 10,000 to \$ 24,999	63,374	17.2%	1,100,726	1.1%
Less than \$10,000	38,437	10.4%	201,467	.2%

Id.

²⁴⁸ The complete figures are shown in Appendix, Contractors' Questionnaire, Question 4, *infra*. These results were cross-checked by a telephone interview with the Director of the Design and Construction Department of the General Services Administration in San Francisco, and by a personal interview with the head of the Los Angeles Bid Collection Office. Both interviews confirmed the reported data, adding that a very small group of contractors reappeared with great frequency on federal projects; the bidding firms were a very closed group.

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make inquiry into what effects one decision or the other might have on the participation of small businesses in the federal construction market.

The first step, therefore, is to attempt to isolate the contributing causes of this lopsided participation.

B. *Financing for Contractors: Needs and Sources*

Over half of the firms personally interviewed during the course of the present study reported that with varying frequencies they had occasion to procure outside financing. Because the sample from which this ratio was drawn included a disproportionate number of larger firms, it is reasonable to suggest that for small businesses in particular the need for financial assistance is even greater than the "over-half" result indicated.²⁴⁹ Obviously the sample does not include any firms which may have withdrawn from the industry entirely because they could not obtain the necessary financial help.²⁵⁰ To adopt a null hy-

²⁴⁹ Although the subjects were randomly selected, the responses were definitely skewed in favor of the larger firms. Compare the distribution of firms by gross receipts in the table in text at note 247 with the distribution reflected in our results:

In order to locate your firm's position within the Bureau of Census statistics, would you categorize your firm's gross receipts into one of the following dollar ranges:

	Interview	Questionnaire	Public Works	Total
a. Under \$ 10,000	0	0	0	0
b. \$ 10,000-\$ 24,999	0	2	0	2
c. \$ 25,000-\$ 49,999	0	2	0	2
d. \$ 50,000-\$249,999	2	18	2	22
e. \$250,000-\$999,999	5	21	3	29
f. \$1 million-\$5 million	21	22	4	47
g. Over \$5 million	10	16	1	27
Totals	38	81	10	129

In this table "Interview" refers to those contractors which were personally interviewed in depth. "Questionnaire" includes those contractors responding to the mail survey who answered this question. "Public Works" refers to those contractors which had been referred to us as public works "repeaters" by the local office of the General Services Administration. See note 248 *supra*.

The "over-half" figure reported in the text was drawn *only* from those in the "Interview" and "Public Works" categories. Question 10 of the mail survey (see Appendix Contractors' Questionnaire, *infra*) could not be scored, due to a severe misunderstanding of its point on the part of some of the subjects, but more to the lack of constant quantifiers allowed by the question. These two columns are even more heavily weighted with larger firms than the total sample is; hence there is an even greater probability that "over-half" is an underestimate of the frequency of financing for the industry as a whole, and especially for the smaller firms.

²⁵⁰ Nor, of course, does the sample include those individuals who may not have been able to *enter* the industry as independent operators, for lack of financial help. I have no data from either of these groups. It is mentioned here only to indicate, again, that "over-

pothesis approach, we should be able to rule out financing problems as a contributing cause of competitive dislocations *if* we can establish that financing is in fact adequately available. Other than commercial banks, there are only a few places the small business contractor might look for help.

For contractors working on National Defense projects, there is a possibility of receiving "advance payments."²⁵¹ There are, however, some limitations: the advance payments can be made only when doing so would be in the national interest, and only upon the authority of the departments of national defense.²⁵² Also, this technique is used only as a last resort for those cases in which private or federally guaranteed loans are unavailable.²⁵³ The decision to grant advance payments is typically made on the basis of "comparative prices, urgency of supply schedules, and the time and expense involved in arranging other sources or in reletting contracts"²⁵⁴—and then only after the agency has done a complete feasibility and cash flow analysis.²⁵⁵ The paperwork alone seems to be an inhibiting factor.²⁵⁶ Advance payments, as a practical matter, are hedged about with so many layers of administrative limitation that their use as a financing tool is limited

half" is most probably a conservative estimate of the demand side of the financing equation.

As to business failures (i.e., insolvency, not including voluntary withdrawal from the industry), contractors certainly have their share:

BUSINESS FAILURES—CONSTRUCTION INDUSTRY

		1955	1960	1965	1970
Size of liability	Under \$100,000:	1239	2171	2025	1229
	\$100,000 and over:	165	436	488	458
	Total:	1404	2607	2513	1687

Department of Commerce, Bureau of the Census, Statistical Abstract of the United States 476 (1971).

Insolvent contractors account for ten percent of all the business bankruptcies in the United States. D. Stanley, M. Girth et al., *Bankruptcy—Problem, Process, Reform* 109, Table 6-1 (1971). And of *all* business bankruptcies, 26% reported "insufficient capital" as the underlying cause of failure. *Id.* at 111, Table 6-2. For a general description of certain hazards of the contracting industry which make contractors so prone to financial collapse, see Note, *Mechanics' Liens and Surety Bonds in the Building Trades*, 68 *Yale L.J.* 138, 138-41 (1958).

²⁵¹ 10 U.S.C. § 2307 (1970).

²⁵² I.e., the Departments of the Army, Navy, Air Force, Coast Guard, and NASA. 10 U.S.C. § 2303 (1970). These departments are authorized to make advance payments only when "the national defense will be facilitated thereby." Exec. Order No. 10,789, 3 C.F.R. 78 (1973). See also ASPR App. E-405(iv), 4 Gov't Cont. Rep. ¶ 35,664 (1972).

²⁵³ See ASPR App. E-404, *id.* at ¶ 35,663; ASPR App. E-408, *id.* at ¶ 35,667.

²⁵⁴ ASPR App. E-409, *id.* at ¶ 35,668. The contractor must also provide "adequate security." See ASPR App. E-405(i), *id.* at ¶ 35,664; ASPR App. E-413, *id.* at ¶ 35,672.

²⁵⁵ ASPR App. E-214.1, *id.* at ¶ 35,616.05.

²⁵⁶ See, e.g., ASPR App. E-214, *id.* at ¶ 35,616; ASPR App. E-411, *id.* at ¶ 35,670.

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to cases of extraordinary circumstance and to contractors possessing unusual bureaucratic skill and perseverance. Certainly this possibility does nothing to stimulate additional participation by contractors in public works.

Federally guaranteed "V"-loans, though highly successful during the Korean War,²⁵⁷ are similarly disfunctional today as a matter of business encouragement. In recent years they have been little used.²⁵⁸ Regulation "V"²⁵⁹—authorizing governmental agencies to guarantee loans to small business contractors, with the Federal Reserve Board (FRB) acting as the agency's fiscal representative—was originally issued pursuant to the Defense Production Act of 1950,²⁶⁰ and has since been extended by Executive Order.²⁶¹ Like the advance payments technique, V-loan guarantees are issued only when they would serve the interests of the national defense. That factor alone substantially limits the effectiveness of the program so far as civil public works are concerned. There is, however, a more serious problem: according to the Armed Services Procurement Regulations, "Contract surety bonds, and guaranteed loans for financing bonded contracts are regarded as fundamentally incompatible unless the interests of the surety are subordinated in favor of the guaranteed loan."²⁶² Consequently, "applications for loan guarantees are approved *only* if the surety . . . will subordinate . . ."²⁶³ Voluntary subordination by a surety is a *rare* event in most cases where guaranteed financing would be useful.²⁶⁴ Thus, so far as the present inquiry is concerned, the "V"-loan program too can be disregarded as a practical source of financing.²⁶⁵

²⁵⁷ "Since [the] inception [of the V-loan program] in 1950, approximately \$3.7 billion in loan guarantees have been issued by guaranteeing agencies. Approximately \$3.1 billion of that total was authorized during the period September 1950 through December 31, 1958." Letter from Tynan Smith, Secretary, Board of Governors of the Federal Reserve System, to the author, Oct. 13, 1972.

²⁵⁸ The Federal Reserve Board authorized no new guarantee agreements in 1969 and in 1970. In 1971 *one* agreement for \$85,000 was issued. See Board of Governors, Federal Reserve System, 56 Ann. Rep. 319 (1969); 57 Ann. Rep. 207 (1970); 58 Ann. Rep. 235 (1971). In a letter to 12th District Member Banks, dated Sept. 4, 1970, the Federal Reserve Bank of San Francisco advised that the maximum guarantees available under Regulation V would thereafter be \$20,000.

²⁵⁹ 32A C.F.R. ch. XV (1972).

²⁶⁰ Pub. L. No. 774, 64 Stat. 798 (1950).

²⁶¹ Exec. Order No. 10480, 18 Fed. Reg. 4939 (1953). See generally Bachman, Defense Department Contract Financing, 25 Geo. Wash. L. Rev. 228, 235 (1957).

²⁶² ASPR App. E-312.2, 4 Gov't Cont. Rep. ¶ 35,645 (1972).

²⁶³ ASPR App. E-312.3, *id.* (emphasis added).

²⁶⁴ This point is verified by the Survey of Commercial Lenders, see Appendix *infra*; by personal interviews with financing bank lending officers; and by information gained in the Rawlins Interview, *supra* note 233: "The subordination is in our—the SBA's—favor less than 10% of the time. Usually we have to give everything up to the surety."

²⁶⁵ There is a further reason for this conclusion, but one which is entirely anecdotal in nature. During the course of this research I investigated the bureaucratic ease of applying

Of somewhat greater utility are the programs run directly by the Small Business Administration (SBA). The financing available to small business contractors through the SBA is of three general types: Direct Basis lending, loan guarantees and a recently begun program involving a revocable line of credit. Under Direct Basis lending the SBA itself extends a loan to the applicant. These loans, intended primarily for capital input and not for project costs, are limited in amount to \$100,000. The more significant limitation, however, is imposed by the funding of the SBA. In the view of one SBA financing officer, the loan amounts available "take care of about one percent of the eligible applicants."²⁶⁶

The other ninety-nine percent have to be satisfied with SBA loan guarantees. The SBA will guarantee an extension of credit made by a private commercial lender up to a maximum of \$350,000. Such a figure should certainly be sufficient to finance the start-up costs of most projects within the capability of small businesses. The extent to which this guarantee has been used, however, is somewhat disappointing.²⁶⁷ The reasons for that are not entirely clear. Some possibilities may be the limitations placed on the bank which has extended the loan. The guarantee only goes to ninety percent of the loaned amount, leaving the bank with a potential exposure of 10% of the total credit. The bank is also limited in its interest charges to 8¼%, an amount which may be a bit low in times of short money. Furthermore, the bank is required to "police" the loan proceeds in a manner agreed to by it and the SBA.²⁶⁸ Our survey indicates that policing can be an expensive item for a bank which has not routinized its contractors' lending operation.²⁶⁹ Finally, the bank is left with the task of negotiating with the sureties on projects requiring bonds.

Recently the SBA has instituted a pilot program which, in its inception, was specifically designed for contractors.²⁷⁰ It differs from the usual loan guarantee program in that the bank issues only a

for a guaranteed loan. Contact was first made with the Office of the Small Business Specialist, Department of Defense, Contract Administration Office, in Los Angeles, California. In response to my inquiry about guaranteed loans I was told by the "small business specialist" with whom I spoke that he was unaware of any department of defense guarantees, and that I should get in touch with the Small Business Administration. The second contact was made by letter, addressed to the Los Angeles Regional Office, Department of Defense Contract Administration Services. In a reply dated September 12, 1972, in response to my request for information concerning guaranteed loans for defense contractors, I was advised to write directly to the Assistant Secretary of Defense. (1)

²⁶⁶ Rawlins Interview, *supra* note 233.

²⁶⁷ See the results in Appendix, Commercial Lenders' Questionnaire, Question 29, *infra*.

²⁶⁸ Rawlins Interview, *supra* note 233.

²⁶⁹ See the results in Appendix, Commercial Lenders' Questionnaire, Question 25, *infra*.

²⁷⁰ The program is described in Small Business Administration, Office of Public Information, Fact Sheet No. 4 (April 1972).

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revocable line of credit against an assigned contract, with a maximum duration of eighteen months. The program was designed by the SBA in conjunction with one of the larger banks in California,²⁷¹ and has been in operation since the early Spring of 1971. While it may be too early to assess the impact this program will have on the availability of financing to small contractors, the early returns are not very promising. In its first fifteen months of operation, only 18 contractors have been funded—twelve in San Francisco and six in Los Angeles. In the opinion of the SBA financing officer in charge of the program, "the problem was still with the sureties."²⁷² Unless a surety is willing to subordinate its claim to the contract payments, the lending bank is exposed to 10% of the credit amount. More significantly perhaps, the SBA is exposed to as much as 90%. Since the guarantee fee is only $\frac{1}{4}$ of 1%, this exposure may be burdensome to the SBA for contractors whose financial status prior to the loan would be less than solid.²⁷³

The operations of the SBA, unlike those of the FRB on the V-loan program and of the contracting agencies on their advance payments techniques, could be fairly said to be of measurable benefit to small business contractors. However, it too has its limitations, and is by no means taking up all of the slack.²⁷⁴ We could therefore conclude

²⁷¹ Rawlins Interview, *supra* note 233.

²⁷² *Id.* In the Rawlins Interview it was understandably difficult to pin down the exact meaning of this statement. The risk of exposure which the sureties' refusal to subordinate caused was disturbing to either the bank or the SBA or both. In any event, it has had some effect in deterring the fullest exploitation of this pilot program. See also note 274 *infra*.

²⁷³ The Small Business Act, 15 U.S.C. §§ 631 et seq. (1970), provides that "[a]ll loans made under this subsection shall be of such sound value or so secured as reasonably to assure repayment." 15 U.S.C. § 636(a)(7).

²⁷⁴ The loan guarantee program, which is the only one large enough to serve the demand for credit, has not been greeted with much enthusiasm by the private lenders from whom the funds must first come. Two items in the Commercial Lenders' Questionnaire (see Appendix *infra*) went to this point; the results are as follows:

Question 28A: If the bank has had experience with guaranteed loans ("V"-loans, or SBA guarantees) to small contractors, was the bank in those cases more willing to make loans for public works construction?

Bank's Credit Commitment to Contractors	Yes	No	No Response
Under \$500,000	2	4	10
\$500,000-2 Million	0	1	5
\$2-6 Million	0	2	2
Over \$6 Million	0	2	4
Total	2	9	21

Question 28B: [Re: answer to 28A] Could you explain briefly why or why not? Of the two banks which had answered 28A "Yes," one responded to 28B: "Because exposure under S.B.A. is reduced by 90%." Of the nine banks which had answered 28A "No," three responded to 28B:

that the financing available to small businesses from the public agencies is not at a level sufficient to rule out inadequate access to financing as a contributing cause of the imperfection of the public contracts market.

C. *Functions and Views of the Surety*

The relative inadequacy of public financing for small business contractors leaves intact the possibility that some of the lack of competition in the public works market has been caused by the unwillingness of commercial banks to fill the breach. This unwillingness, the banks might claim, stems in part from their subordinate priority position vis-à-vis the Miller Act bond sureties. The sureties argue that their cooperation is essential for the protection of the Government's interest in public works,²⁷⁵ and that only through their priority right of subrogation can their contribution be maintained at an appropriate level.²⁷⁶ Such a position invites a closer look.

The functions performed by sureties who bond public works are, by the sureties' own claim, both numerous and important. Moreover, the functions serve *both* federal policies heretofore articulated: protection of the Government's interest as a purchaser of contract services, and assisting small business firms in the contracting industry. As to the former policy, there are four primary functions.

First, the surety protects the Government against unqualified and irresponsible bidders by "screening" bond applicants carefully.²⁷⁷ If

a) SBA lien position is in conflict with insurance companies when extending bonds.

b) Any contractor needing government insurance or SBA is usually not reliable.

c) Usually due to size of loan requests—relating to our maximum lending limitations. [Note—the total deposits of this bank were less than \$50 million, and its credit commitment to the contracting industry as a whole was \$100,000.]

²⁷⁵ Surety Ass'n of America, *The Unseen Services of a Contract Bond Surety* 3-4 (mimeographed, 1971).

²⁷⁶ One who is far more cynical than I might suggest that for both industries the real nub of the matter is profits. Even if that is so, there is still good reason to analyze the competing claims. If either party reacts to profit perturbations in a way which inhibits established economic policy goals, then the profit issue becomes important to the problem's ultimate resolution.

²⁷⁷ Surety Ass'n of America, *supra* note 275, at 4:

To the surety, a minimal number of defaults and an absence of owner-contractor litigation suggests that the surety has been successful in screening out incompetent contractors from the bidding process. To the extent inadequately financed or incompetent contractors are allowed to bid, particularly in our "lowest bidder" award system, the number and cost of defaults will increase.

Pre-qualification of the contractor is the first step in the surety process; it is an extremely important one and must be performed by a politically disinterested body. For this reason, the screening of potential bidders for government work is done by private surety companies rather than by governmental bureaus or municipal agencies. Politically appointed or politically oriented individuals would often be placed under strong pressures in favor of certain contractors. Govern-

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a problem should nevertheless begin to arise, the surety (to protect his own interest) will apply pressure and provide assistance to the contractor, to prevent the difficulty from maturing into a default. "The goal of a surety . . . is to avoid default on a bonded job. To the extent that the surety is successful, the existence of the problem may never become known to the bond obligee"²⁷⁸ Second, the existence of a payment bond gives assurance of payment to subcontractors and suppliers, and thereby reduces net costs (through lower prices) to the Government.²⁷⁹ Third, the surety's bonds provide protection to the laborers and materialmen—a matter which, if left to the Government to provide directly, would be "costly and difficult."²⁸⁰ Finally, the

mental bureaus would lack the depth of experience available in the private companies. Both consistency and objectivity are provided by the corporate surety. It is difficult to bring pressure, political or otherwise, on an entity whose own money is at risk and whose future survival depends on the results it achieves in qualifying for bond only those contractors who can do the work.

See also Comptroller General of the United States, Report to Congress, Survey of the Application of the Government's Policy on Self-Insurance 57 (No. B-168106, June 14, 1972) [hereinafter cited as Comptroller General's Report]. The report states that the heads of all surveyed federal agencies agreed that the requirement of Miller Act bonds be retained because, *inter alia*, the sureties screen out marginal contractors.

In a letter to GAO dated October 5, 1971, the Postmaster General stated that the bid and performance bonds guaranteed maintenance of a standard of service, protected against losses caused by default of the contractor, and acted as a policing device to eliminate excessively low bids by unqualified bidders. He said that the bond exercised a discipline over contractors and bidders that would not otherwise be possible without high administrative costs and possible deterioration in the quality of service.

Comptroller General's Report, *supra* at 50.

²⁷⁸ Letter from Mr. Quentin W. Lerch, Secretary of the Surety Association of America, to the author, Sept. 20, 1972, at 2. The Association of General Contractors expressed it somewhat differently: "The use of bid bonds and surety bonds prevents many of the undesirable bidders and contractors from muddying the water of the construction industry." Comptroller General's Report, *supra* note 277, at 59.

²⁷⁹ Cushman, Brief on Behalf of the Surety Industry, in Hearings before the House Comm. on the Judiciary, Bonds of Contractors on Public Works, 74th Cong., 1st Sess. 32 (1935); Cushman, The Surety's Right of Equitable Priority to Contract Balances in Relation to the Uniform Commercial Code, 39 Temp. L.Q. 239, 250 (1966).

²⁸⁰ Comptroller General's Report, *supra* note 277, at 57, citing statements of agency heads. The same report indicates that for this protection the United States pays \$23-28 million annually in passed-on bond premiums for the \$5.2 billion of civil and defense public works, or approximately 0.5%. *Id.* at 51.

The Government Accounting Office was unable to determine whether or not the Government got a bargain or a bath for its \$23-28 million:

We obtained actual costs of bonds on selected contracts awarded in fiscal years 1970 and 1971 to derive a basis for estimating such costs overall. Data on contractor defaults was obtained where available to determine if bonding requirements have conferred economic or other benefits on the Government. We could not generally obtain accurate information on the extent of the economic benefits to the Government, however, because in most cases of default the surety takes over and completes the construction project using a different contractor, and the surety's records are not ordinarily available for GAO inspection.

Id. at 52.

surety can arrange financing or expertise to assist the contractor in completing the job, again to the benefit of the Government.²⁸¹

Of course, as a result of these four functions the second federal policy is also promoted: "Surety bonds enable many small businessmen to compete for government contracts even though they lack sufficient financial resources of their own to complete the contract."²⁸²

One must question, however, whether the level of any of these services would be retarded if the surety were in some cases effectively denied its right of salvage by being subordinated to financing banks, so far as retained contract funds are concerned. It has been estimated, for example, that approximately one-third of the sums paid out by surety companies on their bonds is recovered through "salvage,"²⁸³ including the sums acquired by subrogation. After recoupment through salvage or otherwise, the net losses incurred by sureties are a substantial portion of the total premiums received.²⁸⁴ On federal construction contracts this loss ratio was 53.8% for the period 1958-1967, and 49.5% for 1960-1970.²⁸⁵ It compares unfavorably with the loss

²⁸¹ Surety Ass'n of America, *supra* note 275, at 7; case histories, *id.* at Appendix Group III (cases 110-51).

²⁸² Haas, *The Corporate Surety and Public Construction Bonds*, 25 Geo. Wash. L. Rev. 206, 207 (1957).

²⁸³ J. Backman, *Surety Rate-Making* 34-35 (1948).

²⁸⁴ Dykehouse, *Construction Surety Bonds: Their Adequacy and Availability*, Supplement to Department of Housing and Urban Development, Report on the Availability of Crime Insurance and Surety Bonds in Urban Areas 181 (1970):

SURETY LOSS EXPERIENCE: CONTRACT BONDS

	Premiums Written	Losses Incurred	Loss Ratio
Federal Contract	\$205,371,000	\$110,458,000	53.8%
Other Contract	\$1,358,911,000	556,931,000	41.0%
Total	\$1,564,282,000	\$677,389,000	43.3%

SURETY LOSS EXPERIENCE: ALL OTHER BONDS

	Premiums Written	Losses Incurred	Loss Ratio
Statutory public bonds, court & fidelity, guarantee, license & permit, misc. bonds	\$780,028,000	\$71,281,000	9.1%

²⁸⁵ From the following unpublished data supplied to the author by the Surety Association of America:

CONTRACT BOND LOSS RATIOS

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970
Federal Const.	85.3	52.9	29.9	75.3	57.0	58.0	44.6	29.8	23.9	43.1	44.8
Other Const.	68.3	47.2	40.5	48.3	45.6	36.7	37.2	28.2	34.3	31.3	40.0

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ratio for non-Miller Act construction bonds (41.6% during 1960-1970), and for all other bonding activities (9.1%).²⁸⁶ Thus, while contractor's bonds represented 66⅔% of the total premiums written, they accounted for 91% of all net losses incurred.²⁸⁷ When expenses are added in, the loss and expense ratio is 99.5% of premiums, leaving a ten year annual underwriting profit average of 0.5%.²⁸⁸ Under these circumstances it is reasonable to expect that subordinating the surety will provoke some sort of a reaction.

Most commentators agree that if such a legal change were to occur, the bond premiums would be increased²⁸⁹ (thus increasing net costs to the United States), or marginal contractors would have a more difficult time securing the statutorily required bonds,²⁹⁰ or both.²⁹¹ Assuming for the moment that these predictions are valid, *i.e.* that reversing the surety's priority status will result in either increased costs and/or in increased selectivity of bonded contractors by the surety companies, it seems clear that both federal construction objectives might be endangered. The case for the sureties would accordingly be a strong one. There are, however, a few observations that should be made.

First, the fact of increased premiums is neither conclusive nor determinative. If costs increase, they will probably do so across the board.²⁹² Thus small contractors will not be at a competitive disad-

²⁸⁶ See notes 284-85 *supra*.

²⁸⁷ Dykehouse, *supra* note 284, at 71.

²⁸⁸ *Id.* at 75. This addition and subtraction is not, however, the whole picture; it omits the sums earned by the surety companies on the collected premiums.

²⁸⁹ See, e.g., Note, 41 Texas L. Rev. 735, 736-37 (1963); Note, 71 Yale L.J. 1274, 1278-79 (1962). The basis for this statement is a judicial opinion. See *id.* at 1279 n.27.

²⁹⁰ Note, 71 Yale L.J. 1274, 1279 (1962); Cushman, *supra* note 279, at 253.

²⁹¹ Note, 9 N.Y.L.F. 226, 230 (1963). This note, and those cited in note 289 *supra*, are commentaries on *Pearlman*, and all agree with its conclusions. Other pro-surety articles include Brady, Bonds on Federal Government Construction Contracts: The Surety's View, 46 N.Y.U.L. Rev. 262 (1971); and Creyke, Jr., Recent Developments in the Right of Sureties in Defaulted Federal Construction Contracts, 5 B.C. Ind. & Com. L. Rev. 139 (1963).

²⁹² The Surety Association of America would probably agree: "*The surety's fee is essentially a flat rate 'service' charge which is related more to averting or controlling loss than it is to paying the ultimate loss.*" Surety Ass'n of America, *supra* note 275, at 2 (emphasis added). Dykehouse, *supra* note 284, at 170, indicates that premiums are a function of contract price, not of assessed risk:

FOR PERFORMANCE OR PERFORMANCE PLUS PAYMENT BOND(S): BASIC RATE TABLE

Where time for completion as stipulated in the contract is not over 24 months or
731 calendar days:

Contract Price	Rate Per M
First \$100,000	\$10.00
Next 2,400,000	6.50
Next 2,500,000	5.25
Next 2,500,000	5.00

vantage vis-à-vis large contractors so far as bidding price is concerned. The increased cost, however, will be passed on to the Government.²⁹³ If that is the case, and if it can be shown that *not* changing the pro-surety legal climate *defeats* competition by affecting the lending policies of commercial banks, then the issue becomes one of deciding whether the increased costs are worth the benefits that would be obtained by occasionally subordinating a surety. To answer that question it is necessary to be able to quantify the value of promoting competition and supporting small businesses, and to be able to compute what the likely cost increases would be. Both would be extremely difficult. For this reason the possibility of increased bonding costs is not determinative. Neither, in my opinion, is it conclusive.

Two recent surveys, one conducted by David J. Dykehouse and the other by this author suggest that a change in the law will in fact have no effect on premium costs.²⁹⁴ Both studies show that presently there is little rate variation geared to risk variation. Dykehouse attributes this to the fact that the sureties have traditionally not done risk-cost-accounting in a very sophisticated way. The surety companies provide a better explanation: the fee paid to the surety companies is a service charge, not an insurance premium.²⁹⁵ Sureties do not operate on the basis of the Law of Large Numbers.²⁹⁶ Whatever the explanation may be, the conclusion is the same: the priority position of the surety vis-à-vis a financing bank in all probability will not affect the Miller Act bond rate structure.

More serious, however, is the possibility that the surety companies may react to increased risk by denying bonds to the smaller (in terms of net worth) contracting firms. Dykehouse's study sheds some interesting light on this possibility. He discovered that surety companies generally seek to establish long term relationships with contractors

Contract Price	Rate Per M
Over 7,500,000	4.70
Minimum—\$10.00	
Maximum—\$50.00 per M on the aggregate penalty of Performance and Payment Bonds.	

Our own survey is in accord. Of the fifty contractors *personally* interviewed, none indicated any cost variations. These fifty were of various sizes, from just over \$50,000 in annual gross receipts to over \$5 million. They also uniformly agreed that they would be bonded without any difficulty if their bonded work in progress did not exceed ten times their net worth, but beyond that ratio bonding was extremely difficult. The surety companies operating in the Los Angeles area have thus apparently translated "risk" into "net worth," and react to risk by curtailing the total bond amounts, not by adjusting prices.

²⁹³ See note 280 *supra*.

²⁹⁴ Dykehouse, *supra* note 284, at 151.

²⁹⁵ Letter to the author, *supra* note 278, at 1.

²⁹⁶ For an explanation of how the Law of Large Numbers differs from the less precise Law of Averages, see W. Wallis & H. Roberts, *Statistics: A New Approach* 121-23 (1956).

who can provide profitable (no loss risk) business, principally to reduce their underwriting costs.²⁹⁷ This tendency, coupled with the competitive pressures of the industry,²⁹⁸ "tend to make the surety companies quite flexible in their approach, in terms of underwriting, to established contractors and quite inflexible in their approach to the prospects of emerging contractors."²⁹⁹

For this reason, among others, "[t]he ease of entry into contracting from the trades or elsewhere is simply not on the same threshold as previously, and the trend is towards higher thresholds."³⁰⁰ Partially because of their internal rate-determination processes as well, surety companies *presently* have a limited ability to respond to the needs of the low asset enterprise.³⁰¹

Our own survey supported this view. Of those contractors responding whose annual gross revenues were \$250,000 or less, fifty percent considered the difficulty of securing the required bonds to be a "determinative" or "important" reason for their not bidding on federal projects. Thirty percent of the contractors between \$250,000 and \$1 million in gross revenues reported this reason as "marginally important," compared to only four percent of those in the \$1-5 million range. Contractors grossing over \$5 million were unanimous in stating that the difficulty in securing bonds was "irrelevant" to their decision.³⁰² Those firms which had tried to get bonds reported similar results, with the relative ease of bonding again varying inversely with the firm's financial size.³⁰³

This artifact of surety risk-response may *presently* (but unwittingly) be serving the interests of the larger firms, and supporting their anti-competitive position. For example, one of the groups most avidly supporting the continued requirement of statutory bonds in the public construction industry is, according to a report of the Comptroller General,³⁰⁴ the Associated General Contractors of America. This group consists of only 9,100 of the nearly 800,000 contractors in the United States. These 9,100, however, do 80% of all the construction

²⁹⁷ Dykehouse, *supra* note 284, at 43-44.

²⁹⁸ 84% of all contract bonds were written by the top twenty surety companies; 56% by the top ten; and 30% by the top five. *Id.* at 41.

²⁹⁹ *Id.* at 45 (emphasis added).

³⁰⁰ *Id.* at 86.

³⁰¹ *Cf. id.* at 151.

³⁰² See Contractors' Questionnaire, Question 5B(f), in Appendix *infra*.

³⁰³ See *id.*, Question 7. To establish some level of validity on this point, we cross-tabulated question 7B with question 5B(f). The results, shown in Appendix, *infra*, at page 1039, demonstrate a high correlation. From such consistency of response we can infer a good degree of accuracy in the reporting of these cross-checked questions.

³⁰⁴ Comptroller General's Report, *supra* note 277.

work annually.³⁰⁵ Their reason for this support is a simple one: "... surety companies perform [the function of] eliminating marginal contractors."³⁰⁶

The word "marginal" can mean either "small" in terms of capital, or "shoddy" in terms of practices and quality of work. Eliminating the latter is of course a worthwhile function. However, deterring the former is *not*. Furthermore, there is no necessary relation between the two. The present study yielded some interesting results here. "Marginal" contractors in the financial sense *were* having bonding difficulties, relative to the larger firms.³⁰⁷ However, contractors "marginal" in the *quality* sense were nevertheless participating in the bidding process!³⁰⁸

This description of the current bonding situation supports the argument that a change in the bank-surety priority law will not have any serious effect on the sureties' relationship with financially small contractors. The hypothesized barriers to entry already exist; the reasons for their existence do not lead to the conclusion that this particular barrier will be raised in an entirely salutary way. It is at least as likely that subordinating the surety will cause it to look more closely at quality marginality than it is currently doing. In short, it is clear that surety companies on the whole *are* performing important and valuable services for the government contracts market. It is *not* clear that these services will be inhibited in any substantial way by some changes in the laws of equitable priority, especially if those changes are made in consideration of the sureties' legitimate functions. However the sureties react to such changes, they will still issue bonds to public works contractors. Thus, the functions of lowering suppliers' costs,³⁰⁹ and of protecting laborers and materialmen, will not be hampered. It is fair to conclude, I believe, that the other functions will not be hampered either.

³⁰⁵ Construction Methods & Equipment 17 (Aug. 1972).

³⁰⁶ Id. See also Engineering News Record 64 (Aug. 3, 1972); Comptroller General's Report, *supra* note 277, at 59, reporting the views of the Association: "The use of bid bonds and surety bonds prevents many of the undesirable bidders and contractors from muddying the water of the construction industry."

³⁰⁷ See Contractors' Questionnaire, Question 7, in Appendix, *infra*.

³⁰⁸ See Comments on Contractors' Questionnaire, in Appendix, *infra*. This is in part due to the fact that there is no statute forbidding "bid shopping" on federal projects, as there is on state and municipal public works. See, e.g., Cal. Gov't Code §§ 4100-08 (1972 Supp). These comments indicated the presence of "corner cutters" as well.

³⁰⁹ See text at note 279 *supra*. This function is itself subject to some question. To my knowledge it has not been empirically verified. In fact, the leading pro-surety theoretician himself failed to support the claim adequately. Cushman, *supra* note 279, at 250 n.43, cited as authority for his claim, in 1966, that the existence of sureties reduces suppliers' prices, three *judicial decisions*, the latest of which had been written fifty-two years earlier. Aside from illustrating a patent flaw in traditional legal writing in general, it demonstrates the weakness of the factual matter asserted.

D. *Dilemmas and Views of the Commercial Bank*

From the point of view of the surety's legitimate functions, and of their relation to the twin goals of federal contracting policy, it is most probable that little of value would be lost if the pro-surety trend of the law were to be partially reversed. The other side of the coin is, what might be *gained* by such a reversal.

It is known that contractors in general have a need for outside financing to enable them to begin substantial public works projects.⁸¹⁰ It is also known that access to financing from the public sector is inadequate to meet this need.⁸¹¹ It is therefore reasonable to conclude that absent the assistance of private commercial lenders, contractors—especially small business contractors—would face an unnecessary barrier to entry into the public works market. If it were to exist, such a barrier would be inimical to both policy goals—that of furthering the growth of small businesses, and that of providing a broadly competitive market for the United States as a purchaser of contractors' services. The inquiry, then, must turn to the matter of commercial lending, and to the question of whether the pro-surety priority decisions have in any way inhibited the processes of private commercial finance.

As prospects for enabling loans, members of the contracting industry as a whole present a relatively unappealing picture. The fixed price bidding system, coupled with the competition for business faced by small firms, has required large segments of the industry to operate on "extremely slender margins."⁸¹² Profits as a function of net worth typically vary from 7.14 to 12.39%; as a function of gross revenues, they range from 1.14 to only 1.5%⁸¹³ It is therefore not surprising that the contracting industry has severe bankruptcy problems; it annually accounts for ten percent of all business bankruptcies,⁸¹⁴ usually leav-

⁸¹⁰ See notes 12, 240 and 249 *supra*, and text at notes 249-50 *supra*. The reasons for business failures also demonstrate contractors' needs for working capital. Among all of the various reasons for such failures is "heavy operating expenses." This cause was cited as the reason for failure by 26.4% of all contracting firms, versus only 14.2% of all other businesses.

The need for financing exists in both the private and public works markets. Referring primarily to the former, Professor Hayes observed that "because the land development and construction process is lengthy, substantial capital is required to carry work in process; as a result, contractors usually require large borrowings in relation to their equity." D. Hayes, *Bank Lending Policies, Domestic and International* 164 (1971). Professor Hayes' work is the result of an *empirical* study of commercial banks' lending policies conducted by the University of Michigan Bureau of Business Research.

⁸¹¹ Discussed *supra*, section III B.

⁸¹² Dykehouse, *supra* note 284, at 238.

⁸¹³ *Id.* at 236.

⁸¹⁴ See note 250 *supra*. The industry's recognition of this phenomenon, and its concern with it, is evidenced by their exultation over a 17% diminution in the fatality

ing no assets to compensate the creditors who have supported it.⁸¹⁵

Furthermore, because of the large dollar size of some projects the gross revenue to working capital ratios of many contractors is relatively high.⁸¹⁶ Such "overtrading" represents a "vulnerable condition for creditors."⁸¹⁷

In terms of security available to the lender, slightly more often than not the public works contractor has little to offer but his rights to payment from the job in progress.⁸¹⁸ The contractor's equipment is often already encumbered with purchase-money security interests,⁸¹⁹ and his available cash is (compared to the typical loan credit) normally quite small.⁸²⁰ Thus contractors, not the best of risks in any event, have little to encourage the participation of private lenders. The surety's prior claim on what is often the only otherwise viable collateral further dims the picture. Given the bank's legal position vis-à-vis the surety, ". . . the prudent lender . . . should begin by looking at the credit as an *unsecured* one . . ."⁸²¹ That, at least, is the crux of the bankers' argument. Such an attitude on the part of the lender is, for the small contractor especially, often fatal to the loan application. Unsecured credit is normally restricted to high (financial) quality companies.⁸²² A small business in an industry as financially questionable

rate. See, e.g., Contractor Failures Drop 17% Below 1971's Mid-Year Mark, *Engineering News Record* 43 (Aug. 24, 1972).

⁸¹⁵ In bankruptcy generally "only 13% of the . . . cases are 'asset' cases in which there is something for creditors." Countryman, *The Bankruptcy Boom*, 77 *Harv. L. Rev.* 1452, 1453 (1964). Countryman's figures include, however, both business and personal bankruptcies.

⁸¹⁶ See note 12 *supra*.

⁸¹⁷ *Id.*

⁸¹⁸ In the Commercial Lenders' Questionnaire, in Appendix, *infra*, we asked the banks to rate certain types of collateral in the order of *availability*. The results are as follows:

	1st	2d	3d	4th	5th
a. Capital assets	8	10	7	3	2
b. Lien or mortgage in the project	17	5	4	1	2
c. Contract rights (Progress payments and retainages)	5	15	8	1	—
d. & e. (Other)	—	2	6	4	1

Item "b" is not relevant to public works projects. Often, small contractors lease their capital assets such as heavy equipment.

⁸¹⁹ Hayes, *supra* note 310, at 165.

⁸²⁰ As to what bankers refer to as "compensating balances," Professor Hayes found that normally only 15% of the individual credit commitment was covered by collected balances for all commercial loans. *Id.* at 94-95. My own information indicates that, as a nationwide figure, 15% is probably low.

⁸²¹ Robert Morris Associates, *Bank-Surety Relationships: An Impasse?*, at 18 (RMA Occasional Paper 1971) (emphasis added).

⁸²² "[U]nsecured loans are usually made to high quality companies where the senior

as contracting is often unlikely to qualify as a "high quality" firm. Loans such as these are:

sometimes classified in a high-risk category, since adequate collateral is difficult to obtain because the performance bonding company usually has a prior lien on the receivables, and often the equipment is not entirely free of debt incurred on purchase. Therefore unsecured loans may be the only practical expedient. Because the credit experience with many contractors has been unfavorable, screening and servicing policies are usually rigorous.⁸²³

These difficulties, inherent in the picture presented by contractors to the commercial banking industry, are in themselves serious. They become even more so when seen in the light of bank lending policies in general. As not-most-favored prospects, contractors are particularly vulnerable to overall changes in the commercial lending environment. For example, affirmative "selling" of loans is now going on at a level below that of previous decades, resulting in a trend toward "critical evaluation of certain types of loans: . . ." ⁸²⁴ For another, the importance of loan quality increases as the bank's loan to deposit ratio increases⁸²⁵ (as well as with fluctuations in the bank's cost of money). With that ratio now near sixty percent nationwide,⁸²⁶ loan quality has become extremely important.

position of a general creditor is clearly adequate, while secured loans are often extended to marginal credits . . ." Hayes, *supra* note 310, at 128-29.

⁸²³ *Id.* at 165 (emphasis added). Of the 62 banks responding to our own survey, 27 (or roughly 43.5%) reported that they make *no* loans to contractors. Thirteen of the twenty-seven explained their policy. Seven of the thirteen responses were from banks in suburban areas who had no contractors among their clientele. The other six explanations are quite interesting:

- (1) "This is a highly skilled, specialized field of lending and entails substantial risk. Therefore, we do not make this type of loan."
- (2) "We have a well diversified clientele, including some small contractors, but our experience with them has made us extremely cautious."
- (3) "No loans (to contractors) as a matter of policy."
- (4) "Banks furnishing the money have no protection of lien losses. High risk loans, Contractors have poor accounting practices." [Note: the accounting practices referred to vary from the normal methods. Because of the length of time most projects require, contractors work on a "percentage completion" accounting system.]
- (5) "Requires specialist—not equipped."
- (6) "No comment."

One other response was, "We do not have any contractors in our trade area; last one liquidated two years ago."

⁸²⁴ Hayes, *supra* note 310, at 41.

⁸²⁵ Gee, *Constructive Lending in Constrictive Times*, 53 J. Com. Bank Lending 9, 10-11 (Mar. 1971).

⁸²⁶ See, e.g., Federal Reserve Bank of Minneapolis, *Functional Cost Analysis Program—Statistical Summary and Chart Book of Data Reported by 98 Ninth District*

While bank's reserve for bad loans ("charge-offs") are typically rather small, and actual charge-offs even smaller,³²⁷ the contributions made by contractors to these losses have been outstanding.³²⁸ Thus again, any contraction in general lending will be magnified for the contracting industry. But of even greater importance is the fact that all of these difficulties will tend to magnify the adverse effect a "bad" legal position can have. Subordinating the bank to a secondary priority in the only collateral that may be available, on a loan made to a small firm in a high-risk industry, cannot help but constrict the availability of credit much more than if the firm and the industry did not suffer from such severe infelicities.

All of this, and more,³²⁹ tends to support the conclusion that the

Member Banks, at A1 (1971): The district average of loans to "assets" was 55.18%. Funds available for loans were 97.65% of "assets," thus loans outstanding were nearly 58% of total available funds.

³²⁷ See, e.g., Federal Reserve Bank of New York, 1971 Operating Ratios of Second District Member Banks; Federal Reserve Bank of St. Louis, Member Bank Operating Ratios—1970. Provisions for loan losses average at approximately 1.5% of total assets; charge-offs in 1970 and 1971 in these representative districts were consistently below an average of 0.29%, and ranged from 0.48% to as low as 0.09%. In both reports, see lines 26 and 40.

³²⁸ Robert Morris Associates annually surveys its members to gather their charge-off experience. The following data are taken from these surveys, reported for 1970 in 54 J. Com. Bank Lending 34, 36 (Sept. 1971), and for 1969 in 53 J. Com. Bank Lending 34, 36 (Sept. 1970):

LOANS TO CONTRACTORS CHARGED OFF COMPARED TO TOTAL LOANS CHARGED OFF

Bank's Loan Size		Percent of Total Number Charged Off			Percent of Total Amount Charged Off		
		Low	Median	High	Low	Median	High
(in millions)							
1969	Under \$100M	0	0	66.7	0	0	96.5
	\$100-500M	0	8.0	20.0	0	6.8	86.5
	Over \$500M	5.0	7.2	13.7	3.8	8.5	15.3
1970	Under \$100M	0	0	37.5	0	0	56.2
	\$100-500M	0	6.6	14.8	0	7.0	36.0
	Over \$500M	1.0	7.6	13.4	1.6	6.1	14.4

While bankers are thus aware of the costs involved in making loans to contractors, they are generally *not* aware of the gains they make. In the course of the present survey we contacted each of the twelve Federal Reserve District Banks, inquiring as to gains and losses reported by type of loan. Each of the districts responded, and all reported that no figures for losses and gains by loan type or "industry" were available. See letters in the author's files. The same answer was received from the Robert Morris Associates (a commercial bankers' organization), and from the Federal Deposit Insurance Corporation. Even apart from these regulatory agencies, very few banks themselves have any idea about their returns from even "construction" loans. As evidence of this fact, see the concern reflected by the authors of the following two articles: Schulkin, Construction Lending REITS are Giving Banks a Run for their Money, 53 J. Com. Bank Lending 23, 26 (June 1971); Solomon, The Determination of Yields on Real Estate Construction Loans, 52 J. Com. Bank Lending 5 (Oct. 1969).

³²⁹ Monitoring loan proceeds in the case of contractors is also more difficult (hence,

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banks' lower status in the bank-surety priority disputes is having, and will continue to have, an inhibitory effect on the financing of small business contractors. A very few banks have responded to this difficulty affirmatively.⁸³⁰ An attitude of extreme caution, however, is more common:

A favorite sport of the live-it-up loan officer is to lend against the assignment of contract receivables or contract retainages on uncompleted jobs as if they were money in the bank. There is no surer way to court disaster. And to have any feeling that the loan should be good because the contract is "bonded" is sheer absurdity unless, as is rarely the case, a special bond has been written for the protection of the bank.⁸³¹

On the face of things the conclusion that *Henningsen, Prairie State*, and *Pearlman* have inhibited the willingness of private commercial banks to lend to small business contractors appears to be justified. In so doing, those decisions have unknowingly interfered with established and clearly identifiable matters of federal policy.

Thus far, however, this conclusion is based on a synthesis of data and assertions not all of which were collected for the sole purpose of inquiring into the instant problem. In the interests of making such an inquiry, and to confirm or refute the above conclusions, the author has conducted a Miller Act survey, the results of which are reported in the following section.

IV. AN EMPIRICAL SURVEY

A. *Hypotheses and Methods*

The hypothesis which was developed by the preceding analyses is that the priority position of Miller Act bond sureties has inhibited the availability of financing to small business public works contractors. The validity of this hypothesis as a place to begin had been *prima facie* established by traditional research into both public⁸³² and pri-

expensive) than for other types of loans. See, e.g., Cerny, *Construction Industry Finances—Musical Chairs with Money*, 52 J. Com. Bank Lending 29, 34 (Jan. 1970): "There is no orderly way in which the cash flow on a project may be monitored."

⁸³⁰ The United California Bank, e.g., has inaugurated a Specialty Contractors Financing Program, described in Bristow, *Specialty Contractors Financing Program*, 52 J. Com. Bank Lending 28 (June 1970). The design is complicated, and its start-up costs are relatively high. It requires an expertise not always within the purchasing power of smaller banks. Its *current* feasibility for these smaller institutions is probabilistic, although further experience may tend to lower its initial costs, and although it should be economically feasible for all but the very smallest of banking institutions. In any event, it is not a panacea for the bank-surety problem, absent judicial recognition of the equitable position it establishes for the bank.

⁸³¹ Gee, *supra* note 325, at 17-18.

⁸³² See, e.g., ASPR App. E-312.4, 4 Gov't Cont. Rep. ¶ 35,645 (1972), demonstrating government procurement officers' reactions, discussed in text at note 262 *supra*.

vate³³³ lending operations. Correspondence with private lenders produced, for example, statements such as this:

In answer to your specific question, first "Does the current legal trend in fact inhibit commercial lenders from undertaking the financial support of marginal contractors?", the answer is definitely yes! . . . [I]n my own opinion a large proportion of small contractors are precluded from participating in U.S. government projects due to a lack of financing.³³⁴

To verify such assertions a "pre-test" of bankers was conducted in the late spring of 1972. Twenty-one banks in Ohio responded to the questionnaire with ten reporting by letter that they had no credit commitments to contractors.³³⁵ One additional letter added, "[T]his institution is not in the business of making loans to contractors for government or similar type projects."³³⁶ Of the remaining ten banks, five responded on the questionnaire that the entire credit commitment was devoted to private projects. Two of these five indicated that their policy was dictated, at least in part, by the difficulty of attaining a secure position in progress payments and retainages. Of the five banks which *were* extending some loans for public projects, only one responded "no" to the question of whether their lending restrictions would be eased if the bank's claim to these funds were to be by law prior to that of the surety. Two made no response to this question, and two answered "yes." Thus, four of the ten banks which were in the business of loaning to contractors (40%) supported the initial hypothesis; only one refuted it.

Although the results of this pre-test could not be considered conclusive, it did establish the general validity of both the hypothesis that bank lending was being inhibited by the pro-surety legal climate, and

³³³ The concern of the commercial banking industry is demonstrated by the activities of the Robert Morris Associates. See, e.g., Robert Morris Associates, *Bank-Surety Relationships: An Impasse?* (RMA Occasional Paper 1971), a paper designed to explore the legal aspects of the problem, and to appraise RMA member banks of the substantial risks involved.

RMA established a "Committee on Cooperation with the Surety Industry," see 50 J. Com. Bank Lending 4 (Jan. 1968). The efforts of the committee to reach some accommodation with the representatives of the surety industry failed, principally because of the sureties' solid legal position. Consequently, the RMA group was restyled "Committee for Cooperation with the Construction Industry."

³³⁴ Letter from Mr. Frank Bristow, Vice President, Construction Industries Division, United California Bank, to the author, April 28, 1972, at 1. Mr. Bristow had originally been contacted as a member of the RMA Committee, *supra* note 333, and has since provided additional assistance to the research here reported.

³³⁵ Letters are in the author's files at the University of Southern California Law Center.

³³⁶ *Id.*

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of the interview/mail-survey method of investigating that hypothesis.⁸⁸⁷ On the basis of this initial experience a second questionnaire was prepared, and was distributed nationally to a random sample of commercial banks. In an attempt to attain a higher validity level than this second bankers' survey alone could provide, the research was "triangulated" by conducting both survey sampling and in-depth interviewing of contractors in Los Angeles and San Francisco. These later surveys were run in the fall and winter of 1972. The point of all of these methods was the same: to detect what, if any, effect the surety-bank priority decisions were having on the financing of public works contractors.

If such an effect were to appear, it would be proper to conclude that these same decisions were interfering with the federal policy goal of encouraging small business firms to participate in government procurement and public works. The minor premise, of course, is that financing is often a prerequisite to participation in that market. That point had been established by the prior research,⁸⁸⁸ and by some incidental results of the present survey.⁸⁸⁹ Thus if financing was either unavailable, or more difficult in terms of cost,⁸⁴⁰ the existence of the unwanted interference could be established.

⁸⁸⁷ Of much greater concern was the response rate. These twenty-one responses were received from seventy-seven mailed inquiries, for a rate of less than 28%.

⁸⁸⁸ See note 250 *supra*.

⁸⁸⁹ Reported in text at notes 249 and 310 *supra*.

⁸⁴⁰ The cost factor is particularly significant in fixed-price bid projects, where a contractor with higher costs of capital is at a competitive disadvantage. In this respect the impact of loan costs on federal projects should not vary significantly from the following data derived from private projects:

HYPOTHETICAL EXAMPLES OF THE IMPACT OF THE CONSTRUCTION LOAN CHARGES ON CONSTRUCTION COSTS*

Type of Construction (1)	Time Construction Loan is Outstanding (2)	Effective Construction Loan Cost to the Builder (As a Percentage of Borrowed Funds) (3) Percent	The Construction Loan Cost as a Percentage of Total Construction Costs (4) Percent	Impact on Column (4) of a One Percentage Point Change in Column (3) (5) Percent
Single-family home	3 months	15	1.500	0.100
Apartment building	1 year	15	6.000	0.400
Office building	2 years	15	12.000	0.800

* Major assumptions:

- 1) That the average balance of the construction loan during the period it is outstanding is one-half the face amount.

The survey instruments employed in the study are reproduced in full in the Appendix.³⁴¹

Fifty contractors in the Los Angeles area were personally interviewed, out of a total sample attempted of less than sixty. Ten of the fifty had been chosen on the basis of federal records as being among "repeat bidders"—contractors who did a substantial amount of the local federal public projects work. The other forty were selected on the basis of personal contacts, referrals from previous interviewees, and some random calls. Data obtained from these fifty personal interviews were recorded on the same instruments as were used in the mail survey, except for additional remarks not solicited by that form.

Three hundred and twenty-seven contractors in the San Francisco area were surveyed by mail. Their names were chosen at random from telephone directories, but within certain numerical constraints: an attempt was made to have each of the subtrades represented in the sample, in a proportion close to that which each represented in the contracting industry as a whole. One hundred and four (31.8%) responded; an appropriate distribution of the subtrades was, by and large, achieved.³⁴²

Our sample did not, however, accurately reflect the real distribution of firms by *size*. A disproportionately small number of responses

- 2) That the face amount of the construction loan is equal to 80 percent of all construction costs, including land.

Schulkin, *Construction Lending at Large Commercial Banks*, New England Economic Review 2 (Federal Reserve Bank of Boston, July/Aug. 1970).

³⁴¹ See pages 1031-48 *infra*.

³⁴² Our sample of responding contractors included the following:

Classification of Business:	Inter- view	Question- naire	Public Works	Total
General Building Contractor	19	26	7	52
Heavy Construction Contractor:				
Highway	1	7	0	8
Non-Highway	2	12	0	14
Specialty Contractor:				
Electrical Work	2	9	0	11
Plumbing, Heating, Air Conditioning	5	6	1	12
Painting, Paper Hanging, Decorating	1	9	2	12
Masonry, Stonework, Plastering	3	3	0	6
Carpentering	0	4	0	4
Concrete Work	2	3	0	5
Roofing & Sheet Metal Work	2	10	0	12
Structural Steel Erection	0	2	0	2
Other	2	10	0	12
Subdividers, Developers, Operative Builders	0	3	0	3
Totals	39	104	10	153

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were received from the smaller firms.³⁴³ Furthermore, our fifty personal interviews were among, generally, even larger firms than were the mail questionnaires. However, neither of these perturbations in what might have been the ideal distribution by size of firm are significant: in scoring and interpreting the results all of the responses were stratified by size of firm. Thus the only effect of the deviation was to have higher or lower numbers of responses than we might have expected in the various stratifications.

A further concern was that the method of selecting the firms to be personally interviewed—being for the most part non-random—would skew the results obtained. This fear turned out to be insignificant when the results of the questionnaire sample were compared to the results of the interview sample. The interviewed subjects were generally larger firms, which again is irrelevant for the reason first noted; how-

The distribution in the industry as a whole is:

Industry Group	# of Estab.	% of Total Firms	Receipts (thousands of \$)	% Receipts
Construction Ind. Totals	794,838	100%	101,735,392	100%
General Building Contractors	156,400	20%	35,457,912	35%
Heavy Const. Contractors	42,839	5%	24,648,649	24%
Special Trade Contractors	563,028	71%	34,830,297	34%
Subdividers, Developers & Operative Builders	32,541	4%	6,796,208	7%

Dep't of Commerce, Bureau of the Census, Summary Statistics for Establishments With and Without Payroll, for Industry Groups and Industries 1A-2, A-1 (1967).

³⁴³ Our sample, stratified into gross revenue ranges, was as follows:

	Interview	Questionnaire	Public Works	Total
a. Under \$ 10,000	0	0	0	0
b. \$ 10,000-\$ 24,999	0	2	0	2
c. \$ 25,000-\$ 49,999	0	2	0	2
d. \$ 50,000-\$249,999	2	18	2	22
e. \$250,000-\$999,999	5	21	3	29
f. \$1 million-\$5 million	21	22	4	47
g. Over \$5 million	10	16	1	27
Totals	38	81	10	129

Figures for the industry as a whole are reprinted in text at note 247 supra.

ever, they had roughly the same level of participation in federal works projects.⁸⁴⁴

The Commercial Lenders' Questionnaire was sent to 400 commercial banks throughout the United States.⁸⁴⁵ Concentration in the larger commercial cities was attempted,⁸⁴⁶ but within each locality the selection was random. The form was eight pages in length, and comprised thirty-five questions and subquestions. Such bulk was the least that could be used to obtain sufficient data, but was still too much to obtain a high response rate. In fact, only sixty-three (16%) banks responded: eleven did so by letter, and fifty-two (13% of the total) completed the questionnaire entirely or in (usable) part. A low response rate was predictable from the earlier pre-test.⁸⁴⁷ The decision was made, however, *not* to risk contaminating the data by sending a covering letter explaining that the research might be of significance to the bank.⁸⁴⁸ The distribution of those banks completing the form, by size and locality, was:

SIZE (POPULATION) OF METROPOLITAN AREA IN WHICH THE BANK IS LOCATED

Under 50,000	16
50,000- 100,000	8
100,000- 300,000	4
300,000- 600,000	5
600,000-1,000,000	7
1,000,000-3,000,000	5
Over 3,000,000	7

⁸⁴⁴ The obvious exceptions to this are the ten "repeaters." The following were the responses to the question, "Have you bid on any federal construction contracts in the past two years?"

	Interview	Questionnaire	Public Works	Total
Yes	23	46	10	79
No	14	20	0	34
Totals	37	66	10	113

⁸⁴⁵ In all, 500 questionnaires were distributed. Through an error in the selection and addressing processes, approximately 100 of the questionnaires were not counted: some were addressed to "Edge Act" banks which do no domestic commercial finance (12 C.F.R. §§ 211.1-.51 (1972)); a few others to branch agents of foreign banks; and the balance of the 100 to suburban branches of banks whose commercial departments had also been surveyed.

⁸⁴⁶ The distribution of mailed questionnaires was:

California	100	Tampa	12	Illinois (other than	
New York City	50	Miami	12	Chicago)	25
New York (other		Jacksonville	12	Detroit	50
than N.Y.C.)	50	Florida (other than		New Jersey	9
Boston area	50	Tampa, Miami,		One each to	
Massachusetts		and		forty-one other	
(other than		Jacksonville)	14	states	41
Boston area)	50	Chicago	25	Total:	500

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TOTAL DEPOSITS OF THE BANK

Under \$50 million	29
\$ 50- 100 million	11
\$100- 200 million	2
\$200- 500 million	7
\$500-1000 million	0
Over \$1 billion	3

B. Responses and Interpretations

The results of the contractors' survey generally support the stated hypothesis, although at a level of persuasiveness below what was originally anticipated.

First, it was confirmed that small contractors participate less frequently in federal public works projects than do larger contractors. Of all reporting firms, 41% derived *no* part of their gross revenues from federal public works projects. Stratifying by firm size, the data shows that of the contractors earning less than \$250,000 annually 59% did no federal work; for those in the \$250,000 to \$1 million range the figure was 48%; from \$1 to 5 million, 34%; and of the largest contracting firms, only 27% had no revenues from federal projects.⁸⁴⁹

Of equal importance is the frequency of bidding, as compared to the figures above which represent actual earned receipts. Of the smallest contractors, 63% had not bid on federal contracts at all in the two years immediately preceding this survey while only 19% of the largest firms had not done any bidding. The overall average was 36% not bidding.⁸⁵⁰

On the question of the ease of procuring financing, the results of the survey are as follows:⁸⁵¹

Gross Receipts	Under \$250K		\$250K-1M		\$1-5M		Over 5M	
	Easy	Diff.	Easy	Diff.	Easy	Diff.	Easy	Diff.
Private Proj.	71%	29%	71%	29%	90%	10%	90%	10%
Federal Proj.	60%	40%	73%	27%	86%	14%	87%	13%

⁸⁴⁷ See note 337 *supra*.

⁸⁴⁸ Two letters we received are instructive; one responding party indicated that a complete answer to the questionnaire would take substantial effort, and there would be little of value to the bank in doing it. The other respondent indicated that the questionnaire would be completed if we would explain how the study would operate to their advantage. Obviously, we did not respond.

⁸⁴⁹ See Contractors' Questionnaire, Question 4, in Appendix *infra*. A similar computation, showing that proportion of reporting contractors whose gross revenues were from 67% to 100% derived from private contracts, supports this result. The ratios here are: all contractors, 60%; under \$250,000, 78%; \$250,000-\$1 million, 70%; \$1-5 million, 64%; and over \$5 million, 27%.

⁸⁵⁰ See Contractors' Questionnaire, Question 5a, in Appendix *infra*.

⁸⁵¹ *Id.* at Question 6.

Thus the ease of procuring financing increases with the size of the firm. That alone proves nothing remarkable. But what is important here is that for three of the four groups, financing is easier for private projects than for federal projects, and further that this divergence is greatest for the smaller firms. Since banks are on occasion the *beneficiaries* of construction bonds in private projects,³⁵² but are never the beneficiaries in cases of federal public works, it is possible to explain this divergence by the existence of the pro-surety legal environment.

Another effect one would expect to see as a result of the bankers' occasional advantage in private projects is that some *individual* contractors would have greater difficulty financing federal work than private. In addition one would expect that this difficulty would be more prevalent among the smaller firms. That, in fact, is what the data shows:

DIFFICULTY FOR A GIVEN FIRM IN SECURING FINANCING WHILE WORKING
ON FEDERAL CONTRACTS, AS COMPARED TO PRIVATE JOBS

Annual Gross Revenues	\$0-250K	\$250K-1M	\$1M-5M	Over \$5M	All
Federal more difficult than private	3	2	4	—	9
Private more difficult than federal	1	1	1	1	4
Private and federal equal	5	10	20	14	49
Total	9	13	25	15	62

Because the numbers within each size group are so small,³⁵³ stating these initially in percentage terms could be misleading. But sample size aside, the results tend to support the hypothesis. For the smallest firms, 33% found it more difficult to finance federal projects than

³⁵² The frequency of bonding contractors on private projects, and of having the bond run not to the owner but to the bank, is as follows:

	Usually Asked For Bonds	Occasionally Asked For Bonds	Rarely Asked For Bonds
Large Volume Banks	2	3	3
Intermediate Volume Banks	7	5	2
Small Volume Banks	11	5	6

P. Schulkin, Commercial Bank Construction Lending, Research Rep. No. 47 to the Federal Reserve Bank of Boston 72, Table 8 (1970).

³⁵³ These are the contractors who have participated in financing both private and federal projects.

private. The percentage drops to 16% for middle-sized firms, and to 0% for the largest. These results are nearly exactly what would have been predicted. Furthermore, it is reasonable to suggest that the differences would be greater had the data included all the responding firms, rather than primarily only those who had actually participated in financing on both types of projects.⁸⁵⁴

Although the "population" of this survey is decidedly not high enough to "prove" my conclusions,⁸⁵⁵ I would like to point out two things in defense of the conclusions. First, more contractors found "federal more difficult than private" to be the case than vice versa in *each* of the first three groups. If the effect were indeed random, one would not expect to see this consistency. Second, the effect demonstrated declines from the smallest firms to the largest. This too was predicted by the original hypothesis, and militates against the possibility that these results are the product of chance. These two points may not enhance the credibility of the magnitude of the expected effect, but they do support its existence. Thus although generally not conclusive, the above data does tend to show that financing is less readily available to contractors working on public projects than to those working on private projects; and further, that this differential in the ease of procuring the necessary financing is greater for small firms (who most need financing) than for large.

The next step, which was an attempt to link the fact of difficulty in financing with the fact of nonparticipation by small contractors, was impeded by the appearance of suppressor variables⁸⁵⁶ at unpredicted intensities.⁸⁵⁷ Nevertheless, the fact is that contractors have a more difficult time being financed for federal works than for private. And financing is very often necessary for a small business firm to undertake federal works.⁸⁵⁸ Therefore, difficulties in obtaining the necessary financing logically should tend to cause a lower level of participation by smaller firms than might otherwise be the case. This is not to say that this factor explains *all* of the non-participation;

⁸⁵⁴ The data does not include all of the contractors surveyed who, for reasons of difficulty in finance, may have never obtained a federal project for which actual cash was needed.

⁸⁵⁵ The relatively low size of this sample is the result of the "masking" effects discussed in text at note 373 *infra*. Sample size, population, is vital in social science research primarily because within large groups random or chance variations tend to be minimized. In small groups, this possibility of random effects makes the data less reliable. That is, the probability that the results observed are due to the variable being tested, rather than to mere chance, is lower in a small sample than in a larger one. Certainly the data printed above can be criticized from this point of view.

⁸⁵⁶ "A suppressor variable is one which weakens a relationship, which conceals its true strength." M. Rosenberg, *The Logic of Survey Analysis* 85 (1968).

⁸⁵⁷ These factors are discussed in text at notes 373-75 *infra*.

⁸⁵⁸ See discussion in text at notes 249-50, 310 *supra*.

rather, it may be one among several causes. Nevertheless, it *is* a cause; and one which could be removed at virtually no cost.

There is a second relationship being asserted here which the contractors' survey also does not "establish."⁸⁵⁹ That is that the dissuasion of commercial lenders from financing public works contractors is the result of the legal status of bank-surety priorities. These data *tend* to show the validity of this causal link, however, by demonstrating the existence of a differential lending policy between private and federal works. Since the bonding practices are different, the bank-surety relationship is, at a minimum, a probable cause.⁸⁶⁰ It may perhaps be enough that it is *a* cause, if not *the* cause. But the argument can go well beyond that. First, our pre-test of the commercial lender's questionnaire indicated a causal connection,⁸⁶¹ at least for some of the banks surveyed. Other interviews and correspondence corroborated this.⁸⁶² Second, to demonstrate that there is *no* causal relationship, one would have to account for the private/federal differential on other plausible grounds. With one possible exception, there are no explanations which I have come across that could entirely block the operation of the priority-in-retainages variable. The exception is that some lenders may make loans to contractors only because they are interested in permanent or "take-out" financing.⁸⁶³ Since that is by definition not available on federal projects, the difference may be entirely explainable on this alternative ground. This possibility was explored in the Commercial Lenders' Questionnaire.

In that form, the banks were asked to rank *in order of preference* the types of collateral they would require of contractors. The responses for those banks which were not then financing anything other than private construction are as follows:⁸⁶⁴

	1st	2nd	3rd	Total
a. capital assets	2	1	1	4
b. mortgage interest in the completed project	3	3	1	7
c. progress payments and retainages	1	2	2	5

⁸⁵⁹ The survey was not designed to establish this relationship, simply because it would have been logically impossible. Contractors are not reliable sources of information about the reasons for bank lending policies.

⁸⁶⁰ See note 352 *supra* and accompanying text.

⁸⁶¹ See text at notes 335-37 *supra*.

⁸⁶² See, e.g., note 359 and text at note 360 *supra*.

⁸⁶³ "A take-out commitment is a contractual commitment of the permanent lender, in consideration of a fee, to become the permanent mortgagee on the property in question" P. Schulkin, Commercial Bank Construction Lending, Research Rep. No. 47 to the Federal Reserve Bank of Boston 35 (1970). "[T]he contractor-developer generally pays off the construction loan with the proceeds of his permanent mortgage." *Id.* at 13.

⁸⁶⁴ Complete data is available in Appendix, *infra*.

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On the basis of these figures, there is little doubt that the desire for "take-out" financing is a strong competing factor. However, the data also shows that such a desire is not of sufficient intensity that it could completely block the operation of the priority factor.

In short, I believe this survey indicates that the bank-surety priority cases are a substantial contributing cause of the commercial bankers' reluctance to finance contractors who are working on federal projects; and that that reluctance is one cause of the small business contractor's relative nonparticipation in the federal public works market.

Other results of the survey of commercial lenders add support to this conclusion. For one, the assertion that banks tend to look at credits for public works contractors as "*unsecured*" was borne out. Those banks which were making loans for both private and public works projects reported, on the average, that only 28% of the "private" loans were unsecured, while the same ratio for "public" loans was 42%.⁸⁶⁵

The questionnaire contained three items which probed directly into the existence of differential lending policies toward federal vis-à-vis private construction projects. The questions and the responses were as follows:

- 10) For a contractor who requires financing to perform a *public* project, does the bank undertake any investigations into creditworthiness, feasibility, or job details which are *different from* those investigations it would undertake if the job were for a private owner?
Yes: 5. No: 14. No Response: 15.
- 16) For a contractor who requires financing to undertake a public construction project, does the bank request security of a different type, or of a different loan-to-collateral

⁸⁶⁵ The nine banks in this group reported the actual percentages as follows:

PERCENT UNSECURED		
No.	Public	Private
1.	70	20
2.	100	70
3.	70	30
4.	10	5
5.	100	50
6.	0	0
7.	0	0
8.	0	0
9.	25	75

For a discussion of the importance of this finding, see the discussion of bank lending policies in text at note 322 *supra*.

ratio, than that which it requires on a private job?

Yes: 5. No: 16. No Response: 13.

- 18) Would a "small" (i.e. less than \$100,000 in owned assets) contractor have a greater chance of being denied a loan if the job in question were a public project, rather than one for a private owner?

Yes: 8. No: 18. No Response: 8.

A "yes" response to any one of these questions indicates, that for the responding bank, the loan policies toward public works contractors are more severe than for private.⁸⁶⁶ As percentages of total responses, the "yes" count was 26.3% for question 10; 23.8% for question 16; and 30.7% for question 18.⁸⁶⁷ Fourteen banks had answered "yes" to one or more of the three questions, for a rate of 41%.⁸⁶⁸ Clearly then, a substantial portion of the banks surveyed reported that contractors employed on public works might find it more difficult to secure financing, than if they were doing only private projects.

The fourteen banks referred to above were then compared to the others in terms of their awareness of the legal bases of the bank-surety priority dispute.⁸⁶⁹ If they were graded on their awareness of these matters of law in the way we law professors are prone to grade, the fourteen banks which did prefer "private" to "public" projects would as a group be in the upper half of the class (2.63), while those banks which reported no such differences would not quite meet the graduation standard (1.92).⁸⁷⁰

⁸⁶⁶ Questions 10 and 16 ask only for differences. However, the answers to Questions 11 and 17 indicate that all of the differences operate in one direction, i.e., "public" is more difficult than "private." See notes 371-75 *infra*.

⁸⁶⁷ These results are drawn *only* from the 34 banks which reported *some* credit commitment to contractors. Banks which did not make loans to any contractors uniformly left Questions 10, 16 and 18 unanswered.

⁸⁶⁸ See note 367 *supra*. There were 34 responses.

⁸⁶⁹ The four legal points so tested were "The Miller Act"; "The Assignment of Claims Act"; "The Surety's Right to Equitable Subrogation"; and the "Priority Rights Among Lenders and Sureties on Bonded Public Construction Jobs."

⁸⁷⁰ Obviously I mean no evaluative statement by this; it is used here only to provide a familiar comparative scale. The actual responses to this "awareness" question are as follows:

	Acutely Aware		Aware		Vaguely Aware		Not Aware	
	14 Banks	Others	14 Banks	Others	14 Banks	Others	14 Banks	Others
Miller Act	—	—	6	—	5	5	3	5
Assignment of Claims Act	—	—	11	4	1	3	2	3

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The natural inference from this disparity is that a differential lending policy is causally related to the awareness of the law of bank-surety relationships. To test that inference, each of the fourteen banks was asked to explain their responses.⁸⁷¹ On balance the answers supported the more clearly stated pre-test results,⁸⁷² *i.e.*, that the surety's priority is most probably one among other contributing factors to the observed differentials.

Although the results of the survey are not unassailably conclusive on the validity of the hypothesis with which this study began, it does tend to support these original suppositions. Most important however, it makes a decent case for some very hard rethinking of the entire bank-surety priority problem, and—I personally feel—for a partial reversal of the now nearly ubiquitous surety's victory.

C. Surprises

There are three possible explanations for the fact that the quantum of support lent to the initial hypothesis by the reported data is somewhat lower than what was originally anticipated. First, the hypothesis may have been false. The intensity of proof which *was* observed indicates that this possibility can be ruled out. Second, the methodology may have been imperfectly conceived and imperfectly executed. I am certain that this is true to some extent; just how true

	Acutely Aware		Aware		Vaguely Aware		Not Aware	
	14 Banks	Others	14 Banks	Others	14 Banks	Others	14 Banks	Others
Equitable Subrogation	2	—	6	3	5	4	1	3
Bank-Surety Priorities	4	1	6	2	4	4	—	3

To "score" this awareness, I have applied the following scale: "Acutely Aware" = 4.0; "Aware" = 3.0; "Vaguely Aware" = 2.0; and "Not Aware" = 1.0. [No one really gives "F" (0.0) grades in law school any more.]

For banks which make credit available to contractors, but who make *no* public loans, the differential is even higher. On the same scoring basis, those who answered "yes" to questions 10, 16, or 18 earned a collegiate grade of 2.69. Those who answered "no" or "no response" earned 1.58.

⁸⁷¹ Of the five banks which responded "yes" to question 10, one did not explain its answer. Of the four that did, three indicated that they were having some difficulty with bonding matters. Five banks answered question 16 affirmatively. In their explanations, two supported the inference, and two suggested other causes. The fifth explained, mysteriously, "We do not anticipate lending for public construction purposes." Finally, of the eight "yes" answers to question 18, two gave no indications of their reasoning, and six suggested five different reasons.

⁸⁷² See discussion in text at notes 334-36 *supra*.

it is I leave to my critics. The third possibility is that there are in the field suppressor variables which "masked" our ability to observe the effects of the variable being tested, and which reduced the intensity of the evidence of its existence. Of the existence of this third possibility, I am virtually certain.

On the basis of the responses to some "shots in the dark," which had been incorporated into the survey instruments, it was discovered that there were some *threshold* difficulties faced by contractors who contemplate getting involved with federal public works. These difficulties were present at such high levels that the difficulty of securing financing would not even be noticed in a measurable number of cases. After all, why bother negotiating with the bank, when for other reasons you do not want the work. The contractors' questionnaire asked, essentially, "If you have not bid on any federal construction projects in the last two years, would you indicate why not?" In the covering letter the respondents were instructed to answer this question even if they *had* done some bidding, but to indicate why they had not bid more frequently. Six factors were specifically set out for comment, and opportunity was provided for the insertion of "Other."³⁷³ Each respondent was asked to indicate whether each of the six (or seven) factors individually was "Determinative," "Important," "Marginally Important," or "Irrelevant" to his decision not to bid or to bid less frequently than would otherwise have been the case. In summary form,³⁷⁴ the results for each of the six factors are as follows:³⁷⁵

	Det.	Imp.	M.I.	Irr.
1) Lower profitability on public projects:	25	18	4	18
2) Cost of preparing a bid:	6	10	12	27
3) Cost of submitting a bid:	5	7	11	36
4) Lack of experience with public projects:	9	3	4	39
5) Impenetrable paper work:	38	15	6	18
6) Difficulty in securing required bonds:	4	2	4	46

In a way, the results speak for themselves: federal projects are not very profitable, but to get them requires an immense amount of paper pushing. In fact over 40% of the responding firms found this latter factor to be at least "important," while over 29% found it to be "determinative."

³⁷³ The items listed under "Other" are discussed in text at notes 376-77 *infra*, and are reproduced in full in Appendix, Results, Contractors' Questionnaire, *infra*.

³⁷⁴ These data were stratified by firm size, and are reported thus in Appendix, *infra*.

³⁷⁵ A total of 130 firms completed this question in whole or in (usable) part.

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To explore the possibility that the "paper work" responses were based on groundless fears rather than actual knowledge, they were again stratified, this time holding constant the level of each firm's actual participation in federal work. The result was as follows:

Percent of Gross Revenue Earned from Private Construction	"Paperwork" Responses				
	% Det.	Det.	Imp.	M. Imp.	Irr.
100%	54.5%	18	5	3	7
91-99%	54.5%	6	1	1	3
71-90%	50.0%	9	5	1	3
51-70%	66.7%	2	—	—	1
0-50%	21.4%	3	4	1	6

Thus—with the exception of those who are primarily public works contractors, and who may through experience and personal contact have been able to "routinize" their operations—roughly the same level of inhibition appears at every level of participation. It can be safely concluded, therefore, that the claim of "impenetrable paper work" is not a frivolous one. Furthermore, the impact of this factor was fairly constant for all firms surveyed, regardless of size. The proportion of "determinative" responses to the paperwork question were, by firm size:

Annual Gross Receipts	Percent "Determinative"
Under \$250K	68.7%
\$250K-1M	45.0%
\$1M-5M	50.0%
Over \$5M	27.3%
All Firms	49.4%

To explore the other large inhibiting factor, that of "lower profitability on public projects," two other questions were included in the survey instrument. The contractors were asked (question 8) whether it was ever appropriate for them to engage in "low profit" contracts to cover irreducible fixed costs; and if so (question 9), whether they ever used public works projects for that purpose:

ANNUAL GROSS RECEIPTS				
	Under \$250K	\$250K-1M	\$1-5M	Over \$5M
Q. 8: Yes	11	13	25	10
No	13	11	25	16
Q. 9: Yes	5	8	14	6
No	7	8	10	3

The next item on the form asked of those who answered "yes" to number 8, but "no" to number 9, the question, "why not?"⁸⁷⁶ Chief among the reasons listed were the difficulties caused by arbitrary and inexperienced inspectors, unqualified and unscrupulous competition, and inflexibility of the Government as an "owner." These responses, coupled with the "paperwork" responses yield a brilliant and unmistakable attitude on the part of contractors: doing business with the United States is an obnoxious process.

There are two principal observations to be made about this. First, in deterring competition through sheer bureaucratic inefficiency, the United States may be operating contrary to its own best interests as a buyer of contracting services.⁸⁷⁷ Second, and for the same reason, it may be interfering with the contracting industry to those firms' detriment.

Since the difficulties noted in this section are operating at such high levels, and are operating as threshold barriers to the participation of many firms in the federal public works market, it is not at all surprising that the observed intensities of the effects of the one variable we set out to study—*i.e.*, the surety's prior legal position—would be severely attenuated. However, these suppressor variables do *not* detract from the validity of the hypothesis; they simply make it far more difficult to "prove."

V. CONCLUSION

At several points throughout this discussion this article has indicated the conclusions to which each of the major themes has led. To reiterate would be superfluous. It may be worthwhile, however, to attempt to collect the themes together, and to see where such an amalgam may ultimately lead.

A. General Conclusions

When a contractor on a public works project defaults, he often leaves behind a Miller Act bond surety and a financing bank. Both of these unfortunates have typically made cash outlays on the contractor's behalf, and both have thereby benefitted the project. In a dispute between them, over which has the prior right to reimbursement from

⁸⁷⁶ The responses, predictably, corresponded closely to the factors listed in the "Other" category of Question 5 of the Contractors' Questionnaire. These factors are detailed at Question 5 in Appendix, *infra*.

⁸⁷⁷ A study of the need for the bureaucratic protections in relation to their spurious costs is now being planned by the author. It will appear in a future issue of the Boston College Industrial & Commercial Law Review.

the withheld funds, with one minor exception³⁷⁸ the surety will always be preferred by the law. How the surety's priority position came to be law is in itself a fascinating piece of history.

The development in this area has, from 1896 until today, been more marked by accident than by sound and rigorous analysis. When the Supreme Court first characterized the parties into different legal camps, the die was cast. The status of "subrogee" carried with it a great deal of doctrinal baggage; the status of "assignee," likewise. But, unfortunately, little of the legal structure of either had been concerned with the interactive effects one could have on the other. Consequently, there were few clear guidelines by which the collision could be untangled or avoided. Exacerbating that difficulty was the fact that the bank-surety disputes arose in a number of diverse factual contexts: some combination of performance vs. payment bond, retainages vs. progress payments, and so on was presented in each case; but no case presented the entire panoply of permutations. Each of the possible factual distinctions could be logically related to an outcome—many of them independently so. The decisional environment was therefore less than perfect for the development of a comprehensive scheme of analysis.

To make things even more confusing, sureties were simultaneously litigating similar (but not identical) matters with bankruptcy trustees. Holdings—and even worse, dicta—generated by these collateral cases were adopted eagerly by later courts as being relevant to the financing bank situation. Few questions were raised whether such adoptions were well founded. It is, in short, fair to characterize the entire patch-work process as having been in part almost accidental—maybe unavoidably so.

But there is an even more telling criticism to be made. Perhaps distracted by the wealth of seeming distinctions that were available, the courts by and large ignored some doctrinal difficulties that inhered in even the seminal cases. First off, the surety's right of subrogation is itself not free from difficulty. But beyond that, the *priority* of subrogative rights is—as a purely legal matter—open to serious question. There is little in the law of suretyship, or in the relevant statutes or contract documents, which forecloses the bankers' claims quite so quickly as the courts seem to have allowed in these recent days. Thus on several grounds the sureties' position is subject to serious doubt.

What all of these doctrinal matters boil down to is that the current shape of the law was far from inevitably mandated by the *relevant* legal sources. At several junctures it could be shown that the

³⁷⁸ That situation is where earned progress payments have been paid over prior to default.

bankers had the better of it. The sureties' position at its *best* is far from impervious.

Legal vacuums are not rare. This is not the first time, nor will it be the last, when the wisdom of the past fails to solve the problems of the present. There is neither reason nor excuse for timidity on such occasions. Unless one is to be satisfied with logic alone (and questionable logic at that) as the font of distributive justice, legal vacuums must be filled with policy. Nothing but bad decisions would be endangered by explicit recognition of that fact.

In the dispute between banker and surety, the policy referents are obvious. They have been declared by Congress, they require no manipulation in order to be ferreted out, and they are patently wise. They are: to protect laborers and materialmen, to protect the United States as a purchaser of services and materials, and to foster a competitive economy by encouraging the growth and proliferation of small business enterprise.

As I have attempted to show, it is quite unlikely that a partial reversal of the surety's now unassailably prior status will have any adverse effects on any one of these three goals. The surety's valuable functions should be and would be retained despite some erosion of their legal rights. The functions of commercial lenders, however, being far more sensitive to the legal environment than those of the surety, would almost definitely be enhanced. This in turn would result in a greater fulfillment of the declared federal policy objectives. The present nature of the contracting industry and the pressures of commercial finance in general have all operated to magnify the ill effects of the bank-surety priority decisions. These effects have inhibited the accomplishment of two of the goals of federal contracting policy. A reversal of this trend is, I believe, therefore necessary.

B. *Specific Recommendations*

Having thus considered both doctrine and fact, I believe a persuasive case can be made for a change in the law of bank-surety priority. Doctrinal considerations do not conclusively support the claims of either party, although at several points the banks seem to have the better of it. Implementation of established policy, however, does tend to dictate a pro-bank result. As I have tried to show, such a reversal of what is now the law will have no deleterious effects, but will in all probability have an impact consistent with established federal policy. Yet, a blanket validation of the banks' position would be uncalled for. There are, I think, some necessary limitations.

At various times during the evolution of the priority cases, decisions had been premised upon a variety of factual matters. Their ap-

pearance has been discussed,⁸⁷⁹ and their disappearance has been noted. Despite the fact that they are no longer deemed relevant, because a change is now being advocated they should be exhumed just long enough to be properly reinterred.

One such distinction was that between payment bond obligations and performance bond obligations. Prior to *Pearlman* it was possible to have differential results for cases involving the one or the other. *Munsey Trust*, in fact, dealt with precisely this factor. Two points should be made about this. First, for either of the bonds there are legal arguments both ways. Doctrine alone is hardly conclusive here, as elsewhere. Second, there should be no distinction made between the two as a matter of policy. The Miller Act requires both. So long as it does so, the laborers and materialmen will be paid and the Government will be held harmless from breach by the contractor. So far as the legitimate functions of the surety are concerned, there is nothing to indicate that its willingness to bond contractors is now or will under any circumstances ever be different for one bond or the other. Similarly, the bank is not concerned with exactly how its rival became its rival. Finally, so far as the question of the bank's contribution to the project may be relevant, funds used to pay for labor, or to buy materials, or to provide any other of the requisites for a completed project are all of equal value to the Government. In short, neither doctrine nor policy requires a resuscitation of the payment bond versus performance bond distinction.

The same can be said for the two "different" types of withheld funds: retainages and progress payments. The various "legal" consequences that arguably result from this classification of withheld funds have been discussed above. Suffice it at this point to say that there is nothing in the several policy referents which would support any continuing distinctions. For the same reasons the *location* of the disputed fund should be irrelevant. When the United States withholds a payment, either by contract (retainages) or informally (progress payments "earned" by performance), it does so for its own protection. It should not be permitted to determine the outcome of what is in every way a private dispute by its decision to pay over or to retain any given sum.

At present, the banks have priority as to progress payments which have been earned and paid over prior to default. This rule, in my opinion, should be amended by the addition of a requirement that the lender must have exercised some amount of policing over the application of its loan. If the bank has failed to make certain that its loans were not dissipated, and that failure has caused a loss to the

⁸⁷⁹ See text at notes 74-75 *supra*.

surety, there is little reason for the bank to be immune from recoupment in an action by way of restitution, or by a constructive trust. If the bank does wish to be able to rely on payments once made, it should be left to do so by contract with the surety, perhaps in return for a binding commitment to finance the contractor through to completion.

The matter of the "timing" of the rival interests, which had been considered to be determinative in *Prairie State* and in certain of the later cases, is also quite irrelevant. Banks are on constructive notice of the existence of the Miller Act, and thus of the existence of the surety's interest. Likewise, sureties should also be held to know that many of their assureds will eventually need to obtain financing, and will have to encumber their progress payments to do so. The policy referents which have been previously discussed should not be sullied by the terribly fortuitous circumstance of who gets the contractor's signature first. Both sureties and banks should be encouraged to participate; there is no reason to favor the swift. This point is especially important in light of actual practice. Contractors often arrange with their sureties not just for one bond at a time, but for a bonding "limit." So long as work in progress does not exceed that limit, issuance of a bond for a particular job is nearly automatic. Thus typically the relationship significantly predates any given bond. The same is true of banks; few loans are "one-shot."³⁸⁰ Much more typical are lines of credit which allow drawings without regard to the particular project. In short, actual timing of the contractual relationships normally has nothing to do with the particular job in question, for the bank as well as for the surety.

The remaining factual distinction, which once briefly flickered in the reports but which has now been snuffed out, is that of the application of loan proceeds. This point, I think, should be infused with new life. As I have indicated earlier,³⁸¹ a commercial lender who fails to even inquire about the use of his loan has a very flimsy legal basis for his claim to priority. Subrogation and priority of subrogees are equitable matters. As between a surety whose advances have gone to help generate the fund in question, and a bank whose advances have not, there should be little doubt that the surety has a more compelling equitable position. As a matter of government contracts policy, a live-it-up lender who fails to assist his borrower on the project in question is not doing the job which he should be encouraged to do. Such a lender adds little to the interests of the United States, and is not par-

³⁸⁰ See Appendix, Commercial Lenders' Questionnaire, Question 8, *infra*.

³⁸¹ See text at notes 379-80 *supra*.

ticipating in the financing of contractors in a way which will necessarily promote competition within the public contracts market.

It is quite a different matter, however, if the proceeds of the loan *have* been used in furthering the project. If such is the case, not only has the Government been benefited and the lender's assistance been "properly" (*i.e.* within the relevant policy framework) applied, but beyond even these, the maximum exposure of the surety on his bonds has been reduced. The equitable positions are thus quite distinct from the case of dissipated proceeds. If only those lenders who will do such "policing" of their loans are protected, the encouragement which Congress has often wished for, would in fact come about. The costs of policing are not excessive.⁸⁸² In fact, a large number of banks are currently policing their loan funds to ensure that they are properly applied.⁸⁸³

If the surety's claim were to be subordinated to that of the lender who has benefited the project (and thereby benefited the surety), there would be a measurable inducement for commercial banks to assist small business contractors in undertaking public works projects. The results would be salutary: one barrier to entry would be lowered, and in all probability the beneficial services now provided by contract bond sureties would not abate. In fact, as suggested previously,⁸⁸⁴ there is some chance that sureties would react by screening bond applicants more for quality than for financial marginality. On the matter of capability and credit-worthiness, banks are at least as adept assessors as are the surety companies. Within the limitations above noted, both doctrinal and empirical analyses support turning back the clock to 1945, and recognizing the wisdom of the "policing" criterion relied on by the Fifth Circuit Court of Appeals in its decision in *Coconut Grove*.

C. *Proposals for Further Study*

The proposal just made is hardly the end of the matter. Rather, there are at least three distinct items which merit further work. The first is the question of implementation.

Cash paid directly to materialmen and laborers should not be the only application of loan proceeds which will support a banker's priority in the retained funds. It may be, for example, that loan proceeds used to satisfy some other demand of the contractor will directly result in the release of other funds which can then be used on the

⁸⁸² See Appendix, Commercial Lenders' Questionnaire, Question 5, *infra*.

⁸⁸³ *Id.*

⁸⁸⁴ See text at notes 308-09 *supra*.

project. Clarifying circumstances such as that, and developing standards for deciding concrete cases is a matter best left to the courts. There are certainly now clear enough policy limits to guide that decisional process. Similarly, standards for the level of "policing" will have to be developed. These I would not leave entirely to the process of judicial rule-making. I would rather see some factual studies made of industry practices, and of the costs and feasibility of various policing techniques. After that is done the courts may more perfectly balance the competing interests without imposing unrealistic burdens.

The second matter that invites further work is the study which has been reported in this essay. I have reached my conclusions, and offered my proposal, with an acute awareness of the existence of some deficiencies in the proof. Obviously, in my judgment the evidence is adequate. I would nevertheless think that replication is in order, as well as rigorous criticism. At this point I believe my conclusions and proposal to be sound. I do not, however, think them to be "proven" beyond a reasonable doubt.

The third proposal for further study is prompted by the data which was uncovered, and which demonstrated the intense level of operation of threshold barriers to entry to the federal public works market. The results of *Henningsen* and *Pearlman* are only a part of the reason for the difficulty faced by the small business contractor, and are only a part of the cause of the relative lack of competition in this market. The federal contracting processes themselves are significantly inhibiting. This is a matter eminently worth being explored. Examining and curing its defects are at least as important as is the need to reverse the current state of the law of banker-surety priority disputes.

APPENDIX

A. CONTRACTORS' QUESTIONNAIRE

Miller Act Survey

Contractors' Questionnaire
Rev. October 11, 1972

All Replies Must Be Kept in the Strictest Confidence; Do Not Record the Contractor's Firm Name on This Sheet.

1. Classification of Business:

General Building Contractor _____
Heavy Construction Contractor: _____
Highway _____
Non-Highway _____
Specialty Contractor: _____
Electrical Work _____
Plumbing, Heating, Air Conditioning _____
Painting, Paper Hanging, Decorating _____
Masonry, Stonework, Plastering _____
Carpentering _____
Concrete Work _____
Roofing & Sheet Metal Work _____
Structural Steel Erection _____
Other, specify _____
Subdividers, Developers, Operative Builders _____

2. Principal place of business (city and state) _____

3. In order to locate your firm's position within the Bureau of Census statistics, would you categorize your firm's gross receipts into one of the following dollar ranges:

- a. Under \$10,000 _____
b. \$ 10,000-\$ 24,999 _____
c. \$ 25,000-\$ 49,999 _____
d. \$ 50,000-\$249,999 _____

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- e. \$250,000-\$999,999 _____
- f. \$1 million-\$5 million _____
- g. Over \$5 million _____
4. Could you estimate the % of your annual gross receipts derived from:
- a. Private construction _____%
- b. Federal construction _____%
- c. State construction _____%
- d. Municipal construction _____%
5. (a) Have you bid on any federal construction contracts in the past two years: _____
- (b) If not, would you indicate which, if any, of the following factors may have influenced your decision not to bid?

	<i>Determinative</i>	<i>Important</i>	<i>Marginally Important</i>	<i>Irrelevant</i>
Lower profitability on public projects	_____	_____	_____	_____
Cost of preparing a bid	_____	_____	_____	_____
Cost of submitting a bid	_____	_____	_____	_____
Lack of experience with public projects	_____	_____	_____	_____
Impenetrable paper work	_____	_____	_____	_____
Difficulty in securing required bonds	_____	_____	_____	_____
Other	_____	_____	_____	_____

6. How have you found the ease of procuring the financing necessary to begin each of the following types of contracts:

	<i>Always Easy</i>	<i>Usually Easy</i>	<i>Occasionally Difficult</i>	<i>Usually Difficult</i>	<i>Always Difficult</i>
a. Private Construction	_____	_____	_____	_____	_____
b. Federal Construction	_____	_____	_____	_____	_____
c. State Construction	_____	_____	_____	_____	_____
d. Municipal Construction	_____	_____	_____	_____	_____

7. How have you found the ease of procuring bonds as required on the following types of contracts:

	<i>Always Easy</i>	<i>Usually Easy</i>	<i>Occasionally Difficult</i>	<i>Usually Difficult</i>	<i>Always Difficult</i>
a. Private Construction	_____	_____	_____	_____	_____
b. Federal Construction	_____	_____	_____	_____	_____

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- c. State Construction _____
- d. Municipal
Construction _____

8. Has it been appropriate in recent years for you to engage in a low profit contract to cover irreducible fixed costs? _____
9. If the answer to #8 is yes, have you considered using public contracts for this purpose? _____
10. If answer to #9 is no, could you briefly explain why?

B. RESULTS: CONTRACTORS' QUESTIONNAIRE

Question 1:

<i>Classification of Business:</i>	<i>Interview</i>	<i>Question- naire</i>	<i>Public Works</i>	<i>Total</i>
General Building Contractor	19	26	7	52
Heavy Construction Contractor:				
Highway	1	7	0	8
Non-Highway	2	12	0	14
Specialty Contractor:				
Electrical Work	2	9	0	11
Plumbing, Heating, Air Conditioning	5	6	1	12
Painting, Paper Hanging, Decorating	1	9	2	12
Masonry, Stonework, Plastering	3	3	0	6
Carpentering	0	4	0	4
Concrete Work	2	3	0	5
Roofing & Sheet Metal Work	2	10	0	12
Structural Steel Erection	0	2	0	2
Other, specify	2	10	0	12
Subdividers, Developers, Operative Builders	0	3	0	3
Totals	39	104	10	153

Question 3:

In order to locate your firm's position within the Bureau of Census statistics, would you categorize your firm's gross receipts into one of the following dollar ranges:

	<i>Interview</i>	<i>Question- naire</i>	<i>Public Works</i>	<i>Total</i>
a. Under \$10,000	0	0	0	0
b. \$ 10,000-\$ 24,999	0	2	0	2
c. \$ 25,000-\$ 49,999	0	2	0	2

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	<i>Interview</i>	<i>Question- naire</i>	<i>Public Works</i>	<i>Total</i>
d. \$ 50,000-\$249,999	2	18	2	22
e. \$250,000-\$999,999	5	21	3	29
f. \$1 million-\$5 million	21	22	4	47
g. Over \$5 million	10	16	1	27
Totals	38	81	10	129

Question 4:

Could you estimate the percentage of your annual gross receipts derived from:
(Public Works "Repeaters" Only)

	Type of Work	0-25%	26-50%	51-75%	76- 100%
Numbers of Responses	a. Private Construction	6	1	2	1
	b. Federal Construction	5	4	0	1
	c. State Construction	8	1	1	0
	d. Municipal Construction	8	2	0	0

Ranges: a. —0 to 91%; b. —3 to 80%; c. —0 to 60%; d. —0 to 35%.

Question 4:

Could you estimate the percentage of your annual gross receipts derived from:

Annual Gross Receipts (%)	Private Construction	Federal Construction	State Construction	Municipal Construction
\$0-250K				
0	—	16	17	15
1-10	—	4	8	8
11-25	1	4	1	3
26-40	1	—	—	1
41-67	4	3	1	—
67+	21	—	—	—
\$250K-1M				
0	1	13	12	14
1-10	2	10	10	6
11-25	1	1	2	4
26-40	—	2	2	2
41-67	4	—	1	1
67+	19	1	—	—
\$1M-5M				
0	2	17	18	18
1-10	5	21	18	18
11-25	3	7	9	7
26-40	3	2	2	4

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Annual Gross Receipts (%)	Private Construction	Federal Construction	State Construction	Municipal Construction
41-67	5	2	2	3
67+	32	1	1	—
Over \$5M				
0	2	7	6	5
1-10	4	7	10	7
11-25	4	5	6	6
26-40	3	3	3	4
41-67	6	2	1	2
67+	7	2	—	2

Question 5a:

Have you bid on any federal construction contracts in the past two years?

1) Stratified by data "source."

	Interview	Question- naire	Public Works	Total
Yes	23	46	10	79
No	14	20	0	34
Totals	37	66	10	113

2) Stratified by gross revenues.

	\$0-\$250K	\$250K-1M	\$1M-5M	Over 5M
Yes	10	19	27	21
No	17	4	17	5

Question 5b:

[If you have not bid on any federal construction contracts in the past two years] . . . indicate which, if any, of the following factors may have influenced your decision not to bid. [From covering letter: If you have bid, please indicate which factors, if any, may have deterred you from bidding more frequently.]

D = Determinative

Imp. = Important

MI = Marginally Important

Irr. = Irrelevant

a. Lower profitability on public projects

Number Resp.	Annual Gross R.	D	Imp	MI	Irr
27	\$0-250K	7	3	—	1
27	\$250K-1M	9	4	1	2
50	\$1M-5M	6	9	2	10
26	Over \$5M	3	2	1	5
130	Totals	25	18	4	18

b. Cost of preparing a bid:

Number Resp.	Annual Gross R.	D	Imp	MI	Irr
27	\$0-250K	2	5	1	—
27	\$250K-1M	1	—	4	7
50	\$1M-5M	2	5	6	13
26	Over \$5M	1	—	1	7
130	Totals	6	10	12	27

c. Cost of submitting a bid:

Number Resp.	Annual Gross R.	D	Imp	MI	Irr
27	\$0-250K	3	4	1	2
27	\$250K-1M	1	1	5	6
50	\$1M-5M	1	2	5	19
26	Over \$5M	—	—	—	9
130	Totals	5	7	11	36

d. Lack of experience with public projects:

Number Resp.	Annual Gross R.	D	Imp	MI	Irr
27	\$0-250K	4	1	1	4
27	\$250K-1M	0	2	1	8
50	\$1M-5M	4	0	2	20
26	Over \$5M	1	0	0	7
130	Totals	9	3	4	39

e. Impenetrable paper work:

Number Resp.	Annual Gross R.	D	Imp	MI	Irr
27	\$0-250K	11	3	1	1
27	\$250K-1M	9	4	4	3
50	\$1M-5M	15	6	1	8
26	Over \$5M	3	2	0	6
130	Totals	38	15	6	18

f. Difficulty in Securing Required Bond:

Number Resp.	Annual Gross R.	D	Imp	MI	Irr
27	\$0-250K	4	2	—	6
27	\$250K-1M	—	—	3	7
50	\$1M-5M	—	—	1	24
26	Over \$5M	—	—	—	9
130	Totals	4	2	4	46

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Question 6:

How have you found the ease of procuring the financing necessary to begin each of the following types of contracts:

Annual Gross Receipts	Private Construction	Federal Construction	State Construction	Municipal Construction
\$0-250K				
AE	7	2	1	2
UE	8	4	2	3
OD	3	2	1	1
UD	2	2	1	—
AD	1	—	1	—
\$250K-1M				
AE	6	4	4	4
UE	9	7	6	5
OD	3	2	2	2
UD	1	1	1	1
AD	2	1	1	1
\$1M-5M				
AE	15	12	12	12
UE	21	12	11	11
OD	4	4	5	5
UD	—	—	—	—
AD	—	—	—	—
Over \$5M				
AE	9	8	5	5
UE	9	5	6	6
OD	1	1	1	1
UD	1	1	1	2
AD	—	—	—	—

AE = "always easy"

UE = "usually easy"

OD = "occasionally difficult"

UD = "usually difficult"

AD = "always difficult"

Question 7:

How have you found the ease of procuring bonds as required on the following types of contracts:

Annual Gross Receipts	Private Construction	Federal Construction	State Construction	Municipal Construction
\$0-250K				
AE	9	5	4	5
UE	10	4	3	5
OD	3	1	1	—
UD	1	3	1	1
AD	1	—	—	—

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Annual Gross Receipts	Private Construction	Federal Construction	State Construction	Municipal Construction
\$250K-1M				
AE	10	7	6	7
UE	13	9	8	7
OD	—	3	1	1
UD	1	1	2	2
AD	—	—	—	—
\$1M-5M				
AE	19	16	15	15
UE	22	16	18	17
OD	5	3	2	2
UD	—	—	—	—
AD	—	—	—	—
Over \$5M				
AE	17	17	15	15
UE	7	3	4	4
OD	—	—	—	—
UD	1	1	1	2
AD	—	—	—	—

AE = "always easy"
 UE = "usually easy"
 OD = "occasionally difficult"
 UD = "usually difficult"
 AD = "always difficult"

Question 8:

Has it been appropriate in recent years for you to engage in a low profit contract to cover irreducible fixed costs?

	\$0-\$250K	\$250K-1M	\$1M-5M	Over 5M
Yes	11	13	25	10
No	13	11	25	16

Question 9:

If your answer to no. 8 is "yes," have you considered using public contracts for this purpose?

	\$0-\$250K	\$250K-1M	\$1M-5M	Over 5M
Yes	5	8	14	6
No	7	8	10	3

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["Paperwork" Responses]

Percentage of Gross Revenue Derived from Private Construction

	100%	91-99%	71-90%	51-70%	0-50%
	38*	11*	24*	13*	43*
Determinative	18	6	9	2	3
Important	5	1	5	—	4
Marginally					
Important	3	1	1	—	1
Irrelevant	7	3	3	1	6
Number					
Responding	33	11	18	3	14

* Number Surveyed in Each Group

For purposes of sampling the internal consistency of the responses, Question 7 (difficulty in bonding) was cross-checked against Question 5(f) (difficulty in bonding as a reason for infrequent bidding on public works). For example, contractors who cited bonding problems as the reason for not bidding should also have had difficulty in securing bonds. Those who found bonding problems "Irrelevant" to their decision not to bid, should have had little difficulty in securing bonds.

As the following table indicates, this cross-tabulation evidences a rather high degree of internal consistency:

Question 7 Response*

	Determinative		Important		Marginal Importance		Irrelevant		No Resp.	
	P.	F.	P.	F.	P.	F.	P.	F.	P.	F.
AE	—	—	—	—	—	—	23	16	34	29
UE	2	—	—	—	2	2	20	8	28	22
OD	—	—	—	—	1	—	1	1	5	5
UD	1	3	—	—	—	—	2	2	—	—
AD	—	—	—	1	—	—	—	—	1	—

[*Question 7: Reasons for Infrequent Bidding on Federal Contracts.]

AE = Always Easy
 UE = Usually Easy
 OD = Occasionally Difficult
 UD = Usually Difficult
 AD = Always Difficult
 P. = Private Contracts
 F. = Federal Contracts

Question 5: "Other" Factors Indicated as Determinative

1. Unreasonable and/or inexperienced inspectors. (Three responses.)
2. Unscrupulous competition engaging in bid shopping, or in corner cutting. (Six responses.)

3. Lack of information that work is available.
4. Not oriented to federal bidding.
5. Impossible specifications.
6. Unavailability of large jobs.
7. Too many unqualified bidders; probability of getting a job therefore too low. (Two responses.)

Question 10: Explanation for a "NO" response to Q. 9.

1. Bond requirements, paper work and generally low profit in jobs are for the most part the reason for not bidding federal, state and municipal jobs.
2. Because of the difficulty in federal work other than the job itself.
3. Bidding on public contracts with a low profit margin going in is likely to result in a net loss at end of job.
4. Because public pay is slow, paperwork tedious and increase (sic) overhead costs.
5. We have tried but were discouraged after talking to Federal personnel (sic).
6. Unreasonable regulatory conditions in all phases of operations.
7. Incompetent government inspectors could turn your low profit contract into a loss.
8. To (sic) many details.
9. Excessive paperwork, unreasonable inspections by arbitrary and sometimes poorly qualified personnel, slow response to payment requests and excessively long retention periods. In a phrase: there is a lot of easier and more profitable work around.
10. Absolutely must have a profit on public work.
11. Overhead too high due to excessive paperwork; inspections performed by inefficient personnel who know nothing about construction industry and constantly interfere with progress of the project.
12. Specifications are too inflexible on public jobs.
13. Too great a risk.
14. We do our own designing. Such work is only available in the private sector.
15. Jobs often run too much over (time) schedule and margin is too low with irresponsible competition.
16. Low profit margin—difficulty in getting jobs completed and accepted—excess "paperwork."

Additional (Unsolicited) Comments on Contractors' Questionnaires

1. "Financing is necessary due to the large amount of money tied up in contract retentions and the *slow* pay of most municipal, state and federal agencies."
2. "More money is lost on public *building* projects than is made because they take too many bids and the inspection is usually unfair and arbitrary, and *all* errors, mistakes, etc. are thrown on the contractor. Check how many (and what %) of contractors go broke on public jobs!!!"
3. "Federal work is the most difficult on which to make a profit because of—1) poorly trained inspectors; 2) red tape; 3) lack of established command; 4) the man in charge frequently is so far up the line that we cannot find out who he is."
4. "Too many bidders—chance of getting work only if one makes an error and is too low in price. Our firm, about twenty years old, did considerable public work early in its life. We were frustrated often by being unable to affect (sic) savings (which were justified) because 1. Many field inspectors were incompetent and therefore insisted on the letter of the specification even though our experience showed a better way. 2. If you bid an alternate at the outset, the public agency takes your idea gratis and puts it out to bid for your competitors to rebid. So why bother to suggest improvements? 3. We tried to do the best job we could and found our costs higher than the very sharp plan and spec contractors who hangs tough on every point."

Additional Comments from Personal Interviews with Contractors

1. The sureties will not bond when the firm's volume to net worth exceeds 10 to 1.
2. The probability of submitting a bid and getting the job are much too low in public

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works. A firm must be specially set-up to handle the large volume of paper work. All of the above requires additional investment with little expectation of an attractive return.

3. The cost of preparing a bid for a public project is four times greater than on private projects.
4. The level of competence of government inspectors was so low that they could cause the firm's low profit contract to turn into a loss. The inspector is able to stop the job with very little, if any, provocation.
5. The element of personal contact is missing on public jobs. This firm bases much of its business on repeat referral jobs.
6. The probability of getting a job was too low, since there are usually large number of bidders.
7. Prefer not to bid on public contracts due to bid auctioning.
8. Here again, bonding capacity is the magic word; if we stay within our limit the procuring of the bond was very easy.
9. On several occasions in the past this firm had closely approached its bonding capacity, and when that point was reached it became much more difficult to procure the necessary bonds.
10. Getting bonds is dependent upon whether you can get financing. (Most firms felt that the opposite was true. You could only get financing if you could first get the bond.)
11. Surety audits the firm's books annually to insure financial stability and to discover any volume (gross receipts) totals which exceed the firm's bonding capacity.
12. Choice to self-finance all government work was not based on difficulty in procuring the financing, but was based on the erratic receipt of progress payments from the government.
13. It takes a much larger quick cash reserve for a firm to operate in the public contract section.
14. Public jobs are less profitable.
15. The firm is very conscious of contractors who bid auction their subcontractor bids. The firm wishes to stay out of federal jobs because there is no statutory restriction on such practice. They cannot compete with firms who do bid auctioning.
16. Although the firm will undertake low profit contracts, they will not do so on government jobs. There is "no latitude to move." You are tied too closely to specifications. The government is too inflexible.
17. Lack of licensing allowed anyone to bid and therefore kept reputable firms out of the government contract area.
18. By severely limiting their bidding so as not to exceed their bonding capacity, the firm finds it always easy to procure its bonds.
19. Profitability is lower on public jobs, mostly because anyone can get a bid bond and then bid the project.
20. Most important complaint about operating in the public construction market was the vast amount of paper work that was required to bid the job. The paper work problem was going to get much worse in the future and is actually bad now "due to the minority problems." Large amounts of paper work are required by the Equal Opportunity Program just to insure that the appropriate percentage of minorities are being employed on the job. If the appropriate percentage is not met, the agency may stop production.

The effect of this increase in paper work will be to significantly lower competition. Since most contractors are currently burdened with heavy loads of paper work, the added load will force them to abandon public works.

The contractor must be specialized into public jobs in order for him to be efficient, competitive and profitable. The handling of the paper work must be highly routinized to minimize its vastness. Once, however, the contractor is very familiar with the paper work, he will know several ways by which to eliminate certain amounts of the materials. Also, by being a repetitive government bidder and if you can establish a good rapport with the heads of the contract awarding agency, he may direct you into eliminating certain paper work.

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21. Bonding companies are never concerned with who the owner of the project is; they are only concerned with your volume and net worth.
22. No quick cash and therefore unable to get a bond.
23. Getting a bond is totally dependent upon either having surplus funds in the firm or first being able to borrow from the bank.

C. COMMERCIAL LENDERS' QUESTIONNAIRE WITH RESULTS

Miller Act Survey

Commercial Lenders' Questionnaire
Rev. December 4, 1972

All Replies Will Be Kept in the Strictest Confidence.

1. Bank's name and address
[See note 346 supra.]
2. Title of bank officer completing this questionnaire (optional)
3. Size (population) of metropolitan area in which the bank is located:

Under 50,000	16
50,000- 100,000	8
100,000- 300,000	4
300,000- 600,000	5
600,000-1,000,000	7
1,000,000-3,000,000	5
Over 3,000,000	7

4. Total deposits of the bank:

Under \$50 million	29
\$ 50- 100 million	11
\$100- 200 million	2
\$200- 500 million	7
\$500-1000 million	0
Over \$ 1 billion	3

- 5A. What is your estimate of the bank's total credit commitment to the *contracting* industry?

\$0	29 Banks
Under \$500,000	16 Banks
\$500,000-\$2,000,000	8 Banks
\$2,000,000-\$6,000,000	4 Banks
Over \$6,000,000	6 Banks
Total Responses	63 Banks

- 5B. If the bank does not extend loans to contractors, could you explain briefly the policy?

[Responses listed in note 323 supra.]

6. What is your *estimate* of the current distribution of the commitment to public vis-a-vis private construction projects? (For purposes of this survey, a "public"

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project is one the ultimate owner of which is the federal, state, or municipal government or government agency.)

Public:	12%	(Mean)
Private:	88%	
Total:	100%	

7. Are loans to contractors handled by:

Regular loan officers	32
A construction industries loan officer	5
A contractors' loan group	0
Other (please specify)	1

8. How are these loans distributed by type:

Transaction
(one-shot, or job loans)—Private proj.-26%; Public-8%.

Term and/or
installment loans—Private proj.-11%; Public-3%.

Interim construction
mortgage lines—Private proj.-52%.

9. What proportion, if any, of your loans to contractors are made on an unsecured basis?

Public projects-42%
Private projects-28%

[See note 365 supra for individual responses.]

10. For a contractor who requires financing to perform a public project, does the bank undertake any investigations into creditworthiness, feasibility, or job details, which are different from those investigations it would undertake if the job were for a private owner?

Yes: 5

No: 14

No Response: 15

11. If number 10 is answered "yes," could you describe briefly what those additional procedures would be?

- (1) "Determine bonding history."
- (2) "Contractor must have previous track record acceptable to us. Must be bondable."
- (3) "Documentation reflecting the evidence that public funds are authorized for subject project and evaluate what restrictions may prohibit payment under the public work contract."
- (4) "—Architect—Payment schedules—Fed. or State, etc."

[See note 371 supra.]

12. To what extent are the following factors important to your loan officers in their decisions to extend a loan to a contractor on an *unsecured* basis:

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	Very Import- tant	Import- tant	Not very Import- tant	Irrelevant
Borrower's total capitalization	23	8	—	—
Borrower's average deposit balance	6	20	4	—
Borrower's experience in the trade	28	3	—	—
Borrower's net unencumbered asset value	16	14	1	—
Ultimate "owner" of the project	7	14	8	2

13. To what extent are these same factors important in the making of a *secured* loan to a contractor:

	Very Import- tant	Import- tant	Not very Import- tant	Irrelevant
Borrower's total capitalization	15	15	—	—
Borrower's average deposit balance	2	21	9	—
Borrower's experience in the trade	24	7	—	—
Borrower's net unencumbered asset value	9	18	4	—
Ultimate "owner" of the project	6	12	11	2

14. For a secured loan to a contractor, what would be your *preferences* among the following types of collateral, assuming them to be equally available: (Indicate 1st, 2d, etc.)

	1st	2d	3d	4th	5th
a. capital assets (equipment)	5	7	12	3	2
b. lien or mortgage interest in the completed project	21	5	4	—	1
c. progress payment and retained percentages	3	14	9	4	—
d. other (specify)	2	3	3	1	—
e. other (specify)	—	1	1	1	2

15. Could you rank the above (a through c, d, or e) in the usual order of *availability*?

	1st	2d	3d	4th	5th
a. capital assets (equipment)	8	10	6	3	2
b. lien or mortgage interest in the completed project	17	3	6	1	2
c. progress payment and retained percentages	5	13	10	1	—
d. other (specify)	—	1	4	3	—
e. other (specify)	—	1	2	1	1

16. For a contractor who requires financing to undertake a public construction project, does the bank request security of a different type, or of a different loan-to-collateral ratio, than that which it requires on a private job?

Yes: 5

No: 16

No Response: 13

17. If the answer to number 16 is "yes," could you describe the differences, and briefly explain why?

MILLER ACT PRIORITIES

- (1) "Public projects will not allow liens or mortgage interest on projects. Public projects require bond."
- (2) "Sometimes, assignment of payment checks."
- (3) "As a general rule the contractor's performance on a public job often must meet higher standards and there is more chance of work not being acceptable."
- (4) "90% financing available on Turnkey projects underwritten by HUD provided contract between local housing authority, contractor and HUD is assigned to bank *prior* to closing construction mortgage." (Emphasis in original.)

18. Would a "small" (i.e., less than \$100,000 in owned assets) contractor have a greater chance of being denied a loan if the job in question were a public project, rather than one for a private owner?

Yes: 8

No: 18

No Response: 8

19. If the answer to number 18 was "yes," would you briefly describe why?

- (1) "Greater chance of serious delays in payouts—and less flexibility of owner in general—specifically with reference to federally funded/financed projects."
- (2) "Primarily because of the cost of the project, and [our] lack of experience in such projects."
- (3) (See Response 17(3) above.)
- (4) "Small contractors cannot handle the cash flow required in large public projects."
- (5) "Depending on size of job of course. Public projects are slow pay and sometimes held up because of someone's decision."
- (6) "Too small to carry most public projects working capital wise."

20. In your state, must contractors bidding on public projects be "prequalified" by some state agency?

Yes: 13

No: 8

21. If your answer to number 20 was "yes," to what extent do your loan officers rely on such screening?

- Not at all; we think the reports given the agency are unreliable. (0)
- Not at all; we think the standards set by the state are too low. (0)
- The screening criteria are not germane to the loan decision. (4)
- The screening is one factor among many others to be considered. (9)
- The prequalification creates a presumption of creditworthiness. (1)

22. In those few situations in which a loan threatens to become a "workout," and the bank is in the position of having to compete with a payment or performance bond surety for the retained funds and the unpaid progress payments,

- a. how often does the bank have a higher priority than the surety, legally speaking?

Responses (in %): 100
100
100
90
90

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50
50
20
10
10
0
0
0
0
0
0
0

Average: 39%

b. how often are the funds shared by the bank and the surety?

Responses (in %): 90
40
30
10
10
10
10
0
0
0
0

Average: 18%

23. Has your bank ever attempted to negotiate subordination or sharing agreements with payment and performance bond sureties?

Yes: 4

No: 28

If so, how often are such contracts entered into?

Four Responses: 0%; 0%; 0%; 1%

At what point in the dealing with the contractor are such agreements made with the surety? [No responses.]

What are the typical subordination terms or sharing ratios?

Two responses, both reporting "100% to surety."

24. Briefly, what system (if any) does the bank use to "police" or control the contractor's application of the disbursed loan funds during the period of construction?

a. No Response: 22

b. Lien Waivers From Subcontractors, or Title Clearance From Title Co.: 6

c. "Active" Policing (Disbursements Only Against Suppliers' Bills; On-Site Review; Spot Checks With Materialmen and Laborers; etc.): 25

25. What is your estimate of the cost of this "policing," in dollars per \$10,000 of loan amount?

Mean: \$ 91.43

Median: \$100.00

Mode: \$100.00

Range: \$ 15.00 to \$400.00

MILLER ACT PRIORITIES

Would this system of "policing" be different for a public project than for a private one?

Yes: 5

No: 10

If so, how?

Two Responses:

(1) "Public projects are inspected by public engineers."

(2) "Many more regulatory bodies would have to be consulted and satisfied.
Result: additional expense."

26. Would the cost of such differences (or the savings) be of significance?

Yes: 3

No: 0

No Response: 2

27. To what extent do you think that most commercial loan officers in your city are aware of the following legal points:

	<i>Acutely Aware</i>	<i>Aware</i>	<i>Vaguely Aware</i>	<i>Not Aware</i>
The Miller Act	1	3	13	11
The Assignment of Claims Act	1	14	7	6
The sureties' rights to "equitable subrogation"	2	12	9	5
Priority rights among lenders and sureties on bonded public construction jobs	6	10	8	4

28A. If the bank has had experience with guaranteed loans ("V"-loans, or SBA guarantees) to small contractors, was the bank in those cases more willing to make loans for public works construction?

Yes: 2

No: 9

No Response: 21

28B. Could you explain briefly why (or why not)?

[See note 274 supra.]

29. What is your estimate of the percentage of loans made to "small business contractors" (less than \$5,000,000 annual gross receipts) which have been guaranteed?

Unguaranteed:	92%	
SBA guaranteed:	6%	(Mean)
"V-Loan":	2%	
Total	100%	

Additional Data: Commercial Lenders' Questionnaire

1. Credit commitment to the contracting industry, by size (total deposits) of bank:

a. Under \$50 million: None, 11 banks.

b. \$50 to 100 million: None, 5 banks.

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Others: \$100,000
500,000
2,000,000
2,000,000
3,000,000
50,000,000

c. \$100 to 500 million: None, 2 banks.

Others: 2,000,000
3,000,000
6,000,000
10,000,000
15,000,000
30,000,000

d. Over \$500 million: None, 0 banks.

Others: 50,000,000
100,000,000

2. Responses to question 27 from banks which have no credit commitment available to contractors:

To what extent do you think that most commercial loan officers in your city are aware of the following legal points:

	Acutely Aware	Aware	Vaguely Aware	Not Aware
The Miller Act	—	—	2	4
The Assignment of Claims Act	—	1	4	1
The sureties' rights to "equitable subrogation"	—	—	3	3
Priority rights among lenders and sureties on bonded public construction jobs	1	—	2	3

3. Collateral preferences, of banks loaning to contractors only for private projects, vis-à-vis banks loaning to contractors for both public and private projects:

Private Construction Loans Only

	1st	2d	3d	Total
Capital assets	13%	6%	6%	25%
Lien or mortgage in completed work	19%	19%	6%	44%
Progress payments and retained percentages	6%	13%	13%	31%

[100% = 16 responses.]

Public and Private Construction Loans

	1st	2d	3d	Total
Capital assets	6%	9%	15%	30%
Lien or mortgage in completed work	26%	6%	5%	38%
Progress payments and retained percentages	4%	18%	11%	32%

[100% = 80 responses.]

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