

**EIGHTEENTH ANNUAL  
NORTHEAST SURETY AND FIDELITY CLAIMS  
CONFERENCE  
SEPTEMBER 26-28, 2007**

**IRS NOTICE OF LEVY ON BONDED CONTRACT FUNDS:  
WHAT DOES THE SURETY DO NEXT?**

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# **IRS NOTICE OF LEVY ON BONDED CONTRACT FUNDS: WHAT DOES THE SURETY DO NEXT?**

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## **INTRODUCTION**

This paper addresses situations when the United States Treasury Department, Internal Revenue Service (the “IRS”) levies under a tax lien upon the bonded contract funds of a performing surety. There are innumerable factual scenarios under which a surety may have its bonded contract funds levied upon by the IRS that may pose different legal issues and may alter the rights of the IRS and/or the surety to the bonded contract funds. This paper is intended to familiarize the reader with the relevant provisions of the Tax Lien Act and with case law that addresses key issues in determining the competing priorities to the bonded contract funds between a performing surety and the IRS under a tax lien. This paper also addresses the basic requirements relating to litigating with the IRS under the Internal Revenue Code’s (the “IRC”) wrongful levy statute and some practical issues in dealing with an obligee that has been served with a notice of levy by the IRS.

### **I. SETTING THE SCENE.**

#### **A. Assumptions Regarding the Pertinent Facts.**

For purposes of this paper we make the following assumptions:

1. A general contractor has entered into a construction contract with an owner (the “Contract”) for the performance of a construction project (the “Project”).
2. The surety (the “Surety”) and the general contractor/principal (the “Principal”) have issued performance and payment bonds (the “Bonds”) to the owner/obligee (the “Obligee”) for the Contract.
3. The IRS has made an assessment against the Principal for unpaid withholding taxes on projects that are unrelated to the bonded Contract.
4. The Obligee is not the taxing authority (namely, the Obligee is not the United States government acting through the IRS).
5. The issuance of the Bonds pre-dates the Principal’s unpaid withholding taxes.
6. Prior to issuing the Bonds, the Principal executed an Indemnity Agreement in favor of the Surety and the Surety issued the Bonds in reliance upon the Indemnity Agreement.
7. The Surety has begun performing under the Performance Bond (the surety’s performance may include financing the principal’s completion of the Bonded Contract) and has made a claim against the Obligee for the Bonded Contract Funds (the balance of the Contract price).

8. The IRS has filed a notice of its tax lien with the appropriate authority and has issued a notice of levy to the Obligee demanding payment from the Bonded Contract Funds of the Principal's unpaid withholding taxes that are unrelated to the Project.<sup>1</sup>

10. The notice of tax lien and notice of levy post-date the Surety's commencement of its performance under the Performance Bond.

11. There are no other parties with competing claims to the Bonded Contract Funds.

## **B. The IRS'S Tax Lien Generally.**

The Federal Tax Lien Act provides a lien in favor of the United States against the property of a delinquent taxpayer. The United States' lien is against all "property" and "rights to property" of the taxpayer and applies to after acquired property. Further, the lien applies to *both* real property and personal property. Section 6321 of Title 26 of the United States Code<sup>2</sup> states:

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

The federal tax lien provided by Section 6321 is deemed to arise at the time that an assessment is made by the United States against the delinquent taxpayer.<sup>3</sup>

However, a federal tax lien is not effective against other potential liens until notice of the federal tax lien has been recorded by the United States in accordance with the Federal Tax Lien Act. Section 6323(a) provides that the lien established in favor of the United States under Section 6321 is not valid against other perfected lien holders unless notice of the lien has been filed by the United States.<sup>4</sup> Section 6323(f) outlines in detail the procedures by which a notice of lien in favor of the United States must be filed.<sup>5</sup>

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<sup>1</sup> An example of an IRS Notice of Levy is attached hereto as **Exhibit 1**.

<sup>2</sup> Hereinafter, unless otherwise stated, all references to "Section" refer to sections of Title 26 of the United States Code.

<sup>3</sup> 26 U.S.C. § 6322 (2007).

<sup>4</sup> Section 6323(a) specifically states:

The lien imposed by [S]ection 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.

<sup>5</sup> It should be noted that Section 6323(f)(5) states: "The filing of a notice of lien shall be governed solely by this title and shall not be subject to any other Federal law establishing a place or places for the filing of liens or encumbrances under a national filing system." Recent legislation has been introduced with the stated

### **C. Notice of Levy.**

The lien created in favor of the United States against the property and rights to property of a delinquent taxpayer may be enforced by the IRS against third-parties holding property of the delinquent taxpayer by serving a notice of levy upon the third-party. A notice of levy is a demand to a third-party that the third-party turn over to the IRS all property held by the third-party in which the delinquent taxpayer has rights. Section 6332(a) provides:

Except as otherwise provided in this section, any person in possession of (or obligated with respect to) property or rights to property subject to levy upon which a levy has been made shall, upon demand of the Secretary, surrender such property or rights (or discharge such obligation) to the Secretary, except such part of the property or rights as is, at the time of such demand, subject to an attachment or execution under any judicial process.

Section 6332(d) provides that personal liability and penalties may be imposed upon persons<sup>6</sup> that fail to turn over property levied upon by the IRS. Section 6332(e) also provides immunity for persons that turn property over to the IRS in response to a notice of levy. Section 6332(e) specifically states:

Any person in possession of (or obligated with respect to) property or rights to property subject to levy upon which a levy has been made who, upon demand by the Secretary, surrenders such property or rights to property (or discharges such obligation) to the Secretary (or who pays a liability under subsection (d)(1)) shall be discharged from any obligation or liability to the delinquent taxpayer and any other person with respect to such property or rights to property arising from such surrender or payment.

## **II. LITIGATING WITH IRS.**

### **A. The Surety's Right to Bring a Wrongful Levy Action.**

In Section 7426, the IRC specifically authorizes actions against the United States by non-taxpayer third-parties for a wrongful tax levy against property when the third-party, such as the Surety that claims rights to the Bonded Contract Funds, claims a superior

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purpose of amending "the Internal Revenue Code of 1986 to simplify, modernize, and improve public notice of and access to tax lien information by providing for a national, Internet accessible, filing system for Federal tax liens, and for other purposes." 2007 Cong US S 1224, 110<sup>th</sup> Congress, 1st Session. This proposed legislation will not be analyzed by this paper.

<sup>6</sup> Section 6332(f) defines the term "person" as follows:

The term "person" as used in subsection (a), includes an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to surrender the property or rights to property, or to discharge the obligation.

interest to the property levied upon by the IRS.<sup>7</sup> The IRC provides that a party alleging a wrongful levy may seek injunctive relief preventing a levy or sale of the property, an order directing the return of the property wrongfully levied upon by the IRS, a money judgment for the amount of any money wrongfully levied upon by the IRS or the greater of the amount received by the United States from the sale of the property and the fair market value of such property immediately before the levy.<sup>8</sup> The IRC also provides for the recovery of interest by a party bringing a wrongful levy action.<sup>9</sup>

## **B. The Applicable Jurisdiction, Venue and Statute of Limitations for a Wrongful Levy Action.**

### **1. Jurisdiction.**

A wrongful levy action against the United States under Section 7426 must be brought in the appropriate United States district court. Section 1346(e) of Title 28 of the United States Code provides that “[t]he district courts shall have original jurisdiction of any civil action against the United States provided in section . . . 7426 . . .”

### **2. Venue.**

The judicial district in which the Bonded Contract Funds were located at the time of the IRS’s levy is the appropriate venue for a wrongful levy action under Section 7426. Section 1402(c) of Title 28 of the United States Code states that “[a]ny civil action against the United States under subsection (e) of section 1346 of this title may be prosecuted only in the judicial district where the property is situated at the time of levy, or if no levy is made, in the judicial district in which the event occurred which gave rise to the cause of action.”

### **3. Statute of Limitations.**

The IRC provides that an action for a wrongfully levy must be brought within nine (9) months from the “date of the levy.”<sup>10</sup> Courts have held that the “date of the levy” is the date of the service of the notice of levy on the party holding the alleged “property” of the taxpayer (such as the Obligee) and that the 9 month statute of limitations for bringing a wrongful levy action by a third-party (such as the Surety) for the levy on the taxpayers’ alleged “property” (such as the Bonded Contract Funds) runs from the date of service of the notice of levy.<sup>11</sup> The 9 month statute of limitations for bringing a wrongful levy action may

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<sup>7</sup> 26 U.S.C. § 7426(a)(1) (2007).

<sup>8</sup> 26 U.S.C. § 7426(b) (2007).

<sup>9</sup> 26 U.S.C. § 7426(g) (2007). Section 7426 also provides for statutory damages against the IRS in cases where it is alleged that any officer or employee of the IRS recklessly or intentionally, or by reason of negligence, disregarded any provision of Title 26. 26 U.S.C. 7426(h) (2007).

<sup>10</sup> 26 U.S.C. § 6532(c) (2007).

<sup>11</sup> See e.g., *State Bank of Fraser v. United States*, 861 F.2d 954 (6<sup>th</sup> Cir. 1988); *American Honda Motor Co. v. United States*, 363 F.Supp. 988, 993 (S.D.N.Y.1973); *DeGregory v. United States*, 395 F.Supp. 171, 173 (E.D.Mich.1975); *Newport Nat’l Bank v. United States*, 556 F.Supp. 94, 97 (D.R.I.1983); *Carlos v. New York State Dept. of Taxation*, 531 F.Supp. 359, 362 (N.D.N.Y.1981); *United Specialties Inc. v. United States*, 443 F.Supp. 87, 88 (D.D.C.1977); *Stuyvesant Ins. Co. v. Department of Treasury*, 378 F.Supp. 7, 10 (S.D.N.Y.1974). See also Mertens, *Law of Federal Taxation* § 54A.72 (1987) (“The nine month period acts as a statute of limitations and commences on the date on which the notice of levy is served.”).

be extended by making a request for a return of the property in accordance with Section 6343(b). If such a request is made, the 9 month statute of limitations will be extended to the shorter of 12 months or 6 months from the registered or certified mailing by the IRS to the requesting party of a notice of disallowance.<sup>12</sup>

The 9 month statute of limitation is strictly construed in favor of the United States.<sup>13</sup> The United States is under no obligation to seek to discover security interests in the property and funds upon which it levies.<sup>14</sup> Even when the United States has not filed a notice of lien and a competing secured creditor establishes that it had no actual or constructive notice of the government's lien or service of the notice of levy, the running of the 9 month statute of limitations for bringing a wrongfully levy action will not be tolled.<sup>15</sup> Further, a performing Surety that has a claim to the Bonded Contract Funds levied on, but that has not fully performed within 9 months of service of a notice of levy, may still be required to institute a wrongful levy action within the 9 month statute of limitations.<sup>16</sup> Alternatively, a Surety in such a situation may seek to extend the 9 month statute of limitations by requesting that the Bonded Contract Funds be returned in accordance with Section 6532(c)(2).

### **III. ANALYZING THE SURETY'S RIGHTS TO THE BONDED CONTRACT FUNDS IN ORDER TO PREVAIL OVER THE IRS IN A WRONGFUL LEVY ACTION UNDER SECTION 7426.**

#### **A. Introduction.**

As addressed below in detail, the Surety has two main arguments that its right to the Bonded Contract Funds is superior to that of the IRS. First, by performing under its Performance Bond, the Surety is subrogated to the rights of the Obligee, including the Obligee's right to use the Bonded Contract Funds to complete the Contract. Therefore, as the defaulting Principal is not entitled to the Bonded Contract Funds, there is no property to which the IRS's tax lien can attach. Second, even if the Principal is found to have some right to the Bonded Contract Funds such that the IRS's tax lien may attach to the Principal's rights, the Surety has a superior right to the Bonded Contract Funds under the Tax Lien Act because the Performance Bond constitutes an obligatory disbursement agreement that covers qualified property and, at the time the IRS's notice of lien was filed, the Surety's security interest in the Bonded Contract Funds was protected under local law from a judgment lien arising out of an unsecured obligation.

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<sup>12</sup> 26 U.S.C. § 6532(c)(2) (2007).

<sup>13</sup> See *American Fidelity Fire Insurance Company v. United States*, 623 F. Supp. 722 (W.D. Tenn. 1985) (holding that statutes of limitations regarding the collection of taxes must be strictly construed in favor of the government).

<sup>14</sup> *American Honda Motor Co., Inc. v. United States*, 363 F. Supp. 988 (1973).

<sup>15</sup> See *id.* at 991-93.

<sup>16</sup> See *American Fidelity Fire Insurance Company v. United States*, 623 F. Supp. 722 (W.D. Tenn. 1985).

## **B. Does the Principal Have Rights to the Bonded Contract Funds Under Applicable State Law?**

### **1. State Law Determines Whether a Party has Property or Rights to Property.**

In analyzing the competing claims of the Surety and the IRS to the Bonded Contract Funds, state law must be analyzed to determine the Principal's interest, if any, in the Bonded Contract Funds. If the Principal has no right to the Bonded Contract Funds, there is nothing to which the IRS's tax lien may attach. As stated by the United States Supreme Court, "[t]he threshold question in . . . all cases where the Federal Government asserts its tax lien, is whether and to what extent the taxpayer had 'property' or 'rights to property' to which the tax lien could attach."<sup>17</sup> The Principal's rights to the Bonded Contract Funds must to be analyzed under the applicable state law, not federal law.<sup>18</sup> However, if it is determined under the applicable state law that the Principal has a right to the Bonded Contract Funds or a portion thereof such that the IRS's tax lien may attach to the Principal's state law right to the Bonded Contract Funds, federal law controls the determination of the priorities to the Bonded Contract Funds.<sup>19</sup>

### **2. The Surety's Subrogation Right to the Bonded Contract Funds Through the Rights of the Obligee.**

#### **i. A Performing Surety's Subrogation Rights.**

A surety that performs its obligations under a performance bond is subrogated to the rights of the obligee as well as to the rights of its principal, including the obligee's rights to the bonded contract funds.<sup>20</sup> This is so because by performing its obligations under a

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<sup>17</sup> *Aquilino v. United States*, 363 U.S. 509, 512, 80 S. Ct. 1277, 1280 (1960).

<sup>18</sup> *See id.* at 512-14, 80 S. Ct. at 1280-81.

<sup>19</sup> *Id.*

<sup>20</sup> The following cases are from the Northeast section of the United States. **Connecticut:** *Amwest Surety Insurance Co. v. United States*, 870 F. Supp. 432, 435 (1994) (Although the court did not explicitly state that the performing surety was subrogated to the rights of the obligee, in holding that the surety had a superior right to the contract funds over the IRS, the court stated: "The surety's right to the contract proceeds arises from its undertaking to guaranty the performance of the contract. The right to enforce the claim to the proceeds results from making expenditures in performing the guaranty. This result insures the project owner against liens otherwise imposable for costs of constructing the project by having its contract payments apply to the costs of construction." **Delaware:** *Hartford Accident and Indemnity Co. v. Long*, 245 A.2d 800, 803 (Del. Ch. 1968); **District of Columbia:** *District of Columbia v. Aetna Insurance Company*, 462 A.2d 428, 430 (D.C. 1983); **Maine:** *Unity Telephone Co. v. Design Service Co.*, 160 Me. 188, 196, 201 A.2d 177, 181(1964); **Maryland:** *Finance Company of America v. United States Fidelity and Guaranty Company*, 277 Md. 177, 182-83, 353 A.2d 249, 252 (1976); **Massachusetts:** *Framingham Trust Co. v. Gould-National Batteries, Inc.*, 427 F.2d 856 (1<sup>st</sup> Cir. 1970) (applying Massachusetts law); **New Jersey:** *Board of Education of City of Linden v. Vail*, 108 N.J. Eq. 207, 208, 154 A. 531(1931); **New York:** *Scarsdale National Bank and Trust Co. v. United States Fidelity and Guaranty Co.*, 264 N.Y. 159, 163, 190 N.E. 330 (1934); **Pennsylvania:** *Sundheim v. School District of Philadelphia*, 311 P.A. 90, 99-100, 166 A.2d 365, 369 (1933); **Rhode Island:** *Glens Falls Indemnity Co. v. American Awning & Tent Co.*, 55 R.I. 284, 180 A.2d 367, 376 (1935); **Vermont:** *American Fidelity Co. v. Delaney*, 114 F.Supp. 702, 711 (D. Vt. 1953) (applying Vermont law).

performance bond, the surety confers a benefit upon the obligee.<sup>21</sup> As explained by the United States Court of Appeals for the First Circuit:

But for the surety's completion of the work, the obligee on the bond, be he owner or prime contractor, would have been entitled to apply the funds against the cost of completion. It is the surety's performance which frees the funds, and, in our view, the surety is entitled to them.<sup>22</sup>

A performing surety's subrogation rights arise out of equity rather than contract.

The surety's subrogation rights are a creation of the courts, which have ruled that a surety that pays or otherwise performs its obligations under its bonds may step into the shoes of those persons to whom or on whose behalf the surety has performed. As a result, the surety may enforce the rights of those persons who have received payment or the benefit of the surety's performance against the other parties in order for the surety to obtain reimbursement for its losses.<sup>23</sup>

## **ii. The Methods by Which a Surety May Perform its Performance Bond Obligations.**

Generally, subject to the terms of the specific performance bond, a performance bond surety may "perform" in a number of ways. These ways include the surety: (1) taking over and completing the contract; (2) tendering a completion contractor to the obligee to complete the contract; and/or(3) allowing the obligee to complete the contract.<sup>24</sup> Further, a surety is also deemed a performing surety when its principal is, in fact, in default of its bonded contractual obligations and the surety finances the principal's performance of the bonded contract.<sup>25</sup> Under the non-financing performance options, the Surety's priority to the balance of the Bonded Contract Funds should not seriously be in dispute in most cases.

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<sup>21</sup> See *American Fire & Casualty Co. v. First National City Bank of New York*, 411 F.2d 755, 758 (1<sup>st</sup> Cir. 1969).

<sup>22</sup> *Id.* See also, *Federal Insurance Company v. Constructora Maza, Inc.*, 500 F. Supp. 246, 250 (1979) (The completing "surety may be seen as filling the shoes of the owner, whose benefits from the completion of the project, may be unjustly enriched if the surety who assumed completion of a project were precluded from seeking reimbursement" from the bonded contract funds.); See *Security Insurance Company of Hartford v. United States*, 428 F.2d 838, 842 (Ct. Cl. 1970) ("The surety who undertakes to complete the project is entitled to the funds in the hands of the government not as a creditor and subject to setoff, but as a subrogee having the same rights to the funds as the government.").

<sup>23</sup> See George J. Bachrach, *The Surety's Rights to Obtain Salvage - Exoneration, Reimbursement, Subrogation and Contribution*, in *SALVAGE BY THE SURETY* 31 (George J. Bachrach, ed. 1998).

<sup>24</sup> See Francis J. McGrath, George J. Bachrach & Adam Cizek, *The Financing Surety as a Performing Surety - Law and Practice* 3-6 (unpublished paper submitted at the Fourteenth Annual Northeast Surety & Fidelity Claims Conference on September 18, 2003).

<sup>25</sup> See *Aetna Casualty and Surety Co. v. United Sates*, 845 F.2d 971, 975 (Fed. Cir. 1988); *Morgethau v. Fidelity and Deposit Company of Maryland*, 94 F.2d 632 (D.C. Cir. 1937); *Morrison Assurance Company, Inc. v. United States*, 3 Cl. Ct. 626 (1983); *Great American Insurance Co. .v United Sates* 481 F.2d 1298, 1308 (Cl. Ct. 1973).

This is so because before the Surety proceeds with any of the non-financing performance options, the Principal will typically have been formally default terminated and the Surety or the Obligee will have taken control of the Bonded Contract Funds in order to complete the Contract. Therefore, the Principal should have no right to the Bonded Contract Funds to which the IRS's notice of lien may attach. On the other hand, when the Surety finances the Principal's completion of the Contract, the Principal will not have been terminated and may not have even been formally declared in default. In such situations, the Surety's performance under the Performance Bond and its subrogation rights may not be as clear to the IRS. Nevertheless, courts have held that a financing surety is a performing surety and is subrogated to the rights of the obligee, including the obligee's right to use bonded contract funds to complete a contract.<sup>26</sup>

### iii. The Surety's Rights to Unearned Bonded Contract Funds Is Superior to that of the IRS.

A surety that is subrogated to the rights of an obligee upon the surety's performance of its obligations under a performance bond has superior rights to unearned bonded contract funds ahead of the IRS.<sup>27</sup> This is true even when the performance bond obligee is the federal government seeking to offset the principal's tax obligations to the IRS from the unearned bonded contract funds.<sup>28</sup>

In *Aetna Casualty and Surety Company v. United States*,<sup>29</sup> the surety issued performance and payment bonds to the Government on behalf of its contractor for three bonded construction contracts. The contractor informed the surety that it would be unable to complete its obligations under one of the bonded contracts, and the contractor and the surety entered into a financing agreement. Thereafter, the surety made payments to its contractor directly and to subcontractors and suppliers on the projects.<sup>30</sup> After the projects were completed, a dispute arose as to the surety's right to bonded contract funds.<sup>31</sup> The United States Claims Court held that the surety was not a performing surety because it had not assumed primary responsibility for completing the projects.<sup>32</sup> In overruling the United States Claims Court, the United States Court of Appeals for the Federal Circuit held that there was no requirement that a performing surety assume primary responsibility for completing a project.<sup>33</sup> The Court of Appeals further held that the lack of a takeover agreement or termination of the bonded contract did not prevent the surety from qualifying

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<sup>26</sup> See *id.*

<sup>27</sup> See, e.g., *Aetna Casualty and Surety Co. v. United States*, 845 F.2d 971 (Fed. Cir. 1988); *Trinity Universal Insurance Co. v. United States*, 382 F.2d 317 (5<sup>th</sup> Cir. 1967); *Morrison Assurance Company, Inc. v. United States*, 3 Cl. Ct. 626 (1983); *Security Insurance Co. v. United States*, 428 F.2d 838 (Ct. Cl. 1970). But see also, *International Fidelity Insurance Company v. United States*, 949 F.2d 1042 (8<sup>th</sup> Cir. 1991) (holding that a performing surety is entitled to

<sup>28</sup> See, e.g., *Aetna Casualty and Surety Co. v. United States*, 845 F.2d 971 (Fed. Cir. 1988); *Trinity Universal Insurance Co. v. United States*, 382 F.2d 317 (5<sup>th</sup> Cir. 1967); *Morrison Assurance Company, Inc. v. United States*, 3 Cl. Ct. 626 (1983); *Security Insurance Co. v. United States*, 428 F.2d 838 (Ct. Cl. 1970).

<sup>29</sup> 845 F.2d 971 (Fed. Cir. 1988).

<sup>30</sup> *Id.* at 976.

<sup>31</sup> *Id.* at 973.

<sup>32</sup> *Id.* at 974.

<sup>33</sup> *Id.* at 975.

as a performing surety. The Court of Appeals also rejected the Government's argument that the surety was a paying rather than a performing surety as payments made directly to suppliers of labor and material by a surety after a surety becomes a performing surety are deemed to be performance obligations.<sup>34</sup> Finally, the Court of Appeals held that the surety was a performing surety based upon its financing of its contractor.<sup>35</sup>

In *Security Insurance Co. v. United States*,<sup>36</sup> the surety, pursuant to the Miller Act, issued performance and payment bonds to the owner, the Army Corps of Engineers, on behalf of the contractor on a project for the construction of certain barracks at Fort Allen, Puerto Rico.<sup>37</sup> The contractor failed to complete the project by the completion date specified in the contract. Although the owner did not terminate the contractor, and the owner and the surety did not enter into a takeover agreement, the surety completed the project. A dispute over the contract funds arose between the contractor and the owner because the owner offset from the contract funds certain federal taxes owed by the contractor. The Court of Claims held that the Federal Government owner was not permitted to offset the federal taxes from the contract funds earned after the surety took over the project or from the retainage withheld under the contract.<sup>38</sup> The Court reasoned that if the owner were permitted to offset tax claims from contract funds when a surety had taken over completion of a project, sureties would almost always discharge their performance bond obligations by electing to allow the owner to complete the project.<sup>39</sup> If the owner completes a project, the surety's only liability to the owner is the cost to the owner to complete the performance of the contract in excess of what the owner would have paid had the contractor not defaulted.<sup>40</sup> By electing to allow the owner to complete a project, sureties would avoid the possibility that they would lose contract funds to the owner through the owner's tax levy or setoff rights.<sup>41</sup>

The Court, quoting the language of *United States v. Munsey Trust Co.*<sup>42</sup> stated:

Respondent (surety) argues that if the work had not been completed, and the surety chose not to complete it, the surety would be liable only for the amount necessary to complete, less the retained money. Moreover, if the surety did complete the job, it would be entitled to the retained moneys in addition to progress payments. The situation here is said to be similar. But when a job is incomplete, the government must expend funds to get the work done, and is entitled to claim damages only in the amount of excess which it pays for the job over what it would

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<sup>34</sup> *Id.* at 976.

<sup>35</sup> *Id.* at 975.

<sup>36</sup> 428 F.2d 838 (Cl. Ct. 1970),

<sup>37</sup> *Id.* at 839.

<sup>38</sup> *Id.* at 840-41, 843.

<sup>39</sup> *Id.* at 841.

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> 332 U.S. 234, 67 S. Ct. 1599 (1947).

have paid had the contractor not defaulted. Therefore, a surety would rarely undertake to complete a job if it incurred the risk that by completing it might lose more than if it had allowed the government to proceed.<sup>43</sup>

Based upon the above-described rationale, the Court held that the surety's right as subrogee to the owner's rights to the retainage and the contract funds earned after the surety took over the completion of the project was superior to the owner's right to offset against the contract funds the taxes owed by the contractor to the owner.

#### **iv. The Surety's Right to Earned, but Unpaid, Progress Payments.**

Whether the Surety is entitled to the Bonded Contract Funds earned by the Principal, but not yet paid by the Obligee to the Principal, is dependent upon state law and the terms of the Contract.<sup>44</sup> If the Surety can establish that, despite the fact that the particular Bonded Contract Funds have been earned by the Principal, the Obligee is still entitled to withhold the Bonded Contract Funds under the terms of the Contract as a result of a default by the Principal, the Surety should be entitled to the Bonded Contract Funds ahead of the IRS.<sup>45</sup> Further, in most cases when a Principal defaults under its bonded Contract, the Surety will be entitled to any earned but unpaid progress payments if the Principal's default pre-dates the IRS's notice of levy.<sup>46</sup>

In *Capitol Indemnity Corporation v. United States*,<sup>47</sup> a performance and payment bond surety notified the obligee that it had received notices of default and claims from the principal's subcontractors and suppliers and demanded that the obligee make no further contract payments to the principal. Subsequently, the principal submitted a payment application in excess of \$127,000 for work performed that was approved by the obligee and the amount of the payment application was listed as due to the principal; however, the obligee did not make payment to the principal.<sup>48</sup> Following the approval of the payment application, the IRS filed notices of liens against the principal and served a notice of levy upon the obligee.<sup>49</sup> Several months later, the principal was terminated for its failure to supply enough skilled workers and materials to complete the project. The surety eventually incurred significant losses in excess of \$235,000 under its payment bond and losses in excess of \$22,000 under its performance bond to complete the contract. Upon completing the project, the surety instituted a wrongful levy action to recover the \$127,000 plus of

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<sup>43</sup> *Id.* at 841.

<sup>44</sup> See *Capitol Indemnity Corp. v. United States*, 452 F.3d 428 (5<sup>th</sup> Cir. 2006); *International Fidelity Insurance Company v. United States*, 949 F.2d 1042 (1991); *Kansas City v. Tri-City Construction Company*, 666 F. Supp. 170 (1987).

<sup>45</sup> See *Capitol Indemnity Corp. v. United States*, 452 F.3d 428 (5<sup>th</sup> Cir. 2006); *Kansas City v. Tri-City Construction Company*, 666 F. Supp. 170 (1987).

<sup>46</sup> *International Fidelity Insurance Co. v. United States*, 949 F.2d 1042 (1991); *Kansas City v. Tri-City Construction Company*, 666 F. Supp. 170 (1987).

<sup>47</sup> 452 F.3d 428 (6<sup>th</sup> Cir. 2006).

<sup>48</sup> See *id.* at 429.

<sup>49</sup> *Id.* at 429-30.

contract funds from the approved payment application and summary judgment was entered in favor of the United States.<sup>50</sup> In reversing the trial court's decision and rendering judgment in favor of the surety, the Fifth Circuit reasoned that the principal's right to payment under the contract required more than just properly performed and approved work.<sup>51</sup> The contract expressly permitted the obligee to withhold contract funds when the principal failed to pay subcontractors and suppliers. The court found that there was no evidence that the principal ever cured its default caused by its failure to pay its subcontractors and suppliers.<sup>52</sup> Therefore, the court held that the United States failed to establish that the principal had a contractual right to the contract funds to which the IRS's lien could attach.<sup>53</sup>

Similarly, in *Kansas City v. Tri-City Construction Co.*,<sup>54</sup> the principal advised the obligee shortly after commencing a construction contract that all future payments should be made to the surety and the surety proceeded to finance the principal's completion of the contract. The principal's direction of the contract funds to the surety was irrevocable and could not be changed without the surety's. More than six months later, the IRS filed notices of tax liens against the principal and served a notice of levy upon the obligee. Subsequently, the principal declared that it could not complete the project and the surety retained a completion contractor to complete the project. In holding that the surety had a superior right to the contract funds, the court found that, under Missouri law, the surety's subrogation rights attached at the time the principal was in default as a *matter of fact* and that the surety's subrogation rights related back to the date of the issuance of the bonds.<sup>55</sup>

In the case of *International Fidelity Insurance Co. v. United States*,<sup>56</sup> the Eighth Circuit purports to reject that reasoning of *Tri-City* under Missouri law. The Eighth Circuit's reasoning is seriously flawed. The issue in *Tri-City* was whether the surety's right to bonded contract funds was superior to that of the IRS under Section 6323 of the Tax Lien Act.<sup>57</sup> The specific issue in *International Fidelity* was whether the surety's security interest in the bonded contract funds was protected under local law against a judgment lien arising out of an unsecured obligation at the time the IRS's notice of lien was filed. With respect to *Tri-City*, the Eighth Circuit stated:

The district court adopted the analysis used in *Kansas City, Missouri v. Tri-City Construction Co.* . . . , that '[s]uretyship law provides the surety an equitable lien to funds owing to a principal upon the surety's performance of the principal's obligation, which

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<sup>50</sup> *Id.* at 430.

<sup>51</sup> *Id.* at 432.

<sup>52</sup> *Id.* at 431-32.

<sup>53</sup> *Id.* at 432.

<sup>54</sup> 666 F. Supp. 170 (W.D. Mo. 1987).

<sup>55</sup> Regardless of the surety's subrogation rights, it appears that the Court could have ruled in favor of the surety based upon the fact that the principal had irrevocably directed its interest in the contract funds to the surety.

<sup>56</sup> 949 F.2d 1042 (1991).

<sup>57</sup> The priority given to the surety over the IRS under Section 6323 is addressed in detail, *infra*, in Section III, C.

relates back to the time the contract of suretyship was executed.’ Relying on this general principle, the *Tri-City* Court held that a completing surety’s claim to undisbursed progress payments had priority over a federal tax levy served after the date of execution of the suretyship agreement. In our view, *Tri-City* was wrongly decided in this respect.<sup>58</sup>

The Eighth Circuit went on to hold that, under Missouri law, a surety’s right to earned, but unpaid, progress payments depends on the date of the principal’s default. The court opined that if a principal’s default occurred after the IRS’s notice of lien, the IRS’s right to the progress payments is superior to that of the surety.<sup>59</sup> However, the court held that if the principal’s default occurred before the IRS’s notice of lien, the surety’s right to the earned, but unpaid, progress payments is superior to that of the IRS. This is exactly what happened in *Tri-City*. The Court in *Tri-City* found that the principal was in default as a matter of fact in August of 1985 and that the surety’s subrogation rights attached at that time.<sup>60</sup> The IRS did not file its notices of lien until February and March of 1986.<sup>61</sup> Therefore, *Tri-City* is clearly not at odds with Missouri law as alleged by the court in *International Fidelity* notwithstanding the court’s ruling

### **C. The Surety’s Claim to the Bonded Contract Funds When the Principal Has a Right to the Bonded Contract Funds Under State Law.**

If it is determined under the applicable state law that the Principal has rights to and interest in the Bonded Contract Funds to which the federal tax lien can attach, federal law will govern the priority between the IRS and the Surety to the Bonded Contract Funds. “Federal tax liens do **not** automatically have priority over all other liens. Absent provisions to the contrary, priority for purposes of federal law is governed by the common-law principle that ‘the first in time is the first in right.’”<sup>62</sup> (emphasis added).

#### **1. The Bond as an Obligatory Disbursement Agreement that Provides the Surety with a Superior Right to the Bonded Contract Funds.**

In the event the IRS has properly filed its notice of tax lien in accordance with Section 6323(f) prior to the Surety having performed under its Performance Bond, the Surety may still be entitled to the Bonded Contract Funds ahead of the IRS. Section 6323(c) provides exceptions to the “first in time is first in right” priority to liens under federal law. Included among these exceptions are obligatory disbursement agreements that meet certain criteria.

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<sup>58</sup> *International Fidelity*, 949 F.2d at 1045.

<sup>59</sup> *Id.* at 1045-46

<sup>60</sup> *Tri-City*, 666 F. Supp. at 172.

<sup>61</sup> *See id.* at 171.

<sup>62</sup> *United States ex rel. Internal Revenue Serv. v. McDermott*, 507 U.S. 447, 450, 113 S. Ct. 1526, 1528 (1993). (citing *United States v. New Britain*, 347 U.S. 81, 85, 74 S. Ct. 367, 370 (1954))

Section 6323(c) states in pertinent part:

**(1) In general.**--To the extent provided in this subsection, even though notice of a lien imposed by section 6321 has been filed, such lien shall not be valid with respect to a security interest which came into existence after tax lien filing but which--

**(A)** is in qualified property<sup>63</sup> covered by the terms of a written agreement entered into before tax lien filing and constituting--

**(iii)** an obligatory disbursement agreement, and

**(B)** is protected under local law against a judgment lien arising, as of the time of tax lien filing, out of an unsecured obligation.

In most cases, surety bonds constitute obligatory disbursement agreements. Senate Report No. 89-1708, 1966 U.S.C.C.A.N. 3722, 3730, addresses the obligatory disbursement agreement provision and states:

(c) Obligatory disbursement agreement.-- The third category of interest given priority over a filed tax lien is that arising from an obligatory disbursement agreement. This is an agreement entered into by a person under which he is obliged to make disbursements because someone other than the taxpayer has relied on his obligation. An example is an irrevocable letter of credit where a bank issuing the letter must honor a demand for payment by a third party who advances credit in reliance upon the letter. *This also covers cases where a surety agrees to finance the completion of a contract entered into by the taxpayer.* In these cases no limitation is placed on the time during which a disbursement may be made as long as the person is obligated to do so at the time of the tax lien filing by a written agreement. As a result, if an effort is made to foreclose on a Federal tax lien before all of the potential obligations under an obligatory disbursement contract are met, these potential obligatory disbursements are given priority over the Federal tax lien. In such a case an amount sufficient to cover the potential obligations usually is set aside and used for these obligations. Only after these obligations have been met is any remainder available to satisfy the liability secured by the Federal tax lien.

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<sup>63</sup> The Tax Lien Act defines qualified property as follows:

The term "qualified property", when used with respect to an obligatory disbursement agreement, means property subject to the lien imposed by section 6321 at the time of tax lien filing and (to the extent that the acquisition is directly traceable to the disbursements referred to in subparagraph (A)) property acquired by the taxpayer after tax lien filing.

26 U.S.C. § 6323(c)(4)(B) (2007).

(emphasis added). The above legislative history makes clear that surety bonds are intended to constitute obligatory disbursement agreements under Section 6323(c).

**i. When the Surety has Filed its Indemnity Agreement as a UCC Financing Statement Prior to the IRS Filing its Notice of Lien.**

Most indemnity agreements contain a security agreement and assignment to the surety of the principal's assets, including accounts receivables, and provide that the surety may file the indemnity agreement as a UCC-1 financing statement in order to allow the surety to perfect its security interest in the principal's assets.<sup>64</sup> If the Surety filed the Indemnity Agreement as a UCC-1 financing statement in the appropriate jurisdiction prior to the IRS filing its notice of lien in accordance with Section 6323(f), the Surety's claim to the Bonded Contract Funds should be given priority over the IRS tax lien under Section 6323(c) regardless of whether the Surety's performance occurred before or after the filing of notice of the IRS tax lien.

**ii. When the Surety has Not Filed its Indemnity Agreement as a UCC Financing Statement and the Surety Relies Upon its Subrogation Rights.**

The more difficult question regarding the priority to the Bonded Contract Funds arises when the Surety has not filed its Indemnity Agreement as a UCC-1 financing statement prior to the United States filing its notice of lien and the Surety asserts its priority to the Bonded Contract Funds under Section 6323(c) as a result of its subrogation rights. There is conflicting case law as to whether a surety's subrogation rights constitute a "security interest" under Section 6323, and, thus, whether Section 6323(c) is applicable to a performing Surety claiming a superior right to the Bonded Contract Funds through its subrogation rights. Several courts have held that a surety's subrogation rights constitute a "security interest" for purposes of Section 6323(c),<sup>65</sup> while other courts have held to the contrary.<sup>66</sup>

In *In re Bay State York Co.*,<sup>67</sup> a subcontractor/principal's performance and payment bond surety ("Hartford") completed its principal's ("BSY") subcontract after BSY advised Hartford that it was unable to complete the subcontract. Hartford completed the subcontract from November of 1990 through May 1991.<sup>68</sup> At the time Hartford undertook to complete the project, the only payment remaining due to BSY was the subcontract retainage. The IRS properly filed notices of tax liens against BSY in the jurisdiction in

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<sup>64</sup> THE SURETY'S INDEMNITY AGREEMENT - LAW & PRACTICE 95 (Marilyn Klinger, Gary Judd & George J. Bachrach, eds. 2002).

<sup>65</sup> See *Amwest Sur. Ins. Co. v. United States*, 870 F. Supp. 432 (D. Conn. 1994); *In re Bay State York Co.*, 162 B.R. 922 (Bankr. D. Mass 1993). See also, *International Fidelity Ins. Co. v. United States*, 949 F.2d 1042 (1991) (holding that surety superior right to bonded contract funds under Section 6323 after principal's default as a result of the surety's subrogation rights).

<sup>66</sup> See *Construction Alternatives, Inc. v. Indiana Lumbermens Mutual Ins. Co.*, 2 F.3d 670 (6<sup>th</sup> Cir. 1993); *In re M & T Electrical Contractors, Inc.*, 267 B.R. 434 (Bankr. D. D.C. 2001).

<sup>67</sup> 162 B.R. 922 (D. Mass 1993).

<sup>68</sup> See *id.* at 925.

which the project was located in September and December of 1990 and May of 1991. BSY filed for bankruptcy in the United States Bankruptcy Court for the District of Massachusetts and BSY's bankruptcy trustee filed a complaint to determine the priority of the liens alleged by Hartford and the IRS to the subcontract retainage.

Hartford argued that it was entitled to priority over the IRS tax lien based upon Section 6323(c).<sup>69</sup> The IRS argued that Hartford was not entitled to the superior claim to the subcontract retainage provided for by Section 6323(c) because Hartford's subrogation rights did not meet the definition of a "security interest" under Section 6323(c) and Hartford's rights were not protected under local law from a judgment lien, as of the time of the tax lien filing, arising out of an unsecured obligation.<sup>70</sup>

Section 6323(h)(1) defines "security interest" as:

[A]ny interest in property *acquired by contract* for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.

(emphasis added). The IRS argued that BSY's assignment to Hartford of BSY's subcontract rights under the indemnity agreement in the event of BSY's default under the subcontract was not protected under local law against a subsequent judgment lien arising out of an unsecured obligation.<sup>71</sup> Further, the IRS argued that Hartford's subrogation rights were not contractual rights, and, therefore, these rights could not constitute a "security interest" as defined by Section 6323. The IRS contended that Hartford was required to have perfected its contractual rights arising out of the indemnity agreement in accordance with the Uniform Commercial Code in order to have obtained a "security interest" under Section 6323.<sup>72</sup>

In rejecting the IRS's positions, the Court found that subrogation rights are not superseded by the Uniform Commercial Code and are not "security interests" within the meaning of Article 9 of the Uniform Commercial Code. Article 9 of the Uniform Commercial Code applies to security interests *created by contract*, whereas "[r]ights of subrogation, although growing out of a contractual setting and oftentimes articulated by the contract, do not depend for their existence on a grant in the contract, but are created by law to avoid

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<sup>69</sup> *Id.* at 932-35. Hartford initially argued that BSY had no interest in the retainage as a result of its material default, and, therefore, the IRS's lien could not attach to the subcontract retainage. However, the Court found that BSY was not in material default of the subcontract at the time it advised Hartford that it could not complete the subcontract and that BSY had an interest in the subcontract retainage. *Id.* at 928-29, 931-32.

<sup>70</sup> *Id.* at 932.

<sup>71</sup> *Id.* at 932-33.

<sup>72</sup> *Id.* at 933.

injustice.”<sup>73</sup> The Court went on to find a distinction between security interests within the meaning of Article 9 of the Uniform Commercial Code and security interests within the meaning of Section 6323 stating:

Unlike the Uniform Commercial Code, which speaks of security interest “created by contract,” section 6323(h) of the Federal Tax Lien Act speaks of security interests “acquired by contract.” Although subrogation rights are not created by contract . . . they may be acquired by contract. Therefore, Hartford’s subrogation rights are not of necessity excluded from the definition of security interest as the IRS suggests.<sup>74</sup>

The Court continued its analysis by finding that Hartford’s subrogation rights were protected under the local law against a subsequent judgment lien arising out of an unsecured obligation because under the applicable state law Hartford’s subrogation rights related back to the date of the issuance of performance bond and would prevail against a judgment lien holder whose lien arises out of an unsecured obligation.<sup>75</sup> Accordingly, the Court held that Hartford had a superior right to the subcontract retainage pursuant to Section 6323(c).

The United States District Court for the District of Connecticut reached a similar conclusion in *Amwest Surety Insurance Co. v. United States*.<sup>76</sup> SMP Developers, Inc. (“SMP”) entered into a contract with Credo Housing Development Corp. (“Credo”) to construct a project. Amwest Surety Insurance Company (“Amwest”), as surety, and SMP, as principal, issued a performance bond to Credo and the State of Connecticut, as obligees. SMP defaulted on its obligations under its contract, and Credo terminated the contract on August 16, 1991 and made demand upon Amwest under the terms of the performance bond. In September of 1991, Amwest cured SMP’s default and arranged for completion of the contract at a total cost in excess of \$60,000. Prior to the termination of the contract by Credo, the IRS filed notices of liens against SMP. On August 5, 1991, the IRS served Credo with a notice of levy and on August 15, 1991 Credo paid the IRS \$42,476.64, which amount represented SMP’s requisition for work performed in July of 1991.<sup>77</sup>

Amwest commenced a wrongful levy action against the United States seeking to recover Credo’s payment of the bonded contract funds to the IRS. The United States conceded that the performance bond issued by Amwest constituted an obligatory disbursement agreement under Section 6323; however, the United States contended that Amwest’s subrogation rights were not protected under local law against a subsequent judgment lien arising out of an unsecured obligation.<sup>78</sup> In rejecting the United States’

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<sup>73</sup> *Id.* at 933.

<sup>74</sup> *Id.* at 934.

<sup>75</sup> *Id.*

<sup>76</sup> 870 F. Supp. 432 (D. Conn. 1994)

<sup>77</sup> *See id.* at 432-33.

<sup>78</sup> *Id.* at 434.

argument, the court held that a surety is not required to make a UCC filing in order ensure the priority of its claims arising from its subrogation rights. The Court stated:

The government's claim is premised on the applicability of the cited U.C.C. sections. There is no reference in the U.C.C. to sureties. There is no explicit requirement that sureties file to ensure their claim. It has been found by this court that the omission was intentional . . . and thus no such filing is required to perfect a surety's interest in proceeds of its principal's contract.<sup>79</sup>

Further, the court found that under the applicable state law, Amwest's subrogation rights related back to the date upon which the surety issued the performance bond, and, therefore, Amwest's claim to the bonded contract funds was protected under local law from a judgment lien arising from an unsecured obligation at the time the IRS filed its notices of liens.<sup>80</sup> Accordingly, the court found that under Section 6323(c) Amwest had a superior right to the bonded contract funds paid to the IRS by Credo, and the court entered judgment in favor of Amwest in the full amount of the payment made by Credo to the IRS.

Other courts have failed to recognize subrogation rights as a "security interest" under Section 6323. In the case of *In re M & T Electrical Contractors, Inc.*,<sup>81</sup> a first-tier subcontractor/principal paid the claim of a third-tier subcontractor against the principal's payment bond as a result of a second-tier subcontractor's failure to pay the third-tier subcontractor.<sup>82</sup> The United States Bankruptcy Court for the District of Columbia acknowledged that the first-tier subcontractor/principal was subrogated to the third-tier subcontractor's right of setoff against the second-tier subcontract as a result of the first-tier subcontractor's payment to the third-tier subcontractor.<sup>83</sup> The court further acknowledged that the first-tier subcontractor's payment was made pursuant to an obligatory disbursement agreement because the first-tier subcontractor was liable to the third-tier subcontractor under the terms of the payment bond and to the surety on the payment bond under the terms of the indemnity agreement that the first-tier subcontractor executed in favor of the surety.<sup>84</sup> However, the court found that the first-tier subcontractor's right of setoff arising from subrogation was not a "security interest" under Section 6323 because it was not "acquired by contract."<sup>85</sup> Therefore, the court found that the first-tier subcontractor's right of setoff did not take priority over federal tax liens filed against the second-tier subcontractor.

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<sup>79</sup> *Id.*

<sup>80</sup> *Id.* at 435.

<sup>81</sup> 267 B.R. 434 (Bankr. D. D.C. 2001).

<sup>82</sup> *See id.* at 443.

<sup>83</sup> *Id.* at 450-53.

<sup>84</sup> *Id.* at 451.

<sup>85</sup> *Id.* at 457.

In the case of *In re Construction Alternatives, Inc.*,<sup>86</sup> the United States Court of Appeals for the Sixth Circuit affirmed a district court's affirmation of a bankruptcy court's holding that IRS's tax liens were superior to that of a surety that had paid suppliers of labor and material to the project. In so holding, the Sixth Circuit held that the surety did not have a "security interest" under Section 6323 in the earned, but unpaid, progress payments of the contractor/principal. The court's decision is devoid of any analysis as to whether the surety's subrogation rights constitute a "security interest" under Section 6323. The court simply held that the surety was required to file its indemnity agreement as a financing statement in order to perfect its "security interest" and to be entitled to the priority provided under Section 6323.<sup>87</sup>

In the event the IRS disputes that fact that the Surety's subrogation rights constitute a "security interest" under Section 6323(c), generally speaking, the Surety may want to consider presenting several arguments in support of its position. First, the Surety may want to argue and present applicable state case law, or case law from other jurisdictions if there is no controlling case law in the applicable jurisdiction, that holds that a surety's subrogation rights are superior to a judgment lien arising out of a unsecured obligation and that such subrogation rights relate back to the date of the issuance of the bond. This argument may satisfy the conditions of Section 6323(c)(1)(B) and of the definition of "security interest" under Section 6323(h)(1).<sup>88</sup> Second, the Surety may want to present the analysis set forth in *Bay State* that a Surety's subrogation rights, while not created by contract, are "acquired by contract" because the Surety's subrogation rights arise out of the Surety's obligations under its tri-party contractual relationship and the Surety's rights under its indemnity agreement. Third, the Surety may want to cite to the legislative history of the Tax Lien Act that establishes that surety bonds were specifically intended to constitute obligatory disbursement agreements and point out to the court that subrogation is the primary mechanism by which sureties protect their interests when called upon to perform under their bonds. Therefore, Section 6323(c) should not be read so narrowly as to defeat one of the primary parties it was intended to protect.<sup>89</sup> Fourth, the Surety may want to cite case law that supports the proposition that a surety's subrogation rights are not "security interests" under Article 9 of the UCC, and, therefore, such rights do not need to be "perfected" by the filing of a financing statement in order to be considered a "security interest" under Article 9 of the UCC nor to be "acquired . . ." under the IRC.<sup>90</sup>

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<sup>86</sup> 2 F.3d 670 (6<sup>th</sup> Cir. 1993).

<sup>87</sup> See *id.* at 678.

<sup>88</sup> Section 6323(c)(1)(B) is redundant in that the term "security interest" set forth in Section 6323(c)(1), by definition, is an interest that is superior to a judgment lien arising out of an unsecured obligation. See Section 6323(h)(1).

<sup>89</sup> The seminal case on a surety's rights of equitable subrogation is *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 138, 83 S. Ct. 232, 235 (1962), which was decided in 1962, several years before the passage of the Tax Lien Act of 1966.

<sup>90</sup> See *e.g.*, *National Shawmut Bank of Boston v. New Amsterdam Casualty Co.*, 411 F.2d 843, 847 (1<sup>st</sup> Cir. 1969); *Jacobs v. Northeastern Corp.*, 416 Pa. 417, 206 A.2d 49, 55 (1965).

#### **IV. ADVISING THE OBLIGEE OF THE SURETY'S SUPERIOR RIGHTS TO THE BONDED CONTRACT FUNDS.**

If the Surety becomes aware that the Obligee has been served with a notice of levy by the IRS, the Surety will want to promptly advise the Obligee of its rights to the Bonded Contract Funds. The Surety will want to closely analyze the controlling state case law and the provisions of the Contract with regard to any express right the Obligee may have to withhold payment to the Principal under the Contract. The exact demand made upon the Obligee by the Surety with regard to the Bonded Contract Funds will depend upon the facts and circumstances of each case and the method under which the Surety is performing its obligations under the Performance Bond. However, to the extent that the Bonded Contract Funds are in the possession of the Obligee, the Surety will want to demand that the Bonded Contract Funds be paid over to the Surety, held by the Obligee for completion of the Contract or, at the very least, interpled with an appropriate court.

Although the Obligee's interpleading of the Bonded Contract Funds will result in the Surety being forced to litigate its priority to the Bonded Contract Funds with the United States, an interpleader action is still preferable to the Obligee paying the Bonded Contract Funds over to the IRS and the Surety being forced to bring a wrongful levy action under Section 7426. An interpleader action puts an initial burden on the United States to investigate the parties' respective rights to the Bonded Contract Funds and to file a pleading asserting the United States' right to the Bonded Contract Funds. An interpleader action may cause the United States Attorney handling the case to promptly and more closely analyze the priority dispute during the early stages of the litigation than the United States Attorney may otherwise act in a wrongful levy action where the United States is simply a defendant. Therefore, the procedural posture of an interpleader action may foster early settlement discussions and help the Surety avoid additional litigation expenses.

#### **CONCLUSION**

A performing Surety that has its Bonded Contract Funds levied upon by the IRS has strong arguments that its rights to the Bonded Contract Funds are superior to that of the IRS. However, the Surety must take action within 9 months of the date that the notice of levy is served on the Obligee to protect its rights. The performing Surety's subrogation rights should provide it with a priority to the Bonded Contract Funds in most cases. However, the Surety must be aware of the various facts that must be established and the legal arguments that must be presented in order for the Surety to prevail in a priority contest with the IRS for the Bonded Contract Funds.

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