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**IS MUNSEY TRUST ALIVE?
RECENT CASES INVOLVING THE PAYMENT BOND
SURETY'S SUBROGATION RIGHTS**

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Introduction

Sureties provide payment and performance bonds on public and private construction projects. A surety bond is a tri-partite agreement, with the contractor as principal obligor, the owner or government¹ as the obligee, and the surety as the secondary obligor. Under a payment bond, a surety ensures that laborers and materialmen² will be paid in the event that the contractor is unable to pay. Under a performance bond, a surety promises to either complete the job or hire another company to complete the job. Upon payment or performance under the respective bonds, a surety is entitled to certain rights and remedies including the doctrine of equitable subrogation as an avenue for reimbursement. Under the general doctrine of equitable subrogation, the surety may step into the shoes of one party to enforce that party's rights in order to be compensated for performance under the bond.

The doctrine of subrogation is tricky and complex enough. Yet, after the Supreme Court decided *United States v. Munsey Trust Co.*,³ courts and practitioners were faced with another wrinkle regarding payment bond sureties' subrogation rights. In *Munsey*, the Supreme Court for the first time distinguished between payment and performance bond sureties⁴ and indicated that a payment bond surety is faced with many obstacles before it may be reimbursed out of retainage via subrogation. In keeping with tradition,⁵ several recent cases from the United States Court of Federal Claims ("Court of Claims") contain rigorous and well-reasoned analyses of the current status of the equitable subrogation rights of payment bond sureties and the status of *Munsey* as precedent.

The purpose of this paper is to determine whether these recent cases weaken the *Munsey Trust* decision. Ultimately, the paper will conclude that the holding of *Munsey Trust* is alive and well, but that the reasoning supporting that holding has been criticized and eroded. Additionally, it is the thesis of this paper that *Munsey Trust* cannot be held to stand for the proposition that a payment bond surety can only be subrogated to certain parties. Rather, the *Munsey Trust* case merely concluded that a payment bond surety, under certain circumstances, will not be helped by subrogating to the rights of certain parties.

¹ In the context of the *Munsey Trust* case and cases like it, a governmental or public entity is often the owner of the construction project. In this paper, these terms should be taken to refer to the same thing.

² This paper will use the terms "laborers and materialmen" and "subcontractors" interchangeably. The terms more than often indicate the same party in the suretyship context.

³ 332 U.S. 234 (1947). In this paper, the terms "*Munsey*" and "*Munsey Trust*" refer to the Supreme Court opinion, not the Court of Claims opinion.

⁴ *Comm. Cas. Ins. Co. of Georgia v. US*, 71 Fed. Cl. 104 (2006)

⁵ The Court of Claims has produced a vast majority of the cases discussing *Munsey Trust* and the doctrine of equitable subrogation. Indeed, the lower court decision in *Munsey Trust* was decided by the Court of Claims. This anomaly is probably due to the fact that the Court of Claims has a disproportionate opportunity to hear cases on government construction projects which the Miller Act (40 U.S.C. §§ 3131-3134) requires to be bonded with both performance and payment bonds.

United States v. Munsey Trust Co.⁶

In *Munsey Trust*, Aetna Casualty and Surety Company (“Aetna”) supplied Federal Contracting Corporation (“Federal”) with a number of performance and payment bonds on a project for the federal government (“United States” or “government”). Federal completed the job but failed to pay a number of laborers and materialmen. Aetna paid the laborers and materialmen pursuant to its payment bonds and sought reimbursement from the United States out of the contract retainage. In the meantime, Federal had defaulted on another unrelated contract with the United States, and the United States was forced to use a replacement contractor at an increased expense. When the Munsey Trust Company (“Munsey”), a court-appointed receiver, demanded funds from the United States to reimburse Aetna, the government deducted its independent offsetting claim for damages from the contract balance. The receiver protested the setoff and the Court of Claims had to answer whether the United States could offset an unrelated independent claim owed by the contractor against a surety seeking reimbursement for performance under a payment bond.

The surety⁷ argued that it was equitably subrogated to the contractor, the laborers and materialmen, and the United States and thus entitled to the funds free from setoff. The Court of Claims agreed:

“By reason of these payments by the Aetna Company it became subrogated to all the rights of the Federal Contracting Corporation, the laborers and materialmen, whose claims the Aetna Company paid, and of the Government so far as its rights under the contracts were concerned, in the balances due under the contracts in connection with which the surety made such payments, to the extent of such balances, and to the extent of payments made where such payments were less than the balances due under the particular contract. The legal and equitable rights of the surety to the balance due under said contracts were superior to those of the United States as a general creditor of the defaulting contractor on a claim arising independently of any of the contracts in connection with which the surety made such payments under its bonds.”⁸

However, the Supreme Court ultimately reversed the Court of Claims and held that the United States could properly offset its independent claim against Aetna’s equitable subrogation claim to the retained funds.

In reaching its conclusion, the Court first decided that the United States “has the same right which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his

⁶ See *Liberty Mutual Ins. Co. v. US*, 70 Fed.Cl. 37, 44-45 (2006) for an excellent analysis of the *Munsey Trust* decision.

⁷ It was actually Munsey, as receiver, that argued for the surety. However, the Supreme Court treated the arguments as coming from the surety. See *Munsey Trust* at 239.

⁸ *Munsey Trust Co. v. U.S.*, 67 F.Supp. 976, 977 (Ct. Cl. 1946) (citations omitted). As stated in *Liberty Mutual* at 44, “[t]his echoed the broad statement of subrogation in *Prairie State* and *Henningsen*,” two landmark subrogation cases discussed below.

hands, in extinguishment of the debts due to him.”⁹ In other words, if the United States faced the contractor’s claim to retained funds or the contract balance (or the surety’s claim via subrogation to the contractor’s claim)¹⁰ the government would clearly be able to exercise its common law right of setoff.

The Court next addressed the surety’s argument that it was entitled to the contract balance based on equitable subrogation to the rights of the laborers and materialmen. It rejected Aetna’s argument for several reasons.

First, the Court reasoned that sureties had only been given equitable priority to retained funds when the owner is a mere stakeholder of funds “with no rights of its own to assert.”¹¹ The Court found that the United States was “not a general creditor” but rather was “the best secured of creditors” by virtue of its offset claim against the contractor.¹² In other words, the United States was not just a stakeholder of the funds and its independent offset claim was superior to the claim of the surety based on equitable subrogation to the rights of laborers and materialmen.

Second, the Court stated that the United States was under no obligation to pay laborers and materialmen because “nothing is more clear than that laborers and materialmen do not have enforceable rights against the United States for their compensation.”¹³ Since the duty to pay the laborers and materialmen falls upon the surety under the Miller Act, the surety has no claim for reimbursement as against the government.

Third, the Court rejected the argument that laborers and materialmen possess “something in the nature of a lien” to the retained funds to the extent that they are unpaid.¹⁴ The Court found that laborers and materialmen could not claim a right to or lien on funds withheld from the contractor due to his default since they cannot claim payment of that which is not due the contractor. A surety therefore has no right that it can subrogate to, vis a vis unpaid laborers and materialmen:

⁹ *Munsey Trust* at 239 (citations and quotations omitted).

¹⁰ Although it is far from clear in *Munsey*, one can presume that the Court was addressing whether subrogation to the contractor’s rights would have allowed Aetna to claim the retained funds free from setoff. Indeed, the Court later in the opinion states that “[t]he surety has yet another party whose rights it would claim, if it cannot prevail by substitution for the contractor or laborers and materialmen,” indicating that the Court was systematically analyzing the results of the surety’s subrogation to first the contractor, second the laborers and materialmen, and third the United States. See *Liberty Mutual* at 44 (“On review, the Supreme Court evaluated the rights of the surety (acting through the receiver) through the lense [sic] of each of the contracting parties—prime contractor, subcontractor, and government.”); see also *USFG v. Ernest*, 854 F.Supp. 1545, 1557 (M.D. Fla. 1994) (“the surety in *Munsey* contended that it was subrogated to the rights of the materialmen as well as the United States.”). This reading of *Munsey* is also consistent with the lower court decision and rule quoted in the text above.

¹¹ *Munsey Trust* at 240.

¹² *Id.*

¹³ *Id.* at 241

¹⁴ *Id.*

“If before [the laborers and materialmen] are paid, the fund to which they are said to be entitled to look is unavailable for the very reason that they are unpaid, the surety relies on nothing when it relies on those nonexistent ‘rights.’ One who rests on subrogation stands in the place of one whose claim he has paid, as if the payment giving rise to the subrogation had not been made. He cannot jump back and forth in time and present himself at once as the unpaid claimant and again, under the conditions as they have changed because payment was made.”¹⁵

The Court finally addressed the argument that the surety was subrogated to the United States. The surety argued that the United States retained the contract balance to assure performance of all the obligations under the contract. By stepping in and performing the obligation of the contractor to pay the laborers and materialmen, the surety argued that it had discharged one of those obligations and could therefore indemnify itself with the contract balance. However, the Court disagreed, reasoning that the contract balance was retained primarily to ensure completion of the project, rather than payment of the laborers and materialmen.¹⁶ Hence, the surety could not through subrogation take advantage of any right of the government to use the funds to pay laborers and materialmen.

Pearlman v. Reliance Insurance Co.: Limiting Munsey to the Offset Issue

The Supreme Court revisited *Munsey* in *Pearlman v. Reliance Insurance Co.*¹⁷ partly because some jurisdictions had interpreted *Munsey* as changing the long-standing law of equitable subrogation.¹⁸ For example, the Ninth Circuit in *Phoenix Indemnity Co. v. Earle*¹⁹ cited to *Munsey* as extinguishing the surety’s claim to subrogation to the Government and establishing that a surety may not be subrogated to laborers and materialmen since such parties do not have enforceable rights against the government.²⁰ Also, The Tenth Circuit in *American Surety Co. of New York v. Hinds*²¹ followed the holding of *Phoenix* and stated that the decision of *Munsey* was based “both on the strength of the government’s right to set-off and the weakness of the surety’s claim to equitable rights in the fund.”²² The court went on to

¹⁵ *Id.* at 242 (citation omitted)

¹⁶ *Id.* at 243 (“But although we have assumed, for the purposes of another argument, that assurances that laborers and materialmen will be paid is one of the reasons for retaining the money, it seems more likely that completion of the work on time is the only motive.”)

¹⁷ 371 U.S. 132 (1962).

¹⁸ *Id.* at 135 and fn. 8

¹⁹ 218 F.2d 645 (9th Cir. 1955)

²⁰ *Id.* at 649 (the surety’s assertion “to be subrogated to the rights of the government...would seem to have been laid to rest in *United States v. Munsey Trust Co.*”)

²¹ 260 F.2d 366 (10th Cir. 1958)

²² *Id.* at 368 (“It would seem clear that if the surety can claim no enforceable right of subrogation through the creditors paid and can assert no equitable claim to the fund itself, either in its own right or through the United

find that there are no enforceable rights for the surety to step into vis a vis the laborers and materialmen.

Given these interpretations of *Munsey*, the Supreme Court granted certiorari in *Pearlman* to address what effect, if any, *Munsey* had on a payment bond surety's right to subrogation. The issue in the case was whether a payment bond surety had any security interest in a retained fund superior to that of a bankruptcy trustee. The Court discussed the two landmark subrogation cases, *Prairie State National Bank v. US*²³ and *Henningsen v. USFG*.²⁴ It found that *Prairie State* held that a surety who completes a contract (i.e. a performance bond surety) has an "equitable right" to the retained fund²⁵ and that *Henningsen* extended that rule to sureties who merely paid debts for the contractor (i.e. payment bond sureties)²⁶. Thus the Court found that "the same equitable rules as to subrogation and property interests in a retained fund [exist] whether a surety completes a contract or whether, though not called upon to complete the contract, it pays the laborers and materialmen."²⁷ In other words, a surety's has a right to retainage via the doctrine of subrogation "whether its bond be for performance or payment."²⁸

Based on this understanding of the doctrine of equitable subrogation, the Court held that the payment bond surety in the case was entitled to step into three sets of shoes to reach the retained funds: the contractor, the laborers and materialmen, and the government. Moreover, the Court held that such subrogation would be successful because the laborers and materialmen had a right to be paid out of the fund and the government had a right to use the retained fund to pay the laborers and materialmen, opposite the reasoning of *Munsey*:

"We therefore hold in accord with the established legal principles stated above 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."²⁹

States, then the Trustee must here prevail and appellant's claims must await their presentation under the administration of the bankruptcy proceedings.")

²³ 164 U.S. 227 (1896)

²⁴ 208 U.S. 404 (1908)

²⁵ *Pearlman* at 138, citing from *Prairie State* at 239.

²⁶ *Id.* at 138-139, citing from *Henningsen* at 410.

²⁷ *Id.* at 139

²⁸ *Id.*

²⁹ *Id.* at 141.

In so holding, the Court explicitly limited *Munsey*'s holding to the issue of offset: "[In *Munsey*, we] held that the Government could exercise the well-established common-law right of debtors to offset claims of their own against their creditors. This was all we held."³⁰ Thus, the Supreme Court departed from its earlier reasoning in *Munsey* that laborers and materialmen have no interest or rights in the fund³¹ or that main purpose of the fund was to complete the job, not pay laborers and materialmen. The Court also rejected interpreting *Munsey* to limit a surety's subrogation right to the retained funds merely based on its payment bond vs. performance bond status.

**Security Insurance Co. of Hartford v. US:
Limiting the Munsey Offset Issue to Payment Bond Sureties**

Munsey was further confined by the Court of Claims in *Security Insurance Co. of Hartford v. US*.³² The issue in that case was whether the Government could set off taxes owed to it by a defaulting contractor against retainages claimed by a performance bond surety. The Court of Claims overruled its decision in *Standard Accident Insurance Co. v. US*³³ and held that the *Munsey* offset rule was intended to apply only to payment bond sureties.

Following the Fifth Circuit's reasoning and holding in *Trinity Universal Ins. Co. v. US*,³⁴ the Court of Claims held that a performance bond surety could claim retainages ahead of the government's setoff as subrogee of the government: "[t]he 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."³⁵ The

³⁰ *Id.* at 140.

³¹ Justice Clark, concurring, disagreed that the surety had a right to the retained fund based on subrogation to the laborers and materialmen. He noted that, as stated in *Munsey*, laborers and materialmen have no enforceable rights against the government, cannot acquire a lien in public buildings, and are intended to be paid by Miller Act sureties, not the federal government. The concurrence would have held more narrowly that the surety was subrogated only to the United States and thereby "entitled to surplus funds remaining in its hands after the contract was completed." The Court of Claims in *USFG v. US*, 475 F.2d 1377, 1382 (Ct. Cl. 1973) (addressing whether subcontractors could bring suit against the government for retainage), reconciled the opposing views in *Pearlman* and *Munsey* on the "rights" of subcontractors to retained funds by holding that laborers and materialmen "might have superior equitable rights to the retainage but no right to sue the defendant." *Accord Matter of RAH Development Co.*, 184 B.R. 525, 533-534 (Bkrtcy. W.D. Mich. 1995) ("The language from *Munsey Trust* [332 U.S. at 241] provides that laborers and materialmen have no *enforceable rights* against the government, not that they have no rights at all.").

³² 428 F.2d 838 (Ct. Cl. 1970)

³³ 97 F.Supp. 829, 832 (Ct. Cl. 1951) ("We cannot agree that a different result is dictated by the fact that *Munsey* involved a payment bond and this case a performance bond. The Supreme Court's holding in *Munsey* that the United States did not, by requiring its contractor to be bonded, lose its right to set off its contractor's debts from the retained percentages is applicable to both situations.") (citation omitted)

³⁴ 382 F.2d 317, 320 ("Whoever, be it the contractor or his surety, pays the laborers and materialmen would be a creditor of the government insofar as the retained funds are concerned. Of course, however, the government has a right to set off claims against its creditors. A different situation occurs when the surety completes the performance of a contract."), citing *Pearlman* at 141.

³⁵ *Security Ins.* at 842.

court reasoned that a completing surety performs a benefit to the government and thus is entitled to the funds. Allowing setoff against performance bond sureties would defeat the purpose of the retained funds to assure completion of the project.³⁶

Current Interpretations of the *Munsey*, *Pearlman*, *Security Insurance* Rules

Courts seem to uniformly follow *Munsey* and *Security Insurance*, holding that the government may offset either an unrelated or related claim against a payment bond surety, but not against a performance bond surety.³⁷ However, the Restatement (Third) of Suretyship & Guaranty § 31 (1996) has rejected the so-called “*Munsey* Doctrine.” In Comment d., the Restatement prohibits an obligee from setting-off an independent claim against a surety because it would lead to unjust enrichment of the contractor:

“If, upon performance by the secondary obligor, the obligee were allowed to set off the separate claim against the secondary obligor’s subrogation rights, the principal obligor would be unjustly enriched because the performance by the secondary obligor would free the principal obligor of two claims—its duty pursuant to the underlying obligation and its duty pursuant to the separate claim.”

The Reporter’s Notes clarify that Comment d. rejects the “*Munsey Trust* doctrine,” and further notes that the doctrine has been “severely criticized since its inception.”³⁸

On the other hand, courts (even within the same jurisdictions) seem widely divergent as to the extent and nature of a payment surety’s subrogation rights after *Munsey*. Many cases do follow the broad holding of *Pearlman* and place no limit on the extent of a payment bond surety’s subrogation rights or at least hold that payment and performance sureties enjoy equal subrogation rights. For example, courts have held that a payment bond surety is subrogated to the rights of the owner, the contractor, and the laborers and materialmen.³⁹ Other courts

³⁶ See also *Balboa Ins. Co. v. US*, 775 F.2d 1158, 1161 (Fed. Cir. 1985), quoting *USFG v. US*, 475 F.2d at 1382.

³⁷ *Miller-Stauch Const. Co. v. Williams-Bungart Elec., Inc.*, 959 S.W.2d 490, 494 (Mo. Ct. App. W.D. 1998) (“it appears to be the generally accepted rule that, although the obligee may have a right of set-off against the surety under a payment bond, the obligee does not have a right of set-off against the surety under a performance bond.”), noting the rejection of *Standard Accident* by *Security Insurance* and *Trinity Universal*; *In re Lanny Jones Welding & Repair, Inc.*, 106 B.R. 446, 449 (Bkrtcy. E.D. Va. 1988) (“This Court holds that under *Munsey Trust* a set-off claim of the United States for taxes against retainages on a government construction contract is superior to the Miller Act payment bond surety’s claim of equitable subrogation.”); *Sentry Ins. v. US*, 12 Cl.Ct. 320, 322 (Cl. Ct. 1987); *Covenant Mutual Ins. Co. v. Able Concrete Pump*, 609 F.Supp. 27, 30-31 (N.D. Cal. 1984) (“A surety is also entitled to retainages when it pays laborers and materialmen although the contractor has completed the contract...The government is also entitled to set off claims it has against the original contractor before the surety who has fully paid laborers and materialmen may recover damages.”).

³⁸ The Note refers the reader to the several articles consistently cited on *Munsey* issues, including Mungall, *The Buffeting of the Subrogation Rights of the Construction Contract Bond Surety by United States v. Munsey Trust Co.*, 46 Ins. Couns. J. 607 (1979). The Note also cites *Pearlman*; *Trinity Universal*; *Universal Bonding Ins. Co. v. Gittens & Sparkle*, 960 F.2d 366 (3d cir. 1992); and *Aetna Cas. & Sur. Co. v. US*, 435 F.2d 1082 (5th Cir. 1970).

³⁹ *RLI Ins. Co. v. N.Y. State Dept. of Labor*, 766 N.E.2d 934, 939-940 (Ct. App. N.Y. 2002); *Transamerica Premier Ins. Co. v. US*, 32 Fed.Cl. 308, 312 (1994), citing *Dependable Ins. Co. v. US*, 846 F.2d 65, 67 (Fed. Cir. 1988)

seem more limited (or at least less specific) and hold that the payment bond surety is subrogated to the owner's right as well as to the laborers and materialmen⁴⁰ or follow the general rule that a surety who *either* completes work on a job or pays laborers and materialmen can invoke the doctrine of equitable subrogation to reach the retainage.⁴¹

However, despite the *Pearlman* Court's attempt to rectify *Munsey's* confusing rationales, some courts still restrict the payment bond surety's pool of subrogors. These restrictive courts hold that the payment bond surety is only subrogated to the rights of the laborers and materialmen.⁴² This same, obviously mistaken characterization of subrogation law was relied upon by the Federal Circuit in *Insurance Company of the West v. US*⁴³ ("*ICW*"), which is discussed in the next section.

The Court of Claims Cases: Reaffirming *Pearlman*, *Security Insurance* and a Less Restrictive Pool of Subrogors

During 2006, the Court of Claims produced several nearly identical opinions on the topic of payment bond sureties' subrogation rights. The issue before all the courts was whether a payment bond surety had standing to sue the United States under the Tucker Act (28 U.S.C. § 1491).⁴⁴ All of the courts rejected as dicta a certain statement in *ICW*, a Federal Circuit opinion about a performance bond surety's claim against the United States. The court in *ICW*

and *Pearlman* at 141; *Western Cas. & Sur. Co. v. Bruns Coal Co.*, 362 F.2d 486, 489-490 (4th Cir. 1966); *N.M. State Highway and Transp. Dept. v. Gulf Ins. Co.*, 996 P.2d 424, 429 (Ct. App. N.M. 1999); *In re Construction Alternatives, Inc.*, 2 F.3d 670, 675 (6th Cir. 1993).

⁴⁰ *State of Ohio ex rel. Star Supply v. City of Greenfield*, 528 F.Supp. 955, 958-959 (S.D. Ohio 1981)

⁴¹ *In re Jones Const. & Renovation, Inc.*, 337 B.R. 579 (Bkrtcy. E.D. Va. 2006); *Dunn & Black v. US*, 366 F.Supp.2d 1008, 1018, 1030-1031 (E.D. Wash. 2005); See *Penn. Nat'l Mut. Cas. Ins. Co. v. Pine Bluff*, 354 F.3d 945, 952 (8th Cir. 2003); *Transamerica Ins. Co. v. Barnett Bank of Marion County*, 540 So.2d 113, 116 (Fla. 1989).

⁴² *Nat'l Fire Ins. Co. of Hartford v. Fortune Const. Co.*, 320 F.3d 1260, 1270 (distinguishing *Transamerica v. Barnett* as a case involving a performance bond surety, the court held that "[w]here a surety pays the claims of laborers and materialmen, the surety is only entitled to stand in the shoes of those laborers and materialmen who might have had liens, 'but for' the surety's payment."); *In re V. Pangori & Sons, Inc.*, 53 B.R. 711, 721 (Bkrtcy. E.D. Mish. 1985) ("It is well-established that the surety subrogates to the rights of only those creditors whom it pays on the principal's behalf. If Continental had been required to pay for completion of the sewer project from the *performance* bond, it would clearly be subrogated to the city's rights, since the performance bond is established for the benefit of the government.") (citing *Munsey* and *Pearlman*); *In re Givoh Assoc.*, 562 F.Supp. 1346, 1351 (E.D.N.Y. 1983) ("As one leading treatise in the field states, 'It is universally recognized that the surety, upon paying the creditor, is entitled to be substituted to the creditor's position.' Clearly this subrogates the sureties only to the rights of the subcontractors who were the creditors here, not to the rights of...the owner debtors."); *American Casualty Co. v. Board of Ed. Of Indep. School Dist., No. 2, Cleveland County*, 228 F.Supp. 843, 850 (W.D. Okla. 1964) ("But the plaintiff as a surety would only stand in the shoes of the laborers and materialmen and would have no greater rights in subrogation than they possess.").

⁴³ 243 F.3d 1367 (Fed. Cir. 2001).

⁴⁴ The Tucker Act grants the Court of Claims jurisdiction over claims against the government.

held that the United States had not waived sovereign immunity as to sureties. However, the court also stated out-of-the-blue the following:

“It is well-established that a surety who discharges a contractor’s obligation to pay subcontractors is subrogated only to the rights of the subcontractor. Such a surety does not step into the shoes of the contractor and has no enforceable rights against the government. See *United States v. Munsey Trust Co.*”⁴⁵

The statement had no relation to the issue before the court on whether a performance bond surety could bring suit against the government and certainly caused uproar in the Court of Claims.

January 12, 2006: *Nova Casualty Co. v. US*

The assault on *ICW* began with *Nova Casualty Co. v. US*.⁴⁶ The court in *Nova* addressed whether a payment bond surety could use the doctrine of equitable subrogation to sue for funds retained by the government. The court noted the rule of *Prairie State* and *Henningsen* that either a performance or payment bond surety could seek reimbursement out of funds retained by the government. The court also recognized the holding of *Munsey* as establishing that payment bond sureties’ subrogation claims are *inferior* to the government’s claims as creditor of the contractor. The court noted that *Pearlman* explicitly limited *Munsey* to the issue of whether the government may offset against a payment bond surety and rejected the idea that *Munsey* was an overhaul of the general law of subrogation. According to the court, the Court of Claims repeatedly has held that a payment bond surety is subrogated both to the rights of the contractor and to the rights of the subcontractor and has acknowledged the *Munsey* offset holding.⁴⁷ The court summarized the law on payment bond sureties as follows:

“[A] surety that performs under a payment bond is subrogated to the rights of *both* the party who owed the debt, the contractor, and the party to whom the debt was owed, the subcontractor. Such a surety is thus entitled to any funds retained by the government under the contract but only after the government has satisfied any claims it might possess against a superior creditor. A surety in this position may invoke the Tucker Act as a jurisdictional predicate for a suit against the government because it stands in the shoes of the contractor for that purpose.”⁴⁸

The defendant United States argued that the sentence from *ICW* “bars a surety who has only satisfied claims under the payment bond, but failed to perform under the performance

⁴⁵ *Id.* at 1371.

⁴⁶ 69 Fed.Cl. 284 (2006)

⁴⁷ *Id.* at 293.

⁴⁸ *Id.* at 293-294.

bond, from seeking relief directly from the government.”⁴⁹ However, the court held that the sentence was mere dicta and did not completely represent the payment surety’s equitable subrogation rights: “[t]he mere omission could not have the effect of superseding the Supreme Court’s decisions in *Henningsen* and *Pearlman* and numerous other precedents of the Federal Circuit and Court of Claims.”⁵⁰

Ultimately the court held that sovereign immunity did not bar either a payment bond surety or a performance bond surety from suing the government under the Tucker Act: “there is no difference between the posture [sic] of the two sureties.”

February 27, 2006: *Liberty Mutual Insurance Co. v. US*⁵¹

The court in *Liberty Mutual* addressed whether a payment bond surety’s claim of equitable subrogation survives a motion to dismiss for lack of jurisdiction under the Tucker Act. In the course of the analysis, the court produced a good history of the law on equitable subrogation, particularly as it relates to payment bond sureties. The court discussed the long line of cases (*Prairie State*, *Henningsen*, *Munsey* and *Pearlman*) and concluded that the Court of Claims follows the rule that “a surety is subrogated to the rights of *both* the subcontractor it pays and the prime contractor whose debts it relieves.”⁵²

The court also specifically mentioned *Pearlman*’s conclusion that *Munsey* had not abandoned “established legal and equitable principles” of *Prairie State* and *Henningsen*.⁵³ The court stated that the “rule of equitable subrogation stated in *Pearlman* has long been applied in the Federal Circuit,” noting that *USFG v. US*⁵⁴ had reconciled *Pearlman* and *Munsey* on the issue of whether subcontractors had rights to sue the United States and that *United Electric Corp. v. US*⁵⁵ held that a payment bond surety gains standing to sue by jointly subrogating to the subcontractor’s *and* the contractor’s rights.⁵⁶

The court found that the troubling language in *ICW* is “facially inconsistent with the Supreme Court’s holding on the scope of suretyship law in *Pearlman*” and “inconsistent with the court’s conclusion in the very same opinion that its earlier decision in *Balboa*⁵⁷ correctly

⁴⁹ *Id.* at 295.

⁵⁰ *Id.* at 296, citing *Pearlman* at 141 (rejecting the notion that the Court in *Munsey Trust* “so casually overruled” the “firmly established rule” from *Prairie State* and *Henningsen*).

⁵¹ 70 Fed.Cl. 37 (2006).

⁵² *Id.* at 42.

⁵³ *Id.* at 46.

⁵⁴ 475 F.2d 1377

⁵⁵ 647 F.2d 1082 (Ct. Cl. 1981)

⁵⁶ *Liberty Mutual* at 46-47.

⁵⁷ Referring to 775 F.2d 1158

stated the law of equitable subrogation.”⁵⁸ The court noted that *Balboa* established the rule that “in general the surety is equitably subrogated *not only to the rights of the subcontractor who is paid, but also to the rights of the prime contractor whose debt is discharged.*”⁵⁹ The court rejected the contention that *Munsey* held or implied that a surety is subrogated only to the rights of the subcontractors, or that a payment bond surety has no enforceable rights against the government. Instead, *Munsey* merely held that subrogation to such rights would “not help [the surety] evade the defense of set-off”: “the statements in *Munsey* must be read in the context of the entire opinion and cannot be parsed, lest they be given unintended meanings.”⁶⁰

May 26, 2006: *Commercial Casualty Insurance Co. of Georgia v. US*⁶¹

The Court in *Commercial Casualty*⁶² followed the conclusions and reasoning of *Nova* and *Liberty Mutual* and held that “a payment bond surety is equitably subrogated to the rights of both the subcontractors whom it pays and the prime contractor whose debt it pays when it fulfills its payment bonds.”⁶³ It also adopted the position of *Nova* and *Liberty Mutual* that the language in *ICW* about payment bond sureties is mere dicta. The court said that *Munsey* for the first time distinguished between performance bond and payment bond sureties by holding that if the government has any unrelated claims against the contractor, it may set-off those claims against any contract funds retained by the government prior to disbursing the funds to the subrogated payment bond surety. According to *Commercial Casualty*, the *Pearlman* Court stated that there is no fundamental distinction between the rights of a payment bond surety and a performance bond surety, except with regard to the right of set-off authorized in *Munsey*. The court noted that *Pearlman* was binding authority on the law of equitable subrogation and that it stands for the proposition that the payment bond surety is subrogated to all three parties:

“*Pearlman* provides that a payment bond surety, by paying the prime contractor’s debts to subcontractors, pays the subcontractors, ‘pays’ the United States by performing the prime contractor’s obligations under the contract, and ‘pays’ the prime contractor by paying its debt to the subcontractors. It is for this reason that the *Pearlman* Court concluded that the payment bond surety is subrogated to the rights of all three parties. In each of these instances the surety fulfills an obligation that is owed to that party.”⁶⁴

⁵⁸ *Id.* at 51.

⁵⁹ *Id.*

⁶⁰ *Id.* at 52, fn. 16.

⁶¹ 71 Fed.Cl. 104

⁶² The court in *Cincinnati Ins. Co. v. US*, 71 Fed.Cl. 544, 546-547 (June 2, 2006), followed the holding and reasoning of *Commercial Casualty*, adopting the opinion as a whole.

⁶³ *Commercial Casualty* at 110.

⁶⁴ *Id.* at 109.

July 26, 2006: *Travelers Indemnity Co. v. US*⁶⁵

The court in *Travelers Indemnity* addressed the same issues and discussed the same precedent as *Nova*, *Liberty Mutual* and *Commercial Casualty* and ultimately held that “(1) a surety that satisfies its payment, but not its performance, bond and settles all unpaid claims of laborers and materialmen is subrogated to the equitable rights both of the subcontractors and of the prime contractor in any retained contract funds, with the limitation that (2) a payment-bond surety has a priority inferior to the government’s right to set off the remaining contract balance if the United States has an unsettled claim against the contractor.”⁶⁶

The court found that *ICW* appeared to mis-cite *Munsey*:

“[T]he portion of the decision in *Munsey Trust* cited by the Federal Circuit in *Insurance Company of the West* seems to describe the substantive relationship between subcontractors and the government. The cited text does not support the proposition that a surety that fulfills its payment bond obligations is subrogated only to the rights of the subcontractors and does not step into the shoes of the contractor.”⁶⁷

The court also agreed with *Nova* that the Federal Circuit’s statement was “incomplete and does not convey the holdings of prior Supreme Court, Federal Circuit, and Court of Claims decisions.”⁶⁸ It finally held that the Federal Circuit’s statements were dicta “that cannot be read to have altered the principles of suretyship previously applied by the Supreme Court and this circuit for nearly a century.”⁶⁹

September 6, 2006: *National American Insurance Co. v. US*⁷⁰

National American followed the lead of *Travelers Indemnity*, *Cincinnati*, *Commercial Casualty*, *Liberty Mutual*, and *Nova*. On *Munsey*, the court stated that *Munsey*’s rejection of the surety’s assertion that it was subrogated to the superior rights of the laborers and materialmen did not constitute “some wholesale revision of the law of equitable subrogation,” but rather was merely a conclusion “that the subrogated surety was subject to the priority claims that the United States held against the contractor.”⁷¹ Accordingly, the court held that “when a surety has made payments on a payment bond and satisfied all outstanding claims, it

⁶⁵ 72 Fed.Cl. 56 (2006)

⁶⁶ *Id.* at 63.

⁶⁷ *Id.* at 64, fn. 12.

⁶⁸ *Id.* at 64.

⁶⁹ *Id.* at 65

⁷⁰ 72 Fed.Cl. 451 (2006)

⁷¹ *Id.* at 456.

is equitably subrogated to the rights of the primary contractor. In such circumstances it is beyond peradventure that the Tucker Act grants a waiver of sovereign immunity for this court to entertain the merits of the surety's damage claim."⁷²

Summary

The Court of Claims cases embrace the idea that a payment bond surety is subrogated both to the rights of the contractor and of the subcontractors. Many courts are in agreement, and some also extend the payment surety's subrogation rights to the owner. The Court of Claims cases also reject the idea that a payment bond surety is only subrogated to laborers and materialmen, even though other courts have held the opposite. Though the Court of Claims cases note that the Restatement rejects the Munsey doctrine,⁷³ the cases and other jurisdictions uniformly distinguish between payment bond sureties and performance bond sureties on the issue of owner or government offset.

It is curious why the court of claims did not extend the range of subrogors to the owner. Clearly *Pearlman* so held, and other courts so hold. Perhaps the Court of Claims did not need to extend the *Pearlman* rule for the issue at hand, since the surety in these Court of Claims cases needed only to be subrogated to the contractor in order to maintain a suit against the government under the Tucker Act.

Conclusion

Any life left in *Munsey* is relegated to a particular set of facts—where the government has an off-setting claim against a payment bond surety. Under such circumstances, the payment bond surety's right to the retained fund is inferior to that of the government asserting an offset. A performance bond surety, on the other hand, can reach the retainage free from set-off. Even this holding has been criticized and rejected by the Restatement.

Any interpretation of *Munsey* to limit the range of equitable subrogation of payment bond sureties is rejected by the Supreme Court, the Court of Claims, and many other jurisdictions. As said by the Court of Claims in *Liberty Mutual*,⁷⁴ *Munsey* has no bearing on whether a surety can bring an equitable subrogation claim and did not pronounce any new rules on when and whether a surety can be helped by claiming equitable subrogation. The Supreme Court in *Munsey* merely evaluated what rights each party had in the retained funds and analyzed whether such rights would actually allow the surety to obtain such funds via the vehicle of equitable subrogation.

⁷² *Id.* at 457.

⁷³ *Nova* at 293, fn. 7; *Liberty Mutual* at 45, fn. 13; *Commercial Casualty* at 109, fn. 4; *Cincinnati* at 546-547, by incorporation; *Travelers* at 61, fn. 6.

⁷⁴ 70 Fed. Cl. at 52, fn. 16.