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The Jacobs Case: Pennsylvania Contract Bond Law Goes Modern

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THE *JACOBS* CASE: PENNSYLVANIA CONTRACT BOND LAW GOES MODERN

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IN THIS ERA of booming construction, surety bonds are increasingly utilized to assure the discharge of a contractor's obligations. A performance bond guarantees the owner that the work will be completed. A payment bond guarantees that persons supplying labor and material in connection with the project[1] will be paid. Private owners require payment bonds to protect their property against mechanics' liens; public owners generally do so pursuant to statutory requirements manifesting a venerable policy of protecting the artisans whose labor and material have gone into public projects.

Contrary to a widely accepted misconception, a surety bond is not an insurance contract; it is a guarantee. As between the surety and the contractor, the latter has the primary obligation. The surety, in executing a bond, expects the contractor to complete the job and pay his suppliers. Hopefully, the contract price will cover both undertakings. If it will not, the surety expects the contractor to make up any loss, if he can.

When the contractor defaults and the surety responds in accordance with its obligation, the surety looks to the unpaid contract price as the principal means of reducing or eliminating its loss. Its claim to the contract balance is based on the equitable principle of subrogation, which is the substitution of one person in place of another with reference to a lawful claim or right.[2] Subrogation is available when the property of one person is used to discharge an obligation owed by another under such circumstances that the other would be unjustly enriched by the retention of the benefit so conferred. The person whose property has been so used is substituted for the obligee with respect to the obligee's claims or rights against the other person.[3] In the present context, the surety which discharges

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1. The bond language and any applicable statutory provision determine the claims covered by the bond.
2. 50 AM. JUR. *Subrogation* § 2 (1944).
3. RESTATEMENT, RESTITUTION § 162 (1937): "The general rule is well settled that if a surety has paid a debt, he is entitled to all the securities the creditor had against the principal debtor." Sundheim v. School District, 311 Pa. 90, 101, 166 Atl. 365, 369 (1933).

the contractor's obligations is substituted for the owner with respect to the latter's rights against the contractor.

The surety's successful assertion of a right to the contract balance by way of subrogation involves two steps. The surety must first establish that it is entitled to claim subrogation. This is done by discharging, pursuant to its suretyship, the contractor's obligations to the owner. The surety must then establish that the owner had a right which it might have asserted as a result of the contractor's default. The surety is then entitled to this right under principles of subrogation. Unfortunately, courts have not clearly differentiated between these two steps — a failure which has led to some confusing language in the opinions on the subject.

When a surety completes the construction under its performance bond, its subrogation to the contract balance is virtually automatic. If, on the contractor's default, the owner hires another to complete the work, the owner has the clear right to apply the unpaid contract price to the cost of completion. When the surety completes the construction, it fulfills the contractor's obligations to the owner and is subrogated to that right of the owner. This universal principle was enunciated almost seventy years ago in the landmark decision of the United States Supreme Court in *Prairie State Nat'l Bank v. United States.*[4] In that case the contractor defaulted and the surety completed the performance. Both the surety and a bank holding the contractor's assignment claimed the contract balance. The surety was successful because, the Supreme Court said, it was subrogated to the rights of the owner to use the contract balances to cure the default.

However, where a surety is required merely to pay the contractor's suppliers, its right to the contract balance has been more hotly, and sometimes successfully, contested. The difficulty stems from the fact that the surety pays third persons, rather than the owner. From this some have concluded that the owner had no rights to which the surety could claim subrogation. This confusion results from a failure to appreciate the legal effect of the payment bond.

A payment bond, in form, is an agreement between the contractor and the surety to pay the owner a specified sum. There is a condition, however, nullifying that obligation if the contractor pays his laborers and materialmen. In practical effect this is an agreement by the contractor and the surety with the owner that the former will pay the contractor's suppliers. It is now universally recognized that the suppliers may sue and recover on such a bond as third party

4. 164 U.S. 227 (1896).

beneficiaries. What is often lost sight of is the fact that the basic promise to pay suppliers has been made *to the owner.*

The contractor has dual obligations to his suppliers. One arises from his direct contracts with those suppliers. The other arises from the payment bond of which the suppliers are third party beneficiaries.[5] The promisee of the payment bond is the owner. When the surety pays the suppliers, it satisfies not only the contractor's dual obligations to the suppliers but also the undertaking which the contractor gave to the owner that the suppliers would be paid. Under principles of subrogation, the surety should be entitled to any rights which the suppliers have against the contractor and also any rights which the owner has as a result of the breach of the bond obligation to pay those suppliers.

In the leading case of *Henningsen v. United States Fid. & Guar. Co.*[6] decided in 1908, the United States Supreme Court held, on the authority of *Prairie State,* that a surety which paid the contractor's suppliers had a right to the contract balance which was superior to that of an assignee bank. While the precise basis for this superiority was not detailed in the opinion, *Henningsen's* reliance on *Prairie State* makes it clear that the surety was subrogated to rights of the owner. Implicit in this conclusion is the reasoning that the contractor was obligated to the owner to pay his bills, that the breach of that obligation gave the owner the right to apply the contract balance to the payment of these bills and that the surety's curing of that default entitled it to that right of the owner. While some cases appear to have questioned the validity of this reasoning,[7] the recent United States Supreme Court decision in *Pearlman v. Reliance Ins. Co.*[8] ringingly reaffirmed the payment bond surety's right to the contract balance by way of subrogation.

Pennsylvania law on the rights of a payment bond surety to contract balances was not so clear. While some decisions recognized

5. Martin v. Nat'l Sur. Co., 300 U.S. 588 (1937); Continental Cas. Co. v. United States, 169 F. Supp. 945 (Ct. Cl. 1959); Note, *Reconsideration of Subrogation Rights of the Miller Act Payment Bond Surety,* 71 YALE L.J. 1274 (1962). At one point Pennsylvania considered that suppliers had no right to sue on a bond conditioned upon the payment of persons supplying labor and material, Greene County v. Southern Co., 292 Pa. 304, 141 Atl. 27 (1928). That view has been abandoned, Commonwealth v. Great Am. Indem. Co., 312 Pa. 183, 147 Atl. 793 (1933), but the suppliers are third party beneficiaries of a promise which is made to the owner as promisee.

6. 208 U.S. 404 (1908).

7. United States v. Munsey Trust Co., 332 U.S. 234 (1947), held that the United States had a right to set-off unrelated debts of the contractor against the contract balance despite the claim of a payment bond surety. American Sur. Co. v. Hinds, 260 F.2d 366 (10th Cir. 1958), and Phoenix Indem. Co. v. Earle, 218 F.2d 645 (9th Cir. 1955), construed *Munsey* as denying the surety any right of the owner. The conflict in the federal court decisions generated by this view prompted the Supreme Court to grant certiorari in *Pearlman, infra,* in which *Henningsen* was reaffirmed.

8. 371 U.S. 132 (1962). See text at p. 53, *infra.*

such a right, others did not. The fact that a payment bond surety executed the bond and paid the claimants did not assure it the right to the contract balance. In addition, the construction contract and underlying statutes, if any, had to be consulted. The decisions developed principles somewhat disconnected from suretyship realities, and left interesting but unanswered questions.

One of the early Pennsylvania appellate court decisions was *Mock v. Bechtel,*[9] which awarded the contract balance to the contractor's trustee rather than the payment bond surety. Under the provisions of the bond and under the procedures set forth in the state statutes which were expressly incorporated by reference into the bond, no supplier could initiate a suit on the bond until six months after the contract price was paid to the contractor. The court concluded that the inability of materialmen to sue on the bond until after the contract balance was paid to the contractor negated the possibility that the contract balance was intended to be security to the owner for the performance of any obligation of the contractor to pay the suppliers. The absence of a right in the owner left nothing for the surety to claim under principles of subrogation.

Mock distinguished the federal decisions, presumably including *Henningsen,* on the ground that this "method of procedure" prescribed in the state statute and in the bond was wholly different from that prescribed for the construction of federal projects. In this respect *Mock* is essentially a sport, turning on the peculiar provisions of that bond and statute[10] and was so treated by the Pennsylvania Supreme Court in *Lancaster County Nat'l Bank's Appeal*[11] which was, until recently, the leading Pennsylvania decision awarding the contract balance to a payment bond surety.

Lancaster involved a highway contract with the Commonwealth of Pennsylvania. There was a single bond which contained both performance and payment conditions and which had been supplied pursuant to the statute which had been incorporated by reference into the *Mock* bond. The contract, however, expressly provided that the semi-final or final estimate would be withheld until all claims for labor and materials had been settled. The contractor failed to pay his suppliers. The surety did so, and then claimed the contract balance against an assignee bank. The court rejected a contention of the bank that its right was superior because the surety had failed to give notice of its assignment contained in the contractor's application for the bonds.

9. 101 Pa. Super. 181 (1931).

10. No other Pennsylvania decision on subrogation has involved such bond provisions.

11. 304 Pa. 437, 158 Atl. 859 (1931).

The court concluded this discussion with the observation that the bank was on notice that the statute required a surety and that common prudence required the bank, before it made a loan, to investigate the circumstances under which the surety assumed its liability. This discussion of assignments was immaterial to the subrogation claim of the surety.

Without indicating that it was turning to a different issue, the court then stated that the point in dispute had been decided in favor of the surety in *Henningsen.* The court quoted the portion of the *Henningsen* opinion holding that the surety, not the assignee bank, was entitled to subrogation and declared itself in complete accord with the *Henningsen* statement of the law. Thus, while the first part of the opinion dealt with the assignment rights of the parties, the actual decision was based on the surety's right to the contract balance by way of subrogation.

The *Lancaster* opinion concluded by distinguishing *Mock* in a very curious fashion. It said that *Mock* was decided against the surety because the contract there contained no provision for the protection of suppliers and there was no statutory requirement that it do so; that, for that reason, the method of procedure "provided by the applicable statute" in *Mock* was wholly different from that involved in federal construction projects; and that *Lancaster,* on the other hand, involved substantially the same statute, contract and procedure as prescribed for federal works. Yet the statute involved in *Lancaster* was the same statute as had been incorporated by reference in the *Mock* bond!

Despite this statutory identity, *Lancaster* differed substantially from *Mock.* In *Mock* the statutory provision that suppliers might not institute suit until six months after final settlement with the owner was repeated in the bond itself; this was not true of the *Lancaster* bond. The *Mock* contract contained no provision for the protection of suppliers; the *Lancaster* contract expressly reserved to the owner the right to withhold contract balances upon the contractor's failure to pay suppliers. In *Mock,* the statutory and bond language was considered to evidence an intent that the owner pay the contractor in full and that unpaid suppliers might thereafter sue on the bond. While the statutory language in *Lancaster* must necessarily have suggested the same intent as the court found in *Mock,* the express provision in the *Lancaster* contract was a clearer and more compelling expression of a contrary intent.

When it is remembered that the important question is whether the owner has a right to withhold contract payments if the contractor fails to pay his suppliers, the results in both *Mock* and *Lancaster* become reasonably acceptable. The opinions might better have addressed themselves to this precise question. Thus, *Mock* could have stated specifically that, in the absence of contract language, the bond and statutory provisions indicated that the owner had no such right; *Lancaster* might better have said that the affirmative contract language in that case overcame the negative implication of the statutory provision and that the owner had such a right. Conceivably this might have pointed the way to different results in two subsequent cases which were, in effect, overruled by *Jacobs v. Northeastern Corporation.*[12]

Pennsylvania imposed a peculiar limitation on the *Henningsen* principle in *Sundheim v. School District.*[13] In that case a separate payment bond was procured by the owner pursuant to statute which required school districts to obtain an "additional bond" providing for the payment of all labor and material. This statute did not contain a six month provision similar to the clause in the statute involved in *Mock* and *Lancaster.* The contractor failed to complete the work and to pay his suppliers. The surety completed the performance and paid the suppliers. The school district paid the surety an amount retained to cover the costs of completing the work and paid the retained percentage into court where it was claimed by the surety because of its payments to suppliers and by the receiver of the contractor. The court awarded the balance to the receiver.

In answer to the surety's contention that the failure to pay suppliers was a default in the construction contract, the court pointed out that an owner, at common law, had no duty to the contractor's suppliers, that that status had been changed by the mechanic's lien statutes and that public bodies were exempt from such statutory liability. This discussion of the obligations of the owner to the suppliers was wide of the mark because the concern, in this context, is not with *obligations* but with *rights* of the owner. Only obligations *of the contractor* are pertinent, and they are important because the breach thereof may create rights in the owner which the surety may acquire by subrogation.

The court distinguished *Lancaster* and *Henningsen* in this fashion:

> It has been held by federal courts that there is a direct contractual obligation to the government as a party to the contract, binding on the contractor and surety, to pay labor and materialmen. Consequently, when the contractor fails to pay labor and materialmen, it is tantamount to a breach of its contract with the United

12. 416 Pa. 417, 206 A.2d 49 (1965). See text at pp. 52–54, *infra*.
13. 311 Pa. 90, 166 Atl. 365 (1933).

> States government. When this occurs and the surety pays the labor and materialmen, it stands in the position of a surety completing a contractual obligation of a defaulting contractor and performing an equitable duty to the United States. It is therefore entitled to subrogation to the rights of the United States in the fund. Subrogation does not arise through the contractor but from the government's rights: Prairie State Bank v. U.S., 164 U.S. 227; Henningsen v. U.S. Fid. & Guar. Co. of Baltimore, 208 U.S. 404; In re Scofield, 215 Fed. 45. *In Pennsylvania, where our statutes and the facts coincide with the cases decided by the federal courts, we are in harmony with those decisions as illustrated by Lancaster County National Bank's App.,* 304 Pa. 437. (Emphasis added.)[14]

Contrary to this last sentence, the statute involved in *Lancaster* did not coincide with the federal statute involved in *Henningsen.* The statute involved in *Sundheim* more nearly coincided with the existing federal statute except that it contemplated a separate bond covering laborers and materialmen rather than a single bond covering both payment and performance obligations. Moreover, the salient facts in *Sundheim* coincided with those involved in *Henningsen.* There is no indication in the *Henningsen* opinion that the contract in that case gave the owner any express rights in the event of non-payment of suppliers or imposed any obligation on the contractor to pay his suppliers. Thus, the placing of *Lancaster* and *Henningsen* in one category and *Sundheim* in another because of the statutes and facts involved was simply not justified.

Sundheim next observed that a state statute required school districts to obtain payment bonds, but that, when such a bond was procured, "no new or additional duty is imposed on such districts to see that labor and materialmen are in fact paid."[15] This concern with obligations of the owner again missed the point. Continuing, the court stated that there was no obligation in the performance bond nor in the contract to pay suppliers, so that the failure to pay did not breach either of these instruments. The court then met and disposed of, indirectly, the essential question in the case with a single sentence:

> Nor was it intended by the Acts of 1917 and 1925 that their provisions should become a part of such contract so as to make such failure a default under these instruments.[16]

The questions which should have been posed and answered were, whether the payment bond imposed on the contractor an obligation

14. *Id.* at 97, 166 Atl. at 367–68.
15. *Id.* at 97, 166 Atl. at 368.
16. *Id.* at 98, 166 Atl. at 368.

running to the owner to pay persons supplying labor and material and, if so, whether the breach of that obligation gave the owner any rights with respect to the contract balances. The result in the case must have been prompted by a negative answer to one of these questions, but which one was so answered and the reason for the answer were left shrouded in mystery by the *Sundheim* opinion.

It cannot be doubted that a payment bond imposes a contractual obligation on the contractor to pay his suppliers. Thus, the conclusion in *Sundheim* can only be explained on the basis either that the payment bond, being a requirement of statute, named the owner as obligee as a mere matter of form, or that the obligations embodied in the payment bond, while running to the owner, were completely separate and apart from the construction contract so that the breach of the former had no effect on the rights and obligations embodied in the latter. The *Sundheim* characterization of the payment and performance bonds as "two distinct and separate obligations" suggests that the court was adopting this latter basis. The subsequent discussion does not, however, appear to follow this concept to a conclusion.

Justification of *Sundheim* on the ground that the owner is obligee in form only is very dubious in view of the facts that the payment bond named the owner as obligee and that the statute required the owner to procure the bond. The statutory duty was on the owner to obtain the additional bond, not on the contractor to supply it. As to the proposition that the obligations of the payment bond are separate and apart from the construction contract, those obligations cannot be construed without reference to the construction contract since the latter determines what labor and material are to be supplied and thus which suppliers are guaranteed payment by the bond. It is quite artificial to suggest that instruments so inter-related represent separate, distinct and independent undertakings.

The decision in *Maryland Cas. Co. v. Nat'l Bank of Germantown & Trust Co.*,[17] in which the payment bond surety unsuccessfully claimed the contract balance by assignment rather than subrogation, is significant in this discussion only because of its characterization of *Lancaster* as deciding that the surety "had paid the claims of materialmen and stood subrogated to their rights."[18] This appears to be the first suggestion that the *suppliers* had any rights in the contract balances which the surety could acquire by subrogation and is directly contrary to the *Sundheim* characterization of *Lancaster* as

17. 320 Pa. 129, 182 Atl. 362 (1936).
18. *Id.* at 134, 182 Atl. at 365.

coinciding with the federal decisions such as *Prairie State* and *Henningsen* which *Sundheim* interpreted as subrogating the surety to rights of the owner. With the court taking contrary views in 1933 and 1936 as to what it had decided in 1931, it is no wonder that the law of Pennsylvania in this area has been somewhat confused, uncertain and unrealistic.

In 1941 the Pennsylvania Supreme Court reaffirmed and solidified the distinction between the *Lancaster* and *Sundheim* situations. *DuBois v. United States Fid. & Guar. Co.*[19] was a successful action by a contractor's trustee in bankruptcy to recover a contract balance paid by the owner to the surety which had paid the contractor's suppliers. The court again rejected the contention that the contractor's failure to pay for labor and materials was a default in the contract, and said that the owner retained no rights against the contractor to which the surety could have been subrogated.

The court asserted that the contract conferred no right on the materialmen to obtain payment of their bills nor to file liens, and contained no provision entitling the owner to withhold funds for the payment of such claims. It held that the surety was not subrogated to any right of the owner but to the rights of the suppliers against the contractor. The observation that suppliers had no right to be paid nor to lien was irrelevant to a consideration of the obligations of the contractor and the rights of the owner. The assertion that there was no provision permitting the owner to withhold payment of suppliers was pertinent to, but not dispositive of, the important question. Such a provision provides an express right which the surety can acquire by subrogation. However, if the contractor promises to pay his suppliers, the failure to do so is a breach of contract for which the law provides remedies even in the absence of remedies expressed in the contract. The most obvious of these is the owner's right to withhold his promised performance, that is, the payment of the contract price, and to use it to cure the default. Thus, even in the absence of an express right to withhold and apply contract balances upon the contractor's failure to pay suppliers, the presence of an obligation to the owner to pay the suppliers should be sufficient to provide the owner with rights, in the event of non-payment of suppliers, which the surety can claim by subrogation. *DuBois* was silent on the question of why the breach of the contractor's obligation in the payment bond did not create rights in the owner which the surety could claim by subrogation.

19. 341 Pa. 85, 18 A.2d 802 (1941).

Sundheim had attempted to dispose of this question with the statement that the statutes pursuant to which the payment bond was procured were not intended to become part of the contract, and as a result of this, the failure to pay suppliers was not a breach of the construction contract. The *DuBois* contract was with the Commonwealth and the City of Scranton so that the payment bond was undoubtedly procured as a result of a state statute. The *DuBois* opinion, however, does not even discuss the statutory origin of the payment bond involved there and does not appear to rely at all on the reasoning which prompted the *Sundheim* conclusion.

The surety in *DuBois* contended that the payment bond was incorporated by reference into the construction contract so as to create a *Lancaster* type situation. The court concluded however, that the language was not sufficiently "definite or pertinent" to accomplish such an incorporation. It was significant that the court did not rule out the possibility that an incorporation by reference of the payment bond into the construction contract might have altered the result by bringing about a *Lancaster* situation.

These decisions, *Mock, Lancaster, Sundheim* and *DuBois,* represented the Pennsylvania law on the rights of payment bond sureties until *Jacobs* was decided in January of 1965. From these cases, the following conclusions emerged:

1. When the payment bond language indicated that the suppliers could not sue until after the owner had paid the contractor in full as in *Mock,* the owner had no rights which the surety could claim under principles of subrogation, in the event the contractor failed to pay suppliers;

2. When the construction contract contained an express reservation to the owner of the right to retain and use the contract balance to pay suppliers as in *Lancaster,* the surety was entitled to the contract balance under principles of subrogation despite the fact that the underlying statute requiring the payment bond contained the same provision as in *Mock;*

3. When the construction contract imposed an obligation on the contractor to pay his suppliers, *Sundheim* indicated that the *Lancaster* rule applied and the payment bond surety was entitled to the contract balance;

4. When the contract contained no express reservation to the owner of a right to retain and use contract balances to pay suppliers and no undertaking by the contractor to pay suppliers and the payment bond was obtained by a public body as required by state statute as in *Sundheim* and *DuBois,* the contractor's failure to pay suppliers

was not a default in the construction contract and the surety could not claim the unpaid contract balance.

This pre-*Jacobs* state of the Pennsylvania law posed some interesting questions. Suppose a private owner had required a payment bond in connection with a contract that (a) contained no undertaking by the contractor to pay suppliers, (b) did not expressly reserve any right to the owner in the event of non-payment of suppliers and (c) did not incorporate the payment bond by reference. Suppose further that both the contractor and the surety became insolvent and unable to pay the contractor's suppliers. It is inconceivable that the court would have held that the owner had no right to use contract balances to pay the suppliers, thereby reducing or eliminating the risk of mechanic's lien claims being filed against the owner's property. Yet to reach such a conclusion the court would either have to overrule *Sundheim* and *DuBois* or to create an artificial and essentially meaningless distinction between public and private contracts. The private owner has a direct interest in the payment bond because of the risk that suppliers may lien his property. The public owner's interest is not as obvious since the suppliers can not lien public works, but that interest, which stems from the public policy of protecting the persons whose contributions make public works possible, is just as real as that of the private owner.

Suppose a public contract expressly made the payment bond one of the contract documents and incorporated it by reference into the construction contract. It seems obvious that the failure to pay suppliers would be a breach of the construction contract giving the owner the right to use the unpaid contract price to pay those suppliers. While the incorporation of the payment bond into the construction contract eliminates any possibility of saying that the bond is an obligation separate and apart from the contract, those words hardly imply an intention to alter substantially the obligations of the parties. The fact is that the payment bond is just as much a part of the construction contract package as the performance bond, although it serves a different purpose. The incorporation by reference merely expresses what should be perfectly obvious from the realities of the situation.

The *Sundheim* emphasis on the fact that there were two bonds involving separate and distinct obligations suggests that a different result might have been reached had there been a single bond conditioned both upon the performance of the contract and upon the payment of suppliers. A distinction with respect to the rights of the owner in the event of the contractor's non-payment of suppliers on the basis of whether there were one or two bonds has no substantive basis and would tend to highlight the error of the *Sundheim* result.

Thus, the Pennsylvania law on the subrogation rights of a payment bond surety was both unsettled and unsatisfactory. Despite this, the Pennsylvania appellate courts did not have occasion to deal with the problem between 1941 when *DuBois* was decided and 1965. During that period the United States Supreme Court handed down two significant decisions in the field. In *United States v. Munsey Trust Co.*,[20] the Supreme Court held that the United States was entitled to set-off against the contract balances, at the expense of the payment bond surety, debts of the contractor arising from matters unrelated to the contract. The result and the language in the opinion led some to conclude that *Henningsen* was no longer good law.[21] In 1962, however, the Supreme Court decided *Pearlman v. Reliance Ins. Co.*,[22] which reaffirmed *Henningsen* in strong and unmistakable terms. The stage was thus set for the Pennsylvania Supreme Court to reconsider its entire position and this it did in *Jacobs*.

Jacobs involved disputes over the unpaid balances in two contracts between the contractor's receiver and the sureties which had been called upon to pay persons supplying labor and material. The court held in favor of the sureties, concluding that the language in each of the contracts created an express undertaking by the contractor to pay suppliers so as to bring each situation within the *Lancaster* rule. The court went further, however, saying that it was time to reconsider its early decisions in this area and "to review the significance of the applicable statutes governing public work contracts as they affect the subrogation rights at issue."[23]

The court observed that the federal rule and the rule prevailing in most jurisdictions was contrary to the import of *Sundheim* and *DuBois*. It quoted Mr. Justice Cardozo's observation in *Martin v. Nat'l Surety Co.*[24] that the terms of a payment bond are read into a contract so that there is a default in the contract when there is a default under the bond. It outlined the facts and holding in *Pearlman* and then concluded:

> Even if we were able to accept appellant's view that the contracts here in question did not create an obligation in Northeastern to pay labor and materialmen, the surety companies should still prevail. The doctrine of subrogation is not founded upon

20. *Supra* note 7.
21. *Ibid.*
22. 371 U.S. 132 (1962).
23. 416 Pa. 417, 423, 206 A.2d 49, 52 (1965).
24. 300 U.S. 588, 597–98 (1937).

> contract, and, under these circumstances, is equally generated by the contractor's compliance with the statutory obligations to provide the bonds in question.[25]

It is true that the doctrine of subrogation is not founded upon contract. It is not true that the doctrine "is . . . generated by . . . compliance with the statutory obligations to provide the bonds. . . ." Subrogation is an equitable right which arises, or is "generated," when the surety discharges the contractor's obligations pursuant to the suretyship.

Sundheim and *DuBois* did not deny the surety's right to be subrogated; they decided merely that there was no right which the surety could acquire by subrogation. This crucial paragraph in *Jacobs* might better have corrected the error of those earlier decisions by stating that the obligation to pay suppliers which arises from a payment bond, whether or not supplied pursuant to a statutory duty, is one of the obligations of the construction contract, the breach of which permits the owner to withhold and apply the unpaid contract price to the payment of suppliers.

It is unfortunate that *Jacobs,* which brings Pennsylvania squarely in line with logic and the great weight of authority, did not articulate its own reasoning with greater clarity. That it accepted the basic principles discussed herein seems apparent, however, from the language of Mr. Justice Cardozo in *Martin* which it selected for quotation and from its reliance on *Pearlman* which reaffirmed the principles enunciated in *Prairie State* and *Henningsen.*

Jacobs' reconsideration of Pennsylvania law on this subject appears to have been prompted by *Pearlman* in which the dispute over the contract balance was between a payment bond surety and the contractor's trustee in bankruptcy. The Supreme Court there held that there were three rights to which the surety was entitled by way of subrogation which gave it a superior right to the contract balances. One of these rights was described as the right of the suppliers to be paid out of the fund. The Pennsylvania Supreme Court approved this proposition in *Jacobs* also, saying that the contract balances were available for the protection and payment of suppliers and that the funds, had there been no bond, would have gone to the payment of suppliers rather than to the general creditors.[26]

It should be apparent from what has been said here that it was not necessary in order to reach the conclusion in either *Pearlman* or *Jacobs* that suppliers have a right to be paid out of the contract

25. 416 Pa. 417, 426, 206 A.2d 49, 54 (1965).
26. *Id.* at 426–27, 206 A.2d at 54.

balances. Each decision recognized that the owner had rights with respect to the contract balances which the surety acquired by subrogation. Nonetheless, the statements as to the right of the suppliers are clear and unequivocal.

Neither *Pearlman* nor *Jacobs* indicated the source and nature of this right of suppliers to the contract balances. A supplier has no contractual and, at least in Pennsylvania, no statutory basis for a direct claim against an owner. The supplier has no right to lien a public project, and his right to lien a private project may be waived or is lost if not properly perfected. Thus, if suppliers have such a right, it is because the courts are prepared to create such a right.

The right must necessarily be somewhat limited. Undoubtedly, the supplier will not be able to claim the contract balance until all obligations of the contractor to the owner have been satisfied including, perhaps, obligations which do not arise out of the contract in question.[27] This will limit the right to situations in which the owner is a mere stakeholder.

Other interesting questions may arise. Are persons with claims for insurance premiums, rental of equipment and capital expenditures, which are not labor and material as those terms are used in a payment bond,[28] entitled to assert this right? If the insurance and the rented or purchased equipment has been acquired in connection with the construction project, the supplier may properly contend that he has contributed to the project to the same extent as other suppliers. The court will have no statutory or contractual language against which to determine who are entitled to assert this right. Will the claim of an unpaid supplier have priority over a bank which has lent money to the contractor and taken an assignment which has been properly filed under the Uniform Commercial Code? If a bank lends money which is used to pay obligations incurred in the prosecution of work, will the bank be a member of the class? One court has commented on the difficulty involved in accurately and justly defining the limits of any such right[29] and this difficulty may very well lead the courts to reject the existence of such a right when called upon to enforce it in particular instances.

Despite the unequivocal assertions in *Pearlman* and *Jacobs* concerning the rights of unpaid suppliers to contract balances, that prop-

27. United States v. Munsey Trust Co., *supra* note 7.

28. Pennsylvania Turnpike Comm'n v. Andrews, 354 Pa. 138, 47 A.2d 220 (1946) (rental of equipment); Pittsburgh v. Parkview Constr. Co., 344 Pa. 126, 23 A.2d 847 (1942) (insurance premiums); Commonwealth v. Nat'l Sur. Co., 253 Pa. 5, 97 Atl. 1034 (1916) (machinery, etc.).

29. *In re* Fowble, 213 Fed. 676, 681 (D.C. Md. 1914), quoted in Pratt Lumber Co. v. T. H. Gill Co., 278 Fed. 783, 793 (E.D. N.C. 1922).

osition should be viewed with some reservation. The concurring opinion in *Pearlman* declined to recognize such a right, pointing out that no decision of the United States Supreme Court had held that suppliers had any such right, and quoting language in *United States v. Munsey Trust Co.*[30] to the effect that suppliers have no enforceable right against the United States. The Court of Claims held that there was such a right in *Madden v. United States,*[31] and that the surety was subrogated to such a right in *Royal Indem. Co. v. United States,*[32] and *National Sur. Corp. v. United States.*[33] However, in *United Pacific Ins. Co. v. United States,*[34] that court rejected a contention of a contractor's trustee in bankruptcy that the surety could not claim subrogation because it had not paid one of the contractor's suppliers, and held that the supplier had no right to the contract balance.

In some cases, courts which have mistakenly assumed that a failure to pay suppliers could not be a default in the construction contract so as to give the owner any rights, have said that suppliers have a right to be paid out of the contract balance as the means of permitting the surety to reach the contract balance.[35] Once it is recognized that the payment bond is an undertaking to the owner, the breach of which permits the owner to withhold and apply the unpaid contract price, it becomes unnecessary to find a right in the suppliers in order to justify the surety's claim to contract balances. This may lead to a re-examination of this asserted right of the suppliers.

It seems safe to conclude that Pennsylvania has adopted the prevailing view that a payment bond imposes an obligation on the contractor to the owner to pay his suppliers, that the breach of that obligation will permit the owner to retain contract balances and utilize them to cure this default, and that the surety may, under principles of subrogation, be substituted for the owner with respect to this right. In going further and recognizing a right of unpaid suppliers to be paid from the contract balance, *Jacobs* opens some interesting avenues for exploration by unpaid suppliers in situations in which there is no surety to pay for the contractor's defaults. It may be, however, that this right will prove to be ephemeral when offered as the sole basis for a right to recover.

30. *Supra,* note 7.
31. 132 F. Supp. 202 (Ct. Cl. 1955).
32. 93 F. Supp. 891 (Ct. Cl. 1950).
33. 133 F. Supp. 381 (Ct. Cl. 1955), *cert. denied, sub. nom.* First Nat'l Bank v. United States, 350 U.S. 903 (1955).
34. 319 F.2d 893 (Ct. Cl. 1963).
35. *Eg.,* Belknap Hardware & Mfg. Co. v. Ohio River Contract Co., 271 Fed. 144 (6th Cir. 1921).