INTRODUCTION TO THE SURETY’S RIGHTS AS THE FOUNDATION FOR THE INDEMNITY AGREEMENT

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A. Background and Summary

The Indemnity Agreement has been at or near the heart of the surety’s relationship with its principal over the course of modern commercial history. A written Indemnity Agreement is the surety’s primary tool for memorializing and enhancing the surety’s established common law rights. By virtue of the Indemnity Agreement, the surety has also extended those rights beyond the principal to include other third parties agreeing to join in the principal’s obligations to the surety as indemnitors.

The law of the Indemnity Agreement is the law of a principal/surety relationship reduced to a written instrument. The elements of surety protection that sureties typically incorporated into the Indemnity Agreement are formally tied to two age-old rules: (1) a person undertaking a debt or promising performance of a contract obligation is responsible, in the first instance, to satisfy that obligation; and (2) if that person fails to do so and another, who has previously bound himself or herself to pay the debt or perform the obligation, then satisfies that debt

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1 Levi Clegg of Snow, Christensen & Martineau rendered helpful assistance in the research and preparation of this chapter.
or obligation, the law entitles the performing party to receive reimbursement for that payment.\footnote{2}

1. **The Nature of Suretyship**

Suretyship is a “contractual relationship whereby one person engages to be answerable for the debt or default of another.”\footnote{3} As a form of collateral security, suretyship is perhaps the oldest and one that has invited the most consistent warnings throughout history. As one commentator noted, “[A]lmost every reference now extant to early suretyship sounds also a note of warning to those who might, however reluctantly, be willing to act as surety for a friend.”\footnote{4} The suretyship relationship is created under a variety of circumstances, including those in which the surety is not strictly identified as a “surety,” but simply as a party undertaking a secondary responsibility for an obligation, the primary responsibility for which lies with another.\footnote{5}


\footnote{3} Sterns, The Law of Suretyship 1 (5th ed. 1951).


\footnote{5} Restatement (Third) Of Suretyship & Guar. (1996) addresses generally the subjects of both suretyship and guaranty in terms of “principal obligors” and “secondary obligors.” There may be instances when the distinction between principal and surety blurs. However, the principal is the party to receive the benefit of the underlying contract. The “one who receives and retains the consideration or benefit of a contract cannot occupy the position of surety.” 74 Am. Jur. 2d Suretyship § 3 (1974).
A surety bond creates a three-party relationship among (1) a named or implied obligee or beneficiary (such as the owner of a construction project or the subcontractors that work on that project) to whom the principal owes contract obligations, (2) a principal (such as a contractor) who is responsible for the contract’s performance, and (3) the surety. Typically, the surety, in exchange for a modest premium and its principal’s duty and (often) one or more indemnitors’ additional promise to protect the surety against any losses, agrees to stand behind the principal to assure to the obligee that the principal will perform its contract. In the construction context, the performance obligation may run solely in favor of the obligee (either the owner or, in the case of a subcontractor bond, the general contractor) or in favor of joint or multiple obligees. Under payment bonds or labor and material bonds, unpaid subcontractors and suppliers (or other claimants identified by statute or in the bond itself) typically have direct rights to pursue recovery against the surety.

Notwithstanding the fact that the principal is primarily liable and the surety is secondarily liable for the obligation, the surety typically stands jointly and severally liable with its principal for the principal’s

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6 There are times when there are “dual obligees” on the performance bond, either in the bond itself or under a dual obligee rider. For example, if the obligee is the owner of a private construction project, the construction lender providing financing for the project may become a dual obligee under the performance bond to give the construction lender a right of recovery against the surety’s performance bond. The dual obligee bond gives both the obligee and the construction lender a direct cause of action against the performance bond if the principal breaches the construction contract. Another example is where the project owner joins with the general contractor as a second obligee on a subcontractor performance bond. Most dual obligee riders to performance bonds contain a savings clause in favor of the surety that provides that (1) any default by either of the obligees relieves the principal and the surety from their performance obligations, and (2) that the penal sum of the bond limits the surety’s obligation. See generally, Martha L. Perkins, The Rights and Obligation of the Surety Under Dual Obligee Bonds (June 23, 2005) (unpublished paper submitted at the Surety Claims Institute annual meeting); Jay M. Mann, Dual Obligee Bonds—An Overview of the Surety’s Liability to Co-Obligees (Jan. 29, 1988) (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting); Thomas R. Elliott, Jr., Dual Obligee Bonds—Some Practical and Legal Considerations, 11 FORUM 1229 (1976).

2. **Comparison with Insurance: The Extension of Credit Concept and Other Distinctions**

Surety bonds, including performance and payment bonds in the context of construction contracts, are not insurance. Nonetheless, compensated sureties are almost invariably divisions of insurance companies, whose conduct is often subject to insurance law regulation in most states. As a result, in many states, surety bonds are included within the broad statutory and regulatory definition of "insurance."\footnote{Many states’ insurance codes define “insurance” in terms broad enough to include contracts of commercial guaranty or suretyship, with the effect of drawing all commercial bonding entities into the regulatory scheme governing insurance companies generally.}

Statutory or regulatory controls notwithstanding, there are important differences between surety bonds and insurance products. One court has summarized some of the practical differences between a surety and its bond, on the one hand, and a liability or casualty insurer and its insurance policy, on the other hand, as follows:

(a) The surety has rights to seek reimbursement from its principal of amounts paid under the bond upon the principal’s default, whereas an insurer has no equivalent rights of indemnification against its insured;

(b) The surety may assert all defenses available to its principal against an obligee’s claims;

(c) The very nature of a surety bond is more in the nature of a financial guaranty furnishing protection against the risk that an obligee will be unable to collect from the principal, as primary debtor, for any
failure of contract performance, rather than to afford protection against accidental and generally unforeseeable losses caused by a calamitous or catastrophic event; 9

(d) A performance bond generally incorporates an underlying contract, the terms and conditions of which the principal and the obligee have negotiated, typically without any surety input. Thus, the bond is not marked with the trappings of adhesion and unequal bargaining power often considered to be inherent in insurance policies and justifying treatment of insurance policies differently than other contracts;

(e) In most jurisdictions, the surety bond does not give rise to a fiduciary or quasi-fiduciary duty of the surety to the obligee as the law has often imposed in the insurer-insured relationship; and

(f) Unlike insurance relationships, which involve the interests of only two parties, the surety relationship is a tripartite relationship implicating the separate legal interests of the principal, the obligee, and the surety. 10

The surety's obligation is intended to supplement the principal's obligations owed to the obligee. In this respect, a surety bond is much closer to a financial product than to an insurance product. A surety bond is like a form of a contingent line of credit in the amount of the bond that the surety underwrites for a principal with the expectation that the obligee will never draw on the bond. 11

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9 It has been described as an ‘article of faith’ in the construction industry that the surety is a guarantor, not an insurer.” B.C. Hart, Bad Faith Litigation Against Sureties, 24 TORT & INS. L.J. 18 (1988).


11 “A surety, by providing bonds to its principal, is, in reality, providing the surety's credit to the principal in order for the principal to enter into a contract with the obligee. In banking parlance, the surety's bonding of its principal creates a “credit facility” where the surety, for a fee, extends its credit to the principal. The surety expects to incur no loss as a result of that extension of credit. The surety's extension of credit is done with the understanding, whether under common law or through a written agreement such as an agreement of indemnity, that the principal, and any third-party indemnitors, will reimburse the surety in the event that the surety incurs a loss under the bonds it executes for the principal. George J. Bachrach, The Surety’s Rights to Obtain Salvage—Exoneration, Reimbursement, Subrogation and Contribution, in SALVAGE BY THE SURETY 1 (George J. Bachrach ed., 1998).
By its bond, a surety provides security to a named obligee for the performance of contractual obligations the surety fully expects its principal to satisfy. On the other hand, "[t]he transaction in which an insurer provides a policy to an insured...is in effect a wager, based on statistical information, that the amount the insurer may be obligated to pay out under the policy will be less than the amount it collects in premium payments from the insured."\textsuperscript{12} The liability or casualty insurer expects that it will suffer certain losses, but tempers that expectation with a hope, based on an actuarial analysis, that its collective losses will not exceed the total of all premiums collected.

Unlike insurance policies, the surety's premiums are not a means of pooling risks.\textsuperscript{13} Actuaries do not calculate the premium or fee that the surety charges for its bonds to reflect overall risk. Rather, the surety's premium is closer in both amount and justification to a service charge or a loan fee based on a percentage of the bond amount. Sureties extend bonding credit based on many of the same criteria as those guiding extensions of financial credit: the principal's financial ability and general capability to handle and perform the underlying obligation, a general consideration and judgment concerning the character of the principal, its business and indemnitors, and a demonstration of a history of credit worthiness.\textsuperscript{14} If a surety sees any appreciable likelihood of the principal defaulting on a contract, it will not provide the bond as security for the principal's performance of that contract.

In the end, however, the most important distinction between insurance and suretyship lies in the difference first noted above: the surety's rights to reimbursement. By extending to an insured the umbrella of financial strength and risk-pooled resources, an insurance policy offers protection to an insurer's customers, its insureds, from the financial ravages of casualty losses or liability to third parties for personal injury or property damage. An insurer has neither the right nor the expectation that its insured will reimburse the insurer's losses suffered within the coverage of a valid policy.\textsuperscript{15} By contrast, it is the

\textsuperscript{12} Ground Imp. Techniques, Inc. v. Merchants Bonding, 63 F. Supp. 2d 1272, 1276 (D. Colo. 1999).
\textsuperscript{14} George J. Bachrach & Matthew L. Silverstein, Financing the Principal, in BOND DEFAULT MANUAL 157-161 (Duncan L. Clore et al. eds., 3d ed. 2005).
\textsuperscript{15} See Am. Inter-Fid. Exch. v. Am. Re-Ins. Co., 17 F.3d 1018, 1022 (7th Cir. 1994) ("The difference between suretyship and insurance lies in the identity of the person ultimately responsible for the loss. An insurer pays the claimant without right of recourse against its client; a surety pays
overriding principle of suretyship that, in the end, the surety should suffer no loss.\textsuperscript{16} Whether common law and implied promise defines it or a formal Indemnity Agreement expands it, the surety has a right to recover from the principal and the principal's indemnitors any loss suffered under its bonds. This principle essentially defines the relationship between the surety and its principal. It defines common law indemnity and justifies and supports the corollary principles of exoneration and reimbursement as well as providing the foundation for the Indemnity Agreement itself.

a. Underwriting Issues and Considerations

As discussed above, suretyship is not an actuarially-based undertaking; it is an extension of bonding credit with no loss expectation. As such, the bond underwriting process focuses on confirming that the principal seeking the bond has both the financial capacity and competence to perform the contract.\textsuperscript{17} In the context of construction surety bonds, it is the general expectation that the principal will perform its contractual obligations for the agreed contract price and that the payments the principal receives will be sufficient to satisfy both the costs of its performance obligations and its financial obligations to subcontractors and suppliers participating in that work. As the obligee pays the contract price and the principal applies that contract price to the costs of the project, the surety's expectation is that its risk is reduced proportionately. By its nature, the risk the surety assumes is short-term


risk comprised of two sequential elements: (1) that the principal may not, in fact, be able to complete the project for the contract price; and (2) that, in the event it does not, the principal and the indemnitors may be financially unable to cover any shortfall, resulting in a loss to the surety.

It is ultimately against these risks, limited in theoretical scope, even if they may involve substantial financial risk, that sureties weigh bond applications and against which they seek protection. Like the extension of loan credit in the banking industry, a surety furnishes bonds upon its determining that its client is a good risk while taking into account all relevant factors. Sureties consider not only the principal’s technical abilities but also the principal’s ability to withstand the difficulties and financial reverses that frequently impact a construction business. The underwriting process typically involves consideration of the principal’s business background, its current financial statements, and its credit history (including its history with banks, subcontractors, suppliers, and prior sureties). It will also consider the financial statements of the principal’s indemnitors who add their indemnity to those of the principal. From the outset, the surety’s goal is to protect itself against any ultimate financial loss. At the same time, and as an experienced surety industry professional has observed, a careful underwriting effort will also have the effect of “help[ing] the contractor protect and preserve his company, his worth.”

b. It is the Surety’s Hope and Expectation that It Will Suffer No Loss

At the root of the surety’s decision to accept potential liability for its principal’s contractual undertakings are both the hope and a rightful expectation that the principal will satisfy its obligations and that no one will have cause, reason, or justification to pursue a claim against the surety’s bond. The expectation is not always the rule, however, and the surety may need to provide payment, security, or performance upon its principal’s failure to pay or perform its contractual obligations. Yet, hope remains for the surety beyond its primary expectation: that, in the end, by way of indemnity and other “salvage,” the surety will be made whole from any losses, costs, or expenses it incurs as a result of its principal’s failure to meet the primary expectation of performing its obligations. The surety’s expectation that it will be made whole is based on the many rights, long recognized under the law and in equity,

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permitting its recovery of losses or costs of performance from or against various parties, including the principal and any indemnitors. Those rights, sometimes referred to broadly as "indemnification" rights, extend beyond the surety's right to obtain reimbursement from its principal. They include the surety's right to require protection or security against potential losses even before it actually suffers a loss.

Certain of the surety's rights have developed historically at common law, that is, created by judicial pronouncements spanning decades, if not centuries. Many of these decisions originally involved guaranties and loan transactions. Others of the surety's rights are purely contractual and exist or not depending on agreements between and among the surety, the principal, and its indemnitors. The chapters that follow discuss these rights, primarily as they arise or may otherwise exist by virtue of a written Indemnity Agreement.

The following provides a brief overview of a few of the surety's key rights as they have developed at common law. These rights include (1) those rights or remedies that the surety has against its principal and others whom the principal may involve as indemnitors, both before and after the surety is required to perform its principal's obligations; and (2) those rights or remedies that the surety gains against third parties, funds, or property purely by virtue of the surety's satisfaction and/or performance of its bond obligations.

B. The Surety's Common Law and Statutory Rights

In general terms, the surety's common law rights divide into three categories: (1) rights of "exoneration" to protect the surety from all losses associated with a principal's likely or imminent failure of performance, including the related collateral right and/or remedy in *quia timet* requiring security against those losses; (2) rights of "reimbursement" (or "indemnity") to provide the surety with repayment of its performance-related losses from its principal; and (3) rights of "subrogation" to allow the surety to stand in the shoes of the obligee, the principal, or a subcontractor or supplier to enforce their rights and priorities against other third parties.\(^{19}\) Each category of rights provides both foundation and context for the Indemnity Agreement.

\(^{19}\) For a historical discussion of the surety's various common law rights of exoneration, subrogation, reimbursement, and contribution, see John B. Hayes, *The General Indemnity Agreement--The Beginning and the End* (January 31, 1986) (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting); see also George J. Bachrach, *The Surety's Rights to Obtain Salvage--Exoneration,*
1. The Surety’s Common Law Right to Protection from Loss: Exoneration

The right or doctrine of exoneration springs from the recognition that it is the principal’s obligation to perform contractual duties owed to others, prior to and in a fashion to avoid a surety loss. Exoneration involves the surety’s pursuit of relief requiring its principal to perform the obligation for which it is primarily responsible in such a manner as to protect the surety from claims, exposure, or secondary liability resulting from the principal’s non-performance. A related but technically distinct remedy to exoneration is the equitable remedy under quia timet. Exoneration “is the surety’s right, after the debt [or obligation] has matured, to compel the principal to honor its obligation to the debtor,” before the surety is required to perform. By comparison, quia timet is “the right to require that the principal place the surety ‘in funds’ when there are reasonable grounds to believe that the surety will suffer a loss in the future because the principal is likely to default on its primary obligation to the creditor.” In contrast to indemnification, which is available to the surety only after it has performed and paid or suffered a loss, exoneration compels the principal to perform the underlying contract, to the extent it has resources available to do so, before the surety has paid or suffered a loss.


See Admiral Oriental Line v. United States, 86 F.2d 201, 204 (2d. Cir. 1936).


Id. At a more esoteric level, the Restatement suggests that quia timet is not an anticipatory relief for a future breach of the principal’s duty to perform or of the duty to reimburse; rather, it is a “present remedy for the [principal’s] current breach of its duty to refrain from conduct impairing the [surety’s] expectation [that the principal will satisfy its obligation, as required.”] RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. § 21 cmt. j (1996).

2. The Surety’s Common Law and Statutory Rights to Reimbursement (Traditional Indemnity)

Reimbursement is the principal’s common law obligation to make the performing surety whole—to pay back its losses.24 Courts and commentators often treat reimbursement as a synonym for indemnity or refer to it as “common law indemnity.” However, as discussed above, indemnity is also interpreted more broadly to include the whole scope of the surety’s rights at common law to be held harmless against losses. One commentator has suggested that reimbursement may actually be “the duty imposed upon the principal by law as a result of his prior breach of duty to indemnify the surety by paying his debt at maturity and so holding the surety harmless.”25

While it was not always so,26 common law and statutory principles have long established the surety’s right, upon paying its principal’s obligation, to obtain reimbursement from the principal for the sums paid.27 While the principle itself now finds little challenge, there have been interesting cases in American jurisprudence that have struggled with the precise theory upon which the principle is based. In Fox v. Kroeger,28 the Texas Supreme Court traced the issue of the surety’s rights of repayment through its own common law and into early American and English decisions and even Roman law, apparently struggling with the question of whether or not a surety who has paid the

26 In early jurisprudence, when equity and law were matters for different courts, courts of law in some quarters seemed to have given the surety who paid its principal’s debt no particular remedy, absent a principal’s express promise to indemnify his surety. See Appleton v. Bascom, 3 Met. 169, 44 Mass. 169 (Mass. 1841). Decker v. Pope, 1 Selwyn, Nisi Prius, 91 (1757), appears to be the first case in which the court allowed the surety to pursue reimbursement at law without the benefit of the principal’s express promise to indemnify him. If present, express promises were not easily challenged. In Scot v. Stephenson, 1 Levinz, 71 (1662) a law court held that the surety’s forbearance to bring a suit in equity was adequate consideration for the principal’s promise to reimburse the surety’s losses.
28 35 S.W.2d 679 (Tex. 1931).
obligation of its principal extinguishes that obligation. The theoretical struggle was whether the surety has a remedy on an assumpsit or "the obligation implied by law on the part of the principal to reimburse the surety." 29

Whatever its original trappings, the theory is that there is implied in the principal’s request for a surety’s bond the principal’s promise to reimburse the surety for such outlay. 30 The origin of the right to reimbursement was undoubtedly to prevent the principal’s unjust enrichment particularly when the principal had requested the surety bond from the surety. 31 In more recent times, the law has blurred the distinctions between a surety entering into an obligation at the request of the principal and one doing so at the request of one other than the principal, or even without the principal’s knowledge, to the point that there may be no difference. 32

29 Id. at 680. The Texas Supreme Court concluded that under “both the Civil and Roman laws the rule was that the surety paying the debt of its principal was subrogated to all the rights of the original creditor, and could maintain an action on the very debt itself.” As of 1931, the courts of last resort of nearly all of the states and the Supreme Court of the United States had adopted the rule. Accordingly, the Court announced that “where the surety pays the debt of the principal he has his election to either pursue his legal remedies and bring an action on an assumpsit, or the obligation implied by law in his favor for reimbursement by the principal; or he can prosecute an action on the very debt itself, and in either event he stands in the shoes of the original creditor as to any securities and rights or priority.” Id. at 681.

30 See Howell v. Commissioner of Internal Revenue, 69 F.2d 447 (8th Cir. 1934).

31 By contrast, many early cases held that a “non-consensual” surety or one who becomes bound to the creditor/obligee other than at the principal’s express or implied request would not be entitled to reimbursement from the principal. Leslie v. Compton, 172 P. 1015 (Kan. 1918); Holmes v. Hughes, 14 P.2d 149 (Cal. Ct. App. 1932); Indem. Ins. Co. of N. Am. v. McClure, 254 N.W. 913 (Minn. 1934).

32 RESTATEMENT OF SEC. §104 drew no distinction between those principals who are charged with notice of the surety’s obligation and those who are not, holding both to a duty of reimbursement. The RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. (1996) holds those principal obligors without notice of the secondary obligation to a duty of restitution, rather than reimbursement. Comment (d) to Section 26 of the RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. explains the difference between restitution and reimbursement as follows:

The amount recoverable by the secondary obligor pursuant to its rights of restitution will usually be relatively close to the amount
The principal’s duty to reimburse the surety is triggered either upon the surety’s performance of its bond obligation or the surety’s settlement with the obligee on terms that discharge the principal, “in whole or in part, with respect to the underlying obligation.” The surety is entitled to reimbursement of the “reasonable cost of performing [the bonded obligation] including incidental expenses.” As itemized under the Restatement, the reasonable cost of performance includes (1) the money paid to the obligee as a result of the principal’s default, (2) the reasonable cost of performing any non-monetary obligation, (3) the reasonable expenses incurred in seeking to determine the existence of any defenses, (4) the reasonable expenses incurred in asserting (whether or not successfully) colorable defenses of the principal available to the surety in the obligee’s suit to enforce the bond obligation and (5) any other incidental expenses that the surety reasonably incurred in connection with performance of its bond obligation. These incidental expenses may include the surety’s reasonable attorneys’ fees incurred in conjunction with its performance of the secondary obligation. However, under common law reimbursement and consistent with the American Rule, the surety is not generally entitled to recover its attorneys’ fees incurred in pursuing and enforcing its reimbursement rights, as opposed to its performance costs as incidental expenses. The law of the

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that would be recoverable pursuant to the principal obligor’s duty to reimburse if that duty were present. The difference is that, under the duty to reimburse, the secondary obligor is entitled to reimbursement of its reasonable outlay...while under the right of restitution recovery is limited to the amount of the principal obligor’s enrichment. These will differ when the secondary obligor’s cost of performance exceeds the cost of the performance of which the principal obligor was relieved.

33 RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. §22 (1996). See also RESTATEMENT OF SEC. § 104 (1941); ALA. CODE § 8-3-5; CAL. CIV. CODE § 2847; MONT. CODE ANN. § 28-11-417(1); OKLA. STAT. A NN. tit. 15, § 381; State of Wis. Inv. Bd. v. Hurst, 410 N.W.2d 560 (S.D. 1987).
34 RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. § 23 (1996).
35 Id. at §23 cmt a.
36 Most jurisdictions outside the United States operate under a “loser pays” system, sometimes called the “English Rule.” Under the English Rule, the losing party pays the successful party’s attorneys’ fees as well as other court costs. The United States is a notable exception, operating under the “American Rule,” under which, absent statutory authority or contractual provisions to the contrary, “are merely incidents of litigation
applicable jurisdiction determines the surety’s rights to its attorneys’ fees and to prejudgment interest against the principal.\(^{37}\)

The law will excuse the principal from its common law duty of reimbursement in certain circumstances. Among those enumerated in the Restatement\(^{38}\) are the following: (1) the principal’s discharge in bankruptcy; (2) the principal’s lack of capacity to enter into the underlying contract in the first place; (3) the existence of a defense by the principal obligor to the underlying obligation that, by virtue of the secondary obligation, was not available to the surety; (4) the obligee’s prior release of the primary obligor; and (5) availability of a principal’s defense to the underlying obligation that is also a defense under the bond, unless the surety’s settlement or performance made business sense under all the circumstances (amounting to business compulsion) of which the principal had notice at the time it incurred the underlying obligation.

Many states have reduced to statute the surety’s common law rights to reimbursement or similar protection from its principal, including Alabama,\(^{39}\) Arkansas,\(^{40}\) California,\(^{41}\) Georgia,\(^{42}\) Indiana,\(^{43}\) Louisiana,\(^{44}\) Montana,\(^{45}\) North Dakota,\(^{46}\) Ohio,\(^{47}\) Oklahoma,\(^{48}\) and South Dakota.\(^{49}\) However, the statutory rights are generally less specific and less helpful than those that may be set forth in an Indemnity Agreement, which


\(^{38}\) RESTATMENT (THIRD) OF SURETYSHIP & GUAR. § 24 (1996).

\(^{39}\) ALA. CODE § 8-3-5 (2001).

\(^{40}\) ARK. CODE ANN., §§ 16-107-303, 304, 305 (Michie 1987).

\(^{41}\) CAL. CIV. CODE §§ 2847-48.

\(^{42}\) GA. CODE ANN. §§ 10-7-40, 41, 42 (2000).

\(^{43}\) IND. CODE ANN. § 34-22-1-4 (LexisNexis 2000) (permitting co-defendant surety to require execution on any judgment first against property of principal, before enforcement against surety.

\(^{44}\) LA. CIV. CODE ANN. art. 3052. (2000).


\(^{47}\) OHIO REV. CODE ANN. §§ 1341.18 – 21 (2001).

\(^{48}\) OKLA. STAT. tit. 15 §§ 381-382 (2000).

courts will usually enforce as written unless clearly contrary to statutory limitations.

The Indemnity Agreement often incorporates and expands the recognized common law principles, including reimbursement, to provide for and tie an expanded set of indemnitors to the broader rights of reimbursement and protection of the surety against losses under its bond. The terms of Indemnity Agreements are typically broad, extending and building upon the surety's rights at common law. In that context, the Indemnity Agreement is much more than a vehicle to require the principal and indemnitors to reimburse the surety for its payments and losses. Rather, it is a contract that may provide a surety with protection well ahead of any actual or potential losses.

By signing the Indemnity Agreement, the principal and its indemnitors bind themselves to obligations that the common law imposes only upon the principal, including the promise to indemnify and protect the surety from losses, costs, and expenses arising from the bonds executed on behalf of the principal. Most modern forms of Indemnity Agreements also include provisions for recovery of costs and attorneys' fees incurred in enforcing the Indemnity Agreement itself, a right not generally available under the common law. 50 Finally, the Indemnity Agreement generally extends surety rights and principal and indemnitor obligations beyond those the common law recognizes, all of which the later chapters of this book more fully describe. 51

50 See discussion infra Chapter IV.

3. The Surety’s Subrogation Rights and the Indemnity Agreement

The surety also holds important common law or equitable subrogation rights against third parties, funds, or property by virtue of the surety’s performance of the principal’s obligations. The surety’s subrogation rights stand separate and distinct from the assignment rights and similar contractual protections under the Indemnity Agreement. Subrogation rights are not typically expressed or enforced in contractual terms.\(^{52}\) They are powerful and important rights, however, fully complementary with the rights that the Indemnity Agreement affords to the surety.

a. The Surety’s Subrogation Rights—Basis at Law and in Equity

Courts and commentators have described subrogation as the substitution of one person in place of another with respect to the other’s lawful claim or right.\(^{53}\) The principle developed in equity to supplant the general rule at common law that an obligation was satisfied and extinguished even if a surety paid it.\(^{54}\) Courts of equity developed and applied the doctrine of equitable subrogation to place a performing surety in the shoes of its obligee, allowing the surety all of the rights that the principal owed to the obligee and that the surety honored.\(^{55}\) The general

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Comment (a) to § 27 of the *RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. (1996)*, states that, although subrogation does not spring from contract, “it may be confirmed or qualified by contract.” Thus, while an Indemnity Agreement may not create rights enforceable against a party who is not a party to the Indemnity Agreement, it may confirm the surety’s subrogation interests vis-à-vis the principal and its indemnitors, who join in the Indemnity Agreement.


*RESTATEMENT OF SEC.* § 141 provides that a surety who satisfies its principal’s obligations to a creditor is subrogated, to the extent it contributed to that satisfaction, in the following ways: (1) to the rights of
principle behind subrogation is that "a surety who pays the debt of another is entitled to all of the rights of the person it paid to enforce its right to be reimbursed."\(^{56}\)

As early as 1834, a court stated that "[t]he rule...is undoubted, and it is founded upon the plainest principles of natural reason and justice, that a surety paying off a debt shall stand in the place of the creditor, and shall have all the rights which he has, for the purpose of obtaining reimbursement."\(^{57}\) Subrogation is often called an equitable assignment or an assignment by operation of law.\(^{58}\) Subrogation rights are independent of contractual assignment rights and enforced solely to accomplish the ends of substantial justice.\(^{59}\) As discussed below, depending on the circumstances, the surety's subrogation rights, or the right to stand in the shoes of other parties to promote the surety's own protection and to preserve funds necessary for the surety's reimbursement, are among the surety's most important and flexible rights.\(^{60}\)

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the creditor against the principal; (2) to the interests of the creditor and security in which the creditor has no continuing interest; (3) to the rights of the creditor against persons other than the principal whose negligence or willful conduct has made them liable to the creditor for the same default; and (4) the rights of the creditor against co-sureties to the extent of contribution. See also RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. (1996) § 28.


Hodgson v. Shaw, 3 Mylne & K., 183, 190 (1834); See also the definition offered by RESTATEMENT (THIRD) OF SURETYSHIP & GUAR. § 27 cmt. a (1996).


The key cases dealing specifically with the contract bond surety’s subrogation rights trace back to several early decisions in the United States Supreme Court. In *Prairie National Bank v. United States*, the Court recognized equitable subrogation rights in favor of a performance bond surety pursuant to which the performing surety, standing in the shoes of the government obligee, benefited from the government’s rights to appropriate the retainage and apply it against the costs of performing the contract, without concern for the claims of the principal’s bank. In *Henningsen v. United States Fidelity and Guaranty Company*, the Court extended to the payment bond surety the same subrogation rights the Court had recognized in *Prairie National Bank* for the performance bond surety, holding that a surety paying labor and material suppliers had superior claims to those of an assignee bank to unpaid contract funds. Finally, in *Pearlman v. Reliance Insurance Company*, the Court held that a payment bond surety was entitled to the unpaid contract funds against the claims of the principal’s bankruptcy trustee. Based upon


61 164 U.S. 227 (1896).
62 208 U.S. 404 (1908).
these cases and hundreds of others, sureties have, in most cases, been successful in enforcing their subrogation rights.\(^{64}\)

Subrogation is dependent upon the equities and the particular facts and circumstances of each situation.\(^ {65}\) The surety's subrogation rights generally depend on the satisfaction of four essential elements:\(^ {66}\) (1) an obligation of the principal to the obligee; (2) the failure of the principal to perform that obligation; (3) the rights of the obligee arising from the principal's failure to perform; and (4) the surety's performance of the obligation that the principal failed to perform.\(^ {67}\) Upon the satisfaction of these elements, the surety becomes subrogated to the rights of others.\(^ {68}\) Those include the right to assert claims against property, including contract funds, that others hold,\(^ {69}\) and to compete against the claims of

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65 73 AM. JUR. 2D Subrogation §11 (1974).


68 A New Mexico court has confirmed the potential scope of the surety's equitable subrogation rights in broad terms: "[I]t stands in the shoes of the contractor insofar as there are receivables due it; and the shoes of the laborers and materialmen who have been paid by the surety—who may have had liens; and, not least in the shoes of the [project owner], for whom the job was completed." N.M. State Highway & Transp. Dept. v. Gulf Ins. Co., 996 P.2d 424, 428 (N.M. Ct. App. 1999) (altered in original and quoting Nat'l Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843, 844-45 (1st Cir. 1969)). See also, Lawrence Lerner & Peter Karney, *Salvage/Subrogation Rights, in Bond Default Manual* 449-95 (Duncan L. Clore et al. eds., 3d ed. 2005); George J. Bachrach & John V. Burch, *The Surety's Subrogation Rights, in The Law of Suretyship* 419-53 (Edward G. Gallagher ed., 2d ed. 2000); Trinity Universal Ins. Co. v. United States, 382 F.2d 317, 320 (5th Cir. 1967); Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962).

those who assert a priority right in the property, either pursuant to subrogation rights or under the Indemnity Agreement.\footnote{George J. Bachrach & John V. Burch, \textit{The Surety's Subrogation Rights}, \textit{in} \textit{The Law of Suretyship} 419-453 (Edward G. Gallagher ed., 2d ed. 2000); L. Simpson, \textit{Handbook of Law of Suretyship} \textsection{} 47 (1950).}

b. The Surety's Subrogation Rights--Practice and Effect

(i) The Surety's Subrogation to the Obligee's Rights

The obligee has rights against the principal and others to which the performing surety may be subrogated. The Restatement (Third) of Suretyship and Guaranty recognizes that a surety who satisfies its principal's obligations to the obligee is subrogated, to the extent it contributes to that satisfaction, in the following respects:

(a) To the rights of the obligee against the principal;
(b) To the rights of the obligee against other sureties;
(c) To the interests of the obligee in property in which the obligee has no continuing interest; and
(d) To the rights of the obligee against other persons whose conduct has made them liable to the obligee.\footnote{Restatement (Third) of Suretyship & Guar. \textsection{} 28 (1996).}

In the context of construction bonds, the most important "property" in which the surety's subrogation rights have an interest are the unpaid contract funds that the obligee holds or controls, including those that the principal earned but that the obligee has not yet disbursed.\footnote{Merritt Commercial Sav. & Loan, Inc. v. Guiney, 766 F.2d 850 (4th Cir. 1985).} While in the hands of the obligee, the contract funds are subject to the obligee's recognized contract rights, statutory rights, and/or common-law set-off rights to use the remaining contract funds to complete the project. As a result, a surety performing its bond obligations to satisfy its principal's contract performance is entitled to use the remaining contract funds to reimburse itself for its costs in completing the project.\footnote{See George J. Bachrach & John V. Burch, \textit{The Surety's Subrogation Rights}, \textit{in} \textit{The Law of Suretyship} 430 (Edward G. Gallagher ed., 2d ed. 2000).} Additional rights to which the surety may be entitled include rights in contract or tort against third-parties such as (1) design professionals for improper certification of payments, premature releases of retainage,
defective design, negligent project administration, and other such claims, (2) accountants or assignees, and/or (3) the principal’s insurers.

(ii) The Surety’s Subrogation to the Principal’s Rights

By satisfying the principal’s obligations, the surety is also subrogated to the principal’s affirmative claims against others. These may include contract claims against the obligee, rights to mechanic’s


liens or other statutory rights, claims or rights against subcontractors and their sureties, and available rights against design professionals and construction lenders. As important as these rights are, a surety risks competition with or against others, such as judgment creditors, secured creditors, assignees, and/or bankruptcy trustees (including the debtor in possession) with similar claims.

(iii) The Surety’s Subrogation to Subcontractor/Supplier Rights

The surety’s payments to the principal’s unpaid subcontractors or suppliers on bonded projects support the surety’s subrogation rights to the claims and rights of those individuals or entities who are third-party beneficiaries under the surety’s bonds. Rights that the surety gains may include contract claims or rights against the principal (or, in the case of other than first-tier subcontractors or suppliers, against those with whom such claimants have privity of contract). Subcontractors or suppliers may have mechanic’s lien and/or other statutory rights against the obligee or its property and statutory trust fund rights or stop notice/withhold/direct payment rights under applicable state statutes, all of which are appropriate subjects of the paying surety’s subrogation rights.

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(iv) The Property Subject to the Surety’s Subrogation Rights

The value or ultimate benefit to the surety of its subrogation rights depends in large measure on the specific property or claim right at issue. In any situation, there is likely to be competition between the surety’s subrogation rights and the legal rights associated with and governing assignment rights and security, whether pursuant to contract or statute. As noted above, to the extent the surety relies on its subrogation rights to assert or pursue the principal’s rights or claims or those of its subcontractors or suppliers, the surety may face strong competition from others, such as bankruptcy trustees, lenders or other secured creditors, taxing authorities, or judgment creditors, all of whom may claim a security interest or similar rights in a principal’s contract claims, funds, or property.

c. Comparing and Contrasting the Surety’s Subrogation Rights to the Surety’s Reimbursement Rights Under the Indemnity Agreement

The Indemnity Agreement assists the surety in preserving, securing, and enforcing its reimbursement and exoneration rights, by including the principal’s direct assignment to the surety of many of the principal’s rights and claims to which the surety might assert its subrogation rights. Chapter III, section B, and Chapter VI, section D, infra discuss assignment in greater detail.

The principal’s default in its bonded obligations triggers a surety’s subrogation rights, followed by the surety’s performance of those same obligations. The surety’s subrogation rights overlap the rights and provisions under the Indemnity Agreement to the extent that the Indemnity Agreement includes assignment of the principal’s rights or claims to property (such as the bonded contract funds) that others hold. However, under the Indemnity Agreement, the surety may also obtain rights to property, claims, or other security that the principal and its indemnitors own, including rights to use and apply such property to reimburse any surety losses or to hold as collateral to secure the surety against anticipated losses.

The surety’s subrogation rights and the surety’s assignment rights under the Indemnity Agreement also overlap where the Indemnity Agreement extends rights to property or interests that others may claim as well. For example, a construction lender may extend credit to the principal in exchange for a perfected security interest in (by way of an assignment of) the contract funds, i.e., accounts receivable. Similarly, an Indemnity Agreement may grant to the surety an assignment of materials and equipment that the principal uses in the performance of the bonded
contract. Those materials and equipment may also be subject to security interests that the principal granted to other creditors, including suppliers, equipment vendors, or (again) lenders.

The surety's subrogation rights arise by operation of law. However, its rights under an assignment or any other grant of a security interest (whether by the Indemnity Agreement or other written instrument) are a matter of contract, the enforcement of which is largely governed by statute.\(^{82}\) A valid assignment begins with an agreement under which, for value, a debtor grants to an assignee or otherwise creates a security interest in particular collateral in which the debtor has rights. When these requirements are met, a security interest "attaches" to the described collateral.\(^{83}\) Once attached, a secured creditor must "perfect" its security interest in order to assure that it retains rights to the collateral that are superior to the claims of other, intervening creditors. The method of perfection depends on the nature of the collateral.\(^{84}\)

An Indemnity Agreement may contain narrow or broad provisions granting to the surety assignments of the principal's contracts, contract funds, and other collateral, including tools, equipment, and inventory.\(^{85}\) If the Indemnity Agreement acts as a security agreement as to various items of collateral and, if perfected, the surety may, on the principal's default, foreclose upon that collateral in the same manner as any other secured creditor.\(^{86}\)

\(^{82}\) Assignments and security interests are the essential subject of Revised Article 9 of the Uniform Commercial Code.

\(^{83}\) U.C.C. § 9-203(a)-(b). See infra Chapter III, section B, and Chapter VI, section D.

\(^{84}\) A security interest in certain types of collateral perfects automatically upon attachment. See, e.g., U.C.C. § 9-309(1), applying to purchase money security interest in consumer goods other than vehicles or fixtures. Others are perfected only upon a physical transfer of possession. U.C.C. § 9-313(a), (e), applying to stock certificates. In most cases, a secured creditor must perfect its security interest by filing a U.C.C.-1 Financing Statement with the governmental agency designated for that purpose in each state, often the Secretary of State. See U.C.C. §§ 9-308(a)-(b), 9-310(a), 9-312(a).

\(^{85}\) See discussion infra Chapter VI, section D.

\(^{86}\) The surety is not precluded, at any time, from obtaining from its principal or indemniters a separate security interest in specific collateral.
(i) Advantages of Subrogation in Comparison with Assignment

The most important advantage of the surety’s subrogation rights over its assignment rights or other rights directly against the principal and its property lies in the surety’s rights to stand in the shoes of those who enjoy claims or rights to funds or property superior to those of the principal. By virtue of its performance and/or payment of its bond obligations to the obligee or other valid claimants, a surety typically establishes a right to the contract funds in the obligee’s hands, which right is superior to its own principal’s rights. As a result, in a contest over undisbursed contract funds, a surety prevails over someone claiming rights derived through the principal (whether by assignment, statute, or otherwise), because (1) by reason of the principal’s default, the principal has no property rights and no title in the unpaid contract funds, (2) there is no property or debt thus due the principal,87 (3) the principal has no rights or interests in the balance,88 and (4) the principal, thus, cannot assign what it does not have.89 In the end, because of the obligee’s right to (a) withhold payment of contract funds for its own protection, and (b) pay unpaid subcontractors or suppliers, there is nothing to which the competing claim to contract funds may attach.

The Uniform Commercial Code (“U.C.C.”), Article 9, does not treat subrogation as a “security interest” and, therefore, subrogation is beyond the scope of its application.90 Thus, courts have held that a surety

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89 In re Alliance Props., Inc., 104 Bankr. 306 (S.D. Cal. 1989) (paying surety vs. assignee bank extending credit to Chapter 11 debtor).
performing its obligations under a performance bond or a payment bond enjoys rights to the remaining contract funds in the obligee’s hands superior to those of a bank with a perfected security interest in the principal’s accounts receivable, even when the principal used the loan proceeds to perform its bonded obligations.\(^{91}\)

The contest between a paying surety and the bankrupt principal’s trustee best illustrates a subrogated surety’s superior position. A trustee, claiming through or in the place of the principal, depends upon the principal’s rights for its own right to contract funds. A surety has a better claim to those same contract funds because it is subrogated to the obligee’s superior right to apply those contract funds to project completion.

(ii) Disadvantages of Subrogation in Comparison with Assignment

The greatest disadvantage of subrogation in comparison with assignment relates to those situations when the property at issue leaves the custody or control of third parties and is paid to or returned to the principal. In such cases, the property is subject to the prior perfected security interests, rendering the surety’s subrogation rights to that property subject to those prior perfected security interests.\(^{92}\)

d. The Effect of the Surety’s Rights Under Its Indemnity Agreement on Subrogation—Selection and Election of Rights

In light of the foregoing and as a general rule, sureties prefer their subrogation rights over their assignment rights pursuant to the Indemnity Agreement or otherwise, at least in those circumstances when the funds or property at issue are in the control of third parties and the surety’s subrogation rights are superior. To the extent that the surety rightfully asserts its subrogation rights to stand in the shoes of the obligee, it asserts

\(^{91}\) See infra Chapter III, section B, and Chapter VI, section D.