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TENETS OF SURETY LAW

Introduction

A surety is traditionally defined as a person or entity who agrees in writing to answer for the debt or default of another.[1] Notwithstanding that suretyship, at least in its most generic sense, originated thousands of years ago, the bankruptcy practitioner is often unfamiliar with many fundamental surety concepts implicated in cases where a bonding company has been part of the debtor's financial background.

This chapter sets out the underlying concepts of surety law, describes the tripartite relationship and its historical and modern applications, and explains how suretyship is distinguished from insurance products, a distinction that when ignored has led to confusion and analytical failures. Finally, this chapter will discuss equitable subrogation, a bedrock principle of modern surety law.

A. The Tripartite Relationship

Suretyship law orders the rights and liabilities among three parties: the debtor, the creditor, and the surety.[2] The essence of suretyship is the

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1. Edward G. Gallagher, *Ch. 1, Introduction*, in THE LAW OF SURETYSHIP 1, (Edward G. Gallagher ed. Am. Bar Ass'n 2000).
2. Peter A. Alces, THE LAW OF SURETYSHIP AND GUARANTY § 1:1 (2020 update). The Restatement refers to the debtor as "principal obligor", the creditor as "obligee", and the surety as "secondary obligor." *See* RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 cmt. d (1996). In the construction context, the debtor/principal obligor may also be referred to as the "principal" when acting as a general contractor, with the owner as obligee. When the general contractor elects to require bonds from its subcontractors, the general contractor is then the obligee, with the subcontractor serving as principal on the bonds provided. *See, e.g.,* Philip L. Bruner & Patrick J. O'Connor, Jr., 4A BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:2 (2020 update). The surety may also be referred to as a "guarantor" or "bonding company." *See, e.g.,* Roger N. LeBoeuf & Thomas W. Heald, MASSACHUSETTS CONTINUING LEGAL EDUCATION, INC. § 9.1 (1st ed. 2011).

undertaking to answer for the debt of another.[3] The surety's liability is co-extensive with that of the debtor[4] and arises only when the debtor fails to discharge its duties or to respond in damages for that failure.[5]

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3. *See* Gen. Auth. for Supply Commodities, Cairo, Egypt v. Ins. Co. of N. Am., 951 F. Supp. 1097, 1108 (S.D.N.Y. 1997) ("a contract of suretyship is '[a] contract whereby one person engages to be answerable for the debt, default, or miscarriage of another.'"); *In re* Boco Enters., 204 B.R. 407, 416 (Bankr. S.D.N.Y. 1997); *In re* Dvorak, 176 B.R. 929, 933 (Bankr. D. Kan. 1994) (a surety promises to pay an obligor's creditor; a surety makes this promise directly to the creditor, rather than to the obligor); Regency Sav. Bank v. Westmark Partners, 756 A.2d 299, 302 (Conn. App. Ct. 2000) (a guarantee is a type of contract whereby the guarantor promises to answer for the debt of another); Capul v. Fleet Bank of Me., 697 A.2d 66, 68 (Me. 1997) ("A surety is one who undertakes to perform in the event of default by the principal."); Great Am. Ins. Co. v. Gen. Builders, Inc., 934 P.2d 257, 260 (Nev. 1997); Carney v. Boles, 643 So.2d 339, 343 (La. Ct. App. 1994) ("Suretyship is an accessory contract by which a person binds himself to a creditor to fulfill the obligation of another upon the failure of the latter to do so."). *See also* Shipley v. Baillie, 547 N.W.2d 711, 714 (Neb. 1996) ("[A] surety's obligation is not an original and direct one for the performance of his own act, but it is accessory or collateral to the obligation contracted by the principal."); Indus. Mech., Inc. v. Siemens Energy & Automation, Inc., 495 S.E.2d 103, 105 (Ga. Ct. App. 1997) ("A contract of guaranty or suretyship is primarily one to pay the debt of another which may be due and payable by the principal debtor to the creditor upon default."); Lindsey Masonry Co. v. Jenkins & Assocs., Inc., 897 S.W.2d 6, 16 (W.D. Mo. 1995) ("A surety's liability is secondary and requires the surety to pay only in the event the principal does not."); Currie State Bank v. Schmitz, 628 N.W.2d 205, 208 (Minn. Ct. App. 2001) (a guarantor is one who guarantees payment of an instrument without the holder first seeking payment from another party); Cranford v. Bartlett, 25 P.3d 918, 923 (Okla. 2001) (a guaranty is the undertaking to answer for the payment of a debt of another should such other fail to perform); McDonald v. Nat'l Enters., 547 S.E.2d 204, 207 (Va. 2001) (a guaranty is an independent contract where one agrees to be answerable for the debt of another who is primarily liable to pay); Crafton v. Brown, 550 S.E.2d 904, 905 (S.C. Ct. App. 2001) (a guaranty is a contract in which one promises to pay the debt of another should such other fail to perform and can only be made by the mutual assent of the parties); Colonial Am. Cas. & Sur. Co. v. Scherer, 214 S.W.3d 725, 730 (Tex. App.—Austin 2007, no pet.) ("The undertaking of [a] surety is to make good any breach of official duty of its principal.") (citation omitted); Carolina First Bank v. Stark, Inc., 660 S.E.2d 641, 644 (N.C. Ct. App. 2008) ("A guaranty is an absolute or unconditional promise to pay a particular debt if it is not paid by the debtor and is immediately enforceable against the guarantor upon the debtor's default."); First Nat'l Bank of Unadilla v. Betts, 748 N.W.2d 76, 81 (Neb. 2008) ("A guaranty is

a contract by which the guarantor promises to make payment if the principal debtor defaults."); Ameris Bancorp v. Ackerman, 674 S.E.2d 358, 362 (Ga. Ct. App. 2009) ("A contract of guaranty or suretyship is primarily one to pay the debt of another which may be due and payable by the principal debtor to the creditor upon default."); Int'l Fid. Ins. Co. v. Sweet Little Mexico Corp., 665 F.3d 671, 679-81 (5th Cir. 2011) (reaffirming Texas holding that a "suretyship involves a contractual agreement between the surety and the principal securing the principal's debt owed to a third party" and can be invoked in cases with open-ended contractual terms such as the payment owed to customs authorities); Wells Fargo Bank, N.A. v. Smuck, 407 S.W.3d 830, 835 (Tex. App.—Houston [14th Dist.] 2013, pet. denied) ("A 'guaranty' is 'an undertaking by one person to be answerable for the payment of some debt or the performance of some contract or duty by another person, who himself remains liable.'") (internal quotations omitted); Nissho of Cal., Inc. v. Bond Safeguard Ins. Co., 163 Cal. Rptr. 3d 575, 582 (Cal. Ct. App. 2013) ("A surety is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.") (internal quotations omitted).

4. *In re* Kaplan, 186 B.R. 871, 877 (Bankr. D.N.J. 1995); N. Bank v. Dowd, 562 N.W.2d 378, 379 (Neb. 1997); Contractors Equip. Maint. Co. *ex rel.* U.S. v. Bechtel Hanford, Inc., 514 F.3d 899, 904 (9th Cir. 2008) (stating that "[i]f [a] contract names a particular principal, the surety's obligations are limited to those of the named principal.") (citation omitted); Morgan Creek Residential v. Kemp, 63 Cal. Rptr. 3d 232, 240 (Cal. Ct. App. 2007) (The California Supreme Court has found that "a surety's liability for an obligation is secondary to, and derivative of, the liability of the principal for that obligation.") (citing CAL. CIV. CODE § 2806 *et seq.*); First Sealord Sur., Inc. v. Suffolk Constr. Co., Inc., 995 So.2d 609, 610 (Fla. Dist. Ct. App. 2008) ("The liability of a surety is coextensive with that of the principal.") (citations omitted).

5. *In re* St. Johnsbury Trucking Co., Inc., 206 B.R. 318, 325 (Bankr. S.D.N.Y. 1997) (stating that a guaranty is a "potential future liability" that becomes an actual liability "when payments on the guarantee are made"); W. Sec. Bank v. Superior Court, 933 P.2d 507, 516 (Cal. 1997) ("Generally, a surety's liability for an obligation is secondary to, and derivative of, the liability of the principal for that obligation."); Honey v. Davis, 930 P.2d 908, 911 (Wash. 1997) (*en banc*) ("both the surety and the principal are bound upon the obligation, with the principal having the primary obligation."); Azar v. Statewide Ins. Co., 681 N.E.2d 84, 88 (Ill. App. Ct. 1997) ("where there is an unsatisfied recovery against a principal on the bond (including a prior unsatisfied judgment), the aggrieved party has a subsequent action against the surety where, as here, the obligation is joint and several."); JPMCC 2006-CIBC14 Eads Parkway, LLC v. DBL Axel, LLC, 977 N.E.2d 354, 366 (Ind. Ct. App. 2012) ("A guarantor is 'a person who is liable for the payment of a debt or performance of a duty to another person.' As such, a guarantor's liability 'is only relevant in the event of a

In this three-party relationship, the surety undertakes the performance to an obligee if the principal fails to do so.[6] The surety stands in the shoes of the principal and must perform the obligation due the obligee at the time of default.[7] In suretyship, the risk of loss remains with the principal while the surety merely lends its credit so as to guarantee payment or performance in the event that the principal defaults.[8] Because a surety is responsible to perform on behalf of another, one cannot be a "surety" for one's own performance.[9]

1. Suretyship Status

The suretyship relation exists where two obligors are bound to an obligee who is entitled to only one performance; and, as between the two who are bound, one, rather than the other, should bear the burden of performing.[10]

A secondary obligor has suretyship status whenever, pursuant to the contract (the "secondary obligation"), an obligee has recourse against a person (the "secondary obligor") or that person's property with respect to the obligation (the "underlying obligation") of another person (the "principal obligor") to that obligee. To the extent that the underlying obligation or the secondary obligation is performed, the obligee is not entitled to performance of the other obligation, and as between the principal obligor and the secondary obligor, it is the principal obligor who

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default by the accommodated party.'") (quoting Irish v. Woods, 864 N.E.2d 1117, 1121 (Ind. Ct. App. 2007)); N. Bank v. Dowd, 562 N.W.2d at 379; Hudson v. Game World, Inc., 484 S.E.2d 435, 440 (N.C. Ct. App. 1997); Town of Melville v. Safeco Ins. Co. of Am., 651 So.2d 404, 408 (La. Ct. App. 1995); *In re* Kreisler, 407 B.R. 321, 327 (Bankr. N.D. Ill. 2009) ("In order for a guarantor to be liable for the debts of a third party debtor, the third party debtor, or principal under terms of the note, would have to be in default.").

6. 74 AM. JUR. 2D *Suretyship* § 1 (2020); McWane, Inc. v. Fid. & Deposit Co. of Md., 372 F.3d 798, 802 (6th Cir. 2004) (applying Ohio law); Pa. Nat'l Mut. Cas. Ins. Co. v. City of Pine Bluff, 354 F.3d 945, 951 (8th Cir. 2004) (applying Arkansas law).
7. 74 AM. JUR. 2D *Suretyship* § 1 (2020); Kiski Area Sch. Dist. v. Mid-State Sur. Corp., 967 A.2d 368, 372 (Pa. 2008).
8. 74 AM. JUR. 2D *Suretyship* § 1 (2020); Am. Contractors Indem. Co. v. Saladino, 9 Cal. Rptr. 3d 835, 839 (Cal. Ct. App. 2004).
9. *In re* Interdiction of DeMarco, 38 So.3d 417, 430 (La. Ct. App. 2010); Ford Motor Credit Co. v. Machias Ford, Mercury, Inc., 509 A.2d 658, 659 (Me. 1986).
10. RESTATEMENT (FIRST) OF SECURITY § 82 (1941).

ought to perform the underlying obligation or bear the cost of performance.[11]

Suretyship status gives the secondary obligor a significant set of rights against both the principal obligor and the obligee.[12] As the term "suretyship status" suggests, the secondary obligor obtains these rights as a matter of status in the transaction rather than by express agreement.[13]

Surety and principal are both bound to their respective duties, though the duties of both may be co-extensive. The surety's obligation may be to perform if the principal does not, or it may be only to compensate the obligee for the principal's non-performance. Where the duties of surety and principal are different, as where the principal has agreed to paint a portrait and the surety has guaranteed that performance, the principal's duty to the creditor is to fulfill its promise. This is also the principal's duty to the surety, but the principal also has the duty to reimburse the surety for any outlay on account of its default.[14]

To better understand the suretyship relationship, it is helpful to examine surety bonds in both the construction and the non-construction contexts.

a. Construction Industry Contract Surety Bonds

A useful illustration of the suretyship relationship dynamics can be found in the construction industry, where surety bonds are commonly-used, often statutorily-mandated financial tools to guarantee the completion of a contracted-for project in the event of a contract party's default.[15] The parties to the construction suretyship relationship are typically the project owner (the obligee), the general or prime contractor (the principal), and the bonding company (the surety).

In the construction setting, the suretyship relationship is created by the surety bond, which is a contract.[16] As part of its terms, the surety bond sets forth the maximum dollar limit of the surety's financial exposure, an amount historically referred to as the "penal sum" of the bond.[17] The penal

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11. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1(1) (1996).
12. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 cmt. a.
13. *Id.*
14. RESTATEMENT (FIRST) OF SECURITY § 82 cmt. f (1941).
15. Peter A. Alces, THE LAW OF SURETYSHIP AND GUARANTY § 10:1 (2020 update).
16. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 cmt. d (1996); Philip L. Bruner & Patrick J. O'Connor, Jr., 4A BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:2 (2020 update).
17. Philip L. Bruner & Patrick J. O'Connor, Jr., 4A BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:22 (2020 update).

sum is dictated by the statute requiring the existence of the bond or contract terms pursuant to which the bond is furnished.[18] Typically, the performance bond amount is 100% of the contract price, which—after taking into consideration the obligee's contract funds plus the bond amount—gives the obligee 200% protection against the principal's default.[19]

In this construction scenario, the owner requires that the general contractor provide a performance bond under which the surety will be obligated up to the penal sum of the bond for the cost of completing the work in the event the general contractor defaults.[20] The owner may require the general contractor to provide a payment bond. This bond provides assurance to the contractor's subcontractors and suppliers on the project that the surety will pay them if the contractor fails to do so. This bond thereby protects the owner from claims from those parties who might otherwise assert claims or mechanic's liens against the owner or its property.[21] This tripartite arrangement typically guarantees obligations arising in the prime contract, but there are occasions, especially on larger projects, where the general contractor will require performance and payment bonds from its subcontractors.[22] In that situation, the subcontractor is the principal and the general contractor the obligee.[23] The financial security provided by surety bonds is essential to the stability of modern construction projects.[24]

b. Non-Construction Surety Bonds

Surety bonds are commonly used in a wide variety of contexts. The following paragraphs describe some commercial surety bonds and their purposes.

In the late 1990s, the Balanced Budget Act amended the Social Security Act to require suppliers of durable medical equipment ("DME") and home health agencies ("HHA") to furnish surety bonds as a condition

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18. *Id.*
19. *Id.*
20. Andrew L. Chapin et al., NORTH CAROLINA CONSTRUCTION LAW § 4:1 (2020 update).
21. *Id.*; Henry Angelo & Sons, Inc. v. Prop. Dev. Corp., 306 S.E.2d 162, 166 (N.C. Ct. App. 1983) (quoting *Contract of Suretyship*, BLACK'S LAW DICTIONARY (rev. 4th ed. 1968)) (describing suretyship as the "lending of credit to aid a principal having insufficient credit of his own").
22. *Id.*
23. *Id.*
24. Philip L. Bruner & Patrick J. O'Connor, Jr., 4A BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:1 (2020 update).

of their certifications.[25] The purpose of the bond requirements was to provide security to the Centers for Medicare and Medicaid Services (the agency tasked with Medicare oversight) to facilitate the collection of overpayments of benefits paid to a participating HHA or DME due to billing errors, abuse, or fraud.[26]

Another example of a non-construction surety bond is the license or permit bond. License and permit bonds are generally "required as a prerequisite to the procurement of licenses or permits for various occupations and professions."[27] The statutory mandate for such bonds has often arisen in response to complaints received by federal, state, or local regulatory agencies from consumers about financial losses or other adverse effects they have suffered as a result of the unethical, illegal, or otherwise improper practices of licensed businesses.[28] As such, license and permit bonds are generally designed to guarantee regulatory compliance, provide a remedy to aggrieved consumers, and offer some assurance of financial responsibility to the regulatory agency.[29]

A third example of a surety bond in a non-construction context is the reclamation bond. The development and production of raw materials that are used to provide energy, transportation infrastructure, construction materials, industrial and manufactured consumer products, and agriculture products cause a significant disruption to the environment.[30] After many decades of merely abandoning mined lands following resource extraction in the United States, it is now public policy to minimize, mitigate, and remediate the adverse effects of mineral extraction and processing while obtaining the benefits of our natural resources.[31] Considered under the

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25. Robert J. Duke & Richard H. Stanziale, *Ch. 1, Medicare and Medicaid Surety Bonds*, in THE LAW OF COMMERCIAL SURETY AND MISCELLANEOUS BONDS 1, 2 (Bruce Charles King, Richard E. Towle, and Samuel J. Arena, Jr. eds., Am. Bar Ass'n 2d ed. 2012).
26. *Id.*
27. Patrick Q. Hustead, *Ch. 9, License and Permit Bonds*, in THE LAW OF MISCELLANEOUS AND COMMERCIAL SURETY BONDS 143 (Todd C. Kazlow & Bruce C. King eds., Am. Bar Ass'n 2001).
28. Catherine Squillace & Richard T. Pledger, *DECEPTIVELY SIMPLE? Demystifying License and Permit Surety Bonds*, 46 NO. 9 DRI FOR DEF. 62 (2004).
29. *Id.*
30. William T. Gorton III, George W. Thompson, and W. Blaine Early, III, *Ch. 7, Reclamation Bonds*, in THE LAW OF COMMERCIAL SURETY AND MISCELLANEOUS BONDS 261, 262 (Bruce Charles King, Richard E. Towle, and Samuel J. Arena, Jr. eds., Am. Bar Ass'n 2d ed. 2012).
31. *Id.*

regulatory moniker of "Financial Assurances,"[32] state and federal laws and regulatory agencies with permitting and enforcement authority require mining companies to provide financial guarantees assuring that their mining operations will be conducted and closed according to technical criteria and that affected lands and waters will be reclaimed according to mandatory environmental quality standards.[33]

Although not an exhaustive list, additional examples of non-construction surety bonds include Medicare and Medicaid bonds, probate bonds, bankruptcy trustee/receiver bonds, public official bonds, commercial bail bonds, fringe benefit bonds, customs bonds, federal excise bonds, Workers' Compensation bonds, judicial bonds, lost instrument bonds, notary bonds, and warehouse bonds.[34]

2. *Suretyship Historically*

"It is contended by some authorities that the general principles and relationships involving suretyship can be dated back to the earliest history of man in a societal relationship."[35] While it is well known that the ancient civilization of Mesopotamia was one of the first notable hubs of learning, writing, and religion, a lesser known fact is that it was home to the first known record of contract suretyship, dating back to 2750 BCE.[36] A tablet recording the making of a surety contract was located in the Library of Sargon I, King of Accad and Sumer.[37] The tablet describes a farmer (obligee) who had been drafted into the King's military. The farmer entered into a contract with another farmer (principal) who agreed to cultivate the obligee-farmer's farm during his absence. The principal also agreed to fertilize the land properly and to maintain the property and return it to the obligee-farmer upon the expiration of the lease in as good of condition as it was received by the principal. The principal, in return, was

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32. The term "reclamation bond" is used commonly throughout the mining industry to cover *all* forms of reclamation financial guarantees.
33. William T. Gorton III, George W. Thompson, and W. Blaine Early, III, *Ch. 7, Reclamation Bonds*, in THE LAW OF COMMERCIAL SURETY AND MISCELLANEOUS BONDS 261, 263 (Bruce Charles King, Richard E. Towle, and Samuel J. Arena, Jr. eds., Am. Bar Ass'n 2d ed. 2012).
34. *See generally* THE LAW OF COMMERCIAL SURETY AND MISCELLANEOUS BONDS (Bruce Charles King, Richard E. Towle, and Samuel J. Arena, Jr. eds., Am. Bar Ass'n 2d ed. 2012).
35. Texas W. Oil & Gas Corp. v. Fitzgerald, 726 P.2d 1056, 1066 n.1 (Wyo. 1986).
36. Willis D. Morgan, *History and Economics of Suretyship*, 12 CORNELL L. REV. 153 (1927).
37. *Id.*

to receive one half of the farm's produce. Because the obligee was away serving in the military and thus could not personally supervise the principal's performance, the tablet stated that a merchant of the city of Accad, as surety for the principal, would guarantee the principal's performance of the contract.[38]

During Hammurabi's rule of the Babylonians from 1792–1750 BCE, he wrote the infamous Code of Hammurabi, which encompassed principles of suretyship extant today.[39] Robert Francis Harper has translated the code, in part, as follows: "If a man have bargained for the field, garden, or house of an officer, constable, or tax gatherer and given securities, the officer, constable, or tax gatherer shall return his field, garden, or house and he shall take himself the sureties given."[40]

Roman surety laws from circa 150 AD described different types of sureties depending upon the obligation undertaken: the sponsor, the fidepromissor, and the fidejussor.[41] Sponsores and fidepromissores could act as sureties only on verbal contracts, while fidejussores could be a surety on any undertaking "whether re verbis, litteris, or consensu."[42] Sponsores were also required to be Roman citizens.[43] Unlike the current business model of the compensated surety, the Roman suretyship was rooted in duty, not compensation.[44]

In England, the Anglo-Saxons also engaged in suretyship and, like the Romans, believed that suretyship was rooted in duty.[45] However, they uniquely used suretyship as a form of criminal law enforcement, whereby individuals—a family member, a master for servants, a lord for dependents—became responsible for producing others in court in the

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38. Gregory L. Daily, Edwin Hubbard, and Darren Grzyb, *Ch. 1, The Creation of the Relationship*, in THE LAW OF PERFORMANCE BONDS 1, 2 (Gregory M. Weinstein & Kimberly Zanotta eds., Am. Bar Ass'n 3d ed. 2018).
39. G. M. Weichelt, *The Contract of the Corporate Surety and Its Distinction from One of Insurance*, 9 CHICAGO-KENT L. REV. 69 (1931).
40. *Id.*
41. Morgan, *supra* note 36, at 153.
42. *Id.* at 158 (internal citation omitted).
43. *Id.*
44. *See, e.g.,* Texas W. Oil & Gas Corp., 726 P.2d at 1066 n.1 (wherein the Wyoming Supreme Court noted: "A well-considered history ascribing the differing derivation of surety from Roman language and usage and guaranty from Teutonic history is to be found in Radin, *Guaranty and Suretyship*, 17 CAL. L. REV. 605 (1928-29).").
45. William H. Woods, Ch. 2, *Historical Development of Suretyship from Prehistoric Custom to a Century's Experience with the Compensated Corporate Surety*, in THE LAW OF SURETYSHIP 3, 7 (Edward G. Gallagher ed., Am. Bar Ass'n 2d ed. 2000).

event of misdemeanors.[46] Suretyship can also be found in the Bible, most notably throughout the Book of Proverbs.[47]

The first contract surety bond written by a corporation in the United States was issued in 1887.[48] Performance bonds arose in the American construction industry in an effort to protect public treasuries against the significant risk of default on uncompleted public projects.[49] The 1894 Heard Act codified the requirement that federal contractors provide performance and payment bonds.[50] The Heard Act required that the performance and payment obligations of federal contractors be guaranteed by a surety bond issued by "good and sufficient" sureties, which included compensated corporate sureties approved by the Department of the Treasury.[51] Corporate compensated sureties proliferated as a result of these enactments.[52] Numerous states subsequently adopted "Little Heard Acts" to mirror the federal Heard Act.[53] In 1935, Congress replaced the Heard Act with the Miller Act.[54] Again, states followed the federal government's

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46. G. O. Sayles, THE MEDIEVAL FOUNDATIONS OF ENGLAND 188 (London 1967).
47. *See* Laurence P. Simpson, SIMPSON ON SURETYSHIP § 2 (1950) ("A thousand years before the birth of Christ, Solomon said: He that is surety for a stranger shall smart for it: and he that hateth suretyship is sure.") (quoting *Proverbs* 11:15).
48. Morgan, *supra* note 36, at 492-93. The introduction dates of the six classes of corporate surety bonds were: (1) Fidelity (1865); (2) Executors, Administrators, and Other Fiduciaries (pre-1879); (3) Court bonds, *i.e.*, appeal, replevin, attachment (1881); (4) Contract (1887); (5) License and Permit (1890); and (6) Public Officials (1894).
49. *See generally* Lynn M. Schubert, *Modern Contract Bonds—An Overview*, in THE LAW OF SURETYSHIP, 3-1 (Edward G. Gallagher ed., 1993).
50. Heard Act, Ch. 280, 28 Stat. 278 (Aug. 13, 1894).
51. On August 13, 1894, the same day that it enacted the Heard Act, Congress passed an act authorizing the government to accept the bonds of approved corporate sureties. U.S. Fid. & Guar. Co. v. United States, 204 U.S. 349 (1907). This led to the creation of what is known as the "Treasury List" of sureties approved by the U.S. Department of the Treasury as acceptable to write bonds for federal projects and the level of authority for each listed surety. *See* 31 U.S.C. §§ 9304, 9305.
52. Philip L. Bruner & Patrick J. O'Connor, Jr., 4A BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:5 (2020 update).
53. *See*, *e.g.,* Lake Cnty. Grading Co., LLC v. Vill. of Antioch, 19 N.E.3d 615 (Ill. 2014) (construing the Illinois "Little-Heard" Act to require a public works "bond" that provided both performance and payment protection and reading into a subdivision performance bond as a matter of law an obligation to pay claims as well as complete the subdivision work).
54. 40 U.S.C. § 3131 *et seq.*

lead and adopted "Little Miller Acts" requiring bonds on state and municipal public works projects.[55]

B. Suretyship and Insurance Distinguished

Suretyship is not insurance, and the difference between the two must be understood.[56] The importance of the distinction lies in the equitable rights and remedies that suretyship status confers upon the surety—e.g., exoneration, subrogation, indemnification, and contribution—and the numerous contract and bond defenses available to it.[57] "[T]he usual view, grounded in commercial practice, [is] that suretyship is not insurance."[58] The confusion can arise from insurance companies frequently being the writers of surety bonds and having "Insurance Company" in their corporate names. The distinction is best understood by examining the elements of insurance and the elements of suretyship.

As explained in Part A of this chapter, a contract of suretyship creates a tripartite relationship among the party secured, the principal obligor, and the party secondarily liable; and, the rights, remedies, and defenses of a surety cannot be disassociated from this relationship.[59] This tripartite relationship is always present in a surety contract, while an insurance contract in itself never creates a tripartite relation analogous to the surety relation.[60] Insurance has been defined as a bilateral contract whereby one (the insurer) undertakes to indemnify or reimburse another (the insured)

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55. Brett D. Divers, P. Keith Lichtman, and Ira Sussman, *Ch. 2, Who is Entitled to Recover?*, in THE LAW OF PAYMENT BONDS 45, 61 (Kevin L. Lybeck, Wayne D. Lambert, and John Edward Sebastian eds., Am. Bar Ass'n 2d ed. 2011).
56. William Schwartzkopf, PRACTICAL GUIDE TO CONSTRUCTION CONTRACT SURETY CLAIMS § 2.02 (3d ed. 2021). The failure of early court opinions to discuss the fundamental differences between a contract of insurance and a contract of suretyship led to numerous problems that were apparently not anticipated until a number of courts began to treat surety bonds and insurance policies as being the same type of agreement. William H. Woods, *Ch. 2, Historical Development of Suretyship from Prehistoric Custom to a Century's Experience with the Compensated Corporate Surety*, in THE LAW OF SURETYSHIP 3, 33 (Edward G. Gallagher ed., Am. Bar Ass'n 2d ed. 2000).
57. Philip L. Bruner & Patrick J. O'Connor, Jr., 4A BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:2 (2020 update).
58. Foster v. Mut. Fire, Marine & Inland Ins. Co., 614 A.2d 1086, 1099 (Pa. 1992) (quoting Pearlman v. Reliance Ins. Co., 371 U.S. 132, 140 n.19 (1962)).
59. *See* Meyer v. Bldg. & Realty Serv. Co., 196 N.E. 250, 253 (Ind. 1935).
60. *Id.*

against loss, damage, or liability arising from an unknown or contingent event; whereas, under a contract of suretyship, the surety undertakes to answer for the debt, default, or miscarriage of its principal.[61] Most courts adhere to this distinction.[62]

1. Insurance Relationship

An insurance contract is a two-party agreement between the insurer and the insured, where the insurer undertakes to indemnify the insured against loss as a result of an unknown or contingent event.[63] The requisite elements of an insurance relationship are as follows:

- There must be a risk of economic consequences with a certainty of losses.
- The risk assumed must be an event that happens by chance that is substantially beyond the control of the individual, such as fire, an accident, or an earthquake.
- The number of risks must be great enough to permit the application of the law of large numbers (the principle that the

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61. *Id.* at 253-54; Andrew L. Chapin et al., NORTH CAROLINA CONSTRUCTION LAW § 4:1 (2020 update).
62. *See*, *e.g.,* Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc., 983 S.W.2d 501, 504-05 (Ky. 1998) (distinguishing between suretyship and insurance, finding that surety could enforce an arbitration clause in its principal's contract against the bond obligee, even though an arbitration exemption applicable to insurance companies existed in state statutes); Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 281 (Tex. 1998) (distinguishing between suretyship and insurance and concluding that surety did not owe principal the common law duties of good faith and fair dealing because the special relationship akin to insurance did not exist); Henry Angelo & Sons, Inc. v. Prop. Dev. Corp., 306 S.E.2d 162, 168 (N.C. Ct. App. 1983) (stating, in response to the argument that surety bonds are in the "nature of insurance contracts" and should be subject to similar rules of interpretation, that such an analysis "no more justifies the conclusion that sureties are insurers and performance bonds are contracts of insurance than does the commonly known fact that sheep are somewhat like goats justify the conclusion that sheep are goats."); *but see* Sur. Underwriters v. E & C Trucking, Inc., 10 P.3d 338, 341 n.5 (Utah 2000) (under Utah law, suretyship *is* an insurance contract; UTAH CODE ANN. § 31A-1-301(92)(b)(ii), which requires a surety to be licensed to enforce the contract's indemnity provisions, defines "insurance" to include contracts of guaranty or suretyship entered into by the guarantor or surety as a business and not as merely incidental to a business transaction).
63. Schwartzkopf, *supra* note 56, at § 2.02.

larger the number of exposures considered, the more closely will reported losses equal the true probability of loss).

- The average hazard, exposure, and coverage must be determinable.
- There must be a spreading of the risk.
- Certain loss (the cost of insurance) is substituted for uncertain loss (the hazard insured against).
- Pooling a large number of similar risks must create a fund sufficiently large to pay losses.[64]

2. Suretyship Relationship

A suretyship relationship is a three-party relationship among: (1) the surety; (2) the principal; and (3) the obligee. The surety undertakes to answer for the debt or default of the principal in performance the principal owes to the obligee.[65]

3. Specific Differentiations

There are various differences between the insurance relationship and the suretyship relationship, and it is helpful to directly compare these differences:

Insurance	Suretyship
Insurance is written to cover expected loss.	Surety bonds assume there will be no losses.
Insurance underwriting is based upon actuarial calculations of expected losses among a group of insureds.	Surety bonds are underwritten based upon a specific principal's creditworthiness and ability to perform.
Insurance premiums become part of a pool from which losses are expected to be paid.	A surety premium is a fee paid to the surety for extending credit.
An insurance premium is generally paid by the beneficiary of the insurance policy.	A surety premium is paid by a principal, but the beneficiary of the bond is the obligee.[66]

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64. *Id.*
65. *Id.*
66. In comparing surety bonds and insurance contracts, courts have noted differences between "their respective premium calculations, payments, and terms and conditions of cancellation and renewal" in support of "the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance." Foster v. Mut. Fire, Marine

Insurance	Suretyship
The insured under the policy has no obligation to repay the insurer for any benefits paid.	The principal is obligated to repay the surety for any losses incurred.
In the insurance context, an express subrogation agreement defines the boundaries of the insurer's ability to pursue the insured's causes of action against others.	In the suretyship context, principles of equitable subrogation define the surety's rights to seek reimbursement for the discharge of its duties.[67]
Payment of the premium is consideration for the issuance of the insurance policy, and if not paid, the policy may be cancelled.	Because the beneficiary of the bond does not pay the premium, failure to receive its premium does not act to cancel or release the surety from an issued bond.[68]

The fundamental distinctions between suretyship and insurance are particularly important when analyzing the scope of the surety's obligation[69] and the applicable rules of interpretation.

C. Equitable Subrogation

1. Background

Equitable subrogation[70] is a sacrosanct foundational underpinning of surety law. As the United States Supreme Court stated, "there are few

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& Inland Ins. Co., 614 A.2d 1086, 1099 (Pa. 1992) (quoting Grode v. Mut. Fire, Marine & Inland Ins. Co., 572 A.2d 798, 806 (Pa. Commw. Ct. 1990)).

67. *See*, *e.g.,* Hanover Ins. Co. v. Corrpro Cos., 312 F. Supp. 2d 816, 822 (E.D. Va. 2004).

68. *See generally* Schwartzkopf, *supra note* 56, at § 2.02.

69. *See* Auto Owners Ins. Co. v. Travelers Cas. & Surety Co., 227 F. Supp. 2d 1248, 1261 (M.D. Fla. 2002) ("Defective construction is an occurrence under a CGL policy. However, CGL policies 'only protect against personal injury or damages to personal property which might result from the defective workmanship itself.'…'[T]he poorly performed work will perforce have to be replaced or repaired by the tradesman or surety.'") (quoting Weedo v. Stone-E-Brick, Inc., 405 A.2d 788, 791-92 (N.J. 1979) (internal citations omitted)).

70. **Subrogation** (səb-rə-gay-shən) *n.* (15c) **1.** The substitution of one party for another whose debt the party pays, entitling the paying party to rights, remedies, or securities that would otherwise belong to the debtor. For example, a surety who has paid a debt is, by subrogation, entitled to any

doctrines better established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed."[71]

The surety's subrogation rights are grounded in equity, applied independently from the surety's contract rights, and "enforced solely for accomplishing the ends of substantial justice."[72] This occurs by treating the surety as the "assignee of the creditor, standing in his shoes to enforce the debt against the debtor together with any collateral held as security for the debt, entitled to all priorities and immunities enjoyed by the creditor."[73]

Essentially, the doctrine of equitable subrogation provides that the surety who has discharged the obligation of the principal to the obligee is entitled to any rights (including security) that the obligee would have against others for the loss sustained by the surety.[74]

Equitable subrogation is endemic in the construction industry. It arises when the underlying obligation of the bonded contract is the provision of goods or services. In exchange for the principal's provision of goods or services, the obligee typically performs—*i.e.*, issues payment—either after the underlying obligation is fully performed or in installments as the principal completes portions of the underlying obligation.[75] The obligee's payments constitute "return performance."[76] The unpaid portion of the

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security for the debt held by the creditor and the benefit of any judgment the creditor has against the debtor, and may proceed against the debtor as the creditor would. BLACK'S LAW DICTIONARY (11th ed. 2019).

71. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136-37 (1962).
72. Am. Sur. Co. of N.Y. v. Bethlehem Nat'l Bank of Bethlehem, Pa., 314 U.S. 314, 323 (1941) (quoting Memphis & Little Rock R.R. Co. v. Dow, 120 U.S. 287, 302 (1887)).
73. Simpson, *supra* note 47, at § 47. *See also* RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27 cmt. a (1996) ("Subrogation is often called an equitable assignment or an assignment by operation of law."). The rights that the surety acquires by being treated as a de facto "assignee of the creditor" should not be confused with the rights which the surety acquires as assignee of the principal under the indemnity agreement.
74. *See, e.g.,* Allen v. See, 196 F.2d 608, 610 (10th Cir. 1952). The surety who has discharged the principal's obligation may also be entitled to assert its subrogation rights to the rights of the obligee against the principal including those under the bonded contract and to the rights of the principal against third parties who caused the loss. When the surety discharges the principal's obligations to third-party beneficiaries, such as payment bond claimants, it is also entitled to assert the rights of those parties.
75. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 31 cmt. a (1996).
76. *Id.,* § 31(1).

obligee's return performance is thus security for the underlying obligation.[77]

For example, P (prime contractor/principal) agrees to construct a building for O (owner/obligee) for $500,000. S (surety) issues a contract surety bond to O, guaranteeing performance of the contract. P defaults on the construction of the building, and S completes the construction. At the time of P's default, O had paid P $200,000 in accordance with the construction contract. The remaining $300,000 of the contract price (the unpaid portion of the return performance) is security for P's underlying obligation to O. Therefore, S is subrogated to O's rights to the return performance.

2. Subrogation: Essential Elements

There are four essential elements to the surety's successful assertion of its subrogation rights: (1) an obligation owed by the principal to the obligee; (2) the failure of the principal to perform that obligation; (3) legal recourse available to the obligee arising from the principal's default and failure to perform; and (4) the performance by the surety, pursuant to its suretyship obligations, of the obligation the principal failed to perform.[78] When these four elements exist, the surety is subrogated to the rights of the obligee, principal, or third-party beneficiary resulting from the principal's failure to perform.[79]

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77. *Id.,* § 28 cmt. e.

78. The concept of the surety's subrogation rights consisting of four elements that are easily applicable to the performance bond surety and the payment bond surety and the focus on contract principles in the context of "equitable" subrogation were first articulated by Daniel Mungall, Jr. in his groundbreaking article entitled *The Buffeting of the Subrogation Rights of the Construction Bond Surety by United States v. Munsey Trust Company*, 46 INS. COUNSEL J. 607 (Oct. 1979). *See also* Daniel Mungall, Jr., *Ch. 1, The Subrogation Rights of the Contract Bond Surety—Some Basics*, in SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY 1 (George J. Bachrach ed., Am. Bar Ass'n 1990); George J. Bachrach & John V. Burch, *Ch. 23, The Surety's Subrogation Rights*, in THE LAW OF SURETYSHIP 419, 422 (Edward G. Gallagher ed., Am. Bar Ass'n 2d ed. 2000); Travelers Cas. & Sur. Co. of Am. v. Paderta, No. 10 C 0406, 2010 WL 5419065, at *3 (N.D. Ill. Dec. 23, 2010) (citing Am. Nat'l Bank & Trust Co. of Chi. v. Weyerhaeuser Co., 692 F.2d 455, 461-63 (7th Cir. 1982)) (listing elements); RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY §§ 27-31 (1996); RESTATEMENT OF SECURITY § 141 (1941).

79. Samuel J. Arena, Jr., et al., *Ch. 1, The Contract Bond Surety's Common Law Right to Equitable Subrogation—The Basics* in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 1, 7 (George J. Bachrach et al. eds., Am.

The elements are defined by contract law, even though subrogation is an equitable doctrine. Using the construction industry example to illustrate, with respect to the first three elements: (a) the bonded construction contract creates the principal's (builder) obligation to the obligee (project owner); (b) whether the principal has failed to perform and is in default is based on the rules of contract interpretation and the terms of the bonded contract; and (c) contract law and the law of contract damages as applicable to the terms of the bonded contract govern the rights of the obligee upon the principal's default and failure to perform.[80] The fourth element, performance by the surety pursuant to its suretyship, is also defined by the terms of the surety's suretyship undertaking as set forth in its bond (a contract) and the performance required of the principal pursuant to the bonded contract with the obligee.[81]

3. Parties to Whose Rights the Surety May Be Subrogated

When the four essential subrogation elements are present, *i.e.*, the principal's obligation to the obligee, the principal's failure to perform that obligation, the obligee's rights arising from the principal's failure, and the surety's performance of its principal's bonded obligations (the principal's obligations under the bonded contract, subcontract, or purchase order), the surety "steps into the shoes"[82] of the obligee, the principal, and any third-party payment bond claimants which the surety has paid. Pursuant to the surety's subrogation rights, the surety may enforce any rights that those parties possess.[83]

Bar Ass'n 2013) ("In the payment bond context, in addition to there being an obligation of the principal to the obligee and rights in the obligee arising from the principal's default and failure to perform, there is also an obligation of the principal to subcontractors and suppliers who may claim as third-party beneficiaries under the payment bond and, correspondingly, rights in those third-party beneficiary subcontractors and suppliers arising from the principal's failure to perform its payment obligations.").

80. *Id.*

81. *Id.* As Mr. Mungall has explained: "It might improve court understanding and analysis in this situation if sureties consistently presented their subrogation arguments in terms of these elements and the contract law principles applicable to them." Mungall Jr., *supra* note 78, at 3.

82. Lumbermens Mut. Cas. Co. v. United States, 654 F.3d 1305, 1312 (Fed. Cir. 2011).

83. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136-37 (1962); Fin. Sec. Assurance, Inc. v. Stephens, Inc., 500 F.3d 1276, 1287 (11th Cir. 2007); Lyndon Prop. Ins. Co. v. Duke Levy & Assocs., LLC, 475 F.3d 268, 270-71 (5th Cir. 2007); Cont'l Cas. Co. v. Am. Sec. Corp., 443 F.2d 649, 652

The Restatement of Suretyship sets forth the rights of the obligee to which the surety is subrogated.[84] The surety is also subrogated to the rights of the principal or of third-party beneficiaries under the surety's payment bond—subrogation rights that have long been recognized by the courts.[85]

a. Rights of the Obligee

The surety is subrogated to the rights of the obligee against the principal, against any other secondary obligors for the same underlying obligation (other sureties who may be liable), against any collateral that secures the principal's bonded obligation to the obligee (collateral held by the obligee to which the obligee has no continuing interest), and against any other persons whose conduct has made the principal and surety liable to the obligee with respect to the principal's default on the bonded obligation.[86]

In the construction contract bond context, the surety is subrogated to the obligee's rights against the principal, including the obligee's possession of the remaining contract funds under the construction contract[87] as well as the obligee's common law right of setoff[88] resulting

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(D.C. Cir. 1970); Trinity Universal Ins. Co. v. United States, 382 F.2d 317, 320 (5th Cir. 1967).

84. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 28 (1996).

85. *See, e.g., Pearlman*, 371 U.S. at 132 (principal); Nat'l Am. Ins. Co. v. United States, 498 F.3d 1301, 1306 (Fed. Cir. 2007) (principal); Nat'l Sur. Corp. v. United States, 118 F.3d 1542, 1546 (Fed. Cir. 1997) (principal); *In re* L.H. Duncan & Sons, 127 F.2d 640, 643 (3d Cir. 1942) (third-party beneficiary); *In re* Comcraft, 206 B.R. 551, 554 (Bankr. D. Or. 1997) (third-party beneficiary); Emp'rs Ins. Of Wausau v. Commonwealth Dep't of Transp., 865 A.2d 825, 830 (Pa. 2005) (third-party beneficiary).

86. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 28 (1996).

87. *In re* Modular Structures, Inc., 27 F.3d 72, 77 (3d Cir. 1994); Am. Fire & Cas. Co. v. First Nat'l City Bank, 411 F.2d 755, 758 (1st Cir. 1969); Cont'l Cas. Co. v. United States, 169 F. Supp. 945, 947 (Ct. Cl. 1959); City of New York v. Cross Bay Contracting Corp., 662 N.Y.S.2d 462, 465 (N.Y. App. Div. 1997), *rev'd in part, appeal dismissed in part*, 709 N.E.2d 459 (1999) (citing U.S. Fid. & Guar. Co. v. Triborough Bridge Auth., 74 N.E.2d 226, 227-28 (N.Y. 1947)).

88. *In re* Larbar Corp., 177 F.3d 439, 445-46 (6th Cir. 1999); Merritt Commercial Sav. & Loan, Inc. v. Guinee, 766 F.2d 850, 853 (4th Cir. 1985); *In re* U.S. Aeroteam, Inc., 327 B.R. 852, 864 (Bankr. S.D. Ohio 2005). *See also* Patrick J. O'Connor, Jr., *Ch. 3, The Surety's Rights of Restitution and Subrogation—Setoff Principles Under the Restatement of the Law (Third), Suretyship and Guaranty*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 23 (T. Scott Leo & Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005); Jarrod W. Stone, *Ch. 14, Common Obligee Theory and Other Setoff Rights—The*

from the principal's failure to perform. When the obligee has multiple sureties, the performing surety will be subrogated to the obligee's right to compel the non-performing surety to perform.[89]

The obligee may also have rights in contract or tort actions against other persons whose conduct has made those other persons liable to the obligee for the principal's default, such as claims against design professionals (like architects and engineers) to which the surety may be subrogated.[90] Such claims include contract claims,[91] the improper

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Surety's Subrogation Rights to the Obligee's or Principal's Setoff Rights, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 513 (George J. Bachrach, James D. Ferrucci, and Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

89. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 28 cmt. d (1996) (citing W. Coach Corp. v. Roscoe, 650 P.2d 449 (Ariz. 1982) (*en banc*)); Collins v. Throckmorton, 425 A.2d 146 (Del. 1980); Weitz v. Marram, 366 A.2d 86 (Md. Ct. Spec. App. 1976). *See also* Samuel J. Arena, Jr., *Ch. 7, Multiple Secondary Obligors: Cosuretyship & Subsuretyship Under the Restatement of the Law (Third), Suretyship & Guaranty*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 121, 125 (T. Scott Leo & Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

90. *See* Christopher R. Ward & Lawrence R. Moelmann, *Ch. 16, The Surety's Subrogation Rights Against Third Parties*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 611 (George J. Bachrach, James D. Ferrucci, and Dennis J. Bartlett eds., Am. Bar Ass'n 2013); Ronald F. Goetsch, Christopher R. Ward, & Patrick J. O'Connor, *Ch. 4, Deciding to Litigate: The Surety's Recourse Against Third Parties* and Patrick J. O'Connor, Jr., *Ch. 5, Deciding to Litigate: The Surety's Rights Against Property and Liability Insurers of the Obligee, Principal, and Subcontractors*, in MANAGING AND LITIGATING THE COMPLEX SURETY CASE 173, 259 (Philip L. Bruner & Tracey L. Haley eds., Am. Bar Ass'n 2d ed. 2007); James D. Ferrucci & Scott D. Baron, *Ch. 5, The Surety's Claims Against Third Parties*, in SALVAGE BY THE SURETY 209 (George J. Bachrach ed., 1998); Martha Crandall Coleman, *Design Professionals' Liability for Negligent Design and Project Management* (unpublished paper submitted at the ABA/TIPS Fidelity & Surety Law Committee program on Jan. 24, 1997, at the 1997 mid-winter meeting); Michael L. Chapman, *The Liability of Design Professionals to the Surety*, 20 FORUM 591 (1985); Martin J. Andrew, *Surety Recovery from the Architect or Engineer—Why Not?*, 8 FORUM 570 (1973).

91. Aetna Cas. & Sur. Co. v. Manshul Constr. Corp., No. 95 CIV 3994 LMM, 2001 WL 225043, *1 (S.D.N.Y. Mar. 6, 2001).

certification of payments,[92] the premature release of retainage,[93] negligent design,[94] negligent project administration,[95] and other claims.[96] The surety may also be subrogated to any claims the obligee may have against accountants and assignees.[97] Finally, the obligee may have claims against security provided by the principal in which the obligee no longer has a continuing interest.[98]

b. Rights of the Principal

The performing surety is subrogated to the rights of its defaulting principal against the obligee.[99] Such rights include the principal's rights under the

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92. Peerless Ins. Co. v. Cerny & Assocs., Inc., 199 F. Supp. 951, 954-55 (D. Minn. 1961); Westerhold v. Carroll, 419 S.W.2d 73, 80 (Mo. 1967).
93. Nat'l Sur. Corp. v. Malvaney, 72 So.2d 424, 429 (Miss. 1954).
94. Miller v. DeWitt, 208 N.E.2d 249, 296 (Ill. App. Ct. 1965).
95. Unity Tel. Co. v. Design Serv. Co., 201 A.2d 177, 181 (Me. 1964).
96. *Id.*; Lyndon Prop. Ins. Co. v. Duke Levy & Assocs., LLC, 475 F.3d 268, 270 (5th Cir. 2007) (breach of contract, breach of warranty, negligence); Aetna Ins. Co. v. Hellmuth, Obata & Kassabaum, Inc., 392 F.2d 472, 475 (8th Cir. 1968) (negligent supervision); *In re* Designed Ventures, Inc., 132 B.R. 677, 678-79 (Bankr. D.R.I. 1991) (negligent supervision, improper certification of payments); Acuity v. McGhee Eng'g, Inc., 297 S.W.3d 718, 733 (Tenn. Ct. App. 2008) (negligent misrepresentation, negligent preparation and issuance of plans and specifications, breach of contractual obligations to principal, and breach of obligations to surety).
97. Armen Shahinian & Scott D. Baron, *The Surety and Fidelity Insurers' Reliance Upon Accounting Professionals in Underwriting: Augmenting Salvage Prospects* (unpublished paper submitted at the Seventh Annual Northeast Surety and Fidelity Claims Conference on October 24, 1996); Michael R. Seidl, James L. Knoll, & Thomas A. Joyce, *A Surety's Guide for Claims Against Providers of Inaccurate Information* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 28, 1994); Jerome M. Joseph, *Sureties' Claims for Negligence Against Accountants, Design Professionals and Lenders*, 24 THE BRIEF 16 (No. 2, 1995); Ins. Co. of N. Am. v. Northampton Nat'l Bank, 708 F.2d 13, 15 (1st Cir. 1983).
98. Allen v. See, 196 F.2d 608, 610 (10th Cir. 1952); Bank of Wichitas v. Ledford, 151 P.3d 103, 115-16 (Okla. 2006); Bradford Partners II, L.P. v. Fahning, 231 S.W.3d 513, 518 (Tex. App.—Dallas 2007, no pet.); E. Quincy Servs. Dist. v. Gen. Accident Ins. Co. of Am., 105 Cal.Rptr.2d 694, 698 (Cal. Ct. App. 2001).
99. *See* Brett D. Divers & Brandon J. Held, *Ch. 3, The Parties' Rights to which the Contract Bond Surety is Subrogated*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 93 (George J. Bachrach, James D. Ferrucci, and Dennis J. Bartlett eds., Am. Bar Ass'n 2013); Nat'l Am. Ins.

bonded contract,[100] as well as the principal's mechanic's lien rights,[101] statutory rights,[102] and common law rights.[103] The surety may also be subrogated to the principal's claims against third parties such as design professionals, engineers, and assignees/lenders who caused or contributed to the principal's default[104] and to the principal's claims against its bonded contract subcontractors and suppliers (and their sureties).[105]

Co. v. United States, 498 F.3d 1301 (Fed. Cir. 2007). *See also* Armen Shahinian *et al.*, *Ch. 2, Deciding to Litigate: The Surety's Recourse Against Its Principals and Indemnitors*, in MANAGING AND LITIGATING THE COMPLEX SURETY CASE 115, 118-19 (Philip L. Bruner & Tracey L. Haley eds., Am. Bar Ass'n 2d ed. 2007); David W. Slaughter, *Ch. 1, Introduction to the Surety's Rights as the Foundation for the Indemnity Agreement*, in THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE 1, 21-22 (Marilyn Klinger, George J. Bachrach, and Tracey L. Haley eds., Am. Bar Ass'n 2d ed. 2008).

100. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 139 (1962); Nat'l Sur. Corp. v. United States, 118 F.3d 1542, 1544 (Fed. Cir. 1997); Cont'l Cas. Co. v. Am. Sec. Corp., 443 F.2d 649, 652 (D.C. Cir. 1970); Cincinnati Ins. Co. v. United States, 71 Fed. Cl. 544, 545 (Fed. Cl. 2006); *In re* Alcon Demolition, Inc., 204 B.R. 440, 449 (Bankr. D.N.J. 1997).

101. *See* Philip L. Bruner & Patrick J. O'Connor, Jr., 4A BRUNER & O'CONNOR ON CONSTRUCTION LAW § 12:100 n. 76 (2020 update) (citing Third Nat'l Bank in Nashville v. Highlands Ins. Co., 603 S.W.2d 730 (Tenn. 1980)).

102. Dole Co. v. Aetna Cas. & Sur. Co., 269 F. Supp. 72, 78 (D. Me. 1967). *See also* Harris County Flood Control Dist. v. Great Am. Ins. Co., 359 S.W.3d 736, 746 (Tex. App.—Houston [14th Dist.] 2011, pet. denied) ("[U]nder principles of equitable subrogation, a surety may be subrogated to the principal's tort and statutory claims.").

103. Fed. Ins. Co. v. Constructora Maza, Inc., 500 F. Supp. 246, 249 (D.P.R. 1979); Harris County Flood Control Dist., 359 S.W.3d at 746.

104. *See, e.g.,* Peerless Ins. Co. v. Cerny & Assocs., Inc., 199 F. Supp. 951 (D. Minn. 1961) (ruling that the surety could bring the obligee's claim for negligent supervision against the architect); Liberty Mut. Ins. Co. v. N. Picco & Sons Contracting Co., No. 05 Civ 217(SCR), 2008 WL 190310, *6-7 (S.D.N.Y. Jan. 16, 2008) (*mem. op.*) (holding that the surety could bring claims for breach of contract and negligence against the principal's "co-prime" contractors if the principal had had valid claims against those parties).

105. *See* Menorah Nursing Home, Inc. v. Zukov, 548 N.Y.S.2d 702 (N.Y. App. Div. 1989) (allowing claims by the surety against a subcontractor and the subcontractor's surety to the extent that the subcontractor caused the principal's default); Twin City Constr. Co. v. ITT Indus. Credit Co., 358 N.W.2d 716 (Minn. Ct. App. 1984); Fred S. Conrad Constr. Co. v. Cont'l Assurance Co., 215 So. 2d 45 (Fla. Dist. Ct. App. 1968).

c. Rights of Third-Party Claimants

Sureties may also be subrogated to claims asserted against the obligee or the principal by third-party beneficiaries under the surety's payment bond. Situations may arise where an unpaid subcontractor or material supplier may have a direct contract claim under a provision of its subcontract with the principal or the payment bond.[106]

For example, P (prime contractor/principal) contracts with O (government owner/obligee) to construct an addition to an interstate highway. S (surety) issues the requisite Miller Act payment bond,[107] which, by its terms, obligates S to pay P's subcontractors and suppliers in the event that P fails to promptly do so. P subcontracts with L (laborer) and C (concrete supplier) to provide labor and concrete to complete the highway addition. P fails to promptly pay L and C, so L and C make timely claims against the payment bond for amounts owed to them under the subcontracts. Pursuant to the bond's terms, S pays both L's and C's claims in full, and there are no other outstanding claims asserted against the payment bond by any other subcontractors or suppliers. S is thereby subrogated to the rights L and C would have had in the bonded contract funds to cover the amounts due to L and C, which S satisfied. This matters because S stands in the shoes of L and C, who would have had superior rights to the funds over P and O.[108] S is therefore subrogated to and thus may assert those superior rights to the remaining contract funds.

Other examples of third-party claims against the principal and obligee to which the surety may be subrogated include claims based on statutory trust fund rights, stop notice/withhold/direct payment rights pursuant to

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106. *See, e.g.,* Active Fire Sprinkler Corp. v. U.S. Postal Serv., 811 F.2d 747 (2d Cir. 1987); *In re* L.H. Duncan & Sons, 127 F.2d 640 (3d Cir. 1942). *See also* Sch. Bd. of Broward Cnty. v. J.V. Constr. Corp., No. 03-60005-CIV-MOR/GAR, 2004 WL 1304058, *17 (S.D. Fla. Apr. 23, 2004) (holding that in accordance with United States Supreme Court precedent, the surety was equitably subrogated to the claims of the "subcontractors, laborers, materialmen, and/or suppliers" to the extent that the surety had paid those claims).

107. The Miller Act specifically requires a contractor on a federal public works project to obtain a payment bond "for the protection of all persons supplying labor and material" under the contract. 40 U.S.C. § 3131(b)(2).

108. A performing payment bond surety stands in the shoes of the laborers and materialmen who might have had liens on the property. That right is generally superior to the rights of either the principal or the obligee. *See* Nat'l Fire Ins. Co. of Hartford v. Fortune Constr. Co., Inc., 320 F.3d 1260, 1276 (11th Cir. 2003).

state law, and subcontractors' mechanic's liens.[109] Additionally, the surety may be subrogated to third-party bond claimants' tort and contract claims.

4. Equitable Subrogation Illustrated in Common Priority Disputes.

As discussed in the preceding Parts 1, 2, and 3 *supra*, a surety's subrogation rights arise upon its principal's default. The nature and scope of a surety's equitable subrogation rights are well illustrated in priority disputes that commonly arise with bonded contracts in the construction industry. The bond principal has promised to complete construction for the project owner. The project owner has promised to pay the principal for these construction services. These monies are "bonded contract funds." The surety bond provides assurance or guarantees to the obligee/project owner that it will receive the principal's agreed performance.

Upon the default of the principal, numerous parties may assert claims against the bonded contract funds in the hands of the obligee/project owner. In competing with the claims of others to the remaining contract funds, the surety may utilize its subrogation rights to the rights of others to obtain priority in the payment of the remaining bonded contract funds.[110] The following subsections provide a synopsis of the types of claimants who seek to obtain the remaining contract funds in opposition to the surety performing under its performance bond or payment bond.

a. Surety v. Obligee

The surety's subrogation rights come into play when the obligee admits that the bonded contract funds are owed under the terms of its bonded contract with the principal, *but* the obligee claims to have a superior right to those bonded contract funds based upon its own claims or the claims of others against the principal.[111]

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109. *See* Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., 960 F.2d 366, 373-74 (3d Cir. 1992) (statutory trust fund rights); State of Ohio *ex rel.* Star Supply, Div. of Star Indus. v. City of Greenfield, 528 F. Supp. 955 (S.D. Ohio 1981) (stop notice/withhold/direct payment rights pursuant to state law); RLI Ins. Co. v. N.Y. State Dep't of Labor, 766 N.E.2d 934 (N.Y. 2002) (statutory trust fund rights); Golden Eagle Ins. Co. v. First Nationwide Fin. Corp., 31 Cal. Rptr. 2d 815 (Cal. Ct. App. 1994) (subcontractor's mechanic's lien).

110. George J. Bachrach & John V. Burch, *Ch. 23, The Surety's Subrogation Rights*, in THE LAW OF SURETYSHIP 419, 433 (Edward G. Gallagher ed., Am. Bar Ass'n 2d ed. 2000).

111. *See* George J. Bachrach & Cynthia E. Rodgers-Waire, *Ch. 4, The Performance Bond Surety's Rights to the Contract Funds*, in THE LAW OF

Two examples frequently arise. First, the obligee may attempt to set off against the remaining contract funds amounts owed to the obligee by the principal on other contracts or obligations between the obligee and the principal. Where the surety is a performance bond surety, the obligee may not exercise its setoff rights against the remaining contract funds.[112] On the other hand, with a payment bond surety, the obligee has been able to exercise its setoff rights.[113]

A second example is the obligee that is also a government taxing authority attempting to set off against the remaining contract funds certain taxes due and owing by the principal to the government obligee.[114] Where the surety performs the contract and incurs losses under its performance bond, the government obligee has not been successful in setting off against the remaining contract funds the amounts of those taxes due from the principal.[115] However, in a case at the heart of great debate, the government obligee was able to set off its tax claims against the remaining contract funds where the losses incurred by the surety were under its payment bond.[116]

PERFORMANCE BONDS 161 (Lawrence R. Moelmann, Matthew M. Horowitz, and Kevin L. Lybeck eds., Am. Bar Ass'n 2d ed. 2009).

112. Sec. Ins. Co. of Hartford v. United States, 428 F.2d 838, 842 (Ct. Cl. 1970); U.S. Fid. & Guar. Co. v. Mo. Highway & Transp. Comm'n 783 S.W.2d 516, 519 (Mo. Ct. App. 1990) (principal's obligation in an unrelated condemnation proceeding); Miller-Stauch Constr. Co. v. Williams-Bungart Elec., Inc., 959 S.W.2d 490, 494 (Mo. Ct. App. 1998).

113. Aetna Cas. & Sur. Co. v. United States, 526 F.2d 1127 (Ct. Cl. 1975); Guarantee Co. of North America v. Tandy & Allen Constr. Co., 184 A.2d 426 (N.J. Super. Ct. App. Div. 1962). *United States v. Munsey Trust Co.*, 332 U.S. 234 (1947) is the leading case distinguishing the rights of the surety performing under its performance bond and paying under its payment bond. The distinction has been criticized. *See* Daniel Mungall, Jr., *Ch. 1, The Subrogation Rights of the Contract Bond Surety—Some Basics*, in SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY 1 (George J. Bachrach ed., Am. Bar Ass'n 1990).

114. Bachrach & Burch, *supra* note 78, at 434.

115. Security Ins. Co. of Hartford v. United States, 428 F.2d 838 (Ct. Cl. 1970); Trinity Universal Ins. Co. v. United States, 382 F.2d 317 (5th Cir. 1967); U.S. Fid. & Guar. Co. v. Missouri Highway & Transp. Comm'n 783 S.W.2d 516 (Mo. Ct. App. 1990) (surety financing principal).

116. *Munsey Trust Co.*, 332 U.S. at 234; U.S. Fid. & Guar. Co. v. United States, 475 F.2d 1377 (Ct. Cl. 1973); Fireman's Fund Ins. Co. v. United States, 362 F. Supp. 842 (D. Kan. 1973); Daniel Mungall, Jr., *The Buffeting of the Subrogation Rights of the Construction Contract Bond Surety by US v. Munsey Trust Co.*, 46 INS. COUNS. J. 607 (1979); Daniel Mungall, Jr., *The Subrogation Rights of the Contract Bond Surety—Some Basics,* in

b. Surety v. Principal

Less commonly, the surety must compete against its own principal for the remaining contract funds.[117] The surety, who may have completed the work of the principal or paid bills of the laborers and suppliers on the bonded project, claims the remaining contract funds pursuant to its subrogation rights to the rights of the laborers and material suppliers against the principal and to the rights of the obligee holding the remaining contract funds.[118]

Where the surety has paid labor and material claimants in excess of the remaining contract funds, it is entitled to the remaining contract funds ahead of the principal.[119] Where the surety makes advances to the principal to pay for labor and materials for which the principal is unable to pay, the surety does not become a "volunteer" as a result of the advances because it has a legal obligation to perform the contract and pay claims for labor and material on the bonded contract; and, as a result, the surety is entitled to the remaining contract funds.[120] However, if the bonded contract is completed at a profit, the principal may be entitled to that profit and not the surety.[121]

c. Surety v. Trustee in Bankruptcy/Debtor in Possession ("Debtor")

Before the Bankruptcy Code[122] was enacted in 1978, there was the Bankruptcy Act. In the seminal case under the old Bankruptcy Act, the Supreme Court found that the surety who paid the claims of the bankrupt principal's laborers and materialmen has priority to the contract funds retained by the government obligee as against the claims of the bankrupt principal's trustee.[123] The Supreme Court held that:

SUBROGATION RIGHTS OF THE CONTRACT BOND SURETY (George J. Bachrach ed., Am. Bar Ass'n 1990).

117. Bachrach & Burch, *supra* note 78, at 436.
118. *Id.* at 436-37.
119. Continental Cas. Co. v. American Sec. Corp., 443 F.2d 649, 652 (D.C. Cir. 1970); Home Indemnity Co. v. United States, 313 F. Supp. 212 (W.D. Mo. 1970); Hanover Ins. Co. v. United States, 279 F. Supp. 851 (S.D.N.Y. 1967); *In re* Alcon Demolition, Inc., 204 B.R. 440 (Bankr. D.N.J. 1997); *In re* Four Star Constr. Co., 151 B.R. 817 (Bankr. N.D. Ohio 1993).
120. Massachusetts Bonding & Ins. Co. v. Fago Constr. Corp., 82 F. Supp. 619 (D. Md. 1949).
121. U.S. Fid. & Guar. Co. v. Worthington & Co., 6 F.2d 502 (5th Cir. 1925).
122. 11 U.S.C. § 101.
123. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 141-42 (1962).

> the [obligee] had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.[124]

Thus, *Pearlman* held that the remaining contract funds were subject to the surety's equitable lien and not property of the estate under the Bankruptcy Act. Section 541 of the Code was subsequently adopted, which significantly expands the definition of property of the estate to include all legal and equitable interests of the debtor.[125] The surety's equitable lien on the remaining contract funds as a result of the surety's performance of the work and payment of claimants supplying labor and materials relates back to the date of the bond[126] and gives the surety priority over the debtor to the remaining contract funds.[127]

Because the surety's subrogation rights relate back to the date of the bonds,[128] post-petition payments by the surety as a result of claims against its bonds executed pre-petition do not allow the debtor to intervene and claim the contract funds as a hypothetical lien creditor under § 544 of the Code.[129] Furthermore, the surety's payment of those claims post-petition is not a violation of the automatic stay.[130] The surety has defeated the trustee's claims of preference under § 547 of the Code because of its equitable lien on the contract funds pursuant to its subrogation rights.[131] Finally, a performance bond surety completing multiple projects for the same obligee at a loss is subrogated to the obligee's common law setoff rights on those other projects completed at a "profit" because allowing

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124. *Id.*
125. *In re* Alliance Properties, Inc., 104 B.R. 306, 312 (Bankr. S.D. Cal. 1989).
126. *In re* Ward Land Clearing & Drainage, Inc., 73 B.R. 313, 315 (Bankr. N.D. Fla. 1987).
127. *In re* Glover Constr. Co., 30 B.R. 873, 882 (Bankr. W.D. Ky. 1983). In fact, the surety is subrogated to the debtor's rights to the remaining contract funds in the hands of the obligee and may obtain the remaining contract funds ahead of the debtor. *In re* Alcon Demolition, Inc., 204 B.R. 440, 447 (Bankr. D.N.J. 1997); *In re* Four Star Constr. Co., 151 B.R. 817, 820-21 (Bankr. N.D. Ohio 1993).
128. *In re* Massart Co., 105 B.R. 610, 612 (W.D. Wash. 1989); *In re* Alliance Props., Inc., 104 B.R. 306, 311 (Bankr. S.D. Cal. 1989); *In re* Pac. Marine Dredging & Constr., 79 B.R. 924, 929 (Bankr. D. Or. 1987).
129. *In re* Pacific Marine Dredging, 79 B.R. at 928.
130. 11 U.S.C. § 362(a)(4).
131. *In re* E.R. Fegert, Inc., 88 B.R. 258, 260-61 (Bankr. 9th Cir. 1988). *See also* Newberry Corp. v. Fireman's Fund Ins. Co., 106 B.R. 186 (D. Ariz. 1989).

setoff under § 553 of the Code serves as an incentive for sureties to complete their performance bond obligations.[132]

d. Surety v. Third-Party Claimants

"In the ordinary case, a court is not confronted with a priority dispute involving the subcontractors because the surety usually pays the subcontractors' claims pursuant to the payment bond."[133] When the principal's subcontractors and suppliers under a payment bond are not paid by the surety for various reasons, these claimants compete with the surety and assert an equitable interest in the remaining bonded contract funds in order to defeat the surety's claim to the bonded contract funds through the surety's assertion of its subrogation rights.[134]

Where the surety completed the performance of the contract at a cost in excess of the remaining contract funds and had also deposited the full amount of the payment bond with the court, the surety was subrogated to the rights of the government obligee to the remaining contract funds even though the payment bond did not fully compensate all of the claimants.[135] Where a claimant failed to timely file a claim against the payment bond and the payment bond was sufficient to pay the claimant's claim in full, the unpaid claimant lost any equitable interest it might have had in the remaining contract funds.[136] The claimant was reduced to the status of a general creditor of the principal, and as between the claimant and the surety, which had paid timely claims against the payment bond, the surety was entitled to the remaining contract funds.[137]

However, other cases have required the surety to show it fully paid the claimants' claims arising out of the bonded contract before the surety can share in the remaining contract funds ahead of those claimants.[138] If the surety is not required to make any payments on the performance bond and

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132. *In re* Larbar Corp., 177 F.3d 439, 447 (6th Cir. 1999).
133. United States v. TAC Constr. Co., 760 F. Supp. 590, 594 (S.D. Miss. 1991).
134. Lawrence Lerner, *Ch. 9, The Surety v. Third Party Beneficiaries Under the Surety's Payment Bonds (Payment Bond Claimants)*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 331, 332 (George J. Bachrach, James D. Ferrucci, and Dennis J. Bartlett eds., Am. Bar Ass'n 2013); Bachrach & Burch, *supra* note 78, at 437.
135. Covenant Mut. Ins. Co. v. Able Concrete Pump, 609 F. Supp. 27, 31 (N.D. Cal. 1984).
136. Gen. Acrylics v. U.S. Fid. & Guar. Co., 623 P.2d 839, 844-45 (Ariz. Ct. App. 1980).
137. *Id.*
138. United States v. TAC Constr. Co., 760 F. Supp. 590, 594 (S.D. Miss. 1991); Active Fire Sprinkler Corp. v. U.S. Postal Serv., 811 F.2d 747, 756 (2d Cir. 1987); N. Denver Bank v. United States, 432 F.2d 466, 473 (Ct. Cl. 1970).

pays the full penal sum of the payment bond, and if the payment bond is insufficient to cover all of the claimants' claims, the claimants' rights to the remaining contract funds are superior to the surety's.[139]

Finally, a surety who pays the claimants' claims up to the full penal sum of the payment bond, but not all of the claims covered by the payment bond, is subordinate to the claimants' rights and may not share in an insolvent principal's assets by reason of the payments until the claimants' covered payment bond claims are first paid in full.[140]

e. Surety v. Assignee/Lender ("Bank")

Courts have uniformly held that the surety's subrogation right to the remaining contract funds is not a security interest requiring perfection under the Uniform Commercial Code ("UCC").[141] As a result, the courts have held that the surety completing the contact under its performance bond[142] and the surety paying persons supplying labor and materials to the project under its payment bond[143] have priority to the remaining contract

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139. U.S. Fid. & Guar. Co. v. United States, 475 F.2d 1377, 1381 (Ct. Cl. 1973).
140. Am. Sur. Co. of N.Y. v. Westinghouse Elec. Mfg. Co., 296 U.S. 133, 137 (1935); Am. Sur. Co. of N.Y. v. Sampsell, 148 F.2d 986, 987 (9th Cir. 1945). *But see* Covenant Mut. Ins. Co. v. Able Concrete Pump, 609 F. Supp. 27, 32 (N.D. Cal. 1984) (surety subrogated to rights of government to remaining contract funds even though payment bond did not make all payment bond claimants whole).
141. *In re* Alcon Demolition, Inc., 204 B.R. 440, 446 (Bankr. D.N.J. 1997); *In re* Comcraft, Inc., 206 B.R. 551, 554 (Bankr. D. Or. 1997); Home Indem. Co. v. United States, 433 F.2d 764, 765 (Ct. Cl. 1970); Nat'l Shawmut Bank of Boston v. New Amsterdam Cas. Co., 411 F.2d 843, 845 (1st Cir. 1969); Transamerica Ins. Co. v. Barnett Bank of Marion Cnty., N.A., 540 So.2d 113, 117 (Fla. 1989); Fin. Co. of Am. v. U.S. Fid. & Guar. Co., 353 A.2d 249, 253 (Md. 1976); Argonaut Ins. Co. v. C & S Bank of Tifton, 232 S.E.2d 135, 140 (Ga. Ct. App. 1976); Jacobs v. Ne. Corp., 206 A.2d 49, 54-55 (Pa. 1965). A different rule would apply if the surety attempts to use its subrogation rights to acquire priority in the principal's personal property other than the remaining contract funds (inventory, equipment, etc.) over a bank, which has a perfected security interest under the UCC in that property. Aetna Cas. & Sur. Co. v. J.F. Brunken & Son, Inc., 357 F. Supp. 290, 292 (D.S.D. 1973); State Bank & Trust Co. v. Ins. Co. of the W., 132 F.3d 206, 208 (5th Cir. 1997).
142. Prairie State Nat'l Bank v. United States, 164 U.S. 227, 239 (1896); Industrial Bank of Wash. v. United States, 424 F.2d 932, 934 (D.C. Cir. 1970); Alaska State Bank v. Gen. Ins. Co. of Am., 579 P.2d 1362, 1368 (Alaska 1978).
143. Henningsen v. U.S. Fid. & Guar. Co., 208 U.S. 404, 404-05 (1908); Riverview State Bank v. Wentz, 34 F.2d 419, 421-22 (8th Cir. 1929); Mid-

funds over the claims of the bank under its perfected security interest. The completing surety under its performance bond has rights to the remaining contract funds superior to those of the bank even though the proceeds of the bank's loan to the principal were used to pay laborers and materialmen to whom the surety would have otherwise been liable.[144] A surety does not waive its subrogation rights to the remaining contract funds even if it perfects a security interest in the contract funds because assignment rights are independent from subrogation rights.[145]

A surety is subrogated to the obligee's rights and can exercise those rights to apply the remaining contract funds to completing the construction contract and paying laborers and material suppliers.[146] The obligee does not owe any contract funds to the principal until the obligations owed to the obligee and to the laborers and material suppliers are satisfied.[147] The principal's bank, whose security interest attaches only to the principal's rights in property, is therefore subject to the surety's superior rights.[148] Furthermore, the surety's subrogation rights relate back to the date that the bonds are executed to defeat the claims of the bank whose rights to the contract funds only arise through the principal and upon the completion of the work.[149]

Banks have been held to be on notice of the surety's subrogation rights.[150] Where the principal is in default under the construction contract

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Continent Cas. Co. v. First Nat'l Bank & Trust Co. of Chickasha, 531 P.2d 1370, 1376-77 (Okla. 1975); Fed. Ins. Co. v. Cmty. State Bank, 905 F.2d 112, 115-16 (5th Cir. 1990) (surety prevailed even though payment bond claimants did not perfect their mechanic's lien rights).

144. *Nat'l Shawmut*, 411 F.2d at 847; Union Indem. Co. v. New Smyrna, 130 So. 453, 455 (Fla. 1930); State *ex rel.* S. Sur. Co. v. Schlesinger, 151 N.E. 177, 178-79 (Ohio 1926).

145. Old Kent Bank-Se. v. City of Detroit, 444 N.W.2d 162, 165 (Mich. Ct. App. 1989).

146. Fin. Co. of Am. v. U.S. Fid. & Guar. Co., 353 A.2d 249, 252 (Md. 1976).

147. *In re* Modular Structures, Inc., 27 F.3d 72, 75 (3d Cir. 1994); Centex-Simpson Constr. Co. v. Fid. & Deposit Co. of Md., 795 F. Supp. 35, 39 (D. Me. 1992).

148. *Nat'l Shawmut*, 411 F.2d at 848.

149. Prairie State Nat'l Bank v. United States, 164 U.S. 227, 232 (1896); Pembroke State Bank v. Balboa Ins. Co., 241 S.E.2d 483, 484-85 (Ga. Ct. App. 1978); Interfirst Bank Dallas, N.A. v. U.S. Fid. & Guar. Co., 774 S.W.2d 391, 397-99 (Tex. App.—Dallas 1989, writ denied); Third Nat'l Bank in Nashville v. Highlands Ins. Co., 603 S.W.2d 730, 734 (Tenn. 1980).

150. Standard Accident Ins. Co. of Detroit v. Fed. Nat'l Bank of Shawnee, 112 F.2d 692, 695 (10th Cir. 1940); Nat'l Sur. Corp. v. United States, 133 F.

prior to the payment of the progress payment and the bank is aware of the default, the surety is entitled to obtain from the bank the progress payment received by the bank.[151] Additionally, where the bank received the contract funds with notice of the principal's default, the bank is not entitled to offset debts owed to it by the contractor that are unrelated to the construction contract.[152]

f. Surety v. Taxing Authorities Other than the Obligee

Whether the surety is a performance bond surety completing the contract of its principal[153] or the surety has paid the claims of laborers and materialmen under its payment bond,[154] the surety will prevail over the tax lien rights of the taxing authority to the remaining contract funds because the taxing authority can only claim those contract funds that the principal is entitled to receive.[155] The surety's subrogation rights arise at the time it gives the bond, and the rights become available to the surety when it suffers a loss.[156] Therefore, the surety's subrogation rights are superior to a government tax lien for unpaid taxes, which arises after the date of the bond but occurs prior to the date that the surety actually makes payment.[157]

Supp. 381, 384-85 (Ct. Cl. 1955); Royal Indem. Co. v. United States, 93 F. Supp. 891, 894 (Ct. Cl. 1950).

151. Ins. Co. of N. Am. v. Northampton Nat'l Bank, 708 F.2d 13, 15 (1st Cir. 1983); Travelers Indem. Co. v. W. Ga. Nat'l Bank, 387 F. Supp. 1090, 1094 (N.D. Ga. 1974).
152. Fed. Ins. Co. v. Fifth Third Bank, 867 F.2d 330, 334-36 (6th Cir. 1989); Pac. Indem. Co. v. Grand Ave. State Bank of Dallas, 223 F.2d 513, 518-19 (5th Cir. 1955); Cent. Nat'l Ins. Co. v. Tri-Cnty. State Bank, 823 F. Supp. 652, 657 (D. Minn. 1993).
153. Cent. Sur. & Ins. Corp. v. Martin Infante Co., 272 F.2d 231, 233 (3d Cir. 1959) (performing surety financed the principal); Aetna Cas. & Sur. Co. v. Port of N.Y. Auth., 182 F. Supp. 671, 673 (S.D.N.Y. 1960) (surety had priority against retainage and upon portion of a bonus for early substantial completion).
154. Fid. & Deposit Co. of Md. v. NY. City Hous. Auth., 241 F.2d 142, 144 (2d Cir. 1957); Fid. & Cas. Co. of N.Y. v. Dykstra, 208 F. Supp. 717, 722 (D. Minn. 1962); Atl. Ref. Co. v. Cont'l Cas. Co., 183 F. Supp. 478, 485 (W.D. Pa. 1960); U.S. Fid. & Guar. Co. v. Triborough Bridge Auth., 74 N.E.2d 226, 227-28 (N.Y. 1947).
155. *Compare* Amwest Sur. Ins. Co. v. United States, 870 F. Supp. 432 (D. Conn. 1994), *with* Capitol Indem. Corp. v. United States, 41 F.3d 320 (7th Cir. 1994); *In re* Constr. Alternatives, Inc., 2 F.3d 670 (6th Cir. 1993).
156. *Triborough Bridge Auth.*, 74 N.E.2d at 227.
157. U.S. Fid. & Guar. Co. v. United States, 201 F.2d 118, 121 (10th Cir. 1952).

One issue that may affect priority to the remaining contract funds as between the surety and the taxing authority is whether the principal is in default.[158] However, all that is necessary for the surety's subrogation rights and equitable lien to attach to the remaining contract funds is for the principal to be in default as a matter of fact such that the surety has become obligated to pay subcontractors, laborers, and materialmen under its payment bond. In that instance, formal notice of default need not be given to the surety before its subrogation rights accrue against the remaining contract funds.[159]

g. *Surety v. General Creditors of the Principal, Including Judgment Creditors*

A surety may compete for the remaining contract funds on a contract bonded by the surety with general creditors of the principal who are not claimants under any contract bonded by the surety.[160]

Similar to the surety's competition with the tax lien of a taxing authority other than the obligee, whether the surety has performed under its performance bond or payment bond, the surety's subrogation rights to the remaining contract funds are superior to those of general creditors even where the remaining contract funds had been attached by general creditors first.[161] Where the surety completed the performance of the contract at a cost greater than the remaining contract funds and had deposited the full amount of the payment bond with the court, the surety was subrogated to the rights of the government obligee to the remaining contract funds even though the payment bond did not fully compensate all of the payment bond claimants, who then became general creditors of the principal.[162]

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158. One court has held that that the surety has priority over the taxing authority's liens filed after the principal is in default but not as to any tax liens filed before the principal is in default. Int'l Fid. Ins. Co. v. United States, 949 F.2d 1042, 1047 (8th Cir. 1991).
159. Kansas City v. Tri-City Constr. Co., 666 F. Supp. 170, 172 (W.D. Mo. 1987).
160. A general creditor may also include a subcontractor claimant who has failed to file a timely claim against the surety's payment bond. Gen. Acrylics v. U.S. Fid. & Guar. Co., 623 P.2d 839, 844-45 (Ariz. Ct. App. 1980).
161. Int'l Fid. Ins. Co. v. Ashland Lumber Co., Inc., 463 S.E.2d 664, 667-68 (Va. 1995); Segovia Dev. Corp. v. Constructora Maza, Inc., 628 F.2d 724, 729-30 (1st Cir. 1980); Stehle v. United Sur. Co., 68 A. 600, 602 (Md. 1908).
162. Covenant Mut. Ins. Co. v. Able Concrete Pump, 609 F. Supp. 27, 32 (N.D. Cal. 1984).

In states that have enacted trust fund statutes, all contract funds received by the principal must be held in trust for the benefit of the laborers and materialmen protected by the trust find statute *and* the surety to the extent that the surety pays the laborers and materialmen, and such contract funds may not be allocated or disbursed to general creditors of the principal.[163]

163. Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters., Inc., 960 F.2d 366, 371 (3d Cir. 1992).