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SURETYSHIP-APPLICATION OF PAYMENTS FROM PRINCIPAL TO CREDITOR-EQUITY OF SURETY IN BUILDING CONTRACT FUNDS

SURETYSHIP—APPLICATION OF PAYMENTS FROM PRINCIPAL TO CREDITOR—EQUITY OF SURETY IN BUILDING CONTRACT FUNDS.—A building contractor's bond, with professional surety, promises to see that all laborers and materialmen assisting upon a certain construction job are fully paid. With moneys received from work upon this building, the contractor pays a certain sum to a materialman without applying it to any particular debt. The contractor owes the materialman upon two separate debts: one for materials furnished upon this very job, and covered by this surety bond; and a pre-existing debt, in no way connected with the present contract. Is the surety able to insist that the materialman use this payment to discharge the debt on which he is surety, or may the contractor apply it to the former debt, and later hold the surety for materials furnished on this building?

It is well established that if a debtor upon making payment to a creditor fails to designate which items of the debt shall be thereby discharged, the creditor may at the time of receiving the payment, apply it to any portion of the debt which he pleases.[1] Moreover, the fact that there is a surety for one of the debts, will not of itself entitle the surety to insist that the creditor discharge the assured debt, rather than one upon which there is no surety.[2] Should the additional fact that the surety has some interest or equity in the funds with which the debtor makes payment, furnish an exception to this rule, and allow the surety to insist that at least such payments shall be used to discharge the assured debt?

On analysis we find three distinct and conflicting interests emerging from this problem, so that in order to reach a solution we must weigh and reconcile not only the interests of the surety and the creditor, but as well the interest of the public in maintaining efficient commercial machinery. Because many of the courts have failed to appreciate all of these competing interests, and have stressed unduly the one or the other, the results of the cases are in hopeless conflict. But they may be said to fall into two main classes, as they either (1) allow the surety to apply and control such payments, or (2) refuse him the right to do so. We will consider each in turn.

(1) Those cases which allow application are among themselves divided into two groups, the first of which (a) allows application by the surety in every case, while the second (b) allows application only where the creditor is put on guard through knowledge of the source of payment, and of the existence of the surety relation.

(a) Those cases which allow application by the surety regardless of knowledge on the part of the creditor seem to lay an unnatural stress upon the equitable interest of the surety.[3] These courts seem to feel that to decide for the creditor would force the surety to stand by and see moneys used to discharge the debts of another, which should be properly used to wipe away the contract obligations upon which the surety may ultimately be held. On the other hand there is no particular hardship in insisting that the creditor discharge the assured debt, since all are equally deserving, and the creditor will receive the full value of the payment in any case. The courts feel that each building contract should be made to support itself, so that the money paid on a certain contract should wipe away the very obligations incurred thereunder.[4]

(b) A second group of cases refuses to allow the surety to direct application of the payments unless the creditor knew the source of the funds and

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[1]WILLISTON, CONTRACTS, sec. 1804.

[2]*Ibid.*

[3]Crane Co. v. Pac. Heat and Power Co., 36 Wash. 95, 78 Pac. 460; Columbia Digger Co. v. Rector et al, 215 Fed. 618; Columbia Digger Co. v. Sparks, 227 Fed. 780; Sioux City Foundry v. Merten, 174 Ia. 332, 156 N.W. 367.

[4]The Columbia Digger Case, supra, the leading case favoring this view, relies on the Crane case, supra; but the Washington court which decided the Crane case, later changed its ground, (see Sturtevant case, infra) and held, contrary to the language in the Crane case, that the surety could not apply payments unless the creditor had knowledge of the surety's equity.

the existence of the suretyship.[5] These cases, undertaking a deeper analysis, recognize that the question as to the right of the creditor to apply usually arises some time after application has actually been made; and that there may be considerable hardship in forcing a creditor who has accepted money from his debtor with no knowledge of any equity in favor of third persons, to make a new application. For by this first application he may have released sureties or collateral security, or have lost the chance to enforce a mechanic's lien; and a debt once adequately secured and collectible will now be worthless, since in these cases the contractor is usually insolvent. These courts seem to feel that the surety's interest is analagous to that of the *cestui* in a constructive trust, in which the contractor is in the position of the trustee, and the contract funds comprise the trust *res*. So, following the analogy (although no court has suggested that this constitutes a true constructive trust), the surety's interest in the fund is protected, unless cut off by bona fide purchase.[6]

(2) Over against these two groups of cases is another, which seems to be receiving the support of the courts more and more. This line of cases holds that the surety can never have a right to insist on application,—not even where the creditor had full knowledge of the source of payment and of the surety relation.[7] Although this rule at first glance seems to give the creditor who knows all the facts an unnecessarily harsh advantage over the surety, it is really both reasonable and fair.

(a) We have already suggested the hardship which may be imposed upon the creditor if we insist that he make a new application of his payment more favorable to the surety. He must revive a debt once considered discharged, on which he may have released his security, or lost his chance to collect through a mechanic's lien, or by a suit against the contractor at a time when collection would have been possible.

Moreover it is clear that the contractor might have used the contract money, which is his under the law, to pay for a newly purchased automobile, whether the vendor knew of the source of the funds or not.[8] And a mere prior debtor whose debt was unrelated to this contract might have been paid

[5]Sturtevant Co. v. Fidelity & Deposit Co., 92 Wash. 52, 158 Pac. 740; Puget Sound State Bank v. Gallucci, 82 Wash. 445, 144 Pac. 698; Chicago Lumber Co. v. Douglas, 89 Kan. 308, 131 Pac. 563; Thacker v. Bullock Lumber Co., 140 Ky. 463, 131 S.W. 271; Salt Lake City v. O'Connor (Utah 1926) 249 Pac. 810, noted in 25 MICH. L. REV. 556.

[6]Perhaps when the exact question is presented, some of these courts will go further; for example, the Utah court which in Salt Lake City v. O'Connor, supra, held that where the creditor had no knowledge of the suretyship, the surety could not direct application, might go further, and say, even if there were such knowledge the surety's equity would be ignored.

[7]Peoples v. Powers, 108 Mich. 339, 66 N.W. 215; Grace Harbor Lumber Co. v. Ortman, 190 Mich. 429, 157 N.W. 96; Jefferson v. Church of St. Mathew, 41 Minn. 392; Standard Oil Co. v. Day, 161 Minn. 281, 201 N.W. 410; Sampson v. Commonwealth, 208 Mass. 372, 94 N.E. 473; Radichel v. Federal Security Co. 170 Minn. 92, 212 N.W. 171; see Bross v. McNicholas, 66 Or. 42, 133 Pac. 782. The recent N. J. case of Grover v. Board of Education, (1928 N. J. Chan.) 141 Atl. 81; is directly in support of this view.

[8]WILLISTON CONTRACTS, Sec. 1806.

off with contract funds regardless of his knowledge.[9] Why should a creditor stand in a worse position because there are two debts rather than one? If the contractor may so apply the fund, though he owes the surety at least a moral duty to see that the contract proceeds are used for his benefit, why should not a creditor have as much right *a fortiori*? The contractor has knowledge of all material facts in every case; why then should knowledge prejudice the creditor?

(b) The public is in a sense interested in this problem. In order to promote industrial and commercial welfare we must have a medium of exchange, readily circulable, which can be safely accepted in discharge of obligations. The courts have gone to some lengths to secure this exchangeability, not only for money, but for negotiable bills and notes as well. Limitations on the free use of money tend to cripple our commerce, and should be avoided, unless clearly necessary.

And to insist that a creditor having certain knowledge as to the source of a payment must very carefully apply it to just this debt or that, at the risk of having such payment set aside, when there is no trust,—when only the feeblest of equities exists in favor of the surety—when the debtor himself could have applied the payment as he pleased—lays a heavy and undesirable burden on the use of money in commercial transactions.

(c) Although it is true that most of the cases we have considered[10] have involved professional sureties, against whom special arguments are available, we feel that the above considerations apply with equal force to the amateur surety, that he too should be denied any right of application. But as to the case of the property owner who, upon engaging a contractor to build for him, must become a surety in that his premises may be charged with payment of materialmen through a mechanic's lien, we come to no decision, since special considerations make this case distinct.[11]

Against the professional surety, two additional arguments have influenced the courts. The surety who makes suretyship his business, demanding a reasonable compensation for the risks he assumes, who enters every contract for profit, and with his eyes open, has every opportunity to protect himself. He can avoid all difficulty at the very outset by refusing to assure a contractor who is already in debt from previous jobs. Surety companies try to avoid such contracts, and inquire carefully into the financial status of each contractor before signing his bond. And if a creditor to whom the contractor owes money at the time states that the contractor is out of debt, the creditor will be estopped to set up such debt as against the surety.[12] And even where the contractor already owes money, the surety can avoid all difficulty by insisting that the owner make all payments to the contractor and surety jointly, thus preventing any use of contract funds without the surety's approval.

Secondly, the surety as quasi-insurer, is the one who should stand any risk which may arise, if the equities are equal. We have come to appreciate

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[9]Fidelity and Deposit Co. v. Union State Bank, 21 F. (2d) 102; see also, Seattle Dock Co. v. Pacific Surety Co., 86 Or. 85, 167 Pac. 510.

[10]See supra notes 3, 5, and 7.

[11]See note on this point, L. R. A., 1916D, 1254.

[12]U. S. v. American Bonding and Trust Co., 89 Fed. 921.

the fact that specialization is economically efficient; and like insurance companies and speculators in futures, surety companies can only refute the argument against their unproductivity, by the fact that they serve to gauge and absorb commercial risks which would prove disastrous to the producer himself. So it is more fitting to let the surety company bear the burden of any occasional loss.

From all these considerations, it seems that the bonded building contract furnishes no exception to the usual rule of contracts, that the mere existence of a surety upon one obligation, will not deprive the creditor of his right to apply an unqualified payment by his debtor to any obligation he pleases.

J. A. S.