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PRINCIPAL AND SURETY- RIGHT OF SURETY ON BUILDING CONTRACT TO BE SUBROGATED TO FUNDS IN OWNER'S HANDS AS AGAINST RIGHT OF BANK THAT ADVANCED FUNDS TO CONTRACTOR

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PRINCIPAL AND SURETY — RIGHT OF SURETY ON BUILDING CONTRACT TO BE SUBROGATED TO FUNDS IN OWNER'S HANDS AS AGAINST RIGHT OF BANK THAT ADVANCED FUNDS TO CONTRACTOR — A contract for construction of a city sewerage system provided for progress payments on the fifteenth of each month of ninety per cent of the engineer's estimate of work done during the preceeding month, ten per cent being retained by the owner until final completion of the contract. The contract also required the contractor by the twentieth of the month to pay all labor costs and ninety per cent of the cost of materials delivered the month before. Because the necessary estimates had not been made, the June check was not paid to the contractor on the payment date. On June 28, the contractor borrowed $4,000 from defendant bank and assigned to it the June estimate check. In July, the bank advanced $800 more on the faith of the assignment. The contractor abandoned the job in August and his surety completed it at an expense of about $20,000, including payment of delinquent accounts for labor and materials. Thereafter the owner paid the June check with interest, $5,105.77, to the bank. The owner then held $10,700 still due on the contract of which $8,200 represented retained percentages. Unknown to either the owner or the bank, the contract between principal and surety, embodied in the application for the bond, provided that "in the event of claim or default under the bond all payments due or to become due under the contract" should be made to the surety. The surety brought a petition against the owner and the bank praying that the $10,700 remaining in the owner's hands be applied to material bills and that the $5,105.77 paid the bank be restored and likewise applied. This would fall $5,000 short of exoneration. The court found the contractor was probably in default in payments for materials prior to June 15 when, absent such default, the June progress payment was due, and was certainly in default when he made the assignment to the bank on June 28. It therefore held he had no right to the payment when he made the assignment and the bank took nothing thereby. But the court found that $4,450.29 of the money loaned by the bank to the contractor was used by him in paying claims of laborers and materialmen for which the surety would have been liable, and it found that the loans were made for this purpose. *Held,* that to the extent that the bank loan was used for claims on which the surety was liable the surety's right of subrogation is not superior to the bank's equitable right to retain so much of the maney paid to it under the assignment. *Town of River Junction v. Maryland Casualty Co.*, (C.C.A. 5th, 1943) 133 F. (2d) 57.

In a prior decision of this case,[1] the court held that on the evidence then in the record the contractor had earned the June progress payment and it held that under these conditions the assignment to the bank was effective as against the surety, distinguishing earlier decisions as concerned with retained percentages, not progress payments. Judge Hutcheson dissented, finding evidence that the contractor was in default and had not earned the June payment, but also holding that even a subsequent default on his part defeated his right (and so defeated the right of his assignee) as against the owner and the surety.[2] In this, a second disposition of the case, the majority persisted in protecting the bank even after a finding that the assignment to it by the contractor was invalid. The basis of the decision is that it would be inequitable to require the bank to refund money paid to it, in spite of the fact the assignment was invalid, when the money loaned in consideration of the assignment was used by the contractor in paying bills for which the surety would otherwise have been responsible. The court felt this was a case for the application of the principle whereby a lender is subrogated to an incumbrance removed with the money he loaned, when the security which he took has proved to be ineffectual.[3] Here again the dissenting judge disagreed.[4] The problem involved is a confusing one, but a consideration of the nature of the surety's right will perhaps throw some light upon the situation. In this field, *Prairie State National Bank v. United States* [5] is the leading decision in which many later cases, on varying aspects of the problem, find root. From the principle therein set forth, the equity of the surety arises at the time he enters into the contract of suretyship and is consequently prior to that of one in the position of the bank, whose equity does not arise until later when loans to the contractor are made.[6] When the surety completes the contract, he is entitled to be subrogated to the rights of the owner which extend to all funds remaining unpaid upon the contract, progress payments as well as retained

[1] Town of River Junction v. Maryland Casualty Co., (C. C. A. 5th, 1940) 110 F. (2d) 278, cert. den. 310 U. S. 634, 60 S. Ct. 1077 (1940).

[2] Union Indemnity Co. v. New Smyrna, 100 Fla. 980, 130 So. 453 (1930); Prairie State Nat. Bank v. United States, 164 U. S. 227, 17 S. Ct. 142 (1896); Farmers' Bank v. Hayes, (C. C. A. 6th, 1932) 58 F. (2d) 34; First National Bank v. City Trust, Safe Deposit & Surety Co., (C. C. A. 9th, 1902) 114 F. 529; Lacy v. Maryland Casualty Co., (C. C. A. 4th, 1929) 32 F. (2d) 48; Henningsen v. United States Fidelity & Guaranty Co., 208 U. S. 404, 28 S. Ct. 389 (1908).

[3] Brannon v. Hills, 111 Fla. 491, 149 So. 556 (1933); Federal Land Bank of Columbia v. Godwin, 107 Fla. 537, 136 So. 513, 145 So. 883 (1932); Federal Land Bank of Columbia v. Dekle, 108 Fla. 555, 148 So. 756 (1933).

[4] "The Florida decisions the majority cites apply to an implied agreement for subrogation to a first mortgage, the generally accepted doctrine, that a lender will be subrogated to a first mortgage which his money has discharged when it was expressly agreed that he should be." 133 F. (2d) at 60. It is not disputed that a person advancing money, on void security, to pay off a lien, is subrogated to the rights of the lienholder. See Thomas v. Lester, 166 Ga. 274, 142 S. E. 870 (1928); Peterson v. Hague, 51 Idaho 175, 4 P. (2d) 350 (1931).

[5] 164 U. S. 227, 17 S. Ct. 142 (1896).

[6] Prairie State Nat. Bank v. United States, 164 U. S. 227, 17 S. Ct. 142 (1896); Union Indemnity Co. v. New Smyrna, 100 Fla. 980, 130 So. 453 (1930); State ex rel. Southern Surety Co. v. Schlesinger, 114 Ohio St. 323, 151 N. E. 177 (1926); Farmers' State Bank v. Hayes, (C. C. A. 6th, 1932) 58 F. (2d) 34; American Bonding Co. v. Central Trust Co., 153 C. C. A. (7th) 326, 240 F. 400 (1917); Massa-

percentages. Upon abandonment by the contractor, the owner can declare the entire fund forfeited notwithstanding an assignment by the contractor, and the surety's right by subrogation should be coextensive.[7] Obviously the contractor, who has agreed to indemnify the surety, could not defeat the surety's right by using other funds of his own in paying expenses incurred under the contract and then claiming a priority to funds retained by the owner after default.[8] The assignee of the contractor should be in no better position.[9] But the court felt that because the money which the contractor borrowed from the bank was used by him in paying expenses embraced within the suretyship contract, it would be inequitable to require the bank to restore all of the money it received under the invalid assignment. This proposition has been rejected in like circumstances in several other cases.[10] Rather than treating the bank merely as the

chusetts Bonding & Ins. Co. v. Ripley County Bank, 208 Mo. App. 560, 237 S. W. 182 (1922); Standard Accident Ins. Co. of Detroit, (C. C. A. 10th, 1940) 112 F. (2d) 692; Fidelity & Casualty Co. of New York v. Livingston, 234 Mich. 375, 208 N. W. 446 (1926).

[7] Union Indemnity Co. v. New Smyrna, 100 Fla. 980, 130 So. 453 (1930); State ex rel. Southern Surety Co. v. Schlesinger, 114 Ohio St. 323, 151 N. E. 177 (1926); Farmers' Bank v. Hayes, (C. C. A. 6th, 1932) 58 F. (2d) 34; Henningsen v. United States Fidelity & Guaranty Co., 208 U. S. 404, 28 S. Ct. 389 (1908); First National Bank v. City Trust, Safe Deposit & Surety Co., (C. C. A. 9th, 1902) 114 F. 529; Fidelity & Casualty Co. v. Livingston, 234 Mich. 375, 208 N. W. 446 (1926); Derby v. United States Fidelity & Guaranty Co., 87 Ore. 34, 169 P. 500 (1917).

[8] First National Bank v. City Trust, Safe Deposit & Surety Co., (C. C. A. 9th, 1902) 114 F. 529.

[9] Union Indemnity Co. v. New Smyrna, 100 Fla. 980, 130 So. 453 (1930); Florida East Coast Ry. v. Eno, 99 Fla. 887, 128 So. 622 (1930); First National Bank v. City Trust, Safe Deposit & Surety Co., (C. C. A. 9th, 1932) 114 F. 529; State ex rel. Southern Surety Co. v. Schlesinger, 114 Ohio St. 323, 151 N. E. 177 (1926); American Bonding Co. v. Central Trust Co., 153 C. C. A. (7th) 326, 240 F. 400 (1917); Standard Accident Ins. Co. of Detroit, Mich. v. Federal Nat. Bank of Shawnee, (C. C. A. 8th, 1940) 112 F. (2d) 692; Fidelity & Casualty Co. v. Livingston, 234 Mich. 375, 208 N. W. 446 (1926).

[10] Union Indemnity Co. v. New Smyrna, 100 Fla. 980, 130 So. 453 (1930); Farmers' Bank v. Hayes, (C. C. A. 6th, 1932) 58 F. (2d) 34; State ex rel. Southern Surety Co. v. Schlesinger, 114 Ohio St. 323, 151 N. E. 177 (1926); Illinois Surety Co. v. City of Galion, (D. C. Ohio, 1913) 211 F. 161; Wasco County v. New England Equitable Ins. Co., 88 Ore. 465, 172 P. 126 (1918); First National Bank v. Pesha, 99 Neb. 785, 157 N. W. 924 (1916); Municipal Housing Authority of City of Utica v. H. G. Hatfield Electric Corp., 264 App. Div. 99, 34 N. Y. S. (2d) 995 (1943); Maryland Casualty Co. v. Board of Water Commrs. of City of Dunkirk, (C. C. A. 2d, 1933) 66 F. (2d) 730, modifying (D. C. N. Y. 1930) 43 F. (2d) 418; Massachusetts Bonding & Ins. Co. v. Ripley County Bank, 208 Mo. App. 560, 237 S. W. 182 (1922); See also note at 45 A. L. R. 379 (1926). In Southern Exchange Bank v. American Surety Co. of New York, 284 Ky. 251, 144 S. W. (2d) 203 (1940), a bank which had lent money to state road contractor for payment of laborers and materialmen was subrogated to their rights in balance due on contract and given priority over claim of surety on contractor's bond under assignment of contractor's rights in the contract. The two distinguishing features are that the laborers and materialmen had liens on the fund and that the court considered the surety as claiming subrogation to the rights of the contractor only and not to those of the owner. In Prairie State Nat. Bank v. United States, 164 U. S. 227, 17 S. Ct. 142 (1896), it

assignee of the contractor, the court has subrogated the bank to the rights of the materialmen whose claims were paid with the money lent. Had the owner itself completed the contract at an expense of $5,000 more than the contract price, it is unlikely that the court would have allowed the bank to recover against the owner on any theory of subrogation to materialmen's rights. Yet the bank is allowed to do so as against the surety who stands in the position of the owner. When it is realized that the bank was under no compulsion to lend money to the contractor, and that in doing so the bank should be charged with notice of the surety's right which arose at the execution of the suretyship contract, whatever equity there is in the bank's position would seem to be inferior to the prior equity of the surety to be subrogated to the rights of the owner upon the contractor's default and completion by the surety.[11]

Mary Jane Morris

was said that it is a mistake to treat the surety as subrogated to the rights of the contractor only; he is entitled to be subrogated to the rights of the owner also.

[11] A result opposite to the principal case on very similar facts was reached by a New York court. Century Cement Mfg. Co. v. Fiore, 264 App. Div. 475, 36 N. Y. S. (2d) 332 (1942), noted 12 FORDHAM L. REV. 73 (1943). The principal case is also noted in 56 HARV. L. REV. 1168 (1943).