RECENT CASES

SUBROGATION OF SURETY TO PRINCIPAL'S RIGHTS AGAINST THIRD PERSONS

A contractor agreed with a state highway department to furnish and deliver all material and to do all work required in improving thirteen miles of a highway. The plaintiff surety company gave a bond to secure performance of this contract. The defendant subcontractor then agreed with the contractor to apply surfacing to the base to be constructed by the latter. Upon default of the contractor, the plaintiff (surety company) completed the contract. The plaintiff brought action against the defendant (subcontractor) to recover the cost of that part of the work covered by the subcontract which the subcontractor failed to perform. It was held that although the surety stood in the position of the contractor (principal) he could not collect from the subcontractor who, in this instance, was excused by the default of the contractor on the subcontract. *National Surety Corp. v. Allen-Codell Co.*[1]

"The surety's usual rights of recourse against his principal, arising as an incident of the relation of principal and surety . . . . in general have been applied to the compensated surety. Thus, such a surety may have exoneration, subrogation, and reimbursement against his principal. . . . ."[2] Subrogation, the remedy which the surety resorted to in this case, has as its general purpose "to give to the surety, who discharges the principal's obligation, any rights and remedies which the obligee had as against the principal. . . . ."[3] But the Kentucky District Court states that a "surety who, under the requirement of his bond, completes the contract of a defaulting contractor may be subrogated to all the rights and remedies of the defaulting contractor against a third person who by a subcontract, was obligated and wrongfully failed to perform some part of the work which the surety was required to complete, although no relation of contract or of privity existed between the surety and subcontractor."[4] While it is generally said that the surety, by subrogation, is placed in the position of the creditor (obligee) and is given the latter's rights against the princi-

[1] 70 F. Supp. 189 (Ky., 1947).

[2] 4 Williston, Contracts § 1212A (rev. ed., 1936).

[3] Gilbertson v. Northern Trust Co., 53 N.D. 502, 512, 207 N.W. 42, 45 (1925): "The right of subrogation may be generally described as an equity by which a person who is secondarily liable for a debt and has paid the same, is put in the place of the creditor so as to entitle him to make use of all of the securities and remedies possessed by the creditor, in order to enforce the rights of exoneration and indemnification against the principal debtor." Spencer, Suretyship § 133 (1913); Rest., Security § 141 (1941).

[4] 70 F. Supp. 189, 191 (Ky., 1947).

pal (contractor),[5] the District Court would place the surety in the position of the principal (contractor) and give him the latter's rights against third parties.

The District Court for the Eastern District of Kentucky is not the first court to state that the surety may be subrogated to the rights and remedies of the principal.[6] However, it appears that never before has a court stated that such subrogation entitles the surety to the principal's rights against one not a party to the suretyship contract. In fact, the usual issue in the building contractor's bond cases concerns the right of the surety to the amounts owed by the creditor to the principal.[7] Upon default of the contractor, the surety may be called upon to complete the contract; after all work is finished the surety seeks payment for his work out of the funds held by the owner (creditor). The courts appear to be unanimous in granting the surety such relief.[8] The majority of courts say that the surety becomes entitled to the funds by way of subrogation to the rights of the creditor.[9] Other courts reach the same result by saying that the surety is subrogated to the rights of the principal (contractor).[10] Confusion in the use of the term subrogation is apparent. Some courts use the term only when they mean the equitable substitution of the surety for the creditor in such a manner that the former gets the latter's rights and remedies against the principal,[11] while other courts use the term in a broader sense meaning any equitable substitution of parties that will result in "ultimate discharge of an obligation by a person who in equity and good conscience ought to pay."[12] The United States Supreme Court pointed out over half a century ago that a great deal of confusion was caused by treating the surety as being subrogated to the rights of the

[5] Gilbertson v. Northern Trust Co., 53 N.D. 502, 207 N.W. 42 (1925).

[6] "The right of subrogation extends not only to rights and remedies of the creditor, but also to those of the principal on the bond." Maryland Casualty Co. v. United States, 32 F. Supp. 746, 754 (Ct. Cl., 1940); United States Fidelity and Guaranty Co. v. City of Bristow, 4 F. 2d 810 (D.C. Okla., 1925); Silver Fleet Motor Exp. v. Zody, 43 F. Supp. 549 (Ky., 1942); People v. Roseland State Savings Bank, 318 Ill. App. 495, 48 N.E. 2d 600 (1943); Labbe v. Bernard, 196 Mass. 551, 82 N.E. 688 (1907); 37 Yale L.J. 391 (1928), noting Fidelity and Deposit Co. v. Union State Bank, 21 F. 2d 102 (Minn., 1927); 10 Minn. L. Rev. 357 (1926), noting Barrett Bros. Co. v. County of St. Louis, 165 Minn. 158, 206 N.W. 49 (1925).

[7] Surety on Building Contractor's Bond, 19 Minn. L. Rev. 454 (1926); Right of Construction Contractor's Surety to Funds in Owner's Hands, 43 Yale L.J. 1135 (1934).

[8] Authorities cited note 6 supra, and Illinois Surety Co. v. Mitchell, 177 Ky. 367, 197 S.W. 844 (1917); Hackensack Brick Co. v. Bogota, 86 N.J. Eq. 143, 97 Atl. 725 (1916). The surety is reimbursed, but the profits, if any, must be given to the contractor. Williston, op. cit. supra note 2, at § 1285; Rest., Restitution § 80 (1937); Lacy v. Maryland Casualty Co., 32 F. 2d. 48 (C.C.A. 4th, 1929).

[9] ". . . . a large majority of courts hold that the surety is subrogated to the rights of the owner, and award the funds to the surety in preference to the assignee of the contractor." Right of Construction Contractor's Surety to Funds in Owner's Hands, 43 Yale L.J. 1135, 1141 (1934).

[10] Maryland Casualty Co. v. Cincinnati, 291 Fed. 834 (D.C. Ohio, 1923); Morgenthau v. Fidelity and Deposit Co. of Maryland, 94 F. 2d 633 (App. D.C., 1937).

[11] Note 3 supra.

[12] National Surety Corporation v. Allen-Codell Co., 70 F. Supp. 189, 191 (Ky., 1947).

contractor; it held in *Prairie State National Bank v. United States*[13] that the surety, by subrogation, was given the rights of the creditor.

From the general definition of the doctrine of subrogation[14] and from the position taken by the United States Supreme Court,[15] it appears that an accurate statement of the surety bond situation might be as follows: unpaid funds are security held by the creditor (obligee) until performance is completed by the contractor. When the surety, in accordance with requirements of the contractor's bond, completes the contract, he then becomes eligible to make use of the remedy of subrogation. The surety is, by subrogation, placed in the position of the creditor (obligee), and he is given the latter's securities against the contractor (principal); such securities would include funds due the contractor.[16]

The case under discussion appears anomalous, not because it states that the surety may be subrogated to the rights of the principal (contractor), but because it would allow such subrogation to be effective against third parties. In the other cases where subrogation to the rights of the principal has been sanctioned,[17] such rights have been allowed only to the extent of enabling the surety to receive funds in the hands of the creditor (obligee).[18]

The effect of the view taken by the Kentucky District Court becomes clearer after reflection upon the situation that will require its use. The surety, in the usual case, will not need the remedy providing for subrogation to the rights of the principal against third parties. When the funds in the hands of the creditor are sufficient to compensate the surety for work done, he has his remedy of subrogation.[19] As long as the principal (contractor) remains solvent, the surety can be repaid by reimbursement.[20] Thus, it is only when there are insufficient funds in the hands of the creditor and when the principal becomes insolvent that the remedy against the third party will really be required in order to save the surety from financial loss.

When the principal (contractor) becomes insolvent, the general rule is that

[13] "Hitchcock's [surety's] right of subrogation, when it became capable of enforcement, was a right to resort to the securities and remedies which the creditor was capable of asserting against its debtor. . . . ." Prairie State National Bank v. United States, 164 U.S. 227, 232 (1896).

[14] See note 3 supra.

[15] Prairie State National Bank v. United States, 164 U.S. 227 (1896).

[16] "The rule is well settled that, independently of assignment, the surety on a contractor's bond, who completes the contract on default of the principal, is subrogated to the rights of the obligee, and to the extent necessary to reimburse himself, has an equity in the funds due the contractor. . . . ." Lacy v. Maryland Casualty Co., 32 F. 2d 48, 51 (C.C.A. 4th, 1929).

[17] See cases cited note 6 supra.

[18] "When the sureties should be called up to make good the default of Rodgers [contractor] and should complete the work which he ought to have done, they would become subrogated to all his rights under the contract and entitled to receive whatever part of the contract price had not been paid to him." Labbe v. Bernard, 196 Mass. 551, 552, 82 N.E. 688, 689 (1907).

[19] 4 Williston, op. cit. supra note 2, at § 1266.

[20] 4 Williston, op. cit. supra note 2, at § 1274.

the surety can seek indemnification or attempt to enforce the creditor's rights to which he succeeds by subrogation.[21] Whichever remedy the surety chooses, he becomes eligible to collect his pro rata share of any assets that the bankrupt principal has; the surety is just one of perhaps many creditors of the principal. That the surety stands upon no better footing than any other creditor of the principal is brought out in *Carlton v. Simonton*.[22] There the principal borrowed money from the creditor, and the plaintiff and another were sureties on the $10,000 note which the principal gave the creditor. The creditor got a judgment for the amount of the note and the sureties were forced to pay it. The principal was insolvent, having deposited the money borrowed on the note in a bank which subsequently became insolvent. The principal was allowed to prove her debt against the insolvent bank for the money so deposited, and an order was made allowing her to draw from the receiver of the bank 30 per cent of her claim, when assets came into his hands, to make her equal with those creditors who had already been paid dividends from the assets; and thereafter, she was to share equally with the other creditors in the assets of the bank. The plaintiff (one of the sureties) contended that since the principal was insolvent, he and the other surety should be "substituted to the rights of the defendant [principal], and allowed to follow the fund in the hands of the receiver, and subject it to the payment of his [plaintiff's] claim against defendant [principal] for money paid to her use."[23] To this suggestion the court said, "If a principal borrow money, give his note for same with surety, and the surety afterwards is compelled to pay the note, this does not give the surety any lien or specific equitable right, to resort to and have the property, right or credit, the principal may have obtained with the very money he so borrowed, applied to the payment of his debt. In such a case, *the surety stands upon no better footing than any other creditor of the principal. The surety is simply a creditor of the principal without security.* .... The complicated interests of society, the constant and rapid dealings of men with each other, the difficulty experienced in tracing the investment and application of money, and like considerations, make it necessary to *treat the surety as an ordinary creditor*, and to give his debt no special advantage over the just debt of any other creditor."[24] By the view of the Kentucky District Court,

[21] "A surety is usually held to have two rights upon the insolvency of the principal debtor; he can seek indemnification in the amount he has actually paid the creditor or he can enforce the creditor's rights to which he succeeds by subrogation." 54 Harv. L. Rev. 349 (1940), noting American Surety Co. v. Bethlehem National Bank, 33 F. Supp. 722 (Pa., 1940).

[22] 94 N.C. 401 (1886).

[23] Ibid., at 402.

[24] Ibid., at 404 (italics added). Contra (as to subrogation to the rights of the principal): Commercial Credit Co. v. Eisenhour, 28 Ariz. 112, 236 Pac. 126 (1925), where a car dealer made a conditional sale of an automobile to the principal. The principal gave notes for the balance of $2,000 due thereon. The car dealer assigned the notes, together with the contract of sale, for a valuable consideration to the director. The car dealer guaranteed payment of the notes as surety. The principal took out fire insurance on the car, making it payable to the creditor. When the principal defaulted and surrendered the car to the creditor, the creditor declared the notes due and payable instead of accepting the car as full settlement. The car was turned over to the surety to sell at a private sale, and it was completely destroyed by fire

however, it seems the surety would not be limited to his pro rata share of the principal's assets. Instead, he would be permitted to be reimbursed in full from this particular asset, regardless of whether there were other creditors of the principal or not. It is submitted that this would show undue solicitude for the compensated surety, especially when he has had a chance to investigate his risk before signing the bond and has been paid to take the risk.[25]

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while in the hands of the surety. The surety paid the creditor the full amount due on the notes and demanded delivery of the insurance policy. The creditor, however, refused to turn over the insurance policy, and instead had it cancelled. The court held that the principal had a vested right to have the proceeds of the policy applied in payment of the debt, and the surety—having paid the debt—was entitled to be subrogated to every right which the principal had. It would appear that such a solution in some cases may lead to difficulties, as indicated in Carlton v. Simonton, 94 N.C. 401 (1886). It is therefore submitted that it might be wise to hold consistently that the surety, upon satisfying the principal's obligation, is subrogated to the rights of the creditor against the principal, Rest., Security § 141(a) (1941), and to the interests which the creditor has in security for the principal's performance, Rest., Security § 141(b) (1941). In this case, the surety would have had the burden of showing that the insurance policy was "security" held by the creditor, before he could claim it. If this could have been shown, the result in the case would have remained unchanged. Perhaps the court wanted to avoid the difficulty of deciding whether insurance was within the meaning of security.

To the same effect, see Deitzler v. Mishler, 37 Pa. 82 (1860), where one of several joint purchasers failed to pay his share of the purchase-money, and the sureties on his bond, who were associates in the original purchase, paid it. The court held that an equitable title to his share in the land became vested in the sureties. It is suggested that this goes too far in subrogation to rights unrelated to the suretyship transaction, and that the sureties are adequately protected if they are given the creditor's rights against the principal. The result is comparable to strict foreclosure of a land contract and it may not be objectionable if it is subjected to appropriate limitations. An intelligible limit that should in any event be placed upon subrogation was indicated by the Supreme Court of Pennsylvania in Buckwalter Stove Co. v. Edmonds, 283 Pa. 236, 241, 128 Atl. 835, 836 (1925), where it was held that ". . . . a surety, on paying an obligation given by the principal as part consideration for property bought, does not thereby become part owner of the property. . . . . Otherwise [his creditors] might recover land on which she [principal] had expended large sums of her money. . . . ."

And see Poe v. Philadelphia Casualty Co., 118 Md. 347, 84 Atl. 476 (1912), where the principal took out casualty insurance against "loss resulting from" liability to its workers. The terms of the insurance precluded actions by workers against the insuring casualty company. A worker died from accidents covered by the policy. His administratrix, now "creditor" of the employer principal, attached the principal's property for payment of any judgment that might be recovered in her pending negligence action against the principal. The surety gave a bond to the creditor wherein it (surety) promised to pay the judgment if one was obtained against the principal and if the principal failed to pay. Relying upon this bond, the creditor released the principal's property which had been attached. The creditor obtained a judgment against the principal, and the surety was forced to pay it. The surety then asserted that it should be subrogated to the rights of the principal and should be permitted to collect from the casualty company. The court held that the insurance was for the protection of the principal alone and that the only rights which the surety acquires by subrogation are those of the creditor of his principal. Since the creditor in the instant case had no rights against the casualty company, it was held that the surety could obtain no such rights. Subrogation to the principal's rights was denied. This case is in accord with Carlton v. Simonton, and it seems sound; cf. Whigham v. W. Hall & Co., 8 Ga. App. 509, 70 S.E. 23 (1911). A surety is not excused by a principal's release of his rights (here rights in security) as he may be by a creditor's surrender of his rights in security. See Sturges, Cases on Credit Transactions 154 (1947).

[25] See Arnold, The Compensated Surety, 26 Col. L. Rev. 171 (1926), for comparison of the gratuitous surety and the compensated surety; note 2 supra.

This position is not meant to imply an opinion upon the closely related problem of the surety's use of the principal's claims against the creditor for defensive purposes. A typical example of the latter situation is the one in which the surety alleges the creditor's breach of warranty in his sales contract with the principal.[26] Here the surety has guaranteed the credit of the buyer to the seller, and the seller (creditor) has his choice of suing either the buyer (principal) or the surety if payment is not made when due. If the creditor chooses to sue the surety, can the surety plead breach of warranty as a defense? "If the creditor sues the surety alone, it is generally held that the surety cannot use defensively a claim of the principal debtor against the creditor. . . . . A few courts, however, allow the surety a defense to the extent of the damage caused by the creditor's breach of his promise to the principal. The prevailing view is also applied by many courts where the principal's claim against the creditor is a liquidated debt. Where the principal and his surety are sued together, the surety is generally allowed the benefit of any claim that the principal can use defensively."[27]

The various arguments in this type case were brought out in *Gillespie v. Torrance*,[28] where the creditor brought an action upon a promissory note against the indorser (surety) only. The surety's defense was that the note was one of several given for oak timber sold by the creditor to the principal, and that there were defects in the quality of this timber. The question was clearly raised as to whether the surety could avail himself of a breach of warranty of the quality of the timber, made by the plaintiffs (creditor) to the principal, on the sale to the latter. The court pointed out that: 1) the principal had the right to elect whether to set up the breach of warranty by way of defense or to resort to cross-action to recover damages, and the surety should not be allowed to make that choice for the principal; 2) although a surety may show a failure of consideration of his principal's contract which he is called upon to perform,[29] the damages involved in the Gillespie case constituted a counterclaim—not mere failure of consideration; and not being caused by the surety, such damages cannot be claimed by him; 3) if the surety were permitted to set up the counterclaim, it would bar

[26] The defenses of the surety based on the principal's other defenses against the obligee are not here considered. For discussion see 4 Williston, op. cit. supra note 2, at § 1218, and cases cited therein; The Availability of a Principal's Defenses to His Compensated Surety, 46 Yale L.J. 833 (1937); 21 Ill. L. Rev. 637 (1927), noting Bank of Clinchburg v. Carter, 101 W. Va. 669, 133 S.E. 370 (1926), a case in which the surety was permitted to use as defense duress practiced on the principal; Sharp, Promissory Liability, 7 Univ. Chi. L. Rev. 1, 250, 274 (1939, 1940); Rest., Security § 118 (1941).

[27] Arant, Suretyship § 60, at 204 (1931). But after making such a statement of the law, the author takes the view that the creditor's breach of warranty should constitute a complete defense to the surety, because the creditor has by such breach produced a risk of non-performance by the principal that could not have been contemplated by the surety. Ibid., at 206. For the view that breach of warranty ought not to work a complete release of the surety in those cases in which the seller was unaware before delivery that the goods did not conform to warranty, see Levine, The Principal's Warranty and Offset Claims Against the Creditor as Defenses to the Surety, 30 Mich. L. Rev. 197 (1931).

[28] 25 N.Y. 306 (1862).

[29] Rest., Security § 126 (1941).

future action by the principal for the breach of warranty; and since no balance could be found in the principal's favor, the surety might thus bar a large claim in cancelling a small one; and 4) in a case where there are a number of sureties severally liable, if they all set up the same defense of breach of warranty, how would the conflicting claims be reconciled? On the basis of these four considerations, the court concluded that the general rule should be that the surety, when sued alone, may not set up in defense the creditor's breach of warranty in his contract with the principal.[30]

As to the surety's use of the principal's claims against the creditor for set-off, "the general rule of law is that, where a surety alone is sued, in the absence of statute permitting it, he cannot avail himself of any claim of his principal against the creditor where he has not interest in the claim. The surety must pay the claim and look to his principal for reimbursement. But where there are special circumstances, such as the insolvency of the principal, which would make it inequitable to deny the set-off, it will be allowed. When the surety has no recourse to his principal, it would be inequitable to deprive him of what was a perfectly good set-off between the principal and his creditor."[31]

The New York Civil Practice Act provides that "where a defendant sets up any counterclaim which raises questions between himself and the plaintiff along with any other persons, he shall set forth the names of all the persons who, if such counterclaim were to be enforced by cross action would be defendants to such cross action."[32] The use of such a rule to enable the surety to bring the principal into the action brought by the creditor against the surety seems desirable. The suggestion has been made that in cases of this type the principal should be joined by an equity proceeding, for only chancery can give due regard to all the interests involved.[33] It is submitted that if joinder of the principal in

[30] Surety cannot in law counterclaim for damages to principal arising out of the defective construction of machinery, when sued by the manufacturer of said machinery (creditor). Hiner v. Newton, 30 Wis. 640 (1872); see 4 Williston, op. cit. supra note 2, at § 1251.

[31] Clark Car Co. v. Clark, 48 F. 2d 169, 170 (C.C.A. 3d, 1931), noted in 16 Minn. L. Rev. 217 (1931). Would it be reasonable to argue that the creditor's need for protection determines the scope of the surety's obligation, so that, at any moment, it extends only to such part of the principal's obligation as may not in effect be cancelled by obligations of the creditor? For an affirmative answer, see Arant, Suretyship § 60, at 210; for a negative answer, see Levine, The Principal's Warranty and Offset Claims Against the Creditor as Defenses to the Surety, 30 Mich. L. Rev. 197, 204–19 (1931); Rest., Security § 133 (1941).

[32] N.Y. Civ. Prac. Ann. (Cahill-Parsons, 1946) § 271. Compare the dictum to the effect that if the principal is insolvent, the surety—when sued by the creditor—can obtain a court order bringing the principal into the action for the purposes of adjudicating the merits of any counterclaims against the creditor, in Hiner v. Newton, 30 Wis. 640, 643 (1872); see Levine, The Principal's Warranty and Offset Claims Against the Creditor as Defenses to the Surety, 30 Mich. L. Rev. 197, 210 (1931); for discussion of the use of joinder to protect the principal against double recovery and double vexation, see also Levine, ibid., at 219–25.

[33] 42 Harv. L. Rev. 443 (1929), noting F. A. Rumery Co. v. Merrill Trust Co., 127 Me. 298, 143 Atl. 54 (1928); see also 26 Col. L. Rev. 1035 (1926), noting Seager v. Ocean Ave. Realty Corp., 217 N.Y. Supp. 471 (1926); when the surety is sued alone, he has in some cases been allowed to set up—with the consent of his principal—counterclaims for liquidated damages not more than the amount sued from. Dolan v. Buckley, 197 Iowa 1363, 199 N.W. 302 (1924).

cases of this type by either code provisions or by equity proceedings were permitted generally, courts would have little objection to the surety's making use of the principal's claims against the creditor. It has been said that "in case of recoupment, set off, or counterclaim, the surety's use of the principal's rights results in no more risk of double recovery against the obligee, than inhere generally in the danger of imperfect proof; and the use of these rights creates no peculiar danger of double vexation if the rules about res judicata properly applicable between assignee, assignor and obligor are applied by proper analogy between surety, principal and obligee."[34]

That the problem of the surety's use of his principal's claims against the creditor for defensive purposes blends into the issue under consideration—the desirability of allowing the surety to be subrogated to the rights of his principal against third parties—is brought out in *Union Indemnity Co. v. Stevens*.[35] In that case, the First National Bank of Jackson, Mississippi became insolvent at a time when the state of Mississippi had $100,000 on deposit. The deposit was secured by the bank's depository bond, upon which the appellant was surety. At the time of the bank's failure, it was holder of a $15,000 warrant, issued by the state auditor of public accounts upon the state treasurer, the warrant having been issued to take up a note which the Mississippi state insane hospital commission had given to the bank to meet its current expenses. The surety, after

[34] Sharp, Promissory Liability, 7 Univ. Chi. L. Rev. 1, 250, 274 (1939, 1940). In an action against the surety, the surety should be permitted to utilize the principal's claims against the creditor only if the three parties would all be bound by the adjudication. If the assignor may be bound by an action between the assignee and the obligor where the obligor seeks to use claims against the assignor to reduce the debt, Chew v. Brumagen, 13 Wall. (U.S.) 497 (1871), then it would appear that where the creditor brings action against the surety and the surety seeks to use the principal's claims against the creditor, the principal could be bound by a decision. Whatever doubt there may be about the "non-consensual" surety, the principal who has dealt with the surety seems to have placed himself in a position where he cannot, any more than the assignor, complain of the result.

In the Chew case, however, reliance was placed upon "privity" between assignee and assignor, and such "privity" may not now be recognized. Taylor v. Barker, 70 Utah 534, 262 Pac. 266 (1927). The rule with respect to res judicata in the assignee-assignor-obligor situation now appears to be that a judgment for or against the assignee is not conclusive upon the assignor when the assignor is neither made a party to the action nor notified of it. Schmidt v. Louisville R. Co., 99 Ky. 143, 35 S.W. 135 (1896); Johnson v. Union Switch Co., 129 N.Y. 653, 29 N.E. 964 (1892); St. John v. Fowler, 165 N.Y. Supp. 377 (1917); Taylor v. Barker, 70 Utah 534, 262 Pac. 266 (1927) This is perhaps but a manifestation of the broad rule that a judgment is effective only between parties to the action and their privies, 1 Freeman on Judgments § 407 (5th ed., 1925), with the qualification that notice to the assignor may be a sufficient basis for a determination binding upon him, though he fails to appear in the suit. Montana Coal & Iron Co. v. Hoskins, 88 Ore. 523, 172 Pac. 118 (1918).

It is submitted that if the principal is given notice, he should, by analogy to the assignment cases, be bound by determinations made in the action of creditor against surety. The surety should be responsible only for the net amount which the principal owes the creditor, unless the terms of the suretyship contract state otherwise. The court may, in the process of deciding the amount which the surety owes the creditor, be obliged to consider as part of the surety's defense the principal's claims against the creditor. The findings should be final as to the three parties concerned.

[35] 57 F. 2d 839 (C.C.A. 5th, 1932).

paying the state $100,000, sought to have the receiver of the bank allow it to deduct the $15,000 represented by the warrant, and to prove an unsecured claim for the balance. Although the receiver would only accept proof of the $100,000 as an unsecured claim, the Circuit Court of Appeals for the Fifth Circuit subsequently held that the surety was entitled to have the receiver transfer and deliver to it the auditor's warrant for $15,000.[36] The reason why the surety got the $15,000 warrant was not that he was subrogated to the rights of the principal, for such a procedure would have been unfair to other creditors of the insolvent bank who were entitled to their pro rata share of the bank's assets. The surety got the warrant because he should never have been required to pay the $15,000 which it represented. When the bank became insolvent, it owed the state of Mississippi $100,000; the state owed the bank $15,000 on the warrant. Since the function of the surety is to protect the creditor from loss in the event that the principal does not perform, it would seem that the surety's duty to pay the state might reasonably be limited to $85,000. The Circuit Court of Appeals explained that ". . . . the debts existing between the bank and the state were mutual, notwithstanding that the indebtedness represented by the warrant was incurred by the hospital commission. The right of set off, even though it did not exist at law, will be recognized and enforced in equity, in view of the bank's insolvency."[37]

It is thus apparent that in some cases where subrogation of the surety to the rights of the principal will be unfair to other creditors of the principal, equitable set-off of the principal's claims against the creditor may be used by the surety. While the same result may be reached in specific cases, the theories of the two means are diverse. Where one line of reasoning will appeal to one's sense of fairness, the other may not.

In the case which gave rise to this discussion, the proposition announced—that of enabling the surety to be subrogated to the rights of his principal against third parties—would be needed most when the contractor becomes insolvent. Inasmuch as application of the proposition in such a situation appears unfair to other creditors of the contractor, and inasmuch as there is no justification for the result on the basis of equitable set-off, and in view of the fact that the proposition appears to be without precedent, there seems little justification for the rule announced in this case.

EFFECT OF INSURANCE BINDER RECEIPT ON APPLICANT'S INTERIM COVERAGE

The plaintiff sued to recover on a contract for life insurance. Liability of the insurance company turned on the construction of these words in the application: "if the Company is satisfied that on the date of the completion of Part B of this application I was insurable . . . . and if this application, including said Part B,

[36] Ibid., at 840. [37] Ibid.