



Spring 3-1-1960

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Recommended Citation

Right Of Surety To Subrogation Against Third Party, 17 Wash. & Lee L. Rev. 112 (1960).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol17/iss1/10>

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RIGHT OF SURETY TO SUBROGATION AGAINST THIRD PARTY

Subrogation is the right of a surety to be substituted to the position of the creditor whom he pays.¹ In the typical subrogation situation a suit is brought by the surety against the principal debtor. A difficult problem arises when the person against whom the surety seeks subrogation is not the principal debtor of the suretyship contract, but rather is a third person not a party to the contract.

This situation is considered in *Bank of Fort Mill v. Lawyers Title Ins. Corp.*² One Sims applied to Perpetual Building and Loan Association for a mortgage loan. Before making the loan, Perpetual procured Lawyers Title Insurance Corporation as surety to guarantee the title. An attorney approved by the surety procured the policy of title insurance for Perpetual and closed the transaction. Without authority, the attorney signed Sims' name to the mortgage and notes and falsely certified that the title was in Sims. Perpetual made the loan by drawing a check on defendant bank payable jointly to Sims and the attorney. The attorney forged Sims' endorsement and deposited the proceeds in his own account in the First National Bank of South Carolina. When the title defect became known, the surety paid Perpetual and took an assignment of all claims and causes of action that Perpetual might have had arising out of this transaction. The surety then proceeded against the Bank of Fort Mill under the theory of subrogation.

The United States District Court of the Western District of South Carolina rendered judgment for the plaintiff surety,³ reasoning that there would have been no loss if the defendant bank had not accepted the forged check, even though the title were defective.⁴ Since the liability of defendant bank to Perpetual and the liability of the surety to Perpetual arose under different circumstances, the court concluded that there was "no reason for balancing equities"⁵ and that, therefore, the bank was liable to the surety.

The Court of Appeals for the Fourth Circuit reversed and remanded the decision on the grounds that subrogation, as an equitable right, demands a balancing of the equities and that the compensated

¹Simpson, *Suretyship* 205 (1950); see e.g., Restatement, *Security* § 141 (1941).

²268 F.2d 313 (4th Cir. 1959).

³*Lawyers Title Ins. Corp. v. Bank of Fort Mill*, 167 F. Supp. 448 (W.D.S.C. 1958).

⁴*Id.* at 452.

⁵*Ibid.*

surety had no right of subrogation as against the innocent drawee bank.⁶ In addition, the court refused to recognize any new rights arising in favor of the surety because of the assignment.⁷

As a general rule, subrogation is allowed the surety when its equities are superior to those of the third party;⁸ but subrogation is denied when the equities of the third party are equal or superior to those of the surety.⁹ The court in the principal case found the equities of the "innocent bank" superior to those of the surety because "the surety company is paid to assume the specific risk."¹⁰ In view of the fact that in modern business transactions most sureties are professional, compensated surety companies, the question arises as to when, if ever, the equities of the surety will be superior to those of a third party. Thus the basic problem confronting the courts is that of determining the relative equities of the surety and the third party.

In the absence of other factors affecting the relative equities, some courts base the result upon the fact that the surety was compensated.¹¹ However, recovery has been allowed the compensated surety against the third party based upon the following factors: (1) negligence on the part of the third party;¹² (2) intentionally tortious conduct by the third party;¹³ (3) knowledge by the third party of fraud on the part of the principal debtor;¹⁴ (4) contractual obligation of the third party,

⁶Bank of Fort Mill v. Lawyers Title Ins. Co., 268 F.2d 313, 317 (4th Cir. 1959).
⁷Id. at 316.

⁸Annot., 137 A.L.R. 700 (1942); Simpson, Suretyship 220 (1950).

⁹Security Fence Co. v. Manchester Fed. Sav. & Loan Ass'n, 136 A.2d 910, 912 (1957); Annot., 137 A.L.R. 697 (1942); Simpson, Suretyship 220 (1950); Sterns, Suretyship 447 (5th ed. 1951). Cf. Northern Trust Co. v. Consolidated Elevator Co., 142 Minn. 132, 171 N.W. 265, 268 (1919) wherein it was said, "It [subrogation] will never be enforced when the equities are equal or the rights not clear."

¹⁰268 F.2d at 315.

¹¹Id.; United States Fid. & Guar. Co. v. First Nat'l Bank, 172 F.2d 258, 263 (5th Cir. 1949); Louisville Trust Co. v. Royal Indem. Co., 230 Ky. 482, 20 S.W.2d 71 (1929); American Bonding Co. v. State Sav. Bank, 47 Mont. 332, 133 Pac. 367, 368 (1913). Cf. Baker v. American Sur. Co., 181 Iowa 634, 159 N.W. 1044 (1916). Contra, Bench Canal Drainage Dist. v. Maryland Cas. Co., 278 Fed. 67 (8th Cir. 1921); Simpson, Suretyship 221 (1950).

¹²Rivers v. Liberty Nat'l Bank, 135 S.C. 107, 133 S.E. 210 (1926). Accord, Fidelity & Deposit Co. v. Oklahoma State Bank, 77 F.2d 734 (10th Cir. 1935); Martin v. Federal Sur. Co., 58 F.2d 79 (8th Cir. 1932); cf. Richfield Nat'l Bank v. American Sur. Co., 39 F.2d 387 (8th Cir. 1930).

¹³Globe & Rutgers Fire Ins. Co. v. Foil, 189 S.C. 91, 200 S.E. 97 (1938) (conversion). It seems that the rule should also apply to fraud.

¹⁴Fidelity & Deposit Co. v. Bank of Smithfield, 11 F. Supp. 904 (E.D. Va. 1932); American Nat'l Bank v. Fidelity & Deposit Co., 129 Ga. 126, 58 S.E. 867 (1907); Randedell v. Fellers, 218 Iowa 1005, 252 N.W. 737 (1934); Fidelity & Deposit Co. v. Queens County Trust Co., 226 N.Y. 225, 123 N.E. 370 (1919); United States Fid. & Guar. Co. v. United Nat'l Bank, 80 Ore. 361, 157 Pac. 155 (1916).

such as by endorsement;¹⁵ (5) participation by the third party in the act which caused the liability;¹⁶ (6) assignment to the surety of claims and causes of action against the third party;¹⁷ and (7) the distinct and unrelated nature of the liabilities between the surety and the principal debtor and those between the third party and the principal debtor.¹⁸

It appears that the last three of these factors might have been grounds for a decision in favor of the surety in the *Fort Mill* case. By honoring the forged check, the Bank of Fort Mill participated in the act which caused the liability. As suggested by the District Court: "If the check of Perpetual had not been honored, Perpetual . . . would have suffered no loss. Perpetual would still have had its funds and no matter how invalid the title might have been without loss there could have been no claim against plaintiff."¹⁹

When the principal debtor has given the surety an assignment of claims and causes of action against the third party, as in the principal case, some courts have recognized a new legal interest as having replaced the old equitable one and have allowed subrogation on the theory that the assignment and its resultant legal interest are superior to the equities of the third party.²⁰ The weight of authority, however, has rejected this on the ground that the rights of the surety cannot be improved by the assignment.²¹

When the liabilities between the surety and the principal debtor and those between the third party and the principal debtor arise from distinct and unrelated transactions, such as in the *Fort Mill* case, the equities of the third party have been held not to be superior to those of the surety. In *Kansas City Title & Trust Co. v. Fourth Nat'l Bank*,²² wherein the defendant bank had paid a large sum of

¹⁵Standard Acc. Ins. Co. v. Pellecchia, 15 N.J. 162, 104 A.2d 288 (1954).

¹⁶American Bonding Co. v. National Mechanics Bank, 97 Md. 598, 55 Atl. 395 (1903) (knowledge equals participation).

¹⁷National Sur. Co. v. Bankers Trust Co., 210 Iowa 323, 228 N.W. 635 (1930); National Sur. Co. v. National City Bank, 184 App. Div. 771, 172 N.Y. Supp. 413 (Sup. Ct. 1918); Grubnau v. Continental Nat'l Bank, 279 Pa. 501, 124 Atl. 142 (1924); cf. First Nat'l Bank v. American Sur. Co., 71 Ga. App. 112, 30 S.E.2d 402 (1944) (Recovery allowed at Law). Contra, American Sur. Co. v. Bank of Calif., 133 F.2d 160, 164 (9th Cir. 1943); Simpson, Suretyship 221 (1950). Cf. Sloat Darugh Co. v. Gen. Coal Co., 276 Fed. 502 (6th Cir. 1921) (Dicta).

¹⁸Kansas City Title & Trust Co. v. Fourth Nat'l Bank, 135 Kan. 414, 10 P.2d 896 (1932) (distinguishes between legal and conventional subrogation).

¹⁹167 F. Supp. at 452.

²⁰See note 17 supra.

²¹Ibid.

²²135 Kan. 414, 10 P.2d 896 (1932).

money on forged endorsements by a real estate dealer, the court reasoned that there was no duty owed by the surety to the third party and that therefore there was no basis upon which to hold the third party's equities superior.

In addition to the foregoing, there is one other factor which affects the equities of the parties. Is the third party the one upon whom the loss ultimately falls? Under well established law the bank which is the recipient of payment upon a forged endorsement is liable for the return of the payment.²³ As stated by the *Restatement of Restitution*, "A person whose claim of title to a bill of exchange or promissory note depends upon a forged or unauthorized indorsement and who has received payment thereof from a person who was liable upon the instrument as a party to it prior to such indorsement and who pays without notice of the invalidity of the indorsement, is under a duty to restore to the payor the amount received, unless he has already satisfied the owner of the instrument."²⁴ Thus the Bank of Fort Mill was not ultimately liable, but the court considered its equities as superior to those of the surety. This appears unjust in view of the fact that the Bank of Fort Mill could recover its loss, if it were found liable, in a subsequent suit against the First National Bank of South Carolina.

If this factor is considered, the surety may be allowed to recover from the third party drawee bank under a theory of subsuretyship.²⁵ Subsuretyship is the relation between two sureties bound to answer for the same duty of the principal debtor when one has the whole duty in respect to the other.²⁶ The surety would be liable to the creditor initially, but it could recover from the third party ultimately. On the other hand, if the third party is sued first, it cannot recover from the surety. This result has not been considered by the courts.

²³At common law the drawee could recover. *La Fayette & Bro. v. Merchants' Bank*, 73 Ark. 561, 84 S.W. 700 (1905); *Canal Bank v. Bank of Albany*, 1 Hill 287 (Sup. Ct. N.Y. 1841); *Britton, Bills and Notes* 641 (1943) (Through NIL § 196 common law rules apply). *Farmers Bank & Trust Co. v. Farmers State Bank*, 148 Ark. 599, 231 S.W. 7 (1921); *Hartford-Conn. Trust Co. v. Riverside Trust Co.*, 123 Conn. 616, 197 Atl. 766 (1938); *Merchants' Nat'l Bank v. Federal State Bank*, 206 Mich. 8, 172 N.W. 390 (1919); *United States Mortgage & Trust Co. v. Liberty Nat'l Bank*, 112 Misc. 149, 184 N.Y. Supp. 32 (Sup. Ct. 1920), *aff'd* 192 N.Y. Supp. 955 (App. Div. 1922); *Pennsylvania Mut. Life Ins. Co. v. Real Estate-Land & Title & Trust Co.*, 116 Pa. Super. 81, 176 Atl. 747 (1935) (cases allowing recovery by drawee); see *Beutel's Brannan Negotiable Instruments Law* 448 (7th ed. 1948). This is a quasi-contractual action for money had and received; it is not based on the NIL provision covering warranties of endorsers. *Britton*, *op. cit. supra* at 643.

²⁴*Restatement, Restitution* § 35 (1937).

²⁵*Restatement, Security* § 145 (1941).

²⁶*Ibid.*

Any one of the previously enumerated factors has generally been found sufficient to establish the surety's equities as being superior to those of the third party.²⁷ However, when none of the factors are present or when the particular jurisdiction has not given weight to the factors even though present, subrogation is usually denied.²⁸ In this situation, *i.e.*, when the courts have found the equities of the parties equal, rather than denying subrogation entirely the courts should consider the recommendation of Professor Stephen I. Langmaid for "contributive subrogation."²⁹

Under contributive subrogation the parties are considered co-sureties.³⁰ Professor Langmaid advocated this doctrine to permit a just solution when the equities of the parties are equal. Referring to the fact that when the equities are equal the courts do not allow subrogation between a true surety and a quasi-surety (one not liable under a suretyship contract),³¹ he says, "If the equities of surety and quasi-surety are in truth to be regarded as equal, the conception means that the ultimate loss will lie where the creditor's choice has put it in the first instance."³² Since each of the parties is liable for the loss, is it not more reasonable to allow the one initially held liable to recover contribution from the other? Professor Langmaid further says, "That one should bear the whole burden while the other escapes scot-free merely because the creditor chose the former is repugnant to our theory of justice."³³

Contribution³⁴ between sureties liable on the same debt in the same manner has long been recognized by the courts;³⁵ contribution

²⁷Stearns, *Suretyship* 448 (5th ed. 1951); see notes 12-18 *supra*.

²⁸*United States Fid. & Guar. Co. v. First Nat'l Bank*, 172 F.2d 258, (5th Cir. 1949); *American Sur. Co. v. Bank of Calif.*, 133 F.2d 160 (9th Cir. 1943); *Washington Mechanics Sav. Bank v. District Title Ins. Co.*, 65 F.2d 827 (D.C. Cir. 1933); *Simpson, Suretyship* 220 (1950); cf. *American Sur. Co. v. Lewis State Bank*, 58 F.2d 559, 560-61 (5th Cir. 1932), wherein it was said, "It [subrogation] is properly applied in favor of a surety on a fidelity bond only against persons who have participated in the wrong of its principal."

²⁹Langmaid, *Some Recent Subrogation Problems in the Law of Suretyship and Insurance*, 47 *Harv. L. Rev.* 976 (1934).

³⁰"Where there are two co-sureties, each fully liable, and one is made to pay more than his share, the doctrine of contribution permits equalization of loss between them. . . . It is this principle that lies at the foundation of the relations to be considered. . . ." *Id.* at 976-77.

³¹*Id.* at 977.

³²*Id.* at 979.

³³*Id.* at 977.

³⁴For a general rule see *Restatement, Security* § 149 (1941).

³⁵*Peter v. Rich*, 1 *Chan. Rep.* 34, 21 *Eng. Rep.* 499 (1629); *Fleetwood v. Charnock*, *Nelson* 10, 21 *Eng. Rep.* 776 (Ch. 1629). Originally the courts sought an implied