Construction Sureties: Don't Put All Your Eggs in the Equitable Subrogation Basket

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CONSTRUCTION SURETIES: DON'T PUT ALL YOUR EGGS IN THE EQUITABLE SUBROGATION BASKET

I. INTRODUCTION

Historically, the doctrine of equitable subrogation has entitled a performance or payment bond surety to a claim superior to that of a construction lender in the event of general contractor default. Until recently, this superiority extended even to those situations where the lender had perfected a security interest in the proceeds in accordance with the Uniform Commercial Code. Several recent decisions have limited or threatened to limit the surety's traditional subrogation rights. In recognition of these decisions; and in order to protect its claim to these funds, the surety should perfect a security interest pursuant to Article 9 of the U.C.C.

This note analyzes the competing claims of a payment or performance bond surety and a construction lender to the undisbursed proceeds of a construction contract on which the general contractor has defaulted. The doctrine of equitable subrogation holds that the surety's claim to the contract funds is superior to the lender's claim. This superiority obtains even though the lender has perfected a security interest in the funds in accordance with Article 9 of the Uniform Commercial Code ("U.C.C."), while the surety has not perfected its security interest in the funds.

This note sets forth the context in which such a dispute will arise and analyzes the case law which established and extended the doctrine of equitable subrogation. This note argues that the


2. The general contractor's assignment to the surety of its right to the contract funds is the surety's security interest. See infra note 12.

3. See infra text accompanying notes 39-70 (subrogation rights are not considered security interests under U.C.C. and are not subject to U.C.C. filing requirements).

4. See infra text accompanying notes 8-26.

5. See infra text accompanying notes 27-70.
surety should perfect a security interest in the contract funds rather than rely solely on its equitable subrogation rights. Finally, this note proposes that the doctrine of equitable subrogation be limited when applied to the contemporary construction surety situation.

II. THE SURETY-LENDER DISPUTE

When a general contractor ("contractor") and owner execute a construction contract, the contractor is often required to obtain performance and payment bonds from a surety company ("surety"). A performance bond obligates the surety to complete construction or arrange for completion in the event of the contractor's default. A payment bond protects the owner from mechanics liens by insuring that laborers, subcontractors, and materialmen are compensated for their goods and services by the surety should the contractor default on its payment obligations. Performance and payment bond sureties generally require the contractor to in-

6. See infra text accompanying notes 71-127.
7. See infra text accompanying notes 128-38.
8. Procurement of performance and payment bonds is generally a prerequisite to entering into public construction contracts. Chapter 642(1) of the Miller Act requires that performance and payment bonds be furnished for contracts in excess of $25,000 entered into with the federal government. Miller Act, 40 U.S.C. §§ 270a-270d (1988). Most states impose similar statutory requirements for contracts entered into with state or local governments. See, e.g., ARIZ. REV. STAT. ANN. § 34-222 (1990); FLA. STAT. § 255.05 (1990); OHIO REV. CODE ANN. § 153.54 (Anderson 1990). Currently, only Delaware, Louisiana, New York, and Virginia do not require performance and payment bonds for construction on public contracts.

Generally, there is no statutory bonding requirement for contractors engaged in private construction projects. However, many private owners or their construction lenders require the contractor to furnish either performance or payment bonds or both. See G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW 836 (2d ed. 1985) ("[o]wners and lenders frequently seek the participation of some financially responsible third party who can step in to rectify the contractor's breach or compensate them for the damage it causes."); J. SWEET, LEGAL ASPECTS OF ARCHITECTURE, ENGINEERING, AND THE CONSTRUCTION PROCESS 301 (2d ed. 1978) (payment bonds often required as means of circumventing subcontractor and supplier liens).


10. Id. In the context of a public project, the payment bond is required to protect laborers and materialmen who are precluded from filing mechanics' liens against a public building or work. 17 AM. JUR. 2D Contractors' Bonds § 44 (1964); Note, A Race to Contract Proceeds: Miller Bond Surety Entitled to All Earned But Unpaid Contract Proceeds Over Equitable Pleas of Untimely Supplier-Claimant, 23 ARIZ. L. REV. 1326, 1335 (1981).
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demnify the surety for any funds it expends on its guaranty, and
to secure the indemnity agreement with an assignment of all con-
struction contract receipts to which the contractor is entitled.11
The resulting indemnity agreement typically provides that it con-
stitutes a “security interest” in accordance with the U.C.C.,12 and
that this security interest is additional to all rights that the surety
possesses in law or in equity 13 Nevertheless, sureties rarely per-
fect their security interest by filing it in accordance with U.C.C §
9-302(1),14 choosing instead to rely on their equitable subrogation
rights.15

After executing the surety bonds, the contractor normally
seeks a construction loan to finance its obligations under the con-
tract.16 Like the surety, the lending institution (“lender”) receives

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11. See Withers, supra note 1, at 357 n.3. Withers provides an example of the typi-
cal indemnity provision found in performance and payment bonds. Under this indemnity
 provision, the contractor agrees to assign to the surety, as collateral for the bonds, “[a]ny
and all percentages retained on account of [the construction] contract, and any and all
sums that may be due under said contract at the time of breach, or that thereafter
may become due” Id. The assignment takes effect at the time the bonds are exe-
cuted but is effective only upon an “abandonment, forfeiture, or breach” of the construc-
tion contract or of the bonds. Id., see also Hoffman, Jacobs—Sureties Panacea or Narco-
sis? Article 9—The Uniform Commercial Code—Some Practical Aspects, 52 INS. Couns.
J. 387, 388 (1967) (indemnity agreements typically include an assignment of the contrac-
tor’s rights in equipment and materials used during construction).

12. The U.C.C. defines “security interest” as “an interest in personal property or
fixtures which secures payment or performance of an obligation The term also in-
cludes any interest of a buyer of accounts, chattel paper, or contract rights which is subject
to Article 9.” U.C.C. § 1-201(37) (1989). A security interest is created by agreement
between creditor and debtor and “attaches” when the following conditions exist: (1) either
the secured creditor is in possession of the collateral or else the debtor has signed an agree-
ment adequately describing the collateral; (2) value has been given; and (3) the debtor has
rights in the collateral. Id. § 9-203(1). In order to be enforceable as against holders of
junior liens or subsequent purchasers, the security interest must be properly “perfected.”
Depending on the type of collateral involved, a security interest is properly perfected by
filing a financing statement in the designated public office, by taking possession of the
collateral, or automatically by attachment. See id. §§ 9-302 to 9-305, 9-401 to 9-403. Sec-
tion 9-312 governs the priority of security interests. A perfected security interest has prior-
ity over an unperfected interest, while priority as between two perfected interests is deter-
dined by which interest is filed or perfected first. Id. § 9-301(1), 9-312(5).

 Ct. App. 1988), rev d on other grounds, 540 So. 2d 113 (Fla. 1989). In Transamerica the
indemnity agreement contained a provision allowing the surety to exercise its U.C.C. rights
without limiting its other rights. Id. at 441 n.2.

14. The U.C.C. provides that, subject to certain enumerated exceptions, “[a] financ-
ing statement must be filed to perfect all security interests” U.C.C. § 9-302(1)
(1989).

15. Transamerica, 524 So. 2d at 441; Withers, supra note 1, at 357.

16. Withers, supra note 1, at 357; Note, Equitable Subrogation—Too Hardy a
as collateral an assignment of contract funds to become due and payable to the contractor. Unlike the surety, however, the lender normally perfects its security interest by filing under U.C.C § 9-302.17

Construction contracts customarily require the owner to make periodic progress payments to the contractor.18 This payment scheme enables contractors to engage in costly and lengthy projects without incurring the responsibility of financing the endeavor.19 However, owners typically mitigate this dilemma through the practice of retainage. Construction contracts customarily permit the owner to withhold a certain percentage of each progress payment, usually ten percent, until the contractor has completed the project to the owner’s satisfaction.20 This retainage is withheld to discourage abandonment by the contractor.21 Thus, the owner will have in its possession three types of contract funds during the executory period: earned but unpaid progress payments, unearned progress payments, and retainage.22

The dispute between the surety and lender over the funds remaining in the possession of the owner arises when the contractor

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Plant to Be Uprooted by Article 9 of the U.C.C?, 32 U. PRR. L. Rev. 580, 581 (1971). In some cases, the contractor will draw on an existing line of credit rather than seek a new source of financing.

17. Withers, supra note 1, at 357. The assignment of the contract funds to the lender does not fall under the exceptions listed in section 9-302(1). In order to perfect its security interest in such funds, the bank must file a financing statement. See U.C.C. § 9-302 official comment 5 (1989).

18. Withers, supra note 1, at 358.


20. See, e.g., American Fire & Casualty Co. v. First Nat'l City Bank, 411 F.2d 755, 758 (1st Cir. 1969) (“retainage is a security for protection against failure of completion.”).

21. See Glover, 30 Bankr. at 876-77 (retainage is an incentive to completion); Withers, supra note 1, at 358 (retained funds protect the owner by inducing the contractor to finish the job).

22. See Withers, supra note 1, at 358. This note does not discuss earned progress payments which have been paid to the contractor or the lender prior to default. The surety is without recourse to recover these funds. E.g., United States Pac. Ins. Co. v. United States, 362 F.2d 805, 808 (Ct. Cl. 1966) (“The right of subrogation of the surety, though superior to claims of other private parties, does not extend to prior payments lawfully disbursed under the contract to the contractor before his default.”); Note, National Shawmut Bank: Another Step Toward Confusion in Surety Law, 64 Nw. U.L. Rev. 582, 590 n.38, 596 (1969) (sureties are unable to recover progress payments earned and paid prior to the default); see, e.g., National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843, 848, reh'g denied, 411 F.2d 843 (1st Cir. 1969) (“Prior to default, the contractor had the right to assign progress payments and had the Bank received payment, it could not (absent circumstances amounting to fraud) have been divested by the surety.”).
fails to complete the project and ceases work in breach of the construction contract. Such a breach triggers the performance and payment obligations of the surety under the executed bonds. A surety which satisfies its obligations under the performance and payment bonds may claim entitlement to the available contract funds under the doctrine of equitable subrogation. On the other hand, a lender may assert a claim to the funds under its properly perfected security interest under the U.C.C.

III. DEVELOPMENT AND PROMINENCE OF THE EQUITABLE SUBROGATION DOCTRINE

Sureties consistently have been successful in the adjudication of surety-lender disputes. Courts view the surety's rights under the equitable subrogation doctrine as superior to the lender's rights acquired through perfection of a security interest in the assigned funds.

In *Pearlman v. Reliance Insurance Co.*, the Supreme Court of the United States firmly established the surety's superior equitable subrogation rights.

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24. *Id.* The breach also effectuates the assignments made in the indemnity agreement. *See supra* note 11 and accompanying text.
28. Subrogation has been defined as:

[T]he equitable remedy by which, where the property of one person is used to discharge a duty of another or a lien upon the property of another, under such circumstances that the other will be unjustly enriched by the retention of the benefit thus conferred, the former is placed in the position of the obligee or lienholder.

*RESTATEMENT OF SECURITY § 141, comment a, at 383 (1941); see also National Shawmut, 411 F.2d at 844 (Subrogation is an "equitable principle that when one, pursuant to obligation - not a volunteer, fulfills the duties of another, he is entitled to assert the rights of that other against third persons."). See generally In Re V. Pangori & Sons, Inc., 53 Bankr. 711, 715-16 (Bankr. E.D. Mich. 1985) (when a surety satisfies the debts of its principal, the surety receives an equitable assignment of the creditor's rights against the principal).
29. *Withers, supra* note 1, at 362-363; *see cases cited supra* note 1.
31. *Id.* at 136-37, 141.
Corp., as contractor, and the United States, as owner, entered into a construction contract in connection with the St. Lawrence Seaway. Due to financial difficulties encountered by the contractor, the contract was terminated by mutual agreement, and another contractor completed the job. There remained, however, numerous unpaid labor and material claims against the original contractor. Reliance Insurance Company, payment bond surety for Dutcher, satisfied these debts. Subsequently, the contractor was adjudicated bankrupt, and the United States turned over the retainage to the trustee. The surety then sued to recover the retainage from the trustee, claiming superior right and title to these funds.

The Court held in favor of the surety under subrogation principles.

Traditionally sureties compelled to pay debts for their principal have been deemed entitled to reimbursement, even without a contractual promise. And probably there are few 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.

The Court concluded that the surety, having discharged labor and material claims, was subrogated to (1) the rights of the owner to use the retained funds to pay laborers and materialmen; (2) the laborers' and materialmen's rights to be paid out of the retainage fund; and (3) the contractor's right to the retainage insofar as the surety had satisfied the contractor's payment obligations.

Subsequent case law has extended equitable subrogation rights beyond recovery of retainage funds to include recovery of unearned progress payments and earned but unpaid progress payments.

32. *Id.* at 133-34.
33. *Id.* at 134.
34. *Id.* at 136-37 (footnote omitted).
35. *Id.* at 141-42. In reaching its decision, the *Pearlman* Court relied on two prior Supreme Court decisions. The first of these, *Prairie State Bank v. United States*, 164 U.S. 227 (1896), involved competing claims to a retainage fund between a project completing surety and a bank which had obtained an assignment of the retainage from the contractor. The Court held in favor of the surety, finding it subrogated to the rights of the government-owner to protect itself out of the fund. *Id.* at 232-33. The second case, *Henningsen v. United States Fidelity & Guar. Co.*, 208 U.S. 404 (1908), involved a similar dispute, except that the surety was seeking reimbursement for payments made to unpaid laborers and materialmen. The Court held in favor of the surety, recognizing the same type of equitable subrogation rights espoused in *Prairie State Bank*. *Henningsen*, 208 U.S. at 410. The *Pearlman* Court described these two cases as "establish[ing] the surety's right to subrogation whether its bond be for performance or payment." *Pearlman*, 371 U.S. at 139.
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payments. More importantly, these later decisions have held that the surety's equitable subrogation rights were not vitiated by the provisions of Article 9 of the U.C.C. A few years after Pearlman was decided, the Pennsylvania Supreme Court, in Jacobs v Northeastern Corp., held that a surety's equitable subrogation rights are neither governed nor invalidated by Article 9 of the U.C.C. In Jacobs the contractor entered into two construction contracts with the state, each of which required a payment and performance bond surety. On both projects, the contractor failed to pay laborers and materialmen, and the sureties were called on to satisfy the unpaid claims. When the contractor fell into receivership, a dispute developed between the receiver and the surety as to the final payments due under each contract. The court, citing Pearlman, held for the sureties under the doctrine of equitable subrogation.

The Jacobs court held that each surety had an equitable claim to the disputed funds even though no financing statement was filed in accordance with the U.C.C. This ruling is based on a distinction between a U.C.C. security interest and equitable subrogation rights. The court reasoned that Article 9 extends only to "security interests created by contract," while subrogation rights arise as a matter of law independent of contractual provisions. Consequently, valid subrogation rights exist despite the absence of a filing under the U.C.C.
Similarly the First Circuit, in National Shawmut Bank v New Amsterdam Casualty Co., concluded that “equitable subrogation is too hardy a plant to be uprooted by a Code which speaks around but not to the issue.” National Shawmut involved a contractor’s default on three Air Force base construction contracts. A dispute followed between the performance bond surety and construction lender over earned but unpaid progress payments held by the federal government-owner.

The National Shawmut court focused on several sections of the U.C.C., as adopted by Massachusetts. The court referred to the “exculpatory general principle” found in section 1-103 that principles of law and equity supplement provisions of the U.C.C. unless displaced by a particular provision of the code. The court then held that subrogation rights fall outside the definition of “security interest” under section 1-201(37). The court found that the surety’s opportunity to minimize its losses by completing the project with available funds did not constitute an interest in personal property or a fixture. The court also observed that a surety is not a buyer of contract rights subject to Article 9. The court then applied the same analysis to section 9-102(1) holding it inapplicable to the surety’s equitable subrogation rights.

In an analysis parallel to that of Jacobs, the court held that section 9-102(2) was inapplicable to subrogation rights in that as

available assets. To the contrary, creditors certainly know of statutory and customary bonding requirements as well as the possibility of surety claims to contract funds upon default by the contractor. Moreover, because of the default, the contract funds do not become due and payable to the contractor. Therefore, creditors cannot reach these funds. Id. at 428-29, 206 A.2d at 54-55.

44. 411 F.2d 843, reh g denied, 411 F.2d 843 (lst Cir. 1969). For an excellent analysis of National Shawmut, see Note, supra note 22.

45. National Shawmut, 411 F.2d at 849.

46. Id. at 844.

47. Id. at 845.

48. Id at 845-46.

49. Id. at 846. In 1972 the U.C.C. eliminated “contract right” as a defined term and expanded the definition of “account.” See infra note 53.

50. National Shawmut, 411 F.2d at 846. The current version of section 9-102(1) provides that:

Except as otherwise provided in section 9-104 on excluded transactions, this Article applies (a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts; and also (b) to any sale of accounts or chattel paper.


51. See supra notes 39-43 and accompanying text.
such rights were not "created by contract."\textsuperscript{52} The court then examined the definitions of "account" and "contract right" contained in section 9-106, and determined that neither definition encompassed equitable subrogation.\textsuperscript{53}

Finally, the court relied on the rejection of proposed section 9-312(7). This provision would have subordinated a surety's security interest to a subsequent security interest.\textsuperscript{54} However, the U.C.C. Editorial Board deleted this provision in order to preserve the existing law.\textsuperscript{55} The National Shawmut court viewed the rejection of section 9-312(7) as evidence of an intent to preserve the superiority of the surety's equitable subrogation rights.\textsuperscript{56}

In Mickelson v Aetna Casualty & Surety Co. (In re J V Gleason Co.),\textsuperscript{57} the Eighth Circuit echoed the rationales set forth in Jacobs and National Shawmut. Gleason involved a dispute similar to that which occurred in Pearlman. The contractor in Gleason defaulted on five state construction contracts and subsequently was declared bankrupt. The payment and performance

\textsuperscript{52} National Shawmut, 411 F.2d at 846 (subrogation rights not created by contract but by "status, resulting from a contract").

\textsuperscript{53} The court found an account distinct from subrogation in that default on an account does not yield a right to payment. A contract right entails "a right to receive payments from one who continues with the performance rather than a right conditioned on performance by the transferee of the 'right.'" \textit{Id.} at 846. Prior to 1972, the U.C.C. distinguished "contract rights" (amounts not yet earned by performance) from "accounts" (amounts which have been earned by performance). U.C.C. § 9-106 (1989) (section amended 1972); Hoffman, \textit{supra} note 11, at 388. In 1972, the Code eliminated the term "contract right" and extended the definition of "account" to include "any right to payment for goods or services whether or not it has been earned by performance." U.C.C § 9-106. It was determined that the distinction was unnecessary since it was not used in Article 9 except in section 9-318(2). U.C.C. § 9-106 (official reasons for 1972 amendments). Consequently, the change does not have any substantive impact and has no effect on the continuing validity of pre-1972 decisions. \textit{Id.}

\textsuperscript{54} Proposed section 9-312(7) stated:

A security interest which secures an obligation to reimburse a surety is subordinate to a later security interest given to a secured party who makes a new advance, incurs a new obligation, releases a perfected security interest or gives other new value to enable the debtor to perform the obligation for which the earlier secured party is liable.


\textsuperscript{55} Hoffman, \textit{supra} note 11, at 393. The Editorial Board commented that the subsection "was a 'complete reversal' of the case law of the U.S. Supreme Court and other courts." R. Smith & V Covalt, \textit{supra} note 38, at 14.

\textsuperscript{56} National Shawmut, 411 F.2d at 846. \textit{But see} Hoffman, \textit{supra} note 11, at 394 (arguing that section 9-312(7) was rejected to establish equality between sureties and creditors with priority determined by the order of filing or perfection under the U.C.C.).

\textsuperscript{57} 452 F.2d 1219 (8th Cir. 1971) (interpreting the U.C.C. as adopted by Minnesota).
bond surety asserted that its rights in the retainage funds were superior to those of the trustee in bankruptcy.\textsuperscript{58}

The \textit{Gleason} court held that subrogation rights were not "consensual security arrangements" and therefore fell outside the scope of U.C.C. section 9-102.\textsuperscript{59} The court restated the rationale set forth in \textit{Jacobs} that the notice objectives of Article 9 would not be served by subjecting the surety's subrogation rights to filing requirements.\textsuperscript{60} Citing \textit{National Shawmut} and the official comment to section 9-101, the court found that the difference between suretyship and commercial lending was compelling and held that the provisions of Article 9 were inapplicable to the former type of transaction.\textsuperscript{61}

The \textit{Gleason} court went further than \textit{Jacobs} and \textit{National Shawmut}, offering additional analytical grounds for its holding. For example, the court found that section 9-104(f)\textsuperscript{62} placed the surety's equitable subrogation rights outside the Code.\textsuperscript{63} The court also held that, even if covered, subrogation rights are exempt from U.C.C. filing requirements under section 9-302(1)(e).\textsuperscript{64} Finally,

\begin{itemize}
\item[58.] \textit{Id.} at 1220.
\item[59.] \textit{Id.} at 1222. The court, relying on the official comment to section 9-102, stated that "the equitable lien does not arise from the consent of the parties or by their intent, but by operation of law." \textit{Id.}
\item[60.] \textit{Id.} at 1223 (quoting \textit{Jacobs}, 416 Pa. at 429, 206 A.2d at 55). For an analysis of the \textit{Jacobs} courts' consideration of the need for notice, see \textit{supra} note 43 and accompanying text.
\item[61.] \textit{Id.} at 1222-23. The court stated:
Suretyship and general financing arrangements are different conceptually and there is no valid reason to paint them with the same broad brush, nor is filing for the sake of filing a cogent reason for favoring the trustee and general creditors over a surety who has suffered the direct loss on performance. To introduce further complications of filing so-called financing arrangements, which are not in fact true financing arrangements, where no legitimate purpose is served is a waste of time and energy.
\textit{Id.} at 1224.
\item[62.] Section 9-104(f) excludes from Article 9 coverage a sale, assignment, or transfer of accounts or chattel paper to an assignee who is to render performance under the contract. U.C.C. \S\ 9-104(f) (1989).
\item[63.] \textit{Gleason}, 452 F.2d at 1224. For an argument that section 9-104(f) was not intended to exclude surety transactions but rather was intended to apply to those situations where there is a total assignment of rights and delegation of duties under the contract, see 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 973-74 (1965).
\item[64.] \textit{Gleason}, 452 F.2d at 1224. Section 9-302(1)(e) excludes from filing requirements "an assignment of accounts which does not alone or in conjunction with other assignments to the same assignee transfer a significant part of the outstanding accounts of the assignor." U.C.C. \S\ 9-302(1)(e) (1989). In finding subrogation rights exempt, the \textit{Gleason} court cited the official comment to Minnesota's version of section 9-302: "This paragraph exempts from the filing requirement assignments of accounts or contract rights which are
the court examined the legislature's failure to expressly apply the U.C.C. to subrogation rights and inferred that such an application was not intended: "[B]efore the Uniform Commercial Code, the doctrine of equitable subrogation in suretyship cases was firmly established and the question of whether this doctrine should be discarded is certainly a legislative one. The doctrine should not be abolished obliquely by labeling or mislabeling certain transactions as 'security interests.'" 86

Although some recently decided cases are in conflict with the traditional notion of the surety's superior equitable subrogation rights, 86 the principles enunciated in Pearlman, Jacobs, National Shawmut, and Gleason generally have prevailed in recent federal, 67 state, 88 and bankruptcy court 89 decisions. The doctrine of equitable subrogation, as applied in nearly every jurisdiction, grants payment and performance bond sureties a superior claim to undisbursed contract funds over the lender with a perfected security interest in such funds. 70

65. Id. at 1224.

IV  WHY THE SURETY SHOULD FILE ITS INDEMNITY AGREEMENT AS A SECURITY INTEREST UNDER THE U.C.C.

Despite the widespread acceptance of the equitable subrogation doctrine, sureties should consider perfecting their security interests in contract funds by filing their indemnity agreements under the U.C.C. The following sections set forth the arguments for such a course of action.

A. Erosion of the Equitable Subrogation Doctrine

Several recent decisions limit or threaten to limit the surety's traditional subrogation rights. For example, the 1988 decision by the Florida District Court of Appeals in Transamerica Insurance Co. v. Barnett Bank completely departed from the holdings and rationales of Pearlman, Jacobs, National Shawmut, and Gleason. Although this decision was overturned by the Florida Supreme Court in 1989, it is worthwhile to revisit the lower court's reasoning. Because equitable subrogation is a federal common law doctrine, it is not binding on state courts interpreting the U.C.C. or ruling on disputes involving non-federal projects governed by state law. Thus, the well-established Supreme Court precedent does not foreclose the possibility that other jurisdictions will adopt the position of the intermediate appellate court in Transamerica.

Transamerica involved a question of priority between the performance and payment bond surety and the construction financing bank as to earned but unpaid progress payments held by the owner after the contractor's default. The appellate court based its ruling in favor of the lender over the surety on both policy and legal rationales.

74. Transamerica, 524 So. 2d at 443, rev'd on other grounds, 540 So. 2d 113 (Fla. 1989); R. Smith & V Covalt, supra note 38, at 13, 21; see also Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).
75. Transamerica, 524 So. 2d at 441. The facts in Transamerica are similar to those in Pearlman, Jacobs, National Shawmut, and Gleason. See supra notes 28-70 and accompanying text.
76. Id. at 443-44.
First, the Transamerica court observed that when the United States is not in the position of owner and party litigant, the Assignment of Claims Act and the Miller Act are inapposite. Therefore, state law determines the priority question.\textsuperscript{77} Next, the court noted that the doctrine of equitable subrogation was developed through federal construction contract cases in the pre-1940 era when neither the surety nor the bank could secure a “valid” assignment against the United States.\textsuperscript{78} The Transamerica court also disregarded federal policies which it considered irrelevant to state judicial decisions, such as favoring sureties because they directly assist the United States in construction completion.\textsuperscript{79} Finally, the court found that the purpose of the Miller Act in requiring surety bonds is to ensure that laborers and materialmen have protection not afforded by mechanics’ lien statutes. Granting priority to sureties, however, is not necessary to achieving this purpose.\textsuperscript{80}

The Transamerica appellate court held that the surety’s indemnity agreement “constitute[d] a security interest subject to the filing and perfection requirements of [the U.C.C.]”\textsuperscript{81} Turning to the exemption provisions of section 9-104(f), the court rejected an argument that this section was intended to place assignments to sureties outside Article 9,\textsuperscript{82} ruling that “section [9-104(f)] was intended to exclude transfers, not for security, in which the assignee of the construction contract takes over the contract and receives an assignment of rights and assumes the contractor’s duty of performance.”\textsuperscript{83} The appellate court criticized the inferences the National Shawmut court drew from the rejection of proposed U.C.C. § 9-312(7),\textsuperscript{84} reasoning that “deletion of the proposed special priority rule merely put the problem back into the general

\textsuperscript{77} Id. at 443.
\textsuperscript{78} Id. The federal Assignment of Claims Act validated assignments to banks and motivated federal courts to continue to apply equitable subrogation principles to afford sureties a remedy. Id.
\textsuperscript{79} Id. at 443-44.
\textsuperscript{80} Id. at 444.
\textsuperscript{81} Id.
\textsuperscript{82} But see supra notes 62-63 and accompanying text.
\textsuperscript{83} Transamerica, 524 So. 2d at 444; see also In re Kuhn Constr. Co., 11 Bankr. 746, 749 (Bankr. S.D.W Va. 1981) (section 9-104(f) exclusion not applicable to surety because surety may engage another contractor to complete performance); 2 G. Gilmore, supra note 63, at 973-74.
\textsuperscript{84} See supra notes 54-56 and accompanying text.
priority rule, U.C.C. § 9-312(5) The court then interpreted section 9-312(5) as granting priority to the party perfecting its interest first, regardless of knowledge of outstanding interests. The appellate court found that its holding would engender an efficient filing system which would, in turn, promote efficient commerce generally.

The Transamerica appellate court concluded that where the surety possessed, but failed to take advantage of, an adequate remedy at law, it should not be able to recover under the doctrine of equitable subrogation. Had this ruling withstood review, it would have required sureties to perfect their security interest in available contract funds before other creditors in order to maintain the priority previously afforded by equitable subrogation. The court was not persuaded that this requirement would work a hardship on sureties, noting that even where a creditor has a prior, perfected claim, a surety can refuse to issue a bond unless the bank agrees to subordinate its interest to the surety.

The Transamerica appellate decision is not alone in its departure from the majority position. Several recent bankruptcy court decisions have limited a surety's equitable subrogation rights in much the same way. In Great American Insurance Co. v Universal Builders (In re Universal Builders), a contractor filed a Chapter 11 petition, yet continued to work on nine Miller Act projects. The surety filed a motion for adequate protection, seeking to limit the contractor-debtor-in-possession's use of progress.

85. Transamerica, 524 So. 2d at 444 n.13; see also Hoffman supra note 11, at 393-94 (arguing that even with the rejection of section 9-312(7), surety should be required proceed under its legal assignment in accordance with the U.C.C.).

86. Transamerica, 524 So. 2d at 445 (“Because knowledge is a subjective question, easy to allege and argue but difficult to disprove, its controlling importance in a commercial system greatly impedes commerce”).

87. Id.

88. Id. at 446. Similar arguments were espoused more than twenty years earlier. See, e.g., Hoffman, supra note 11, at 393-94; Note, Suretyship: Subrogation under the Uniform Commercial Code, 65 Colum. L. Rev. 927, 933 (1965); Note, supra note 22, at 593-95.

89. See In re V Pangori & Sons, 53 Bankr. 711 (Bankr. E.D. Mich. 1985) (for a detailed discussion of Pangori, see infra notes 100-12); Great Am. Ins. Co. v. Universal Builders (In re Universal Builders), 53 Bankr. 183 (Bankr. M.D. Tenn. 1985) (for a detailed discussion of Universal Builders, see infra notes 90-99); see also J. Sheak & T. Korzun, supra note 70, at 22 (commenting that these decisions “are illustrative of the policy choice of the bankruptcy courts to enlarge the general assets of the estate as much as possible.”).


SURETIES: EQUITABLE SUBROGATION

payments to satisfaction of labor and material claims for which the surety was contingently liable.92 The court denied the motion, noting that the surety had failed to perfect its indemnity agreement under the U.C.C.93 The court held that the surety "ha[d] no equitable right in the progress payments which would entitle it to adequate protection."94 Specifically, the court recognized that the surety, upon discharge of the claims of laborers and materialmen, would be subrogated to the rights of such persons. However, such claimants were deemed unsecured creditors of the estate.95 The court concluded, therefore, that the surety also occupied the position of unsecured creditor.96 This holding is appropriate since a surety possesses "no greater rights than those of the person whose rights he is asserting."97

Critical to the Universal Builders holding was the distinction drawn between retainage funds and progress payments in In re Glover Construction Co.98 Focusing on this distinction, the Universal Builders court limited the equitable subrogation principles espoused in Pearlman to retainage funds and refused to apply those principles to progress payments.99

93. Id. at 186.
94. Id. at 187.
95. Id. The court offered no rationale for this conclusion. See J. Sheak & T. Korzun, supra note 70, at 25-26 (discussing the inconsistency of Universal Builders with other federal cases).
96. Universal Builders, 53 Bankr. at 187; see also Haug & Haug, Bankruptcy 1984 vs. the Surety's Rights to Contract Proceeds, 20 Forum 725, 745-46 (1985) (warning that "[r]elying solely on the subrogation to the right of laborers and materialmen can be dangerous. The surety's subrogation to the rights of the owner and debtor can be far more effective in the bankruptcy context."). Universal Builders is troubling due to the court's failure to consider the surety's subrogation to the right of the owner to use earned but unpaid progress payments to satisfy the claims of unpaid labor and material claims. Compare National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843, 845, 848, reh'g denied, 411 F.2d 843 (1st Cir. 1969) (surety is subrogated to owner's right to apply earned but unpaid progress payments to completion costs); Trinity Universal Ins. Co. v. United States, 382 F.2d 317, 320 (5th Cir. 1967), cert. demed, 390 U.S. 906 (1968) (stating that if the surety undertakes the completion of the project, it has the right to defray costs with the retained funds and remaining progress payments). Arguably, this right of subrogation would justify giving the surety adequate protection. But see infra note 105 and accompanying text (discussing a court's rejection of such a subrogation right as applied to a payment bond surety).
97. R. Smith & V Covalt, supra note 38, at 12.
98. 30 Bankr. 873, 875-77 (Bankr. W.D. Ky. 1983). The Glover court characterized retainage as an "indemnity resource for unpaid subcontractor's claims or guarantor payments of claims of secondary parties" and progress payments as "funds which the owner contracts to pay periodically based upon satisfactory performance " Id. at 875, 877.
99. Universal Builders, 53 Bankr. at 186. This limitation is in derogation of the ma-
In *In re V Pangori & Sons*, a contractor defaulted on a construction contract entered into with the City of Sterling Heights, Michigan. After notification that its contract had been terminated, the contractor filed for Chapter 11 protection and obtained a post-petition bank loan to provide working capital for other, ongoing projects. As security, the lending bank was given priority status in all unencumbered assets of the bankrupt. A settlement between Sterling Heights and the contractor was reached regarding the latter's claims under the construction contract, and the bankruptcy court issued an order awarding the settlement amount to the bank. The surety then moved to vacate the order, claiming that the equitable subrogation doctrine gave it a superior right to the funds.

The *Pangori* court followed the majority view and held that the surety's equitable subrogation rights were outside the scope of the U.C.C. Nonetheless, the court held the rights of the trustee and the assignee bank to be superior to those of the surety. In so holding, the court dismissed *Pearlman* as non-binding precedent, stating that "federal common law interpretations of surety's rights" did not apply to this non-Miller Act project.

The cornerstone of the *Pangori* court's decision was its holding that a surety's equitable subrogation rights arise only when the surety becomes obligated to perform under the executed bonds, which, in the case of a payment bond, occurs when laborers or materialmen demand payment. In addition, the court held that

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101. *Id.* at 713-14.
102. *Id.* The bankruptcy court granted an ex parte motion by the receiver, who was later appointed trustee, approving an assignment to the bank of all proceeds due under the Sterling Heights contract. *Id.*
103. *Id.* The surety also claimed a superior right pursuant to a contract of indemnity which the surety believed was not governed by the U.C.C. filing requirements. *Id.*
104. *Id.* at 717. The court noted that the right of subrogation does not depend on an express contractual grant but is created by operation of law to avoid injustice and, thus, is not a security interest governed by Article 9. *Id.*, see supra note 12 and accompanying text.
105. *Id.* at 718. The *Pangori* court further distinguished *Pearlman*. In denying the surety's asserted subrogation to the government-owner's rights, the court stated that unpaid laborers and materialmen were not creditors of the government-owner insofar as the latter had no obligation to ensure that the former were paid. *Id.* at 721. The court commented that "the payment bond is 'solely for the protection of' laborers and materialmen; not for the benefit of the municipality." *Id.* (construing MICH. COMP. LAWS § 129.203 (1985)).
such rights do not relate back to the date of execution of the bonds. In Pangori no demand for payment had been made at the time of the bankruptcy filing. Accordingly, the trustee's rights as a judicial lien creditor and the bank's rights as the trustee's assignee defeated the surety's equitable subrogation rights.

Cases such as Transamerica, Universal Builders, and Pangori clearly depart from the majority view of a surety's equitable subrogation rights. These opinions illustrate that such rights are not invincible. These decisions erode the doctrine of equitable subrogation and encourage lenders to fight vigorously over the right to contract funds. By engaging in the relatively simple task of filing its indemnity agreement under the U.C.C. before the lender perfects its assignment of contract funds, the surety will have clearly established its superior right to such funds.

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106. Id. at 720, 721. The court based this holding on an extension of principles set forth in Earl Dubey & Sons v. Macomb Contracting Corp., 97 Mich. App. 553, 559, 296 N.W.2d 582, 585 (1980) (equitable subrogation rights accrue when contractor is in default and surety is obligated to perform). The principle enunciated in Pangori is contrary to the overwhelming majority of cases which hold that equitable subrogation rights relate back to the date of execution of the performance or payment bond. See, e.g., cases cited supra notes 27-28; J. Sheak & T. Korzun, supra note 70, at 18 n.38.

107. See 11 U.S.C. § 544(a)(1) (1988) (stating that "[t]he trustee shall have the rights and powers of a creditor that extends credit to the debtor and that obtains, at such time and with respect to such credit, a judicial lien on all property, on which a creditor could have obtained such a judicial lien ").


109. See R. Smith & V Covalt, supra note 38, at 15 ("[T]he desperate situation of creditors of a failed contractor probably assures that the attacks will continue.").

110. While filing entails the expenditure of time and money, including the procurement of specialized U.C.C. forms, determination of the appropriate filing office, and the payment of filing fees, these costs are trifling as compared to the potential costs of extended litigation. See R. Smith & V Covalt, supra note 38, at 40. Moreover, most indemnity agreements provide that the agreement constitutes a financing statement in accordance with the U.C.C., thus allowing the surety to file the original agreement bearing both the surety's and the contractor-debtor's signatures. See T. Leo, supra note 66, at 15.

111. R. Smith & V Covalt, supra note 38, at 17. One potential problem is that the lender may already have filed a financing statement, thus vesting it with a superior claim to the funds. Often this occurs where the lender has filed a prior "blanket" or "dragnet" financing statement. Such statements perfect a security interest in the present accounts of the contractor as well as those which may arise in the future. See Hoffman, supra note 11, at 389; Note, supra note 16, at 592 (lender may be able to keep a financing statement on file for future contracts entered into by a regular customer, thereby taking priority over the surety's security interest).

Where the lender files a blanket financing statement, the U.C.C. rules governing purchase money security interests allow the surety to gain priority over the lender by filing its security interest. U.C.C. § 9-107 provides:

A security interest is a "purchase money security interest" to the extent that it is (b) taken by a person who by making advances or incurring an obligation
utilizing the protection offered by the U.C.C., the surety will enhance the predictability and clarity of its rights. The end result will be a substantial savings in time, money, and efficiency.

B. Procurement of Set-Off Rights

Perfection of its security interest allows a surety to attach the contractor’s profits from projects unrelated to the project that triggers the surety’s performance and to apply these profits against the surety’s performance losses. These surplus funds would be unavailable to the surety under the equitable subrogation doctrine.

An example may help illustrate the significance of this distinction. Suppose a contractor and the federal government enter into two separate construction contracts (K1 and K2) for two projects each to be completed within one year at a price of $120,000 per project and calling for monthly progress payments of $10,000 per project. Since both projects qualify as public con-

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gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.


The surety’s execution of the indemnity agreement qualifies it as a holder of a “purchase money security interest” as defined by U.C.C. § 9-107(b). Because the surety has a purchase money security interest it will have priority over a conflicting security interest in the same collateral or its proceeds “if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.” U.C.C. § 9-312(4) (1989). Thus, as long as the surety files the indemnity agreement either before execution of the construction contract or within ten days after its execution, the surety will have priority over the “floating lien” of the lender. Note, supra note 16, at 593. Alternatively, a surety may achieve priority through a subordination agreement with the lender. Id. This method has the advantage of forcing the surety and the lender to define their respective rights before the principal’s Chapter II proceeding and the distribution of funds. See T. Leo, supra note 66, at 15. This will result in a decrease in surety-assignee litigation and lower the cost of defining rights to contract funds after default by a contractor. See Note, supra note 22, at 594-95. Because the rights of each party are defined initially, each method will reduce the likelihood of an expensive dispute.

112. See R. Smith & V Covalt, supra note 38, at 40.

113. See Hoffman, supra note 11, at 391 (legal assignment gives surety broader rights than equitable subrogation).

114. J. Sheak & T. Korzun, supra note 70, at 19 n.39; see, e.g., Anderson v. United States, 561 F.2d 162, 167 (8th Cir. 1977) (stating that surety’s equitable subrogation rights “in no event existed beyond the extent necessary to reimburse itself for expenditures made in fulfilling its obligations under the bonds”); Transamerica Ins. Co. v. Barnett Bank, 540 So. 2d 113, 117 (Fla. 1989) (“Priority based on equitable subrogation in one contract does not provide priority in excess funds from another contract.”).

115. For simplicity this illustration assumes zero retainage. This assumption does not affect the outcome of this example.
struction projects governed by the Miller Act, the contractor would be required to obtain payment and performance bonds.\textsuperscript{116}

Assume the contractor defaults on both projects nine months later, after earning $90,000 and receiving $80,000 per project with $40,000 per project remaining in the government-owner's hands.\textsuperscript{117} The surety then enters the project, compensates unpaid laborers and materialmen, and completes the projects at a cost of $60,000 for the K1 job and $25,000 for the K2 job. If the surety perfects its security interest in the contract funds due and payable under each contract, the surety's net loss would be only $5,000, $85,000 total cost incurred under the bonds less the $80,000 in contract funds received. This is because the surety can apply the surplus funds from K2 against the loss incurred on K1. If, on the other hand, the surety seeks reimbursement solely under the doctrine of equitable subrogation, its net loss will be larger. The surety will receive contract funds in an amount equal to the lesser of its costs incurred or the amount of the undisbursed funds for each project. Thus, it will receive the $40,000 balance for payments and performance under K1, but only $25,000 for K2, resulting in a net loss of $20,000 ($85,000 - $65,000).

C. Procurement of a Security Interest in the Contractor's Material and Equipment

The surety should file its indemnity agreement under the U.C.C. because filing provides the surety with a perfected security interest in the contractor's other assets, such as materials and equipment used in the course of construction. Equitable subrogation rights do not reach these assets.\textsuperscript{118} The indemnity agreement generally includes an assignment of materials and equipment used

\begin{footnotes}
\textsuperscript{116} See supra note 8.
\textsuperscript{117} In other words, the government-owner would be holding $10,000 in earned but unpaid progress payments and $30,000 in unearned progress payments.
\textsuperscript{118} See R. Smith & V. Covalt, supra note 38, at 13, 36-37; T. Leo, supra note 66, at 16 (surety's decision to file depends on its willingness to make the effort to perfect and monitor the security interest); see also Aetna Casualty & Sur. Co. v. Bunken, 357 F. Supp. 290, 293 (D.S.D. 1973) (failure to file and perfect Article 9 security interests in compliance with U.C.C. 9-102 provisions is fatal to a surety's claim on personal property); United States Fidelity & Guar. Co. v. Leach (In re Merts Equip. Co.), 438 F. Supp. 295, 298 (Bankr. M.D. Ga. 1977) ("The surety cannot accede to the general assets of the contractor absent some assignment of title or attachment through a perfected security interest."); Travelers Indem. Co. v. Clark, 254 So. 2d 741, 747 (Miss. 1971) (assignment contained in a bond application cannot create security interest in proceeds of other projects without compliance with U.C.C. provisions).
\end{footnotes}
by the contractor in performing the construction project in addition to an assignment of contract funds.\textsuperscript{119} However, the lender typically obtains an assignment of these items as well.\textsuperscript{120} By perfecting its security interest in these assets as the first to file\textsuperscript{121} or by asserting its interest as a purchase money security interest,\textsuperscript{122} the surety will ensure that its right to these assets is superior to the lender's right. Since contract funds remaining in the hands of the owner are often grossly insufficient to reimburse the surety for amounts expended pursuant to the performance or payment bonds, it behooves the surety to file its security interest.\textsuperscript{123}

Perfecting a security interest in materials and equipment could entail greater time and expense than perfecting a security interest in the contract funds.\textsuperscript{124} However, when faced with tremendous discrepancies between amounts expended under the bonds and contract funds available for reimbursement, these addi-

\begin{footnotes}
\footnote{119. See Withers, supra note 1, at 357 n.3. Withers's model indemnity agreement contains a clause assigning to the surety "all machinery, equipment, plant tools and materials which are now, or may hereafter be, about or upon the site of said work or elsewhere"
\footnote{Id.}
\footnote{120. This is frequently the case where the lender has filed a dragnet financing statement. Such financing statements, then, encompass the contractor's interest in equipment and inventory, as well as his interest in contract funds. Hoffman, supra note 11, at 389. The lender's security interest in materials derives from the assignment of the contractor's "inventory" The U.C.C. defines inventory as goods which are "held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in progress or materials used or consumed in a business." U.C.C. § 9-109(4) (1989). The Official Comment to this section states in pertinent part that:
Goods to be furnished under a contract of service are inventory even though the arrangement under which they are furnished is not technically a sale. In general it may be said that goods used in a business are inventory, even though not held for sale, if they are used up or consumed in a short period of time in the production of some end product.
U.C.C. § 9-109 official comment 3 (1989). Pursuant to section 9-109, materials used by the contractor during the construction work constitute "inventory" For a further discussion, see R. Smith & V Covalt, supra note 38, at 23.
\footnote{121. See supra note 111.}
\footnote{122. See R. Smith & V Covalt, supra note 38, at 27-28; see also supra note 12 (discussing how U.C.C. prioritizes security interests).
\footnote{123. For example, the surety in National Shawmut incurred performance bond expenses of approximately $97,000, while the earned but unpaid progress payments it sought totalled only $44,202.05. National Shawmut Bank v. New Amsterdam Casualty Co., 441 F.2d 843, 844, reh'g denied, 441 F.2d 843 (1st Cir. 1969). In Pearlman the surety who had discharged payment bond claims of approximately $350,000 was seeking reimbursement from retainage amounting to only $87,737.35. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 134 (1962).
\footnote{124. See T. Leo, supra note 66, at 15.}}
tional expenditures are easily justified.\textsuperscript{125}

D. "Nothing to Lose"

Other than added time, effort, and expense,\textsuperscript{126} the surety has nothing to lose by filing an indemnity agreement under the U.C.C. Filing is not a waiver of any rights the surety enjoys under the equitable subrogation doctrine.\textsuperscript{127} The surety that files its indemnity agreement only strengthens its secured position — it does not relinquish or waive any rights.

V A Case For Partial Abrogation Of The Equitable Subrogation Doctrine In The Construction Surety Context

By affording the surety an opportunity to claim the undisbursed contract proceeds whether it files its security interest or not, the majority position violates the long established principle that equitable remedies are available only where there is no adequate remedy at law\textsuperscript{128} Since the surety can, in most cases, fully protect its interest in the contract funds by filing its indemnity agreement, there is no need to clothe it with equitable rights.\textsuperscript{129}

\textsuperscript{125} Some commentators contend that by perfecting a security interest in materials and equipment, the surety might disrupt the construction process by restricting the contractor's ability to obtain financing or by violating the loan agreement between the contractor and construction lender through the creation of a lien on the contractor's assets. See T. Leo, supra note 66, at 14; R. Smith & V Covalt, supra note 38, at 39. However, these problems can be alleviated by the surety and lender meeting "to define relative rights before the problems arise." R. Smith & V Covalt, supra note 38, at 39-40. One possible solution may be the execution of subordination agreements with respect to certain assets, to ensure that both surety and lender are secured adequately, without occupying a position of "over-security" at the expense of each other or other creditors. See Note, supra note 16, at 594. Moreover, early cooperation by the surety and lender may help to avoid later disputes which could erupt into costly litigation. See supra note 111 and accompanying text. Smith and Covalt point out that, insofar as loan proceeds were used to purchase materials or equipment, a lender may hold a purchase money security interest superior to the prior perfecting surety's interest. R. Smith & V Covalt, supra note 38, at 36.

\textsuperscript{126} See supra note 110 and accompanying text.

\textsuperscript{127} R. Smith & V Covalt, supra note 38, at 38; see also Canter v. Schlager, 358 Mass. 789, 267 N.E.2d 492 (1971) (filing under the U.C.C. is not necessary to preserve the surety's rights, nor does it affect the surety's rights under law or equity).

\textsuperscript{128} See Note, supra note 88, at 933; R. Smith & V Covalt, supra note 38, at 38-39.

\textsuperscript{129} See Hoffman, supra note 11, at 394:

Prior to the Code, the surety could justifiably plead that it was without an adequate legal remedy and was entitled to recourse to equity, where it could assert subrogation. However, the law, through the Code, has provided a remedy where
The evolution of suretyship from the time when the equitable subrogation doctrine was devised suggests the need for evolution in the law governing sureties. No longer is the typical surety a relative guaranteeing the debts or obligations of a family member. Rather, the contemporary performance or payment bond surety is generally an insurance company, which, as a profit-motivated entity, sets bond premium rates by engaging in complex actuarial calculations. Thus, in addition to being able to protect itself by perfecting a security interest in the contract proceeds, the surety has the ability to spread the risk of contractor default throughout the construction industry.

The purpose of U.C.C. Article 9 is to simplify the formalities required to create security interests, in order to allow a greater number of secured transactions to proceed "with less cost and with greater certainty." In addition, section 1-102 provides that the policies and purposes of the Code are, inter alia, "to simplify, clarify and modernize the law governing commercial transactions and [and] to make uniform the law among the various jurisdictions." Given the characteristics of the modern day construction surety and that the surety is able to protect itself under the U.C.C., subjecting the surety's interest in undisbursed contract proceeds to the provisions of Article 9 would further the proffered goals of simplicity, efficiency, modernization, and uniformity. It would either significantly reduce or put an end to litigation over what one commentator has termed "the quarrel that will not before one did not exist. Therefore, in cases such as Jacobs, the surety should be denied access to equity. If the surety pleads that it is without an adequate remedy at law, equity should not listen, since the inadequacy arises because of the surety's own fault, in that it failed to file its legal assignment.

Id. (emphasis in original).

130. See Transamerica Ins. Co. v. Barnett Bank, 524 So. 2d 439, 446 (Fla. Dist. Ct. App. 1988), rev d, 540 So. 2d 113 (Fla. 1989) (the original purposes of equitable subrogation do not exist in the context of modern sureties); see also G. Osborne, Secured Transactions Cases and Materials, 7-9 (1967) (drawing a distinction between professional surety and traditional "warm hearted but imprudent" surety).

131. See Commercial Standard Ins. Co. v. Bank of Am., 57 Cal. App. 3d 241, 129 Cal. Rptr. 91 (1976). Commercial Standard involved a surety's negligence claim against a bank which advanced construction funds to a contractor in violation of the construction loan agreement. The court, although holding in favor of the surety, expressed reservations due to the surety's superior risk spreading capability as compared to that of the bank. Id.


134. See supra notes 114-27 and accompanying text.
The equitable subrogation doctrine should complement Article 9 of the U.C.C. in governing surety-lender disputes over undisbursed contract proceeds. Under this approach, sureties should be allowed to recover pursuant to equitable subrogation only where filing in accordance with the U.C.C. would not afford legal protection. For example, in jurisdictions which hold that the contractor forfeits the right to earned but unpaid progress payments upon default, the surety does not possess an adequate remedy at law under the U.C.C. In such cases, resort to equitable subrogation allows the surety to recover the funds. Conversely, in those jurisdictions which hold that defaulting contractors have an interest in earned but unpaid progress payments, the surety is able to claim the funds by means of its perfected U.C.C. security interest. This limitation on the equitable subrogation doctrine preserves the principle that equity should not intervene where an adequate remedy at law is available.

VI. CONCLUSION

This note has argued that it is prudent for the performance or payment bond surety to file under U.C.C. Article 9 the indemnity agreement entered into with the contractor. Generally, filing is in the best interests of the surety and affords it maximum protection. Such protection will allow sureties to continue to insure that construction projects will be completed even when there has been a default by the contractor. Moreover, it is in each party's interest, as well as that of the public, that construction jobs come to fruition.

This note has advocated a partial rejection of the equitable

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136. See, e.g., National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843, 848, reh'g denied, 411 F.2d 843 (1st Cir. 1969) (holding that defaulting contractor forfeits rights to earned but unpaid progress payments).
137. An assignee acquires an interest in collateral only to the extent of the assignor's interest. In this case the assignor's interest in the collateral is zero due to the forfeiture.
139. See Transamerica Ins. Co. v. Barnett Bank, 540 So. 2d 113, 117 (Fla. 1989) ("The interests of all concerned parties, whether they be contractors in default, nonsurety assignees, owners, or other obligees, are best served by prompt performance by the surety.").
subrogation doctrine as applied to surety-lender disputes over undisbursed contract proceeds. Such a rejection would not adversely affect the filing surety's prospects for reimbursement and would eliminate redundancies between law and equity

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