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## 2016 Northeast Surety and Fidelity Claims Conference

### A Primer for the RESTATEMENT OF THE LAW SURETYSHIP AND GUARANTY

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#### I. Introduction.

The RESTATEMENT OF THE LAW SURETYSHIP AND GUARANTY (the “RESTATEMENT OF SURETYSHIP”)<sup>1</sup> seems to be written in a foreign language for those who work in the contract bond and the commercial bond surety world. While the RESTATEMENT OF SURETYSHIP sets forth the basic foundation of suretyship principles, one must get into the “flow” and “jargon” of the language that is used in the RESTATEMENT OF SURETYSHIP in order to understand those fundamental suretyship principles.

The goal of this paper is two-fold. First, this paper will redefine the terminology used in the RESTATEMENT OF SURETYSHIP and use terms that are much more familiar to those who work in the contract bond surety and commercial bond surety industries. However, while contract bond surety and commercial bond surety underwriting and claims handling standards and procedures have much in common, for simplicity and to eliminate confusion, this paper will address the RESTATEMENT OF SURETYSHIP principles as they apply to contract bond surety situations only. Second, this paper will address four issues that are critical for surety claim representatives, whether they are attorneys or adjusters, or outside surety attorneys to understand. Those issues include the obligee’s rights against the surety under the bond, the surety’s defenses to the obligee’s claims, the surety’s rights of indemnity and reimbursement from the principal, and the surety’s subrogation rights.

Much has been written about the issues addressed in this paper that is outside the particular wording or concepts contained in the RESTATEMENT OF SURETYSHIP. The text and footnotes of this paper are limited to and focused on an examination and analysis of the actual RESTATEMENT OF SURETYSHIP terms and provisions. However, there are other sources and publications that address and expand on such issues as the surety’s rights under a bond, the surety’s defenses to the obligee’s claims, and the surety’s reimbursement and subrogation rights. A summary of those other sources and publications may be referred to in the footnotes of this paper and are then found in the Appendices attached to this paper.

#### A. The Drafting of the RESTATEMENT OF SURETYSHIP.

When one reviews the history of the drafting of the RESTATEMENT OF SURETYSHIP, one can discover the backdrop for both the terminology used in the RESTATEMENT OF SURETYSHIP and the black letter law suretyship principles set forth therein. The formal title of the RESTATEMENT OF

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<sup>1</sup> RESTATEMENT OF THE LAW (THIRD) OF SURETYSHIP & GUARANTY (Am. Law Inst. 1996).

SURETYSHIP is the RESTATEMENT OF THE LAW SURETYSHIP AND GUARANTY.<sup>2</sup> The reason for this is that surety bonds are not the only commercial transaction for which the suretyship principles apply. The suretyship principles apply to various commercial guarantees and other commercial transactions, including surety bonds, and a common terminology was necessary to set forth the suretyship principles that would cover all such suretyship transactions, not just those applicable to surety bonds. As a result, the drafters of the RESTATEMENT OF SURETYSHIP included representatives from all sides of the suretyship industry including commercial guarantees for loans and surety bonds, and the language and terminology used in the RESTATEMENT OF SURETYSHIP reflects both the need for a common terminology applicable to all suretyship transactions and the ultimate consensus of the drafters.

A number of publications have discussed the history of the drafting of the RESTATEMENT OF SURETYSHIP and how the RESTATEMENT OF SURETYSHIP sets forth the basic black letter law and principles of the American common law with respect to suretyship principles.<sup>3</sup> They are worth a review for a better understanding of the suretyship principles.

#### B. Defining the Terms Used in the RESTATEMENT OF SURETYSHIP.<sup>4</sup>

In order for a person or an entity to achieve “suretyship status” and to obtain the rights granted to one who has achieved “suretyship status,” including those discussed in this paper, certain transactions must arise. Section 1(1) of the RESTATEMENT OF SURETYSHIP provides as follows:

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<sup>2</sup> Although The RESTATEMENT OF SURETYSHIP is identified as the third version, there was no “second” Restatement for surety law. See T. Scott Leo, *Ch. 2, The Treatment of the Fundamental Principles of the Surety’s Subrogation Rights in the Restatement of the Law*, in THE CONTRACT BOND SURETY’S SUBROGATION RIGHTS 62 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass’n 2013). There was also no “first” Restatement for surety law which existed as an independent source; instead, the “first” Restatement of surety law was included with other topics in the RESTATEMENT OF SECURITY §§ 82-211 (Am. Law Inst. 1941). See *id.*

<sup>3</sup> See Daniel Mungall, *Ch. I, Origin and Overview of the Restatement Project*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 1-13 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass’n 2005) and the Appendix to Chapter 5 in Daniel Mungall and Samuel J. Arena, Jr., *Ch. V, The Effect on Surety of Obligee’s Release of Principal: A Critical Look at the Rules in the Restatement*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 99-105 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass’n 2005). See also T. Scott Leo, *Ch. 2, The Treatment of the Fundamental Principles of the Surety’s Subrogation Rights in the Restatement of the Law*, in THE CONTRACT BOND SURETY’S SUBROGATION RIGHTS 59-68 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass’n 2013); Geoffrey C. Hazard, Jr., *Introduction*, 34 Wm. & Mary L. Rev. 985 (1993) (Note: Volume 34 of the William & Mary Law Review was devoted exclusively to a review of the then forthcoming publication of the RESTATEMENT OF SURETYSHIP and the framework and background surrounding its formulation and adoption); Donald J. Rapson, *History and Background of the Restatement of Suretyship*, 34 Wm. & Mary L. Rev. 989 (1993). For a discussion of the RESTATEMENT OF SURETYSHIP’S impact twenty years after its publication, see Matthew C. Bouchard, Benjamin T. Buskirk, & Jennifer Leuschner, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016).

<sup>4</sup> For another discussion of the terminology used in the RESTATEMENT OF SURETYSHIP, see T. Scott Leo, *Ch. 2, The Treatment of the Fundamental Principles of the Surety’s Subrogation Rights in the Restatement of the Law*, in THE CONTRACT BOND SURETY’S SUBROGATION RIGHTS 71-73 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass’n 2013). Section 15 of the RESTATEMENT OF SURETYSHIP is entitled “Interpretation of the Secondary Obligation – Use of Particular Terms,” including “guarantor” and “surety” (see comment *d* and Illustrations 1 and 2).

## § 1. Scope; Transactions Giving Rise to Suretyship Status

(1) This Restatement applies (except as provided in § 3) and a secondary obligor has suretyship status whenever:

(a) pursuant to contract (the “secondary obligation”), an obligee has recourse against a person (the “secondary obligor”) or that person’s property with respect to the obligation (the “underlying obligation”) of another person (the “principal obligor”) to that obligee; and

(b) to the extent that the underlying obligation or the secondary obligation is performed the obligee is not entitled to performance of the other obligation; and

(c) as between the principal obligor and the secondary obligor, it is the principal obligor who ought to perform the underlying obligation or bear the cost of performance.

The RESTATEMENT OF SURETYSHIP applies and “suretyship status” exists when the above criteria are met.<sup>5</sup> In order to use the vernacular and terminology common and well known to the contract bond surety industry, the definitions in Section 1(1)(a) may be rewritten as follows:

- The “obligee” – the **Obligee**.
- The “principal obligor” – the **Principal**.
- The “underlying obligation” – the underlying obligation/contract (the construction contract, or the **Bonded Contract**) between the Obligee and the Principal.
- The “secondary obligor” – the **Surety**.
- The “secondary obligation” – the **Bond**<sup>6</sup> provided by the Surety to the Obligee.

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<sup>5</sup> See *AgGrow Oils, L.L.C. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 242 F.3d 777, 781 (8th Cir. 2001) (citing Section 1 of the RESTATEMENT OF SURETYSHIP in support of the statement that a “performance bond provides recourse to an obligee (AgGrow) against a secondary obligor (National, the surety) in the event the principal obligor (TEI) fails to perform the underlying obligation.”); *Commercial Money Ctr., Inc. v. Illinois Union Ins. Co.*, 508 F.3d 327, 338 (6th Cir. 2007) (citing Section 1 of the RESTATEMENT OF SURETYSHIP in finding existence of suretyship relationship between banking institutions and insurance companies despite being written as insurance coverage); *CRM Collateral II, Inc. v. TriCounty Metro. Transp. Dist.*, 669 F.3d 963, 970 (9th Cir. 2012) (noting that “Oregon courts look to the [RESTATEMENT OF SURETYSHIP] as authoritative on suretyship law” and citing Section 1 of the RESTATEMENT OF SURETYSHIP in holding that letters of credit do not by themselves create a suretyship relationship); *AmTote Int'l, Inc. v. PNGI Charles Town Gaming Liab. Co.*, 66 F. Supp. 2d 782, 792 (N.D.W. Va. 1999) (citing Section 1 of the RESTATEMENT OF SURETYSHIP in finding suretyship relationship existed for provider of computer gaming services to race track owner when provider assigned certain contract obligations to third party but guaranteed certain of those contract obligations); *Liberty Mut. Ins. Co. v. Sumo-Nan LLC*, No. CIV. 14-00520 DKW, 2015 WL 4093337 (D. Haw. July 6, 2015) (citing Section 1 of the RESTATEMENT OF SURETYSHIP in rejecting arguments by indemnitors that they, in part, were acting as sureties and therefore retained suretyship defenses); *Acuity v. McGhee Eng'g, Inc.*, 297 S.W.3d 718 (Tenn. Ct. App. 2009) (citing Section 1 of the RESTATEMENT OF SURETYSHIP in holding that a suretyship relationship existed in favor of a performance bond surety that entitled it to file suit against project engineers pursuant to the doctrine of equitable subrogation).

<sup>6</sup> Most contract bond surety situations involve two bonds, a performance bond and a payment bond. At other times, the contract bond surety situation may involve only one bond (a combination performance/payment bond, a bid bond, a maintenance bond, and, perhaps, a subdivision bond, a mechanics’ lien release bond and/or other such instances). The RESTATEMENT OF SURETYSHIP refers to the singular “secondary obligation” and not a multiple set of secondary obligations such as a performance bond and a payment bond. This paper will refer to the Surety’s

Using the contract bond surety industry terms and definitions as we define them above instead of and by replacing the “terms” found in Section 1(1)(a) of the RESTATEMENT OF SURETYSHIP, Section 1(1)(a) would read as follows: “suretyship status” arises whenever pursuant to the Bond, an Obligee has a claim against a Surety as a result of the Principal’s failure to perform the Bonded Contract. Unlike the actual and “foreign sounding” language found in Section 1(1)(a) of the RESTATEMENT OF SURETYSHIP, the concept that the Obligee may have a claim against the Surety under the Bond with respect to the Principal’s failure to perform its obligations to the Obligee under the Bonded Contract is very familiar to contract bond surety claims representatives and surety attorneys.

Furthermore, the following suretyship principles found in Sections 1(1)(b) and (c) of the RESTATEMENT OF SURETYSHIP would read as follows:

(1) Section 1(1)(b) – To the extent that the Principal performs the Bonded Contract or the Surety performs the Bonded Contract obligations under the Bond, the Obligee is not entitled to performance of both of the obligations.<sup>7</sup> Namely, if the Principal performs the Bonded Contract, the Obligee is not entitled to the Surety’s performance under the Bond; and

(2) Section 1(1)(c) – As between the Principal and the Surety, it is the Principal who should perform the Bonded Contract obligations, or, if the Surety performs the Bonded Contract obligations under the Bond, it is the Principal who should bear the cost of the Surety’s performance by the Principal’s reimbursement of the Surety for the Surety’s cost of performance of the Bonded Contract under the Bond.<sup>8</sup>

None of these suretyship principles should appear strange to contract bond surety claim representatives or outside surety attorneys. In fact, the basic factual format of the Principal and the Obligee entering into the Bonded Contract for which the Surety is obligated to perform under the Bond if the Principal fails to perform is the essence of the contract bond surety world and obviously provides the Surety with “suretyship status” as defined in the RESTATEMENT OF SURETYSHIP. But there are times when the Obligee, the Principal, and/or the court may refuse to believe that the Surety has rights and defenses and that the Obligee and the Principal have duties and obligations when references and citations to the RESTATEMENT OF SURETYSHIP may be helpful in convincing the Obligee, the Principal and/or the court that the Surety’s position is valid and supportable. That is the reason for this “Primer” paper.

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obligations under the singular term “Bond” even though in most instances the “Bond” is actually two separate Surety “secondary obligations,” an obligation to perform under the performance bond and an obligation to pay under the payment bond. When distinctions may be necessary in describing the Surety’s secondary obligations under the “Bond,” we will refer to either the performance bond or the payment bond or both as necessary and appropriate.

<sup>7</sup> RESTATEMENT OF SURETYSHIP, Section 1(1)(b).

<sup>8</sup> RESTATEMENT OF SURETYSHIP, Section 1(1)(c).

### C. Transactions Giving Rise to Suretyship Status.

Sections 2 and 3 of the RESTATEMENT OF SURETYSHIP describe a number of situations, or transactions, which give rise to suretyship status. Sections 2 and 3, along with Section 1, set out the ground rules for the RESTATEMENT OF SURETYSHIP, which “adopts the principle that the substance of a transaction, rather than its form, should determine whether the transaction is governed by the law of suretyship and guaranty.”<sup>9</sup> The contract bond surety “transaction” is described in Section 3(2), which provides as follows:

#### **§ 3. When Principal Obligor and Secondary Obligor Are Parties to Same Contract**

**(2) When, by one or more contracts with the obligee, both the principal obligor and the secondary obligor agree to a duty to the obligee that is conditioned on the failure of the principal obligor to perform a separate duty owed to the obligee, unless the context indicates otherwise both duties of the principal obligor to the obligee constitute the underlying obligation.**

In the contract bond surety industry, there are normally two separate “contracts.” The first separate contract (the underlying obligation) is the Bonded Contract between the Obligee and the Principal under which both the Obligee and the Principal have certain duties and obligations to perform. The second separate contract (the secondary obligation) is the Bond executed by the Principal and the Surety in favor of the Obligee under which the Principal agrees to perform the Bonded Contract for the Obligee and the Principal and the Surety agree to perform the Bonded Contract in the event that the Principal fails to perform the Bonded Contract.<sup>10</sup> Both the duties and obligations of the Principal to the Obligee under the Bonded Contract and the duties and obligations of the Principal to the Obligee under the Bond constitute the Principal’s “underlying obligations.”

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<sup>9</sup> See RESTATEMENT OF SURETYSHIP, Introductory Note to Chapter 1. The Introductory Note goes on to state that Sections 2 and 3 of the RESTATEMENT OF SURETYSHIP “further elaborate on the breadth of transactions governed by the law of suretyship and guaranty,” including “the various contractual pairings that may establish a secondary obligation and clarify the relationships that result from the common situation in which the principal obligor and the secondary obligor are both obligors on the contract creating the secondary obligation.” For additional comments on the transactions giving rise to suretyship status, see Section 1, comment *b*, which refers to such transactions, including those involving a “surety bond.”

<sup>10</sup> Section 3(2), comment *b*, states as follows:

*b. Surety bonds.* In many contexts in the surety bond area, it is common for the principal obligor to have two related obligations to the obligee. One obligation may be contractual or may be created by law. The second obligation, though, is created by a “surety bond” that has three parties—the principal obligor, the secondary obligor, and the obligee. Pursuant to this contract, the principal obligor and the secondary obligor jointly agree to perform a duty if the principal obligor defaults on the first obligation. In such a case, it is the combined set of duties of the principal obligor to the obligee arising from the combination of the two obligations that constitutes the underlying condition.

For additional comments on the distinction between “surety” and “guaranty” and the nomenclature that is used in describing “suretyship,” including “surety bonds,” see Section 1, comments *c* (including Illustration 1) and *d*.



## D. The Ability of the Obligee, the Principal and/or the Surety to Modify and/or Define Their Obligations by Contract.

The RESTATEMENT OF SURETYSHIP does not provide the only source of the law affecting suretyship transactions.<sup>11</sup> Furthermore, Section 6 of the RESTATEMENT OF SURETYSHIP allows the parties to vary their obligations by contract,<sup>12</sup> with the terms of the contract governing the various obligations rather than the rules contained in the RESTATEMENT OF SURETYSHIP. Specifically, Section 6 provides as follows:

### **§ 6. Rules Subject to Agreement of Parties**

**Each rule in this Restatement stating the effect of suretyship status may be varied by contract between the parties subject to it.<sup>13</sup>**

In the contract bond surety situation, the Bonded Contract sets forth the duties and obligations of the Obligee and the Principal with respect to the “underlying obligations” of the parties, including when one of the parties may be in breach or default of their obligations under the Bonded Contract.<sup>14</sup> Those Bonded Contract obligations may tie into the terms and provisions of the Bond (the secondary obligation) provided by the Surety. Some Bonds are required by statute.<sup>15</sup> Furthermore, with respect to the reimbursement obligations that the

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<sup>11</sup> See Sections 4 and 5 of the RESTATEMENT OF SURETYSHIP. Section 4 acknowledges that the transactions which may result in a person or entity having “suretyship status” may be subordinate to and governed by other law, such as the law governing negotiable instruments, secured transactions and letters of credit, which controls in those situations, and not the provisions in the RESTATEMENT OF SURETYSHIP. Section 5 recognizes that, unless inconsistent with the RESTATEMENT OF SURETYSHIP, other principles of law and equity, such as the law of contracts and other such matters and issues, “are applicable to the transactions resulting in suretyship status.”

<sup>12</sup> The contractual nature of the secondary obligation, the Bond, is discussed in a number of places in the RESTATEMENT OF SURETYSHIP, including Section 1, comments *f*, *g* and *h*, and Section 7 (“The requisites of contract formation apply generally to formation of a contract creating a secondary obligation.”). See also the RESTATEMENT OF SURETYSHIP: (a) Section 9, **Consideration** (“the requirement of consideration for secondary obligations is the same as for contracts generally.”); (b) Section 10, **Capacity** (the capacity of a natural person and a person other than a natural person to become a secondary obligor by contract); and (c) Section 14 concerning the interpretation of the secondary obligation generally (“The standards that apply to interpretation of contracts in general apply to interpretation of contracts creating secondary obligations.”)

<sup>13</sup> For additional discussion of Section 6 of the RESTATEMENT OF SURETYSHIP, see Peter A. Alces, *Reconsidering Consideration in the Restatement (Third) of Suretyship*, 34 Wm. & Mary L. Rev. 1053 (1993).

<sup>14</sup> See *McWane, Inc. v. Fid. & Dep. Co. of Md.*, 372 F.3d 798, 803 (6th Cir. 2004) (citing Section 6 of the RESTATEMENT OF SURETYSHIP in holding that a payment bond surety contractually waived its right to receive notice of time extensions and therefore additional time provided by the “obligee” under the payment bond, the material supplier payment bond claimant, to the principal to remit payment did not impair the surety’s status).

<sup>15</sup> With respect to surety bonds required by statute, the statute may mandate the terms of the surety bond obligation and may be relevant in determining the meaning of the surety bond. See the RESTATEMENT OF SURETYSHIP, Section 14 (comment *d*) and Section 71, **Legally Mandated Bonds – Generally** [with comments concerning the scope of the rule and the general principle, official bonds, judicial bonds, public construction bonds (comment *e*), license and permit bonds, and bail bonds].

Principal may have to the Surety, they may also be addressed in a written contract known as an “indemnity agreement.”<sup>16</sup>

Despite the fact that the Obligee, the Principal and/or the Surety may define and/or modify their various rights and obligations by one or more written contracts, the provisions of the RESTATEMENT OF SURETYSHIP still come into play to support the general suretyship principles that underlie those various contracts (the Bonded Contract, the Bond and the indemnity agreement).

**E. The Issues that will be Addressed or Not Addressed in this Paper.**

This paper will address in detail the treatment by the RESTATEMENT OF SURETYSHIP of the following four issues:

1. The Obligee’s rights against the Surety under the Bond.
2. The Surety’s defenses to the Obligee’s claims.
3. The Surety’s right of reimbursement from the Principal.
4. The Surety’s subrogation rights.

We believe that by addressing these four important issues – the Obligee’s rights under the Bond and the Surety’s defenses, and the Surety’s rights of indemnity, reimbursement and subrogation – we kill two birds with one stone. First, these are the issues of primary importance to the Surety that are discussed in the RESTATEMENT OF SURETYSHIP, and the issues that one needs to be familiar with for each of their surety cases. Second, as one gets more proficient in the flow and language of the RESTATEMENT OF SURETYSHIP, one is able to expand their knowledge and use of the RESTATEMENT OF SURETYSHIP with respect to the other issues that we do not fully address in this paper.

However, with respect to some of the other issues that are addressed in the RESTATEMENT OF SURETYSHIP that affect the Obligee’s, the Principal’s and the Surety’s rights and obligations which are not discussed in detail in this paper, they will be mentioned briefly at the end of this paper.

**II. The Obligee’s Rights Against the Surety Under the RESTATEMENT OF SURETYSHIP.**

**A. Introduction – The Obligee’s Claim Against the Surety Under the Bond.**

Section 1(2) of the RESTATEMENT OF SURETYSHIP states when the Obligee has a claim against the Surety and the Bond. Section 1(2) of the RESTATEMENT OF SURETYSHIP provides, in part, as follows:

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<sup>16</sup> Section 16 of the RESTATEMENT OF SURETYSHIP concerns a “Continuing Guaranty,” such as an indemnity agreement, and how one terminates a continuing guaranty, normally with notice. Most indemnity agreements have their own contractual termination provisions that must be met when the “continuing guaranty” is terminated, including the provision that the guarantor/indemnitor remains liable for the secondary obligations (the Bonds) executed prior to termination, but not for the Bonds executed after an effective termination.

## § 1. Scope; Transactions Giving Rise to Suretyship Status

**(2) An obligee has recourse against a secondary obligor or its property with respect to an underlying obligation whenever:**

**(a) the principal obligor owes performance of the underlying obligation; and**

**(b) pursuant to the secondary obligation, . . .**

**(ii) The obligee has recourse against the secondary obligor or its property in the event of the failure of the principal obligor to perform the underlying obligation; . . .**

The Principal owes performance of the Bonded Contract (the underlying obligation) to the Obligee.<sup>17</sup> To the extent that the Principal performs the Bonded Contract or the Surety performs under the Bond, the Obligee is not entitled to the performance of the other obligation (the Obligee does not get performance under both the Bonded Contract and the Bond).<sup>18</sup>

As a result, in accordance with Section 1(2) of the RESTATEMENT OF SURETYSHIP, the Obligee has no claim against the Surety or the Bond until the Principal fails to perform the Bonded Contract and is, therefore, in breach or default of the Principal's obligations to the Obligee to perform under the Bonded Contract. Conversely, the Obligee has a claim against the Surety and its Bond with respect to a Bonded Contract whenever the Principal owes performance of the Bonded Contract to the Obligee and the Principal fails to perform the Bonded Contract, subject to the Surety's defenses as described below. Obviously, the Bonded Contract and the Bond set forth the relevant terms of the various duties and obligations of the parties,<sup>19</sup> but the RESTATEMENT OF SURETYSHIP also sets forth those duties and obligations, and the defenses to those duties and obligations, as a matter of law and suretyship principles.

### B. The Surety's Duties (and the Obligee's Duties<sup>20</sup>) Under the Bond.

The duties of the Surety to the Obligee and the duties of the Obligee to the Surety are those existing pursuant to the terms of the Bond, subject to the Surety's defenses to its Bond obligations to the Obligee (see below in Section III). Section 17(2) provides as follows:

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<sup>17</sup> RESTATEMENT OF SURETYSHIP, Section 1(2)(a).

<sup>18</sup> RESTATEMENT OF SURETYSHIP, Section 1(1)(b).

<sup>19</sup> Every Bond requires the Principal to be in default under the Bonded Contract (the Principal's failure to perform) before the Surety may be obligated to perform under the Bond. Many Bonds have contractual conditions precedent in addition to the Principal's default under the Bonded Contract (the Obligee is not in default, the Surety receives notice of the default, the Principal is terminated under the Bonded Contract, etc.) before the Surety's obligations under the Bond arises. See **Appendix A** attached to this paper which addresses those conditions precedent under a performance bond that must be met before the Surety's duties and obligations arise.

<sup>20</sup> See T. Scott Leo and James A. Black, *Ch. VI, Finding the Duties of the Obligee in the Restatement*, in *THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER* 107-119 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

## **§ 17. Effect of Suretyship Status on Rights and Duties of the Secondary Obligor—Generally**

**(2) The duties of the secondary obligor to the obligee, and of the obligee to the secondary obligor, are those existing pursuant to the contract creating the secondary obligation, subject to the secondary obligor’s defenses arising out of suretyship status (§§ 19, 32-49)**

The duties of the Surety to the Obligee are determined by the Bond, subject to the Surety’s defenses, and the duties of the Obligee to the Surety are determined by the Bond and by the Surety’s defenses as a Surety. Section 32(1) provides as follows:

### **§ 32. Effect of Suretyship Status on Duties of Secondary Obligor and Obligee: Undisclosed Suretyship Status and Change in Relationship of Parties**

**(1) The duties of the secondary obligor to the obligee are determined by the contract creating the secondary obligation, subject to defenses resulting from suretyship status (§§ 37-49). The duties of the obligee to the secondary obligor are determined by the contract creating the secondary obligation and by suretyship status (§ 37).**

In the contract bond surety world, the respective duties and obligations, and the Surety’s defenses to those duties and obligations, are set forth in the contractual agreements among the Obligee, the Principal and the Surety (the Bonded Contract and the Bond).<sup>21</sup> The RESTATEMENT OF SURETYSHIP sets forth the Surety’s defenses as supported by the law and suretyship principles.

## **III. The Surety’s Defenses Under the RESTATEMENT OF SURETYSHIP.<sup>22</sup>**

### **A. Introduction.**

The Surety has a number of defenses to its obligations under the Bond.<sup>23</sup> The first set of Surety defenses address the Obligee’s ability to enforce the Surety’s secondary obligation under

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<sup>21</sup> Section 32 (which addresses in comment a the fact that “the obligee is not affected by the incidents of suretyship status unless and until the obligee has notice of that status”) discusses in detail what happens when an obligee has no knowledge of the existence of the secondary obligor or the secondary obligation and then takes actions that affect the undisclosed secondary obligor, perhaps providing the undisclosed secondary obligor with a defense under the secondary obligation. This is never the case in the surety world. The Obligee requests the Bond from the Principal, the Principal and the Surety execute the Bond, and the Bond is only effective once it has been delivered to the Obligee (and, perhaps, accepted by the Obligee). There should never be an “undisclosed” suretyship status in the contract bond surety situation.

<sup>22</sup> For a further discussion of suretyship defenses addressed by the RESTATEMENT OF SURETYSHIP, including discussion of the Obligee’s duties to the Surety as well as the incompatibility of Article 3 of the Uniform Commercial Code with contract Surety obligations, see T. Scott Leo, *The Construction Contract Surety and Some Suretyship Defenses*, 34 Wm. & Mary L. Rev. 1225 (1993); see also Neil B. Cohen, *Striking the Balance: The Evolving Nature of Suretyship Defenses*, 34 Wm. & Mary L. Rev. 1025 (1993).

the Bond. The second set of Surety defenses address the Surety's specific defenses against the Obligee's claim, whether they are the Principal's defenses under the Bonded Contract or the Surety's own defenses under the Bonded Contract and the Bond.

B. Defenses to the Obligee's Enforcement of the Surety's Secondary Obligation under the Bond.

1. Statute of Frauds.

Section 11 of the RESTATEMENT OF SURETYSHIP discusses the Statute of Frauds as a possible defense to the enforcement of a secondary obligation such as the Bond.<sup>24</sup> With the Principal's and the Surety's execution of the Bond and the Principal's delivery of the Bond to the Obligee, there should not be a Statute of Frauds issue in the contract bond surety situation.

2. Obligee's Fraudulent or Material Misrepresentation.

Section 12 of the RESTATEMENT OF SURETYSHIP is entitled "When Secondary Obligation is Voidable Due to Misrepresentation." The misrepresentation may be induced by the Obligee,<sup>25</sup> the Principal<sup>26</sup> or some other third party.<sup>27</sup> This may be a real Surety defense under the Bond

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<sup>23</sup> See James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 41-76 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005). With respect to the surety's defenses and their effect on the scope of the surety's subrogation rights, see also T. Scott Leo, *Ch. 2, The Treatment of the Fundamental Principles of the Surety's Subrogation Rights in the Restatement of the Law*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 85-90 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

<sup>24</sup> Section 11(1) of the RESTATEMENT OF SURETYSHIP provides: "Pursuant to the Statute of Frauds, a contract creating a secondary obligation is unenforceable as a contract to answer for the duty of another unless there is a written memorandum satisfying the Statute of Frauds or an exception applies."

<sup>25</sup> Section 12(1) of the RESTATEMENT OF SURETYSHIP provides: "If the secondary obligor's assent to the secondary obligation is induced by a fraudulent or material misrepresentation by the obligee upon which the secondary obligor is justified in relying, the secondary obligation is voidable by the secondary obligor." Section 12, comment *a*, *Requirements*, sets forth three requirements that "must be met in addition to the requirement of a misrepresentation:" (a) "the representation must have been either fraudulent or material;" (b) "the misrepresentation must have induced the secondary obligor [the Surety] to make the contract [the Bond];" and (c) "the secondary obligor [the Surety] must have been justified in relying on the misrepresentation." Additional comments following Section 12 of the RESTATEMENT OF SURETYSHIP address a number of issues, including: (a) comment *b*, *Fraudulent and nonfraudulent misrepresentations*; (b) comment *c*, *Inducement*; (c) comment *d*, *Justifiable reliance*; (d) comment *f*, *Nondisclosures*; and others.

<sup>26</sup> See *Am. Mfg. Mut. Ins. Co. v. Tison Hog Mkt., Inc.*, 182 F.3d 1284, 1290 (11th Cir. 1999) (citing Section 12(2) of the RESTATEMENT OF SURETYSHIP in holding that the surety's liability was not extinguished by the indemnitors' fraudulent execution of the indemnity agreement because the principal's creditors did not participate in or have knowledge of the fraud); *Ground Imp. Techniques, Inc. v. Merchants Bonding Co.*, 63 F. Supp. 2d 1272, 1276 (D. Colo. 1999) (holding that, based under the "intensely fact-based inquiry into the reasonability of both the surety's and the obligee's conduct" for determining fraud under Section 12 of the RESTATEMENT OF SURETYSHIP, summary judgment in favor of the surety based upon the principal's alleged fraudulent concealment of material facts underlying the bonded contract was inappropriate).

<sup>27</sup> See Section 12(2) of the RESTATEMENT OF SURETYSHIP, and the additional comments following Section 12 of the RESTATEMENT OF SURETYSHIP, including: (a) comment *e*, *Misrepresentation by other than obligee*; (b) comment *g*, *Obligee's reasonable beliefs*; and others.

under the appropriate factual circumstances even though the situations in which a Surety may raise the defense may not occur very often. Since such a Surety defense is both factual and legal, and not contractual (as the Surety may seek to avoid its contractual obligations under the Bond due to some misrepresentation), the elements and provisions of Section 12 of the RESTATEMENT OF SURETYSHIP are important if and/or when the Surety raises such a defense.<sup>28</sup>

### 3. The Assignment of the Obligee's Rights Against the Bond.

Section 13(1) of the RESTATEMENT OF SURETYSHIP provides for the Obligee's right to assign its rights against the secondary obligor (the Surety) arising out of the secondary obligation (the Bond) except in the following circumstances: (a) if the assignment "would materially change the duty of the secondary obligor or materially increase the burden or risk imposed on it by its contract;" (b) "the assignment is forbidden by statute or is otherwise ineffective as a matter of public policy;" or (c) "the assignment is validly precluded by contract." As to the contract bond Surety, the first exception – the material increase to the Surety's burden or risk – should serve to significantly limit the right of an Obligee to assign its rights under the Bond. Many Sureties consider the risk of an Obligee's inability to pay in making their underwriting decisions. Moreover, a Bonded Contract construction project typically involves a series of coordinated contract documents and obligations, and any assignment of a contract performance bond should at a minimum be accompanied by an assignment of the obligations under all of the Bonded Contract documents, payment or otherwise, of the Obligee to the Principal (the primary obligor).<sup>29</sup> Some Bonds prohibit assignments by an Obligee and limit any subsequent Obligee claimants to successors, but not to assignees.<sup>30</sup> Other Bonds provide that the Obligee's rights are assignable to assignees.<sup>31</sup>

### C. The Surety's Defenses Against the Obligee Under the Bond.

The duties of the Surety to the Obligee and the duties of the Obligee to the Surety are those existing pursuant to the terms of the Bond, subject to the Surety's defenses to its Bond obligations to the Obligee.<sup>32</sup> Generally, the Surety may assert the Principal's defenses and the Surety may assert its own Surety defenses.

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<sup>28</sup> See **Appendix B** for citations to secondary sources that discuss the Surety's defense of misrepresentation and the avoidance of the Surety's obligations under the Bonds. See also James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 44-47 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

<sup>29</sup> The cases citing to this provision of the RESTATEMENT OF SURETYSHIP are not contract bond Surety cases. Typically, they are guarantees for the purchase of open supply of goods. See, e.g., *B.S.G. Foods, Inc. v. Multifoods Dist. Group*, 54 S.W.3d. 553 (Ark. Ct. App. 2001). As comment *b* to Section 13 notes, where the obligation is solely to pay money, an assignment is less likely to pose a material change in risk or burden.

<sup>30</sup> See, for example, the AIA A312-1984 Performance Bond, paragraph 7. See Section 13, comment *b* (and Illustrations 2 and 3) and comment *c*.

<sup>31</sup> See, for example, the AIA A312-2010 Performance Bond, section 9. See Section 13, comment *b* (and Illustrations 2 and 3) and comment *c*.

<sup>32</sup> RESTATEMENT OF SURETYSHIP, Section 17(2).

1. The Surety's Assertion of the Principal's Defenses.

Obviously, the Surety has the defense of the Principal's actual performance of the Bonded Contract (the underlying obligation) because the Principal is discharged from its obligations to the Obligee when it performs the Bonded Contract. Section 19(a) provides as follows:

**§ 19. Suretyship Status—Defenses of Secondary Obligor Against Obligee**

**Suretyship status gives the secondary obligor a defense to its duties pursuant to the secondary obligation to the extent that:**

**(a) the underlying obligation has been discharged by performance in accordance with its terms or other satisfaction by the principal obligor;...**

As stated previously, under Section 1(1)(a) of the RESTATEMENT OF SURETYSHIP, the Obligee is only entitled to one performance of the underlying obligation (the Bonded Contract), and if that underlying obligation is performed by the Principal, the Surety is discharged and has no further obligation to the Obligee to perform under the Bond.

Furthermore, the Principal may have defenses to its own performance under the Bonded Contract, and the Surety may assert those Principal defenses to the Principal's performance under the Bonded Contract. Section 19(b) provides as follows:

**§ 19. Suretyship Status—Defenses of Secondary Obligor Against Obligee**

**Suretyship status gives the secondary obligor a defense to its duties pursuant to the secondary obligation to the extent that:**

**(b) there is a defense of the principal obligor to the underlying obligation that is available to the secondary obligor pursuant to § 34;**

Section 34 provides that the Surety may raise as a defense to its obligations under the Bond any defense of the Principal under the Bonded Contract with the Obligee, with certain exceptions. Those exceptions are the discharge of the Principal's obligations to the Obligee under the Bonded Contract due to the Principal's bankruptcy proceeding and the unenforceability of the Bonded Contract due to the Principal's lack of capacity to enter into the Bonded Contract.<sup>33</sup>

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<sup>33</sup> Section 34(1) of the RESTATEMENT OF SURETYSHIP provides as follows:

**§ 34. When Defenses of Principal Obligor May Be Raised by Secondary Obligor as Defenses to Secondary Obligation**

**(1) Except as provided in subsection (3), the secondary obligor may raise as a defense to the secondary obligation any defense of the principal obligor to the underlying obligation except:**

**(a) discharge of the underlying obligation in bankruptcy proceedings;**

There are many contractual and other defenses that the Principal may have to its obligations to the Obligee for the performance of the Bonded Contract.<sup>34</sup> There are a number of publications which list and/or discuss those Principal defenses that the Surety may assert as a defense to an Obligee's claim against the Bond.<sup>35</sup>

Finally, the Surety may use the Principal's claims against the Obligee to reduce the Surety's obligations to the Obligee under the Bond. Section 35 of the RESTATEMENT OF SURETYSHIP addresses this issue, as do other publications.<sup>36</sup>

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**(b) unenforceability of the underlying obligation due to the principal obligor's lack of capacity.**

Comment *a* to Section 34 of the RESTATEMENT OF SURETYSHIP provides as follows:

*a. Defenses.* The purpose of the secondary obligation is to stand behind the obligation of the principal obligor to perform the underlying obligation, thereby assuring the obligee of the performance to which it is entitled. It is not the purpose of the secondary obligation to assure the obligee of performance to which it is not entitled pursuant to its contract with the principal obligor. Thus, to the extent that the principal obligor can raise a defense to its duty pursuant to the underlying obligation, the secondary obligor should be able to raise that defense to its secondary obligation; this is so even if the principal obligor chooses not to raise the defense. There are two exceptions to this principle. First, the secondary obligor is free to contract to be liable on the secondary obligation even when the principal obligor has a defense to the underlying obligation. See § 6. Second, there are two possible defenses of the principal obligor—discharge in insolvency proceedings and lack of capacity—against which the secondary obligation is designed to protect. Thus, these defenses may not be raised by the secondary obligor.

See also the following comments to Section 34 of the RESTATEMENT OF SURETYSHIP: (a) comment *b*, *Discharge in bankruptcy proceedings*; and (b) comment *c*, *Lack of capacity*. However, Section 34(3) and comment *e*, *Impairment of suretyship status*, provides that if the Obligee impairs the Surety's suretyship status, the effect of such impairment of suretyship status on the Surety's obligations to the Obligee under the Bond is governed by Sections 37 to 49 of the RESTATEMENT OF SURETYSHIP and not by Section 34. See Section III. C. 2 of this paper for the Surety's assertion of its own defenses to the Obligee's claims against the Bond.

<sup>34</sup> See *U.S. Fid. & Guar. Co. v. State ex rel. Oklahoma Tax Comm'n*, 2002 OK 42, 54 P.3d 1010, 1024 (2002) (dissenting opinion in appeal of tax commissioner's order forfeiting the bond citing, *inter alia*, Sections 19 and 34 of the RESTATEMENT OF SURETYSHIP in stating that the surety must have timely access to information in order to present the principal's statute of limitations defense and that the failure to do so may support the surety's exoneration defense).

<sup>35</sup> See **Appendix C** to this paper for citations to secondary sources that list and/or discuss those Principal defenses under the Bonded Contract that the Surety may assert as a defense to an Obligee's claim against the Bond.

<sup>36</sup> Section 35 of the RESTATEMENT OF SURETYSHIP is entitled "When Principal Obligor's Claim Against Obligee May Be Utilized by Secondary Obligor to Reduce Secondary Obligation." The comments to Section 35 and the Reporter's Note and additional comments provide a detailed explanation of the issues and are worth reading just because at least one of the author's of this paper finds the issues fascinating. See also Jarrod W. Stone, *Ch. 14, Common Obligee Theory and Other Setoff Rights – The Surety's Subrogation Rights to the Obligee's or Principal's Setoff Rights*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* 543-557 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).



## 2. The Surety's Assertion of its Own Defenses.

The Surety may assert its own defenses against the Obligee's claims. The Surety may have defenses under the Bond, including any defenses that may be found in the Bonded Contract.

Initially, the Surety may have the right to set off its own claims against the Obligee to reduce the Surety's obligations to the Obligee under the Bond. Section 36 of the RESTATEMENT OF SURETYSHIP provides as follows:

### **§ 36. Right of Secondary Obligor to Set Off Claims Against Obligee Against Secondary Obligation**

**A secondary obligor who has a claim against the obligee that is unrelated to the transaction giving rise to the secondary obligation may set off that claim against the secondary obligation. In such case, the secondary obligor's rights against the principal obligor are those that would exist if the secondary obligor had performed the secondary obligation to the extent of such set-off.**

For example, if the Obligee owes contract funds to the Surety on one contract for a principal entity that is not the Principal or under a separate takeover agreement as a result of the default on a contract by a principal entity that is not the Principal (\$50,000), and the Surety owes an obligation to the Obligee (\$125,000 under the Bond) on a Bonded Contract where the principal is the Principal, the Surety may set off against the Obligee's claim of \$125,000 the \$50,000 the Obligee owes the Surety on the transaction unrelated to the Principal, and pay the Obligee the \$75,000 owed. The Surety does not have to pay the Obligee \$125,000 under the Bonds and hope to get the other \$50,000 back from the Obligee on the transaction unrelated to the Principal.<sup>37</sup> Furthermore, the Surety may recover the whole amount of the \$125,000 from the Principal, who is obligated to reimburse the Surety for its total loss.<sup>38</sup>

Finally, the RESTATEMENT OF SURETYSHIP provides a listing of the Surety's own "suretyship defenses," which are found in Section 19(c) and Sections 37 to 45 of the RESTATEMENT OF SURETYSHIP. Section 19(c) provides as follows:

### **§ 19. Suretyship Status—Defenses of Secondary Obligor Against Obligee**

**Suretyship status gives the secondary obligor a defense to its duties pursuant to the secondary obligation to the extent that:**

**(c) the secondary obligor has available a "suretyship defense" (§§ 37-45);**

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<sup>37</sup> See Section 36 of RESTATEMENT OF SURETYSHIP, comment *a*.

<sup>38</sup> Pursuant to Section 36 of RESTATEMENT OF SURETYSHIP, comment *b*, the Principal is obligated and liable to reimburse the Surety for both the \$75,000 Surety loss and the \$50,000 of the Surety's independent claim used to resolve the Surety's obligations under the Bond with its "payment" to the Obligee of \$125,000 as provided under Sections 22 to 25 of the RESTATEMENT OF SURETYSHIP.

Those Surety defenses are discussed below.<sup>39</sup>

a. Impairment of suretyship status.

Section 37(1) of the RESTATEMENT OF SURETYSHIP provides that an Obligee's action that increases the Surety's risk of loss by increasing the Surety's potential cost of performance under the Bond or by decreasing the Surety's potential ability to require the Principal to be liable for the cost of the performance of the Bonded Contract is an "impairment of suretyship status" of the Surety.<sup>40</sup> Specifically, Section 37(1) provides as follows:

**§ 37. Impairment of Suretyship Status**

**(1) If the obligee acts to increase the secondary obligor's risk of loss by increasing its potential cost of performance or decreasing its potential ability to cause the principal obligor to bear the cost of performance, the secondary obligor is discharged as described in**

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<sup>39</sup> Section 19 of the RESTATEMENT OF SURETYSHIP, comment c, provides:

*c. Suretyship defenses.* Sections 37-45 provide the secondary obligor with its most important defenses—the so-called “suretyship defenses.” These defenses, to the extent not modified or eliminated by agreement (§ 48), provide discharge arising from impairment by the obligee of the secondary obligor's right of recourse against the principal obligor, from modification of the underlying obligation, and from conduct of the obligee.

See also James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 48-76 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005); *U.S. Fid. & Guar. Co. v. State ex rel. Oklahoma Tax Comm'n*, 2002 OK 42, 54 P.3d 1010, 1024 (2002) (in appeal of tax commissioner's order forfeiting the bond dissenting opinion citing, *inter alia*, Sections 19 and 34 of the RESTATEMENT OF SURETYSHIP and stating that the surety must have timely access to information in order to present the principal's statute of limitations defense and that the failure to do so may support the surety's exoneration defense).

<sup>40</sup> The **Introductory Note** to Title B, Suretyship Defenses, in the RESTATEMENT OF SURETYSHIP describes the three suretyship relationships: (a) the relationship between the Principal and the Obligee (the Bonded Contract); (b) the relationship between the Surety and the Obligee (the Bond); and (c) the relationship between the Principal and the Surety. The first two are contractual relationships created by the parties' actions. The third is created by law due to the Principal's duties of performance and reimbursement and the doctrine of subrogation that “are imposed by suretyship law to complete the bargain of the” Surety. “As between the principal obligor and the secondary obligor, it is the principal obligor who ought to perform or bear the cost of performance” of the underlying obligation. The Suretyship Defenses arise because of the duties that the Principal has to the Surety. “If, after the secondary obligor enters into the secondary obligation, the obligee does an act that changes the risks that were the subject of the secondary obligor's assessment [of the risk that the principal obligor will not perform the underlying obligation at the time that the secondary obligor entered into the secondary obligation], there is the potential for a loss to the secondary obligor.” Sections 37 to 49 of the RESTATEMENT OF SURETYSHIP address the Surety's relationship with the Obligee when the Obligee acts in a fashion that changes the Surety's risk (subject to the Surety's agreement or consent to such changes that waives the Surety's discharge due to such Obligee actions). See also James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 48-53 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005); Matthew C. Bouchard, Benjamin T. Buskirk, & Jennifer Leuschner, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* 12-21 (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016).

**subsections (2) and (3), and the secondary obligor has a claim against the obligee as described in subsection (4). An act that increases the secondary obligor's risk of loss by increasing its potential cost of performance or decreasing its potential ability to cause the principal obligor to bear the cost of performance is an "impairment of suretyship status."**

Therefore, there are two situations when the Surety's "suretyship status" may be impaired and may provide the Surety with a defense to an Obligee's claim under the Bonds. The first is that the Obligee's actions increase the Surety's risk of loss by increasing the Surety's potential cost of performance after the Principal fails to perform and is in default under the Bonded Contract. The second is that the Obligee's actions decrease the Surety's potential ability to have the Principal bear the cost of the performance of the Bonded Contract. In either instance, the Surety may be discharged.<sup>41</sup>

Under Section 37(2) of the RESTATEMENT OF SURETYSHIP, if the Obligee releases the Principal from its performance duties under the Bonded Contract or if the Obligee takes actions that fundamentally change the risks imposed on the Surety, those actions may completely discharge the Surety in full from its Bond obligations to the Obligee. Specifically, Section 37(2) provides as follows:

### **§ 37. Impairment of Suretyship Status**

**(2) If the obligee fundamentally alters the risks imposed on the secondary obligor by:**

**(a) releasing the principal obligor from a duty other than the payment of money (§ 39(c)(iii)); or**

**(b) agreeing to a modification of the duties of the principal obligor that either amounts to a substituted contract or imposes risks on the secondary obligor fundamentally different from those imposed on the secondary obligor prior to modification (§ 41(b)(i));**

**the secondary obligor is discharged from any unperformed portion of the secondary obligation as more fully set forth in those sections.**

Under Section 37(3) of the RESTATEMENT OF SURETYSHIP, the Obligee's decreasing of the Surety's potential ability to have the Principal pay the cost of the performance of the Bonded Contract may discharge the Surety from its Bond obligations to the Obligee to the extent of the

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<sup>41</sup> See *Nat'l Sur. Corp. v. United States*, 118 F.3d 1542, 1544 (Fed. Cir. 1997) (holding, in accordance with Section 37 of the RESTATEMENT OF SURETYSHIP, that when the principal was paid retainage by the obligee in violation of the terms of the bonded contract, the surety was discharged to the extent of the surety's injury); *United States v. Great Am. Ins. Co. of NY*, 791 F. Supp. 2d 1337, 1359 (Ct. Int'l Trade 2011), *aff'd sub nom. United States v. Great Am. Ins. Co. of New York*, 738 F.3d 1320 (Fed. Cir. 2013) (stating that "This Court has relied upon suretyship law principles explained in the [RESTATEMENT OF SURETYSHIP] in determining the rights and obligations of parties under customs bonds" but finding that the obligee did not impair the surety's rights pursuant to Section 37 of the RESTATEMENT OF SURETYSHIP by failing to provide notice to the surety because the failure to provide such notice did not materially alter the surety's bargained-for obligation); *Pennsylvania Nat. Mut. Cas. Ins. Co. v. City of Pine Bluff*, 354 F.3d 945, 952 (8th Cir. 2004) (citing Sections 31 and 37 of the RESTATEMENT OF SURETYSHIP to hold that the obligee that paid the principal after receiving notice from the surety that the principal was in default was liable to the surety for losses incurred by the surety after notice of default).

Surety's loss resulting from the Obligee's actions. Specifically, Section 37(3) provides as follows:

### **§ 37. Impairment of Suretyship Status**

- (3) If the obligee impairs the secondary obligor's recourse against the principal obligor by:**
- (a) releasing the principal obligor from a duty to pay money (§ 39(c)(ii));**
  - (b) granting the principal obligor an extension of time for performance of its duties pursuant to the underlying obligation (§ 40(b));**
  - (c) agreeing to a modification of the duties of the principal obligor, other than a release or an extension of time, that does not amount to a substituted contract or impose risks on the secondary obligor fundamentally different from those imposed on the secondary obligor prior to modification (§ 41(b)(ii));**
  - (d) impairing the value of an interest in collateral securing the underlying obligation (§ 42);**
  - (e) failing to institute an action before expiration of the statute of limitations governing the underlying obligation (§ 43); or**
  - (f) any other act or omission that impairs the principal obligor's duty of performance, the principal obligor's duty to reimburse, or the secondary obligor's right of restitution or subrogation (§ 44);**
- the secondary obligor is discharged from its duties pursuant to the secondary obligation to the extent set forth in those sections in order to prevent the impairment of recourse from causing the secondary obligor a loss.**

This is not a complete list of the Obligee's actions that may impair the Surety's rights against the Principal.<sup>42</sup> It is obvious that not every action that an Obligee may take results in the discharge

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<sup>42</sup> See Section 37 of the RESTATEMENT OF SURETYSHIP, comment *c*, *Acts that impair recourse*. Furthermore, Section 37(4) of the RESTATEMENT OF SURETYSHIP addresses the issue of when the Obligee's actions may impair the Surety's rights (such as an overpayment of the contract funds to the Principal either before or after the Principal's default) that may result in a Surety's claim against the Obligee. First, the Obligee's impairment of the Surety's rights may occur before the Surety performs under the Bond. If the Surety then performs under the Bond when the Surety is without knowledge or notice of the Obligee's impairment of the Surety's rights, the Surety may have a claim against the Obligee. Second, if the Obligee impairs the Surety's rights under the Bond after the Principal is in default and Surety begins to perform under the Bond, the Surety may have a claim against the Obligee. In either case, the Surety may have a claim against the Obligee "with respect to the [Surety's] performance to the extent that such impairment would have discharged [the Surety] with respect to that performance." Section 37 (4) of the RESTATEMENT OF SURETYSHIP, including comment *d*, provides support for the Surety's claim against the Obligee arising from the Obligee's actions that result in a Surety loss, including the overpayment of the Principal. Section 37 of the RESTATEMENT OF SURETYSHIP, Illustrations 1 and 2, help in explaining the Surety's rights and claims against the Obligee and provide as follows:

#### **Illustrations:**

1. S has issued a performance bond with respect to P's contract to construct a house for O for \$100,000. Pursuant to the contract between O and P, O is to pay P monthly for the portion of the work completed that month minus a 15 percent "retainage." After completing 60 percent of

of the Surety from its obligations under the Bond. Furthermore, even those actions that an Obligee may take that would discharge the Surety under the provisions of the RESTATEMENT OF SURETYSHIP may be altered by the terms and provisions of the Bond and by the provisions that may exist in the Bonded Contract, and those contractual provisions may result in no release and discharge of the Surety's obligations under the Bond.<sup>43</sup> The measurement of the Surety's loss and the burden of persuasion with respect to the Surety's loss are governed by Section 49 of the RESTATEMENT OF SURETYSHIP.<sup>44</sup>

The rest of Section III. C. 2 of this paper will address the release and other provisions of the RESTATEMENT OF SURETYSHIP that may provide the Surety with a defense to its obligations to the Obligee under the Bond. There will also be references to **Appendix D** of this paper for other secondary sources that discuss some of the factual situations when a Surety may be released and discharged from its obligations to the Obligee under the Bond due to the Obligee's actions and "impairment" of the Surety's suretyship status.

b. Release, extension of time and modification of the underlying obligation.

The concepts of the Obligee's releasing the Principal from the underlying obligations in the Bonded Contract, providing the Principal with an extension of time, and/or modifying the Principal's underlying obligations in the Bonded Contract and their effect on the Surety are addressed in the following sections of the RESTATEMENT OF SURETYSHIP:

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the project and receiving \$51,000 (\$60,000 minus the \$9,000 retainage) from O, P defaults. S completes the project at a cost to S of \$40,000. After S completes the project, O pays the \$9,000 retainage to P, who, despite this payment, is insolvent. Had O paid the retainage to P before S completed the project, S would have been discharged to the extent of \$9,000 by application of § 38 [*sic* § 42] (impairment of collateral). S has a claim against O for \$9,000 because the payment to P would have discharged S from the secondary obligation to that extent.

2. Same facts as Illustration 1, except that the payment to P is made before S completes the project, but without the knowledge of S. S has a claim against O for \$9,000 because the payment to P would have discharged S from the secondary obligation to that extent.

See also T. Scott Leo, *Ch. 2, The Treatment of the Fundamental Principles of the Surety's Subrogation Rights in the Restatement of the Law*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 85-91* (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013) and the discussion of Section 42, **Impairment of Collateral**, of the RESTATEMENT OF SURETYSHIP in Section III.C.2.c. of this paper, *infra*.

<sup>43</sup> See Section 37 of the RESTATEMENT OF SURETYSHIP, comment *e*, and the discussion of Section 48, **Waiver of Suretyship Defenses; Consent**, of the RESTATEMENT OF SURETYSHIP in Section III.D. of this paper, *infra*.

<sup>44</sup> See Section 37 of the RESTATEMENT OF SURETYSHIP, comment *f*, and the discussion of Section 49 of the RESTATEMENT OF SURETYSHIP in Section III.E. of this paper, *infra*.

- Section 39 – Release of the Underlying Obligation<sup>45</sup>
- Section 40 – Extension of Time<sup>46</sup>
- Section 41 – Modification of the Underlying Obligation<sup>47</sup>

The **Introductory Note** to these three sections states that to “describe the effect of these acts, two interrelated questions must be answered initially. First, what is the effect of a release, extension, or modification of the underlying obligation on the duties owed to the secondary obligor by the principal obligor? Second, what is the effect of the release, extension, or modification of the underlying obligation on the relationship between the secondary obligor and the obligee?” Remember, as between the Principal and the Surety, it is the Principal who should perform the Bonded Contract (the underlying obligation) or bear the cost of performance if the Surety is required to perform under the Bond (the secondary obligation).<sup>48</sup>

Pursuant to Section 39 of the RESTATEMENT OF SURETYSHIP, the Obligee’s release of the Principal from the Bonded Contract releases and discharges the Surety from having to perform under the Bond. Section 39(c)(iii) provides as follows:

**§ 39. Release of Underlying Obligation**

**To the extent that the obligee releases the principal obligor from its duties pursuant to the underlying obligation:**

**(c) . . . the secondary obligor is discharged from those duties to the extent:**

**(iii) that the release discharges a duty of the principal obligor other than the payment of money;**

In the contract bond surety world, the Surety’s obligations under the Bond are to perform the Principal’s obligations, whether those obligations are to perform the work required under the Bonded Contract pursuant to a Performance Bond or to pay the Principal’s subcontractors and

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<sup>45</sup> See Daniel Mungall and Samuel J. Arena, Jr., *Ch. V, The Effect on Surety of Obligee’s Release of Principal: A Critical Look at the Rules in the Restatement*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 77-105 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass’n 2005). See also James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 53-59 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass’n 2005); Matthew C. Bouchard, Benjamin T. Buskirk, & Jennifer Leuschner, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* 21-24 (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016).

<sup>46</sup> See James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 59-60 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass’n 2005).

<sup>47</sup> See James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 60-62 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass’n 2005).

<sup>48</sup> See Section 1(c) of the RESTATEMENT OF SURETYSHIP.

suppliers under the Payment Bond. While those Bond obligations may result in the Surety's "payment of money," it is the contract bond Surety's obligation to perform under the Bond. As a result, if the Obligee performs acts that release the Principal from its obligations to perform under the Bonded Contract, the Obligee also releases the Surety from its obligations to perform under the Bond.<sup>49</sup>

However, while the RESTATEMENT OF SURETYSHIP addresses the issues of extension of time [Section 40] and modification of the underlying obligation [Section 41] and their effect on the secondary obligor, frequently the Bonded Contract and, sometimes, the Bond, provide contractual terms that allow, within described parameters, certain extensions of time and/or modifications to the underlying obligations in the Bonded Contract and/or the Bond. This is in line with the concepts in the RESTATEMENT OF SURETYSHIP that the parties – the Obligee, the Principal and the Surety – are free to make other contractual agreements.<sup>50</sup>

c. Impairment of collateral.

Section 42(1) of the RESTATEMENT OF SURETYSHIP discusses the obligee's impairment of collateral when the underlying obligation is secured by collateral.<sup>51</sup> In the contract bond surety context, the "collateral" for the Bonded Contract is the Obligee's agreement to pay the contract funds from the Bonded Contract to the Principal for the Principal's performance of the work, or to the Surety if the Principal defaults and the Surety is then obligated to perform the work under the Bond, whether it is to pay for the performance of the completion of the Bonded Contract work

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<sup>49</sup> See Section 39 of the RESTATEMENT OF SURETYSHIP, comment *a*, *General principle*; comment *b*, *Effect on duties owed to secondary obligor*; comment *d*, *Discharge of secondary obligor – obligee's intent*; and comment *g*, *Discharge of secondary obligor – underlying obligation other than the payment of money*. See also *Kiski Area Sch. Dist. v. Mid-State Sur. Corp.*, 600 Pa. 444, 451, 967 A.2d 368, 372 (2008) (citing Section 39 of the RESTATEMENT OF SURETYSHIP to hold the obligee's release of the principal acts to discharge the surety unless the language of the release reserves the obligee's rights against the surety); *Will H. Hall & Son, Inc. v. Ace Masonry Const., Inc.*, 260 Mich. App. 222, 231, 677 N.W.2d 51, 56 (2003) (noting that "Michigan case law is minimal concerning sureties, and there are no cases, of which we are aware, that directly, substantively, and fully address the effect on a surety's liability following the obligee's release of any and all claims against the principal. However, we find guidance [the RESTATEMENT SURETYSHIP] § 39 (Release of Underlying Obligation)" in holding that, based upon Section 39, the obligee's release of the principal acted to discharge the surety).

<sup>50</sup> See **Appendix C** and **Appendix D** of this paper for other secondary sources that discuss the potential Surety defenses when there have been extensions of time and/or changes to the Bonded Contract.

<sup>51</sup> Section 42 of the RESTATEMENT OF SURETYSHIP, comment *a*, states:

*a. General purpose.* The collateral securing the underlying obligation increases the ability of the obligee to recover with respect to the underlying obligation. When the secondary obligor is subrogated to the rights of the obligee with respect to the underlying obligation, the collateral protects the secondary obligor. Thus, when the obligee impairs the value of the collateral, the obligee impairs the ability of a secondary obligor who performs the secondary obligation to pass the cost of that performance to the principal obligor. As between the principal obligor and the secondary obligor, it is the principal obligor that ought to bear this cost. The obligee's impairment of collateral interferes with this allocation. Accordingly, the secondary obligor is discharged to the extent of the impairment of collateral.

See also James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in *THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER* 62 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

under the Performance Bond or the payment of the Principal's subcontractors and suppliers under the Payment Bond.<sup>52</sup>

Section 42(2) describes some of the actions that an Obligee could take to impair the Surety's rights to the contract funds from the Bonded Contract.<sup>53</sup> The Obligee's overpayment of the contract funds to the Principal prior to the Principal's default<sup>54</sup> and/or the Obligee's subsequent payment of the contract funds to the Principal after the Principal's default may result in an impairment of the Surety's "collateral," the contract funds remaining or which should have been remaining in the Bonded Contract for the Surety's performance under the Bond.<sup>55</sup> Pursuant to Section 37(4) of the RESTATEMENT OF SURETYSHIP, the Surety may have a cause of action against the Obligee for such an overpayment to the Principal.<sup>56</sup>

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<sup>52</sup> See *infra*. at Section V.D. of this paper for a discussion of Section 31 of the RESTATEMENT OF SURETYSHIP and the concept of the payment of the contract funds on the Bonded Contract as the Obligee's "return performance" being the security for the Principal's performance of the work on the Bonded Contract and the Surety's security in the event of the Principal's default requiring the Surety's performance under the Bond.

<sup>53</sup> Section 42 of the RESTATEMENT OF SURETYSHIP, comment *b*, states:

*b. Acts constituting impairment of collateral—generally.* In general, impairment of collateral includes any act or omission that lessens the secondary obligor's expected recovery from the collateral through subrogation.

<sup>54</sup> See *Transamerica Premier Ins. Co. v. United States*, 32 Fed. Cl. 308, 313 (1994) (citing Section 38 of Tentative Draft 2 [later renumbered in final publication as Section 42] of the RESTATEMENT OF SURETYSHIP, comment *e*, to hold that the obligee's payment to the principal rather than to the surety, in violation of the terms of the bonded contract, impaired and discharged the surety to the extent of its loss).

<sup>55</sup> Section 42 of the RESTATEMENT OF SURETYSHIP, comment *d*, states:

*d. Release of collateral.* If the obligee releases its security interest in collateral securing the underlying obligation, it has obviously diminished the ability to recover with respect to that obligation. The subrogated secondary obligor is similarly harmed by the release.

**Illustration:**

3. B agrees to construct a building for O for \$400,000. S issues a performance bond to O pursuant to which S agrees to be jointly and severally liable with B on the obligation to O. B defaults on the construction project, and S completes construction. At the time of B's default, O had paid B \$100,000 in accordance with the terms of the construction contract. As "return performance," the remaining \$300,000 owed by O to B under the contract serves as security for B's underlying obligation. Payment of any portion of that \$300,000 to B is a release of collateral constituting impairment of collateral.

Section 42 of the RESTATEMENT OF SURETYSHIP, comment *g*, *Extent of discharge*, discusses the measurement of the Surety's discharge when the Obligee takes an action that impairs the Surety's collateral, including the contract funds.

<sup>56</sup> See *supra* note 42 and especially Section 37, comment *d* and Illustrations 1 and 2. Furthermore, Section 31 of the RESTATEMENT OF SURETYSHIP, comment *c*, provides as follows:

*c. Improper payment of return performance.* If the obligee pays the return performance to the principal obligor before such payment is owed under the contract between the principal obligor and the obligee, the ability of the secondary obligor to be made whole through subrogation may be impaired if the secondary obligor is called upon to perform. Accordingly, such a payment may constitute impairment of collateral. See § 42. The secondary obligor is similarly disadvantaged if,



d. Other provisions relating to the Surety's defenses.<sup>57</sup>

There are a number of additional Sections of the RESTATEMENT OF SURETYSHIP that address the Surety's defenses to the Obligee's claims against the Bond that will merely be mentioned briefly here in this paper.

Section 43 discusses the effect of the Obligee's delay in its enforcement of any actions against the Principal on the Bonded Contract and/or the Surety under the Bond. Section 44 discusses the effect on the Surety for other actions that may be taken by the Obligee, such as the Obligee impairing the Principal's duty of performance, the Principal's duty to reimburse the Surety, or the Surety's right of subrogation. Under Section 44, if the Obligee takes such actions, "the secondary obligor is discharged from its duties pursuant to the secondary obligation to the extent that such impairment would otherwise cause the secondary obligor a loss."

Section 19(d) of the RESTATEMENT OF SURETYSHIP provides that the Surety has a defense to its obligations under the Bonds to the extent that "tender of performance by the principal obligor or secondary obligor discharges the secondary obligor pursuant to § 46." Section 46(1) discusses the Principal's tender of complete or partial performance of the underlying obligation (the Bonded Contract), which may discharge the Surety under the Bond if the Obligee "unreasonably refuses such tender ... to the extent that the performance tendered would have discharged the secondary obligation" (the Bond). Section 46(2) is similar, and discusses the Surety's tender of complete or partial performance of the secondary obligation (the Bond). If the Obligee "unreasonably refuses such tender," the Bond may be discharged "to the extent that refusal of such tender causes the secondary obligor a loss."

D. Waiver of Defenses.

As we have stated in a number of places in this paper, the rules set forth in the RESTATEMENT OF SURETYSHIP may be varied by agreements between and among the Obligee, the Principal and/or the Surety. Many of the above actions by the Obligee that would support a Surety's defense to its obligations under the Bond and, therefore, would otherwise provide a discharge to the Surety, may be waived or consented to by the Surety as described in Section 48 of the RESTATEMENT OF SURETYSHIP, which provides as follows:<sup>58</sup>

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after performance of the secondary obligation, return performance is paid to the principal obligor. In such a case, the secondary obligor may have a claim against the obligee pursuant to § 37(4).

Section 31, comment *d*, *Set-off by obligee*, discusses the Obligee's claim against the Principal on an obligation unrelated to the Bonded Contract and the Obligee's possible attempts to reduce by setoff the amount of the bonded contract funds on the Bonded Contract and use them to pay the Principal's obligation on the unrelated underlying obligation. See also Section V.D. of this paper, *infra*.

<sup>57</sup> See James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 65-71 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

<sup>58</sup> See James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 71 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

## § 48. Waiver of Suretyship Defenses; Consent

**(1) The secondary obligation is not discharged pursuant to § 39(c)(ii)-(iii), § 40(b), § 41(b)(ii), § 42(1), § 43, or § 44 to the extent that, in the contract creating the secondary obligation or otherwise, the secondary obligor consents to acts that would otherwise be the basis of the discharge, agrees that such discharges are unavailable to the secondary obligor, or waives such discharges. Consent may be express or implied from the circumstances. Such consent, agreement, or waiver, if express, may be effectuated by specific language or by general language indicating that the secondary obligor waives defenses based on suretyship.**

Many Bonded Contracts and Bonds provide for such waivers of suretyship defenses or provide the Surety's consent to a waiver of such defenses and the discharge of the Surety under the Bond. The secondary sources referenced in **Appendix C** and **Appendix D** provide examples of situations when such Surety waivers and/or consents may exist either pursuant to the terms of the Bonded Contract or the Bond.

### E. Burden of Persuasion With Respect to Impairment.

Section 49 of the RESTATEMENT OF SURETYSHIP sets forth the burden of persuasion standards when the Surety seeks a discharge from its Bond obligations due to the Obligee's actions.<sup>59</sup> When the Surety seeks to obtain a discharge from its Bond obligations to the Obligee due to the Obligee's "impairment of the secondary obligor's suretyship status (§ 37)," the Surety "has the burden of persuasion with respect to the occurrence of the act constituting the impairment."<sup>60</sup> Section 49(2) sets forth the burden of persuasion when the Obligee's act may impair the Surety's rights of indemnity and reimbursement against the Principal.

## IV. The Surety's Rights of Reimbursement From the Principal Under the RESTATEMENT OF SURETYSHIP.<sup>61</sup>

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<sup>59</sup> See James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 62-64 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005); see also *McWane, Inc. v. Fid. & Dep. Co. of Maryland*, 372 F.3d 798, 804 (6th Cir. 2004) (citing Section 49 of the RESTATEMENT OF SURETYSHIP in noting that "[t]he burden is on F&D, as a compensated surety, to prove that McWane [material supplier] is liable for any alleged loss or prejudice resulting from its impairment of F&D's suretyship status."); *Will H. Hall & Son, Inc. v. Ace Masonry Const., Inc.*, 260 Mich. App. 222, 246, 677 N.W.2d 51, 64 (2003) (stating in dissenting opinion that, based upon Section 49 of the RESTATEMENT OF SURETYSHIP, "the surety, has the burden of persuasion with respect to the occurrence of the act constituting the impairment, and, if the secondary obligor is, as is Capitol, in the business of entering into secondary obligations, it also has the burden of persuasion with respect to loss or prejudice caused by an obligee's act impairing the secondary obligor's recourse against the principal obligor.")

<sup>60</sup> Section 49(1) of the RESTATEMENT OF SURETYSHIP.

<sup>61</sup> See James F. Crowder, Jr., *Ch. II, The Duties of the Principal to the Surety and the Surety's Rights*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 15-22 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

## A. Introduction.

In the contract bond surety world, it may seem strange that this section of the paper is discussing the Surety's indemnification and reimbursement rights against the Principal when practically every Surety obtains a written agreement with the Principal, and usually other third-party individuals and entities (the "Indemnitors"), that comes with various titles, but which we will generally refer to as an "Indemnity Agreement." But it is appropriate that the RESTATEMENT OF SURETYSHIP addresses both the Surety's common law rights (indemnification and reimbursement) and common law remedies (such as exoneration, *quia timet*, and others) against the Principal because those common law rights and remedies have found their way into most Indemnity Agreements,<sup>62</sup> along with other Surety rights and remedies, and include those Surety rights and remedies against both the Principal and the Indemnitors.

The benefit of the sections in the RESTATEMENT OF SURETYSHIP concerning the Surety's indemnification and reimbursement rights and remedies against the Principal is that they provide further support for the Surety's assertion of its contractual Indemnity Agreement rights and remedies against the Principal and the Indemnitors, and can show the court that there is a strong historical and precedential basis for the arguments that the Surety may make in asserting its contractual rights and remedies under the Indemnity Agreement.

## B. The Principal's Obligations and the Surety's Rights Against the Principal.

The starting point is Section 1(1)(c) of the RESTATEMENT OF SURETYSHIP, which provides that as between the Principal and the Surety, "it is the principal obligor who ought to perform the underlying obligation or bear the cost of performance." If the Principal performs the underlying obligation (the Bonded Contract), then the Surety should have no obligation under the Bond to pay for "the cost of performance" as the Obligee is not entitled to both the Principal's performance of the underlying obligation, the Bonded Contract, and the Surety's performance under the Bond.<sup>63</sup> But, if the Principal defaults on its underlying obligations in the Bonded Contract, and the Surety incurs losses under its Bond, the Principal, and not the Surety, is the one who should "bear the cost of performance."

Section 17(1) of the RESTATEMENT OF SURETYSHIP sets out the Surety's rights against the Principal as a result of the execution of the Bond, and provides as follows:

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<sup>62</sup> The relationship between the Surety's common law rights and remedies against the Principal and their expansion against both the Principal and the Indemnitors in the Indemnity Agreement is discussed in a number of places, including David W. Slaughter, *Ch. 1, Introduction to the Surety's Rights as the Foundation for the Indemnity Agreement*, in THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE 9-15 (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds., Am. Bar Ass'n, 2d ed. 2008) and Samuel J. Arena, Jr., *et al.*, Ch. 1, *The Contract Bond Surety's Common Law Right to Equitable Subrogation – The Basics*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 17-33 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013). See also **Appendix E**, which lists a number of topics and secondary sources that address the issues discussed in Section IV of this paper concerning the Surety's indemnity and reimbursement rights and remedies and the Surety's rights and remedies under its Indemnity Agreement.

<sup>63</sup> See Section 1(1)(b) of the RESTATEMENT OF SURETYSHIP and the discussion of the issues in Section I.B. of this paper, *supra*.

## **§ 17. Effect of Suretyship Status on Rights and Duties of the Secondary Obligor—Generally**

**(1) The rights of the secondary obligor against the principal obligor are (i) those existing as a result of any contract between them, and (ii) those that arise out of suretyship status (§§ 18, 21-31).**

Clearly, Section 17(1) recognizes that the Surety's rights against the Principal may exist through contract, such as the Indemnity Agreement. But, to the extent that such an Indemnity Agreement does not exist, or does not have the necessary provisions covering certain aspects of the suretyship status arising out of the relationship between the Surety and the Principal, other sections in the RESTATEMENT OF SURETYSHIP come into play and may provide the Surety with certain rights and remedies.

Section 18 of the RESTATEMENT OF SURETYSHIP sets out the rights of the Surety against the Principal when suretyship status exists. Section 18 provides as follows:

## **§ 18. Suretyship Status—Recourse of Secondary Obligor Against Principal Obligor**

**(1) Suretyship status gives the secondary obligor recourse against the principal obligor to cause the principal obligor to perform the underlying obligation or bear the cost of performance.**

**(2) Recourse against the principal obligor to cause the principal obligor to perform the underlying obligation or bear the cost of performance may be effected by:**

**(a) enforcement of the principal obligor's duty of performance § 21); or**

**(b) enforcement of the principal obligor's duty to reimburse the secondary obligor (§§ 22-24); or**

**(c) enforcement of the secondary obligor's right of restitution (§ 26); or**

**(d) subrogation of the secondary obligor to the rights of the obligee (§§ 27-31).**

Section 18(1) restates the Principal's obligations to the Surety under Section 1(1)(c) of the RESTATEMENT OF SURETYSHIP described above and provides that the Surety has rights against the Principal to require and enforce the Principal's duty to perform the underlying obligation, the Bonded Contract, or pay the costs of such performance. Section 18(2) then sets out how the Surety may obtain "recourse" against the Principal and what actions the Surety may take to require and enforce the Principal's duty to either perform under the Bonded Contract [Section 18(2)(a)] or reimburse the Surety if the Surety is required to initially bear the cost of performance under the Bond [Section 18(2)(b)].<sup>64</sup>

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<sup>64</sup> Section 18(2)(c) of the RESTATEMENT OF SURETYSHIP refers to the Surety's right to enforce its right of restitution against the Principal under Section 26 of the RESTATEMENT OF SURETYSHIP. The Surety's performance may unjustly enrich the Principal who may not otherwise have the obligation to reimburse the Surety for the reasons discussed in Section 26. As a result of the contractual Indemnity Agreement between and among the Surety, the Principal and the Indemnitors, the common law right of restitution is rarely necessary for the Surety's protection.

### C. The Principal's Duty of Performance.

Section 18(2)(a) of the RESTATEMENT OF SURETYSHIP provides that the Surety has the right to enforce the Principal's duty to perform the underlying obligation (exoneration and/or *quia timet* relief), namely the Bonded Contract, and refers to Section 21 of the RESTATEMENT OF SURETYSHIP. Pursuant to Section 21(1)(a), the Principal has the duty to the Surety to perform the Bonded Contract to the extent that the Principal's failure to perform would make the Surety liable for the performance,<sup>65</sup> therefore entitling the Surety to obtain reimbursement from the Principal. Pursuant to Section 21(1)(b), the Principal must refrain from conduct that impairs the Surety's expectation that the Principal will honor its duty to perform the Bonded Contract. Section 21(1) provides as follows:

#### **§ 21. Principal Obligor's Duty of Performance**

- (1) . . . the principal obligor has the duty to the secondary obligor**
- (a) to perform the underlying obligation to the extent that failure to do so would leave the secondary obligor liable for performance that would entitle the secondary obligor to reimbursement by the principal obligor, and**
  - (b) to refrain from conduct that impairs the expectation of the secondary obligor that the principal obligor will honor its duty of performance.**

However, the Principal may not perform the underlying obligations in the Bonded Contract as required in Section 21(1). As a result, Section 21(2) of the RESTATEMENT OF SURETYSHIP provides that upon the Principal's breach of its duties under Section 21(1), the Surety is entitled to relief against the Principal that will properly protect the Surety's rights with respect to the Principal's duty of performance. Section 21(2) provides as follows:

#### **§ 21. Principal Obligor's Duty of Performance**

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But the Surety's right to enforce its right of restitution exists if it is needed to require the Principal to ultimately bear the cost of performance and not be unjustly enriched by the Surety's performance of its obligations under the Bond. Section 18(2)(d) of the RESTATEMENT OF SURETYSHIP refers to the Surety's right of subrogation to the Obligee's rights and references Sections 27 to 31 of the RESTATEMENT OF SURETYSHIP, which will be addressed in Section V of this paper.

<sup>65</sup> See Section 21 of the RESTATEMENT OF SURETYSHIP, comment *a*, *Justification*, which states, in part: "there is an implied agreement between the principal obligor and the secondary obligor that the principal obligor will perform the underlying obligation so that the secondary obligor will not have to perform the secondary obligation. While, in most cases, performance by the secondary obligor will give rise to a right of reimbursement (see § 22), realization of this right obviously involves expense and uncertainty. Accordingly, where the principal obligor is charged with notice of the secondary obligation, the secondary obligor is entitled to the principal obligor's performance, not merely a cause of action for its failure to perform." In the contract bond surety world, the Principal that both executes the Bond with the Surety and then delivers the Bond to the Obligee as part of the Principal's obligations under the Bonded Contract will always be "charged with notice of the secondary obligation," namely the Bond.

**(2) Upon breach by the principal obligor of a duty set forth in subsection (1), the secondary obligor is entitled to relief that will properly protect its rights with respect to the principal obligor's duty of performance.**

The RESTATEMENT OF SURETYSHIP sets out in the comments to Section 21(2) various forms of relief for the protection of the Surety,<sup>66</sup> including exoneration and *quia timet* relief.<sup>67</sup>

**D. The Principal's Duty to Reimburse the Surety.**

Section 18(2)(b) of the RESTATEMENT OF SURETYSHIP provides that the Surety has the right to obtain reimbursement from the Principal for the Surety's performance under the Bond, and refers to Sections 22 to 24 of the RESTATEMENT OF SURETYSHIP. Pursuant to Section 22(1), the Principal has the duty to reimburse the Surety to the extent that the Surety performs its obligations under the Bond.<sup>68</sup> Section 22(1) provides as follows:

**§ 22. Duty of Principal Obligor to Reimburse Secondary Obligor**

**(1) Except as provided in § 24, when the principal obligor is charged with notice of the secondary obligation it is the duty of the principal obligor to reimburse the secondary obligor to the extent that the secondary obligor:**

**(a) performs the secondary obligation; or**

**(b) makes a settlement with the obligee that discharges the principal obligor, in whole or part, with respect to the underlying obligation.**

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<sup>66</sup> See *Travelers Cas. & Sur. Co. v. Ockerlund*, No. 04 C 3963, 2004 WL 1794915, at \*5 (N.D. Ill. Aug. 6, 2004) (citing Section 21 of the RESTATEMENT OF SURETYSHIP, comments *i, j, and k*, in support of the court's order granting the surety's motion for preliminary injunction to compel the principal and the indemnitors to post collateral and to require them to indemnify and exonerate the surety for all losses and liabilities the surety incurred as a result of issuing bonds, but denying the surety's motion for preliminary injunction to create a lien on the principal's and the indemnitors' assets or to freeze those assets); *U.S. Fid. & Guar. Ins. Co. v. Cler Const. Servs., Inc.*, No. 03 C 1405, 2003 WL 1873926, at \*2 (N.D. Ill. Apr. 11, 2003) (citing Section 21 of the RESTATEMENT OF SURETYSHIP, comments *j, k, and l*, in support of an order granting the surety's motion for preliminary injunction to compel the principal to post collateral in sufficient amount to protect the surety, but denying the surety's motion for preliminary injunction to freeze the principal's and the indemnitors' assets or to provide accounting of those assets).

<sup>67</sup> See Section 21 of the RESTATEMENT OF SURETYSHIP, comment *i*, *Enforcement of the duty of performance; exoneration*; comment *j*, *Enforcement of the duty of performance; quia timet*; comment *k*, *Form of relief*; and comment *l*, *Assertion of defenses by principal obligor*. See also **Appendix E** for a list of the Book chapters, articles and papers that discuss the Surety's common law remedies of exoneration and *quia timet*.

<sup>68</sup> See Section 22 of the RESTATEMENT OF SURETYSHIP, comment *a*, *Source of duty*, which states, in part: "Just as the principal obligor impliedly agrees that it will perform the underlying obligation so that the secondary obligor will not have to perform, the principal obligor also agrees that it will reimburse the secondary obligor to the extent that the secondary obligor does perform, thereby fulfilling all or part of the underlying obligation." See also **Appendix E** for a list of the Book chapters, articles and papers that discuss the Surety's common law and contractual Indemnity Agreement rights of indemnity and reimbursement.

Even if the Surety only partially performs under the Bond, the Principal is still liable to reimburse the Surety to the extent of the Surety's partial performance,<sup>69</sup> and this includes when the Surety settles its obligations under the Bond, whether in whole or in part,<sup>70</sup> because, in both cases, the Surety's performance has, to that extent, discharged the Principal's duty under the Bonded Contract.

The timing of when the Principal has the duty and is obligated to reimburse the Surety is found in Section 22(2) of the RESTATEMENT OF SURETYSHIP, which provides as follows:

**§ 22. Duty of Principal Obligor to Reimburse Secondary Obligor**

**(2) The duty of the principal obligor to reimburse the secondary obligor does not arise until the time for performance, pursuant to the underlying obligation, of the duty satisfied by the secondary obligor's performance or settlement.**

Under Section 22(2), the Surety's duty to perform occurs when the Principal is in default under the Bonded Contract. The Surety's performance before the Principal has the duty to perform requires the Surety to wait for reimbursement until the date that the Principal's performance was due.<sup>71</sup> However, in the contract bond surety world, the Principal's obligations under the Bonded Contract require continuous and/or continuing performance of the Principal's obligations. Once there is a default in the Principal's performance of its Bonded Contract obligations, the Surety may and/or may be required to perform under the Bond and then seek to enforce its common law rights of indemnity and reimbursement through the remedies of exoneration and *quia timet*, and through an action for specific performance of the Surety's rights and remedies under the Indemnity Agreement.<sup>72</sup>

Finally, Section 23(1) of the RESTATEMENT OF SURETYSHIP addresses the measure of the reimbursement damages, namely the amount of the reimbursement due from the Principal to the Surety, which is the reasonable cost of the Surety performing under the Bond. Section 23(1) provides as follows:

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<sup>69</sup> See Section 22 of the RESTATEMENT OF SURETYSHIP, comment *b*, *Partial performance by secondary obligor*.

<sup>70</sup> See Section 22 of the RESTATEMENT OF SURETYSHIP, comment *c*, *Settlements*.

<sup>71</sup> See Section 22 of the RESTATEMENT OF SURETYSHIP, comment *d*, *When duty arises*.

<sup>72</sup> See **Appendix E**.

## § 23. Measure of the Reimbursement to Which Secondary Obligor is Entitled.

**(1) When the principal obligor has a duty to reimburse the secondary obligor (§ 22), that duty is to reimburse the secondary obligor for the reasonable cost of performing the second obligation, including incidental expenses.**

Section 23, comment *a* (*Reasonable cost of performance*), lists many of the damages that a Surety may seek to recover as reimbursement due to the Surety's performance under the Bond and the Principal's obligation to reimburse the Surety for the Surety's performance.

### E. When the Principal's Duty to Reimburse the Surety Does Not Arise.

There are a number of instances when suretyship status exists between the Principal and the Surety, but the Principal does not owe a duty to reimburse the Surety for its losses under the Bond. Two have been discussed previously, namely when the Principal is discharged in a bankruptcy proceeding<sup>73</sup> and when the Principal lacks the capacity to enter into the underlying obligation, the Bonded Contract.<sup>74</sup> Furthermore, the Principal may have a defense to its performance of the Bonded Contract that, pursuant to the terms and provisions of the Bond, was not available to the Surety.<sup>75</sup>

Pursuant to Section 24(1)(d) and to Section 39 of the RESTATEMENT OF SURETYSHIP, the Principal has no duty to reimburse the Surety to the extent that the Obligee's release of the Principal with respect to the underlying obligation, the Bonded Contract, has discharged the Principal's duty to reimburse the Surety.<sup>76</sup> The Principal may or may not have a defense to its duty to reimburse the Surety: (a) if, at the time of the Surety's performance or settlement with the Obligee under the Bond, the Surety knew of a Principal's defense to the Principal's obligations under the Bonded Contract that was also available as a defense to the Surety under the Bond;<sup>77</sup> or (b) if, at the time of the Surety's performance or settlement with the Obligee under the Bond, the Surety knew of a defense to its obligations under the Bond that was not available to the Principal as a defense under the Bonded Contract.<sup>78</sup> The Surety's contractual rights under

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<sup>73</sup> See Section 24(1)(a) of the RESTATEMENT OF SURETYSHIP and comment *a*, *Underlying obligation discharged in bankruptcy proceedings*.

<sup>74</sup> See Section 24(1)(b) of the RESTATEMENT OF SURETYSHIP and comment *b*, *Defenses of principal obligor unavailable to secondary obligor*.

<sup>75</sup> See Section 24(1)(c) of the RESTATEMENT OF SURETYSHIP and comment *b*, *Defenses of principal obligor unavailable to secondary obligor*.

<sup>76</sup> Section 39(a) of the RESTATEMENT OF SURETYSHIP provides that to the extent that the Obligee releases the Principal from its duties under the Bonded Contract, the Principal is discharged from both its obligations to the Obligee to perform under the Bonded Contract and its reimbursement obligations to the Surety.

<sup>77</sup> See Section 24(1)(e) of the RESTATEMENT OF SURETYSHIP and comment *c*, *Defenses to secondary obligation*; comment *d*, *Performance of secondary obligation with notice of defense to underlying obligation available to secondary obligor*; and comment *e*, *Business compulsion*.

<sup>78</sup> See Section 24(1)(f) of the RESTATEMENT OF SURETYSHIP and comment *c*, *Defenses to secondary obligation*; comment *d*, *Performance of secondary obligation with notice of defense to underlying obligation available to secondary obligor*; and comment *e*, *Business compulsion*.



the Indemnity Agreement may override the common law defenses that the Principal may assert to its indemnity and reimbursement obligations to the Surety (such as the Surety's rights to settle claims in good faith and to obtain reimbursement for its losses in the absence of the Surety acting in bad faith).<sup>79</sup>

The issues of the Surety's notice to the Principal and what that notice contains may be important to the Surety's rights in obtaining reimbursement from the Principal.<sup>80</sup>

#### F. The Principal's Collateral.

If the Principal provides collateral to the Surety to secure the Principal's duty to reimburse the Surety for any losses the Surety incurs under the Bond, the Surety may also use the collateral to secure the Principal's duty to perform the Bonded Contract.<sup>81</sup>

#### G. The Surety's Contractual Indemnity and Reimbursement Rights.

Section 6 of the RESTATEMENT OF SURETYSHIP provides that each rule in the RESTATEMENT OF SURETYSHIP "stating the effect of suretyship status may be varied by contract between the parties subject to it." While the terms and provisions of the Bonded Contract and the Bond may well vary the suretyship status and relationship of the Obligee, the Principal and the Surety, probably the Principal's, and the Indemnitors', execution of the Indemnity Agreement in favor of the Surety is the most contractually affected relationship when it comes to defining the Surety's rights and remedies against the Principal and the Indemnitors. The ABA/TIPS Fidelity and Surety Law Committee publication of THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE (Marilyn Klinger, George J. Bachrach & Tracey L. Haley eds., Am Bar Ass'n, 2d ed. 2008) is probably the best source of discussions of how the Surety's common law rights and remedies and many other Surety rights and remedies against the Principal and the Indemnitors have been incorporated into the Surety's Indemnity Agreement.<sup>82</sup>

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<sup>79</sup> See **Appendix E.**

<sup>80</sup> See Sections 24(2) and 24(3) of the RESTATEMENT OF SURETYSHIP and comment *f*, *Inquiry to principal obligor* and comment *g*, *Vouching in*.

<sup>81</sup> See Section 25 of the RESTATEMENT OF SURETYSHIP and comment *a*, *Purpose* (which is to avoid unnecessary harm to the secondary obligor who may have to pay or perform with its own funds and assets when it is holding the principal obligor's collateral to secure the reimbursement of the secondary obligor's loss). Section 25 allows the secondary obligor to use the principal obligor's collateral to either perform the underlying obligation as a result of the secondary obligor's obligations under the secondary obligation or to reimburse the secondary obligor for its performance under the secondary obligation.

<sup>82</sup> See **Appendix E.**

## V. The Surety's Subrogation Rights Under the RESTATEMENT OF SURETYSHIP.

### A. Introduction.

The discussion of the Surety's subrogation rights under the RESTATEMENT OF SURETYSHIP in this paper would be far longer and much more detailed if Scott Leo had not recently written a thorough and excellent chapter on that very topic [*Chapter 2, The Treatment of the Fundamental Principles of the Surety's Subrogation Rights in the Restatement of the Law*, hereinafter referred to as "Leo's Chapter 2"] in a recent ABA/TIPS Fidelity and Surety Law Committee published book entitled *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).<sup>83</sup> Rather than even attempt to repeat what Mr. Leo has already ably published in Leo's Chapter 2, this paper will merely outline the issues addressed in the RESTATEMENT OF SURETYSHIP concerning the Surety's subrogation rights, and refer back to Leo's Chapter 2 and/or other secondary sources for additional information and support.<sup>84</sup>

From the Surety's standpoint, there are four essential elements to the Surety's successful assertion of its subrogation rights:<sup>85</sup>

- An "underlying obligation" (the Bonded Contract) of the Principal to the Obligee;
- The failure of the Principal to perform that "underlying obligation" (the Bonded Contract);<sup>86</sup>
- Rights in the Obligee arising from the Principal's default and failure to perform; and
- The performance by the Surety, pursuant to its suretyship obligations (the Bond), of the "underlying obligation" (the Bonded Contract) which the Principal failed to perform.<sup>87</sup>

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<sup>83</sup> See also Patrick J. O'Connor, Jr., *Ch. III, The Surety's Rights of Restitution and Subrogation – Setoff Principles Under the Restatement of the Law Third, Suretyship and Guaranty*, in *THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER* 23-40 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

<sup>84</sup> The many comments that follow the Surety's subrogation rights sections, Sections 27 through 31 of the RESTATEMENT OF SURETYSHIP, are extremely valuable in explaining the Surety's subrogation rights – when they arise, what they are, and their effect on the Obligee, the Principal and the Surety. While Leo's Chapter 2 is extremely thorough, the comments to Sections 27 through 31 of the RESTATEMENT OF SURETYSHIP may also add to one's understanding of the Surety's subrogation rights. See also **Appendix F**, which lists a number of topics and secondary sources that address the issues found in Section V of this paper concerning the Surety's subrogation rights.

<sup>85</sup> See Samuel J. Arena, Jr., et al., *Ch. 1, The Contract Bond Surety's Common Law Right to Equitable Subrogation – The Basics*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* 6-7 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013) and especially footnotes 18, 19 and 20 (and the list of other secondary sources that address the four essential elements to the Surety's assertion of its subrogation rights).

<sup>86</sup> See Carol Z. Smith, *Ch. 4, The Necessity of the Principal's Default*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* 175-201 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

<sup>87</sup> See David W. Slaughter, *Ch. 5, The Necessity of the Surety's Performance*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* 203-63 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

“When these four elements exist, the surety is subrogated to the rights of the obligee, principal or third party beneficiary resulting from the principal’s failure to perform.”<sup>88</sup>

To fully understand the treatment of the Surety’s subrogation rights in the RESTATEMENT OF SURETYSHIP, Sections 27 through 31 of the RESTATEMENT OF SURETYSHIP must be reviewed and their interrelationships understood. Leo’s Chapter 2 does just that, and frequent references to Leo’s Chapter 2 will continue in this Section V of the paper.<sup>89</sup>

## B. The Surety’s Right of Subrogation.

The starting point is Section 27 of the RESTATEMENT OF SURETYSHIP, which provides as follows:

### § 27. When Secondary Obligor Has a Right of Subrogation

**(1) Upon total satisfaction of the underlying obligation, the secondary obligor is subrogated to all rights of the obligee with respect to the underlying obligation to the extent that performance of the secondary obligation contributed to the satisfaction.**

“Section 27 of the Restatement of Suretyship sets forth the general principle of traditional subrogation that the surety is entitled to all of the rights of the obligee upon the surety’s total satisfaction of the principal’s obligation to the obligee.”<sup>90</sup> The concept of the Surety’s performance and the purpose of the Surety’s “total satisfaction” of the underlying obligation,<sup>91</sup>

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<sup>88</sup> See Samuel J. Arena, Jr., et al., *Ch. 1, The Contract Bond Surety’s Common Law Right to Equitable Subrogation – The Basics*, in THE CONTRACT BOND SURETY’S SUBROGATION RIGHTS 7 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass’n 2013).

<sup>89</sup> For an historical framework on the RESTATEMENT OF SURETYSHIP’s treatment of subrogation, see Matthew C. Bouchard, Benjamin T. Buskirk, & Jennifer Leuschner, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* 3-12 (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016).

<sup>90</sup> Leo’s Chapter 2 at page 68.

<sup>91</sup> See Leo’s Chapter 2 at pages 73 to 76 and Section 27 of the RESTATEMENT OF SURETYSHIP, comment *b*, (which describes the purpose of the necessity of the Surety’s complete discharge of the underlying obligation as avoiding having the Surety compete with the Obligee for recoveries when the Obligee has not yet been made whole). See also Samuel J. Arena, Jr., et al., *Ch. 1, The Contract Bond Surety’s Common Law Right to Equitable Subrogation – The Basics*, in THE CONTRACT BOND SURETY’S SUBROGATION RIGHTS 35-40 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass’n 2013), including notes 134 to 144; David W. Slaughter, *Ch. 5, The Necessity of the Surety’s Performance*, in THE CONTRACT BOND SURETY’S SUBROGATION RIGHTS 237-60 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass’n 2013); *Pennsylvania Nat. Mut. Cas. Ins. Co. v. City of Pine Bluff*, 354 F.3d 945, 951 (8th Cir. 2004) (citing Section 27 of the RESTATEMENT OF SURETYSHIP, comment *b*, in support of holding that the payment bond surety was entitled to right of subrogation because it had fully satisfied its payment bond obligations); *Nat’l Fire Ins. Co. of Hartford v. Fortune Const. Co.*, 320 F.3d 1260, 1272 (11th Cir. 2003) (citing Section 27 of the RESTATEMENT OF SURETYSHIP in support of determination that performance bond surety on a non-indemnity performance bond was not entitled to subrogation where it paid, instead of performed, its obligations under the performance bond); *Hanover Ins. Co. v. Corpro Companies, Inc.*, 312 F. Supp. 2d 816, 823 n.4 (E.D. Va. 2004) (granting third party consultant’s motion to dismiss the surety’s lawsuit for negligence and other claims, because, although Section 27 of the RESTATEMENT OF SURETYSHIP permits a fully

the Bonded Contract, under Section 27 is confusing, and needs to be reviewed with the context of Section 31 of the RESTATEMENT OF SURETYSHIP in mind (*see infra*. this paper for a discussion of Section 31 of the RESTATEMENT OF SURETYSHIP, which only requires the Principal's default under the Bonded Contract, and not the Surety's performance under the Bond, for the Surety's ability to assert its subrogation rights to the bonded contract funds).<sup>92</sup>

### C. The Rights the Surety Obtains Through Subrogation.

Section 28 of the RESTATEMENT OF SURETYSHIP lists the rights the Surety obtains through subrogation, and provides as follows:

#### **§ 28. Rights Obtained Through Subrogation**

**(1) To the extent that the secondary obligor is subrogated to the rights of the obligee, the secondary obligor may enforce, for its benefit, the rights of the obligee as though the underlying obligation had not been satisfied:**

**(a) against the principal obligor pursuant to the underlying obligation;**

**(b) against any other secondary obligor for the same underlying obligation, unless the other secondary obligor is a subsurety for the subrogated secondary obligor;**

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performing surety to stand in shoes of the obligee to seek reimbursement from its principal, it does not permit a surety to assert claims against unrelated third parties against which the obligee has no claim); *In re Enron Corp.*, 307 B.R. 372, 380 n.54 (S.D.N.Y. 2004) (holding that the fully performing surety was not entitled to excess collateral in the bankrupt principal's margin account pursuant to Section 27 of the RESTATEMENT OF SURETYSHIP under the doctrine of subrogation because the obligee to which the surety was subrogated was not entitled to such excess collateral); *Home Ins. Co. v. United States*, 46 Fed. Cl. 160, 163 (2000) (citing Section 27 of the RESTATEMENT OF SURETYSHIP as "instructive" in holding that the surety was only entitled to recover from the obligee those amounts to which it was equitably subrogated); *Reliance Ins. Co. v. U.S. Bank of Washington, N.A.*, 143 F.3d 502, 506 (9th Cir. 1998) (in the payment bond surety's action against the bank for progress payments owed to the principal, held that, in accordance with Section 27 of the RESTATEMENT OF SURETYSHIP, the payment bond surety's subrogation rights attach only when the surety performed the principal's obligations); *Nova Cas. Co. v. United States*, 69 Fed. Cl. 284, 295 (2006) (citing Section 27 of the RESTATEMENT OF SURETYSHIP in holding, *inter alia*, that the surety which discharged its payment bond obligations was subrogated to the rights of paid subcontractors and to rights of the party whose debts were satisfied, namely the principal, and thus the surety could sue the obligee for contract funds wrongfully held or paid by the obligee); *Gulf Liquids New River Project, LLC v. Gulsby Eng'g, Inc.*, 356 S.W.3d 54, 82 (Tex. App. 2011) (citing Sections 27 and 28 of the RESTATEMENT OF SURETYSHIP in holding that "under principles of equitable subrogation, a Surety may be able to assert its principal's contract, tort, or statutory claims against the Obligee arising out of the bonded contract.")

<sup>92</sup> "Section 27 deals with subrogation generally, and section 31 deals with the surety's subrogation rights to property held by the obligee for the principal's performance. In the case of a construction contract, the property held by the obligee for the principal's performance is the remaining bonded contract funds after the principal's default." Leo's Chapter 2 at page 69. Therefore, while the Surety may not be subrogated to ALL of the Obligee's rights prior to the Surety's performance as stated under Section 27 of the RESTATEMENT OF SURETYSHIP, the Surety "is subrogated to the obligee's right to return performance upon the principal's default in section 31 in order to enable the surety to reduce or avoid the loss arising from the principal's default. Section 31 recognizes that it would be inequitable for the principal to continue to receive payment of the bonded contract funds from the obligee (the "return performance") after the principal is in default under the terms of the bonded contract but before the surety has paid a loss under its performance and/or payment bonds." Leo's Chapter 2 at pages 70-71 and note 44.

- (c) against any interest in property securing either the obligation of the principal obligor or that of any other secondary obligor against whom the rights of the obligee may be enforced; and**
- (d) against any other persons whose conduct has made them liable to the obligee with respect to the default on the underlying obligation.**

From the Surety's standpoint, Section 28(1)(c) identifies security, such as the bonded contract funds, that secures both the Principal's and the Surety's obligations to perform or pay, and reduces the potential Surety losses as a result of the Surety's obligations under the Bond to perform or pay. However, to the extent that the bonded contract funds exceed that Surety's cost of performance under the Bond (whether that cost of performance is performance and/or payment under the performance bond or payment under the payment bond), the Surety's recovery of the bonded contract funds is limited to and "may not exceed the secondary obligor's cost of performance of the secondary obligation."<sup>93</sup> Namely, the Surety can fully reimburse its losses from the bonded contract funds, but cannot receive a profit beyond its costs of performance under the Bond.

In addition, the Surety may succeed to the Obligee's priority status in whatever rights the Obligee may have,<sup>94</sup> and to certain of the Obligee's defenses.<sup>95</sup>

#### D. The Surety's Right to Return Performance and the Obligee's Setoff Rights.

As discussed in great detail in Leo's Chapter 2 and other chapters of *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013),<sup>96</sup> Section 31 of the *RESTATEMENT OF SURETYSHIP* is the most significant provision of the *RESTATEMENT OF SURETYSHIP* with respect to the Surety's subrogation rights to the bonded contract funds, specifically addressing the Surety's right to return performance (the Obligee's payment of the bonded contract funds to the Surety upon the Principal's default under the Bonded Contract) and limiting the Obligee's setoff rights against the bonded contract funds.

Section 31 of the *RESTATEMENT OF SURETYSHIP* provides as follows:

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<sup>93</sup> See Section 28(2)(a) of the *RESTATEMENT OF SURETYSHIP*.

<sup>94</sup> See Section 29 of the *RESTATEMENT OF SURETYSHIP*. However, the Surety does not succeed to the Obligee's priority status if prohibited by statute, such as the Bankruptcy Code, 11 U.S.C.A. § 507(d).

<sup>95</sup> See Section 30 of the *RESTATEMENT OF SURETYSHIP* (When the Surety is subrogated to the Obligee's rights against the Principal or another person or party, and the Principal or the other person or party has no defense to the Obligee's claim, they have no defense to the Surety's claim through its assertion of its subrogation rights to the Obligee's rights.).

<sup>96</sup> See T. Scott Leo, *Ch. 2, The Treatment of the Fundamental Principles of the Surety's Subrogation Rights in the Restatement of the Law*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* 68-84 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013). See also Samuel J. Arena, Jr., et al., *Ch. 1, The Contract Bond Surety's Common Law Right to Equitable Subrogation – The Basics*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* 35-40 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013), and note 144 and David W. Slaughter, *Ch. 5, The Necessity of the Surety's Performance*, in *THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS* 240 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013) at note 93.

**§ 31. Secondary Obligor’s Right to Return Performance; Obligee’s Right of Set-Off**

**(1) For purposes of a subrogated secondary obligor’s right to enforce for its benefit the obligee’s rights against property securing the underlying obligation (§ 28(1)(c)), performance owed by the obligee to the principal obligor pursuant to the contract creating the underlying obligation (“return performance”) is security for the underlying obligation.**

**(2) To the extent that, through subrogation, the secondary obligor has rights to the obligee’s return performance:**

**(a) except as provided by agreement between the obligee and the secondary obligor, the obligee may not set off against the secondary obligor’s right to return performance any claim against the principal obligor that is unrelated to the underlying obligation; and**

**(b) the right of any person claiming an interest in return performance through the principal obligor is subordinate to the secondary obligor’s right to that performance.<sup>97</sup>**

We will not repeat the outstanding analysis found in Leo’s Chapter 2 with respect to the Surety’s right to return performance and all of its ramifications<sup>98</sup> to the Surety’s assertion of its subrogation rights to the bonded contract funds, and the other discussions contained in the ABA/TIPS Fidelity and Surety Law Committee published book entitled THE CONTRACT BOND SURETY’S SUBROGATION RIGHTS as set forth in the footnote below.<sup>99</sup> What we can best recommend is that those writings should be read again and again to obtain a thorough and comprehensive understanding of one of the most important issues for Surety’s asserting their subrogation rights to the bonded contract funds.

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<sup>97</sup> See *Pennsylvania Nat. Mut. Cas. Ins. Co. v. City of Pine Bluff*, 354 F.3d 945, 952 (8th Cir. 2004) (citing Sections 31 and 37 of the RESTATEMENT OF SURETYSHIP to hold that the obligee that paid the principal after receiving notice from the surety that the principal was in default was liable to the surety for losses incurred by the surety after notice of default).

<sup>98</sup> See, for example, the discussions in Section III.C.2.a. and note 42, and Section III.C.2.c. and note 56, *supra.*, of this paper concerning the Surety’s cause of action against the Obligee under Section 37(4) of the RESTATEMENT OF SURETYSHIP when the Obligee makes an overpayment of the bonded contract funds to the Principal. See also Leo Chapter 2 at pages 85-91.

<sup>99</sup> See Leo Chapter 2 at pages 78-84.

## VI. What Else May be Found in the RESTATEMENT OF SURETYSHIP?

### A. Introduction.

This paper has addressed four issues in the RESTATEMENT OF SURETYSHIP that are critical for surety claim representatives, whether they are attorneys or adjusters, or outside surety attorneys to understand, including the Obligee's rights against the Surety under the Bond, the Surety's defenses to the Obligee's claims, the Surety's rights of indemnity and reimbursement from the Principal, and the Surety's subrogation rights.

However, the RESTATEMENT OF SURETYSHIP goes on to discuss some other issues and topics that will be briefly described below.

### B. The Obligee's Enforcement of the Underlying Obligation [Sections 50 and 51 of the RESTATEMENT OF SURETYSHIP].<sup>100</sup>

Section 50 of the RESTATEMENT OF SURETYSHIP discusses the effect on the Surety due to the Obligee's lack of action to enforce the underlying obligation (the Bonded Contract) against the Principal.<sup>101</sup> Section 51 of the RESTATEMENT OF SURETYSHIP discusses when an Obligee must first seek to collect by applying the Principal's collateral for the underlying obligation before it can compel the Surety to pay under the Bond. Frequently, the "contract" for the Surety's "secondary obligation" to the Obligee, the Bond, may address these two issues.

However, the Obligee may be holding the remaining bonded contract funds that were due to the Principal prior to the Principal's default under the Bonded Contract, bonded contract funds that constitute the Obligee's "return performance" to the Principal and the Surety pursuant to the Surety's subrogation rights. The Surety may be able, under certain circumstances, to compel the Obligee to use the bonded contract funds to perform the Bonded Contract obligations prior to the Surety's payment or payments under the Bond.<sup>102</sup>

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<sup>100</sup> See James A. Black and T. Scott Leo, *Ch. IV, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 72-73 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005); see also *John T. Callahan & Sons, Inc. v. Dykeman Elec. Co.*, 266 F. Supp. 2d 208, 238 (D. Mass. 2003) (noting that the principal's delay in default terminating subcontractor did not discharge the surety because it did not fall within the enumerated exceptions set forth in Section 50 of the RESTATEMENT OF SURETYSHIP and stating, in so holding, that Massachusetts courts are likely to adhere to the principles set forth in the [RESTATEMENT OF SURETYSHIP] . . . particularly [ ] where, as here, no Massachusetts case is directly on point.")

<sup>101</sup> Generally, the Obligee may choose to pursue its rights against either and/or both the Principal and the Surety. Unless varied by agreement or by statute, "the obligee may choose whether to seek enforcement first of the underlying obligation or the secondary obligation." See Section 50 of the RESTATEMENT OF SURETYSHIP, comment a.

<sup>102</sup> See Section 51 of the RESTATEMENT OF SURETYSHIP, comment c, *Hardship*.

C. Multiple Sureties – Co-Suretyship and Sub-Suretyship [Sections 52 to 61 of the RESTATEMENT OF SURETYSHIP].<sup>103</sup>

Sections 52 through 61 of the RESTATEMENT OF SURETYSHIP discuss the issues of when there are multiple secondary obligors, whether they are Co-Sureties or Sub-Sureties, including the rights of the Obligee against the multiple Sureties and the rights between the multiple Sureties, whether they are Co-Sureties or Sub-Sureties.<sup>104</sup> While these relationships are frequently determined by agreements and contracts among the parties, the provisions of the RESTATEMENT OF SURETYSHIP may assist in determining the respective rights and obligations among the Obligee and the Sureties, among and between the multiple Sureties, and the multiple Sureties rights against the Principal.<sup>105</sup>

D. Enforcement Issues [Sections 62 to 70 of the RESTATEMENT OF SURETYSHIP].

Sections 62 through 70 of the RESTATEMENT OF SURETYSHIP discuss certain issues with respect to the enforcement of the secondary obligations,<sup>106</sup> including accrual of actions and

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<sup>103</sup> See Samuel J. Arena, Jr., *Ch. VII, Multiple Secondary Obligors: Cosuretyship and Subsuretyship Under the Restatement of the Law (Third), Suretyship and Guaranty*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 121-139 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

<sup>104</sup> For further discussion of the treatment of Co-Sureties and Sub-Sureties in the RESTATEMENT OF SURETYSHIP, see Matthew C. Bouchard, Benjamin T. Buskirk, & Jennifer Leuschner, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* 26-28 (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016).

<sup>105</sup> See *Nat'l Am. Ins. Co. v. Indiana Lumbermens Mut. Ins. Co.*, No. 97 C 5431, 1999 WL 35339, at \*12 (N.D. Ill. Jan. 13, 1999), *aff'd*, 221 F.3d 1339 (7th Cir. 2000) (holding in action by one group of sureties to recover from a different group of sureties on separate, unrelated project for payment and performance bond losses that, pursuant to Section 53 of the RESTATEMENT OF SURETYSHIP, comment *d*, "Occasionally, one principal obligor [i.e. contractor] owes a number of separate underlying obligations ... and each underlying obligation is the subject of a secondary obligation incurred by a different secondary obligor [i.e. surety]. In such a case, the secondary obligors are not liable with respect to the same underlying obligation ... [and] the secondary obligors have neither a subsuretyship nor cosuretyship relationship."); *Lestorti v. DeLeo*, 298 Conn. 466, 475, 4 A.3d 269, 276 (2010) (citing Section 55 of the RESTATEMENT OF SURETYSHIP to hold that a co-surety does not have a right of contribution against another co-surety unless it pays more than its contributive share).

<sup>106</sup> See Daniel Mungall, Jr., *Ch. VIII, The Statute of Limitations, the Effect of Judgments in Actions Between the Parties, Legally Mandated Bonds and Miscellaneous Provisions*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 44-47 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005); Matthew C. Bouchard, Benjamin T. Buskirk, & Jennifer Leuschner, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* 24-26 (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016); *Ins. Co. of N. Am. v. Metro. Dade Cty.*, 705 So. 2d 33, 35 (Fla. Dist. Ct. App. 1997) (citing Section 67 of the RESTATEMENT OF SURETYSHIP for authority that a default judgment against a principal was merely evidence of, but did not by itself establish, a surety's liability). For discussion of additional suretyship situations not previously discussed but which are included in the RESTATEMENT OF SURETYSHIP, see D. Benjamin Beard, *Suretyship on the Fringe: Suretyship by Operation of Law and by Analogy*, 34 Wm. & Mary L. Rev. 1157 (1993) (discussing situations addressed by the RESTATEMENT OF SURETYSHIP in which a non-typical surety achieves, by operation of law, suretyship status); James A. Black, Jr., *Miscellaneous Surety Bonds and the Restatement*, 34 Wm. & Mary L. Rev. 1195 (1993) (discussing miscellaneous surety bonds, such as court bonds, license bonds, and permit bonds); Gerald T. McLaughlin, *Standby Letters of Credit and Guarantees: An Exercise in Cartography*, 34 Wm. & Mary L. Rev. 1139 (1993); Hugh E. Reynolds, Jr. & James Dimos, *Fidelity Bonds and the Restatement*, 34 Wm. & Mary L.



statute of limitations issues; the effect on the Surety of any litigation between the Obligee and the Principal, and the effect on the Principal of any litigation between the Obligee and the Surety; and the status of the third-party beneficiaries (such as the payment bond claimants)<sup>107</sup> under the Bond.

## VII. Conclusion.

We hope if you have gotten this far that you don't have a severe headache, or that you have taken appropriate medications to subdue the headache. However, what comes to mind is Andy's hand-written note to Red in the movie, *The Shawshank Redemption*, once Red gets out of prison after forty years<sup>108</sup> and is sitting under the huge oak tree next to the rock wall in Buxton, Maine – "if you've come this far, maybe you're willing to come a little further." Now Red goes to Mexico to join Andy on the Pacific Ocean, and most of us don't have that luxury.

But, we do have the "luxury" and the opportunity to incorporate into our work life the basic suretyship principles that are set out in the RESTATEMENT OF SURETYSHIP and use them when we run into problems explaining to the Obligee, the Principal and/or the court why the Surety should prevail – whether it is prevailing under a defense to the Obligee's claim against the Bond, under the Surety's indemnity and reimbursement rights against the Principal and any indemnitors, or in the Surety's assertion of its subrogation rights.

If you ever get stuck in a jam and need to address the Surety's most basic rights, you may find the descriptions, words and support you need in the RESTATEMENT OF SURETYSHIP.

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Rev. 1249 (1993); Amelia H. Boss, *Suretyship and Letters of Credit: Subrogation Revisited*, 34 Wm. & Mary L. Rev. 1087, 1089 (1993).

<sup>107</sup> See Section 69 of the RESTATEMENT OF SURETYSHIP, comment *b*.

<sup>108</sup> The RESTATEMENT OF SURETYSHIP has been around since 1996, only twenty years.

## **2016 Northeast Surety and Fidelity Claims Conference Biographies of Authors**

### **George J. Bachrach**

George J. Bachrach is a partner in the Baltimore, Maryland law firm of Wright, Constable & Skeen, LLP. He is a graduate of Harvard University, B.A., cum laude, 1971, and Georgetown University Law Center, J.D. 1974. He has represented surety companies in performance bond, payment bond and commercial surety bond claims, workouts and related bankruptcy proceedings for over 40 years. Mr. Bachrach is a former Chair of the ABA/TIPS Fidelity and Surety Law Committee (2001 to 2002), and is a member of many surety industry groups and affiliations. On May 21, 2009, Mr. Bachrach received the ABA/TIPS Fidelity and Surety Law Committee Martin J. Andrew Award for Lifetime Achievement in Fidelity and Surety Law. Mr. Bachrach is a frequent author, editor, program chair and speaker on many surety-related topics and issues, including the surety's performance bond rights, obligations and options (including financing the principal, takeover and completion, and others); the surety's indemnity agreement, subrogation and salvage rights; the surety's claims investigation rights and claims handling process; commercial surety and contract surety bankruptcy issues; and others.

### **Jason R. Potter**

Jason R. Potter is an associate in the Baltimore, Maryland law firm of Wright, Constable & Skeen, LLP. He graduated from The Ohio State University in 1995 with a B.A. degree in political science and a minor in Spanish. After graduation, Mr. Potter worked in Madrid, Spain for a multinational Dutch bank. He graduated from the University of Baltimore School of Law in 2005, where he was awarded the Clinical Excellence Award. After graduation, Mr. Potter served as judicial law clerk for the Honorable Thomas E. Marshall of the Circuit Court for Harford County. After his clerkship, Mr. Potter joined Wright, Constable & Skeen, where he has concentrated his practice in the areas of suretyship, construction law, and commercial litigation. Mr. Potter has presented papers before various organizations, including the Maryland Bar Association's Construction Law Section, the Northeast Surety & Fidelity Claims Conference, and the Surety Claims Institute. He is also a member of various bar associations and industry groups, including the Bar Association of Baltimore City, The Maryland State Bar Association, the American Bar Association, and the Surety Claims Institute. Mr. Potter has been named as a Super Lawyer® for 2016 in the area of suretyship and a Super Lawyer® Rising Star from 2011 to 2015.

### **William P. Pearce**

William P. Pearce is Surety Claims Counsel with Arch Insurance Company in Philadelphia, where he handles claims on contract performance and payment bonds and subdivision bonds. Prior to joining Arch, Will was in private practice, handling surety, fidelity, and construction matters at Whiteford, Taylor & Preston LLP in Baltimore. Will received his law degree from The Dickinson School of Law of the Pennsylvania State University and his Bachelor of Arts degree in Political Science from Indiana University of Pennsylvania.

## 2016 Northeast Surety and Fidelity Claims Conference

### A Primer for the RESTATEMENT OF THE LAW SURETYSHIP AND GUARANTY

#### APPENDICES

The paper entitled *A Primer for the Restatement of the Law of Suretyship and Guaranty* that concerns the RESTATEMENT OF SURETYSHIP focuses on the most relevant provisions for surety claim professionals found in the RESTATEMENT OF SURETYSHIP and the cases that interpret those provisions. However, much has been written about a number of the issues discussed in the RESTATEMENT OF SURETYSHIP and in the paper that relate to the topics, but not necessary to the specific provisions, that are contained in the RESTATEMENT OF SURETYSHIP.

The attached Appendices that are referenced in the paper discuss various issues and topics and the books, articles, papers and other secondary sources outside of the RESTATEMENT OF SURETYSHIP that address those issues and topics.

1. **Appendix A** – The Conditions Precedent Under a Performance Bond That Must Be Met Before the Surety’s Duties and Obligations Arise
2. **Appendix B** – The Surety’s Defense of Misrepresentation and the Avoidance of the Surety’s Obligations Under the Bond
3. **Appendix C** – The Surety’s Assertion of the Principal’s Defenses Under the Bonded Contract as the Surety’s Defenses Under the Bond
4. **Appendix D** – The Surety’s Assertion of the Surety’s Own Defenses Under the Bonded Contract and the Bond, Including the Surety’s Release and Discharge Due to the Obligor’s Impairment of the Surety’s Rights
5. **Appendix E** – The Surety’s Common Law and Contractual Indemnity Agreement Rights and Their Relationship to the RESTATEMENT OF SURETYSHIP
6. **Appendix F** – The Surety’s Subrogation Rights and Their Relationship to the RESTATEMENT OF SURETYSHIP

The goal of the attached Appendices is to supplement the paper’s discussion of the rights and obligations of the various parties described in the RESTATEMENT OF SURETYSHIP. We hope that this added material and their references to secondary sources assist the reader in obtaining a further and deeper understanding of the relationship of the RESTATEMENT OF SURETYSHIP to the issues and topics that the contract bond surety and surety claim professionals must address on a regular basis.

## Appendix A

### The Conditions Precedent Under a Performance Bond That Must Be Met Before the Surety's Duties and Obligations Arise

The Principal owes the performance of the Bonded Contract (the underlying obligation) to the Obligee.<sup>109</sup> To the extent that the Principal performs the Bonded Contract or the Surety performs the Bonded Contract obligations under the Performance Bond, the Obligee is not entitled to the performance of the other obligation (the Obligee does not get performance under both the Bonded Contract and the Performance Bond).<sup>110</sup>

As a result, in accordance with Section 1(2) of the RESTATEMENT OF SURETYSHIP, the Obligee has no claim against the Surety or the Performance Bond until the Principal fails to perform the Bonded Contract and is, therefore, in breach or default of the Principal's obligations to the Obligee to perform under the Bonded Contract. Conversely, the Obligee has a claim against the Surety and its Performance Bond with respect to a Bonded Contract whenever the Principal owes performance of the Bonded Contract to the Obligee and the Principal fails to perform the Bonded Contract (subject to the Surety's defenses as described in the paper). Obviously, the Bonded Contract and the Performance Bond set forth the relevant terms of the various duties and obligations of the parties, but the RESTATEMENT OF SURETYSHIP also sets forth those duties and obligations, and the defenses to those duties and obligations, as a matter of law and suretyship principles.

Therefore, every Performance Bond requires the Principal to be in default under the Bonded Contract (the Principal's failure to perform) before the Surety may be obligated to perform under the Performance Bond. However, many Performance Bonds have contractual conditions precedent in addition to the Principal's default under the Bonded Contract (for example, the Obligee is not in default, the Surety receives notice of the default, the Principal is terminated under the Bonded Contract, etc.) that must be met before the Surety's obligations under the Performance Bond arise.

There are a number of books, articles and papers that discuss the contractual conditions precedent that may be found in a Performance Bond. These include the following.

#### **Books**

1. THE LAW OF PERFORMANCE BONDS, 2D ED. (2009), Chapter 2, *Conditions Precedent to Asserting a Performance Bond Claim*, pages 21 to 27 (what constitutes a contractor's default and a discussion of breach, material breach, default, declaration of default, and termination).
2. THE LAW OF PERFORMANCE BONDS, 2D ED. (2009), Chapter 3, *Performance Options Available to the Surety*, pages 61 to 62, notes 3 to 7, and the need for a principal's default and, perhaps, a declaration of default.
3. THE LAW OF PERFORMANCE BONDS, 2D ED. (2009), Chapter 11, *Defenses Available to the Surety*, pages 590-595 (the surety must be given notice of default and an opportunity to perform).

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<sup>109</sup> RESTATEMENT OF SURETYSHIP, Section 1(2)(a).

<sup>110</sup> RESTATEMENT OF SURETYSHIP, Section 1(1)(b).

4. BOND DEFAULT MANUAL, 4TH ED. (2015), Chapter III, *The Surety's Obligations Under the Performance Bond: To Perform or Not To Perform*, pages 118 to 122 (the contents of the obligee's notice, and whether there is a default and termination, a demand that the surety perform, and/or a dedication of the bonded contract funds to the surety); pages 165 to 174 (the failure of the obligee to meet the implied conditions precedent in the A311 Performance Bond and/or the express conditions precedent in the A312 Performance Bond); pages 174-182 [an improper default and termination (distinction between breach and default, including material breach, and termination) and substantial completion]; and pages 204-208 (the failure to allow the surety to complete performance under the performance bond).

### **Articles and Papers**

- Alber, Philip G. & Keating, James Andrew, *Breach, Default, Termination and Other Contract Provisions: The Need to Connect the Dots in a Performance Bond Claim* (unpublished paper submitted at the Twenty-Sixth Annual Northeast Surety and Fidelity Claims Conference on Sept. 17, 2015)
- Bouchard, Matthew C., Buskirk, Benjamin T., & Leuschner, Jennifer, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016)
- Crafton, Thomas E., *Owners Payment Defaults* (unpublished paper submitted at the Forum on the Construction Industry and the ABA/TIPS Fidelity and Surety Law Committee joint program on Jan. 28, 1993)
- Frerichs, Scott, *Stuck in the Middle With Who? Consequences When the Obligee Fails to Declare a Default but Still Seeks Surety Performance* (unpublished paper submitted at the Twenty-Seventh Annual Surety Claims Institute meeting on June 20, 2002)
- Giroux, Tammy N. & Rondinelli, Cherie, *Loss Control Strategies for the Surety – Prior to Formal Notice of Default or Termination* (unpublished paper submitted at the Twenty-Sixth Annual Southern Surety and Fidelity Claims Conference on Apr. 23, 2015)
- Knoll, James, *What Constitutes a Default Sufficient to Justify the Obligee or Surety in Terminating Performance by the Principal* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual meeting in Aug., 1979)
- Leonard, Darrell, Lambert, Wayne D. & Bonacci, JoAnne, *Has the Starting Gun Been Fired? The Default* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee Spring Meeting on May 8, 2014)
- Piper, William S., *L&A Contracting and its Progeny* (unpublished paper submitted at the Thirtieth Annual Surety Claims Institute meeting on June 23, 2005)
- Rosales, Marcha L., Rourke, John W., Emeish, Issa K. & Collins, Jennifer K., *Read the Darn Bond – Default, Declaration of Default, Cure Opportunity, Failure of Cure and Contract Termination as Preconditions to Performance Bond Liability* (unpublished paper submitted at the Fourteenth Annual Northeast Surety and Fidelity Claims Conference on Sept. 18, 2003)
- Schember, Steven G., *“The Ying and Yang Surety Defenses”: Failure of Obligee to Give Proper Notice of Default and/or Acceptance by Obligee of Improper Work, Some New Wrinkles* (unpublished paper submitted at the Twelfth Annual Southern Surety and Fidelity Claims Conference on Apr. 26, 2001)

Selden, Thomas L., *Necessity for Default Declaration and Other Conditions Precedent to Invoke Surety's Obligations Under Performance Bond* (unpublished paper submitted at the Twelfth Annual Southern Surety and Fidelity Claims Conference on Apr. 26, 2001)

Stone, Jarrod W. & Czap, Kimberly B., *What is a Default and Why Does it Matter* (unpublished paper submitted at the Twenty-Fifth Annual Southern Surety and Fidelity Claims Conference on Apr. 10, 2014)

## Appendix B

### The Surety's Defense of Misrepresentation and the Avoidance of the Surety's Obligations Under the Bond

Section 12 of the RESTATEMENT OF SURETYSHIP is entitled "When Secondary Obligation is Voidable Due to Misrepresentation." The misrepresentation may be induced by the Obligee,<sup>111</sup> the Principal or some other third party.<sup>112</sup> This may be a real Surety defense under the Bond in the appropriate factual circumstances even though the situations in which a Surety may raise the defense may not occur very often. Since such a Surety defense is both factual and legal, and not contractual (as the Surety may seek to avoid its contractual obligations under the Bond due to some misrepresentation), the elements and provisions of Section 12 of the RESTATEMENT OF SURETYSHIP are important if and/or when the Surety raises such a defense.

There are a number of books, articles and papers that discuss the Surety's defense of misrepresentation and the avoidance of the Surety's obligations under the Bond. These include the following.

#### Books

1. THE LAW OF PERFORMANCE BONDS, 2D ED. (2009), Chapter 1, *Creation of the Relationship*, pages 17-20 (fraud by the principal, fraud by the obligee, mistake and/or illegality as providing a defense to the surety).
2. THE LAW OF PERFORMANCE BONDS, 2D ED. (2009), Chapter 11, *Defenses Available to the Surety*, pages 616-621 (the obligee's lack of good faith, including concealment, non-disclosure, and misrepresentation, and other issues that affect the surety's bond obligations).
3. James A. Black and T. Scott Leo, *Ch. 4, Suretyship Defenses*, in THE RESTATEMENT OF SURETYSHIP AND GUARANTY: A TRANSLATION FOR THE PRACTITIONER 44-47 (T. Scott Leo and Daniel Mungall, Jr. eds., Am. Bar Ass'n 2005).

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<sup>111</sup> Section 12(1) of the RESTATEMENT OF SURETYSHIP provides: "If the secondary obligor's assent to the secondary obligation is induced by a fraudulent or material misrepresentation by the obligee upon which the secondary obligor is justified in relying, the secondary obligation is voidable by the secondary obligor." Section 12, comment *a*, *Requirements*, sets forth three requirements that "must be met in addition to the requirement of a misrepresentation:" (a) "the representation must have been either fraudulent or material;" (b) "the misrepresentation must have induced the secondary obligor [the Surety] to make the contract [the Bond];" and (c) "the secondary obligor [the Surety] must have been justified in relying on the misrepresentation." Additional comments following Section 12 of the RESTATEMENT OF SURETYSHIP address a number of issues, including: (a) comment *b*, *Fraudulent and nonfraudulent misrepresentations*; (b) comment *c*, *Inducement*; (c) comment *d*, *Justifiable reliance*; (d) comment *f*, *Nondisclosures*; and others.

<sup>112</sup> See Section 12(2) of the RESTATEMENT OF SURETYSHIP, and the additional comments following Section 12 of the RESTATEMENT OF SURETYSHIP, including: (a) comment *e*, *Misrepresentation by other than obligee*; (b) comment *g*, *Obligee's reasonable beliefs*; and others.

## **Articles and Papers**

- Brasco, Christopher J., *et al.*, *A Government Obligee's Duty to Disclose Information as a Basis for Performance Bond Discharge* (unpublished paper submitted at the Twenty-Sixth Annual Northeast Surety and Fidelity Claims Conference on Sept. 17, 2015)
- Case, James R., *Void Ab Initio: The Right of the Construction Surety to Rescind Fraudulently or Mistakenly Issued Bonds* (unpublished paper submitted at the Thirtieth Annual Surety Claims Institute meeting on June 23, 2005)
- Clarke, Bogda M.B., Ferrucci, James D. & Shahinian, Armen, *Fraud and Inducement as a Defense to Fidelity and Surety Claims*, 42 TORT & INS. LAW J.181 (Fall 2006)
- Clarke, Bogda M.B., Ferrucci, James D. & Shahinian, Armen, *Fraud and Inducement as a Defense to Fidelity and Surety Claims* (unpublished paper submitted at the Seventeenth Annual Northeast Surety and Fidelity Claims Conference on Sept. 21, 2006)
- Ferrucci, James D., *Fraud in the Inducement as a Defense to Surety Claims* (unpublished paper submitted at the Thirty-Eighth Annual Surety Claims Institute meeting on June 26, 2013)



## Appendix C

### The Surety's Assertion of the Principal's Defenses Under the Bonded Contract as the Surety's Defenses Under the Bond

The following is a list (in no particular order) of some of the Principal's defenses under the Bonded Contract that the Surety may assert as defenses to the Obligee's claims under the Bond. There may be other such Principal defenses depending upon the terms and provisions of the Bonded Contract and the factual circumstances. After each such Principal defense, the footnotes cite to a number of books, articles and papers that address each such Principal defense.

For the purposes of the footnotes referenced in this Appendix C, the following defined terms refer to the following ABA/TIPS Fidelity and Surety Law Committee books.

A. **Krebs – BDM4, Chapter 3** refers to David J. Krebs and Shannah J. Morris, *Chapter 3, The Surety's Obligations Under the Performance Bond: To Perform or Not to Perform*, in BOND DEFAULT MANUAL 109-208 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox eds., Am. Bar Ass'n, 4th ed. 2015).

B. **Gelinas – LPB2, Chapter 11** refers to Julia Blackwell Gelinas and Genise W. Teich, *Chapter 11, Defenses Available to the Surety*, in THE LAW OF PERFORMANCE BONDS 575-621 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009).

C. **Bruner – BDM3, Chapter 3** refers to Philip L. Bruner, Patrick J. O'Connor, Jr., and Tracey L. Haley, *Chapter 3, The Surety's Analysis of Investigative Results: "To Perform or Not to Perform – That is the Question,"* in BOND DEFAULT MANUAL 77-154 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds., Am. Bar Ass'n, 3rd ed. 2005).

D. **Bruner – Complex** refers to Philip L. Bruner and Tracey L. Haley, *Chapter 1, Strategic "Generalship" of the Complex Construction Suretyship Case*, in MANAGING AND LITIGATING THE COMPLEX SURETY CASE 1-114 (Philip L. Bruner & Tracey L. Haley eds., Am. Bar Ass'n, 2d ed. 2007).

E. **Egan – Suretyship** refers to M. Michael Egan and Marla Eastwood, *Chapter 7, Discharge of the Performance Bond Surety*, in THE LAW OF SURETYSHIP 119-145 (Edward G. Gallagher, ed., Am. Bar Ass'n, 2d 3d. 2000).

Furthermore, see *generally* the treatise, BRUNER & O'CONNOR ON CONSTRUCTION LAW, for additional comments and cases with respect to the Surety's assertion of the Principal's defenses under the Bonded Contract as the Surety's defenses under the Bond.

## The Principal's Defenses under the Bonded Contract

The Principal's defenses under the Bonded Contract may include the following.

1. The Obligee's wrongful termination of the Principal's Bonded Contract.<sup>113</sup>
2. The Obligee's failure to pay the contract funds.<sup>114</sup>

Obviously, if the Obligee wrongfully fails to pay the Principal the contract funds, the Principal may have a defense as a result of the Obligee's material breach of the Bonded Contract.

3. The Obligee's duties incident to the project's design.

If the Obligee fails to fulfill its duties incident to the design of the project, including but not limited to the Obligee's failure to provide plans and specifications that are free from defects, the Principal may be discharged from its performance under the Bonded Contract. The Obligee's duties include the following:<sup>115</sup>

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<sup>113</sup> An obligee's wrongful termination of the principal's construction contract is itself a breach of that construction contract that relieves the principal from its obligations under the construction contract and the principal and the surety from their liability under the performance bond. During its investigation, the surety will attempt to determine what constitutes default under the principal's construction contract and whether the obligee's termination of the principal for default is proper and justified, or whether the obligee wrongfully terminated the principal's construction contract. There are a number of facts and factors that are relevant for the issue of a wrongful termination, including the importance of a good faith motive for the obligee's termination, the importance of a proper cure notice, and/or the obligee's waiver of its right to terminate the principal for default. See Bruner - Complex, pp. 16-28; Bruner – BDM3, Chapter, pp. 93-112. Furthermore:

The obligee's termination of the principal under the termination clause of a bonded contract can be upheld only if the obligee sustains its burden of proof that (1) the principal materially and inexcusably breached its contract, (2) the principal's breaches were not induced or preceded by the obligee's own supervening material breaches of contract, such as nonpayment, maladministration of the construction process, or refusal to grant proper time extensions or other recognized "contract defenses," (3) the obligee's termination was not improperly motivated or conceived in bad faith and was made independently and with the exercise of discretion by its representative having authority to terminate the contract, (4) the principal was given ample notice of deficiencies so as to understand what needed to be "cured," and (5) the obligee properly followed its contractually-specified termination procedure.

Bruner – BDM3, Chapter 3, p. 104; see also Krebs – BDM4, Chapter 3, pp. 182-83; Gelinas – LPB2, Chapter 11, pp. 583-84; Bruner - Complex, pp. 20-21. The obligee's wrongful termination of the principal's construction contract may lead to the obligee's release and discharge of the surety's principal and the surety and/or the obligee's failure to comply with the performance bond's conditions precedent requiring the surety to perform.

<sup>114</sup> Gelinas – LPB2, Chapter 11, p. 589; Bruner - Complex, pp. 46-47; Bruner – BDM3, Chapter 3, pp. 128-29; Egan - Suretyship, pp. 138-39; T. Scott Leo & B. Scott Douglass, *The Obligee's Duties to Provide Plans and Specifications, Make Payment, and Process Change Orders* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

- a. The Obligees implied warranty of design adequacy (including the “government contractor” defense<sup>116</sup>).
  - b. The Obligees implied warranty of commercial availability of specified construction materials.
  - c. The Obligees implied duty of disclosure.
  - d. The blending of design and performance specifications.
  - e. The Obligees approval of the Principal’s work plan.
  - f. The Obligees implied warranty of design versus the Principal’s warranty of materials.
  - g. The Obligees responsibility for latent ambiguities in its design.
4. The Obligees implied duty of cooperation.<sup>117</sup>
  5. The impossibility or impracticality of the performance of the work.<sup>118</sup>
  6. The Obligees failure to properly administer the Bonded Contract (including the Obligees lack of response to requests for information and proposed change orders and other failures to act timely).<sup>119</sup>
  7. The Obligees failure to provide the Principal with an opportunity to cure the default.<sup>120</sup>

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<sup>115</sup> Krebs- BDM4, Chapter 3, pp. 186-90; Gelinias – LPB2, Chapter 11, pp. 577-78; Bruner - Complex, pp. 34-42; Bruner – BDM3, Chapter 3, pp. 117-25; T. Scott Leo & B. Scott Douglass, *The Obligees Duties to Provide Plans and Specifications, Make Payment, and Process Change Orders* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

<sup>116</sup> Bruner - Complex, pp. 36-37 and its footnotes 103-05; Bruner – BDM3, Chapter 3, pp. 119-20.

<sup>117</sup> Krebs – BDM4, Chapter 3, pp. 194-95; Bruner - Complex, pp. 42-44; Bruner - BDM3, Chapter 3, pp. 125-26.

<sup>118</sup> Krebs – BDM4, Chapter 3, pp. 190-91; Gelinias – LPB2, Chapter 11, pp. 580-82; Bruner - Complex, p. 50; Bruner – BDM3, Chapter 3, p. 132; RESTATEMENT (2D) OF THE LAW OF CONTRACTS § 261 (1981).

<sup>119</sup> Gelinias – LPB2, Chapter 11, pp. 579-80; Bruner - Complex, pp. 45-49; Bruner – BDM3, Chapter 3, pp. 127-32; Egan - Suretyship, pp. 138-39; T. Scott Leo & B. Scott Douglass, *The Obligees Duties to Provide Plans and Specifications, Make Payment, and Process Change Orders* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997).

<sup>120</sup> Krebs – BDM4, Chapter 3, pp. 184-86; Gelinias – LPB2, Chapter 11, pp. 585-87; Bruner - Complex, pp. 23-27; Bruner – BDM3, Chapter 3, pp. 107-10.

8. The Obligee's implied waiver of contract requirements.<sup>121</sup>
9. The Obligee's insistence upon strict compliance in the face of economic waste, and hyper-technical inspection.<sup>122</sup>
10. The Obligee's release and settlement of claims against the Principal.<sup>123</sup>
11. The Principal's setoffs and/or counterclaims.<sup>124</sup>

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<sup>121</sup> Krebs – BDM4, Chapter 3, pp. 193-94; Bruner - Complex, pp. 50-51; Bruner – BDM3, Chapter 3, p. 133; see BRUNER & O'CONNOR ON CONSTRUCTION LAW, § 18:17-18:20.

<sup>122</sup> Krebs – BDM4, Chapter 3, p. 196; Bruner - Complex, pp. 51-52; Bruner – BDM3, Chapter 3, pp. 133-34.

<sup>123</sup> Gelinas - LPB2, Chapter 11, pp. 613-15; Bruner - Complex, pp. 53-54; Bruner – BDM3, Chapter 3, pp. 135-36; RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 39 (1996).

<sup>124</sup> Gelinas – LPB2, Chapter 11, pp. 587-89. See also, Jarrod W. Stone, *Ch. 14, Common Obligee Theory and Other Setoff Rights – The Surety's Subrogation Rights to the Obligee's or Principal's Setoff Rights*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 543-57 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

## Appendix D

### The Surety's Assertion of the Surety's Own Defenses Under the Bonded Contract and the Bond, Including the Surety's Release and Discharge Due to the Obligee's Impairment of the Surety's Rights

The following is a list (in no particular order) of some of the Surety's own defenses under the Bond that may result in the release and discharge of the Surety's obligations to the Obligee under the Bond, primarily a Performance Bond, as a result of the Obligee's actions or inactions and the "impairment" of the Surety's rights. After each such Surety defense, the footnotes cite to a number of cases, in some instances, and to a number of books, articles and papers that address each such Surety defense.<sup>125</sup>

For the purposes of the footnotes referenced in this Appendix D, the following defined terms refer to the following ABA/TIPS Fidelity and Surety Law Committee books.

A. **Krebs – BDM4, Chapter 3** refers to David J. Krebs and Shannah J. Morris, *Chapter 3, The Surety's Obligations Under the Performance Bond: To Perform or Not to Perform*, in BOND DEFAULT MANUAL 109-208 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox eds., Am. Bar Ass'n, 4th ed. 2015).

B. **Gelinas – LPB2, Chapter 11** refers to Julia Blackwell Gelinas and Genise W. Teich, *Chapter 11, Defenses Available to the Surety*, in THE LAW OF PERFORMANCE BONDS 575-621 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009).

C. **Bruner – BDM3, Chapter 3** refers to Philip L. Bruner, Patrick J. O'Connor, Jr., and Tracey L. Haley, *Chapter 3, The Surety's Analysis of Investigative Results: "To Perform or Not to Perform – That is the Question,"* in BOND DEFAULT MANUAL 77-154 (Duncan L. Clore, Richard E. Towle & Michael J. Sugar, Jr., eds., Am. Bar Ass'n, 3rd ed. 2005).

D. **Bruner – Complex** refers to Philip L. Bruner and Tracey L. Haley, *Chapter 1, Strategic "Generalship" of the Complex Construction Suretyship Case*, in MANAGING AND LITIGATING THE COMPLEX SURETY CASE 1-114 (Philip L. Bruner & Tracey L. Haley eds., Am. Bar Ass'n, 2d ed. 2007).

E. **Egan – Suretyship** refers to M. Michael Egan and Marla Eastwood, *Chapter 7, Discharge of the Performance Bond Surety*, in THE LAW OF SURETYSHIP 119-145 (Edward G. Gallagher, ed., Am. Bar Ass'n, 2d 3d. 2000).

Furthermore, see *generally* the treatise, BRUNER & O'CONNOR ON CONSTRUCTION LAW, for additional comments and cases with respect to the Surety's defenses under the Bond.

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<sup>125</sup> **NOTE:** This list excludes the potential Surety defenses already addressed in **Appendix A** to the paper (the conditions precedent in the Performance Bond), **Appendix B** to the paper (the Surety's defense of misrepresentation and the avoidance of the Surety's obligations under the Bond), and **Appendix C** to the paper (the Surety's assertion of the Principal's defenses under the Bonded Contract).

## The Surety's Own Defenses under the Bonded Contract and the Bond

The Surety's defenses under the Bond, and in particular, the Performance Bond, may include the following.

1. The release and/or discharge of the Surety's Principal (including but not limited to the Obligee's wrongful termination of the Principal's Bonded Contract).<sup>126</sup>
2. The Obligee's failure to provide notice to the Surety and/or to comply with the Performance Bond's conditions precedent requiring the Surety to perform (including the Obligee's failure to allow the Surety to have the opportunity to exercise and/or perform its options under the Performance Bond).

During the Surety's investigation and analysis, the Surety attempts to determine from the facts gathered and its legal review what constitutes a Principal's alleged Bonded Contract default so that an Obligee may require the Surety to perform its obligations under the Performance Bond.<sup>127</sup> In making its analysis, the Surety will review the distinction between a breach of

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<sup>126</sup> See RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 39 (1996) (the obligee's release of the principal from its duties and obligations pursuant to the underlying construction contract releases the surety's obligations under the bond). Furthermore, an obligee's wrongful termination of the principal's construction contract is itself a breach of that construction contract that relieves the principal from its obligations under the construction contract and the principal and the surety from their liability under the performance bond. During its investigation, the surety will attempt to determine what constitutes default under the principal's construction contract and whether the obligee's termination of the principal for default is proper and justified, or whether the obligee wrongfully terminated the principal's construction contract. There are a number of facts and factors that are relevant for the issue of a wrongful termination, including the importance of a good faith motive for the obligee's termination, the importance of a proper cure notice, and/or the obligee's waiver of its right to terminate the principal for default. See Bruner - Complex, pp. 16-28; Bruner – BDM3, Chapter, pp. 93-112. Furthermore:

The obligee's termination of the principal under the termination clause of a bonded contract can be upheld only if the obligee sustains its burden of proof that (1) the principal materially and inexcusably breached its contract, (2) the principal's breaches were not induced or preceded by the obligee's own supervening material breaches of contract, such as nonpayment, maladministration of the construction process, or refusal to grant proper time extensions or other recognized "contract defenses," (3) the obligee's termination was not improperly motivated or conceived in bad faith and was made independently and with the exercise of discretion by its representative having authority to terminate the contract, (4) the principal was given ample notice of deficiencies so as to understand what needed to be "cured," and (5) the obligee properly followed its contractually-specified termination procedure.

Bruner – BDM3, Chapter 3, p. 104; see also Krebs – BDM4, Chapter 3, pp. 182-83; Gelinias – LPB2, Chapter 11, pp. 583-84; Bruner - Complex, pp. 20-21. The obligee's wrongful termination of the principal's construction contract may lead to the obligee's release and discharge of the surety's principal and the surety and/or the obligee's failure to comply with the performance bond's conditions precedent requiring the surety to perform.

<sup>127</sup> See **Appendix A** to the paper (the conditions precedent in the Performance Bond) and **Appendix C** to the paper (the Surety's assertion of the Principal's defenses under the Bonded Contract). See also Shannon J. Briglia & Jarrod Stone, *Ch. II, Construction Contract Provisions Critical to the Performing Surety: Scope of Work, Contract Price, and Time of Completion*, in BOND DEFAULT MANUAL 102-05 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox eds., Am. Bar Ass'n, 4th ed. 2015).

contract and a default,<sup>128</sup> what is a material breach of contract,<sup>129</sup> whether the Bonded Contract provisions defining a “default” or an “event of default” are the exclusive grounds for determining the Principal’s default, or whether there are other grounds,<sup>130</sup> and the Obligee’s potential waiver of the Principal’s default.<sup>131</sup>

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<sup>128</sup> In *L&A Contracting Company v. Southern Concrete Services, Inc.*, 17 F.3d 106, 110 (5<sup>th</sup> Cir. 1994), the court articulated the distinction between a breach and a default as follows:

Although the terms breach and default are sometimes used interchangeably, their meanings are distinct in construction suretyship law. Not every breach of a construction contract constitutes a default sufficient to require the surety to step in and remedy it. To constitute a legal default, there must be (1) material breach or series of material breaches (2) of such magnitude that the obligee is justified in terminating the contract. Usually the principal is unable to complete the project, leaving termination of the contract the obligee’s only option.

<sup>129</sup> While there are a number of definitions in the case law of “materiality” or “material breach,” the RESTATEMENT (2D) OF CONTRACTS § 241 provides:

1. The extent to which the injured party will be deprived of the benefit which he reasonably expected;
2. The extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
3. The extent to which the party failing to perform (or failing to offer to perform) will suffer forfeiture;
4. The likelihood that the party failing to perform (or failing to offer to perform) will cure his failure, taking account of all of the circumstances including any reasonable assurances; and
5. The extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

<sup>130</sup> The question is whether the default provisions in a construction contract are “exclusive” or “non-exclusive.” Specifically, if the construction contract default provision is silent on whether it is exclusive or not, may the obligee assert a basis or ground for default that is not described in the construction contract? In *Olin Corporation v. Central Industries, Inc.*, 576 F.2d 642 (5<sup>th</sup> Cir. 1978), the court noted the split in authority between (1) what the court referred to as the “Corbin view” [6 Richard Corbin *Contracts* § 1266 at 64 (1962)], namely that “where such a termination provision is included in a contract, it constitutes the exclusive means of terminating the contract, and (2) what the court referred to as the “Williston view” [Samuel Williston, *Williston on Contracts*, § 842, note 1 at 165 (3d ed. 1959)], namely that “[U]nless a contract provision for termination for breach is in terms exclusive (citation omitted), it is a cumulative remedy and does not bar the ordinary remedy of termination for a ‘breach which is material, or which goes to the root of the matter or essence of the contract.’”

<sup>131</sup> Even if the obligee has grounds for asserting that the principal is in default under the construction contract, the obligee may waive, by its actions or words, the right to declare the principal in default. See Bruner - Complex, pp. 50-51; Bruner – BDM3, Chapter 3, p. 133.

In addition, many courts have found that the Surety may be entitled to a notice<sup>132</sup> from the Obligee of the Obligee's declaration of the Principal's default.<sup>133</sup> Some courts have found differently and concluded that such an Obligee notice to the Surety is unnecessary.<sup>134</sup> There may be consequences to the Obligee if the required notice of its declaration of a Principal's default is not provided to the Surety. If the notice to the Surety is a condition precedent for the Surety to perform its obligations under the Performance Bond, the Surety may be released from all of its liability to the Obligee under the Performance Bond because of the Obligee's failure to provide the Surety with such notice.<sup>135</sup> In other cases, however, the Obligee's failure to provide such notice to the Surety may only reduce the Surety's liability under the Performance Bond to

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<sup>132</sup> Numerous cases have held that the notice to the surety must be stated in clear, direct, definite, explicit, unambiguous and unequivocal language. See *Seaboard Sur. Co. v. Town of Greenfield*, 266 F. Supp. 2d 189 (D. Mass. 2003), *aff'd*, 370 F.3d 215, 223 (1<sup>st</sup> Cir. 2004) [citing *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106, 111 (5<sup>th</sup> Cir. 1994) ("A declaration of default sufficient to invoke the surety's obligations under the bond must be made in clear, direct, and unequivocal language. The declaration must inform the surety that the principal has committed a material breach or series of material breaches of the subcontract, that the obligee regards the subcontract as terminated, and that the surety must immediately commence performing under the terms of its bond."); *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC.*, 281 F. Supp. 2d 406 (D. Conn. 2003), *aff'd*, 376 F.3d 96 (2d Cir. 2004); and *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 86 (D. Conn. 1997)]; *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003).

<sup>133</sup> A number of cases hold that the surety is entitled to the obligee's notice of a declaration of a principal's default either under the performance bond or under the construction contract. *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5<sup>th</sup> Cir. 1994) (the court found that the performance bond required a formal declaration of default as a condition precedent to the surety's liability. The court held that the obligee's failure to send the surety any notice of default resulted in a complete discharge of the surety's performance bond obligations); *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. Ct. 1997) (the court held that a performance bond was null and void when the obligee failed to provide seven days' notice to the surety and the principal as required, not under the performance bond, but under the general conditions of the construction contract that was incorporated into the performance bond); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003); *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997); *Town of Plainfield v. Paden Eng'g Co.*, 943 N.E.2d 904, 907 (Ind. Ct. App. 2011).

<sup>134</sup> *Siegfried Construction, Inc. v. Gulf Insurance Co.*, 203 F.3d 822 (4<sup>th</sup> Cir. 2000) (where no formal declaration of default or termination of the construction contract was required under Virginia law to trigger a surety's performance bond obligations); *Walter Concrete Constr. Corp. v. Lederle Lab.*, 788 N.E.2d 609, 610 (N.Y. 2003) ("Notwithstanding [the surety's] contrary claim, the AIA-311 performance bond contains no explicit provision requiring a notice of default as a condition precedent to any legal action on the bond . . . Unlike the AIA-312 bond, another industry standardized bond, an action on the AIA-311 bond is not tied to a declaration of default, the principal's cessation of work or the surety's refusal to perform under the bond."); *Winston Corp. v. Continental Cas. Co.*, 361 F. Supp. 1023, *rev'd*, 508 F.2d 1298 (6<sup>th</sup> Cir. 1975).

<sup>135</sup> *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106 (5<sup>th</sup> Cir. 1994); *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997); *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. Ct. 1997); *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 281 F. Supp. 2d 406 (D. Conn. 2003), *aff'd*, 376 F.3d 96 (2d Cir. 2004); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003); *The School Board of Escambia County, Florida v. TIG Premier Insurance Company* 110 F. Supp. 2d 1351 (N.D. Fla. 2000); *153 Hudson Dev., LLC v. DiNunno*, 778 N.Y.S.2d 482 (App. Div. 2004); *120 Greenwich Dev. Assocs., LLC v. Reliance Ins. Co.*, No. 01 Civ. 8219 (PKL), 2004 WL 1277998 (S.D.N.Y. June 10, 2004); *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff'd*, 6 F. App'x 828 (10<sup>th</sup> Cir. 2001); *Seaboard Sur. Co. v. Town of Greenfield*, 266 F. Supp. 2d 189 (D. Mass. 2003), *aff'd*, 370 F.3d 215 (1<sup>st</sup> Cir. 2004).



the extent that the Surety has been prejudiced or harmed as a result of not receiving the Obligee's notice of the declaration of the Principal's default.<sup>136</sup>

Finally, whether or not the Obligee has provided the Surety with notice of the Obligee's declaration of the Principal's default under the Bonded Contract, if the Obligee takes actions that deny the Surety the ability to exercise its rights to perform under the Performance Bond, the Surety may be released and discharged from any liability to the Obligee under the Performance Bond.<sup>137</sup>

3. The Principal's substantial performance of the Bonded Contract.<sup>138</sup>

4. The Obligee's actions that are prejudicial to the Surety.

a. Material alterations to the Bonded Contract (cardinal changes).<sup>139</sup>

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<sup>136</sup> *Winston Corp. v. Continental Cas. Co.*, 361 F. Supp. 1023, *rev'd*, 508 F.2d 1298 (6<sup>th</sup> Cir. 1975) (the court found that the failure to give a seven-day notice required by the general conditions of the contract was an insubstantial breach that might permit the surety to a discharge to the extent of the harm, but would not justify a complete discharge of the surety's obligations); *Blackhawk Heating & Plumbing Co. v. Seaboard Surety Co.*, 534 F. Supp. 309 (N.D. Ill. 1982) (a failure by the obligee to give notice of a declaration of default might result in a *pro tanto* rather than complete discharge of the surety's obligations under the performance bond); *Plowden & Roberts, Inc. v. Conway*, 192 So.2d 528, 533 (Fla. Dist. Ct. App. 1966) (the "surety's liability is merely reduced by any harm which it suffered by the fact that it was not accorded its rights to remedy the default."); *Continental Bank & Trust Co. v. American Bonding Co.*, 605 F.2d 1049 (8<sup>th</sup> Cir. 1979).

<sup>137</sup> *Elm Haven Constr. Ltd. P'ship v. Neri Constr. LLC*, 281 F. Supp. 2d 406 (D. Conn. 2003), *aff'd*, 376 F.3d 96 (2d Cir. 2004); *Balfour Beatty Constr., Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82 (D. Conn. 1997); *Enterprise Capital, Inc. v. San-Gra Corp.*, 284 F. Supp. 2d 166 (D. Mass. 2003); *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55 (Ill. App. Ct. 1997); *Town of Plainfield v. Paden Eng'g Co.*, 943 N.E.2d 904, 907 (Ind. Ct. App. 2011); *Insurance Company of North America v. Metropolitan Dade County*, 705 So. 2d 33, 35 (Fla. Dist. Ct. App. 1977) (the court noted that the obligee's failure to comply with the terms of INA's bond notice provisions, "stripped the surety of its bargained for right and relieved the surety of its liability."); *St. Paul Fire and Marine Ins. Co. v. City of Green River, Wyoming*, 93 F. Supp. 2d 1170 (D. Wyo. 2000), *aff'd*, 6 F. App'x 828 (10<sup>th</sup> Cir. 2001) ["[t]he effect of the [obligee's] termination of [the surety] was to divest [the surety] of its ability to minimize its liability by selecting the lowest cost option and by directing the construction or participating in the contractor selection process. Courts have consistently held that an obligee's action that deprives a surety of its ability to protect itself pursuant to performance options granted under a performance bond constitutes a material breach, which renders the bond null and void," citing *L&A Contracting Co. v. Southern Concrete Services, Inc.*, 17 F.3d 106, 111 (5<sup>th</sup> Cir. 1994); *Balfour Beatty Construction, Inc. v. Colonial Ornamental Iron Works, Inc.*, 986 F. Supp. 82, 86 (D. Conn. 1997); *Insurance Company of North America v. Metropolitan Dade County*, 705 So.2d 33, 34-35 (Fla. Dist. Ct. App. 1977); and *Dragon Construction, Inc. v. Parkway Bank & Trust*, 678 N.E.2d 55, 58 (Ill. App. Ct. 1997). 93 F. Supp. 2d at 1178.].

<sup>138</sup> Krebs – BDM4, Chapter 3, pp. 179-82; Bruner - Complex, pp. 30-33; Bruner – BDM3, Chapter 3, pp. 113-17; see *Bank of Brewton, Inc. v. Int'l Fid. Ins. Co.*, 827 So. 2d 747, 753 (Ala. 2002) ("[The surety's] obligations to [the obligee] concluded upon completion of the project.").

<sup>139</sup> Krebs – BDM4, Chapter 3, pp. 191-93 and 196-97; Gelinis – LPB2, Chapter 11, pp. 595-603; Bruner - Complex, pp. 47-49 & 63-64; Bruner – BDM3, Chapter 3, pp. 129-31 & 137-38; Egan - Suretyship, pp. 128-36; RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 41 (1996).

- b. Overpayments or improper payments - impairment or release of collateral (the bonded contract funds).<sup>140</sup>
- c. Extensions of time.<sup>141</sup>
- d. The failure to give timely notice<sup>142</sup> and/or to timely default and terminate the Principal,<sup>143</sup> including the Obligees' completion of the Bonded Contract work without notice to the Surety.<sup>144</sup>
- e. The Obligees' failure to mitigate its damages.<sup>145</sup>
- f. The Obligees' supplementation of the Principal's work forces prior to or after the Principal's default, and the notice issues to the Surety under the Performance Bond.<sup>146</sup>

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<sup>140</sup> Krebs – BDM4, Chapter 3, pp. 198-200; *Nova Cas. Co. v. United States*, 72 Fed. Cl. 755, 763 (2006) (holding that government's overpayment to principal was pro tanto discharge to surety, but noting that surety's claim under a payment bond is inferior to government's claim under a performance bond); Gelinas – LPB2, Chapter 11, pp. 603-06 and 610-13; Bruner - Complex, pp. 67-69; Bruner – BDM3, Chapter 3, pp. 141-43; Egan - Suretyship, pp. 120-28; Randall I. Marmor & Gilbert J. Schroeder, *Overpayment of the Principal as a Defense to the Surety* (unpublished paper submitted at the ABA/TIPS Fidelity and Surety Law Committee annual midwinter meeting on January 24, 1997); RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 42 (1996).

<sup>141</sup> Gelinas – LPB2, Chapter 11, p. 607; Egan - Suretyship, pp. 136-38; James A. Knox, Jr., *The Surety's Extension of Time Defense*, 33 TORT & INS. L.J. 891 (1998); RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 40(b) (1996).

<sup>142</sup> Gelinas – LPB2, Chapter 11, pp. 590-95; Bruner - Complex, pp. 71-73; Bruner – BDM3, Chapter 3, pp. 144-45; Egan - Suretyship, pp. 136-38.

<sup>143</sup> In *Ohio Casualty Insurance Company v. United States*, 12 Cl. Ct. 590 (1987), the surety alleged that the obligee violated its equitable duty to the surety and abused its discretion in failing to terminate the surety's principal. The court found that the obligee abused its discretion by failing to timely terminate the principal. The court found that the evidence "overwhelmingly showed a pattern of unreasonable conduct on the part of those responsible for the administration of the contract," 12 Cl. Ct. at 591, and that "it would be manifestly unjust to make the surety pay for the Navy's mistake." 12 Cl. Ct. at 591. "The evidence clearly supports a finding that the contractor in this case should have been terminated no later than November of 1981 and that it was an abuse of the contracting officer's discretion to not do so. In so abusing its discretion, the Navy violated an equitable duty it owed to plaintiff [surety]. The evidence also supports a finding that the plaintiff [surety] suffered financial losses of \$592,687.81 as a result of the government's failure to terminate by such date." *Id.*

<sup>144</sup> See Lee M. Brewer & Omar J. Harb, *Ch. VII, Completion by the Bond Obligees*, in BOND DEFAULT MANUAL 495-97 (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox eds., Am. Bar Ass'n, 4th ed. 2015).

<sup>145</sup> Krebs – BDM4, Chapter 3, pp. 204-08; Gelinas – LPB2, Chapter 11, pp. 607-08.

<sup>146</sup> The effect of the obligee's supplementation of the principal (and avoiding and without complying with the performance bond conditions precedent such as notice, default and/or termination) on the obligee's claim against the performance bond is addressed in a number of places, including: (a) Charles W. Langfitt, Bennett J. Lee & Robert C. Niesley, *Ch. 3, Performance Options Available to the Surety*, in THE LAW OF PERFORMANCE BONDS 135-37 (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009) (and notes 107 to 110); and (b) Shannon J. Briglia & Jarrod Stone, *Ch. II, Construction Contract Provisions Critical to the Performing Surety: Scope of Work, Contract Price, and Time of Completion*, in BOND DEFAULT MANUAL 63-66 (Mike

- g. Other Obligee actions, including changes in the Obligee or the Principal.<sup>147</sup>
- 5. Contractual and statutory limitations.<sup>148</sup>
- 6. The Obligee's lack of good faith (concealment, non-disclosure and/or misrepresentation of facts).<sup>149</sup>

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F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox eds., Am. Bar Ass'n, 4th ed. 2015) (including one case under the A311 Performance Bond in note 58 on page 66).

<sup>147</sup> Krebs – BDM4, Chapter 3, p. 198; Gelinas – LPB2, Chapter 11, pp. 602-03 and 608-09; Bruner - Complex, pp. 64-67; Bruner – BDM3, Chapter 3, pp. 138-41; Egan - Suretyship, pp. 129-31.

<sup>148</sup> Krebs – BDM4, Chapter 3, pp. 200-03; Bruner - Complex, pp. 73-76; Bruner – BDM3, Chapter 3, pp. 145-48; Egan - Suretyship, pp. 139-43.

<sup>149</sup> Gelinas – LPB2, Chapter 11, pp. 616-19; Bruner - Complex, pp. 76-77 n.243, 246 [see RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 12. See also *Ground Imp. Techniques, Inc. v. Merchants Bonding Co.*, 63 F. Supp. 2d 1272 (D. Colo. 1999) (applying RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY and upholding the surety's right to rescission upon proof that its issuance of a bond to an excavation subcontractor on a Department of Energy environment cleanup project was induced by concealment of material information); see also *Kvaerner Constr., Inc. v. Am. Safety Cas. Ins. Co.*, 847 So. 2d 534 (Fla. Dist. Ct. App. 2003) (upholding a surety's discharge from liability under a subcontractor performance bond, where the contractor obligee had hired the subcontractor knowing that it was not licensed and then had demanded that the surety perform after the county stopped work on the project due to the failure of the subcontractor to be licensed)]; Bruner – BDM3, Chapter 3, pp. 148-49; Egan - Suretyship, pp. 144-45. See also **Appendix B** to the paper (the Surety's defense of misrepresentation and the avoidance of the Surety's obligations under the Bond).

## Appendix E

### **The Surety's Common Law and Contractual Indemnity Agreement Rights and Their Relationship to the RESTATEMENT OF SURETYSHIP**

The most extensive and exhaustive treatment of the Surety's indemnity and reimbursement rights, both under the common law and under a contractual indemnity agreement, may be found in a recent ABA/TIPS Fidelity and Surety Law Committee published book entitled *THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE* (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds., Am. Bar Ass'n, 2d ed. 2008) (the "Surety's Indemnity Agreement Book"). Much of that book, and other books, articles and papers, discuss the various indemnity and reimbursement rights that are addressed in the RESTATEMENT OF SURETYSHIP, and compare those indemnity and reimbursement rights with other rights that the Surety may have at common law.

#### **The following chapters in the Surety's Indemnity Agreement Book are applicable:**

David W. Slaughter, *Ch. I, Introduction to the Surety's Rights as the Foundation for the Indemnity Agreement*, in *THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE* 1-28 (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds., Am. Bar Ass'n, 2d ed. 2008). Chapter I addresses in some detail the Surety's common law right to protection from loss (exoneration and *quia timet*) and reimbursement rights, and compares the Surety's indemnity agreement rights with the Surety's subrogation rights.

Lawrence R. Moelmann, John P. Connelly & Laird E. Lawrence, *Ch. IV, Liability of the Principal and Indemnitors to Indemnify and Reimburse the Surety*, in *THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE* 178-224 (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds., Am. Bar Ass'n, 2d ed. 2008). Chapter IV addresses in detail the liability of the Principal and the Indemnitors to indemnify and reimburse the Surety under the indemnity agreement, the basis for the Surety's claim for reimbursement, and the Surety's losses for which the Surety seeks reimbursement.

Shannon J. Briglia, Mike F. Pipkin, & David C. Olson, *Ch. VI, The Surety's Enforcement of its Rights to Collateral from the Principal and the Indemnitors*, in *THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE* 277-322 (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds., Am. Bar Ass'n, 2d ed. 2008). Chapter VI addresses the Surety's common law and equitable rights of enforcement (exoneration and *quia timet*), the specific performance of the Surety's rights under the indemnity agreement (to demand collateral and to require the bonded contract funds to be held in trust), and the Surety's assignment rights.

M. Michael Egan, Jr., Omar J. Harb, & Brett D. Divers, *Ch. VII, The Indemnity Agreement and the Handling of Surety Claims*, in *THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE* 323-368. (Marilyn Klinger, George J. Bachrach & Tracey L. Haley, eds., Am. Bar Ass'n, 2d ed. 2008). Chapter VII addresses, among other things, the Surety's rights to settle claims against the performance and payment bonds.

Patrick J. O'Connor, Jr., Carter B. Reid, & Ann M. Conway, *Ch. IX, Defenses*, in *THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE* 405-446 (Marilyn Klinger, George J.

Bachrach & Tracey L. Haley, eds., Am. Bar Ass'n, 2d ed. 2008). Chapter IX addresses, among other things, the Principal's and the Indemnitors' asserted defenses to the Surety's claims under the indemnity agreement (and the Surety's responses to those asserted defenses), including their asserted defenses that the Surety failed to make payments under the performance and/or payment bonds in good faith, that the Surety's payments were not reasonable, and that the Surety acted in bad faith.

There are other chapters in the Surety's Indemnity Agreement Book that may be applicable to the Surety's rights of indemnity and reimbursement as discussed in the RESTATEMENT OF SURETYSHIP.

In addition, the following ABA/TIPS Fidelity and Surety Law Committee published books and various chapters are relevant to the Surety's indemnity and reimbursement rights under the RESTATEMENT OF SURETYSHIP.

1. BOND DEFAULT MANUAL (Mike F. Pipkin, Carol Z. Smith, Thomas J. Vollbrecht & J. Blake Wilcox eds., Am. Bar Ass'n, 4th ed. 2015).
  - a. Armen Shahinian & Brian Kantar, *Ch. I, Bond, Contractual and Statutory Provisions and the General Agreement of Indemnity*, pages 35-49 (discussing a number of indemnity agreement provisions).
  - b. George J. Bachrach, Michael A. Stover & Shane C. Mecham, *Ch. IV, Financing the Principal*, pages 214-20 (the surety's common law and indemnity agreement rights applicable to the surety's financing of the principal).
  - c. Joel M. Long & Denise C. Puente, *Ch. XII, The Performing Surety's Mitigation of Loss*, pages 681-709 (addressing the surety's common law and indemnity agreement rights and remedies under various provisions of the indemnity agreement as well as the surety's right of exoneration and *quia timet*).
2. THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).
  - a. Samuel J. Arena, Jr., et al., *Ch. 1, The Contract Bond Surety's Common Law Right to Equitable Subrogation – The Basics*, pages 17-33 (addressing the relationship between the surety's common law rights and remedies against the principal and their expansion against both the principal and the indemnitors in the indemnity agreement).
3. The Law of Payment Bonds (Kevin L. Lybeck, Wayne D. Lambert, & John E. Sebastian eds., Am. Bar Ass'n, 2d ed. 2011).
  - a. J. Michael Hennigan, Jeffrey S. Price & Jarrod W. Stone, *Ch. 13, The Surety's Common Law and Contractual Rights of Indemnity*, pages 719-820.
4. THE LAW OF PERFORMANCE BONDS (Lawrence R. Moelmann, Matthew M. Horowitz & Kevin L. Lybeck eds., Am. Bar Ass'n, 2d ed. 2009).

- a. Brett D. Divers, Kenneth M. Givens, Jr., & P. Keith Lichtman, *Ch. 5, Surety's Rights Against Principals and Indemnitors Under the General Indemnity Agreement and the Common Law*, pages 267-296.
- b. Richard E. Towle, Sam H. Poteet & Jeffrey S. Price, *Ch. 6, Surety's Rights Under the General Indemnity Agreement to Minimize Loss*, pages 297-349.
- c. Lee McGraw Brewer, Bogda M. B. Clarke & Phillip G. Alber, *Ch. 10, Claims and Defenses Asserted by Principals or Indemnitors Against the Surety*, pages 513-574.

Finally, THE SURETY'S INDEMNITY AGREEMENT: LAW AND PRACTICE contains as an Appendix a Bibliography of Surety Indemnity Agreement Books, Articles and Papers (pages 523-538) with all of such books, articles and papers updated through the book's publication date of 2008.

## Appendix F

### The Surety's Subrogation Rights and Their Relationship to the RESTATEMENT OF SURETYSHIP

The most extensive and exhaustive treatment of the Surety's subrogation rights may be found in a recent ABA/TIPS Fidelity and Surety Law Committee published book entitled THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013). As discussed in the Surety's subrogation rights portion of the paper, Section V., Leo's Chapter 2 in that book is an essential secondary source for understanding the Surety's subrogation rights as addressed in the RESTATEMENT OF SURETYSHIP.

However, the book addresses many more legal, equitable and practical issues with respect to the contract bond surety's assertion of its subrogation rights. With respect to the most basic and fundamental discussions of the Surety's subrogation rights, see:

Samuel J. Arena, Jr., et al., *Ch. 1, The Contract Bond Surety's Common Law Right to Equitable Subrogation – The Basics*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 1-57 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

T. Scott Leo, *Ch. 2, The Treatment of the Fundamental Principles of the Surety's Subrogation Rights in the Restatement of the Law*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 59-91 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

Brett D. Divers and Brandon J. Held, *Ch.3, The Parties' Rights to Which the Contract Bond Surety is Subrogated*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 93-174 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

Carol Z. Smith, *Ch. 4, The Necessity of the Principal's Default*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 175-201 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

David W. Slaughter, *Ch. 5, The Necessity of the Surety's Performance*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 203-63 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

Joel M. Long, *Ch. 6, The Necessity of Notice to the Obligee or Third Parties*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 265-288 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

Jarrold W. Stone, *Ch. 14, Common Obligee Theory and Other Setoff Rights – The Surety's Subrogation Rights to the Obligee's or Principal's Setoff Rights*, in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS 513-557 (George J. Bachrach, James D. Ferrucci, & Dennis J. Bartlett eds., Am. Bar Ass'n 2013).

However, THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS also addresses the competition among the assertion by other entities who may have of competing rights that may or may not prevail against the Surety's subrogation rights. Those additional chapters in THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS include:

Chapter 7, Thomas J. Vollbrecht, *The Surety v. The Obligee* (pages 289-317).

Chapter 8, Jay M. Mann, *The Surety v. The Principal* (pages 319-329).

Chapter 9, Lawrence Lerner, *The Surety v. Third Party Beneficiaries Under the Surety's Payment Bonds (Payment Bond Claimants)* (pages 331-362).

Chapter 10, Steven H. Rittmaster, *The Surety v. The Assignee/Lender* (pages 363-432).

Chapter 11, Chad L. Schexnayder, *The Surety v. Trustees/Debtors in Bankruptcy* (pages 433-464).

Chapter 12, Matthew M. Horowitz, *The Surety v. Other Taxing Authorities and Governmental Lienors* (pages 465-491).

Chapter 13, David C. Olson and Shannah J. Morris, *The Surety v. General Creditors and Judgment Creditors* (pages 493-511).

Chapter 15, Omar J. Harb, David Krebs and Cynthia Rodgers-Waire, *The Surety's Subrogation Rights and Claims Against the Federal Government* (pages 559-610).

Chapter 16, Christopher R. Ward and Lawrence R. Moelmann, *The Surety's Subrogation Rights Against Third Parties* (pages 611-662).

Furthermore, THE CONTRACT BOND SURETY'S SUBROGATION RIGHTS contains as an Appendix a Bibliography of Contract Bond Surety Subrogation Rights Books, Articles and Papers (pages 701-716) with all of such books, articles and papers updated through the book's publication date of 2013.

In a recent 2016 Surety Claims Institute paper, the authors address the Surety's subrogation rights in the context of the treatment of those Surety subrogation rights in the RESTATEMENT OF SURETYSHIP. See Matthew C. Bouchard, Benjamin T. Buskirk, & Jennifer Leuschner, *The Distance Traveled and the Road that Lies Ahead: The Impact of the Restatement (Third) of Suretyship & Guaranty as of its Twentieth Anniversary* (unpublished paper submitted at the Forty-First Annual Surety Claims Institute Annual Meeting on June 23, 2016).