Should the Surety Stand on Its Equitable Subrogation Rights or File Its Indemnity Agreement under the Uniform Commercial Code?

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I. INTRODUCTION

It has long been said "Sureties are the darlings of the law." Over the years that love-fest has been well proved. After Pearlman v. Reliance Ins. Co.2 was decided by the U.S. Supreme Court in 1962, nearly everyone was fully convinced of the law's deference for the position of the surety. In Pearlman, the trustee, in the course of a bankruptcy proceeding instituted by the contractor who had failed to pay for labor and materials, induced the government's contracting officer to turn over the contract balances. As might be expected, the trustee, once capturing the contract balances, refused to pay them over to the surety. The trial court vacated the referee's order and awarded the contract balances to the surety.3 The Second Circuit Court of Appeals affirmed.4

The Supreme Court affirmed the circuit court's holding that under the Miller Act bond,5 a surety who had paid laborers and materialmen was entitled to the unpaid contract balance. However, the Court was decisively split on which theory should underlie the decision.

The majority opinion in *Pearlman*, written by Justice Black, reasoned that the surety was entitled to the advantage of subrogation to the rights of these materialmen and laborers whom the surety had paid. Three justices, in a separate concurring opinion, disagreed with the rationale of awarding the contract balances to the surety. They concluded that the surety was not subrogated to the rights of the unpaid materialmen and laborers, but rather was subrogated to the rights of either the owner (the government, in the *Pearlman* case) or the contractor. Regardless of the correct rationale, *Pearlman* remains the flagship of the surety's right to contract balances under the doctrine of equitable subrogation. It establishes federal law on the subject and has been followed by many states.

The ascendancy of the surety's priority to the contract balances did not make everything sweet for him and sour for everyone else. The trouble for the surety is that now someone is continually trying to defeat its claim for priority rights against the contract proceeds under the Uniform Commercial Code ("U.C.C."). For example, the discussion of the issues of the U.C.C. versus equitable subrogation was recently rekindled by a Florida Intermediate Court of Appeals decision in *TransAmerica Insurance Co. v. Barnett Bank of Marion County N.A.* The intermediate appellate court affirmed a trial court decision holding that the surety's equitable subrogation remedy was not available since it had a convenient, practical remedy under the U.C.C. The court held that a bank lender which has previously filed its security agreement under the U.C.C. (securing its loans to a construction contractor with an assignment of contract proceeds), had priority over the surety's later U.C.C. filing of its assignment of contract balances in the contractor's application for a payment bond. Chief Justice Sharp wrote a strong dissent, arguing that the surety should prevail since the remedy of equitable subrogation

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7. *Prairie State Nat'l Bank v. United States*, 164 U.S. 227 (1896); *Hennington v. U.S. Fidelity & Guar. Co.*, 208 U.S. 404 (1908); and United States v. Munsey Trust Co., 332 U.S. 234 (1947) were all discussed in *Pearlman*. In *Pearlman*, the Court found precedent in the two earlier cases for holding that the surety who paid debts owed by the defaulting contractor to materialmen and laborers or who finished the performance of the contract were entitled to recovery of retainages. The Court then held that neither the Miller Act nor the *Munsey Trust Co.* decision changed that result.


9. The U.C.C. was not involved nor alluded to in *Pearlman*. All references will be to the *UNIFORM COMMERCIAL CODE, OFFICIAL TEXT WITH COMMENTS* (1978), unless specified [hereinafter "U.C.C."].


11. *Id.* at 447.
had long been recognized in Florida and that the U.C.C. should not govern the surety’s claims.12

Upon further appeal, the Florida Supreme Court quashed the lower court decision and remanded.13 The court held that the surety’s assignment is not a security interest under the U.C.C. Instead, it is a contingent assignment based on contractual performance excluded under U.C.C. § 9-104. In addition, even if it were a U.C.C. security interest, the surety’s assignment would not abrogate the doctrine of equitable subrogation. The court noted that equitable subrogation arises as a matter of law, not contract, and that the U.C.C. is expressly supplemented by general principles of law and equity. The Court then concluded that in the interest of both the parties involved and uniformity of laws, the surety should have priority to the extent of its performance.

In reaching its decision, however, the Florida Supreme Court again struggled with the theory of subrogation. The Court noted that the surety’s subrogation right is one in which the surety is entitled to stand in (i) the shoes of the bond obligee; (ii) the shoes of the contractor; and (iii) the shoes of the subcontractor or materialman. The Florida Supreme Court then said, “These rights of the surety as subrogee are not inferior even to the rights of the obligee and may be asserted against the obligee.”14 It then turned to the public policy of uniform laws and encouraging prompt performance by the surety to ultimately justify its holding. Thus, after struggling with the theory of subrogation, the Court upheld the surety’s priority to the contract proceeds.

TransAmerica illustrates that the surety’s claims to contract funds under equitable subrogation are subject to continuing attack for two primary reasons. First, the theoretical basis for the surety’s priority is open to argument. Second, the disappointed banker facing serious financial loss through the failed contractor has a lot of monetary incentive to attack the surety’s position.

TransAmerica also demonstrates why the surety cannot completely ignore the U.C.C. Equitable subrogation has so far been limited to recovery of contract balances to reimburse costs of completing performance. In TransAmerica, the surety failed in its effort to set-off excess funds from other contracts to reduce its losses incurred on the job at issue. The Florida Supreme Court held: “Priority based on equitable subrogation in one contract does not provide priority in excess funds from another contract.”15

Thus, equitable subrogation remains a viable theory of recovery as to contract proceeds. However, the surety in a defaulting contractor

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12. Id. at 447-51 (Sharp, C. J., dissenting).
14. Id. at 116.
15. Id.
situation faces problems and monetary losses which equitable subroga-
tion will not cure. The U.C.C. may offer solutions to some of these
problems. Thus, the issue remains: Should the surety rely solely on
equitable subrogation or should it pursue available remedies under the
U.C.C.?

II. THE HYPOTHETICAL CASE

A hypothetical case will help illustrate the differences between eq-
uitable subrogation and the U.C.C. and highlight the issues raised by
this tension. The following discussion provides guidance for determin-
ing whether the surety should rely on its rights of equitable subroga-
tion or file its indemnity agreement under the U.C.C.16

Contractor was the successful bidder on a project to erect a large building
in Nebraska. The owner required a payment bond and a performance bond
for the full contract amount of $800,000.00. The contractor applied to a surety
and the application included a general indemnity agreement containing the
following clauses:

Assignment - Third: The contractor ... will assign ... and does hereby
assign, transfer and set over to the surety, as collateral, to secure the obligations
in any and all of the paragraphs of this Agreement and any other indebted-
ess and liabilities of the contractor to the surety, whether heretofore or
hereafter incurred, the assignment in the case of each contract to become ef-
fective as of the date of the bond covering such contract, but only in the event
of (1) any ... breach of any contracts referred to in the bonds or of any breach
of any said bonds; or ... (6) ...: (a) all of the rights of the contractor in, and
growing in any manner out of, all contracts referred to in the bonds, or in, or
growing in any manner, out of the bonds; (b) all the rights, title and interest of
the contractor in and to all machinery, equipment, plant, tools and materials
which are now, or may hereafter be, about or upon the site or sites of any and
all of the contractual work referred to in the bonds or elsewhere, including
materials purchased for or chargeable to any and all contracts referred to in
the bonds, materials which may be in process of construction, in storage else-
where ...; (c) ... (d) all actions, causes of action, claims and demands whatso-
ever which the contractor may have or acquire against any subcontractor ...;
(e) any and all percentages retained and any and all sums that may be due or
hereafter become due on account of any and all contracts referred to in the
bonds and all other contracts whether bonded or not in which the contractor
has an interest.

Uniform Commercial Code - Fifth: That this Agreement shall constitute a
security agreement to the surety and also a financing statement, both in ac-
 accordance with the provisions of the Uniform Commercial Code of every juris-
diction wherein such code is in effect and may be so used by the surety
without in any way abrogating, restricting or limiting the rights of the surety
under law or in equity.

Takeover - Sixth: In the event of any breach, delay or default asserted by the

16. The authors wish to acknowledge that many issues raised herein have not been
fully decided by the courts. In this article, the authors have at times made some
rather flat conclusions about the results of this hypothetical case. However, the
article must be read as a suggestion of possible arguments and postulates under
the U.C.C. in relation to the surety's position. Some conclusions set forth herein
are still hotly debated between even the authors of this article.
obligee in any said Bonds, or the contractor has suspended or ceased work on any contract or contracts covered by any said bonds, or failed to pay obligations incurred in connection therewith, . . . the surety shall have the right, at its option and in its sole discretion and is hereby authorized . . . to take possession of any part or all of the work under any contract or contracts covered by any said Bonds . . . and to complete or arrange for the completion of the same, and the contractor and Indemnitors shall promptly, upon demand, pay to the surety all losses and expenses so incurred . . . 17

The surety issued the bonds in reliance upon the application and audited financial statements of the contractor. However, the surety did not file the indemnity agreement in accordance with the U.C.C.

With bond in hand, the contractor then obtained a $700,000.00 operating line of credit for the project from the bank, secured by an assignment to the bank of the contract proceeds and a blanket security interest in the contractor's accounts, contract rights, inventory, general intangibles, and equipment previously owned or thereafter acquired, as securing all indebtedness including future advances. The bank properly filed financing statements to perfect its assignment and security interest. Immediately thereafter, the contractor drew funds on its line of credit and purchased a new backhoe for use on the job.

The contractor arrived on site and commenced construction, but soon defaulted and deserted the job. The owner promptly made claim to the surety on the bonds, hoping that the surety would choose to complete performance.

The surety inspected the project and found that while the job was only 50% completed, $600,000.00 had been properly paid to the contractor under a contract provision allowing full payment for materials delivered to the site and 80% payment against labor costs incurred.

A takeover contractor was found who agreed to complete the work for $300,000.00 if he could use the materials on the site; otherwise, he would charge $400,000.00. In negotiations, the owner offered to accept $200,000.00 in cash payment from the surety and a waiver of surety's right to the contract balance in lieu of completion of the work. Thus, the surety found itself facing a minimum loss of $100,000.00 if it hired the takeover contractor and obtained possession of the materials. Otherwise, a cash settlement with the owner or completion of the work without use of the materials on site would result in a $200,000.00 loss.

The contractor had, of course, collapsed financially. Its only assets remaining were its equipment, including the backhoe, and the materials on site. The bank loan was in default. The bank immediately made claim on the owner for the contract balance. The bank also in-

stituted a replevin action to recover the equipment and materials on
site.

This hypothetical case was designed to illustrate the operations of
the U.C.C. in a typical dispute between the bank and surety by raising
the following issues:

1. Who has the superior claim to the contract balance?
2. Who has the superior claim to the materials on site?
3. Who has the superior claim against the construction equip-

ment on site?
4. What are the benefits and the disadvantages of filing the
indemnity agreement as a security agreement and financ-
ing statement under the U.C.C.?

It is important to emphasize the key facts of the hypothetical case
to set the stage for determining the positions of the bank and the
surety under the U.C.C. First, this is a private project located in Ne-
braska;18 it is not a federal project. Second, the contractor first exe-
cuted security agreements in favor of the surety in the bond
application and then to the bank as part of the loan transaction.
Third, the surety did not file its indemnity agreement in accordance
with the U.C.C. The bank, on the other hand, did file a financing
statement in relation to its security agreement.19 Fourth, there are no
unpaid materialmen or laborers in this problem; we are only dealing
with the performance bond in this hypothetical. Finally, in the hypo-
thetical case, performance of the contract has not been completed.

III. THE U.C.C. AND EQUITABLE SUBROGATION

With these facts in mind, let us first examine the relevant differ-
cences between the positions of the bank and the surety under the
U.C.C. The principal difference is that the bank apparently has a
“perfected security interest” while the surety has only an “un-
perfected security interest.”

A. The Bank Has Superior Claims to the Contractor’s Assets Under the
U.C.C.

Under the U.C.C. provisions relating to secured transactions, a se-
curity interest is an “interest in personal property or fixtures which

18. Nebraska law recognizes the doctrine of equitable subrogation. See, e.g., Indem-
nity Ins. Co. v. Lane Contracting Corp., 227 F. Supp. 143 (D. Neb. 1964). However,
we have found no cases under Nebraska law in which the conflict between the
U.C.C. and equitable subrogation has been raised or decided.
19. For the purposes of this paper we will assume that the indemnity agreement
could have been filed under the U.C.C. as a financing statement and that the
bank’s filing was in the correct office and properly described the collateral at
issue. However, in real life, issues as to the appropriateness of documents and
filings should not be overlooked.
securities payment or performance of an obligation." It is created by agreement between creditor and debtor and becomes enforceable and "attaches" when (1) either the collateral is in possession of the secured party or the debtor has signed an agreement containing an adequate description of the collateral; (2) value has been given; and (3) the debtor has rights in the collateral. Once the interest attaches, it is enforceable against the debtor. However, to be superior to and enforceable against third parties, the security interest must also be "perfected."

"Perfection" is a term of art under the U.C.C. It means that the secured party has taken all steps necessary under the U.C.C. to enable it to enforce its security interest against subsequent lienholders or purchasers for value. Depending on the type of collateral involved, perfection may be accomplished by filing an appropriate notice in the designated public office, taking possession of collateral, or both. Underlying the requirement of "perfection" is the concept of notice. Before an interest in personal property may be enforceable against third parties (such as other secured creditors and purchasers for value), there must be actual or constructive notice of the creditor's claim of an interest in such property.

Possession of collateral is an excellent but often impractical way of notifying others of claims to the personal property. Therefore, in some instances (such as for inventory and equipment), a financing statement must be filed with the designated office as constructive notice to the world of the security interest. Generally, perfection is accomplished by filing or possession. The creditor's security interest then becomes valid, binding, and enforceable against subsequent lienholders and/or purchasers.

"Perfection" is extremely important when two or more creditors claim rights in the same property. A perfected security interest has priority over an unperfected security interest. Priority between two perfected security interests is generally awarded to the first in time to either file or perfect. Priority allows the holder, upon repossession and sale of the collateral, to satisfy (after expenses) its own secured debts in full prior to any application of proceeds towards interests of junior lienholders.

20. U.C.C. § 1-201(37).
21. Id. § 9-203(1).
22. Id. § 9-203(2).
23. See, e.g., id. §§ 9-203, 9-301, 9-303, 9-312.
25. See id. § 9-302.
26. Id. § 9-301(1).
27. Id. § 9-312(5).
28. Perfection is also extremely important in the context of bankruptcy. Under 11 U.S.C. § 544 (1988), the trustee may avoid or defeat any interest which would be
Returning now to our hypothetical case, the surety's failure to file its indemnity agreement as required to perfect its claim against the contractor's inventory is fatal to any attempt under the U.C.C. to defeat the bank's claims under its prior perfected security interest; therefore, the surety must seek other routes to claim superiority over the bank's claim.

B. The Doctrine of Equitable Subrogation

Equitable subrogation is one route available to the surety to claim priority over the bank as to the contract funds. Broadly speaking, subrogation means that one person is substituted for and may assert the rights and claims of another. It is an equitable principle that "when one, pursuant to an obligation—not a volunteer, fulfills the duties of another, he is entitled to assert the rights of that other against third persons." The essential elements which must be met to claim equitable subrogation are as follows:

1. That the party claiming rights of equitable subrogation has paid the debt or performed an obligation;
2. That he was not a volunteer but had a direct interest in discharging the debt or performing the obligation;
3. That he was secondarily liable on such debt or obligation; and
4. That no injustice will be done to the other party by allowance of equity.

As noted above, the United States Supreme Court in Pearlman seemed to solidify the surety's right to contract proceeds due to the contractor when the surety pays debts of the contractor or performs the obligations of the contractor under its binding obligations. The Court reasoned that:

Traditionally sureties compelled to pay debts for their principal have been deemed entitled to reimbursement, even without a contractual promise such as the surety here had. And probably there are few doctrines better established than that a surety who pays the debt of another is entitled to all the

voidable by a lien creditor who obtains a judicial lien on all the debtor's property at the time the petition is filed. Under U.C.C. § 9-301, an unperfected security interest would be subordinate to such a lien creditor. Therefore, upon the filing of a petition in bankruptcy, the holder of an unperfected security interest suddenly becomes just another general creditor of the bankruptcy. See also 11 U.S.C. § 506 (1988).

29. There are two types of subrogation: "conventional subrogation" arises by agreement or in a contract between the parties. "Legal subrogation" or "equitable subrogation" is implied by law, or, more appropriately, by equity to do substantial justice. It is this second type, "equitable subrogation" which forms the foundation for Pearlman.


rights of the person he paid to enforce his right to be reimbursed.\textsuperscript{32}

The Court in \textit{Pearlman} held that a surety paying materialmen and laborers is entitled to priority as to contract funds over the claim of a trustee in the contractor's bankruptcy proceeding. In reaching this conclusion, the court cited the earlier case of \textit{Prairie State National Bank v. United States},\textsuperscript{33} for the proposition that a surety who completed a contract was subrogated to the rights of the owner in the retained funds as security, and that the surety had the remedies of the owner as against the contractor. It also discussed the holding of \textit{Henningson v. United States Fidelity and Guaranty Co.},\textsuperscript{34} that a surety paying materialmen and laborers had similar equitable rights to retained funds. The \textit{Pearlman} Court then concluded:

\begin{quote}
We therefore hold in accord with the established legal principles stated above that the Government had a right to use the retained funds to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of that fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the benefit of the fund; and that the surety, having paid the laborers and materialmen, is entitled to all these rights to the extent necessary to reimburse it.\textsuperscript{35}
\end{quote}

Three concurring justices disagreed with the Court's theory that the surety should prevail because it was subrogated to the rights of laborers and materialmen. The laborers and materialmen, they pointed out, do not have enforceable rights against the government for the funds. Quoting from \textit{United States v. Munsey Trust Co.},\textsuperscript{36} they noted: "It is elementary that one cannot acquire by right of subrogation what another whose rights he claims did not have. . . ."\textsuperscript{37} The concurring opinion acknowledged that the surety could be subrogated to the rights of the owner, concluding that the rights of the surety in \textit{Pearlman} arose out of the assignment of funds in the bond agreement between the surety and the contractor.\textsuperscript{38}

Although \textit{Pearlman} established and defended the surety's rights to contract proceeds, it left the waters muddied as to the reason for the priority. That is, \textit{Pearlman} did not establish a clear rule that a performing surety is always entitled to the contract proceeds. Instead, it tied the right to the surety's ability to assert others rights to the funds. However, as the concurring opinion pointed out, even this principle cannot be easily applied in the instance of a claim on a payment bond such as was the case in \textit{Pearlman} itself.

As a result, the applicability of the equitable subrogation doctrine

\begin{footnotes}
\item[33.] 164 U.S. 227 (1896).
\item[34.] 208 U.S. 404 (1908).
\item[36.] 332 U.S. 234 (1947).
\item[37.] 371 U.S. 132, 144 (1962).
\item[38.] \textit{Id.} at 143-44.
\end{footnotes}
and the priority of the surety may well depend on any one of several factors including: (1) the party whose rights are being asserted; (2) what rights they have under this particular contract or at law; (3) what type of bond—payment or performance—is at issue; and (4) what are the nature and status of the funds at issue.39

These factors have often controlled the ultimate question of entitlement to the proceeds. For example, a surety completing a project under a performance bond is not subject to set-offs of the owner against the contractor which arise from other projects or debts.40 On the other hand, a surety making payments to materialmen on a payment bond is subject to such set-offs by the owner.41

This highlights a major problem under subrogation: a surety can have no greater rights than those of the person whose rights he is asserting, and the surety's position is subject to any and all defenses to those rights.42 In other words, the surety's right to recovery depends on the rights of others which are asserted and their defenses to those rights.

Unfortunately, as in Pearlman, this type of analysis does not always result in a clear victory for the surety. The subcontractors or materialmen may not have enforceable claims against the contract funds. When contractors assign their rights to the bank, the owner has no right against the contractor to withhold payment for a completed job. This type of analysis, required by the theory of subrogation, often results in a detailed factual and legal analysis, which, as in the lower court opinion in TransAmerica, may well defeat the surety.43 It certainly should discourage total reliance by the surety upon the doctrine of equitable subrogation as its security in the event it must perform on the bond.

The doctrine of equitable subrogation has other limitations which affect its utility. First, it is limited to disputes over contract proceeds; it has not been extended to cover other rights or assets of the contrac-

39. See Comment, Equitable Subrogation - Too Hardy a Plant to be Uprooted by Article 9 of the U.C.C., 32 U. Pri. L. Rev. 580, 582 (1971).
41. United States v. Munsey Trust Co., 332 U.S. 234 (1947). Similarly, sureties have been successful in claiming funds due and unpaid. See Industrial Bank v. United States, 424 F.2d 932 (D.C. Cir. 1970). However, sureties have been unsuccessful in recovery of funds already paid to the contractor or its lender. See United Pac. Ins. Co. v. United States, 362 F.2d 805 (Ct. Cl. 1966).
43. For another example, in Barnes v. Hampton, 198 Neb. 151, 252 N.W.2d 138 (1977), the surety's claim against a subcontractor was barred by the applicable statute of limitations because the contractor whose rights were being asserted under subrogation had been dissolved more than two years prior to institution of the action.
tor. Second, *Pearlman* and its direct progeny are federal decisional law which may or may not be controlling on non-federal projects involving state law. Third, by existing outside of the normal priorities as recognized by state law or bankruptcy law, it constantly invites litigation from other creditors of the contractor who thought they were fully secured against the contract proceeds. Each of these factors should cause a surety to ponder the wisdom of total reliance on equitable subrogation as security for performance under a bond.

C. The Tension Between the U.C.C. and Equitable Subrogation

Whenever a contractor fails, there is a scramble among his creditors to claim as much of his property or funds as possible to satisfy or reduce their debts and claims. When a surety takes over a project for a defaulted contractor, it often joins the scramble. Therefore, it seems that confrontation between the surety and the contractor’s creditors is always likely.

1. *Equitable Subrogation Was Not Replaced by the U.C.C.*

The surety versus bank dispute predates the U.C.C. For ten years before the 1962 decision in *Pearlman*, there had been a major confrontation between the banks and the sureties.

In the original text of the 1952 Official Draft of the Uniform Commercial Code, proposed § 9-312(7) stated:

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

The editorial board of the framers of the U.C.C. acknowledged that § 9-312(7) was a “complete reversal” of the then existing case law. Representatives of the Association of Casualty & Surety Companies met with the editorial board and strongly protested § 9-312(7)’s reversal of the surety’s established priority for contract balances. The surety association prevailed. The board deleted the offending section and it has never been adopted by any state.\(^4\)

The exclusion of § 9-312(7) did not dissuade the banks from arguing that the surety’s subrogation rights were, in fact, a security interest governed by the U.C.C. or were otherwise of a lesser priority. However, most courts which have addressed this issue have concluded that the surety’s subrogation rights lie outside the U.C.C. and its priority provisions.\(^5\)


In addition to citing the surety's triumphant defeat of proposed § 9-312(7), the courts commonly note that Article 9 of the U.C.C. is limited to security interests created by contract, whereas equitable subrogation arises by operation of law. The courts have also relied on U.C.C. § 9-103 which preserves general law not displaced by particular provisions of the code. In the National Shawmut case, the court also noted that the surety's security is really the opportunity to complete the job and apply funds available to reimburse its costs of completion. The surety is not in the ordinary business of financing. Rather, it accepts the unliquidated and contingent risks of bonding jobs in reliance on this opportunity which does not neatly fit within the definitions of either “personal property” or “a security interest.”

However, the courts have also acknowledged that if the surety wishes to rely solely on its assignment by the contractor and other rights granted in the bond documents, then it must conform to the U.C.C.'s filing requirements, for an “assignment” is usually considered a security agreement under the U.C.C.

To date, sureties have successfully defeated these attacks under the U.C.C. However, the desperate situation of creditors of a failed contractor probably assures that the attacks will continue.

2. Weaknesses of Equitable Subrogation

The Achilles heel of the surety's position lies not in the U.C.C. or in the court opinions, but in the tenuous applicability of the doctrine of equitable subrogation to the surety-contractor situation. Despite surety lawyers' efforts to claim the name “equitable subrogation” for the concept that the surety receives the contract proceeds, that doctrine is not really a mainstream function of subrogation. In Transamerica, the Florida Intermediate Court of Appeals examined the concepts of contractual and equitable subrogation in theory and then noted that under modern commercial reality, the concept of equitable

Corp., 416 Pa. 417, 206 A.2d 49 (1965); Gallagher, Unpaid Subcontractor's Right To Payment Out of Contract Funds, 10 THE CONSTRUCTION LAWYER 9-13 (Forum on the Construction Industry, American Bar Association, Jan. 1990.) The Florida Supreme Court in Transamerica seems to have been persuaded from applying the U.C.C. because the Drafting Committee of the U.C.C. had rejected a proposed provision which would have granted the lending bank, with a prior recorded security statement, priority over the surety's subrogation right.

46. See U.C.C. § 9-102(2).
subrogation does not really fit the situation of the modern-day surety.
The court commented:

The second type of subrogation is the remedy known as "equitable subro-
gation." This concept originated in equity to provide a remedy to one (the plain-
tiff) whose property had been used, more or less inadvertently, to satisfy and
discharge an obligation of another (the obligor or debtor) under circumstances
such that if the plaintiff were not subrogated to the rights of the obligee (the
creditor) against the obligor (debtor), the obligor (debtor) would be unjustly
enriched at the expense of the plaintiff. In effect, the remedy of equitable
subrogation merely implies in law a reimbursement agreement or assignment
of rights in favor of one (the plaintiff) whose property was used to discharge
the obligation of another. However this just does not seem to describe the
situation of the modern day payment or performance bond surety who regu-
larly and in the course of business for profit, undertakes the calculated risk of
guaranteeing to an owner payment and performance by a contractor. When
such a surety performs under its bond it is merely fulfilling its own undertak-
ing. Such a surety has ample opportunity to make any contractual subroga-
tion agreement it desires, not only with the contractor but also with the owner
for whose protection the surety bonds are issued. The original purposes of
equitable subrogation do not appear to exist where a surety has, as appellant
surety company has in this case, intentionally and contractually, for a consid-
eration, obligated itself to perform a contractor's contractual duties and the
surety is not seeking to enforce the original obligee's (the owner's) rights
against the original obligor (the contractor) or vice versa.50

Second, equitable relief is generally only available when there is no
adequate remedy at law. It has now become common practice to in-
clude terms granting security interests in property under the bond
applications as in the hypothetical case, which raises a question of
whether an adequate remedy at law is available. At least one court
has commented that the similar concept of equitable liens has been
discarded because of the minimum requirements under the U.C.C. for
obtaining a legal lien.51 The availability of a legal remedy under the
U.C.C. may cause the courts to look less favorably on the surety's posi-
tion. However, to date this argument has been generally rejected and
one state court has even held that filing under the U.C.C. is not a
waiver of equitable subrogation rights.52

A third problem is that the surety must always search to find a
right of another to be asserted. If the right relied upon is an assign-
ment under the bond application or otherwise, the U.C.C. may well
defeat the claim. Similarly, assertion of an assignment or contract
right in favor of another may also be subject to defeat under the
U.C.C. because a subrogee can assert no greater rights than his subro-
gor had.53 If the right relied upon is found to be a "security interest"

50. Transamerica Ins. Co. v. Barnett Bank, 524 So. 2d 439, 455-57 (Fla. 1988), quashed
and remanded, 540 So. 2d 113 (Fla. 1989) (footnotes omitted).
in favor of the owner or a materialman, then the surety proceeding under equitable subrogation may well lose to the bank because the right asserted is nothing more than an unperfected security interest.

3. Potential Uses of the U.C.C. by Sureties

The surety may be able to achieve the same or better results as to contract balances under the U.C.C. as it receives under equitable subrogation. If he perfects before any other security interest is filed against the contractor's property, he will have priority under U.C.C. § 9-312 as to all contractor's assets as described in the indemnity agreement.54 Even if there is a prior perfected security interest on all of the contractor's assets, or on all of his "accounts," the concept of a "purchase money security interest" may still give the surety priority as to the contract proceeds. U.C.C. § 9-107 provides:

A security interest is a purchase money security interest to the extent that it is:

(a) taken or retained by the seller of the collateral to secure all or part of its price; or
(b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.55

In general, the importance of the classification as a "purchase money security interest" is that it will take priority over a prior perfected security interest in the same collateral if it "is perfected at the time the debtor receives possession of the collateral or within ten days thereafter."56 Thus, it is possible, in the limited circumstance of a purchase money security interest, to defeat a prior perfected security interest as to particular collateral obtained as a direct result of the furnishing of value by the party claiming a purchase money security interest to acquire that collateral.

Furnishing a bond for a project would seem to constitute incurring an obligation which gives value to enable the debtor (i.e., the contractor) to obtain the collateral (i.e., a contract right to payment) that is necessary to obtain financing for the project. As such, perfecting the assignment under the indemnity agreement before or within ten days of the execution of the construction contract may give the surety a purchase money security interest and accordingly give the surety priority over the bank as to contract balances.57

However, any claim to other collateral described in the indemnity

54. It must be noted that the collateral description in the general agreement of indemnity does not utilize the U.C.C. description system and may cause disputes over the surety's priority even if filed in an appropriate and timely manner.
55. U.C.C. § 9-107. See also U.C.C. § 9-312.
56. Id. § 9-312(4).
57. See Comment, supra note 39, at 592-94.
agreement (such as materials and equipment) would still be junior to any prior perfected security interest in such collateral. The furnishing of a bond only stands as an obligation incurred to enable the contractor to obtain the construction contract; it does not stand as a giving of value to purchase materials or equipment to perform the contract.

Thus, the concept of a "purchase money security interest" cannot be used to gain a prior position as to the contractor's existing assets. However, it is a mechanism to obtain a first right to the contract balances under the U.C.C. alone, without any reliance on the doctrine of equitable subrogation.

IV. ANALYSIS OF THE HYPOTHETICAL

Let us now return to our hypothetical to see how our surety, with its rights of equitable subrogation and its unperfected security interest, fares against the bank.

In examining these results, it should be remembered that the bank's position is the same as the surety's position could have been but for its choice to not file its indemnity agreement under the U.C.C.

A. Who Gets the Contract Balance?

The surety should prevail as to the funds remaining unpaid under the contract by claiming subrogation to the owner's positions as to earned but unpaid funds. The owner has a defense to payment to the contractor by reason of its default and this defense should be sufficient to defeat the bank's claims as assignee of the contractor's right to payment.

1. Rights Under the U.C.C.

Under the U.C.C., the bank's claim to the contract balance stands as a security interest in an "account" or, more particularly, in a "contract right." It is, in essence, an interest in a right to payment not yet earned by performance. Under U.C.C. § 9-318, a secured party's claim to an "account" under a perfected security interest is subject to any and all defenses and claims which the account debtor (i.e., the owner) has against the assignor (i.e., the contractor). Until the "contract right" is transformed into an "account receivable" by full performance, the secured party may not force the owner to disgorge the contract balance.

2. Completion of Performance

However, the conclusion that the surety will prevail must be qualified. First, as noted above, completion of the project is a condition

58. See U.C.C. § 9-106.
precedent to claiming the contract proceeds under equitable subroga-
tion. In our hypothetical, the surety has not yet completed the pro-
ject; therefore, it does not have a presently enforceable right to the
contract proceeds.

This raises a question of whether the surety, acting under the
U.C.C. with a perfected assignment, may also obtain the proceeds by
completing performance? If so, may the bank also perform the con-
tract and earn the right to payment?

The U.C.C. implies that such a right to perform debtor's obligations
may be granted by the debtor in appropriately drafted security docu-
ments. However, the U.C.C. also clearly specifies that a grant of a
security interest in an account does not create obligations or liabilities
in the secured party to perform the debtor's duties or obligations.
Therefore, the bank may have the right to perform but no duty to do
so. The owner would have no ability to compel the bank to complete
performance of the contract. However, the surety is liable to the
owner upon the contractor's default under the bond if the surety does
not perform.

The lack of an enforceable obligation upon the bank to perform
should also deprive it of rights of equitable subrogation. In absence of
a binding obligation or liability to complete performance, the bank or
other secured party acts as a mere volunteer in completing the work
or performing the obligation. Having no obligation to perform, the
bank does not have and may never obtain rights of equitable subroga-
tion. Performance by the bank, at best, may only "crystallize" the
contractor's right to payment of the proceeds by eliminating the
owner's defense of nonperformance.

This highlights one serious shortcoming of the U.C.C. It is
designed to provide a mechanism to secure repayment of financial ob-
ligations. The U.C.C. is ill-equipped to cover the contingent liability of
a surety under its bond, and to give it incentive to and protection for
its efforts to honor the bond's obligations.

3. Governing Law

Another necessary qualification to the conclusion that the surety
will prevail is that both the project and contract are governed by Ne-
braska law. Pearlman involved a federal contract, an interpretation of
a federal act (the Miller Act), and the rights of a trustee in a federal
bankruptcy. As such, it is binding only as federal law, but not under

60. See U.C.C. § 9-106 comments.
61. See id. § 9-317.
62. See, e.g., United States v. Western Contracting Corp., 341 F.2d 383, 388 (8th Cir.
1965).
63. See U.C.C. § 9-317 comments.
the laws of various states. Fortunately for our surety, Nebraska law has adopted the doctrine of equitable subrogation. It seems probable that the Nebraska courts will recognize the superiority of the surety’s position.

4. Conclusions as to Contract Balances

Overall, a surety’s claim under the doctrine of equitable subrogation is still superior to rights under the U.C.C. as to contract balances. Performance by a secured party, as a volunteer under the U.C.C., may merely earn a right of payment in favor of the contractor which the secured party may claim by legal assignment. On the other hand, the surety’s subrogation to the positions of the owner and materialmen are superior to the rights derived through the contractor. Therefore, the surety should generally prevail over the claim of a lender claiming the funds under a security interest perfected under the U.C.C., and the courts have consistently held in favor of the surety over the lien of a lender claiming the funds under a security interest perfected under the U.C.C.

B. Who Gets the Materials?

In our hypothetical, the surety’s cost of completion can be reduced by $100,000.00 if the takeover contractor is allowed to use the materials already on the site. However, the bank has instituted a replevin action to repossess the materials under its perfected security interests in “inventory” of the contractor. Does the bank have a superior claim to the materials or may the surety intervene in the replevin action to claim the materials for its purposes?

1. The Bank Has a Perfected Security Interest in the Materials

It appears the bank has a good claim to the materials under its perfected security interest in the contractor’s “inventory.” Under the U.C.C., “inventory” is defined as goods “held by a person who holds them for sale or lease or to be furnished under contracts of services or if he has so furnished them, or if they are raw materials, work in process or materials used or consumed in a business.” The U.C.C. comments further explain: “The principal test to determine whether goods are inventory is that they are held for immediate or ultimate sale. Implicit in the definition is the criterion that the prospective sale

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65. But see U.C.C. § 9-106 comment.
66. See Withers, supra note 31, at 362-63.
is in the ordinary course of business."\textsuperscript{68}

Materials furnished under a construction contract constitute "inventory" under these tests. Although a construction contract is probably not governed by Article 2 of the U.C.C. governing sales, the materials furnished under that contract clearly are "inventory" under Article 9. The comments to U.C.C. § 9-109(4) recognized this point, stating: "Goods to be furnished under a contract of service are inventory even though the arrangement under which they are furnished is not technically a sale."\textsuperscript{69} Thus, under the U.C.C., the materials on site should be found to constitute "inventory." The bank, therefore, has a right to repossess and sell the materials under its security interest in inventory.

2. The Owner May Have Rights Superior to the Bank's Interest

In order to defeat the bank, our surety needs to find someone who has rights superior to the Bank which can be asserted by a subrogee. The owner may have such rights.

A perfected security interest in inventory is not enforceable against a purchaser for value in the ordinary course of business. U.C.C. § 9-307 provides that "a buyer in the ordinary course of business . . . takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."\textsuperscript{70} This provision is primarily applied to the sale of inventory due to the limitation that the sale must be to the "buyer in the ordinary course of business."\textsuperscript{71} The U.C.C. defines "buyer in the ordinary course of business" as "a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest of a third party in the goods buys in the ordinary course from a person in the business of selling goods of that kind . . ."\textsuperscript{72} Of course, materials specially purchased by the contractor for a particular project are not the same as toasters on a retail shelf offered to the general public. Is the contractor really "in the business of selling goods of that kind?" However, there is an argument that a contractor routinely "sells" building materials. Therefore, upon purchase, the owner may take the materials free of the security interest of the bank, even if he knows of the bank's security interest, so long as he does not know that the sale is in violation of the bank's security agreement with the contractor.\textsuperscript{73}

However, the owner's protection from the bank's claim under § 9-

\textsuperscript{68} Id. § 9-109 comment 3.
\textsuperscript{69} Id.
\textsuperscript{70} Id. § 9-307(1).
\textsuperscript{71} Id. comment 2.
\textsuperscript{72} Id. § 1-201(9).
\textsuperscript{73} Id. § 9-307 comment 2.
307 depends on whether the materials have been “sold” to the owner prior to the bank’s assertion of the claim. Under the U.C.C., a sale is defined as the passage of title from the seller to the buyer for a price.\textsuperscript{74} U.C.C. § 2-401 provides that title passes, in absence of other agreement, when the seller completes his performance with reference to physical delivery of the goods.\textsuperscript{75}

Thus, the validity of the owner’s claim against material may depend on whether the contractor has completed his obligations of delivery. The bank may well argue that, under a construction contract, the contractor has not completed his performance as to delivery until the material has been installed. The owner may counter under our hypothetical by pointing out that the materials were in fact paid for in full upon delivery to the job site, and therefore the sale has been completed.

So who wins? Probably the attorneys who will battle over this question in court to clarify ownership in the uncertain context of applying the U.C.C. concept of sales within the setting of a construction contract. However, § 9-307 gives the owner a good chance to defeat the bank’s claim.

3. \textit{The Surety Has No Enforceable Claims to Materials Under Equitable Subrogation}

Assuming that the owner may prevail against the bank as to the materials, the surety still has not solved its problems to gain use of the materials on site.

The surety appears to have an advantage over the bank only if it can claim subrogation to the owner’s rights as a buyer under U.C.C. § 9-307. However, as noted above, one essential element of equitable subrogation is that the rights only arise upon full performance.\textsuperscript{76} This creates a “Catch-22” for the surety in that its right to claim the materials through the owner will arise only upon completion of performance, and not before. The “catch” is this: without the materials, it cannot complete performance. If it completes performance, then it will no longer need the materials.

Therefore, although the bank may have problems in overcoming the owner’s claim to the materials, the surety’s ability to obtain the materials for its benefit is even more difficult to establish. Practically, the owner will probably cooperate with the surety to claim the materi-

\textsuperscript{74} Id. § 2-106(1). \textit{But see id.} § 2-401(1)(title passage is generally irrelevant under the U.C.C. except as explicitly agreed).
\textsuperscript{75} Id. § 2-401(2).
\textsuperscript{76} As discussed in section III.B, supra, performance is a condition precedent to an enforceable right of subrogation. In most reported cases, performance is completed. Obviously, one could argue that a binding commitment to perform may satisfy this requirement.
als and turn them over to the surety. On the other hand, the owner, knowing that it has the surety on the line, may forego the expense and difficulty of defeating the bank's claims, and simply insist on performance by the surety. Unless the surety can raise a defense to its liability based upon the owner's failure to protect its rights in the materials or failure to turn over such materials, the surety, without a filed and perfected security interest, may well find itself purchasing additional materials to complete the work or purchasing the original materials from the bank upon sale thereof under the U.C.C.

Another apparent alternative available to the surety would be to assert clause Six in the bond application which allows it to take possession of the work upon the contractor's default. However, this claim is in essence, an assignment by the contractor of rights in property arising upon the contractor's default. As a contractually-created assignment, it may be a "security interest" subject to the U.C.C., and subject to the prior perfected security interests in the bank.

Asserting the owner's claim under a similar contractual clause by equitable subrogation would also appear to be similarly flawed. The owner's claims also arise from and are derived through a contract with the contractor. Given this fact and the limitations of equitable subrogation, a court could easily conclude that the bank's prior perfected security interests in the materials will prevail over the owner's or surety's unperfected right arising under the contract. In any event, the surety would once again be dependent upon the strength of the owner's claim and its cooperation in turning over the materials to the takeover contractor.

In each of the options outlined above, the surety must weave an intricate web of legal and factual theories to claim the material on site.

77. From a pragmatic view, delay of the project while disputes over materials on the job are resolved may well mean that whatever rights to the materials under subrogation the surety may have will be worthless.
78. See United States v. Continental Casualty Co., 512 F.2d 475 (5th Cir. 1975).
79. Another legal route which may be available to the Surety is to claim the materials by subrogation through the materialman's rights. Changing our hypothetical slightly, let's assume that the materialman has not been paid in full for the materials. Under U.C.C. § 2-702, he has a right to claim the materials upon learning of the buyer's insolvency but only if demand is made within 10 days after receipt of the goods by the seller. The 10 day limit does not apply if a written statement of solvency is made by the buyer within three months prior to delivery. This provision is a right to rescind the contract based upon a tacit business misrepresentation of solvency. As noted, Pearlman indicates that the surety is subrogated to the rights of the materialman upon payment for goods furnished. Although the doctrine may not extend beyond claims as to contract balances, the surety may be in a position to assert that it is equitably subrogated to the materialman's right to reclaim the goods themselves upon full payment to the materialman. However, given the 10 day period after delivery in which this right may be asserted, it seems that this route of already questionable worth will seldom be available.
Given the theoretical limitations of equitable subrogation, the surety's chances of prevailing as to the materials are slim indeed.

4. The Surety Has Problems Even If It Filed Its Indemnity Agreement Under the U.C.C.

On the other hand, if the surety had filed its indemnity agreement under the U.C.C. before the bank's filing, the surety's position against the bank would have been greatly improved. It could assert priority over the bank under U.C.C. § 9-312(5), which generally gives priority among conflicting perfected security interests to the party who is the first to file or perfect.

Even if the indemnity agreement has been properly filed under the U.C.C., the default provisions under Article 9 will plague our surety in its efforts to use the materials in completing the project. Under U.C.C. § 9-505, a secured party is obligated to sell collateral within 90 days after repossession. Otherwise, the debtor or the bank, at its option, may sue for conversion or recover damages under U.C.C. § 9-507.

This obligation to sell under § 9-505 is certainly inconsistent with our surety's desire to use the materials to complete the work. If the surety uses the materials without conducting a U.C.C. sale, it becomes liable for any losses thereby caused to the contractor or the bank.81 The surety will also lose its rights to proceed against the contractor to recover its ultimate losses arising from completing performance.82

The surety can ask the contractor and the bank to waive their rights to recover losses from the surety under U.C.C. § 9-507(1), as allowed under U.C.C. § 9-501. However, U.C.C. § 9-501 does not allow waiver of certain rights of the debtor (contractor). In particular, it does not allow a waiver of the secured party's (surety's) obligation to sell collateral under U.C.C. § 9-505.

A better approach is to structure a sale of the materials at public or private sale as provided in U.C.C. § 9-504 to meet the surety's goal of using the materials to reduce its cost of performing the contract. At public sale, the surety or the takeover contractor can purchase the materials and then use them. However, § 9-504(1) requires the proceeds of the sale to be immediately disbursed to first satisfy the expenses of the sale, then the indebtedness secured by the security interest, then to pay junior lienors who have given proper notice of their interest, and finally, the surplus, if any, is to be paid to the debtor.83

The surety has one major problem with conducting any kind of U.C.C. sale: What is the amount of the indebtedness which is secured?

82. Id. § 9-507.
83. Id. § 9-504(1).
Once again, the U.C.C. is not well suited for use in the suretyship situation, for the surety's claim against the contractor is, at this stage, contingent and unliquidated. To merely hold all sale proceeds until its losses are quantified may well be a violation of the U.C.C. provisions which govern disposition of collateral. Therefore, the surety once again is faced with a loss of its rights to proceed against the contractor to recover its ultimate losses and faces liability to the contractor and the bank under U.C.C. § 9-507.84

A solution to this dilemma is to quantify the loss by execution of a contract with the takeover contractor for a fixed amount, and then by public or private sale, sell the material to the takeover contractor and apply the proceeds against the new contract price. This is not a perfect solution, however, because the contractor or the bank may still protest that the sale was made on a collusive basis between the only interested bidders (the surety and the takeover contractor) or otherwise does not conform to the technical rules of the U.C.C. If these arguments are successful, the surety is exposed to liability in favor of the contractor or the bank; and the surety loses entitlement to a deficiency judgment as against the contractor.

The lesson of this analysis is simply that the U.C.C. is not designed to allow the surety to use material on site to complete a project. The U.C.C. is designed to protect financial obligations through security interests in personal property. As such, it contemplates sale of collateral to satisfy a pre-existing debt. The U.C.C. does not contemplate use of the materials in the takeover situation and, in essence, it requires contortions by the surety to achieve this result.

5. Conclusion - Materials

In conclusion, it seems safe to say that under our hypothetical, as written, if the materials are or were inventory of the contractor, then either the bank or the owner will receive them. Absent cooperation of the owner, side-deals, or special construction contract terms with the owner, the surety, relying on equitable subrogation, may not be able to obtain and utilize the materials. Even if the surety files its indemnity agreement and proceeds under the U.C.C., the materials would not be instantly available for use by the takeover contractor. Instead, the surety must comply with the rules of U.C.C. § 9-504 and § 9-505 requiring the sale of the materials and a proper application of the proceeds.

84. Another option is to propose to simply keep the material in full satisfaction of the debt under id. § 9-505(2). However, if the debtor or junior lienor objects in writing within 21 days after the notice is sent, then a sale is required. If no such objection is received, then the secured party (surety) accepts the material in fully satisfaction of all the debtor's (contractor's) obligations and wholly releases the contractor from all liability under the indemnity agreement. As such, this is not an attractive option.
While filing of the indemnity agreement may reduce the surety’s ultimate loss in taking over the project, the U.C.C. generally is not well designed to aid the surety in accomplishing its primary goal of completing the project expediently and through the use of the materials on site.

C. Who Gets the Equipment?

In our hypothetical, the bank has also claimed the contractor’s equipment under its perfected security interest. However, the surety naturally realizes that upon liquidation of the equipment, it will have no recourse to recover its losses incurred in completing the project. Under different facts, it may also want to use the equipment to complete the project. Does the surety have any way to defeat the bank’s claim as to the equipment?

1. The Bank Has Superior Rights to the Equipment

It is clear that the bank’s perfected security interest under the U.C.C. is superior to the unperfected security interest of the surety. The surety’s arguments are further limited by the fact that neither the owner nor the materialmen have any apparent claim to the equipment which may be asserted by equitable subrogation. The surety’s position, therefore, does not appear hopeful.

2. Equitable Subrogation Does Not Give the Surety Any Rights to Contractor’s Equipment

In desperation, we can well imagine the surety asking his lawyer the following question: “If under Pearlman, I am entitled to the contract proceeds upon completing performance under the bond, then why don’t I also have priority as to the equipment?” The question seems logical on the surface, for there is no apparent difference between a right to the contractor’s money and a right to the contractor’s equipment. However, there is a very real difference between the surety’s position against the contract proceeds as compared to the surety’s position against the equipment.

This difference was well demonstrated in Aetna Casualty & Surety Co. v. Brunken & Son, Inc.85 In that case, Aetna, as surety, took over and completed four bonded jobs incurring a total loss, after application of contract balances, in excess of $300,000.00. The contractor had simultaneously defaulted upon loans made by two banks which were secured by perfected security interests in the contractor’s equipment. The banks began the process under the U.C.C. for sale of the equipment but a court-appointed receiver took over the equipment and liq-

uidated it, resulting in proceeds of about $150,000.00. Aetna then brought the action claim entitlement to the proceeds on a theory of an equitable lien.

Aetna, relying on *Pearlman* and the doctrine of equitable subrogation, argued that by reason of its performance under the bonds, an equitable lien upon the equipment arose in its favor and that this lien had priority from the date of the bond applications. In doing so, it relied on a granting clause in the application similar in effect to that set forth in our hypothetical.

The court, however, was unimpressed with Aetna's position. It acknowledged that a surety has equitable rights to contract balances under a theory of subrogation and that these rights survived enactment of the U.C.C. However, it refused to extend the doctrine to create equitable liens on personal property superior to properly perfected security interests.

The court rejected Aetna's attempt to recast the *Pearlman* line of cases as being based on a concept of an equitable lien. Instead, the court concluded that these cases were based upon a concept of subrogation as to others' rights to receivables due. Further, the court found that since enactment of the U.C.C. and its minimum requirements for lien creation, the equitable liens were in disfavor in the commercial setting. Ultimately, the court concluded that under general principles of equity, equitable subrogation was based on a concept that the surety is entitled to the retained funds to prevent unjust enrichment of others and those claiming through them. However, in this instance, there was no unjust enrichment to the banks by allowing foreclosure of their security interest. The court commented that "the practical consequence of Aetna's theory is nothing less than an appropriation of a secured creditor's collateral to reimburse the performing surety, a judicial act in contradiction of South Dakota law." The court finally held that "the interest Aetna seeks to enforce in Brunken's personal property is by definition a 'security interest,' [citation omitted] and therefore falls within the filing provisions of Article Nine [citation omitted]. The failure to file and perfect its interests is fatal to Aetna's claim in the fund now under litigation." In short, Aetna's arguments

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86. The court analyzes the claim as if the equipment had not been sold. The security interests in equipment under the U.C.C. attach to proceeds to the sale of collateral and have the same order of priority. See U.C.C. §§ 9-302, 9-306.


88. Id. at 294. The court also quickly rejected Aetna's argument that the grant of an interest in the bond applications was not governed by the U.C.C. since it arose as a "contract right" excluded under U.C.C. § 9-104(f). The court responded that regardless of form, the provision in the indemnity agreement granting rights in the equipment was a grant of a security interest under the U.C.C. and was fatal to Aetna's claim.
were quickly disposed of and Aetna's claim to the proceeds from the equipment failed entirely.

The Aetna Casualty case clearly demonstrates that the doctrine of equitable subrogation probably will not be extended to cover equipment and materials. It did so by highlighting the concept of unjust enrichment which underlies the doctrine.

In the case of contract balances, the surety's performance of its obligations, in essence, creates the balances or at least renders contract funds due and payable. Without these efforts, the owner has good defenses to payment thereof to the contractor and therefore, under U.C.C. §9-318, the bank would have no enforceable claim. To honor the bank's claim when these defenses have been removed by the surety's performance would enrich the bank unjustly through the surety's efforts. Further, honoring the bank's claim would certainly discourage the surety from honoring its bond obligations to perform the construction contract.

However, the surety's efforts do not furnish funds or value for the acquisition of the equipment nor bear any relationship to the enforceability of the bank's interests therein. The bank had a right to the equipment, whether or not the bond obligations were performed. To award the equipment to the surety because of performance which, in essence, had nothing to do with the equipment, would enrich the surety unjustly at the expense of the bank. If anyone has an equitable right to the equipment it would be the bank who probably furnished the financing for its purchase.

In short, if the surety wishes to have good recourse in regard to the equipment, it ought to file its indemnity agreement as a financing statement under the U.C.C. Otherwise, it has chosen to be content to stand as a general creditor to the balance of the contractor's assets.

3. Filing Under the U.C.C. Would Have Given the Surety Rights in the Equipment

On the other hand, if our surety had taken its opportunity to file and perfect its security interests before the bank perfected its security interests, the surety would have happily been in a position to claim most of the equipment and defeat the bank's replevin action.89

89. Obviously, there are numerous issues under the U.C.C. under which the bank could attack the surety's position, not the least of which are the questions of adequacy of description of the collateral (particularly since the assignment is only as to equipment which is or may be "upon the site" of the project), whether value has been given, whether the granting language in the indemnity agreement is sufficient, and whether the filing and the form of the filings are proper. These issues are beyond the scope of this paper. It is sufficient to say, however, that there are plenty of points to argue under the U.C.C., even if the security interest is perfected by a filing.
Although it would have still been crippled in its efforts to use the equipment to complete the job under the sales provisions of U.C.C. § 9-504 and § 9-505 as discussed above, it certainly would find itself in a much better position of recourse to lessen or eliminate its ultimate losses.

Our hypothetical case raises one issue wherein the bank would have had superiority over the surety even if the surety had filed under the U.C.C. If you recall, the contractor took the bank funds and purchased a backhoe for use on this project. This raises a question of whether there is a “purchase money security interest” in favor of the Bank as to the backhoe which may have priority over the surety's prior perfected security interest. Thus, even if the surety had filed its indemnity agreement, the bank would likely be able to establish priority as to the backhoe.

4. Conclusion - Equipment

In conclusion, absent a U.C.C. security interest properly perfected by the surety, the bank has superior right to the contractor's equipment. The doctrine of equitable subrogation will not be of much assistance to the surety as to such equipment or any other property of the contractor other than contract proceeds. If the surety does file its indemnity agreement, then it must establish its priority under the U.C.C. and enforce its liens in accordance with its provisions.

V. WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF RECORDING THE INDEMNITY AGREEMENT UNDER THE U.C.C.?

The hypothetical has demonstrated the differences between equitable subrogation and liens under the U.C.C. The obvious conclusions are that equitable subrogation stands as stalwart protection for the surety's claims to the contract balances. On the other hand, a U.C.C. perfected security interest is necessary to allow resort to the contractor's materials and equipment. Does this mean that the surety should always file its indemnity agreement as a financing statement with the U.C.C.? The only real answer is maybe.

A. Advantages of Filing Under the U.C.C.

One advantage of filing under the U.C.C. is that the surety receives enforceable rights not only to materials and equipment but to any other personal property of the contractor which is adequately described in the agreement. This, for example, could give the surety a

90. See discussion in section IV.B.4 supra.
91. See U.C.C. §§ 9-107, 9-312(4). See also id. § 9-312(3)(special rules for inventory).
right to assert claims against owners and subcontractors and to collect other accounts receivables and amounts due on other contracts, all in an effort to reduce or eliminate losses from a takeover situation on this project. This advantage carries over into bankruptcy proceedings to give the surety specific resource to specific property and thereby avoiding the no-win situation of being another general unsecured creditor.

Another advantage is that a proper U.C.C. filing may discourage disputes with the bank and others in regard to contract balances, as well as other assets. Obviously, the banks will not be anxious to attack the equitable subrogation rights when they will be ultimately defeated on their “home court” under the U.C.C. It will also eliminate the perplexing question of whether the individuals who have been paid for their services (such as laborers and materialmen) have rights to the funds which may be asserted by the surety.

A third advantage is that the U.C.C. default provisions offer a mechanism, through the sales processes of § 9-504 and § 9-505, to transfer materials and equipment to a takeover contractor. However, as discussed above, the sales mechanisms are somewhat ill-suited for this use, especially when the ultimate loss to the surety is not quantified or liquidated.

Although not an “advantage,” it is also comforting to know that the courts which have addressed the issue have concluded that filing under the U.C.C. does not waive or relinquish the rights of equitable subrogation. In essence, this is one time when you may be able to have your cake and eat it too. However, this holding of “no prejudice from filing” is not in accordance with the general principle that equity is not available where the party has adequate remedies available at law. As such, this holding may be subject to a change of position by the courts.

B. The Disadvantages of Filing Under the U.C.C.

The disadvantages to filing are also numerous. First, many of the advantages disappear or are less important when the surety’s filing is subordinate to a prior perfected security interest on file against the contractor. Except in the purchase money security interest situation discussed earlier, the rights of a junior lienholder are always subject to the senior lienholder’s rights, including rights to possession and to the

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92. See discussion in section IV.B.4 supra.
94. In O. K. Door Co. v. Lincoln Eng’g Constr. Co., 174 Neb. 682, 119 N.W. 153 (1963), it was held that the implied subrogation promise arising from performance under a bond was not enforceable when the surety subsequently took an express assignment of the construction contract proceeds.
proceeds of the sale of collateral. The rights of a junior lienholder are often in jeopardy. For example, under U.C.C. § 9-504, the right to share in proceeds is dependent on the junior lienholder giving written notice of demand therefore before distribution of proceeds is complete.

Further, a filing of any lien will often, if not always, be a violation of the bank's loan documentation. In essence, the surety may create an instant default on the loan which may cause the surety to take over projects much more quickly or frequently than the surety wishes. Even if the surety files first, the practical consequence is that the surety may extinguish or severely inhibit the contractor's ability to obtain needed financing. Most banks require a first priority position on collateral before the loan will be made. However, this may work to the surety's advantage, especially in regard to the marginal contractor or the new entrant, by giving the surety an opportunity to work with the bank to define relative rights before the problems arise.

Another serious disadvantage is that the surety may offend its clients, especially the better and more financially sound clients. Obviously, they have often dealt with sureties without these formalities. They will also recognize the restriction of credit which the surety's filing may cause, and thus, they may shop for another surety who does not demand the formalities of a U.C.C. filing.

Another disadvantage of filing is the added time, effort, and expense it will require. If a surety does wish to file, it will be well advised to use separate, specialized security agreements and standardized U.C.C. financing statement forms. Many states charge extra filing fees for non-standard forms. Several states have various approved forms so you may end up with a drawer full of forms.

Determining the appropriate place to file is a real problem. The U.C.C. is not, in fact, uniform as to the public office in which a filing should be made. The appropriate office may vary within a state depending on the type of collateral in which perfection is desired. Determining the appropriate office may require investigations as to the location of collateral, the debtor's principal place of business, and other factual matters. In a true multi-state transaction, determining where to file as to what type of property is even more complex.95 Finally, security interests in certain types of goods, most notably titled vehicles, cannot be perfected by a simple U.C.C. filing. Additional effort will be required to claim an interest in this type of property. Ultimately, employing a service organization or attorneys in each state in which a surety desires to file may be necessary.

The mechanics of perfection also involve proper continuances of the filings, amendments, and termination statements. Imagine the

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95. See U.C.C. § 9-103.
time and expense which will be consumed in furnishing releases of liens every time a major client wants to sell one piece of equipment to buy another.

Finally, some commentators argue that acknowledgment of the applicability of the U.C.C. by filing may ultimately result in a loss of equitable subrogation rights. The courts may soon look upon equitable subrogation with disfavor if the sureties begin to take advantage of the U.C.C. However, language referring to the U.C.C. in bond applications may have the same effect, even without filing.\textsuperscript{86} Ultimately, this may prove to be false reasoning as the courts can certainly consider the availability of easily obtained legal rights under the U.C.C. even if the surety does not file under the U.C.C.

C. Filing After Default

It may be suggested that many disadvantages of filing would be avoided if the surety filed its indemnity agreement in accordance with the U.C.C. only after the contractor has defaulted on the project. This would avoid the nightmare of paperwork associated with filing and maintaining a secured position against every contractor. It would also avoid premature confrontation with the contractor's creditors and the resulting restriction of his credit. However, to do so is to assume a greater risk of ultimate loss.

The U.C.C. does not limit how long a creditor may wait before filing.\textsuperscript{97} Most creditors will perfect their secured position as soon as possible to make it enforceable against third parties. Therefore, an outside limit on when a filing may be made in connection with a security agreement is not established within the U.C.C. Thus, late filing is certainly permissible.

The most obvious problem with awaiting default before filing is that the filing may be too late to be of any real value. As noted above, priority generally dates from the time of filing.\textsuperscript{98} The surety's choice not to file immediately will concede priority to all others who choose to file in the interim. A late filing, in essence, will be junior to all other liens and will give the surety priority over only the contractor's general creditors. Therefore, assuming that a majority of defaults occur when the contractor is having financial difficulties, it seems unlikely that a late filing will often result in additional recoveries for the surety.

The possibility of a bankruptcy filing by the contractor before or

\textsuperscript{86} See O. K. Door Co. v. Lincoln Eng'g Constr. Co., 174 Neb. 682, 685-88, 119 N.W.2d 153, 157 (1963) ("[t]he implied promise is by its terms inapplicable in the event that there is an express promise on the part of the principal").

\textsuperscript{97} See U.C.C. §§ 9-303, 9-312.

\textsuperscript{98} Id. § 9-312(5).
after default also dictates against waiting to file until a claim on the bond is made. As an unperfected security interest, the surety's claim against the assets of the contractor is subject to and subordinate to the rights of a judgment lien creditor. The trustee in bankruptcy is deemed a judgment lien creditor at the time the petition is filed; therefore, an unperfected security interest is not effective against the trustee. Thus, if the surety has not filed a financing statement before the petition in bankruptcy is filed, it will be reduced to the status of a general creditor except to the extent allowed under *Pearlman* and its progeny as the law develops in each jurisdiction.

Further, upon filing of a petition in bankruptcy, creditors are automatically stayed from taking any act to create, perfect, or enforce a lien against property of the bankruptcy estate or the debtor. Violation of this “automatic stay” may result in both citation for contempt of court and damages. In theory, the filing would be ineffective since all the debtor's property is transferred to the trustee by operation of law upon filing of a bankruptcy petition. Therefore, the debtor has no assets against which the post-petition filing would be effective.

In short, if a petition in bankruptcy is filed before the indemnity agreement is recorded under the U.C.C., then the surety will be unable to file and will stand as a general creditor of the bankruptcy estate.

Even if the surety files in accordance with the U.C.C., the filing may be subject to being set aside as a voidable preference. Under 11 U.S.C. § 547, the trustee may set aside transfers of property (including perfection of liens) made within 90 days prior to the filing of a petition in bankruptcy which are for or in consideration of an antecedent debt and which will allow the creditor to recover more than it would have otherwise recovered without the transfer. The policy is to avoid maneuvers to improve one creditor's position at the expense of the others. An argument could be made that the filing of the indemnity agreement under the U.C.C. after default is not “for or in consideration of an antecedent debt” because the contractor had no immediate liability to the surety until default on the project. On the other hand, the concept that the surety's rights “relate back” to the date when the bond was issued may make this liability an “antecedent debt.” Which argument will prevail is a decision for the courts. Perhaps it is reasonably predictable that any surety unfortunate enough to have filed its indemnity agreement within 90 days prior to a bankruptcy filing will

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99. *Id.* § 9-301.
101. U.C.C. § 9-301.
103. *See id.* § 541.
104. *Id.* § 547.
probably be engulfed in litigation and will have an opportunity to allow a court to decide this point.

Overall, if the surety has not filed to perfect its security agreement prior to default, it would be prudent to do so upon default. However, the likelihood of additional recoveries is not good and litigation may arise if bankruptcy is filed shortly thereafter. The real risk in doing so, however, is that the courts will find an election to pursue the surety's legal rights at the expense of its equitable subrogation rights which in turn may equate to a real loss from such last minute maneuvers.

D. Filing When Necessary Under the Circumstances May Be the Best Solution

As such, the question "Should the surety rely on its rights of equitable subrogation or file under the U.C.C.?" does not have a clear answer. Theoretically, the lawyer will tell the surety to file to protect itself from loss. Practically, it may not be worth the time, effort, expense, and consequences of filing. Pragmatically, it is suggested that reliance on equitable subrogation is easy and efficient, but with some measure of risk which should be assessed on a case-by-case basis. In those cases where filing is appropriate, possible, or absolutely necessary, then filing should be made. Otherwise, you may well benefit by carefully screening your clients and insisting on good provisions in both bond documents and contracts. Ultimately, working with the contractor, the owner, and the banks to fashion solutions and to avoid later disputes may well be the best answer to the question of whether or not the indemnity agreement should be filed under the U.C.C.

VI. CONCLUSION

The U.C.C. was designed to facilitate the taking of security for repayment of debt. As such, it is not well designed to protect the surety in a situation of contingent, unliquidated liability where the real object is to complete the project efficiently and expeditiously.

On the other hand, equitable subrogation is designed to protect the surety's interest in taking over and completing the project and to assure recourse to the contract balances which are the fruits of such efforts. However, equitable subrogation offers little recourse against other assets of the contractor and it does not serve the purpose of ultimate recoupment of losses incurred.

The doctrine of equitable subrogation has limitations even as to contract balances, primarily because the surety must always find someone's rights to assert which are superior to those of the contractor's secured creditors. The confusion over the theoretical basis of the surety's position created by Pearlman also leaves the door open for
further judicial changes in the doctrine. One thing, however, is very clear; namely, that the surety will be grossly plagued in his performance of his obligation to complete if he is denied the right to take over the work. This means he must have immediate access to materials on site (or in storage with permission of the owner) and be allowed to continue working with performing subcontractors, all with an objective to fulfill its promise to complete the defaulting contractor's performance.

It is suggested that the need to protect the surety should be based not only on principles of subrogation but additionally upon the principles of unjust enrichment as used in the Aetna Casualty case.\textsuperscript{105} To do so would help solve the dispute created by the split of opinion in Pearlman and it would certainly avoid the nagging question of whether materialmen have rights in contract proceeds which may be asserted by a surety performing under a payment bond, especially in public construction contracts.

In all fairness, however, it must be realized that the bank's assertions of the superiority of the U.C.C. is not truly based upon theoretical considerations. It is based upon the fact that when a contractor defaults, all his creditors are scrambling to avoid losses. In this scramble, the surety is a competitor and the U.C.C. is a weapon which may be used either by or against it.

Ultimately, the doctrine of equitable subrogation is both a necessary safeguard and an important incentive to the surety to perform the work for which the surety issued the bond. Before equitable subrogation can be replaced by the U.C.C., the U.C.C. needs to be modified to accommodate the surety's unusual position and to give it the projections and incentives that sureties need and require.

\textsuperscript{105} U.C.C. § 9-507.