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Robert K. McCalla

*University of Nebraska College of Law*

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## THIRD PARTY INDEMNITY CONTRACTS †

### I. INTRODUCTION

The term, "indemnity", has been used to illustrate a variety of legal relationships.<sup>1</sup> For example, "indemnity" has been used to illustrate: (1) an original, independent contract to save the indemnitee from contingent loss of a specified character;<sup>2</sup> (2) a right to recover for injuries;<sup>3</sup> (3) an implied right of reimbursement owed to one who has discharged the debt of another.<sup>4</sup>

This article discusses indemnity contracts given by third persons as security for sureties on contracts between two other persons. For example: *S*, a surety, guaranties the performance of a contract between *P*, the principal, and *C*, the creditor. *X*, indemnitor, agrees with *S* to pay the amount of any loss incurred by *S* on the suretyship obligation. This legal relationship will be termed "the four party situation" for the purposes of discussion in this article.<sup>5</sup>

### II. THE INDEMNITY CONTRACT

Those requirements necessary to make any contract enforceable are similarly applicable to a contract of indemnity. Under this section only the following more troublesome requisites of an indemnity contract are discussed: (A) Statute of frauds; (B) capacity of persons and corporations to execute an indemnity contract; (C) consideration; (D) construction of the indemnity con-

† Contribution of funds by the Universal Surety Company of Lincoln, Nebraska, has made this study possible.

<sup>1</sup> See Arnold, *Indemnity Contracts and the Statute of Frauds*, 9 MINN. L. REV. 401, 413 (1925); Comment, 44 YALE L.J. 1053 (1935), note 2; Treanor, *The Rationale of Corporate and Non-Corporate Suretyship Decisions*, 3 IND. L.J. 105, 213-15 (1927).

<sup>2</sup> Hall v. Equitable Surety Co., 126 Ark. 535, 191 S.W. 32 (1917).

<sup>3</sup> Proctor v. Dillon, 235 Mass. 538, 546, 129 N.E. 265, 269 (1920).

<sup>4</sup> U.S. Fidelity & Guaranty Co. v. Centropolis Bank, 17 F.2d 913, 916 (8th Cir. 1927).

<sup>5</sup> A suretyship relationship involves three parties; the surety, creditor and principal. The relationship which is the subject of this article merely adds one party to the suretyship relation; the surety's indemnitor.

tract; and (E) public policy affecting the validity of an indemnity contract.

#### A. STATUTE OF FRAUDS

Courts disagree whether an agreement to indemnify a surety is a contract to answer for the debt or default of another person.<sup>6</sup> The typical situation which results in conflicting decisions is where *P*, contractor, desires to bid on a job let for bid by *C*. *P* must obtain a surety bond executed by a surety in favor of *C* before *P*'s bid will be accepted. *S*, surety, will not execute the surety bond unless *X*, a third person, executes a contract agreeing to indemnify *S* against any loss suffered under its obligation on the surety bond. It should be noted that *S* is an obligor in so far as he is obligated to *C* on the surety bond, but an obligee in so far as *P* is expressly or impliedly obligated to indemnify him against loss suffered on the suretyship obligation.

Since *P* is obligated to indemnify *S*, a minority of courts construe *X*'s promise of indemnity to be a contract to answer for *P*'s obligation of indemnity to *S* and hence a contract to answer for the debt or default of *P*.<sup>7</sup>

The majority of courts, including Nebraska,<sup>8</sup> hold *X*'s promise to indemnify *S* is not a promise within the statute of frauds.<sup>9</sup> The reasons generally set forth by the courts following this view are:

<sup>6</sup> NEB. REV. STAT. § 36-202(2) (Reissue 1952).

<sup>7</sup> 2 Williston, Contracts § 482 (rev. ed. 1936): "It is in regard to promises to indemnify those who become sureties for the debts of third persons, given as an inducement to the sureties for entering into the obligation that the question has given rise to the greatest difficulty. In the first place it must be asked: Was the principal debtor also bound to indemnify the surety? If so, even though that promise is an implied one, the new promisor is entering into an identical obligation which should be subject to the same rule which governs all promises to satisfy the obligations of another." See also, Burdick, *Suretyship and the Statute of Frauds*, 20 COL. L. REV. 153 (1920); *Hurt v. Ford*, 142 Mo. 283, 44 S. W. 228 (1898); *Easter v. White*, 12 Ohio St. 219 (1861). Even the minority courts will hold the oral contract enforceable if there is a direct benefit accruing to the promisor; *Garner v. Hudgins*, 46 Mo. 399 (1870).

<sup>8</sup> *Minick v. Huff*, 41 Neb. 516, 59 N.W. 795 (1894).

<sup>9</sup> See an excellent article, Corbin, *Contracts of Indemnity and the Statute of Frauds*, 41 HARV. L. REV. 689 (1928); Annot., 1 A. L. R. 383 (1919); *Mills v. Brown*, 11 Iowa 314 (1860); *Patton v. Mills*, 21 Kan. 163 (1878); *George v. Hoskins*, 30 S.W. 406 (1895); *Dyer v. Staggs*, 217 Ky. 683, 290 S. W. 494 (1927); *Fidelity & Casualty Co. v. Lawler*, 64 Minn. 144, 66 N.W. 143 (1896); *Rose v. Wollenberg*, 31 Ore. 269, 44

1) there would be a great injustice to allow X to plead the statute of frauds after S, relying on the indemnity agreement, has executed a surety bond; 2) there is little danger of fraud because if X did not agree to indemnify S, there would be sufficient proof of S's motive to execute the surety bond without the indemnity agreement but little or no proof of X's motive for executing the alleged contract; and 3) the meaning of the indemnity contract should be determined from the intent of the parties, and in most instances P's obligation to indemnify S would not be considered by X when he executes the contract.

## B. CAPACITY TO EXECUTE AN INDEMNITY CONTRACT

In determining whether a contract is or will be enforceable the question arises whether the person or corporation has capacity to enter into the contract. The discussion below of contract capacity is subdivided into three sections: 1) corporations; 2) agents; and 3) other persons.

### 1. Corporations

Whether a surety in this four party situation can rely on the validity of a corporate indemnity contract depends on whether the corporation is expressly authorized to enter into such agreements and whether the corporate agent had authority to execute the particular contract. In absence of express corporate authority, the contract may nevertheless be enforceable if it was impliedly authorized because the corporate business was furthered or if the corporation is estopped to set up lack of capacity because of benefit received. In addition, the indemnity agreement may be enforceable because the corporation is prohibited by statute from relying on the defense of ultra vires.

#### a. *Express corporate authority*

Whether the articles of incorporation expressly provide for corporate power to execute an indemnity contract is a question peculiar to each particular corporation. There are no statutes expressly granting corporations power to enter into contracts of indemnity, but a few laws authorize corporations to enter into

P. 382 (1896); *Shook v. Vanmater*, 22 Wis. 532 (1868). Also see Arnold, *Indemnity Contracts and the Statute of Frauds*, 9 MINN. L. REV. 401 (1925).

contracts of guaranty.<sup>10</sup> Although guaranty is easily distinguishable from indemnity,<sup>11</sup> no reason exists to make the distinction when determining the extent of corporate powers in this four party situation; the statute should be construed to include both powers.<sup>12</sup> If the corporation is authorized by statute to execute a contract of guaranty, it should be able to do this indirectly by executing an indemnity contract which another company relies

<sup>10</sup> ARK. STAT. ANN. § 64-109 (1947); NEV. REV. STAT. § 78-070 (1957). Some other states have similar statutes, however, they are subject to certain conditions; e.g., that the corporation have a direct interest in the contract being guaranteed; GA. CODE ANN. § 22-1828 (Supp. 1958); N. Y. STOCK CORP. ACT § 19 (1951).

<sup>11</sup> The major distinctions are set forth in an article by Arnold; *Indemnity Contracts and the Statute of Frauds*, 9 MINN. L. REV. 401, 414 (1925). (a) In an indemnity contract, no debt is owed to the promisee by the third person. A contract of indemnity is an original and independent one. A guaranty, however, presupposes a debt owing to the promisee by a third person. (b) The indemnitor engages to save another from loss upon some obligation he has incurred or is about to incur on account of a third person, while a guarantor's promise is to one to whom another is answerable. (c) The contract of indemnity is an original one to save the indemnitee harmless against future loss or damage. The contract of guaranty is a collateral one, and presupposes some contract or transaction to which it is secondary. (d) The indemnitor agrees to become liable whenever the promisee suffers loss; the guarantor's promise is to become liable conditionally when the principal debtor defaults. (e) If the liability of the third person is existing, and not merely in contemplation at the time the defendant makes his promise, it cannot be an indemnity contract. It must be one of guaranty if the obligation of the third person, for whom the promisee becomes responsible, is pre-existing. (f) An indemnitee has no remedy on the contract against a third person. His remedy is by direct action against the indemnitor. In the case of guaranty, the third person for whom the promisee became responsible, may be sued by the promisee for reimbursement, if he is damaged. (g) Under an indemnity contract, no right of action accrues against the indemnitor until the indemnitee suffers the loss against which the contract protects him. The indemnitee has no rights against the indemnitor merely because he may possibly suffer loss, but it is the actual loss which entitles him to recovery. A guarantor however, if it be a guaranty of payment, fixes the liability of the guarantor at the time when the principal debtor fails to pay at maturity.

<sup>12</sup> FLETCHER, PRIVATE CORPORATIONS § 3646 (perm. ed. rev. repl. 1931): "The rule requiring a strict construction of the corporate charter will not generally be applied where the corporation or its members are seeking to evade a liability by giving a narrow and restricted meaning to words . . . . In such case the courts are reluctant to grant relief, and the strict construction rule does not apply. And it should never be applied if it would defeat the evident intention of the legislature."

on when executing the guaranty or surety contract.<sup>13</sup> There is certainly no basis for objection by the shareholders or creditors because the corporate assets are not being risked in any other manner than that consented to by the shareholders or relied on by the creditors.

b. *Implied authority*

In absence of express authority the corporation may be held liable on the theory of implied authority or equitable estoppel; viz. the corporation had implied authority to execute the contract because it furthered the corporate business or the corporation cannot raise the defense of ultra vires because of a benefit received.<sup>14</sup>

In this four party situation, the corporation executing the the indemnity contract will be receiving some benefit or furthering the corporate business in most situations. For example, a cement company which contracts to supply cement to a contractor executes an indemnity agreement in favor of a surety to induce the surety to execute a necessary surety bond for the indemnitor's customer, the contractor. This has been held to be within the implied powers of a corporation<sup>15</sup> and seems to be the better holding; but the predictable outcome on a particular factual situation which has not been decided is uncertain.<sup>16</sup>

<sup>13</sup> See *Texas Fidelity & Bonding Co. v. General Bonding & Casualty Ins. Co.*, 184 S.W. 238, *rev'd*, 216 S.W. 144 (Tex. Com. App. 1919). The case was reversed on the grounds that since the statute granted the corporation power to execute the bail bonds, the corporation could clearly execute an indemnity agreement to another corporation which executed the bail bonds; it would merely be doing indirectly what it could do directly. See also, Slover, *Enforceability of Guaranties Made by Texas Corporations*, 10 SW. L.J. 134 (1956).

<sup>14</sup> In those states which have not abolished the defense of ultra vires by statute, the courts, often on the same type of factual situation alternate between the two theories of estoppel and implied power when they hold the corporation liable. See 6 INS. COUNSEL J. 20 (1940).

<sup>15</sup> *London & Lancashire Indemnity Co. v. Fairbanks Shovel Co.*, 112 Ohio St. 136, 147 N.E.2d 329 (1925).

<sup>16</sup> For example, compare *Globe Indemnity Co. v. McCullom*, 313 Pa. 135, 169 Atl. 76 (1933) where a corporation executed an indemnity agreement in favor of an indemnity company which in turn executed a necessary bond to the contractor in favor of the creditor. The indemnitor was supplying lumber for the job to the contractor. The court held the indemnity contract was ultra vires because there was not a sufficient benefit accruing to the corporation which executed

c. *Statutes abolishing the defense of ultra vires*

If a corporation lacks express or implied power to execute an indemnity contract, the contract is ultra vires, and in the absence of legislation it is unenforceable unless public policy prohibits the corporation from asserting the defense.<sup>17</sup> Because the law is uncertain in this area,<sup>18</sup> many states have enacted statutes limiting the ultra vires doctrine. The discussion which follows is not all inclusive but illustrates the various ways used by those states which have dealt with the problem.

The original Model Business Corporation Act, promulgated by the Commission on Uniform Laws in 1928,<sup>19</sup> changes the ultra vires doctrine in two general aspects: 1) third persons dealing with the corporation are not charged with knowledge of the contents of recorded articles of incorporation,<sup>20</sup> and 2) the act

the indemnity contract. In *Timm v. Grand Rapids Brewing Co.*, 160 Mich. 371, 125 N.W. 357 (1910), the court held that it was not ultra vires for a brewing corporation to execute an indemnity agreement to a surety company which in reliance thereon executed a necessary bond to one of the brewing companies retailers. If the corporation for which the surety or guaranty bond is executed is the subsidiary of the indemnitor corporation, the courts have less trouble finding or holding the corporation liable; *American Surety Co. v. 14 Canal St. Inc.*, 276 Mass. 119, 176 N.E. 785 (1931).

There is no reason to distinguish between contracts of guaranty from indemnity contracts when determining the enforceability of such a contract executed by a corporation which did not have express authority. See Annot., 11 A.L.R. 554 (1921); *Warren Creamery Co. v. Farmers' State Bank*, 81 Ind. App. 453, 143 N.E. 635 (1924).

<sup>17</sup> When public policy will disallow a corporation from setting up ultra vires as a defense is uncertain because of the conflicting decisions. See FLETCHER, *PRIVATE CORPORATIONS* § 3478 (perm. ed. rev. repl. 1931).

<sup>18</sup> Stevens, *A Proposal as to the Codification and Restatement of the Ultra Vires Doctrine*, 36 YALE L.J. 297 (1927).

<sup>19</sup> THE MODEL BUSINESS CORPORATION ACT was promulgated by the commissioners in an attempt to clear up the numerous conflicts in the field of corporation law. The particular sections dealing with constructive notice and ultra vires followed the suggestions set forth by Stevens in his article; note 18, *supra*.

<sup>20</sup> MODEL BUSINESS CORPORATION ACT § 10, 9 U.L.A.: "The filing or recording of the articles of incorporation, or amendments thereto, or of any other papers pursuant to the provisions of this Act is required for the purpose of affording all persons the opportunity of acquiring knowledge of the contents thereof, but no person dealing with the corporation shall be charged with constructive notice of the contents of any such articles or papers by reason of such filing or recording."

distinguishes between corporate capacity and corporate authority, and declares a corporation shall have the capacity possessed by natural persons.<sup>21</sup> The effect is to do away with the conception held by some courts that an unauthorized act of a corporation has no legal effect unless the contract is performed by both sides. Under the act the defense of ultra vires is left to be developed by the courts within the well settled rules of agency. For example: 1) A corporation may defend itself against a third party who dealt with corporate agents knowing that the transaction was ultra vires and that the agents had no authority from the corporation to engage in the transaction; 2) A corporation may defend itself against a third party who dealt with the corporate agent but who was ignorant of the agent's lack of authority because of his negligence in ascertaining the facts; 3) The third party may hold the corporation liable even though the act was ultra vires if the act was within the apparent authority of the agent; 4) The third party may hold the corporation liable even though the act is ultra vires if the stockholders have authorized or ratified either expressly or impliedly, or if they are prevented from showing their dissent because of estoppel or laches; 5) Often the defense of ultra vires will be allowed when it appears to be the best method of discouraging ultra vires acts without injustice to the parties. For example, the defense may be permitted when both parties have knowledge that the transaction is ultra vires and when there has been no performance on either side.<sup>22</sup> The

<sup>21</sup> MODEL BUSINESS CORPORATION ACT § 11, 9 U.L.A.: "A corporation which has been formed under this Act, or a corporation which existed at the time this Act took effect . . . shall have the capacity to act possessed by natural persons, but such a corporation shall have authority to perform only such acts as are necessary or proper to accomplish its purposes and which are not repugnant to law." In 2 La. L. Rev. 597, 607 (1940) the author states that the promulgators of the Model Act wisely left the consequences of a ultra vires agreement flexible. The abrogation of the doctrine of limited capacity is merely a restatement of the law in a majority of courts prior to the promulgation of the Model Act, and hence this prior law can be relied upon for interpretation. Thus, a fully executed contract will not be disturbed, and a completely executory contract will not be a basis for any enforceable rights in most situations. The partly executed ultra vires contract is still an area of uncertainty in so far as the consequences are concerned. For criticism of these sections of the Model Act, see Ballantine, *A Critical Surety of the Illinois Business Corporation Act*, 1 U. CHI. L. REV. 357, 381 (1934).

<sup>22</sup> See commissioners notes, 9 U.L.A. 149 (1957).



states which have adopted §10 and §11 of the Model Business Corporation Act are Idaho,<sup>23</sup> Indiana<sup>24</sup> and Louisiana.<sup>25</sup>

A number of states have adopted the Model Business Corporation Act promulgated by the Committee on Corporate Laws of the American Bar Association.<sup>26</sup> This statute completely abolishes the ultra vires defense to both the corporation and third persons. However, if the contract is not already performed, a stockholder may have the performance enjoined if the court believes it to be equitable, but any loss other than expected profit suffered by the third persons because of the court's action may be compensated in the court's discretion.<sup>27</sup> Defenses based either on the lack of actual or apparent authority of the corporate officers to execute the contract or of the directors to authorize the contract have not been abrogated. There is no section abrogating the doctrine of constructive notice or recorded articles of incorporation. If the courts in these states do not extend the defenses based on agency any further than the question of the corporate officers' authority to execute an indemnity contract,<sup>28</sup> a surety, after obtaining a certification of the minutes of the board meeting

<sup>23</sup> IDAHO CODE §§ 30-113, -114 (1948).

<sup>24</sup> IND. STAT. ANN. § 25-202 (1948). Indiana has not abolished the doctrine of constructive notice. The state has adopted the Model Act only to the extent of providing a corporation has the capacity possessed by natural persons.

<sup>25</sup> LA. REV. STAT. tit. 12, §§ 11, 12 (1950).

<sup>26</sup> ABA-ALI MODEL BUS. CORP. ACT § 6 (1953): "No act of a corporation and no conveyance or transfer of real or personal property to or by a corporation shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such conveyance or transfer, but such lack of capacity or power may be asserted; (a) In a proceeding by a shareholder against the corporation to enjoin the doing of any act or acts . . . . (c) In a proceeding by the Attorney General . . . ."

<sup>27</sup> ABA-ALI MODEL BUS. CORP. ACT § 6 (1953) comment: "In abolishing the doctrine, Section 6 does not distinguish between complete lack of power and abuse of power, and does not distinguish between express power and implied powers. Likewise, the Section does not give regard to performance by either party, except in cases governed by clause (a)." Clause (a) allows for compensation to a party injured if the act is enjoined.

<sup>28</sup> See note, 29 NW. U.L. REV. 1075 (1935). If the courts extended the defenses based on agency to include lack of authority of the board of directors, it would tend to bring back the uncertainty prevalent under the ultra vires doctrine. Of course, the authorization by the board of directors of an act which they did not have the power to authorize could be ratified by the stockholders. How-

authorizing the execution of the indemnity contract, could be fairly certain the indemnity contract will be enforceable. Alaska,<sup>29</sup> Colorado,<sup>30</sup> Illinois,<sup>31</sup> Iowa,<sup>32</sup> Maryland,<sup>33</sup> North Dakota,<sup>34</sup> Oregon,<sup>35</sup> Virginia,<sup>36</sup> Wisconsin<sup>37</sup> and Texas<sup>38</sup> are among the states which have adopted either this Model Act or a similar statute.

The corporation statutes in Michigan,<sup>39</sup> Minnesota<sup>40</sup> and Kansas<sup>41</sup> completely abolish the doctrine of ultra vires in so far as

ever, ratification would be virtually impossible in a large corporation, but very likely in a close corporation.

In those states which have abolished both the defense of ultra vires and the doctrine of constructive notice, it would seem a strange anomaly to say the corporation can defend on the ground that the directors had no actual or apparent authority. The authority comes from the articles of incorporation, and except for persons with actual notice of the contents of the articles, the statute abolishing the doctrine of constructive notice seemingly abolishes any constructive notice of the limitations on the board of directors' authority. Although the Model Act does not expressly abrogate the doctrine of constructive notice, it seems to impliedly abolish the doctrine.

<sup>29</sup> ALASKA COMP. LAWS ANN. § 36-2A-14 (Supp. 1958).

<sup>30</sup> COLO. CORP. ACT § 6, Colo. Laws 1958 S.B. 14 (Eff. 1/1/59).

<sup>31</sup> ILL. REV. STAT. c. 32, § 157.8 (1957).

<sup>32</sup> Iowa Sess. Laws c. 321, § 6 (1959).

<sup>33</sup> MD. ANN. CODE art. 23, § 124 (1957).

<sup>34</sup> N.D. REV. CODE § 10-1096 (Supp. 1957).

<sup>35</sup> ORE. REV. STAT. § 57.040 (1955).

<sup>36</sup> VA. CODE ANN. § 13.1-5 (1956).

<sup>37</sup> WIS. STAT. § 180.06 (1955).

<sup>38</sup> TEX. BUS. CORP. ACT art. 2.04 (1956).

<sup>39</sup> MICH. STAT. ANN. §§ 21.9, 21.11 (1937); see 34 U. DET. L.J. 297 (1956).

<sup>40</sup> MINN. STAT. ANN. § 301.11 (1947): "The filing for record of articles and certificates pursuant to sections 301.01 to 301.61 is for the purposes of affording means of acquiring knowledge of the contents thereof, but shall not constitute constructive notice of such contents." MINN. STAT. ANN. § 301.12 (1947): "Every corporation shall confine its acts to those authorized by the statement of purposes in the articles of incorporation and within the limitations and restrictions contained therein but shall have the capacity possessed by natural persons to perform all acts within or without this state. No claim of lack of authority based on the articles shall be asserted or be of effect except by or on behalf of the corporation (a) against a person having actual knowledge of such lack of authority . . . ."

<sup>41</sup> KAN. REV. STAT. art. 30, § 17-3001; art. 41, § 17-4104 (1949).

third persons without actual knowledge are concerned.<sup>42</sup> It must be remembered that in these states, as elsewhere, although the defense of ultra vires is abrogated, there are still defenses based on principles of agency available, such as lack of authority of corporate officers to execute the indemnity contract.

At the present time, Nebraska limits application of the ultra vires doctrine to the extent of raising the lack of legal organization. There are no limitations on a defense based on lack of capacity or authority.<sup>43</sup> However, at the present time the Nebraska Bar Association is considering whether to urge adoption of the Model Business Corporation Act.

Due to the uncertainty of the law in many states, it would be advisable for a surety to make certain the corporation has express authority to execute an indemnity contract before it executes a surety bond relying on the indemnity contract.

## 2. Agents

The authority of an attorney or individual to execute an indemnity contract for another individual or for an officer of a corporation to execute an indemnity contract binding on the corporation are governed by the same general rules of agency, but are peculiar in many characteristics. For this reason, the various types of agents will be discussed separately.

Although the courts often fail to distinguish between the various theories upon which a principal can be held liable, the distinctions set forth in the *Restatement of Agency*<sup>44</sup> will be adhered to in this article.

<sup>42</sup> Even though the person dealing with the corporation has actual knowledge of the lack of corporate authority to enter into the transaction, if the contract is already performed on both sides, the defense could not be asserted to defeat the transaction. This was true at common law and is true after passage of the statute; note, 29 NW. U.L. REV. 1075 (1935).

<sup>43</sup> NEB. REV. STAT. § 21-1,117 (Reissue 1954). See annotations to General Corporation Law of Nebraska, 21 NEB. L. REV. 210, 262 (1942).

<sup>44</sup> *Restatement (Second), Agency* § 8: "Apparent authority is the power to affect the legal relations of another person by transactions with third persons, professedly as agent for the other, arising from and in accordance with the other's manifestations to such third persons." 8A: "Inherent agency power is a term used in the restatement of this subject to indicate the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of

a. *Corporate Agent's Authority*

A corporate agent can bind the corporation to an indemnity contract if he is authorized by a resolution of the board of directors.<sup>45</sup> The corporation also can be held liable on the theory that the corporate agent has implied authority to execute the contract. To find implied authority two general requirements must be fulfilled: 1) The corporate agent executing the contract must be the general manager of the corporation,<sup>46</sup> and 2) execution of the contract must further the corporate business.<sup>47</sup> The

persons harmed by or dealing with a servant or other agent." 8B: Estoppel: "1) A person who is not otherwise liable as a party to a transaction purported to be done on his account, is nevertheless subject to liability to persons who have changed their positions because of their belief that the transaction was entered into by or for him, if (a) he intentionally or carelessly caused such belief, or (b) knowing of such belief and that others might change their positions because of it, he did not take reasonable steps to notify them of the facts. 2) An owner of property who represents to third persons that another is the owner of the property or who permits the other so to represent, or who realizes that third persons believe that another is the owner of the property, and that he could easily inform the third persons of the facts, is subject to the loss of the property if the other disposes of it to third persons who, in ignorance of the facts, purchase the property or otherwise change their position with reference to it. 3) Change of position, as the phrase is used in the restatement of this subject, indicates payment of money, expenditure of labor, suffering a loss or subjection to legal liability."

<sup>45</sup> Since apparent authority requires some manifestation of the principal to the third person, when the principal is a corporation the question would seldom arise. In most cases the manifestation of the principal, the board of directors, would be in the form of a resolution, and hence the agent would have actual authority rather than apparent authority.

<sup>46</sup> In FLETCHER, PRIVATE CORPORATIONS § 665 (perm. ed. rev. repl. 1954) a general manager is defined as: "... the person who really has the most general control over the affairs of a corporation, and who has knowledge of all its business and property, and who can act in emergencies on his own responsibility; who may be considered the principal officer."

<sup>47</sup> Fletcher uses the term, "implied power"; FLETCHER, PRIVATE CORPORATIONS § 695 (Rev. ed. 1954). The restatement uses the term "inherent power"; *Restatement (Second), Agency*, § 8A. Many courts have said that in this situation the agent has apparent authority, or that the corporation is estopped from raising the defense because of a benefit received; *Eastern Shore Brokerage & Commission Co. v. Harrison*, 141 Md. 91, 118 Atl. 192 (1922); *Advance Rumely Thresher Co. v. Evans Metcalf Implement Co.*, 103 Kan. 532, 175 P. 392 (1918); *M. Burg & Sons v. Twin City Four Wheel Drive Co.*, 140 Minn. 101, 167 N.W. 300 (1918).

typical situation where an indemnity agreement would be enforceable on the theory of implied authority is where the general manager of a corporation executes an indemnity contract to enable one of its customers to secure credit.<sup>48</sup> Where the question of the implied authority of an agent of a close corporation arises the courts generally will go further to find liability because of the nature of ownership and management.<sup>49</sup>

It is well settled that a corporate president,<sup>50</sup> secretary or other officer who is not the general manager does not have in-

<sup>48</sup> In *Woods Lumber Co. v. Moore*, 183 Cal. 497, 191 P. 905 (1920) the defendant corporation was engaged in the making of theatrical costumes. The articles of incorporation did not grant the corporation power to enter into contracts of guaranty. The defendant corporation had a contract to supply costumes to X corporation for a theatrical production. X corporation needed lumber for the theatrical production but did not have sufficient credit to buy the lumber. Without authority, the president who was also the general manager authorized the secretary to execute a guaranty, guaranteeing the payment for purchase of lumber by X corporation. The court held 1) the contract was not ultra vires because it was essential to the successful prosecution of defendant's business, and 2) the corporation was estopped from defending on the grounds of the agent's lack of authority. The basis for the decision was that the board of directors had clothed the agent with apparent authority to execute the contract of guaranty which the plaintiff had relied on to his detriment while the defendant had received a benefit. For the purposes of determining the extent of an agent's incidental authority here there is no reason to distinguish between contracts of guaranty and those of indemnity. There are no cases on point in Nebraska. In *Drainage Dist. No. 2 v. Dawson County Irr. Co.*, 140 Neb. 866, 2 N.W.2d 321 (1942) the court, in holding the president and general manager of a corporation could bind the corporation on the basis of authority, stated: "An act of an agent, although without actual authority from his principal, may be with such apparent authority as to bind the principal. Such apparent authority of the agent cannot be extended or restricted by by-laws or other instructions to the agent by its principal, in absence of actual notice thereof." See cases cited in Annot., 34 A.L.R.2d 290 (1954).

<sup>49</sup> O'NEAL, CLOSE CORPORATIONS § 8.05 (1958): "Although the same broad principles of corporation and agency law determine the powers of officers in both close and publicly held corporations, the factual differences in the patterns of operation of the two kinds of corporations lead to wide disparities in the powers the courts actually recognize in corporate officers. In a close corporation, ownership and management normally coalesce; and the participants often conduct their enterprise internally much as if it were a partnership."

<sup>50</sup> The general rule is stated in *Atlantic Refining Co. v. Ingalls & Co.*, 37 Del. 503, 185 Atl. 885 (1936): "Depending somewhat on the nature and character of the corporate business, or on whether by continued and repeated conduct, the principles of the law of estoppel apply,

herent or implied authority by virtue of their office to execute an indemnity contract binding the corporation, and this is true in Nebraska.<sup>51</sup>

b. *Ratification*

If the corporate agents execute the indemnity contract without express, implied or apparent authority, the corporation may still incur liability on the theory of either ratification or estoppel. It is axiomatic that in order to have the power to ratify an act, the ratifying body must have been able to authorize the act. Hence, assuming a corporation has power to enter into a contract of indemnity and a corporate officer executes a particular contract without authority, either the board of directors or the stockholders could ratify the contract.<sup>52</sup>

there may, perhaps, be occasional cases requiring the application of a different rule, but in most cases it is, therefore, clear that the president of the ordinary business corporation has no implied or presumed authority to bind it by a mere contract of guaranty, in which it has no apparent interest." See also, *Bent v. Carney*, 339 Mich. 642, 64 N.W.2d 687 (1954); *FLETCHER, PRIVATE CORPORATIONS* § 613 (perm. ed. rev. repl. 1954).

<sup>51</sup> Nebraska adopts a strict construction of a corporate agent's implied authority by virtue of his office, e.g., *Electronic Development Co. v. Robson*, 148 Neb. 526, 28 N.W.2d 130 (1947): "As a general rule the president of a corporation has little or no inherent power to bind the corporation outside of a comparatively narrow circle of the functions especially pertaining to his office."

<sup>52</sup> *FLETCHER, PRIVATE CORPORATIONS* §§ 762, 763, 764 (perm. ed. rev. repl. 1954). In some cases, the corporate agent may have been authorized to execute the contract by the board of directors, where the board of directors did not have authority to authorize the execution of the contract either because the act is ultra vires, or there is a defect in the proceedings such as lack of a quorum. The power of the stockholders to ratify a contract in this situation is dependent on 1) whether the state has abolished the ultra vires doctrine, and if not, whether the state adheres to the doctrine of general capacity as distinguished from limited capacity and 2) whether the contract is ultra vires, or merely unenforceable because of some defect in the proceedings.

In those jurisdictions which have not abolished the ultra vires doctrine, but adhere to the doctrine of general corporate capacity, the stockholders may by their acts either ratify the contract or be estopped from denying its validity; *Lancaster County v. Lincoln Auditorium Ass'n.*, 87 Neb. 87, 122 N.W. 226 (1910). Where the jurisdiction adheres to the doctrine of limited capacity, it has been held the contract cannot be ratified by the stockholders; *People v. Wiensema State Bank*, 361 Ill. 75, 197 N.E. 537 (1935); *Piedmont Feed & Grocery Co. v. Georgia Feed & Grocery Co.*, 52 Ga. 847, 184 S.E. 899 (1936). Note

In this four party situation, ratification or estoppel may appear in the form of acquiescence<sup>53</sup> or acceptance and retention of the benefits. If the ratifying body has actual knowledge of the contract<sup>54</sup> a corporation cannot retain the benefits of an unauthorized contract without ratifying the contract or being estopped from raising the lack of authorization as a defense.<sup>55</sup> For example, in *London & Lancashire Indemnity Co. v. Fairbanks Shovel Co.*,<sup>56</sup>

that in both of these jurisdictions the law has been changed by statute and the cases are cited as illustrations of the decisions if the jurisdiction adheres to the doctrine of limited capacity.

If the state has abolished the doctrine of ultra vires, or if the lack of authority is because of some defect in the proceedings such as lack of a quorum, the stockholders can ratify the contract; *Fish v. Harrison*, 87 N.J.Eq. 103, 100 Atl. 185 (1917); *Mann v. Mann*, 57 N.D. 550, 223 N.W. 186 (1929). The problem is governed by statute in California. See *Levin v. Martin C. Levin Inv. Co.*, 123 Cal. App.2d 158, 266 P.2d 553 (1954); *Lebowitz, Director Misconduct and Shareholder Ratification in Texas*, 6 BAYLOR L. REV. 1 (1953).

<sup>53</sup> *Alexander v. Culbertson Irrigation & Water-Power Co.*, 61 Neb. 333, 85 N.W. 283 (1901): "A corporation having power to ratify or repudiate a contract made in its name by a self-constituted agent, or one acting outside of his authority should, within a reasonable time, determine which to do, and if it does not disavow the agency and dissent from the contract, assent and approval may well be presumed." See *Be-Mac Transport v. Michigan Express*, 348 Ill. App. 460, 109 N.W.2d 370 (1952); *FLETCHER, PRIVATE CORPORATIONS* § 769 (perm. ed. rev. repl. 1954).

<sup>54</sup> The corporation, ratifying body, must have knowledge of the transaction before their acts will amount to ratification or estoppel. In some cases where an officer or other corporate agent which holds a significant position in the corporation has knowledge of the ultra vires act, if the agent is not the wrongdoer, his knowledge is imputable to the corporation; *FLETCHER, PRIVATE CORPORATIONS* §§ 757, 759 (perm. ed. rev. repl. 1954). For illustration of the principle see *London & Lancashire Indemnity Co. v. Fairbank Shovel Co.*, 112 Ohio St. 136, 147 N.E. 329 (1925). However, when the corporation receives and retains benefits from the unauthorized contract there is a presumption of ratification; *FLETCHER, PRIVATE CORPORATIONS* § 779 (perm. ed. rev. repl. 1954).

<sup>55</sup> On this general rule see *Rich v. State Nat'l. Bank*, 7 Neb. 201 (1878); *Miller v. Ortman*, 235 Ind. 641, 136 N.E.2d 17 (1956); ". . . the law does not permit a corporation to receive and retain the benefits of a contract or transaction and at the same time repudiate liability thereunder or attempt to escape the burdens thereof on the ground that the contract or transaction was not authorized, or that authority therefore was not set forth in its records." See also, *Alexis v. Werbell*, 209 Ga. 665, 75 S.E.2d 168 (1953); *Russ v. United Farm Equipment Co.*, 230 La. 889, 89 So.2d 380 (1956). Usually the problem is not whether retention of a benefit amounts to ratification or estoppel, but whether the corporation did in fact receive a benefit.

<sup>56</sup> 112 Ohio St. 136, 147 N.E. 329 (1925).

the defendant corporation was engaged in the manufacture of dredges. Contractor agreed to buy two dredges from the defendant corporation which they needed to fulfill a construction contract with McWilliams Brothers. Fairbanks, secretary-treasurer of the defendant corporation, requested the plaintiff surety company to execute certain surety bonds guaranteeing the contractor's performance on his contract with McWilliams Brothers. The surety company agreed to execute the surety bonds if the defendant would execute an indemnity contract agreeing to indemnify the surety against any loss which it might suffer on the surety bonds. Fairbanks, without any authorization from the board of directors, executed an indemnity contract on behalf of the defendant corporation. The court held that retention of the contract benefits, profit from the sale of the dredges, worked an equitable estoppel against the defendant corporation. The same result should and probably would be reached in Nebraska.<sup>57</sup>

Frequently, the corporation executing an indemnity contract will be a close or family corporation. Because of the characteristics of a close corporation,<sup>58</sup> the unauthorized act by an officer is extremely susceptible to ratification or estoppel.<sup>59</sup> Although in

<sup>57</sup> Although there are no cases directly on point in Nebraska, the courts follow the general rules on ratification and estoppel by acquiescence or retention of benefits. *E.g.*, in *Citizens' Savings Trust Co. v. Independent Lumber Co.*, 104 Neb. 631, 178 N.W. 270 (1920) the defendant corporation owned stock in a cement company which was in need of money. One of defendant's directors, without authority, executed a guaranty binding the defendant to enable the cement company to borrow money. When the corporation's president and general manager found out about the contract they did nothing. The court held their inaction amounted to a ratification. For a case on ratification by retention of the benefits see *Rich v. State Nat'l Bank*, 7 Neb. 201 (1878).

<sup>58</sup> O'NEAL, *CLOSE CORPORATIONS* § 1.07 (1958): "A close corporation typically has the following attributes: (1) the shareholders are few in number, often only two or three; (2) they usually live in the same geographical area, know each other, and are well acquainted with each other's business skills; (3) all or most of the shareholders are active in the business, usually serving as directors or officers or as key men in some managerial capacity; and (4) there is no established market for the corporate stock, the shares not being listed on the stock exchange or actively dealt in by brokers; little or no trading takes place in the shares." Although close corporations have been defined in many different ways, the above definition sets forth the important characteristics. One man and family corporations are merely versions of the close corporation; see comment, 51 HARV. L. REV. 1373 (1938).

<sup>59</sup> This is self evident when it is considered that the characteristics of a close corporation include shareholders which are few in number and which know each other and usually live in the same geographical area.



general the courts have not articulated any distinction between the rules applicable to a close corporation as distinguished from a large publicly held corporation, the actual results in the decisions has been to make such a distinction.<sup>60</sup>

c. *Other agents*

The question of an agent's power to execute an indemnity contract binding on his principal arises in two major situations. First, where there is a partnership and one partner executes an indemnity contract purporting to bind the partnership and second, where an agent has broad express authority, such as a power of attorney, to carry on the business affairs of his principal. In the latter situation, there usually will be some evidence of the agent's authority and the major question will be whether the agent has implied authority to execute an indemnity contract on the basis of his express authority.

A partner can be given express authority to execute an indemnity contract binding on the partnership either by the original partnership agreement or by a subsequent agreement among a majority of the partners if the purposes of the partnership remained unchanged.

In absence of express authority, a partner's power to execute an indemnity contract binding on the partnership depends on whether the execution of the contract is within the usual business of the partnership.<sup>61</sup> This is a question of fact for a

<sup>60</sup> O'NEAL, CLOSE CORPORATIONS § 8.05 (1958): "The courts have not articulated a difference in the rules governing officers' powers in close and publicly held corporations; yet they appear in fact to have often cut through the technical legal form of close corporations to reach the results that would be reached if the enterprises were conducted as partnerships."

"In view of the typical patterns of operation in close corporations, holdings of this kind can usually be reconciled with traditional doctrine by viewing an officer whose powers are in question as in fact a general manager of the company or as having a general manager's broad powers or by applying principles of ratification or of authority or apparent authority by acquiescence. In any event, only in rare instances, have courts failed to hold a close corporation bound by inter vivos contracts entered into by any officer of the corporation."

<sup>61</sup> NEB. REV. STAT. § 67-309 (Reissue 1958) "(1) Every partner is an agent of the partnership for the purpose of its business, and the act of ever partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act

jury.<sup>62</sup> It has been stated that the execution of a contract of indemnity is generally not within the ordinary course of business for a partnership and that a partner does not have implied power to bind the partnership.<sup>63</sup> However, the contract has been held binding on the partnership where the partnership has executed an indemnity contract in previous dealings with the same parties or where the partnership receives a benefit furthering its business.<sup>64</sup>

Where agents other than corporate agents or partners are concerned, the question usually will be one of interpretation of the authority manifested by the principal.<sup>65</sup> It is generally held there must be specific express authorization to grant the agent power to bind the principal to an indemnity contract. An instrument such as a power of attorney which grants the agent general powers such as power to manage a business, will not confer upon the agent the implied power to bind the principal to a contract of indemnity.<sup>66</sup> In *Bullard v. De Groff*,<sup>67</sup> the agent was the gen-

for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has not such authority.

(2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners." This is section 9 of the UNIFORM PARTNERSHIP ACT which has been adopted in the following states: Alaska, Arizona, Arkansas, California, Colorado, Delaware, Idaho, Illinois, Indiana, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oregon, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Texas, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin. The UNIFORM PARTNERSHIP ACT is a codification of the common law.

<sup>62</sup> *Brocater v. Serio*, 173 Md. 374, 196 Atl. 125 (1938); *Nicolai-Nerrach Co. v. Abrams*, 116 Ore. 424, 240 P. 870 (1925).

<sup>63</sup> See *Woodruff v. Lillis*, 174 Miss. 91, 164 So. 225 (1935); CRANE, PARTNERSHIP § 51 (1952).

<sup>64</sup> See *Wolff v. First Nat'l Bank*, 47 Ariz. 97, 53 P.2d 1077 (1936); CRANE, PARTNERSHIP § 51 (1952). The court's discussion in *Bullard v. De Groff*, 59 Neb. 783, 82 N.W. 4 (1900) although not dealing with a partnership, is applicable, since a partner is merely an agent.

<sup>65</sup> It is doubtful that a surety company would rely on the mere representation by a person that he has authority to bind another to an indemnity contract. There would usually be some evidence of the principal's manifestation from which could be inferred that the agent has authority to execute the indemnity contract.

<sup>66</sup> Formal instruments such as power of attorney are strictly construed; *Burns v. Commonwealth Trailer Sales*, 163 Neb. 308, 79 N.W.2d 563 (1956): "Indeed, according to the established rule, powers of attorney will be given a narrow and restricted construction, and will be held

eral manager of a partnership engaged in the lumber business. Without express authority, he executed a performance bond for a contractor in the name of the partnership. In holding the agent did not have implied authority to bind the partnership, even though the partnership would possibly furnish the lumber for the contract, the Nebraska Supreme Court stated:

An agent in charge of a retail lumber business, with the power and authority ordinarily incident to the conduct of such business, exceeds the scope of his agency in signing his principal's name to an obligation for the faithful performance by a third party of a contract for the construction of a building, or an obligation of like character.<sup>68</sup>

If the principal manifests to the surety that the agent has authority to execute an indemnity contract, for example, if the surety calls up the principal and the principal tells the surety the agent has authority to execute the contract, the principal is liable on the indemnity contract because of the agent's apparent authority regardless of whether the agent had actual authority.<sup>69</sup>

If the agent executing the indemnity contract did not have authority to bind the principal, the principal may become bound

to grant only those powers which are expressly specified and such others as are essential to carry into effect the expressed powers." See also *Gramam Ice Cream Co. v. Petros*, 127 Neb. 172, 254 N.W. 869 (1934); *Bergman v. Dykhouse*, 316 Mich. 315, 25 N.W.2d 210 (1946); *Von Wedel v. Clark*, 84 F. Supp. 299 (1949) and *Thompson v. Evans*, 256 Ala. 383, 54 So.2d 774 (1951) where the agent was authorized to sign the principal's name to appeal bonds. The court held the agent was not authorized to sign the principal's name to criminal bail bonds. The general rule of construction is contrary to the one advocated by the *Restatement (Second) Agency*, § 34, comment h: "... they are construed so as to carry out the intent of the principle. There should be neither a strict nor a liberal interpretation, but a fair construction which carries out the intent as expressed. It is true that dangerous powers, such as the power to borrow money, will not be inferred unless it is reasonably clear that this was intended." It is probable that the power to execute an indemnity contract binding the principal is a dangerous power and will not be inferred; *Hearst Publishing Co. v. Litsky*, 339 Mich. 642, 64 N.W.2d 687 (1954): "Authority to bind the principal by a contract of guaranty or suretyship is not ordinarily to be implied from the existancy of a general agency." In determining the powers of the agent there is little reason to distinguish between a contract of indemnity and one of suretyship.

<sup>67</sup> 59 Neb. 783, 82 N.W. 4 (1900).

<sup>68</sup> *Id.* at 788, 82 N.W. at 5.

<sup>69</sup> *Restatement (Second), Agency* § 8. For an example of how Nebraska uses the term "apparent authority" see *Oleson v. Albers*, 130 Neb. 823, 266 N.W. 632 (1936).

on the theories of ratification or estoppel. Generally, a contract is ratified when there is:

- (a) a manifestation of an election by one on whose account an unauthorized act has been done to treat the act as authorized, or
- (b) conduct by him justifiable only if there were such an election.<sup>70</sup>

There is an estoppel when:

- (1) A person who is not otherwise liable as a party to a transaction purported to be done on his account, is nevertheless subject to liability to persons who have changed their positions because of their belief that the transaction was entered into by or for him, if (a) he intentionally or carelessly caused such belief, or (b) knowing of such belief and that others might change their positions because of it, he did not take reasonable steps to notify them of the facts.<sup>71</sup>

The many varied situations in which ratification or estoppel can arise are beyond the scope of this paper.<sup>72</sup>

#### d. *Suggested procedure*

If the indemnitor is a corporation, the indemnitee should

- 1) make certain the articles of incorporation expressly grant the corporation authority to enter into an indemnity contract and
- 2) have the corporation provide a properly certified copy of the minutes of the board of directors meeting in which the agent was authorized to execute the specific indemnity contract.

If the indemnitor is a partnership, the indemnitee should either have all of the partners sign the indemnity contract or have the partner executing the contract provide a letter in which all of the partners authorize and consent to the execution of the contract binding the partnership.

If the indemnitor is an individual, the indemnitee should secure a copy of written express authority for the agent to execute

<sup>70</sup> *Restatement (Second)*, Agency § 8A.

<sup>71</sup> *Restatement (Second)*, Agency § 8B.

<sup>72</sup> For example, in *Singer Sewing Machine Co. v. Barger*, 92 Neb. 539, 138 N.W. 741 (1912) the court stated; "A principal must disaffirm the unauthorized act of his agent within a reasonable time after such act comes to his knowledge, or he will be bound thereby." In *Furrer v. Nebraska Building & Inv. Co.*, 111 Neb. 423, 196 N.W. 680 (1923) the court stated; "The rule is well settled that a principal cannot knowingly retain the benefits accruing from the unauthorized act of his agent and escape legal obligations, assumed by the agent in the name of the principal, from which the benefits accrue."

the indemnity contract, or, secure a letter from the principal stating the agent has authority to bind the principal to this contract of indemnity.

### 3. *Capacity of persons other than corporate agents and partners*

When an individual, other than an agent or a partner, executes an indemnity contract, questions relating to individual contract capacity arise; for example, the capacity of a married woman or of a minor to enter into an enforceable contract; or the capacity of either spouse to individually bind community property in those states which have adopted community property acts.

The common law restriction on a married woman's capacity to contract has been abrogated to various degrees by statute in most states.<sup>73</sup> In those states which have granted the married woman the capacity to contract as if she were unmarried, an indemnity contract executed by her would be enforceable against her separate estate.

The statutes of Nebraska, as now amended, state:

A married woman may bargain, sell, and convey her real and personal property. Such a woman may enter into any contract in the same manner, to the same extent, and with like effect as a married man. The obligations of her contracts shall be the same as a married man.<sup>74</sup>

Although there has been no case decided under the statute the legislative intent was to abrogate judicial refinements and restrictions found to exist in the previous statute.<sup>75</sup> Assuming this to

<sup>73</sup> For example, indemnity contracts executed by married women would be of probable validity in the following states: COLO. REV. STAT. § 90-2-10 (1953); IOWA CODE ANN. § 597.18 (1950); KAN. GEN. STAT. § 23-202 (1949); MINN. STAT. ANN. § 519.01 (1947); MO. STAT. ANN. § 451.290 (1952); OHIO REV. CODE § 3103.05 (1953); ORE. REV. STAT. § 108.010 (1957); SO. DAK. CODE § 14.0207 (1939); TEX. CIV. STAT. art. 4614 (Supp. 1958) if she elected to have sole management; WIS. STAT. ANN. §§ 6.015, 246.03 (1957); WYO. COMP. STAT. §§ 50-201, 202 (1946). In KY. REV. STAT. § 404.010 (1955) the husband must be joined in the instrument. Also in NEV. REV. STAT. § 124.010 (1957).

<sup>74</sup> NEB. REV. STAT. § 42-202 (Supp. 1957).

<sup>75</sup> The previous section stated: "A married woman, while the marriage relation subsists, may bargain, sell and convey her real and personal property, and enter into any contract with reference to the same in the same manner, to the same extent, and with like effect as a married man may in relation to his real and personal property." Under this statute, in the situation which this paper is about, where the consideration moves to a third party other than the wife, the

be so, a married woman could execute an indemnity contract binding her present estate and possibly her future estate.

In those states which have adopted community property acts,<sup>76</sup> difficult questions arise concerning the definition of community property and whether one spouse can bind community property by the execution of an indemnity contract. A discussion of these problems is beyond the scope of this paper.<sup>77</sup> It is suggested however that in those states the indemnitee secure the signature of both husband and wife on the indemnity contract.

If the indemnity contract is executed by a minor, insane or intoxicated person, the more common view is that the contract is voidable at the option of the indemnitor.<sup>78</sup> In a majority of jurisdictions, an infant's misrepresentation as to his age will not estop him from raising his lack of capacity as a defense,<sup>79</sup> although

indemnity contract in order to be binding, had to be made upon the faith of the separate estate of the married woman, and the burden of proof was on the party attempting to hold her liable; *State Nat'l. Bank v. Smith*, 55 Neb. 54, 75 N.W. 51 (1898). However, if the indemnity contract contained wording to the effect; "I or we, each of us, personally hereby charge our separate and individual estate with payment", the wife would be estopped from setting up evidence to the effect that she did not intend to bind her separate estate; *Sturn v. Lloyd*, 30 Neb. 89, 264 N.W. 150 (1936). But see *Fidelity & Deposit Co. v. Lapidus*, 136 Neb. 473, 286 N.W. 386 (1939) where the court held a covenant did not estop the wife. It was held that the contract would not bind the future estate of the married woman, but merely the present estate because she could not contract with reference to her future estate; *Kocher v. Cornell*, 59 Neb. 315, 80 N.W. 911 (1899). See an excellent article on the subject; Ginsburg, *Contractual Liability of Married Women in Nebraska*, 20 NEB. L. REV. 191 (1941).

<sup>76</sup> The following states have adopted community property acts; Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

<sup>77</sup> For an excellent discussion of the community property law in those states which have enacted community property laws, see *Community Property Symposium*, 15 LA. L. REV. 512 (1955).

<sup>78</sup> Although some of the older cases have made the statement that if the contract executed by a minor is prejudicial, such as a surety contract, it is void as distinguished from voidable; *Chandler v. McKinney*, 6 Mich. 216 (1859); *Green v. Wilding*, 59 Iowa 679, 13 N.W. 761 (1882), the better, and more recent view is that such contracts are merely voidable, and can be ratified upon reaching majority; *Pierce Co. v. Wallace*, 251 Mass. 383, 146 N.E. 658 (1925). The same rule is applicable to insane and intoxicated persons; *De Vries v. Crofoot*, 148 Mich. 183, 111 N.W. 775 (1907); *Carpenter v. Rogers*, 61 Mich. 384, 28 N.W. 156 (1886).

<sup>79</sup> See WILLISTON, *CONTRACTS* § 235 (1936).

a minority of states, some of which have enacted statutes, disallow such a defense.<sup>80</sup>

### C. CONSIDERATION

Consideration sufficient for an indemnity contract does not differ from consideration necessary to support any contract. The Restatement of Contracts defines consideration as:

(a) an act other than a promise, or (b) a forbearance, or (c) the creation, modification or destruction of a legal relation, or (d) a return promise, bargained for and given in exchange for the promise. (2) Consideration may be given to the promisor or to some other person. It may be given by the promisee or by some other person.<sup>81</sup>

If for example, the indemnitor is engaged in the lumber business, and executes the indemnity contract in reliance upon a promise by the contractor to buy lumber from him, the consideration for the indemnity contract is the bargained for promise of the contractor to buy lumber from the indemnitor.

In the more common situation, the consideration for the indemnity contract is the execution of the surety bond; i.e. the consideration for the promise to indemnify the surety company is the bargained for act of the surety company to execute the surety bond. It is in this situation, when the indemnity contract is executed subsequent to the execution of the surety bond, which presents the majority of problems concerning the sufficiency of consideration for an indemnity contract.<sup>82</sup> The cases can be divided into three main factual situations.

When the indemnity contract is executed subsequent to the execution of the surety bond, without any prior agreement by the contractor to secure an indemnitor, the indemnity contract is unenforceable because of lack of consideration.<sup>83</sup> The general

<sup>80</sup> *E.g.* IOWA CODE ANN. § 559.3 (1950): "No contract can be thus disaffirmed in cases where, on account of the minor's own misrepresentations as to his majority, or from his having engaged in business as an adult, the other party had good reason to believe him capable of contracting." Also see UTAH CODE ANN. tit. 15, ch. 2, § 3 (1953); WASH. REV. CODE tit. 26, ch. 28, § 070 (1956); see notes 16 U. CHI. L. REV. 183 (1948), 6 FORDHAM L. REV. 126 (1937).

<sup>81</sup> *Restatement, Contracts* § 75.

<sup>82</sup> See *Lack of Consideration—The Indemnitor's Defense*, 25 Ins. Counsel J. 294 (1958).

<sup>83</sup> See *Hartford Accident & Indemnity Co. v. Black*, 39 N.Y.S.2d 778, 265 App. Div. 524 (1943); *Davies County Bank & Trust Co. v. Wright*,

rule is stated in *Thompson v. Moe*.<sup>84</sup>

In the case now before us, the bond, as stated, was not supported by the original consideration for the contract . . . because it was something that arose subsequently and was not in contemplation of the parties at that time. It was necessary that it be supported by an independent consideration.<sup>85</sup>

There is no consideration for the indemnity contract in this situation because the alleged consideration, the execution of the surety bond, was not bargained for as the bond was executed before the indemnitor was asked to execute the indemnity contract. If the indemnity contract is erroneously dated prior to the execution of the surety bond, the parol evidence rule will not prevent the indemnitor from showing lack of consideration on the grounds that the indemnity contract was in fact executed subsequent to the execution of the surety bond.<sup>86</sup>

In the second situation, the prospective indemnitor notifies the surety prior to the execution of the surety bond that he will execute the indemnity agreement. Here, there is consideration for the indemnity contract even though it is executed subsequent to the execution of the surety bond.<sup>87</sup> For example, in *Title Guaranty & Surety Co. v. Packard-Spink Co.*<sup>88</sup> the court stated:

It is not necessary to its validity that a written agreement to indemnify against liability under a contract be executed simulta-

129 Ky. 21, 110 S.W. 361 (1908); *Rusk v. Johnston*, 19 Cal. App.2d 408, 63 P.2d 1167 (1937); *Greenwold Grift Co. v. Durham*, 191 Ga. 586, 13 S.E.2d 346 (1923); *First Nat'l. Bank v. Gibbs*, 84 Ind. App. 491, 141 N.E. 265 (1923); *Gloucester Mut. Fishing Ins. Co. v. Boyer*, 294 Mass. 35, 200 N.E. 557 (1936); *Tri-State Lumber & Shingle Co. v. Proctor*, 233 Mo. App. 1207, 128 S.W.2d 1116 (1939); *Kosson & Sons v. Harris*, 108 N.J.L. 162, 154 Atl. 726 (1931); *Van Beeber v. Vechill*, 166 Ore. 10, 109 P.2d 1046 (1941); *Harr v. Perkins*, 335 Pa. 186, 6 A.2d 534 (1939); dissent in *Cowles Pub. Co. v. McMann*, 25 Wash.2d 726, 172 P.2d 235 (1946).

<sup>84</sup> 147 Wash. 133, 265 P. 457 (1928).

<sup>85</sup> *Id.* 265 P. at 457.

<sup>86</sup> *Restatement, Contracts* § 238, Comment b.

<sup>87</sup> See *Cook v. Parker*, 22 Cal. App.2d 539, 71 P.2d 591 (1937); *Allison v. Sumner*, 210 Ill. App. 25 (1918); *Robertson v. Rowell*, 158 Mass. 94, 32 N.E. 898 (1893); *Eitel v. Farr*, 178 Mo. App. 367, 165 S.W. 1191 (1914); *Mass. Bonding & Ins. Co. v. Master Laboratories*, 143 Neb. 617, 10 N.W.2d 501 (1943); *Burt v. Gage*, 50 S.D. 208, 208 N.W. 985 (1926); *Williamson & Co. v. Ragsdale*, 170 Tenn. 439, 95 S.W.2d 922 (1936).

<sup>88</sup> 75 Wash. 178, 134 P. 812 (1913).



neously with the contract indemnified. It is enough that it be executed in compliance with the agreement whether at the time of the agreement or thereafter.<sup>89</sup>

In the third situation, the contractor gives his word that a certain named person will indemnify the surety, but that person is ignorant that his name has been given as an indemnitor. The surety company issues the bond and subsequently receives the indemnity contract executed by the named person. In this situation, the indemnitor can argue the alleged consideration for his indemnity contract, the execution of the surety bond, was not bargained for, and cannot therefore be considered for the indemnity contract. However, the cases hold otherwise.<sup>90</sup> The basis for the decisions is that since the contractor agreed to secure a certain person to execute an indemnity contract, that person in signing in fact carried out that agreement and must be conclusively presumed to have so intended when he signed.<sup>91</sup>

Although not supported or discussed by authority, it can be argued for the surety that the execution of the indemnity contract by the indemnitor was a novation. The Restatement of Contracts defines a novation as:

... a contract that (a) discharges immediately a previous contractual duty or a duty to make compensation, and (b) creates a new contractual duty, and (c) includes as a party one who neither owed the previous duty nor was entitled to its performance.<sup>92</sup>

The contractor had a duty to supply an indemnitor for the surety and the new liability of the indemnitor, a third party who owed no previous duty and was entitled to no previous performance, replaced the duty of the contractor to secure the indemnitor.

#### D. CONSTRUCTION OF THE INDEMNITY CONTRACT

The rules of construction applicable to any contract are equally applicable to indemnity contracts. Hence, the important factor is to determine the intention of the parties by considering the wording of the contract, the situation and circumstances surrounding

<sup>89</sup> *Id.* at 180, 134 P. at 813.

<sup>90</sup> See *Loveland v. Sigel-Companion Livestock Co.*, 77 Colo. 22, 234 P. 168 (1925); *Bowen v. Thwing*, 56 Minn. 177, 57 N.W. 468 (1894); *Devitt v. Foster*, 159 Miss. 687, 132 So. 182 (1931); dissent in *Cowles Pub. Co. v. McMann*, 25 Wash. 2d 726, 172 P.2d 235 (1946).

<sup>91</sup> *Bowen v. Thwing*, 56 Minn. 177, 57 N.W. 468 (1894).

<sup>92</sup> *Restatement, Contracts* § 424.

the formation of the contract and known customs of the trade.<sup>93</sup> In most jurisdictions, if the indemnity contract is capable of more than one interpretation, it will be strictly construed against the surety company on the policy that the surety company prepared the form and hence is responsible for any ambiguity<sup>94</sup> or that the indemnitor entered into the obligation without pecuniary compensation.<sup>95</sup> The contract will not be construed to enlarge upon the indemnitor's liability beyond that expressly provided for in the indemnity contract.

If the contract is ambiguous as to whether it indemnifies against loss as distinguished from liability, the courts tend to construe it to indemnify against loss.<sup>96</sup>

#### E. PUBLIC POLICY

Public policy affecting the validity of an indemnity contract in this four party situation would arise only when the persons executing the indemnity contract are the persons whom a statute intended to protect by requiring the surety bond. The issue presented is whether the statutory required protection was meant to protect the general public and therefore incapable of being waived by an indemnity contract.<sup>97</sup> In the analogous cases found, the courts hold the indemnity contract is valid and does not contravene public policy<sup>98</sup>

<sup>93</sup> For a general statement of the applicable rules of construction see *First Trust Co. v. Airedale Ranch & Cattle Co.*, 136 Neb. 521, 286 N.W. 766 (1939). Also see *Chideckel v. Dime Savings Bank*, 103 N.Y.S.2d 616 (1951); *Moriarty v. Tomlinson*, 58 S.D. 431, 235 N.W. 363 (1931).

<sup>94</sup> *Royal Indemnity Co. v. Gray*, 289 Ill. App. 367, 7 N.E.2d 358 (1937).

<sup>95</sup> See *Kramer v. Linz*, 73 S.W.2d 648 (Tex. Civ. App. 1934); *Mfg. & Merchants Building & Loan Ass'n. v. Willey*, 321 Pa. 340, 183 Atl. 789 (1936); *Halliburton Oil Well Cementing Co. v. Paulk*, 180 F.2d 79 (5th Cir. 1950); *Barratt v. Greenfield*, 137 Pa. Super. 310, 9 A.2d 188 (1939). *Contra*, *Fidelity & Deposit Co. v. Thieme*, 193 So. 496 (1940).

<sup>96</sup> See *Lyle v. McCormick Harvesting Co.*, 108 Wis. 81, 84 N.W. 18 (1900); *Stuart v. Carter*, 79 W.Va. 92, 90 S.E. 537 (1916); *State v. Mills*, 23 N.M. 549, 169 P. 1171 (1917).

<sup>97</sup> See Annot., 154 A.L.R. 838 (1945).

<sup>98</sup> *E.g.*, *Allen v. Commercial Casualty Ins. Co.*, 131 N.J.L. 475, 37 A.2d 37 (1944); *Nat'l. Auto Ins. v. Winter*, 58 Cal. App.2d 11, 136 P.2d 22 (1943).

### III. THE INDEMNITOR'S LIABILITY

The circumstances affecting the accrual and extent of the indemnitor's liability will be discussed in this section. Those matters which will completely discharge the indemnitor are discussed in a subsequent section.

#### A. EXTENT OF LIABILITY

There are many things which will affect the amount of the indemnitor's liability. For example, acts by the surety which prejudice the indemnitor may reduce the amount which the indemnitor is required to pay the surety; the amount recovered by the creditor in a judgment against the surety may be conclusive as against the indemnitor. Although some of the factors discussed do not vary the amount recoverable, they do affect the ultimate recovery against the indemnitor.

##### 1. *Judgment against surety as conclusive evidence of amount*

Whether a judgment against a surety on a bond is conclusive as to the determination and extent of the indemnitor's liability is dependent on 1) whether the indemnitor predicated his liability on litigation, and if not, 2) whether the surety notified the indemnitor of the pending action and gave the indemnitor a chance to defend.

The indemnity contract, in order to make the indemnitor's liability conclusively dependent on a judgment against the surety, must expressly so provide,<sup>99</sup> and a general provision that the indemnitor will indemnify the surety against any loss incurred because of the execution of the surety bond will not make such judgments conclusive.

<sup>99</sup> For example, In *United States Fidelity & Guaranty v. Jones*, 87 F.2d 346 (5th Cir. 1937) the bond contained the following provision: ". . .the vouchers or other evidence of payments made by the company under its obligation of suretyship shall be conclusive evidence of the fact and extent of the liability of the undersigned to said company under said obligation. . .whether said payments were. . .incurred in investigation of a claim made thereon, adjusting a loss or claim in connection therewith. . .and whether voluntarily made or paid after suit and judgment." A payment under this contract was conclusive against the indemnitor. In *Halstead Lumber Co. v. Hartford Accident & Indemnity Co.*, 38 Ariz. 228, 298 P. 925 (1931) the court construed a similar contract provision and stated; "If the money was actually paid, the only way in which it can be attacked by the indemnitor is through a plea and proof of bad faith in the payment."

In absence of an express provision in the indemnity contract, judgments against the surety are not conclusive against the indemnitor unless he was notified of the pending action and given a chance to defend, or the defense which the indemnitor is attempting to raise was necessarily decided in the prior action. For example, in *United States Fidelity & Guaranty Co. v. Paulk*,<sup>100</sup> a surety executed a payment bond for a contractor on a construction job relying on an indemnity agreement executed to the surety by a third person. Without the knowledge of the surety or the indemnitor, the contractor and creditor materially altered the construction contract. After completion of the altered contract the creditor filed suit against the contractor and surety for unpaid labor and material accounts. The surety failed to give the indemnitor notice of the action. The surety did not raise the defense of material alteration of contract and judgment was entered against the surety. The surety then brought action against the indemnitor for the amount of the prior judgment against the surety. The indemnitor alleged the surety had a good defense in the prior action; i.e. material alteration of the construction contract without the consent of the surety. The court held for the indemnitor, stating:

. . . according to the weight of authority, as a general rule, where the indemnitor has not been notified of the prior suit and has not made his liability over depend expressly on the event of a litigation to which he was not a party and has not stipulated to abide by the judgment of the suit, estoppel is not created by the judgment therein and such judgment does not become conclusive evidence of the ultimate liability over to the defendant therein. It is regarded as prima facie evidence of the fact of its rendition and the amount of damages.<sup>101</sup>

In a Nebraska case, *National Surety Co. v. Love*,<sup>102</sup> the court in holding the indemnitor could not defend on the grounds that the surety had a good defense in the prior action when the surety had raised that defense and the issue had been decided, stated:

From the general tenor of the authorities bearing upon this question we are inclined to the view that the judgment, though rendered without notice to the indemnitor, was conclusive as to the facts necessarily taken into consideration by the Oregon court in arriving at the judgment, where it appears that the defense sought to be interposed by the indemnitor to show his non-liability upon the cause of action on which the judgment was based, had in good faith been presented by the indemnitee in the

<sup>100</sup> 15 S.W.2d 100 (Tex. Civ. App. 1929).

<sup>101</sup> *Id.* 15 S.W.2d at 103.

<sup>102</sup> 105 Neb. 855, 182 N.W. 490 (1921).

action wherein the judgment rendered, and there is no plea of fraud or collusion.<sup>103</sup>

If the surety had notified and given the indemnitor a chance to defend the pending action, the judgment would be conclusive against the indemnitor even though the surety had not raised good defenses available in the prior action:

Unless an express contract of indemnity provides otherwise, it is not necessary, in order to maintain an action against an indemnitor to recover for a liability which has been determined in a prior action against the indemnitee, that the indemnitor should have been notified of the suit against the indemnitee. But unless notice is given the first judgment is prima facie evidence only of liability and the indemnitor may show the indemnitee had a good defense which he neglected to set up.<sup>104</sup>

Hence, where the indemnity contract has no provision making the indemnitor's liability dependent on a judgment against the surety, 1) if the surety notified and gave the indemnitor a chance to defend the pending action, a judgment against the surety is conclusive as to existence and extent against the indemnitor, or 2) if the surety did not notify the indemnitor, in Nebraska the judgment is conclusive as to matters necessarily decided in the prior action.<sup>105</sup> If neither of the above apply, then the judgment is merely prima facie evidence of the indemnitor's liability, and the surety can recover only the loss and damage proved.<sup>106</sup>

## 2. *Whether contract is a continuing one?*

If the indemnity contract does not expressly cover subsequent bonds executed by the surety for the same principal, the question is whether from the wording of the contract and surrounding circumstances the parties intended this to be a continuing indemnity contract. Illustrating some of the surrounding circumstances pertinent in resolving the question is the statement in *Employers' Liability Assurance Corp. v. Tebbs*:<sup>107</sup>

Reading the indemnity bond in its entirety and particularly those words 'and other obligees' and taking into consideration all the evidence, facts and circumstances, including the poor financial rating of the defendant . . . at the time the indemnity bond was

<sup>103</sup> *Id.* 862, 182 N.W. at 492. But see note 105, *infra*.

<sup>104</sup> *op. cit. supra* 859, 182 N.W. at 492.

<sup>105</sup> See notes, 12 IOWA L. REV. 426 (1927); 18 VA. L. REV. 556 (1932); *Restatement, Judgments* § 107(a).

<sup>106</sup> *Kramer v. Linz*, 73 S.W.2d 648 Tex. Civ. App. 1934).

<sup>107</sup> 137 F. Supp. 869 (D. Wyo. 1956).

executed and also the fact that his financial condition had not been enhanced by the first contract, together with his request for a second bond without making any suggestion as to further indemnity, I am inclined to believe that it was the intention of the parties at the time the indemnity bond was executed that it was to be considered as a continuing bond for the protection of the plaintiff in any future contract bonds which it might issue on behalf of the defendant . . .<sup>108</sup>

In absence of a provision in a continuing contract, it will remain in force a reasonable time.<sup>109</sup>

### 3. *Surety's duty to minimize indemnitor's damages*

The surety has a duty to take reasonable precautions to minimize the indemnitor's loss. If greater damage is caused by a surety's failure to take reasonable precautions, the amount by which the damages were increased are not recoverable from the indemnitor.<sup>110</sup> For example, in *Columbia Casualty Co. v. Tibma*,<sup>111</sup> the Highway Improvement Company entered into a contract with the State Highway Commission for the construction of a road. The company subcontracted part of the work out to Barcus, requiring the subcontractor to provide a performance bond. The surety company executed the performance bond relying on an indemnity contract executed by a third party. Prior to October 1, 1925, the principal contractor notified surety that Barcus's manner of work was not satisfactory and there might be liability under the bond. Shortly thereafter, surety's agents inspected the work for the first time and reported to the indemnitor's attorney that Barcus was getting along as well as could be expected and they were sure the contract would work itself out without liability to anyone. The indemnitor's attorney notified surety that Barcus was not qualified to handle the job and would have to be watched. On April 22, 1926, indemnitor's attorney discovered the principal contractor had done a considerable amount of Barcus's work at exorbitant prices and was threatening to take over the entire con-

<sup>108</sup> *Id.* at 871.

<sup>109</sup> *Employers Liability Assurance Corp. v. Tebbs*, 137 F. Supp. 869 (D. Wyo. 1956).

<sup>110</sup> See *Calamita v. De Ponte*, 122 Conn. 20, 187 Atl. 129 (1936); *Northern Welding Co. v. Jordan*, 150 Minn. 12, 184 N.W. 39 (1921) where the court stated the general rule: "It was the duty of the corporation to use reasonable care and diligence to minimize its damages. No particular course can be mapped out as the proper one unless it can be shown that such course would be the only one which a reasonably prudent and diligent person would pursue."

<sup>111</sup> 63 F.2d 538 (7th Cir. 1933).

tract. Informing the surety of these facts he requested a responsible man take over the job, and denied any liability on the indemnity contract because the surety had failed to take any steps to minimize the indemnitor's liability. The surety had the job completed and sued the indemnitor. The court, in denying full recovery, stated:

. . . the law imposed upon appellant the duty, when it learned of default or threatened default under its bond, to exercise diligence to keep the loss as low as possible, and that it could not stand idly by and permit loss to accrue and mount and then collect in full from the indemnitor.<sup>112</sup>

#### 4. *Surety's right to settle claims*

If the indemnitor provides in the indemnity contract that the indemnitee has authority to settle any suits brought against it on the suretyship obligation the indemnitor can attack a settlement only on the basis of fraud. For example, in *Halstead Lumber Co. v. Hartford Accident & Indemnity Co.*,<sup>113</sup> the court construed the following contract provision:

That in any accounting which may be had between the Under-signed and the Surety, the Surety shall be entitled to charge for any and all disbursements and about the matters herein contemplated made by it in good faith, under the belief that it is or was liable for the sum and amounts so disbursed, or that it was necessary or expedient to make such disbursements, whether or not such liability, necessity, or expediency existed.

On the basis of this provision the court stated: "If the money was actually paid, the only way in which it can be attacked by the indemnitor is through a plea and proof of bad faith in payment."<sup>114</sup>

Where there is no specific provision allowing the indemnitee to settle claims against it, the indemnitee has a right to settle the claim in good faith if the indemnitor after notification of the pending action refuses to defend and denounces all liability.<sup>115</sup> In *Chicago R.R. v. Dobry Flour Mills*,<sup>116</sup> the court stated:

. . . where the indemnitor denies liability under the indemnity contract and refuses to assume the defense of the claim then

<sup>112</sup> *Id.* at 541.

<sup>113</sup> 38 Ariz. 228, 298 P. 925 (1931).

<sup>114</sup> *Id.* 298 P. at 928.

<sup>115</sup> See authority cited in *Chicago R.R. v. Dobry Flour Mills*, 211 F.2d 785, 788 (10th Cir. 1954).

<sup>116</sup> 211 F.2d 785 (10th Cir. 1954).

the indemnitee is in full charge of the matter and may make a good faith settlement without assuming the risk of being able to prove absolute legal liability or the actual amount of the damage. A contrary rule would make the right to settle meaningless in cases where the indemnitor has denied liability.<sup>117</sup>

#### 5. *Indemnitor's liability for attorney fees and costs*

Where reasonable attorney fees are incurred in an action seeking indemnification, the law implies a right to recover them plus costs.<sup>118</sup> When an action is brought by the surety to recover attorney fees incurred in a prior action against the surety, in absence of specific provision in the indemnity contract, the courts generally construe the contract to include reasonable attorney fees if they are not unnecessarily incurred.<sup>119</sup> However, in *Queen City Coach Co. v. Lumberton Coach Co.*,<sup>120</sup> the court held an agreement to indemnify against any loss occasioned by the operation of motor vehicles over a franchise route did not cover attorney fees incurred in a successful defense. Whether notice to the indemnitor of the pending action against the surety is a prerequisite to recovering attorney fees is uncertain.<sup>121</sup>

#### B. ACCRUAL OF LIABILITY

To determine the question of when liability accrues, indemnity contracts are generally divided into two classifications:<sup>122</sup> 1) in-

<sup>117</sup> *Id.* 788.

<sup>118</sup> See *Hartford Accident & Indemnity Co. v. Cassanassa*, 301 Mass. 246, 16 N.E.2d 860 (1938); *Sigmond Rothchild Co. v. Moore*, 166 S.W.2d 744 (Tex. Civ. App. 1942); *Pure Oil Co. v. Goetechnical Corp.*, 129 F. Supp. 194 (E.D. La. 1955); must be a reasonable amount, *Girard Fire and Marine Ins. Co. v. Koenigsberg*, 65 S.W.2d 783 (Tex. Civ. App. 1933).

<sup>119</sup> For example, *United States Fidelity & Guaranty Co. v. Garrett*, 156 S.C. 132, 152 S.E. 772 (1930).

<sup>120</sup> 229 N.C. 534, 50 S.E.2d 288 (1948).

<sup>121</sup> Compare dictum in *United States Fidelity & Guaranty v. Garrett*, 156 S.C. 132, 152 S.E. 772 (1930): "Conceding the rule to be that an indemnitee who is sued on a claim covered by an indemnity agreement may not recover from the indemnitor the attorney's fees paid by him in defending the suit, unless he has notified the indemnitor to defend against the claim and the indemnitor has refused . . ." with *United States Fidelity & Guaranty Co. v. Paulk*, 15 S.W.2d 100 (Tex. Civ. App. 1929), where the court went on the basis of collateral estoppel and fact that the indemnitor had made his liability dependent on litigation.

<sup>122</sup> In *Alberts v. American Casualty Co.*, 88 Cal.App.2d 891, 200 P.2d 37 (Cal. App. 1948) the court distinguished between the two types of



demnity against liability and 2) indemnity against loss or damage. The classification which a particular contract falls within is dependent on the wording. If the contract is ambiguous or not clear as to which classification it should come within, the courts tend to construe it to be a contract of indemnity against loss.<sup>123</sup>

### 1. *Indemnity against liability*

When the indemnitor agrees to indemnify the indemnitee (surety) against "claims or demands"; "before the indemnitee shall be compelled to pay the same"; or "when the indemnitee becomes liable" or similar wording, it is an agreement to indemnify against liability. On this type of indemnity contract, the indemnitee's cause of action accrues when the liability of the indemnitee becomes fixed,<sup>124</sup> in absence of a provision in the contract that the indemnitee's liability is fixed when demand is made on the indemnitee.<sup>125</sup> It is at this time the statute of limitations begins to run.<sup>126</sup>

### 2. *Indemnity against loss or damage*

If the contract is one of indemnity against loss, an action against the indemnitor does not arise until the indemnitee suffers

indemnity contracts: "There are two classes of contracts of indemnity. In one class the indemnitor engages to save the indemnitee from loss, meaning actual loss. In the other class the indemnitor engages to save the indemnitee from liability. In the first class the indemnitee must prove loss actually suffered by him. . . . In the second class the indemnitee need not prove actual loss but only that he has become liable. The indemnitee may, without having paid anything, recover from the indemnitor as soon as liability is legally imposed." See also *Ramey v. Hopkins*, 138 Cal. App. 685, 33 P.2d 443 (1934).

<sup>123</sup> *Solary v. Webster*, 35 Fla. 363, 17 So. 646 (1895); *Valentine v. Wheeler*, 122 Mass. 566, 23 Am. Rep. 404 (1876); *Miller v. Fries*, 66 N.J.L. 377, 49 Atl. 674 (1901).

<sup>124</sup> In *Alberts v. American Casualty Co.*, 88 Cal. App.2d 891, 200 P.2d 37 (1948) the court stated: "Liability is established upon the rendition of a judgment against the indemnitee with respect to the thing indemnified although the judgment remains unpaid."

<sup>125</sup> For example, in *MacArthur Bros. Co. v. Kerr*, 213 N.Y. 360, 107 N.E. 572 (1915) the contract provided: ". . . further covenant and agree to pay to said company or its representative all damages for which said company or its representatives shall become responsible upon said bond or undertaking before said company or its representatives shall be compelled to pay the same . . . ." See also, *Chermin v. International Oil Co.*, 261 Wis. 543, 53 N.W.2d 425 (1952); *King v. Capitol Amusement Co.* 222 Ala. 115, 130 So. 799 (1930).

<sup>126</sup> NEB. REV. STAT. § 25-206 (Reissue 1956); the action must be brought within 5 years.

loss, and the statute of limitations does not commence running until that time.<sup>127</sup> The problem is determining when the indemnitee has suffered loss.

In *Thermopolis Northwest Electric Co. v. Ireland*,<sup>128</sup> the court held loss accrued under the wording of the indemnity contract when the indemnitee compromised and settled a suit against it. In *State v. Mills*,<sup>129</sup> the indemnitor requested a surety to execute a depository bond in favor of the state. The bank failed and the state recovered judgment against the surety. Before the state levied execution against the surety on the judgment, the surety went bankrupt. The state, seeing it was useless to levy execution, failed to enforce the judgment. The state then brought an action against the indemnitor on the theory that they were subrogated to the surety's rights on the indemnity contract. The court held that the contract was one of indemnity against loss and the surety had lost nothing, stating:

Where a stranger undertakes to indemnify a surety, such undertaking does not create a trust in favor of creditors, nor can they be subrogated to the surety's rights, and likewise, where a stranger undertakes to indemnify a surety, and the surety thereafter becomes bankrupt so that it cannot pay any of its suretyship obligations . . . the legal representatives of such surety cannot enforce the indemnity because such surety lost nothing, and was not damaged and cannot be damnified by such judgment.<sup>130</sup>

Under the theory of the holding, it would not have changed the decision even if the state had levied execution against the surety.

If the indemnitor agrees to indemnify the surety against both loss and liability, the statute of limitations does not commence to run on the part against loss until the indemnitee has actually

<sup>127</sup> See *Cody v. Gaynes*, 110 N.Y.S.2d 633 (1952); *Borek v. Bazarewski*, 21 N.Y.S.2d 916 (1940); *Ramey v. Hopkins*, 138 Cal. App. 685, 33 P.2d 443 (1934) where the bond provision was: ". . . if the principal shall indemnify the obligee against any loss or damage directly arising by reason of the failure of the principal to faithfully perform said contract, then this obligation shall be void; otherwise to remain in full force and effect." In respect to this provision the court stated: "The distinction between an undertaking against 'liability' and the strict contract of indemnity against 'loss' is that between contracting that an event shall not happen, and contracting to indemnify against the consequences of the event if it should happen."

<sup>128</sup> 119 F.2d 409 (10th Cir. 1941).

<sup>129</sup> 23 N.M. 549, 169 P. 1171 (1917).

<sup>130</sup> *Id.* 556, 169 P. at 1173.

suffered loss even though the statutory time has run against the indemnity against liability.<sup>131</sup>

Under the general contract rule, if the indemnitor agrees to do something other than indemnify the surety, for example, advance money or security for contingent claims against the indemnitee, a breach of the material covenant gives the indemnitee an immediate right of action. The general rule is stated in *Stuart v. Carter*:<sup>132</sup>

Whether an action lies or not, depends upon the true intent and meaning of the covenant; if it is simply to indemnify, and nothing more, then damages must be shown, before the plaintiff can recover; but if there is an affirmative covenant to do a certain act, or pay certain sums of money, then it is no defense in such an action to say that the plaintiff has not been damnified . . . Where indemnity alone is expressed, it has always been held that damage must be sustained before a recovery can be had; but where there is a positive agreement to do the act which is to prevent damage to the plaintiff, then action lies, if the defendant neglects or refuses to do such act.<sup>133</sup>

#### IV. DISCHARGE OF THE INDEMNITOR

The general question discussed in this section is what acts by the surety will discharge the indemnitor? The criterion used in the few cases discussing the question seems to be whether the surety's act prejudices the indemnitor or increases his risk.<sup>134</sup> The situations where the question has arisen are analogous to the situations in which the question is what acts of a creditor will discharge the surety. For example, extension of time for performance or payment by the surety without the consent of the indemnitor; alteration of the principal contract without the con-

<sup>131</sup> See *Aetna Casualty & Surety Co. v. Bros.*, 226 Minn. 466, 33 N.W.2d 46 (1948) where the indemnity contract contained the following provision: "... the indemnitors will pay over to the surety . . . all sums of money which it . . . shall pay or cause to be paid, or become liable to pay on account of such suretyship . . . such payment to be made to the surety as soon as it shall have become liable therefore . . . ." This was held to be indemnity against both liability and loss.

<sup>132</sup> 79 W.Va. 92, 90 S.E. 537 (1916). See also *Fidelity & Casualty Co. v. Angle*, 243 N.C. 570, 91 S.E.2d 575 (1956); *Loewenthal v. McElroy*, 181 Mo. App. 399, 168 S.W. 813 (1914).

<sup>133</sup> *Stuart v. Carter*, 79 W.Va. 92, 96, 90 S.E. 537, 539 (1916).

<sup>134</sup> E.g., *United States Fidelity & Guaranty Co. v. Putfark*, 180 La. 893, 158 So. 9 (1934): "It is a general rule of law that any act on the part of an indemnitee which materially increases the risk, or prejudices the rights of the indemnitor, will discharge the indemnitor under the contract of indemnity."

sent of the indemnitor; failure to proceed against the principal debtor. This can be explained on the basis that the surety's third party indemnitor, after payment to the surety, in fact becomes a surety.<sup>135</sup> Hence, there is a correlation between acts which prejudice an indemnitor and acts which prejudice a surety.

#### A. EXTENSION OF TIME

When the surety consents to an extension of time for payment or performance by the principal debtor without the consent of the surety's indemnitor, the few cases discussing the question hold the indemnitor is not discharged.<sup>136</sup> In reaching this conclusion in *German-American State Bank v. Bear*,<sup>137</sup> the court stated:

The extension of the time for the payment of the notes did not alter the terms of the indemnity contracts, and did not change the liability of the defendant there under.<sup>138</sup>

It should be noted that in this situation the rule applied to indemnitors is different from that applied to a surety.<sup>139</sup>

#### B. MODIFICATION OF THE PRINCIPAL DEBTOR'S CONTRACT

It has been held that if the surety consents to a material modification of the contract<sup>140</sup> which he has guaranteed, an indemnitor of the surety who has not consented to the modification is discharged.<sup>141</sup> Although the court did not state the rationale used for the result reached, it is submitted that the rationale used to determine whether a surety is discharged by a modification of the principal contract is applicable. Hence, any modification of the principal debtor's contract will discharge the indemnitor either on the theory that the modification increased his risk, or infringed

<sup>135</sup> *Restatement, Security* § 82 comment 1.

<sup>136</sup> See *Northcott v. Nieman*, 117 W.Va. 313, 185 S.E. 217 (1936); *Watanabe v. Ota*, 137 Wash. 368, 242 P. 379 (1926); See Annot., 43 A.L.R. 1368 (1926).

<sup>137</sup> 111 Kan. 193, 206 P. 902 (1922).

<sup>138</sup> *Id.* at 194, 206 P. at 903.

<sup>139</sup> STERNS, SURETYSHIP § 6.16 (1951).

<sup>140</sup> See *Restatement, Contracts* § 435.

<sup>141</sup> In *Kelsey Lumber Co. v. Rotsky*, 178 S.W. 837 (Tex. Civ. App. 1915) the court stated: "The thousand dollars was deposited with the Surety Company to indemnify it as surety upon the bond of Helm under the first contract. Without the consent of Presley and John-

on his rights.<sup>142</sup> It is questionable whether the rule that a non-compensated surety is discharged by any modification even though beneficial to him will be applied to a third party indemnitor.

#### C. SURETY'S FAILURE TO PROCEED AGAINST THE PRINCIPAL DEBTOR

It is not a condition precedent to recovery from the indemnitor, unless so stipulated in the contract, that the surety first proceed against the principal debtor. The rule was stated in *United States Fidelity & Guaranty Co. v. Bank of Hattiesburg*.<sup>143</sup>

Clearly, therefore, this is an indemnity contract. And, in the absence of any express agreement it was not a condition precedent to recovery that appellant, indemnitee, should have first sought reimbursement for the loss sustained from the principal debtor.<sup>144</sup>

Since there is no duty to proceed against the principal debtor as a condition precedent to proceeding against the indemnitor, in *Fidelity & Deposit Co. v. O'Bryan*,<sup>145</sup> the court held that the failure to proceed against the principal debtor within a reasonable time does not discharge the indemnitor. The court stated:

Under the law, as we understand it, the laches or negligence of the indemnitee that will release the indemnitors on a bond of indemnity conditioned like the one here in question must be the direct result of some act or conduct on the part of the indemnitee but for which he would have suffered any loss. In other words, when the indemnitee is sought to be made liable on his undertaking, he must not, by his laches or negligence, put upon the indemnitors a burden they would not otherwise be compelled to bear, but his duty does not go to the extent of obliging the indemnitee to bring suit against his principal or their parties to protect the indemnitors or to take any steps to recover from his principal or their parties the fund for which he has become liable on his undertaking. It is the business of the indemnitor to resort, for their own protection, to remedies like these if they desire to do so.<sup>146</sup>

There are many other situations which might discharge the indemnitor. For example, change in the principal's identity; fail-

son (indemnitors) the Surety Company entered into the second contract, and both buildings were constructed as under one contract. This is such an alteration as would release Presley and Johnson." Also see Annot., 43 A.L.R. 1372 (1926).

<sup>142</sup> SIMPSON, SURETYSHIP § 72 (1950).

<sup>143</sup> 128 Miss. 605, 91 So. 344 (1922).

<sup>144</sup> *Id.* 91 So. at 346.

<sup>145</sup> 180 Ky. 277, 202 S.W. 645 (1918).

<sup>146</sup> *Id.* 287, 202 S.W. at 646.

ure of the surety to disclose material facts known about the principal and not known by the indemnitor; alteration by the surety of the instrument expressing the principal debtor's obligation without the knowledge of the indemnitor. The author could find no cases discussing these questions, however, it is submitted the answers may be similar to those that would be reached under the law of suretyship.

#### V. CONCLUSION

The discussion does not attempt to cover all of the problems raised in the surety-third party indemnitor relationship, many of which are undecided. In approaching the problems, it should be remembered that the surety-creditor relationship is similar in many respects to the surety-indemnitor relationship, and in some areas such as where the question is whether the indemnitor is discharged, the rationale and arguments applicable to the former have been applied to the latter.

*Robert K. McCalla, '61*