TENTH ANNUAL
NORTHEAST SURETY AND FIDELITY CLAIMS CONFERENCE

OCTOBER 21 - 22, 1999

THE SURETY'S SET OFF AND RECOUPMENT RIGHTS

PRESENTED BY:

MATTHEW M. HOROWITZ
WOLF, HOROWITZ, ETLINGER, CASE & RAY, LLC
241 MAIN STREET
HARTFORD, CONNECTICUT 06106
(860) 724-6667
(860) 293-1979

THE SURETY'S SET OFF AND RECOUPMENT RIGHTS

Introduction

As a secondary obligor, a surety's liability on a payment or performance bond should not be in excess of that of its principal.[1] As a corollary, sureties typically assume that they may assert against a payment or performance bond claimant any defense that would be available to their principal.[2] Sureties further assume that the scope of these available "defenses" should include the right to assert as set offs its principal's claims against the claimant either related to or unrelated to the bonded obligation. This expectation on the part of sureties reflects the fact that, in the absence of a right to claim such offsets as a defense to a claim, the surety could potentially owe more to a claimant than the claimant would have otherwise recovered from the principal. Moreover, if a claimant's recovery against a surety did not account for the principal's claims against the claimant, the surety would seek to account for its principal's claims through such devises as securing an indemnity judgment against its principal and attaching the debt allegedly owed to the principal by the claimant or suing the claimant directly in a second proceeding on its principal's claims, asserting the right to do so as either its principal's subrogee or assignee. Sureties typically assume that the law does not require such circuitry.

While these expectations on the part of sureties typically prove accurate, the reality, as with the application of any proposition of law in a specific context, is that "the devil is in the details." Put another way, the reality is not always consistent with the surety's justifiable expectations either because there may be legal rules that prohibit the surety from asserting a defense of its principal or because of legal rules that preclude both the surety and the principal from asserting what could potentially be valid defenses in whole or part.

This paper is in two parts. The first section will explore limitations on a surety's right to itself assert the defenses and claims of its principal in response to payment and performance bond claims. The second section will address a subset of the first; the surety's right to compel an obligee under a subrogation theory to offset against its performance bond claims the bonded principal's claims against the obligee on unbonded projects. Both sections will explore these issues from the perspectives of the availability of such defenses under surety law and in light of more general legal principles relating to security interests, set-offs and civil procedure.

In addressing these issues, this paper will draw a distinction between "recoupment" and "set-off." A defendant's demand for "recoupment" arises out of the same transaction which is the subject matter of the plaintiff's complaint and has as its objective the defeat of the plaintiff's claim in whole or part based on the plaintiff's failure to fully comply with its legal obligations.[3] For instance, a surety asserts "recoupment" in response to a payment

---

[1] 74 Am.Jur.2d, Suretyship § 104 at p. 76. See U.S. ex.rel. Hussman Corp. v. Fidelity & Deposit Co., 999 F.Supp. 734, 747-48 (D.N.J. 1998) ("Hussman").

[2] 72 C.J.S., Principal and Surety, § 189 at p. 318. See Hussman, supra, 999 F.Supp. at 747-48.

[3] 20 Am. Jur.2d, Counterclaim, Recoupment § 5 at p. 231. See United Structures v. G.R.G. Engineering, 9 F.3d 996, 998 (1st Cir. 1993) ("United Structures"); Newberry Corp. v. Fireman's Fund Insurance Co., 95 F.3d 1392, 1398-40 (9th Cir. 1996); United States v. Summ, 282 F.Supp. 628, 630-31 (D.N.J. 1968); Howard v. Abernathy, 751 S.W.2d 432, 434 (Tenn.Ct.App. l988). For cases which address whether a defense arises out of the same

bond claim where it alleges that the amount owed to the claimant for services performed but unpaid for should be reduced by the damages incurred as a consequence of the delays on the Bonded Project for which the claimant bears responsibility. In contrast, a demand for "set-off" poses as a defense an obligation owed by the claimant to the principal on a separate project or transaction; for instance, the surety's claim that the $10,000 owed for work performed by the claimant for the principal on the "Bonded Project" should be reduced by the $5,000 owed to the principal by the claimant for the claimant's defective work on the "Unrelated Project."[4]

As discussed more fully below, a surety defending a payment or performance bond claim faces a far easier task in asserting related claims as recoupment defenses as opposed to "unrelated" set-offs.

Analysis

I. The Surety's right to assert the defenses and setoff and recoupment rights of its principal.

A. Suretyship Principles

The Restatement of Security generally recognizes that the surety has the right to assert the defenses of its principal in response to a claim under a payment or performance bond.[5]

§ 133 of the Restatement of Security states as follows in regard to the Surety's rights to set-off the claims of its principal:

> (2) The surety cannot set-off against the creditor the principal's claims against the creditor unless:
>
> (a) the principal has assigned his claim to or consented to its use by the surety; or
> (b) the principal is made a party to the action instituted by the creditor; or
> (c) the principal is insolvent.[6]

These limitations reflect the commentators' concerns that either the principal or the obligee could be unfairly prejudiced by the Surety's unregulated assertion of the principal's set-offs.[7] For instance, the commentators posit the risk that the surety's assertion of the principal's set-off claims in the absence of the principal's participation or consent could

---

transaction as the plaintiff's case in chief, see Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 299 (1946); Vari-Build, Inc. v. City of Reno, 622 F. Supp. 97 (D. Nev. 1985).

[4] Id. See 20 Am. Jur.2d, Counterclaim, Recoupment § 6 at p. 232-4. Claims in the nature of set-offs will be referred to, infra, as "set-offs" or, alternatively, as "Unrelated Claims."

[5] See generally Restatement of Security §§ 126, 128, 133.

[6] Restatement of Security § 133 (2).

[7] Restatement of Security § 133, Comment on Subsection (2).

allow the principal to later seek affirmative relief against the obligee based on these claims, putting the obligee at risk of a kind of double jeopardy.[8]

Alternatively, the commentators posit a situation where the principal's claim asserted by the surety as a set-off is for an amount well in excess of the obligee's claim against the surety.[9] Allowance of the set off in favor of the surety might bar the principal from pursuing a subsequent action against the obligee. Moreover, if the set off claim was worth meaningfully less to the surety than the principal, the surety may not have the same incentive as the principal to aggressively litigate the claim.

The Restatement of Security accommodates these concerns by requiring, as a prerequisite to the surety asserting its principal's set-offs, that the principal must either assign the set-off claim to the surety or the principal must consent to the surety's assertion of the claim as a defense, or the surety must make the principal a party to the action against it brought by the obligee.[10]

In most cases, these surety rules should not prove to be insurmountable obstacles to a surety asserting the claims of an uncooperative principal, given the liberal joinder rules in the federal and most state courts and the fact that many general indemnity agreements provide for assignments of a principal's claims on Unrelated Projects in the event of claims or losses on bonded projects . However, there are reported decisions denying a surety's attempt to assert its principal's unrelated, set-offs in response to a bond claim.[11] This problem will primarily arise where either the principal is outside of the jurisdiction of the court in which the claimant is suing the surety or the principal is pursuing its claim against the claimant in a separate, existing action and the court is unwilling to have all of the claims litigated in a single action.

Though the scope of § 133 of the Restatement of Security seems to be limited on its face to the Surety's set-off rights, the assertion of claims from Unrelated Projects, many courts have also applied these rules to the surety's recoupment defenses, the assertion of the principal's claims from the Bonded Project.[12] While recognizing the surety's rights to

---

[8] Id.

[9] Id.

[10] Id. The Restatement does not require these accommodations in the event that the principal is insolvent. The commentators conclude that an insolvent principal is unlikely to be injured by the surety's unilateral assertion of its claims and that whatever risk of prejudice may exist is outweighed by the surety's interests in asserting the set off and its likely inability to secure the consent or participation of an insolvent principal. See In re Yale Express Systems, Inc., 362 F.2d 111 (2d Cir. 1966). For a thorough discussion of a Surety's right to assert the set-off and recompment defenses of an insolvent principal, See Schexnayder, "The Surety's Right to Assert Recoupment and Set-off defenses of its Principal, when the Principal has filed for Bankruptcy Protection," Surety Claims Institute, June 1997.

[11] See Thornton Construction Co. v. United States Fidelity & Guarantee Co., 8 Mich. App. 540, 154 N.W.2d 532 (1967); Whaley v. Henderson, 143 So. 848 (Ala. l933). See also In re Yale Express Systems, Inc., 362 F.2d 111 (2d Cir. 1966); United States v. P.J. Walker Construction Co., 24 F.R.D. 136 (S.D. Cal. 1959).

[12] See Saxis Steamship Co. v. Multifacs International Traders, Inc., 375 F.2d 577 (2d Cir. 1967); Rhode Island Hospital Trust v. Martin Trust, 1992 Ct.Sup. 1844 (1992); Arctic Contractors, Inc. v. State, 573 P.2d 1385 (Alaska Sup. Ct. l978); Taylor & Jennings, Inc. v. Bellino Brothers Construction Co., 57 A.D.2d 42, 393 N.Y.S.2d 203 (l977); Carpenter .v Massachusetts Bonding & Insurance Co., 206 A.2d 225 (Mass. Sup. Ct. 1965); Johnson v. Morley Construction Co., 98 F.2d 781 (2d Cir. 1938); National Surety Co. v. George E. Breece Lumber Co., 60 F.2d 851 (10th Cir. 1932).

assert the defenses of its principal in connection with a claim, these courts attempt to draw a distinction between "defenses"— i.e., the claimant's own failure of performance—as opposed to "affirmative claims"— i.e., the claimant's responsibility for delay damages incurred by the principal. However, the line between "a defense" and "an affirmative claim" is far from a clear one and can be the subject of countless labeling exercises. For instance, in Walcutt v. Clevite Corp.,[13] the majority opinion allowed a guarantor to assert the defense of "lack of consideration" based on the claimant's alleged misrepresentation of the inducements offered to the principal to enter into the transaction, while the dissent objected to this holding on the basis that misrepresentation was an independent cause of action and not a defense. The notion of subjecting a surety's recoupment defenses to this sort of analysis seems to be particularly unwarranted since a surety which pays a claim after being unable to assert such defenses would be subrogated to its principal's causes of action against the claimant arising out of the Bonded Project.[14] As the cause of action would therefore belong to the surety in whole or part following its payment of the claim, there would seem to be no reason to attempt to protect the principal's interests in bringing suit on the claim following the resolution of the bond claim against the surety.

These ambiguities have seemingly been clarified by the subsequent Restatement of the Law Third on Suretyship and Guaranty. With certain minor qualifications which are not relevant to the instant discussion, §§ 19 and 34 of the Restatement reflect that a surety may generally assert all of the defenses of its principal in response to a bond claim.[15] §35 of the Restatement imposes limits on the surety's right to assert its principal's defenses, but solely as these relate to set-offs (claims that do not arise out of or do not relate to the bonded obligation):

> When the … [principal] has a claim against the obligee that is unrelated to the underlying obligation and, under the law governing set-offs, the … [principal] could set-off that claim against the underlying obligation, the … [surety] may utilize that claim to reduce its duty under the secondary obligation:
>
> (a) to the extent that the claim is uncontested by the obligee or there is no genuine issue as to the obligee's liability to the … [principal];
> (b) if the … [principal] consents to the use of its claim by the … [surety];
> (c) if the … [principal] is made a party to the … [claimant's] action to enforce the secondary obligation; or
> (d) if the … [principal] is charged with notice of the secondary obligation and the … [surety] gives the … [principal] reasonable notice of the … [claimant's] action and of the … [surety's] intent to assert the

[13] 13 N.Y.2d 48, 191 N.E.2d 894 (1963).
[14] See text accompanying footnotes 25-28, infra.
[15] Restatement of Law Third, Suretyship and Guarantee, § 34 (1).

claim and an opportunity to join its assertion, unless the court , based on considerations of the appropriate administration of justice, determines that it would be inappropriate to litigate the claim in that court.

§§ 34 and 35 of the Restatement Third confirm that there should be no limitation to the surety's rights to assert its principal's defenses to a claim, including its right to allege recoupment.[16] In regard to the surety asserting its principal's set-offs, § 35 preserves the surety's right to do so where the circumstances are such that such assertion would be unlikely to expose the claimant to the risk of "double jeopardy" or expose the principal to securing less than full value for its set-off or risking a less than vigorous prosecution of the set off by the surety. §35 further provides that if the principal refuses to consent to the surety litigating its disputed set off, a court might allow the surety to assert the claim so long as the principal is afforded a timely opportunity to join the pending litigation and there are no other factors that would render it inappropriate to litigate the set off in the suit against the surety.[17]

§ 35 of the Restatement Third embodies the proposition that the Surety should be able to assert all of its principal's defenses and recoupment claims in response to a claim and should, in most instances, be able to assert its principal's set-offs so long as the assertion of such set offs would be allowed under principles of set-off and civil procedure had the claimant sought to seek recovery from the principal and not the surety.[18] Therefore, the next issue to address is the extent to which more generalized rules of law permit a surety to

---

[16] On its face, §35 of the Restatement may only address the principal's Unrelated Claims against an obligee asserted in response to a performance bond claim to the exclusion of the principal's Unrelated Claims against a subcontractor or vendor asserted in response to a payment bond claim. This paper assumes that §35 would be applied by the courts by analogy in the context of payment bond claim disputes.

[17] The Miller Act case law appears to approach the question of the surety's right to allege the recoupment and set-off defenses of its principal as a matter of statutory interpretation. The Miller Act authorizes recoveries to payment bond claimants of "sums justly due." 40 U.S.C. § 270b(a). It has been held that since the "sums justly due" to a claimant cannot be determined without consideration of the principal's claims and backcharges from the bonded project, its recoupment defenses, the text of the Miller Act requires a court to consider all defenses sounding in recoupment which are asserted by a surety. See United Structures, supra, 9 F.3d at 999-1000; Hussman, supra, 999 F.Supp. at 748. This same analysis has caused one court to question in dicta whether a principal's set-offs against the claimant should be considered in a Miller Act case as such unrelated offsets may not be relevant to determining what is "justly due" to a claimant. United Structures, supra, 9 F.3d at 999. Another line of Miller Act cases has addressed contexts where a payment bond claim is asserted by a second tier subcontractor and the surety and its principal attempt to assert the claims and back charges of the first tier subcontractor against the claimant. Without drawing a distinction between recoupment and set-off, these cases hold that a principal and its surety cannot assert the claims and back charges of a first tier subcontractor in defense of a payment bond claim due to an absence of privity between the claimant and the principal or surety. See United States ex. rel. Bartec Industries, Inc. v. United Pacific Insurance Co., 976 F.2d 1274, 1278 (9th Cir. 1992), mod. on other grounds, 15 F.3d 855 (9th Cir. 1994); United States ex.rel. Martin Steel Constructors, Inc. v. Avanti Constructors, Inc., 750 F.2d 759, 762-3 (9th Cir. 1984); United States ex.rel. Johnson v. Morley, 98 F.2d 781 (2d Cir. 1938). The premise underlying these cases does not appear to be logically supportable, particularly since the courts that have applied the "privity" rule have applied it equally to set-off claims and to all claims and back charges arising out of the bonded project. Id. The better reasoned Miller Act decisions have held that the question of "privity" bears no relation to whether a surety should be entitled to assert set-off and recoupment defenses in response to a bond claim. See United Structures, supra, 9 F.3d at 999-1000; Hussman, supra, 999 F.Supp. at 748. Accord, C.A. Oakes Construction Co. v. Ajax Paving Industries, 652 So. 2d 914, 916 (Fla.App. 1995).

[18] Restatement of Law Third, Suretyship & Guaranty, § 35, comment a.

assert as a defense to a bond claim its principal's defenses, recoupment claims, and set offs.

B. General Law Principles

1. Law of secured transactions

In many situations where a surety is confronted by a payment or performance bond claim, the principal's lender will have perfected a security interest which covers the principal's claims, intangibles, and accounts receivables. This raises the question as to whether a perfected security interest under Article 9 of the Uniform Commercial Code has priority over a set-off asserted in the course of litigation.

Article 9 states that it does not apply to set-offs.[19] The majority of jurisdictions have construed this exclusion as exempting a set-off from the perfection requirements of Article 9.[20] Nonetheless, the majority rule is that the priority rules of Article 9 apply to set-offs and that, therefore, a set-off is, in all cases, subordinate to a perfected Article 9 security interest.[21] In a minority of jurisdictions, the courts have held that set-offs are exempt from both the perfection requirements and the priority rules of the U.C.C.[22] In these few jurisdictions, the relative priority of a set-off versus a perfected security interest is determined by common law priority rules.[23] While the proponent of a set-off therefore has at least a possibility of success under the minority rule, it is likely in all jurisdictions that a surety seeking to set-off against a claimant its principal's claims against the claimant on an Unrelated Project will lose a priority dispute over the claim to a perfected lender unless the surety has recorded its indemnity agreement as a U.C.C. filing in advance of the filing by the lender.[24]

In contrast, the surety's ability to claim recoupment against a claimant should not, in most cases, be prejudiced by a prior U.C.C. filing by a secured lender. The receivable to which a lender's security interest should attach should be computed based on the net obligation from a particular project and not each of its component parts. Moreover, the surety is subrogated to all of the principal's claims on a bonded project.[25] The surety is deemed to have an equitable lien in regard to such claims.[26] This equitable lien is not

---

[19] See UCC §9-104(i)

[20] Anderson, Uniform Commercial Code, §§ 9-104:85, 9-104:86, 9-312:54. See MNC Commercial Corp. v. Joseph T. Ryerson & Son, Inc., 882 F.2d 615 (2d Cir. 1989); Valley National Bank v. Cotton Growers Hail Insurance, Inc., 155 Ariz. 526, 747 P.2d 1225 (1987); Insley Manufacturing Corp. v. Draper Bank & Trust, 717 P.2d 1341 (Utah l986); Coachmen Industries, Inc. v. Security Trust & Savings Bank, 329 N.W.2d 648 (1983).

[21] Id.

[22] See State Bank v. First Bank, 320 N.W.2d 723 (Minn.Sup.Ct. l982); First National Bank v. Lone Star Life Insurance Co., 529 S.W.2d 67 (Tex. 1975).

[23] Id.

[24] The relevance of the assignment clause of a general indemnity agreement is discussed in more detail below.

[25] See, e.g., Pearlman v. Reliance Insurance Co., 371 U.S. 132 (1962); National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969).

[26] Id.

subject to the perfection requirements of the U.C.C.[27] For priority purposes, the equitable lien relates back to the date of the issuance of the bonds.[28] For these reasons, the surety should have priority over a secured lender in connection with a recoupment defense in all or almost all circumstances.

2. Law of set-offs

In most jurisdictions, a defendant may freely assert its relevant defenses to the complaint allegations, including the right to allege recoupment.

In contrast, the doctrine of set-offs is premised on equity; that mutually indebted parties should fully account for all of their mutual obligations based on notions of fairness and also to avoid circuitry of litigation.[29] As such, certain equitable notions have arisen in connection with the set-off right, which are designed to balance the interests generally favoring set-offs with the factors that may make the assertion of a set-off undesirable in certain contexts. Though these limitations on the doctrine vary depending on the jurisdiction, there are certain rules relating to set-offs which are generally applicable and which bear on the usefulness of the doctrine from the perspective of a surety attempting to assert its principal' s Unrelated Claim against a claimant as a defense to a bond claim.

In most jurisdictions, a set-off must be "mutual"; that is, the set off must be between the same parties in their same capacities or rights.[30] From the perspective of the surety attempting to assert as a set-off a claim by its principal against the claimant in connection with an Unrelated Project, this is generally not a meaningful impediment. Typically, in the context of payment bond litigation, the set-off claim will arise out of another contractor/subcontractor or contractor/vendor relationship between the principal and the claimant vendor or subcontractor. Similarly, in litigation arising out of a performance bond claim, the set-off will typically reflect that the principal worked for the owner or contractor obligee on another construction project. In either case, the two unrelated, countervailing debts would arise in analogous contexts and would therefore be "mutual."

More significantly, most jurisdictions do not allow the assertion of a set-off unless the obligation to be set-off is ascertained and "liquidated"; that is, the merits of the claim and the amount owed have been determined or are not in dispute.[31] The rationale for this requirement is a practical one; to avoid the confusion that could result by the defendant

[27] See, e.g., In re J.V. Gleason Co., 452 F.2d 1219 (8th Cir. 1971); Home Indemnity Co. v. United States, 433 F.2d 764 (Ct.Cl. l970); National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843 (1st Cir. 1969).

[28] Id.

[29] 20 Am.Jur.2d, Counterclaims, Recoupment § 6 at p. 232-33. See Pearlman v. Reliance Surety Co., supra, 371 U.S. at 140.

[30] 20 Am.Jur.2d Counterclaim, Recoupment § 47 at 266-67. See Sullivan v. Merchants National Bank, 108 Conn. 497, 499, 144 A. 34 (1928).

[31] 20 Am.Jur.2d Counterclaims, Recoupment §§ 22 and 23. See, e.g., National Glass & Glazing, Inc. v. Grimaldi Construction Co., 680 So.2d 56 (La.App. 1996) (a surety cannot assert against a claimant a claim of its principal from an unrelated transaction because the claim had not been liquidated). For cases that hold to a minority view, allowing the assertion of unliquidated set offs, see Piland Corp. v. League Construction Co., 380 S.E.2d 652 (Va. 1989); Henderson v. Northwest Airlines, Inc., 43 N.W.2d 786 (Minn. 1950); McGrath v. Wisner, 55 A.2d 793 (Md.App.Ct. 1947).

injecting into a case an entirely different set of facts requiring an entirely separate adjudication. In contrast, there is no requirement that a defense by way of recoupment be liquidated since the courts can readily address and resolve all claims arising out of the same transaction.[32]

The requirement that a set-off be liquidated would, in many contexts, preclude a surety from being able to assert as a defense to a claim on a Bonded Project a claim by the principal against the claimant in relation to an Unrelated Project. The question therefore arises as to what alternative courses of action are available to the surety so that the surety is able to secure value from its principal's Unrelated Claim against a claimant. The answers lie predominantly in resort to the remedies afforded by the General Indemnity Agreement.

C. Alternative Strategies

Based on the interplay of surety law and the law regarding set offs and civil procedure, the surety should be able, in most cases, to assert the recoupment claims of its principal as part of its defense to a payment or performance bond claim. The surety should also be able, in most instances, to assert the liquidated, set-offs of its principal.

As noted above, the surety's ability to assert the unliquidated set-offs of its principal is decidedly more problematic. In the absence of an ability to set-off, the surety faces a risk that if it incurs liability on the Bonded Claim, the claimant could separately pay the principal on the Unrelated Claim, and the surety could be unable to access sufficient resources from the principal to secure full reimbursement for its claims payment and expenses. Assuming an inability to set-off, the surety could attempt to secure an agreement from the principal that the proceeds of the Unrelated Claim would be escrowed to be used as collateral security for the claims being asserted against the surety and the surety's resulting costs and fees. The surety could persuasively cite the principal to the collateral security clause of the indemnity agreement. Assuming that the principal was not willing to voluntarily treat the Unrelated Claim as collateral security, the surety could consider the following strategies:

1. If the payment or performance bond claim against the surety is in suit, the surety can cross claim against the principal for indemnity and collateral security per the terms of the applicable general indemnity agreement. If prejudgment attachments are readily available in the particular jurisdiction, the surety could attempt to secure a prejudgment remedy in order to garnish the Unrelated Claim. In some jurisdictions, the surety may be able to secure a preliminary injunction ordering the posting of collateral security.[33] A preliminary injunction could include a provision enjoining the principal from dissipating any payments received as a result of the Unrelated Claim or requiring that the proceeds of such claim be escrowed or segregated upon receipt. In the absence of the availability of

[32] 20 Am.Jur.2d, Counterclaim, Recoupment §23 at pp.246-48.

[33] Compare Safeco Insurance Co. v. Schwab, 739 F.2d 431 (9th Cir. 1984) (An indemnitor's refusal to post collateral security entitles the surety to equitable relief.) with Borey v. National Union Fire Insurance Co., 934 F.2d 30 (2d Cir. 1990) (An indemnitor's refusal to post collateral security does not, without more, warrant the granting of equitable relief).

prejudgment attachments or preliminary injunctive relief, the surety would hope to secure a judgment against its principal for collateral security or indemnity simultaneous with any judgment being entered against the surety on the bond claim. The surety would then need to move expeditiously to attempt to garnish the Unrelated Claim through post judgment procedures and hope that the proceeds of the Unrelated Claim could be attached before their release to the principal.

The complexity and uncertainty of this alternative is in contrast with the relative simplicity of the set off procedure.

2. The surety could also invoke the "Assignment Clause" of the general indemnity agreement. Such clauses generally assign to the surety the principal's claims from bonded and unbonded projects.[34] Under certain indemnity agreements, the assignments are deemed effective as of the date of the issuance of a bond. Under other agreements, such assignments are effective as of the date of a default of the obligations under the indemnity agreement and are deemed to relate back for priority purposes to the date on which bonds were issued. Assuming that a claim against the surety has been filed and adequate collateral security has not been posted by the principal or indemnitors, it is likely that the principal would be in default under most indemnity agreements, thereby activating the surety's assignment rights.

Assuming that the surety must rely on the Assignment Clause as its principal mechanism for accessing the proceeds of an Unrelated Claim, the surety must address the question of whether to record the Indemnity Agreement as a U.C.C. filing. There are always a myriad of reasons that a surety must assess in deciding whether a U.C.C. filing is advantageous on balance. The existence of an Unrelated Claim may create one more reason favoring a U.C.C. filing.

As noted supra, the perfecting of the Surety's assignment does not guarantee its priority to assert the Unrelated Claim.[35] If there is a secured creditor of the principal which has previously perfected a security interest in the principal's claims and receivables, such a creditor could assert such priority and thereby frustrate the Surety's access to the claim as a source of salvage.

Assuming that a surety chooses to rely on the Assignment Clause in relation to an Unrelated Claim, the surety confronts options as to how to make use of its assignment. It may opt to simply put the Claimant on notice of the assignment and advise the Claimant that payment of the unrelated claim to the principal in derogation of the assignment would expose the Claimant to a cause of action by the surety sounding in conversion.[36] The principal may respond by threatening the surety with a cause of action for tortious interference with contract.[37] However, the surety's rights under the Assignment Clause and

---

[34] See Insurance, Inc. v. United States Fidelity & Guarantee Co., 323 F.2d 513 (9th Cir. l963); Grey v. Travelers Indemnity Co., 280 F.2d 549 (9th Cir. l960).

[35] See p. 8, supra.

[36] Anderson, Uniform Commercial Code, §§ 9-102:119, 9-102:123, 9-306:11, 9-306:111.

[37] See Larsen Chelsey Realty Co. v. Larsen, 232 Conn. 480, 656 A.2d 1009 (1995). See generally 84 A.L.R. 43.

its other rights under the Indemnity Agreement should be a sufficient defense to any such allegation.

Alternatively, the surety could choose to file suit against the Claimant in its capacity as assignee of the claim. This option is often not feasible since the Unrelated Claim addresses facts which may be entirely foreign to the surety. In the absence of the principal's cooperation, it may be impossible for the surety to marshall the facts necessary to litigate the Unrelated Claim. However, the principal may have no incentive to pursue an Unrelated Claim if the proceeds of such a claim have been assigned to the surety. This may create an incentive for the principal and the surety to reach an accomodation upfront regarding the disposition of any proceeds from a suit brought by the principal on the Unrelated Claim.

In summary, the surety faces serious impediments to asserting unliquidated, Unrelated Claims as set-offs in defense to a bond claim by a claimant. The surety must therefore consider alternative strategies for accessing Unrelated Claims as sources of salvage. These strategies may contemplate circuitous litigation and are far from certain to result in either reducing the surety's payment to the claimant in the first instance or allowing the surety to collect the proceeds from an Unrelated Claim as a source of salvage.

(II) *The Surety's subrogation right to require an obligee/claimant to set off debts owed to the principal on unbonded projects.*

A surety facing a performance bond claim may discover that its principal has performed work for the same owner/obligee on other projects which were not bonded by the surety. The owner may owe a debt to the principal from the Unrelated Projects, possibly in the form of a progress payment or retainage or possibly due to claims asserted by the principal. Under these circumstances, the surety may argue that should it pay a performance bond claim in whole or part, it would become subrogated to all of the owner's rights vis a vis its principal, including being subrogated to the owner's right to set off the principal's debt on the Bonded Project against its debt to the principal on the Unrelated Project.[38] In effect, this argument begins with the "set off" analyses discussed supra and adds an additional component in the form of a subrogation overlay.

The courts appear to recognize this subrogation right on behalf of the surety with certain qualifications.[39] First, the courts note that since subrogation is an equitable remedy, the surety's right to compel the owner to set off its debt to the principal should be qualified by equitable principles. Where there are claimants to the sum owed on the Unrelated Project other than the principal and where these claimants have a direct relationship to the Unrelated Project—i.e., the owner, unpaid subcontractors and vendors or the surety that bonded the Unrelated Project—the courts hold that these other parties have a greater equitable right to the sum owed than the "Unrelated Surety" and that, therefore, the Unrelated Surety cannot compel the owner by way of subrogation to set off.[40] On the other hand, where the only other party claiming the funds from the Unrelated Project is the principal, the courts hold that the surety who has incurred a loss as a consequence of the

[38] See Pearlman v. Reliance Insurance Co., supra, 371 U.S. at 140.

[39] See Transamerica Insurance Co. v. United States, 989 F.2d 1188 (Fed.Cir. 1993); District of Columbia v. Aetna Insurance Co., 462 A.2d 428 (D.C.Ct. App. 1983).

[40] See Dependable Insurance Co. v. United States, 846 F.2d 65 (Fed.Cir. 1988); Security Insurance Co. v. United States, 428 F.2d 838 (Ct.Cl. l970); Western Casualty & Surety Co. v. Brooks, 362 F.2d 486 (4th Cir. 1966).

principal has a greater equitable claim to these funds and should be able to vindicate this equity through its subrogation rights.[41]

Second, this set off/subrogation right has been recognized in contexts where the debt owed the principal from the Unrelated Project is uncontested—i.e., a retainage payment. The Reporter's Notes to the Second Restatement state that, as matter of surety law, this doctrine necessarily presumes that the debt from the Unrelated Project is uncontested.[42] The Reporter notes that an owner/obligee could not be compelled to set off the unrelated debt owed to the principal where the owner/obligee disputes that the debt is owed. Thus, under this alternative set off analysis, the surety's ability to assert an unliquidated, Unrelated Claim of its principal is also problematic, returning the surety to consideration of its reimbursement and assignment rights under the general indemnity agreement.

Conclusion

The rights to allege recoupment and assert set offs provide important procedural mechanisms for minimizing a surety's exposure to payment and performance bond claims. There should be few substantive or procedural impediments to a surety asserting as a defense to a payment or performance bond claim the defenses or claims of its principals from the Bonded Project. To the extent that the surety attempts to assert the claims of its principal from an Unrelated Project, the set-off mechanism may be unavailable to the extent that the Unrelated Claims are unliquidated. To the extent that the surety seeks to access unliquidated, Unrelated Claims as a source of salvage, it will often need to adopt less efficient procedural mechanisms predicated on its indemnity and assignment rights under the general indemnity agreement.

[41] See Transamerica Insurance Co. v. United States, 989 F.2d 1188 (Fed.Cir. 1993); District of Columbia v. Aetna Insurance Co., 462 A.2d 428 (D.C.Ct. App. 1983).
[42] See Restatement of Law Third, Suretyship and Guarantee, § 35, Reporter's Notes at p. 154.

MATTHEW M. HOROWITZ

Matt Horowitz graduated from Tufts University in 1973 and New York University School of Law in 1976. He is a member of the Connecticut and Massachusetts Bars. Over the last 20 years, he has engaged in a varied litigation practice. For the past twelve years, his practice has focused primarily on fidelity and surety issues. He has presented papers at the Northeast Surety and Fidelity Conference and the Surety Claims Institute, is a Co-Chair of the ABA Fidelity and Surety Committee, and has participated in the drafting of the TIPS Miscellaneous Bond Monograph and The Law of Payment Bond Manual.

Matt is a partner in the law firm of Wolf, Horowitz, Etlinger, Case & Ray, LLC.