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**“EXONERATION BASICS:  
ENFORCING THE SURETY'S RIGHTS”**

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# EXONERATION BASICS: ENFORCING THE SURETY'S RIGHTS

by

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*"Between the idea  
And the reality  
Between the motion  
And the act  
Lies the Shadow"*

*T. S. Eliot, 1888-1965*

## INTRODUCTION

To the surety underwriter, the "idea" is that there will be no loss. The optimistic view of suretyship is based in part upon firmly-established legal principles which assume that the compensated surety will be exonerated and indemnified, regardless of the circumstances which may develop after issuance of the bond. As a result of the dynamic tension between the idea of zero loss and the changing realities of commercial life, the surety claims professional must frequently labor "in the shadows."

It is easier to define the nature of exoneration than to implement the surety's rights when, for whatever reason, the principal and its indemnitors refuse to perform their duties. The primary weapon in the surety's arsenal of remedies is the exoneration action. By enforcing the surety's right to be placed in funds before a loss is incurred, the utopian underwriting assumption can be achieved. This paper offer some practical observations and suggestions on improving the chances for succeeding in the quest for exoneration.

### I. The Nature of Exoneration

Most commercial indemnity agreements used require that its signatories "exonerate the surety," but the concept of "exoneration" is not expressly defined. Funk & Wagnall advises that the verb "exonerate" means to relieve, discharge, or free from a responsibility or the like. Blacks Law Dictionary provides a more specific definition:

***Exoneration*** *Equitable right of a surety, confirmed by statute in many states, to proceed by action in court to compel the principal debtor, against whom the surety will have a right of reimbursement, to satisfy the obligation where it would be inequitable for the surety to compelled, and thereby suffer the inconvenience and temporary loss which a payment by her will entail, if the principal debtor can satisfy the obligation.*<sup>1</sup>

To the surety, exoneration is a condition which results from either affirmative acts by the principal or indemnitor to eliminate exposures to loss or the receipt or deposit of sufficient assets from the

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<sup>1</sup>See Restatement of Securities, § 112 (1941).

principal or indemnitors such that any loss exposure will be resolved therefrom. The concept of "exoneration" is distinguishable from the surety's rights (1) to be indemnified against loss, and (2) to be reimbursed upon payment of loss. In general, the rights to indemnification and reimbursement arise **after** payment. The right of exoneration matures **before** payment.

The surety's right of exoneration is recognized at common law. A frequently cited example is the case of *Doster v. Continental Casualty Company*,<sup>2</sup> decided by the Alabama Supreme Court in 1958. The facts of *Doster* are typical. The contractor agreed to build an elementary school. When the job was substantially completed, the contractor advised his surety that he was unable to pay for approximately \$24,000.00 worth of materials furnished for use in the construction. The contractor also advised the surety that it had funds in hand totaling approximately \$21,000.00, but that it did not intend to use those funds to satisfy the bonded obligations. In the surety's exoneration action, Continental requested injunctive relief in the form of an order directing the contractor to use all cash on hand to pay bills identifiable to the project and, if the assets proved to be insufficient to retire all claims potentially within the scope of the payment bond, that Doster and its indemnitors be required to transfer sufficient assets to Continental so the surety would be secured and indemnified **prior** to making payment. The trial court agreed with the surety and entered a decree in accordance with the surety's request. On appeal, the contractor argued that the injunction should be dissolved on the grounds that there was no evidence at trial indicating that the contractor was about to fraudulently convey, conceal, or secrete assets.

The Supreme Court of Alabama clearly rejected the contractor's arguments, and quoted with approval from earlier cases the following summary of applicable law:

*No principle of equity is more familiar, or more firmly established, than that a surety, after the debt for which he is liable has become due, without paying, or being called on to pay it, may file a bill in equity to compel the principal debtor to exonerate him from liability by its payment, provided no rights of the creditor are prejudiced thereby. The principle has been extended to cases of pledged or mortgaged property.*

.....

*The right of the surety to be exonerated from liability is founded on equitable principles - the primary duty of the principal to pay the debt, and it being unreasonable that the surety should be burdened with the liability, a cloud hanging over him, at the will of the creditor, and the risk of ultimate loss.*

.....

*And in order to maintain such bill it is not necessary for the surety to show any fraudulent disposition of property on the part of the principal or any special reason for fearing a loss. When a surety comes into a court of equity to compel the principal to pay the debt, he stands in the position of an equitable assignee and may use the remedies of the creditor at his own risk and cost.*

*Doster* is significant also because it does **not** involve rights arising from an indemnity agreement.<sup>3</sup> Most sureties now require the execution of General Agreements of Indemnity (GAI) which give the surety the right to request the deposit of collateral - including cash - whenever the surety feels insecure, pending a return of the optimistic feeling which existed at the beginning of the surety

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<sup>2</sup>268 Ala. 123, 105 So.2d 83 (1958).

<sup>3</sup>An indemnity agreement was executed in favor of the surety by the contractor but the decision is not based upon any contractual provisions.

relationship. These agreements offer the surety additional arguments and vehicles to obtain the state of exoneration, which are separate from and in addition to the remedies available at common law.

## **II. Setting the Stage**

### **Preparing for the Exoneration Action**

In the real world, the feeling of discomfort to the surety can stem from a variety of causes, including claims of labor and material suppliers to projects, rumblings from disgruntled owners concerning job progress and performance by the contractor, and consultations with nervous underwriters concerning changes in the financial conditions of the principal. The surety's investigation may indicate that there are meritorious defenses to claims threatened or asserted against the bonds, that the principal appears to be discharging his duties in a reasonable manner, and that the financial pulse of the principal, while perhaps weaker and more irregular than might be desired, is nonetheless perceptible. The comfort level of the surety will depend upon a variety of facts and circumstances as disclosed by its investigation.

If the surety determines that it wishes to invoke its right to become exonerated, it should so advise its principal and indemnitors in writing. All written communications between the surety and its indemnitors should be drafted with a view toward their becoming evidence at the preliminary injunction hearing. If the surety is going to request a deposit of collateral, the communication should reference the specific language of the indemnity agreement which requires such action, demonstrate compliance by the surety with the conditions precedent to the request for collateral,<sup>4</sup> and should request an amount of collateral consistent with the realities indicated by the investigation. The collateral demand should provide a reasonable period of time for compliance or response, and should request that the principal furnish the surety with updated financial information reflecting the nature and existence of any and all assets owned or controlled by the indemnitors.

Most GAIs contain language conveying a security interest in all physical assets of the principal. The surety may wish to avail itself of remedies provided by the Uniform Commercial Code by recording the GAI as a financing statement. Additionally, the surety may desire to obtain a third-party asset investigation and will want to be mindful of any indication that the indemnitors are conveying, secreting, or encumbering assets.

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<sup>4</sup>For example, the GAI may require the posting of a reserve before collateral can be requested.

## **Jurisdiction and Venue**

Assuming that the surety portends a loss in excess of \$75,000.00 and that its citizenship is diverse from its principal, a Federal court will have jurisdiction over the action. Ordinarily, the surety would file suit in the judicial district in which most, if not all, of the indemnitors reside, thereby avoiding any delays which might result from objections to venue.

### **III. Defining the Objective - Specific Requests for Relief**

The exoneration action will be tailored to the specific facts of each case. If the surety is primarily interested in obtaining collateral, the first objective of the action should be a decree of specific performance directing the deposit of collateral by a date certain. Should the defendants fail to comply with the court's directive, the surety will ordinarily seek an alternative order directing the defendants to marshal all assets, deposit them with the Clerk pending final disposition of the action, provide an itemized, sworn statement of all assets in their control or possession, and directing that no transfers or conveyances of assets be made absent the surety's prior consent. If the surety's investigation discloses that assets have in fact been transferred or conveyed without consideration, the focus of the action will shift to having those transfers set aside. If the surety has paid some portion of the claims outstanding, a request for an immediate judgment in the amount of the claim will ordinarily be appropriate.

### **IV. "Fast Tracking" the Action - Injunctive Relief**

In rare cases, the facts will justify a request for a Temporary Restraining Order (TRO). Once service has been perfected on the defendant, a TRO provides the surety with a chance for a preemptive strike on what is essentially an ex parte basis. A TRO, if issued, is effective upon service but will remain in effect for a maximum duration of ten days. Accordingly, most Federal courts will routinely deny a surety's request for temporary relief, but will schedule a preliminary injunctive hearing on an expedited basis.

A preliminary injunction hearing is the equivalent of trial on the merits. While the surety will have submitted an affidavit from a claims professional detailing and confirming the facts as set forth in the complaint, a personal representative of the surety having requisite knowledge should attend the preliminary injunction hearing and be prepared to testify. The surety will want to provide the court with the best available picture of the claims scenario and should be prepared to offer excerpts from the claims file and testimony from the claims executive confirming the results of the surety's investigation. Finally, the surety should anticipate factual and legal defenses which may be forthcoming at the hearing and be prepared to rebut them with appropriate testimony, documentation and legal argument.

### **V. Muddying the Water - The Irreparable Injury Problem**

To be entitled to injunctive relief, a litigant must demonstrate to the satisfaction of the court that adequate facts and circumstances exist which would support injunctive relief **and** that there is no equivalent legal remedy. As stated by the Second Circuit:

*Perhaps the single most important prerequisite for the issuance of a preliminary injunction is a demonstration that if it is not granted the applicant is likely to suffer irreparable harm before a decision on the merits can be rendered.*<sup>5</sup>

Thus, whether the surety seeks traditional injunctive relief or asks the court for exoneration or *quia timet* relief, it must bear the burden of persuasion that no legal remedy - including damages - would be as effective.

In *Firemen's Insurance Company of Newark, New Jersey v. Keating*,<sup>6</sup> the surety was unsuccessful in persuading the court that it was entitled to expedited relief. This case involved bonds issued to guarantee performance of obligations under limited partnership agreements. The indemnity agreement executed by the investors in favor of the surety contained a "cash collateral" clause in which each indemnitor agreed to post cash collateral in the event of default in the payment of the notes secured by the bonds. The surety was called upon to pay and sought to invoke the cash collateral clause. The indemnitors refused to collateralize the surety. Firemen's then brought an exoneration and *quia timet* action in which it sought preliminary injunctive relief to enforce the terms of the cash collateral clause.

After a thorough review of applicable law, the court declined to issue the requested relief, concluding that the surety had failed to demonstrate that it could not be compensated for any harm it might sustain during the pendency of the case absent issuance of injunctive relief. The court therefore found that any "irreparable harm" to the plaintiff surety would be "remote and speculative," although the court seemed to acknowledge that the plaintiff surety would be less secure in the absence of the requested relief. Finally, the court noted that plaintiff's delay in seeking to prosecute its claims for injunctive relief reflected the surety's "own doubts as to the severity and harm at hand."

Although a result similar to that in the *Firemen's* case has been reached before one federal judge of the Northern District of Alabama,<sup>7</sup> the great weight of authority seems to support the use of injunctive relief to obtain specific enforcement of indemnity and collateralization provisions.<sup>8</sup> The surety should be prepared, however, to articulate clear reasons why delay in enforcing and implementing its rights would be prejudicial and alternatively, to seek final judgment as expeditiously as possible on the exoneration and *quia timet* claims.

## CONCLUSION

The surety is vested with extensive rights. To enforce them, the surety must be prepared to proceed with **prompt** and **aggressive** action. The authors hope that this discussion will assist in achieving the surety's objectives in litigation.

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<sup>5</sup>*Citibank, N.A. v. City Trust*, 756 F.2d 273 at 275 (2d Cir. 1985).

<sup>6</sup>753 F.Supp. 1146 (S.D.N.Y. 1990).

<sup>7</sup>See *Fireman's Ins. Co. of Newark, N.J. v. Price*, No. 96-N-2215-NE (N.D. Ala. Sept. 19, 1996)(memorandum of opinion).

<sup>8</sup>*Marine Medland Trust Co. of N.Y. v. Allegheny Corp.*, 28 F.Supp. 680 (S.D.N.Y. 1939); *Citibank, N.A. v. Singer Co.*, 684 F.Supp. 382 (S.D.N.Y. 1988).