

**ELEVENTH ANNUAL
SOUTHERN SURETY & FIDELITY CLAIMS
CONFERENCE**

**DOES THE SURETY FOR THE GENERAL CONTRACTOR
HAVE RIGHTS AGAINST A SUBCONTRACTOR'S
PERFORMANCE BOND?**

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INTRODUCTION

Upon receipt of that oft-dreaded notice that your principal is either financially unable to complete the project or pay its subcontractors and suppliers or even worse, has been defaulted by the owner and demand has been made upon you to perform, the surety's focus is to minimize any loss suffered under its bonds and if loss there be, maximize recovery of those losses from as many solvent sources as can be found.

It is in just such a situation that the surety's valuable right of equitable subrogation comes into play. When faced with a defaulting contractor on a bonded project, the surety should look first to subrogation as a means of minimizing its loss. By virtue of its right to become subrogated to the claims of its principal, the surety is able to extend the reach of its subrogation rights beyond its principal and obligee to the subcontractors, suppliers and their respective sureties. *Transamerica Insurance Company v. Barnett Bank of Marion County, N.A.*, 540 So.2d 113 (1989); *Argonaut Ins. Co. v. C&S Bank of Tifton*, 140 Ga. App. 807, 232 S.E.2d 135 (1976).

The purpose of this paper is to discuss a general contractor's claim against a subcontractor's surety for losses suffered on the project both from the perspective of the general contractor's surety in seeking to enforce the claim and the subcontractor's surety in defending against that claim.

Courts Have Recognized a Completing Surety's Claim Against the Subcontractor's Surety for Losses Suffered on a Bonded Project.

The first step in pursuing and perfecting a claim against a subcontractor's surety is to review the bond itself with particular emphasis upon the specific language employed in the right-of-action clause. It is generally understood that the liability of a surety is determined by the language of the bond itself. *Getters v. Eagle Ins. Co.*, 834 S.W.2d 49, 50 (Tex. 1992). The right-of-action clause may limit the liability of the surety to those named therein by expressly excluding others from any right of action under the bond. Lybeck, *Scope of the Performance Bond Surety's Obligation*, *The Law of Suretyship* 10-5 (E. Gallagher, ed. 1993); *Rush Presbyterian St. Luke's Medical Center v. SAFECO Ins. Co. of America*, 1986 W.L. 2007 (N.D. Ill. 1986).

It is becoming more and more common for sureties to limit rights-of-action under their bonds to the Obligee named therein or its legal successors. In order to prevail on an action under such a bond, the general contractor's surety, obviously not the named Obligee on the subcontractor's bond, would have to qualify as a "legal successor" of the named Obligee, its principal.

Subrogation is the valuable and important tool by which the general contractor's surety qualifies as a "successor" of its principal. The United States Supreme Court noted that "...there are few doctrines better established than that a surety that pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed." *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962). This rule holds true whether the surety performs by completing the project or by paying its principal's

subcontractors and suppliers. *Prairie State Bank v. United States*, 164 U.S. 227, 17 S.Ct. 142, 41 L.Ed. 412 (1896); *Henningsen v. United States Fid. & Guar. Co.*, 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547 (1908).

A Subrogee is a Successor.

In the context of suretyship, the terms “subrogee” and “successor” are interchangeable. In BLACK’S LAW DICTIONARY 1596 (Revised 4th ed. 1968), subrogee is defined as “...one who succeeds to the rights of another by subrogation.” In that very same source, subrogation is defined as “the substitution of one person in the place of another with reference to a legal claim, demand or right, [Cit.]; so that he who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights, remedies or securities.”

The subrogation definition adopted by the Georgia courts almost tracks the BLACK’S definition word for word. In *First Nat. Bank of Atl. v. American Sur. Co.*, 71 Ga. App. 112, 30 S.E.2d 402 (1944), the court stated: “[S]ubrogation is the substitution of another person in the place of the creditor whose obligation is paid, so that the person in whose favor it is exercised succeeds to all the rights of the creditor.”

A Surety May Satisfy Its Performance Bond Obligations in a Variety of Ways in Order to Qualify as a “Subrogee.”

While the performance bond surety’s sole obligation is to guarantee completion of the construction project, there is no one right way in which to do so. *American Home Assurance Co. v. Larkin General Hospital, Ltd.*, 593 So.2d 195 (S. Ct. Fla. 1992). There are many ways, in fact, in which the general contractor’s surety may satisfy its obligations under its bond and thus qualify as its principal’s “subrogee.” For example, the surety can tender a sum of money to the owner in return for the bond, rebid the project and complete it with a replacement contractor, tender a completion contractor to the owner for the owner to complete the project, finance its principal to completion and even elect to do nothing and allow the obligee to complete. *The Law of Suretyship*, § 10-1.

There is no substantial difference between a surety’s completion of a bonded project in its own name and financial assistance to the original bonded contractor to enable proper completion. This very issue was addressed in the case of *Great American Insurance Company v. United States*, 481 F.2d 1298 (Ct. Cl. 1973). In that case, Great American’s principal was financially unable to complete its project and at its request, Great American financed the contractor to completion. *Id.* at p. 1300, n. 8 The Court noted that when the contractor notified the surety that it was unable to complete the contract work, the obligation of the surety vested under the performance and payment bonds. Once the surety financed the contractor to completion, the surety was then subrogated to the rights of the contractor. *Id.* at p. 1308 Great American is subrogated and succeeds to the rights of its principal.

Further support on this issue is found in the case of *Aetna Cas. and Sur. Co. v. United States*, 845 F.2d 971 (Fed. Cir. 1988). Aetna provided bonds for a contractor on three separate projects. During the course of the construction of those projects, the contractor informed Aetna that “it was unable to meet its obligations under the contracts.” Aetna agreed

to fund the contractor's operations. The contractor advised Aetna that its future earnings under the three contracts would be sufficient to allow the contractor to complete. Upon receipt of that notice, Aetna ceased all funding to the contractor yet continued to pay its subcontractors and suppliers. The contractor was not in fact able to meet its construction schedules. The owner suggested that Aetna apply some financial pressure or provide management assistance to bring about the completion of the projects but Aetna declined to do so.

Ultimately, the contractor failed to complete the project and the owner took beneficial occupancy of the project, executing deductive change orders for all of the work that had not been completed by the contractor, thereby reducing the contract prices. Aetna asserted its subrogation rights to the remaining contract balances. Aetna lost its case in the Claims Court because the Claims Court erroneously held that a surety "qualifie[s] as a performing surety...if- and only if- it assumed the primary responsibility for the completion of the work under the several contracts." On appeal, however, the United States Court of Appeals for the Federal Circuit overturned the Claims Court ruling as follows:

A performance bond gives the surety the option of completing performance or of assuming liability for the Government's costs in completing the contract which are in excess of the contract price. [Cit.] ...Neither formal termination of the contract by the Government nor execution of a formal take-over agreement by the surety is necessary in order for a surety to qualify as a performing surety. [Cit.] Thus, a surety may satisfy its obligation in various ways....A performing surety may ... satisfy its obligation by providing funds to an insolvent contractor to complete performance. *Great American Ins. Co. v. U.S.*, 481 F.2d 1298, 1300 n.8 (Ct. Cl. 1973); *Morgenthau v. Fidelity & Deposit Co.*, 94 F.2d 632 (D.C. Cir. 1937) ("No difference between completion of the work by the surety...and the furnishing of money to the contractor after his default...to enable him to perform the contract.") [Cit.]...Since Aetna was acting as a performing surety prior to the time when direct payments to labor and materialmen were made, these periodic payments are part of the cost of completing the contract and fall within Aetna's performance bond obligations. [Cit.]
845 F.2d at p. 975-976.

The general rule holds that no formal declaration of default is required; default in the relevant sense occurs when the principal finds itself unable to pay and calls upon the surety to pay in accordance with the terms of the bond. The right of subrogation actualizes once the surety either pays the first subcontractor or supplier or performs to complete the project. *Cotton States Mut. Ins. Co. v. Citizens and Southern Nat. Bank*, 168 Ga. App. 83, 308 S.E.2d 199 (1983)

Georgia's courts have routinely held that a surety who completes a contract on behalf of its principal is subrogated not only to the rights of its principal but also to the rights of the owner for whom the contract was completed and the rights of the creditors whose claims for

labor and materials the surety paid. *Argonaut Ins. Co. v. C&S Bank of Tifton*, 140 Ga. App. 807, 232 S.E.2d 135 (1976). The significance and importance of a surety's right of subrogation was underscored by the *Argonaut* court when it noted that "[T]he surety, in a sense, is 'secured' by its right of subrogation, which relates back to the issuance of the bond to defeat intervening creditors."

To sum up, sureties who complete projects on behalf of their principals are subrogated to the rights of their principals. As an aside, the surety is also subrogated to the rights of their bond obligee and the rights of the creditors it paid for labor and material. This right is so valuable that the courts have ruled that it relates back to the date of the issuance of the bond and that as a result of this relation back, completing sureties may defeat the rights of intervening creditors. As a "subrogee," the completing surety may then qualify as a "successor" of its principal.

Completing Sureties Have Been Recognized as Successors with Rights of Action Under Bonds

Recognizing the unique service that sureties provide in insuring the completion of construction projects and the payment of laborers and materialman for work done and material supplied on those projects, appellate courts around the country have ruled in favor of a general contractor's surety's cause of action against subcontractor's sureties for losses suffered on construction projects.

The premier case on the issue in Florida is *Argonaut Ins. Co. v. Commercial Standard Ins. Co.*, 380 So.2d 1066 (2d Fla. DCA 1980). In that case, the general contractor's surety sought to recover against the subcontractor's surety. The right-of-action clause in the bond reads as follows:

"No right of action shall accrue on this bond to or for the use of any person or corporation other than the Obligee named herein or the heirs, executors, administrators or successors of the Obligee."
380 So.2d at p. 1067.

The subcontractor's surety in the *Argonaut* case contended that the general contractor's surety had no standing to bring suit on the bond. The court ruled that the general contractor's surety occupied the status of "successor" to the Obligee on the subcontractor's surety's bond and as such, had a cause of action on the bond. The court noted that the terms of the general contractor's performance bond required it to complete the construction when and if its principal defaulted.

When the general contractor defaulted and its surety completed the construction, the surety became subrogated to the rights of its principal. The general contractor's surety, as the completing surety, stepped into the shoes of its principal and assumed its principal's rights.

In likening a subrogee to a successor, the *Argonaut* court noted that a "successor" is generally defined as "he that followeth or cometh in another's place" or "who follows or takes the place another has left and sustains the like part or character." *Id.* at p. 1068. Just as a successor takes the place of another, a completing surety takes and succeeds to the rights

of its principal.

Of particular note is the *Argonaut* court's assertion that the reason that the subcontractor's bond included a clause limiting those who could maintain a cause of action on the bond was to protect the surety from claims of the subcontractors and materialmen of its principal who might claim protection otherwise as third party beneficiaries under the performance bond. The introductory clause in the *Argonaut* bond clearly stated that the protection afforded under the bonds extended to the interest of the obligee. As a subrogee of the Obligee, the protection afforded by the bond extended to the general contractor's surety.

The *Argonaut* decision was followed in the 4th District of Florida in 1981 by the case of *Financial Ind. Co. v. Steele & Sons, Inc.*, 403 So.2d 600 (4th Fla. DCA 1981). In that case, as in *Argonaut*, the general contractor's surety filed suit to recover against its subcontractor's surety. The Fourth District Court of Appeals in Florida relied on the *Argonaut* decision, *supra*, in holding that the general contractor's surety did in fact have a cause of action on the subcontractor's bond under the doctrine of subrogation.

The Florida courts are not the only courts that have ruled on this very specific issue in favor of the general contractor's completing surety. The Supreme Court of New York, relying on the *Argonaut* decision from Florida, ruled that a completing surety was a "successor" of its principal, the general contractor, and as such, had standing to sue one of the subcontractor's sureties for damages resulting from the subcontractor's wrongful conduct which occasioned and contributed to the general contractor's default. *Menorah Nursing Home, Inc. v. Zukov*, 153 A.D.2d 13, 548 N.Y.S.2d 702 (1989).

The District Courts of Appeals in both the Third and Fourth Districts of California have also rendered similar decisions. In the case of *Storm & Butts v. Lipscomb*, 3 P.2d 567 (4th Cal. DCA 1931), the court ruled that the general contractor's surety, upon satisfying the obligation of its principal, was subrogated to its principal's rights and was in fact a proper party plaintiff in a suit against the subcontractor and the subcontractor's surety for a breach of that subcontract. The general contractor's surety acquired its rights by way of subrogation and not merely by way of assignment.

In *Continental Cas. Co. v. Hartford Acc. & Ind. Co.*, 52 Cal. Rptr. 533 (3d. Cal. DCA 1966), the court ruled that the subcontractor's surety was liable to the general contractor's surety for unpaid bills for construction materials for which the subcontractor had failed to pay.

The *Continental Cas.* decision, when viewed in light of its complex facts, may provide the strongest support for the proposition that a completing surety is a successor of its principal. The general contractor, in that case, Hal Hayes, entered into a contract with the United States for a construction project on an Air Force base. Continental provided the surety bond on behalf of Hal Hayes. Thereafter, Hal Hayes assigned the entire contract to Hayes-Cal. It was Hayes-Cal that subcontracted the plumbing work to Country Boys. Hartford was the surety for Country Boys. Country Boys failed to pay for goods and materials furnished by its suppliers. Continental, the surety for Hal Hayes, paid the suppliers and thereafter filed suit against Country Boys' surety, Hartford, to recover for the amounts paid.

Hartford contended that Continental could not maintain an action on the subcontractor's bond because the obligations owed under the bond were owed only to Hayes-Cal, the named obligee. In response, the court ruled that where the completing surety has made a payment, satisfied an obligation or suffered a loss by reason of a subcontractor's breach of its contract, the completing surety is entitled to recover for that loss from the surety of the subcontractor. Having suffered a loss as a result of the subcontractor's default, the general contractor's surety, regardless of the technical differences in the names of the obligee and the surety's principal, was entitled to recover for its loss from the subcontractor's surety.

It is clear from these decisions that the courts have recognized that the general contractor's surety who performs under its bonds earns its status as "successor" of the obligee on the subcontractor's bond, its principal, by stepping into the shoes of its principal, the obligee and satisfying its contractual obligations, whether by arranging for the completion of the contract or by paying the claims of subcontractors and suppliers for labor and material incorporated into that project.

The Subcontractor's Surety Enjoys the Same Right of Action Against the General Contractor's Surety

In terms of preserving rights to the recovery of contract balances due its principal for losses suffered as a result of satisfying its obligations under performance and payment bonds, the subcontractor's surety enjoys the same rights as the general contractor's surety with respect to such a claim. In the 5th Circuit case of *Traveler's Ind. Co. v. Peacock Constr.* 423, F.2d 1153 (5th Cir. 1970), Judge Brown began his decision by noting that not only does a completing surety succeed to the rights of the obligee, but also succeeds to the rights of its principal. The general contractor's surety had defended the claim on the basis that the subcontractor's surety was not a "claimant" as defined under the general contractor's bond and as such, was not entitled to maintain the cause of action. The Court noted that the subcontractor's surety's principal was a "claimant" as defined under that bond and that in light of the fact that the subcontractor's surety was subrogated to its principal's claim, the subcontractor's surety was entitled to recover under the bond of the general contractor.

Subcontractor's Surety's Reliance on Equitable Principles May Provide the Greatest Defense to the Claim.

The decisions which address a subcontractor's surety's successful defense to a claim by the general contractor's surety appear to rest upon the fact that the right of subrogation is founded upon equity and that one asserting a right cannot thereby profit from his own wrong, but must himself be without fault. Faced with a claim by the general contractor's surety, a subcontractor used the fact that the general contractor had materially breached the subcontract in order to successfully defend against the claim of a completing surety in the case of *National Surety Corporation v. Allen-Codell Co.*, 70 F.Supp. 189 (E.D. Ky. 1947).

In *Allen-Codell*, Gwinn entered into a contract with the Kentucky Department of Highways for the construction and improvement of a particular section of highway. National Surety Corporation provided the performance bond for Gwinn. Gwinn subcontracted the surfacing portion of the contract to Allen-Codell Company. Although the subcontract contained no express provision as to when the surfacing should be begun or completed, it was understood that it was necessary for Gwinn to first complete the base before the surface could be applied. The general contract provided that the work contained thereunder was to be commenced within ten (10) days of the date of the contract and completed by a definite time. That general contract also contained a "time is of the essence" clause and a provision for the payment of liquidated damages for each and every day after the fixed date of completion for which the work remained incomplete.

Only a small portion of the base had been made ready for surfacing by Gwinn prior to the specified completion date for the general contract. Allen-Codell Company promptly applied the surfacing to that portion of the base that had in fact been completed. The project was suspended due to weather, but Gwinn did not resume work on the project at the end of the suspension period, rather, Gwinn apparently abandoned it altogether. No further work was done towards the preparation of the base of the road for surfacing.

Almost nine (9) months after the specified completion date of the general contract, Allen-Codell Company received in the mail a letter purporting to be from Gwinn advising that the road would be ready for surfacing approximately ten (10) days later. (The evidence at trial revealed that the surety, not the contractor, sent the letter and that, in reality, no work was being done at all.). Allen-Codell Company, considering that it was no longer obligated under its subcontract, declined to do anything more on the road. The work was ultimately completed approximately eighteen (18) months after the original contract completion date by another contractor employed by Gwinn's surety.

Relying on its subrogation rights, Gwinn's surety sued Allen-Codell Company for the loss it suffered as a result of having to complete the surfacing of the road with another contractor and the amount of liquidated damages the surety was required to pay to the State on account of the delay.

The *Allen-Codell* Court recognized the general proposition that, a surety who, under the requirement of his bond, completes the contract of a defaulting contractor may be subrogated to all the rights and remedies of the defaulting contractor against a third person who, by a subcontract, was obligated and wrongfully failed to perform some part of the work which the

surety was required to complete. It went further to note, however, that the surety stands in no better position than the principal contractor through whom his right is derived. The rights and remedies to which the surety succeeds are taken subject to all defenses, limitations, and disqualifications incident to them in the hands of the party to whom he is subrogated. In other words, according to the court, the surety stands in the shoes of the principal contractor, with no better right or remedy. Thus, in order to determine whether the surety was entitled to recover against Allen-Codell Company, the Court had to first determine whether Gwinn could have recovered against Allen-Codell Company had it completed the work in question instead of the surety.

After consideration of all the evidence, the Court ruled that Gwinn's failure to pay Allen-Codell Company the amount due, its failure to resume operations at the expiration of the suspension period, its removal of its machinery and discharge of its employees from the job, its statement of its inability to complete the work and its delay of almost a year before pretending to have any substantial amount of the base of the road made ready to be surfaced altogether constituted a material breach of the subcontract with Allen-Codell Company and a complete defense to any claim which Gwinn, and thus, its surety, might have asserted against Allen-Codell Company on account of its refusal to complete the subcontract. In reaching this decision, the Court relied on the well-settled principle that the material breach of a contract excuses further performance by the other party and precludes an action for damages on the unexecuted part of that contract. *Id.* at p. 192.

The actionable phrase in the successful defense asserted in the *Allen-Codell* case is "material breach." As is shown in the case of *Sentry Insurance v. Lardner Elevator Co.*, 153 Mich. App. 317, 395 N.W.2d 31 (1985), the mere fact that the general contractor may have defaulted on a project and its surety had to complete under its bond will not bar the action of the general contractor's surety against the subcontractor for recovery of losses suffered as a result of a subcontractor's breach unless that default constituted a "material breach" of the subcontract.

According to the facts, Division contracted with Ingham County to renovate a shelter home. Sentry issued the performance bond on behalf of Division. Division subcontracted the installation of the elevator to Lardner. Division abandoned the project after running into serious financial difficulties and Sentry, in satisfaction of its obligations under the performance bond, hired a replacement contractor to complete the project for Division. Sentry, Lardner and Ingham thereafter executed an agreement under which Lardner was to be paid Twenty Thousand Dollars (\$20,000.00) up front and was to proceed to complete the elevator installation. The balance of the funds owing to Lardner was to be placed in escrow.

Lardner accepted the Twenty Thousand Dollars (\$20,000.00) but thereafter only performed sporadically. Evidence was presented that Lardner did not work at all on the project for an entire twenty-one (21) day period, unrelated to Division's default. Lardner also failed to do any work during deer hunting season, during Thanksgiving, or the week immediately thereafter. In addition, Lardner removed equipment from the construction site for storage.

When the replacement contractor arrived onsite, it noted that the elevator was the most incomplete item. This delayed other aspects of the construction. Taking all of the evidence into account, the Court found that little work on the elevator had been done after Lardner

received its Twenty Thousand Dollar (\$20,000.00) lump sum payment and that the lack of progress on the shelter home project was attributable to Lardner's slow progress on the elevator. Sentry was ultimately required to hire another contractor to complete the elevator installation. Sentry thereafter sued Lardner to recover the cost of replacement, damages for delay and attorneys' fees.

In reaching its decision, the trial court stated that the basic issue before it was who had breached the contract first. It noted that had Division breached the subcontract with Lardner, Lardner could have asserted that breach against Sentry to excuse its performance, citing the *Allen-Codell* decision as controlling authority for that proposition. The Court reiterated that "one who commits the first substantial breach of a contract cannot maintain an action against the other contracting party for failure to perform."

In reviewing the evidence, the Court found that although Lardner contended that Division's default on the project constituted a total breach, Lardner did not demonstrate such a belief by its conduct. Lardner continued working on the project after Division's default, dealing with Sentry and Ingham County. In addition, Ingham County paid Lardner Twenty Thousand Dollars (\$20,000.00) pursuant to an agreement under which Lardner agreed to complete the elevator installation with all due haste. Lardner, contrary to that agreement, failed to do so and removed equipment from the work site, thereby causing further delay.

The Court concluded that Lardner breached the subcontract by failing to perform and was not justified in terminating its performance, particularly after its acceptance of payment and its agreement to proceed to complete the installation of the elevator.

The *Lardner* and *Allen-Codell* decisions illustrate the courts' inclination to view the equities of the situation in determining the viability of a general contractor's surety's claim against a subcontractor's surety. In the *Lardner* case, although Division was financially unable to complete the project and Sentry, its surety, was called upon to and did satisfy its obligations under the performance bond to do so, the court did not find that Division's default constituted a "material breach" of the subcontract such that it excused Lardner from performing. In the *Allen-Codell* case, however, the acts of the general contractor and its surety were deemed to constitute a "material breach" of the subcontract, excusing the subcontractor from performing and granting the subcontractor a complete defense to the general contractor's surety's claim against it for losses resulting from its failure to perform. The facts of your particular case are going to drive the defense and the surety with the "superior equity" will most likely prevail.

In the *Lardner* decision, the court skims over an issue which might have provided the subcontractor's surety with yet another defense against the general contractor's surety's cause of action on its bond, that of novation. Under the facts of the *Lardner* case, upon Division's default, Sentry, Lardner and the Owner entered into an agreement whereby Lardner was paid a lump sum up front and agreed to proceed to complete the construction of the project. Under the agreement, the balance of the funds owing to Lardner were to be placed in escrow. *Id.* at p. 319. Under the original subcontract, however, "... on or before the last day of each month, Lardner was to submit to Division on a required form a written pay request for the proportionate value of the work installed to date, which requisition was to be approved for payment by the contractor's project manager." *Id.* at p. 320. In addition, while the original subcontract provided, after amendment, that the elevator was to be completed by November,

the new agreement entered into between Lardner, Sentry and Ingham County in October merely provided that the Lardner was to "...proceed post-haste to complete..." the installation of the elevator.

The Lardner court never truly addressed the issue of novation, but merely noted that it was one viable theory under which Lardner proceeded to complete the project. For the subcontractor's surety, however, a finding by a court that such an agreement constituted a novation could result in a complete discharge of the subcontractor's surety from any liability under its bond or a discharge to the extent that the surety could prove it had been injured or prejudiced thereby. *Brunswick Nursing & Convalescent Center, Inc. v. Great American Ins. Co.*, 308 F. Supp. 297 (S.D. Ga. 1970); O.C.G.A. §10-7-21. Any unconsented to increase in the risk is an independent ground for discharge of a surety. *Upshaw v. First State Bank*, 244 Ga. 433, 260 S.E.2d 483 (1979). The new agreement in Lardner altered the payment terms and the timing of the performance terms of the subcontract. Just such a change in the terms of payment under a building contract may operate to discharge a surety. *Brunswick Nursing & Convalescent Center, Inc.*, supra. Although the novation defense was not raised or addressed in *Lardner*, the decision is illustrative of yet another defense that may be raised by subcontractor's sureties that find themselves defending against a claim of the general contractor's surety after the general contractor's default.

In defending against claims against their bonds, subcontractor's sureties have also tried to argue that the completing surety is merely an "assignee" of its principal, not its "successor," and as such, the cause of action is barred by the restrictive right-of-action clause in the bond.

The restrictive right-of-action clause in a bond has been used to defeat causes of action against the bond by those who had acquired their rights solely by way of assignment. Such was the case of *Southern Patrician Associates v. International Fidelity Ins. Co.*, 191 Ga. App. 106, 381 S.E.2d 98 (1989) wherein the Georgia Court of Appeals ruled that the right-of-action clause in a surety bond specifically excluded the owner, as assignee of the general contractor, from bringing an action on the bond.

Southern Patrician Associates ("Southern"), owner, entered into a contract with C.M. Systems, Inc. ("C.M."), as general contractor, to renovate a shopping mall. C.M. subcontracted a portion of the work to Construction Concepts d/b/a R&M Mechanical, Inc. ("R&M"). International Fidelity Ins. Co. ("IFIC") supplied the bond for R&M under which C.M. was the named obligee.

Before work on the project was completed, C.M. filed bankruptcy. C.M.'s surety assigned all of C.M.'s rights to Southern. Southern ultimately terminated R&M and called upon IFIC to complete the work under its bond. IFIC failed to respond and Southern completed the work itself.

Southern filed an arbitration action against IFIC. IFIC argued, and the Georgia Court of Appeals agreed, that it was not obligated to arbitrate because the right-of-action clause in its bond limited the right-of-action to the obligee or "the heirs, executors, administrators or successors of the obligee."

Southern's sole source of its rights in the arbitration action was the assignment of

C.M.'s rights under the construction contract that it had received from C.M.'s surety. The Court found that the inclusion of the phrase "successors and assigns" in the general obligation clause of the bond and the use of the term "successors" alone in the right-of-action clause in a one-page bond clearly showed that the words "successors" and "assigns" had two different meanings, with the result that Southern, as an "assign," was prohibited from bringing a cause of action under the bond. In reaching its decision, the court adopted a very limited definition and asserted that "... the term 'successor' means, ordinarily in the case of a corporation, another corporation which by a process of amalgamation, consolidation or duly authorized legal succession has become invested with the rights and has assumed the burdens of the first corporation.[Cit.]..." Id. at p. 107.

A similar result was reached in *TRST Atlanta, Inc. v. 1815 The Exchange, Inc.*, 220 Ga. App. 184, 469 S.E.2d 238 (1996). There, the owner assigned all of its interest in a construction project to its lender, TRST. The lender filed suit against the general contractor for breach of contract and negligent construction and against St. Paul Fire & Marine Ins. Co. ("St. Paul"), the general contractor's surety under its performance bond.

St. Paul defended on the basis that TRST had no cause of action against the bond as the right-of-action under the bond was expressly limited to the owner named therein "...or the heirs, executors, administrators or successors of the owner...." TRST was not a successor of the owner but was merely an assignee.

The Georgia Court of Appeals, relying on the *Southern Patrician* precedent and adopting the definition of "successor" espoused in that decision, ruled that in the absence of any evidence of a "...duly authorized legal succession by which TRST had become invested with the rights and had assumed the burdens of the owner....," St. Paul's bond specifically excluded TRST, as a mere assignee of the owner, from a right of action under the bond. There being no such evidence, the dismissal of TRST's cause of action against St. Paul was affirmed.

Courts in other jurisdictions have, on identical right-of-action clauses, refused to extend a right-of-action to parties other than those expressly named in the clause. *Augusta Court Co. - Owners' Assoc. v. Levin, Roth & Kasner, P.C.*, 971 S.W.2d 119 (Tex. 1998); *Stonecipher v. Mitchell*, 655 So.2d 1381 (La. App. 1995); *Bd. of Ed. School Dist. No. 15, DuPage County v. Ockerlund & Assoc.*, 165 Ill. App. 3d 439, 519 N.E.2d 95 (1988); *Rush Presbyterian St. Luke's Medical Center v. Safeco Ins. Co. of America*, 825 F.2d 1204 (7th Cir. 1987); *Tony & Leo, Inc. v. United States Fidelity & Guaranty Co.*, 281 N.W.2d 862 (Minn. 1979); *Stahlhut v. Sirloin Stockade, Inc.*, 568 S.W.2d 269 (Mo. App. 1978); *Young v. General Ins. Co.*, 33 Ill. App. 3d 119, 337 N.E.2d 739 (1975).

None of the cases cited above in which the surety successfully defended a claim against its bond on the basis that the claim was barred under the right-of-action clause because it was brought by an "assignee," however, involved a claim by a completing surety. The reason for that is that subrogation and assignment are two very different concepts. In the case of *Maryland Cas. Co. v. Brown*, 321 F. Supp. 309 (N.D. Ga. 1971), the District Court noted that subrogation differs from an ordinary assignment of a debt in that the ordinary assignment assumes the continued existence of the debt, while subrogation follows upon its payment. *50 Am. Jur. Subrogation*, § 4, p. 681. In other words, in the context of subrogation,

the party who satisfies the obligation or pays the debt of another, actually steps into the shoes of the party whose obligation or debt it satisfied and acquires all of the rights, securities and remedies of that party by reason of the actual satisfaction of that obligation or debt. *Argonaut Ins. Co. v. C&S Bank of Tifton*, 140 Ga. App. 807, 232 S.E.2d 135 (1976); *Cotton States Mut. Ins. Co. v. Citizens & Southern Nat. Bank*, 168 Ga. App. 83, 308 S.E.2d 199 (1983); *First Nat. Bank of Atl. v. American Sur. Co.*, 71 Ga. App. 112, 30 S.E.2d 402 (1944).

Even where the financing agreements may provide that the defaulting general contractor “assigns” its rights to the contract, including the right to collect and receive the remaining contract balances, to the surety or the indemnity agreement provides that upon default, the principal “assigns” all of its rights to the surety, those assignments are in addition to and not in derogation of the more valuable subrogation rights of the completing surety. Once that surety performs under its payment and performance bonds, it succeeds to its principal’s rights, including the right to pursue a cause of action against a subcontractor’s surety for damages resulting from its breach.

CONCLUSION

As a general rule, a completing surety, as subrogee and successor of its principal, has and may pursue a cause of action against a subcontractor’s surety for recovery of losses suffered as a result of a subcontractor’s breach. It would be a mistake to assume, however, that all such causes of action will be successful. The courts will look to the equities of the situation in deciding between two sureties. When its principal has defaulted on the contract, the completing surety must prevail on the argument that its principal’s default did not constitute a “material breach” and in no way contributed to or caused the subcontractor’s breach. When it steps in to finance or take over the contract, the completing surety must be very circumspect as to any agreements it enters into with the subcontractors, ever cognizant that any novation will serve to discharge the subcontractor’s surety. Just as completing sureties, by performing under their performance and payment bonds, “succeed” to the rights of their principals, so those completing sureties should succeed against subcontractor’s sureties in their actions against their bonds.

