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COMMENTS

THE RIGHT OF A PAID SURETY TO SUBROGATION

Bank of Fort Mill v. Lawyer's Title Insurance Corp., 268 F. 2d 313 (4th Cir. 1959), is a recent case raising the question of whether a paid surety may recover against a so-called "innocent" third party under the equitable doctrine of subrogation. Plaintiff issued a policy to Loan Association guaranteeing it against loss by reason of defects in title to real estate described in a mortgage. The mortgage was forged by Attorney, and was offered to secure a loan from Loan Association. Attorney also forged the check issued by Loan Association, and deposited the proceeds to his own account. In due course defendant drawee bank received the check and made payment. Upon discovery of the fraud, plaintiff paid Loan Association the amount of the "loss" under the terms of its policy, and took an assignment from it of all its claims or causes of action arising out of the fraudulent transaction. Plaintiff then brought this action against the defendant drawee bank, claiming to be subrogated to Loan Association's cause of action against its drawee for reimbursement of the drawer's account to the extent of the forged check. Held: For defendant drawee bank. Subrogation is an equitable doctrine, not a matter of right. Since the equities of the innocent, non-negligent defendant bank are not inferior to those of the plaintiff, who was paid to accept the risk, subrogation will not be allowed. Plaintiff not being entitled to subrogation, its position is not improved by the assignment to it of the insured's cause of action against the drawee bank.1

Despite the general rule that, upon payment of a loss, an insurer (or insurers in the case of coinsurance) is entitled to be subrogated pro tanto to any right of action which the insured may have had against a third person whose negligence or wrongful act caused the loss,2 the result reached in the foregoing decision represents what is unquestionably the overwhelming majority view on the present issue. In its simplest terms, the majority rule states flatly that a compensated surety (insurer) will not be allowed to enforce a right or claim, as subrogee, against a party which was not negligent or actually at fault, even though the later is otherwise legally liable. Most of these cases appear to be based upon the premise that because the surety has been paid for the sole purpose of assuming the very risk which, in fact, did occur, its position or standing in a court of equity, where it is attempting to enforce its rights on the basis of the equitable doctrine of subrogation, is inferior as against a defendant who is legally liable, albeit not actually at fault. Its equities will be deemed inferior.3

1 Bank of Fort Mill v. Lawyer's Title Insurance Corp., 268 F.2d 313 (4th Cir. 1959).
3 United States Fid. & Guar. Co. v. First Nat. Bank in Dallas, 172 F.2d 258
For the sake of simplicity, the problem is best broken down into two main categories. Variations off the main theme will often appear within each, but general principles should remain steadfast throughout. In the first category, the obligation of both the principal and surety may be considered identical, except that the obligation of the principal is primary, that of the surety only secondary. Two examples may conveniently be given: 1) A, depositor, requires his bank, B, to furnish a "bond" to protect his deposits therein. C, surety, furnishes the bond. Obviously B is primarily liable on the debt, the deposit, while C, upon furnishing the bond, becomes only secondarily liable to A on the same debt. B is truly the principal. Or, also within the confines of the same category: 2) A, employer, may be furnished a bond by C, surety, protecting A against dishonesty by his employee B. Here again it is apparent that C is secondarily liable only, but still on the same underlying obligation as B, the principal. In the event of default by B in either of the foregoing instances, the majority of courts have readily permitted the surety, C, to be subrogated to all of the rights of the depositor, A, in the first illustration, or the employer, A, in the second, against the defaulting principal, B. Each of these cases represents a manifest compliance with the familiar principle of subrogation that a surety who has been compelled to pay the obligations of a defaulting principal possesses stronger equities than his principal, and is entitled to be subrogated against him. By virtue of his default, the courts simply deem the "equities" of the principal inferior to those of the surety, and the fact that the surety may have been compensated for assuming the risk is no longer material. To allow the defaulting principal, the party primarily


4 Though if B himself does not take out the bond, which is the rule rather than the exception, it must be said that he is a principal but in a loose sense of the word. This has been described as a non-consensual suretyship by one writer. See Campbell, Non-Consensual Suretyship, 45 Yale L. J. 69 (1935). The courts do not appear to have made a distinction when dealing with the rights of the surety to be subrogated against the employee in cases of his defalcation.
liable on the obligation, to escape unscathed would result in clear unjust enrichment.5

The second of the categories alluded to above is exemplified by the Bank of Fort Mill decision, supra.6 The most significant distinction between the two arises from the fact that in the Fort Mill situation the obligations of the surety (or insurer) and the defendant bank are not identical. To the contrary, the obligations are separate and distinct, and both are essentially primary. This is to say that the defendant bank is obligated to A, its depositor, solely by virtue of its contract of deposit; whereas C, the surety, is obligated to A on its forgery policy only. Neither of the obligations is related to the other in any manner, and, absent the "paid surety" defense, the obligation of neither obligator is contingent upon the existence or defaulted performance of the other. The addition of but one further element to the first category, then, can set the stage for the introduction of the "paid surety" defense. Thus, if in the second illustration a check or other negotiable instrument belonging to A and had been forged by employee B, and then cashed by A's bank,7 A would be in a position to seek recovery from either of two sources. A could go against his bank on the contract of deposit for paying on the forged instrument; or A could look to his surety, C, on the forgery policy. Should A decide to recover from his surety, C, and should B be unavailable or insolvent (either or both of which commonly appear, for obvious reasons), then C, upon payment of the loss, has recourse only against A's depository bank. However, as stated above, the right to subrogation is now asserted not against a defaulting principal, on the same obligation, but rather, it is against a third person, the depository bank, which is liable to A on its own obligation, the contract of deposit. To the majority of courts, this difference, at least to the surety, is insurmountable.8 The issue has re-

5 RESTATEMENT, RESTITUTION §162 (1937): "where the property of one person is used in discharging an obligation owed by another . . . under such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred, the former is entitled to be subrogated to the position of the obligee . . . ."

6 Supra, note 1.

7 It would seem that similar considerations become involved by hypothecating C, insurer of the bank, proceeding against a prior indorser of the forged instrument.

8 See American Surety Co. v. Bank of California, 133 F.2d 160, 162 (9th Cir. 1943) where the court expressed the view: "The right of subrogation is a creature of equity, applicable where one person is required to pay a debt for which another is primarily responsible, and which the latter should in equity discharge. In theory one person is substituted to the claim of another. But only when the equities as between the parties preponderate in favor of the plaintiff. That is, a surety's right of recovery from a third party through subrogation does not follow, as of course, upon proof that the losing but recompensed party could have recovered from the third party. Accordingly, subrogation will not operate against an innocent person wronged by the principal's fraud. A surety may pursue the independent right of action of the original creditor against a third person, but it must
solved itself then to the question of whether the surety has any right to be subrogated to the contractual rights of its insured against this third party; and if so, in what manner.

It has been suggested that there are three possible solutions to the problem:

(1) To prohibit recovery by the surety against the third person, who is thus in effect given the benefit of insurance on which he has not paid any premium and where there is no direct contractual or other relationship between him and the surety.

(2) To allow the insured to recover from both the surety and third party and thus to be doubly indemnified—a situation which the law has always deemed contrary to public policy not only by reason of its unfairness but because of its incitement to fraud.

(3) To give the surety the benefit of the contractual obligation of the insured against the third party by allowing subrogation.9

Still a fourth alternative has been advanced, though to the knowledge of this writer never adopted, to the effect that the party first discharging the obligation should be entitled to contributive subrogation against the other.10 Thus the surety-insurer and the defendant bank could effectively divide the loss.

In the light of the aforementioned majority rule that subrogation will not lie against an “innocent” third person wronged by the fraud of the principal, it is proper here to mention that the converse of the rule is also true. It is the almost universal rule that when the third party has been negligent, or has knowingly participated in the original wrong, such conduct will be sufficient to balance the “equities” in favor of the paid surety. As is made amply clear by the court in Bank of Fort Mill, the payment of instruments on which indorsements have been forged is not such negligence as to raise any equities in favor of the surety. But where the bank has allowed a diversion of the depositor’s funds despite cognizance of some irregularity, equities have been found in favor of the surety so as to uphold its claim to subrogation.11
Implicit in such decisions would seem to be a recognition that rules imposing liability upon a particular party, most commonly a bank, in the field of negotiable instruments, or in fiduciary relationships, are founded upon an almost indispensable public policy; and, although from a viewpoint of moral culpability oftentimes severe, should be waived only to avoid real injustice or hardship.\(^2\) Since the activity of the bank in these cases is instrumental in the achievement of the fraudulent purpose, there is no substantial injustice done by holding it liable to the full extent of the loss.

What, then, of the situation where the third party is neither negligent, nor a knowing participant in the fraud of the principal—the second of our main categories. As shown by Bank of Fort Mill,\(^3\) this has been the source of all the controversy. Unquestionably, if it be assumed that the fraud is the cause of the loss, the very fact that the party against whom liability is sought to be enforced is not in any degree the cause of the fraud, itself makes a finding in favor of the surety with respect to subrogation less compelling. But is the basic assumption correct? It is the theory of negotiable instruments law that when one deposits money on general deposit with a bank, a relationship whereby the bank becomes the debtor of the depositor for the amount so deposited results. With this relationship, the bank implicitly undertakes to pay the money either to the depositor himself or to someone to whom he directs it to be paid. Necessarily then, assuming the depositor does nothing to give rise to an estoppel, when the drawee has debited the account of the drawer of an instrument, bearing a forged or other unauthorized indorsement of any holder whose indorsement was required for the transfer of title, the drawer has the right to have his account reimbursed to the amount paid out by the drawee. The contract of deposit unmistakeably prohibits any effective debit of the depositor's account.\(^4\) Liability to the depositor cannot be avoided since it is no defense for the bank to show that it paid out the money in good faith on the mistaken belief that the person presenting the check was one authorized by the depositor to sign it and draw out the money, when in fact he was not.\(^5\) Even the fact of the drawer's

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1. Footnotes:

1. See supra, note 1.
2. See Merrill, Banker's Liability for Deposits of A Fiduciary to His Personal Account, 40 Harv. L. R. 1077 (1927).
3. See Merrill, Banker's Liability for Deposits of A Fiduciary to His Personal Account, 40 Harv. L. R. 1077 (1927).
4. The drawee bank paying a depositor's check on a forged indorsement is held to have paid it out of its own funds and cannot charge the payment to the depositor's account. See Metropolitan Casualty Ins. Co. v. First Nat. Bank in Detroit, 261 Mich. 450, 246 N.W. 178 (1933), and Land Title & Trust Co. v. Northwestern Nat. Bank, 196 Pa. 230, 46 Atl. 420 (1900).
5. In Denbigh v. First Nat. Bank of Seattle, 102 Wash. 546, 174 Pac. 475, 478 (1918) the court said: "The implied contract between the bank and its de-
negligence will not generally defeat a recovery by the drawee bank against the collecting bank. In short, therefore, it can be said that the liability of the bank paying the forged instrument is “absolute” and not predicated upon negligence at all. Unquestionably these factors have played a role in the decisions of the majority. The question is whether the result is sound. It is submitted that it is not, and that it ignores more fundamental considerations.

Most fundamental of all is, perhaps, the objection that no ultimate or irretrievable loss has been visited upon the holder of negotiable paper payable to order when it is stolen from him and forged. He remains the holder, and neither the paper itself nor the obligation giving rise to it can be discharged, by payment or otherwise, pursuant to the forgery. The assumption of “loss” caused by the forgery is therefore predicated upon a supposition that, irresistibly, the paper will clear to the drawee, be paid, and that all parties will treat the transaction as a closed one. While in a purely practical sense, this assumption may prove true in many cases; nevertheless, in a strict legal sense there will be a “loss” to the holder only because some aspect of waiver or estoppel intervenes to make it so. This is to say that a drawer (holder) really suffers no loss unless he has estopped himself to assert

16 State Bank v. Mid-City Trust & Savings Bank, 232 Ill. App. 186 (1924). Note that the fact such action is based upon a restitutional theory of mutual mistake of fact, as opposed to a breach of the contract of deposit, the liability remains the same. “Under the Negotiable Instruments Law, an indorser of a check with a modification warrants to all subsequent holders that the instrument is genuine and in all respects what it purports to be, that he has good title to it, that all prior parties had capacity to contract, that the instrument is at the time of his indorsement valid and subsisting, and he engages that on due presentment it will be paid, and that if it is not paid he will pay the amount thereof to the holder or to any subsequent indorser who may be compelled to pay it. Each subsequent indorser of the checks becomes liable to subsequent indorsers under his or its warranties and engagements.” Boserine v. Maryland Casualty Co., 112 F.2d 409, 415 (8th Cir. 1940). See also Home Ins. Co. v. Mercantile Trust Co., 219 Mo. App. 645, 284 S.W. 834 (1926). The rule would simply seem to be that if the court is willing to apply the “paid surety” defense, then it will apply it to the restitutional action by the insurer of the drawee against a prior indorser of the instrument also.

17 Obviously this is not meant as an objection to the result of cases involving a contract whereby everyone is to be indemnified for any loss suffered. Thus where the liability of the surety is not alone to the insured, but either by the terms of the bond or the requirement of statute is also to ANYONE who should suffer loss by reason of misconduct, it would be absurd to allow the surety to be subrogated to the rights of one whom it had indemnified against another who, if compelled to pay, would have a right to recover from the surety what he had been compelled to pay. American Bonding Co. v. Welts, 193 Fed. 978 (9th Cir. 1912); American Bonding Co. v. State Savings Bank, 47 Mont. 332, 133 Pac. 367 (1913), and Stewart v. Commonwealth, 104 Ky. 489, 47 S.W. 332 (1898).
his claim against his bank, since no payment on a forged instrument can effect his account in any manner. Indeed, the technical verity of this can lead only to the conclusion that, under the circumstances, no compensable loss has occurred under the policy. Since no loss, to what can the surety claim to be subrogated, even conceding the payment by it to the depositor? As a corollary to this, of course, is the stark reality that if there has been a loss, it has been caused by estoppel or waiver of the depositor. Since the surety can succeed to no better rights than those held by its subrogor, the former is also effectively blocked along this path to recovery.

It is submitted that while this may, as stated, be a technically valid objection to any action by a surety, it loses sight of the practicalities of the matter. The depositor insures himself against the possibility of loss, in order to avoid any and all difficulties in this respect. In a very real sense there is at least the appearance of liability and loss whenever a forged check is cashed, whatever the legal realities may be. It is this “loss” which is being insured throughout the whole system, and it is this loss which should be sufficient to support any claims by the surety. As will be seen later no injustice is thereby worked, for the claim of the bank against prior indorsers remains unaffected, and any defenses assertable against the depositor are good against his subrogee.

The first objection of the writer to the finding of the majority is directed at the reason for excepting this particular field of insurance from the normal rules pertaining to insurance. To say merely that the equities of one party or the other are superior, and therefore subrogation should or should not be allowed, seems tenuous. A more proper question would seem to be whether the third party is liable. If the third party is liable, then what difference should it make whether the surety claims to be subrogated to a contractual right which its insured possesses against the third party, or whether the claim is based on a right arising out of the negligent operation of a motor vehicle. To defend on the ground that, in the latter situation, the defendant is truly a tortfeasor begs the question. The fact remains that the law in both cases has imposed liability, and there is no requirement that the defendant be morally culpable.

The majority view is all the more weakened when it is remembered that the defendant itself is usually insured against the same possibility of loss. In what is perhaps the leading case espousing the minority view on the subject, the court made the following interesting and poignant observation:

It would seem that the cases denying subrogation to a surety of its insured’s contractual right against a third party are unrealistic in ignoring the fact that the third party itself is generally insured by another surety or casualty company against losses
caused by the neglect of its officers or employees. . . . In states which follow the criticized rule the surety or insurer of the third party . . . would go free of obligation. These cases are also unrealistic in implying a 'superior equity' in favor of a third party defendant where a court of equity did not find any unconscionable conduct at all. As applied in the surety-subrogee cases discussed herein the phrase is mere language devoid of meaning.\textsuperscript{18}

In other words, hasn't the majority stretched common sense to the point of breaking when one compensated surety can assert as a defense to an action by another compensated surety the fact that the latter has been compensated, without regard to whether in fact there is any other defense to an otherwise-defined legal liability?

A third obvious deficiency in the mechanics of the "paid surety" defense is that it is up to the caprice of the insured to determine where liability is ultimately to lie. Thus, if the insured arbitrarily chooses to hold his bank liable on the contract of deposit, irrespective of the fact that his forgery insurance might cover, the bank is left without any defenses which it would otherwise possess against the surety. Yet, under the tenets of the doctrine, because the insured has chosen to pursue the surety, the bank is afforded a magic defense which becomes impregnable as to the surety. Practically, of course, such a result effectually gives the bank the benefit of insurance which its depositor had the foresight to carry, despite the fact that it has paid no premium whatsoever, has no other interest or privity in the matter, and has in fact been the legal cause of the loss. Logically, it seems, the argument that the surety has no right to be subrogated to contractual rights, which its insured might possess against its drawee, because its liability is predicated on a separate and distinct obligation could better be employed. Is it not more sound to say that this is the very reason why the drawee bank has no legitimate claim to benefits which the depositor might obtain from his own insurance? It is the bank which has paid on the forged instrument which is legally liable, albeit on a contract of deposit, and logically this liability is no different because the depositor happens to be insured. The claim that the "equities have not been balanced" is no substitute for reality, and contains no magic potion to absolve the bank from its otherwise patent liability. Again as stated by the New Jersey court:

\begin{quote}
We adhere to the third alternative and give the surety the benefit of the insured's contractual rights against the third person, first because it is sound in principle, giving force to the contractual relations of the several parties and, second, because it is in harmony with the rule adopted in this state in all other forms of insurance with respect to subrogation.\textsuperscript{19}
\end{quote}

\textsuperscript{18} Supra, note 9 at 303.
\textsuperscript{19} Id at 302.
As still another of the minority courts has said: "And what difference can it possibly make to the bank whether it pays the loan company on its unavoidable liability, or pays the title company as assignee of the loan company, so long as in paying it satisfies a liability it cannot escape."\(^{20}\) The force of such reasoning in this day and age seems overwhelming;\(^{21}\) and, until Bank of Fort Mill,\(^{22}\) it appeared that the ranks of the minority were destined to grow.\(^{23}\)

II. Assignment

It is the purpose of this section to focus attention upon the last problem faced by the court in Bank of Fort Mill\(^{24}\) where the surety claims not only under an alleged right to subrogation, but also under a formal assignment of all rights from the insured. The argument on the part of the surety is usually to the effect that since the insured was

\(^{20}\) Kansas City Title & Trust Co. v. Fourth Nat. Bank in Wichita, Kans., 135 Kans. 414, 10 P.2d 896, 899 (1932).

\(^{21}\) See "The End of the 'Compensated Surety Defense' in Subrogation Cases," by George C. Bunge and Marvin F. Metge, Vol. 22, Ins. Counsel J. 453, 455, where the authors give the following explanation of the origin of the doctrine:

A Kentucky court back in 1905, seems to have originated the 'superior equity' doctrine, in American Bonding Company of Baltimore v. First National Bank of Covington, Ky. (27 KY. L. REP. 393, 85 S.W. 190). While perhaps still brooding over the outcome of the Civil War, the court was confronted with a controversy between a great eastern financial insurance octopus and a 'pore li'l ol' innocent, well-meaning, Kentucky bank, which at that time, probably had never heard of forgery insurance. The court, accordingly, administered homespun Kentucky justice in favor of the Kentucky bank. However, the "Compensated Surety Defense" was chiefly developed in decisions handed down amidst the bank failures and nearfailures of the Great Depression. To hold a bank which was having a hard time to survive, and whose influential stockholders were facing possible double liability on their stock, liable to the corporate surety as subrogee, in a case where the bank was not actively at fault, was not in harmony with the temper of those times. The changed conditions prevailing today have removed many of those emotional factors, which may have contributed to the development of the "Compensated Surety Defense."

\(^{22}\) Supra note 1.

\(^{23}\) Boserine v. Maryland Cas. Co., 112 F.2d 409 (8th Cir. 1940), where forgery insurance is treated as indemnity insurance; First Nat. Bank v. American Surety Co., 71 Ga. App. 332, 30 S.E.2d 402 (1944); First & Tri-State Nat. Bank & Trust Co. v. Massachusetts Bonding & Ins. Co., 102 Ind. App. 361, 200 N.E. 449 (1936), where the court expressly excluded a minority finding when a fidelity bond was involved. "The doctrine (subrogation) has . . . with almost unanimity been held not to apply in favor of surety on a fidelity bond except only as against persons who participated in the wrongful act of the wrongdoer." Bank of Fort Mill, involving forgery insurance, is to be contrasted with a fidelity bond situation. In the latter case, it is arguably permissible to deny a surety the right to recover for a wrong perpetrated by his principal against another party, in no way implicated. Obviously, in forgery insurance the wrongdoer is not the principal of the surety. Home Ind. Co. v. State Bank, 233 Iowa 103, 8 N.W. 2d 757 (1944); Kansas City Title & Trust Co. v. Fourth Nat. Bank, 135 Kans. 414, 10 P.2d 896 (1932); Royal Ind. Co. v. Poplar Trust Co., 223 Mo. App. 908, 20 S.W. 2d 971 (1929); Standard Acc. Ins. Co. v. Pellecchia, 15 N.J. 162, 104 A.2d, 288 (1954); Maryland Cas. Co. v. Chase Nat. Bank, 153 Misc. 538, 275 N.Y. Supp. 311 (1934); Nat. Sur. Co. v. Nat. City Bank, 184 App. Div. 771, 172 N.Y. Supp. 413 (1918), where surety on a fidelity bond was allowed to recover, and Liberty Mutual Ins. Co. v. First Nat. Bank, 151 Tex. 12, 245 S.W.2d 237 (1951).

\(^{24}\) Supra note 1.
the owner of an assignable cause of action against the defendant-drawee bank, he also had the legal right to assign it to his surety-indemnitor; furthermore, that because both the cause of action against the bank, and the assignment thereof, were legal in nature, this subsequent action by the surety on the assignment was one at law, so as to make inapplicable any of the equitable considerations inherent in pure subrogation. The defendant bank of course must ask the court to overlook the maneuver by making any recovery for the surety dependent upon the traditional concepts of subrogation. The conclusion reached by the court in Bank of Fort Mill,26 denying the efficacy of the assignment, is supported by a clear numerical majority.26 The theme underlying most of these cases is perhaps best expressed by the court in Meyers v. Bank of America Nat. Trust & Savings Assn.27

Under these cases the conclusion seems inevitable that one who asserts a right of subrogation, whether by virtue of an assignment or otherwise, must first show a right in equity to be entitled to such subrogation, or substitution, and that where such right is clearly shown by the application of equitable principles, an assignment adds nothing to his right thereto. Otherwise stated, where by the application of equitable principles, a surety has been found not to be entitled to subrogation, an assignment will not confer upon him the right to be so substituted in an action at law upon the assignment. His rights must be measured by the application of equitable principles in the first instance, his recovery being dependable upon a right in equity, and not by virtue of an asserted legal right under an assignment.28

Thus the surety is effectively relegated to the position occupied prior to the attempted assignment. If he is not entitled to be subrogated under the principles of that doctrine, then an assignment by the insured will be ineffectual to give him a right of subrogation which he would not otherwise possess.29

23 Ibid.
24 United States Fid. & Guaranty Co. v. First Nat. Bank, 172 F.2d 258 (5th Cir. 1949); American Surety Co. v. Bank of California, 135 F.2d 160 (9th Cir. 1943); American Surety Co. v. Lewis State Bank, 58 F.2d 559 (5th Cir. 1932); New York Title & Mort. Co. v. First Nat. Bank, 51 F.2d 485 (8th Cir. 1931); 77 A.L.R. 1052; Meyers v. Bank of America Nat. Trust & Sav. Assn., 11 Cal. 2d 92, 77 P.2d 1084 (1938); Louisville Trust Co. v. Royal Indemnity Co., 230 Ky. 482, 20 S.W.2d 71 (1929); Oxford Production Credit Assn. v. Bank of Oxford, 196 Miss. 50, 16 So.2d 384 (1944); American Bonding Co. v. State Sav. Bank, 47 Mont. 332, 133 Pac. 367 (1913), and American Surety Co. v. Western Surety Co., 71 S.D. 126, 22 N.W.2d 429 (1946).
26 Id. at 1086.
27 60 C.J. 749 states: "While the creditor may properly make an assignment of his rights and remedies where the surety is entitled to be subrogated, the completion of the surety's subrogation . . . is not dependent on the willingness of the creditor to make an assignment . . . [A]n assignment by the creditor will be ineffectual to give the surety a right of subrogation he would not otherwise have."
It may be noted also that the court in *Bank of Fort Mil!* adopted the reasoning expressed in an earlier case,* that when the surety pays the insured depositor, the payment has the necessary effect of destroying any rights which the depositor might have had against his drawee bank; this on the theory that to hold otherwise would be to permit double recovery. We have the anomalous situation, therefore, whereby the bank is discharged by virtue of a payment made under one contract (to which the bank is not a party), from any liability under the terms of its own contract with its depositor. Since an enforceable claim is no longer in existence against the bank, it must follow under such reasoning that there is precisely nothing which remains to be assigned to the surety.

Whether correct or not, such a rationale has not gone unchallenged, either in its reasoning or in its result. In *First Nat. Bank of Atlanta v. American Surety Co.,!* the court allowed the surety to prevail against the bank under an assignment on the theory that the claim asserted by the surety was based on a so-called "conventional subrogation" as opposed to "legal subrogation." The former, the court explained, is synonymous with an assignment and has as an essential ingredient, the agreement of the parties whereby the surety pays with the understanding that it is to be subrogated to the rights of the insured against all third parties. Apparently the agreement itself was enough to negate the idea that the surety was depending upon equity for its action, so that the court felt free to apply straight legal principles free of equitable limitations. The same result, if not flowing from precisely similar reasoning, has been reached elsewhere.* It is submitted that in the final analysis and disregarding needless terminology, these courts are merely expressing a willingness to break with the majority. Emphasis placed by a court on the supposed intent of the parties, or on the fact that the surety is claiming under its agreement, as opposed to pure subrogation, is only incidental to this willingness to depart from the

*Supra* note 1.

1. *American Surety Co. v. Bank of California,* 133 F.2d 160 (9th Cir. 1943).
2. *Metropolitan Cas. Ins. Co. v. First Nat. Bank in Detroit,* 261 Mich. 450, 246 N.W. 178 (1933). See also *National Surety Co. v. Bankers Trust Co.,* 210 Iowa 323, 228 N.W. 635, 636 (1930) where the court expressed the feeling that payment by the surety in no way affected the liability of the bank to its depositor, and that the possibility of double payment was negated by the assignment to the surety by the assured after payment. "The (defendant bank) . . . was an entire stranger to the contract between the annuity company and the surety company. The fidelity . . . contract was one of indemnity, and payment of the indemnity was not a payment of the bank's liability to the annuity company. The plaintiff surety company did not pay the bank's liability, and did not, impliedly or otherwise, intend to do so." Other cases enforcing assignments are: *Royal Indemnity Company v. Poplar Bluff Trust Co.,* 223 Mo. App. 908, 20 S.W.2d 971 (1929); *National Surety Co. v. National City Bank of Brooklyn,* 184 App. Div. 771, 172 N.Y.Sup. 413 (1918), and *Liberty Mutual Ins. Co. v. First Nat. Bank in Dallas,* 151 Tex. 12, 245 S.W.2d 237 (1951).
past. As mentioned earlier, under the traditional view, the willingness of the insured to make an assignment to his surety is immaterial, for the doctrine operates automatically and irrespective of a written or oral assignment. To this writer the departure seems logical. There can be little doubt that the debt owed by the bank to its depositor is legally assignable to anyone other than the surety. Why then an exception in the case of the surety? Had the surety not paid the depositor, and yet taken an assignment, it would be just another third party and its rights as assignee unassailable. Under what theory can this forfeiture by payment occur? The surety has simply advanced the very amount for which the bank itself is legally liable to its depositor. Yet, by some magic, this works itself into a defense to an action for breach of a contract of deposit.

To escape the stigma of the “paid surety” defense, sureties have occasionally attempted still other devices. It can be said with relative certainty that once the court is committed to the defense, the matter becomes a closed issue, and such things as loan receipts, or an agreement by the surety to pay the claim of the insured if the latter is unable to recover from the bank, will, like the assignment already discussed, fail to sway the court from its chosen way.

III. ELECTION OF REMEDIES

A small number of American courts, in denying the right of the paid surety to be subrogated, have rested the decision on a so-called election of remedies theory. The basic proposition seems to be that when the depositor-insured discovers its loss, with full knowledge of the details, it is faced with a choice of two remedies. Alternatively, it may make demand on the bank, upon the theory that when the bank paid the instrument on the forged endorsement, it paid out its own money and not that of the depositor; or the depositor may affirm the action of the bank in paying out the money on the forged instrument and proceed either against the forger (on the ground that the forger

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34 60 C.J. 749.
35 See Grubnau v. Centennial Nat. Bank, 279 Pa. 501, 124 Atl. 142, 144 (1924), wherein it is said in speaking about the assignment made to the surety by the insured: “Nor is it a case of subrogation, wherein the equities of the bank may be said to exceed those of the insurer. Any person could have purchased the depositor’s right against the bank, and there was no reason why the insurance company should not do so.” [Italics supplied].
had embezzled or otherwise obtained money belonging to the depositor or the surety. The former remedy is founded upon the idea that the money of the depositor is still in the bank and the bank must pay it over on demand. The latter remedy, it is stated, necessarily must be based upon the premise that the depositor's money actually left the possession of the bank and came into the hands of the forger; for to allow a recovery on a surety bond the employee must have embezzled money belonging to his employer. Since the depositor has chosen to recover from the surety, he is deemed to have made an election of remedies so as to bar any further action against the drawee bank. The depositor himself has no action against the drawee bank, so it follows there is nothing to which the surety may claim to be subrogated.

A number of cases from various jurisdictions have held that to choose between an action against the faithless employee and an action against the bank, amounts to an election of remedies, so that an election having been made, the plaintiff-depositor may not later pursue another remedy against the bank. But the application of this doctrine to cases under discussion herein has been thoroughly and effectively attacked to such an extent that it is doubtful whether its use will expand beyond those jurisdictions wherein it is already employed. In effectively reversing an earlier Federal decision, the Supreme Court of Texas stated:

Those courts which hold that the depositor by collecting from the surety has made an election of remedies must find something inconsistent in the right of the depositor to proceed against both the surety and the bank. . . . careful analysis of the relationship of the parties fails to satisfy us that this inconsistency actually exists in the position of the depositor. The indemnity policy does not insure the depositor against loss through the acquisition by an employee of depositor's money. It insures the depositor against loss sustained by reason of the dishonest acts of the employee. The dishonest acts of the employee here were in his fraudulent procuring of depositor's checks payable to fictitious payees, the forging of the names of the payees and the cashing of such checks. But if the sequence of events had stopped at that point depositor would have suffered no loss though the dishonest employee would have benefitted by ill-gotten gain from his dishonest acts. Depositor did not even suffer a loss when Bank honored the checks and paid them. Depositor's loss occurred only when Bank charged the checks against depositor's

39 United States Fidelity & Guar. Co. v. First Nat. Bank in Dallas, 172 F.2d 258 (5th Cir. 1949).
40 Fowler v. Bowery Sav. Bank, 113 N.Y. 450, 21 N.E. 172, 173 (1889), where the court said: "Nothing could be more inconsistent than an action against Flynn (forger) on the ground that money due to the plaintiff had been paid to him, and an action against the bank on the ground that it had not paid the deposit, and still remained debtor therefore." See also Crook v. First Nat. Bank of Baraboo, 83 Wis. 31, 52 N.W. 1131 (1892).
41 United States Fidelity & Guar. Co. v. First Nat. Bank in Dallas, supra, note 39.
account without legal right to do so and in breach of its contract. Accordingly, the position of depositor in making claim against Fidelity (surety) was that by virtue of the dishonest acts of depositor's employee, Bank had been led to pay out its own money but that Bank had unlawfully and wrongfully charged the amount against and deducted the same from depositor's account thereby causing it a loss. Until Bank could be compelled to restore the account to its proper status... (depositor) ... had suffered a loss. This position is wholly consistent with the position taken with bank to the effect that it had paid out its own funds and not those of ... (depositor).42

Another leading case in opposition to the theory of election of remedies is Grubnau v. Centennial Nat. Bank,43 which emphasized the severability of the two liabilities—the bank to its depositor, and the surety to its assured. The position was taken that the legal status of the depositor was not really that of a party holding a claim against two indemnitors, in the sense that the payment by one would act as an offset to any suit against the other. To the contrary, the court reasoned, the depositor had a claim first against his surety; secondly, against the bank which was violating its contract of deposit. The remedies could not really be considered in the same right, since it could not be said that the insurance was "in ease of the bank's mistake."44 The court felt that "[I]t would be a novel proposition to hold that an insurance contract could reach out to indemnify a stranger, in no way a party to the insurance, whose wrongful act caused the insurance company to pay the loss to the insured which would not have occurred but for the wrongul act."45 Careful analysis of the opinion would seem to indicate that the court did not really supply a technical argument to refute an equally technical doctrine. Indeed it is questionable whether erudition would be at all effective, in light of the obvious uncertainty and lack of unanimity surrounding the doctrine of election of remedies in its own area. Any court attempting a refutation must face indiscriminate usage of waiver,46 estoppel,47 election and the like. The

44Id. at 143.
45Ibid.
46Hensley-Johnson Motors v. Citizens Nat. Bank, supra note 38: "[W]hen plaintiff accepted the agreement from the surety, it waived its claim against defendant."
47United States Fidelity & Guar. Co. v. First Nat. Bank in Dallas, supra, note 39 at 262: "the election ... to pursue to a successful conclusion its right against the bonding company estopped it, we think, from asserting any claim against the drawee bank." The court in the Liberty Mutual Ins. Co. v. First Nat. Bank in Dallas, supra, note 42 at 243, had the following to say about the estoppel argument: "Again it is sometimes said that having proceeded against the surety the depositor is estopped to proceed against the bank. Any right that Bank had here cannot have been prejudiced by Liberty Mutual's (depositor) collection from Fidelity. Bank continues to urge against Fidelity's (surety) suit all the defenses it had against Liberty Mutual and it still has
doctrine is just vague enough that a court so disposed can readily apply it. It would seem, however, that the strongest rebuttal of the theory lies in the simple fact that, when the suit is on the deposit contract, the fact of deposit itself will support the recovery and it is not necessary for the depositor to allege possession of his money by the bank in order to recover.

CONCLUSION

At the risk of being tautological, suffice to say that the doctrine of the "paid surety" has no sound place in modern legal thinking. The fact always remains that the party cashing a forged instrument is legally liable (not because he cashed it, but because he failed to account for the deposit), and the fortuitous act of a depositor in insuring him-independently with a surety should in no way effect an otherwise absolute legal liability.

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