Suretyship: Effect on Surety Contract of Application of Funds Derived from Assured Contract to Other than Secured Debt

Raymond A. Huevler

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alighting from an automobile which he had parked, but he was not allowed to recover from the insurer where the policy insured him against loss resulting from injuries sustained while "operating (driving) or riding in an automobile," since the word "driving" qualified the word "operating" and connoted some action referable to physical control of the automobile in motion or connected therewith. *D'Allessandro v. Merchants' Mutual Casualty Co.*, N.Y.S. (2d) 200 (1941). Words in a policy of insurance limiting coverage to injuries received while insured was "in" or "on" the vehicle precluded recovery where insured was killed while cranking the automobile when it lurched forward. *Turner v. Fidelity and Casualty Co. of N. Y.*, 274 Mo. 260, 202 S.W. 1078 (1918).

The decision in the principal case is not inconsistent, then, with the majority view under either type of policy, for the court said, "... if the policy had insured ... against loss as the result of injury sustained while "operating" a motor vehicle, then the injury sustained ... while engaged in removing the tire might be deemed within the coverage afforded by the policy." *Miller v. Washington National Insurance Co.*, supra.

PHILIP W. GROSSMAN, JR.

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Suretyship—Effect on Surety Contract of Application of Funds Derived from Assured Contract to Other than Secured Debt.—Defendant contractor agreed to construct a highway for the state of Nebraska, and defendant surety company guaranteed faithful performance and assured payment to all materialmen. Plaintiff, a materialman, furnished all necessary cement. The contractor was indebted to the materialman upon a prior contract. Certain funds derived from the state contract were paid to the materialman by the contractor, with direction to apply these funds to the prior debt. The materialman knew the source of the funds and applied them as directed. The contractor having failed to pay the materialman $26,181, the latter sued both contractor and surety. The lower court held for the materialman against the surety. *Held*, reversed. The execution of the bond created an implied understanding that the money received from the government on the work was to be applied only to the debts arising therefrom, until they were satisfied. "A creditor, with knowledge of the source of the money, cannot apply it to a debt other than that secured by the bond, so long as the bond remains unsatisfied." *Ash Grove Lime & Portland Cement Co. v. Moran Construction Co.*, 296 N.W. 761 (Neb. 1941).

Generally when a creditor holds more than one claim against his debtor, the latter, on making a payment, may direct on which debt it shall be credited, and it is the duty of the creditor so to apply it. Where the debtor fails to direct how a payment is to be applied, the creditor may ordinarily make the application as he sees fit. *Wheeler v. American Investment Co.*, 167 Okla. 558, 31 P. (2d) 117 (1934); *Sipes v. John et al.*, 177 Okla. 299, 58 P. (2d) 854 (1936); *Carson et al. v. Cook County Liquor Co.*, 37 Okla. 12, 130 Pac. 303 (1913); *City of Lincoln v. Lincoln St. R. Co.*, 67 Neb. 469, 93 N.W. 766 (1903); *Johnston et al. v. Northwestern Live Stock Ins. Co.*, 107 Wis. 337, 83 N.W. 641 (1900).

And where the funds are not derived from the contract which is assured there is little question that the creditor can apply payments to any debt in the absence of a direction by the debtor. *City of Marshfield ex rel McGeorge Gravel Co. v. United States Fidelity and Guaranty Co. et al.*, 128 Ore. 547, 274 Pac. 503 (1929).

Where the funds are derived from the contract which is assured, Utah has held that a direction by the debtor is controlling in the absence of knowledge on the part of the creditor. *Salt Lake City v. O'Connor et al.*, 68 Utah 233, 249
Pac. 810 (1926). And some courts have held that direction by the debtor is controlling, regardless of knowledge upon the part of the creditor. *Grasser & Brand Brewing Co. v. Rogers et al.*, 112 Mich. 112, 70 N.W. 445 (1897); *U. S. Fidelity & Guaranty Co. v. Eichel*, 219 Fed. 803 (C.C.A. 3rd, 1915); *Baumgartner v. McKinnon*, 10 Ga. App. 219, 73 S.E. 519 (1912).

However, the creditor has no right to make application two years after the payments have been made, and several months after the principal debtor has gone into bankruptcy. *U. S. Fidelity & Guaranty Co. v. Eichel*, supra. In such case the law will generally apply the money to the oldest debt, the application being regarded as made at the time of payment. 21 R.C.L. 166.

Where the funds are derived from the contract which is assured, and the debtor gives no direction, there is great diversity among the courts on the rights of the surety. Some jurisdictions hold that if the creditor has knowledge of the source of the fund, he must apply it to the secured debt. *B. F. Sturtevant Co. v. Fidelity & Deposit Co. of Maryland*, 92 Wash. 52, 158 Pac. 740 (1916); *Aetna Casualty & Surety Co. v. Hawn Lumber Co.*, 128 Tex. 140, 97 S.W. (2d) 460 (Texas 1936); *Harrison v. First Nat. Bank*, 117 Ark. 260, 174 S.W. 553 (1915).

Other jurisdictions hold that whether the creditor has knowledge or not, he must apply the payment to the secured debt. The reasoning of such cases is that where the money paid to the materialman is derived from the contract funds, upon which contract faithful performance and payment of materialmen is assured, there is privity of contract between the surety and the owner which creates for the surety an equitable right to have all such money applied to the secured debt. *Columbia Digger Co. v. Sparks*, 227 Fed. 780 (C.C.A. 9th, 1915); *Sioux City Foundry & Mfg. Co. v. Merten*, 174 Iowa 332, 156 N.W. 367 (1916); *Alexander Lumber Co. v. Aetna Accident & Liability Co.*, 296 Ill. 500, 129 N.E. 871 (1921); *Merchants' Ins. Co. v. Herber*, 68 Minn. 420, 71 N.W. 624 (1897); *Crane Co. v. Pacific Heat & Power Co.*, 36 Wash. 95, 78 Pac. 460 (1904). The burden is upon the surety to prove the source of the fund. *Merchants' Ins. Co. v. Herber*, supra.

Where a plaintiff materialman had received $300.00 from a contractor to pay him for the amount due on the assured contract, and the materialman applied the money to a prior debt, the court ruled that the $300.00 should be applied to the secured debt. Even though the materialman may have lost his lien rights on the prior contract by the time this action was brought, he had placed himself in that position, and all equity is against him. *Sioux City Foundry & Mfg. Co. v. Merten*, supra.

The third view, followed by many states, is that whether the creditor has knowledge of the source of the funds or not, he need not apply the payment to the secured debt, provided he acts in good faith and is not given a clue as to direction of payment. *People to Use of Hirth v. Powers et al.*, 108 Mich. 339, 66 N.W. 215 (1896); *City of Marshfield ex rel McGeorge Gravel Co. v. United States Fidelity & Guaranty Co. et al., supra; United States Fidelity & Guaranty Co. v. Eichel*, supra; *George H. Sampson Co. v. Commonwealth et al.*, 208 Mass. 372, 94 N.E. 473 (1917); *Standard Oil Co. v. Day*, 161 Minn. 281, 201 N.W. 410 (1924); *Jefferson v. Church of St. Matthew*, 41 Minn. 392, 43 N.W. 74 (1889). But the creditor may not apply payment to the unsecured debt when he knows that the debtor is seeking to divert the application of specific money or property which he is bound under his contract with the creditor to remit or deliver. *Boyd v. Agricultural Ins. Co.*, 20 Colo. App. 28, 76 Pac. 986 (1904). The surety's knowledge of the other indebtedness of his principal is
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Not to allow free application by a creditor would unduly hamper business relations, the surety always having ample opportunity to protect itself. City of Marshfield ex rel McGeorge Gravel Co. v. United States Fidelity & Guaranty Co., supra. The burden of discovering the state of a contractor's secured amounts should not be put on his creditors even though they received payment with knowledge that it is compensation for work covered by a surety bond. Mack v. Colleran et al., 136 N.Y. 617, 32 N.E. 604 (1892).

The exact question of the principal case apparently has not arisen in Wisconsin, and the views of the neighboring states are in conflict. At one time Minnesota held to the rule of free application regardless of knowledge. Jefferson v. Church of St. Matthew, supra. Yet where an agent had turned over certain money derived from Insurance contracts made under his agency wherein his faithful performance was assured and the company had applied the money to a prior agency contract, the Minnesota court has held that the funds must be applied to the assured agency contract. Merchants' Ins. Co. v. Herber, supra. But it has been since pointed out that any money remitted under an agency never does belong to the agent, and such cases are to be distinguished from those in which the money, regardless of source, is the debtor's own until paid to the creditor. Standard Oil Co. v. Day, supra; Radichel v. Federal Surety Co., 170 Minn. 92, 212 N.W. 171 (1927); Fidelity and Deposit Co. of Maryland v. Union State Bank of Minneapolis, 21 F. (2d) 102 (D. Minn. 1927).

While at one time Iowa held that where there was no direction by either creditor or debtor, the court would apply the fund to the unsecured claim, Cain v. Vogt, 138 Iowa 631, 116 N.W. 786 (1908), the law in both Iowa and Illinois today seems to be that all funds derived from an assured contract must be applied by the creditor to the assured debt. Sioux City Foundry & Mfg. Co. v. Merten, supra; Alexander Lumber Co. v. Aetna Accident & Liability Co., supra.

Michigan has rather generally held to the doctrine of free application, People v. Powers, supra, and where neither debtor nor creditor directs application, and the fund is applied to a general or open account, the court will make the application, usually applying the first payment to the oldest debt. Grasser & Brand Brewing Co. v. Rogers et al., supra.

In Georgia, the view of letting the creditor apply the fund to any debt regardless of source and regardless of knowledge is statutory: "When a payment is made by a debtor to a creditor holding several demands against him, the debtor has a right to direct the claim to which it should be appropriated. If he fails to do so the creditor has a right to appropriate at his election. If neither exercises this privilege the law will direct the application in such manner as is reasonable and equitable, both as to the parties and third persons. As a general rule the oldest lien and the oldest item in an account will be first paid, the presumption of law being that such would be the fair intention of the parties." Civil Code of 1910 § 4316. Baumgartner v. McKinnon, supra.

RAYMOND A. HUEVLER.

Torts—Liability of Manufacturer to Consumer for Defects in Manufacture of Articles.—A hot water bottle was purchased from a dealer. As a result of a defect in the bottle, the plaintiff, a two-year old child at the time of the accident, was scalded by hot water. Action was brought in tort, against the manufacturer, to recover damages for personal injuries suffered. Held, the maker of