SETTING THE LIMITS IN TEXAS CONSTRUCTION LAW: A LOOK AT THE SURETY'S LIMITATIONS UNDER INDEMNITY AGREEMENTS AND EQUITABLE SUBROGATION

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I. INTRODUCTION

Shortly after beginning the construction of what would become eight miles of concrete pipeline, representatives of CAT Contracting and Michigan Sewer Construction Company (the contractors) became increasingly concerned about the area's unstable soil conditions.[1] Considering the project's design, the contractors knew that instability in the soil could cause the pipe to rupture with any amount of settlement.[2] Although they expressed their concerns to the project owner, the contractors relied on the owner's engineers, who assured them the design was sound.[3] Recognizing that under the contract the project owner bore the ultimate responsibility for design errors, the contractors inevitably followed the engineer's orders and continued with the construction.[4] Nevertheless, after completion of the pipeline, the contractors discovered fourteen "leaks" pursuant to a standard pressure test.[5]

Creating the "classic dilemma" prevalent in many similar surety conflicts,[6] the contractors placed liability for the leaks with the owner—alleging they were caused by the pipeline's defective design—and insisted upon additional consideration prior to proceeding with any requested repairs.[7] However, the owner fully denied any fault of its own; rather, the owner stood by its contention that the contractors' faulty installation techniques caused the leaks.[8] Thus, because the contractors refused to make any repairs without further payment, the contract was declared to be "in default," and the owner called upon the surety to complete the work pursuant to its performance bond.[9] After settling with

1. Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 278 (Tex. 1998).

2. *See id.* at 278–79.

3. *Id.* at 279.

4. *Id.*

5. *Id.*

6. *See* John W. Hinchey, *Surety's Performance Over Protest of Principal: Considerations and Risks*, 22 TORT & INS. L.J. 133, 133 (1986) (describing the "classic dilemma" often encountered in surety conflicts—when a principal protests liability to the obligee).

7. *Associated Indem. Corp.*, 964 S.W.2d at 279.

8. *Id.*

9. *Id.*

the owner, the surety exercised its rights by and through its indemnity agreement and demanded reimbursement from the contractors.[10] When the contractors denied liability and refused to pay such demand, the surety brought suit to enforce its indemnity agreement.[11]

While the abovementioned facts have been presented and ruled upon in the Texas Supreme Court decision of *Associated Indemnity Corp. v. CAT Contracting*,[12] the court's narrow opinion hinged on the showing of "some" evidence of the "[s]urety's bad faith in settling the claim"[13]—relying on specific "good faith" requirements provided in the language of the indemnity agreement.[14] Thus, although the lower court recognized that a "surety has *almost* unlimited power of reimbursement from the indemnitors for any funds it spends on an obligee's claim,"[15] the Texas Supreme Court—affirming in part in its limited no-evidence review—found at least some evidence of the surety's bad faith in the settlement of the claim and denied the surety's relief under the indemnity agreement.[16]

As the Fourteenth Court of Appeals later opined, "*Associated Indemnity* does not stand for the general proposition that a surety

10. *See id.* at 279–80 (noting that the surety settled with the owner without notifying the contractor—then demanded $835,000 as indemnity). The indemnity agreement in this case—among other things—vested exclusive authority in the surety to determine whether any claim should be settled, provided that any decision to settle a claim by the surety was binding on the contractor "if 'made in good faith,'" and stated that the contractor's default "constitute[d] an assignment to Surety of Contractor's claims . . . against Owner . . . ." *Id.* at 279.

11. Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 280 (Tex. 1998) (stating that the reason for the suit was due to the contractors' refusal to indemnify the surety from settlement payments to the owner). However, it is important to note that the settlement agreement did not affect the contractors' rights to pursue claims against the owner. *Id.* at 279. Thus, by failing to adequately assert its claim of design error, the surety failed to protect the contractors' best interests, which constituted the basis of the contractors' counterclaim. *Id.* at 280.

12. Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276 (Tex. 1998).

13. *Id.* at 286–87.

14. *See id.* at 283–87 (holding that the surety was not entitled to indemnity based on specific language provided in the indemnity agreement that required surety's actions to be "made in good faith").

15. Associated Indem. Corp. v. CAT Contracting, Inc., 918 S.W.2d 580, 595 (Tex. App.—Corpus Christi 1996) (emphasis added) (recognizing the surety's enormous power over a defaulted principal; however, seeming to acknowledge that the power is not absolute), *rev'd on other grounds,* 964 S.W.2d 276 (Tex. 1998).

16. *Associated Indem. Corp.*, 964 S.W.2d at 286.

is . . . required to exercise good faith in settling *any* claim."[17] Rather, the court interpreted *Associated Indemnity* as merely holding that a surety is limited by a good faith standard only where the parties specifically contracted for such a standard.[18] Therefore, in an effort to both clarify the deceptively limited holding in *Associated Indemnity* and explore its effect upon other indemnity agreements, this Comment will present a hypothetical with similar facts to those found in *Associated Indemnity*—typical in the construction context—and analyze the extent of a surety's control over a defaulted contractor's rights, in Texas, when the indemnity contract lacks an express good faith provision.

A. *The Hypothetical*

Consider a hypothetical similar to the facts presented above; however, to distinguish it from *Associated Indemnity*, this Comment will analyze a scenario in which a contractor places liability for a cracked building foundation on a concrete material supplier—alleging that an admixture used in the foundation's cement mix was defective.[19] According to the contractor, the use of such admixture caused the concrete to set up prematurely, ultimately causing the surface to crack. Thus, blaming the material supplier for the resulting failure in the foundation, assume the contractor, in this hypothetical, refused to remit any further payment to the supplier.[20] As a result of this failure to pay, the material supplier sued the contractor and its surety as a bond beneficiary, and sought protection under the contractor's payment bond.[21]

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17. Park v. Universal Sur. of Am., 25 S.W.3d 738, 740 (Tex. App.—Houston [14th Dist.] 2000, no pet.) (emphasis added).

18. *Id.*

19. *See, e.g.*, *Associated Indem. Corp.*, 964 S.W.2d at 279 (illustrating a typical situation in which a contractor placed liability for a contract default on another party—in this case, the owner's engineers—for an alleged design flaw); Travelers Prop. & Cas. Ins. Co. v. Triton Marine Constr. Corp., 473 F. Supp. 2d 321, 325 (D. Conn. 2007) (challenging the owner's termination of the contract, arguing that the "defects were due to design flaws rather than poor workmanship"); John W. Hinchey, *Surety's Performance Over Protest of Principal: Considerations and Risks*, 22 TORT & INS. L.J. 133, 133 (1986) (describing the common situation of when a contractor protests liability as the "classic dilemma").

20. *See, e.g.*, *Associated Indem. Corp.*, 964 S.W.2d at 279 (refusing to make repairs without receiving additional payments).

21. *See* TEX. GOV'T CODE ANN. § 2253.021(c) (Vernon Supp. 2006) (stating that a

Despite the contractor's ardent contention that the material supplier ultimately caused the alleged default—which would potentially constitute a valid counterclaim—assume the surety settled with the material supplier against the contractor's wishes.[22] Indeed, although the terms of the settlement specifically excluded the contractor[23]—which would arguably allow the contractor to seek his own redress—the surety then asserted ownership over any counterclaims the contractor purported to own against the material supplier through its rights afforded by (1) their indemnity agreement[24] and (2) the common law doctrine of equitable subrogation.[25] For the purposes of this hypothetical, assume the

payment bond protects the bond beneficiaries "who have a direct contractual relationship with the prime contractor or a subcontractor to supply . . . labor or material" for the contract amount); *see, e.g.*, *Associated Indem. Corp.*, 964 S.W.2d at 279 (calling upon the surety to complete the work under a performance bond when the contractor refused to make repairs).

22. *See, e.g.*, *Associated Indem. Corp.*, 964 S.W.2d at 279 (emphasizing that when settling claims with the owner, the surety did so without notifying the contractor).

23. *See, e.g., id.* at 279 (noting that the settlement agreement "did not purport to affect [c]ontractor's right to pursue contract claims against [o]wner").

24. *See, e.g.*, Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 55–56 (George J. Bachrach ed., 1989) (noting that an indemnity agreement generally "assigns for the benefit of the surety any claims of the principal," authorizing it to "assert and prosecute any right or claim . . . assigned, transferred or conveyed in the name of the [p]rincipal and to compromise and settle any such right or claim on such terms as it considers reasonable under the circumstances"); Robert L. Lawrence et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Enforcement of the Surety's Rights Against the Principal and the Indemnitors Under the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 93, 161–162 (George J. Bachrach ed., 1989) (noting that, under a general indemnity agreement, the principal and indemnitors irrevocably designate the surety or its representatives as their attorney-in-fact, giving them the right to exercise all of their rights assigned in the agreement).

25. *See, e.g.*, McBroome-Bennett Plumbing, Inc. v. Villa Fr., Inc., 515 S.W.2d 32, 36 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.) (stating that subrogation substitutes one person into the place of another, and "he who is substituted succeeds to the rights of the other in relation to the debt or claim"). The court additionally stated that "[b]y subrogation, a court of equity, for the purpose of doing exact justice between parties in a given transaction, places one of them, to whom a legal right does not belong, in the position of a party to whom the right does belong." *Id.* (citing 53 TEX. JUR. 2d *Subrogation* § 1, at 429 (1964)); *see also* E. Y. Chambers & Co. v. Little, 21 S.W.2d 17, 22 (Tex. Civ. App.—Eastland 1929, writ ref'd) (recognizing that subrogation substitutes a person into the place of a creditor in which such person succeeds); RESTATEMENT (FIRST) OF RESTITUTION: SUBROGATION § 162 cmt. a (1937) ("A court of equity may give restitution to the plaintiff and prevent the unjust enrichment of the defendant . . . by

parties contracted to the following indemnity clause:

> Contractor will indemnify and hold harmless the company from and against every claim, cause of action, liability, and expense which the company may incur as a consequence of having executed such bonds. The company has the exclusive right to decide for itself and the contractor whether any claim or cause of action brought against the company or the principal on the bond shall be settled or defended and its decision shall be binding upon the contractor. In the event of default, the contractor hereby assigns and transfers all of its rights under the contract, including all subcontracts let in connection therewith, over to the company.[26]

It is important to note that the indemnity agreement in this hypothetical does not include an express good faith requirement—as did the agreement in *Associated Indemnity*.[27] Nonetheless, the surety's actions in this hypothetical seem particularly unscrupulous.

In this hypothetical, assume the surety not only settled the bond claim against the contractor's wishes, but also claimed ownership of the counterclaim the contractor wished to assert and refused to pursue it on its own. Further, the surety demanded that the contractor be denied the ability to bring the claim himself—insisting that he dismiss the claim with prejudice. As a result of the debt accrued by the surety's actions, suppose the contractor undoubtedly faced bankruptcy—an unfavorable result for either party—and was left with no other available remedy.

1. Analogy

In an effort to clarify the issue at hand, it may be helpful to compare the abovementioned counterclaim to a more common

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creating in the plaintiff rights similar to those which the obligee or lien-holder had before the obligation or lien was discharged.").

26. This hypothetical indemnity clause was written by the author and is intended to reflect a typical indemnity clause. *See, e.g.*, Charles M. Pisano, *Judicial Interpretation of Indemnity Clauses*, 48 LA. L. REV. 169, 169 (1987) (illustrating the "typical" indemnity clause); Hess v. Am. States Ins. Co., 589 S.W.2d 548, 550–51 (Tex. Civ. App.—Amarillo 1979, no writ) (providing, in full, pertinent excerpts from the indemnity agreement in question); Ford v. Aetna Ins. Co., 394 S.W.2d 693, 696 n.1 (Tex. Civ. App.—Corpus Christi 1965, writ ref'd n.r.e.) (noting pertinent portions of the indemnity agreement construed).

27. *See Associated Indem. Corp.*, 964 S.W.2d at 283 (distinguishing the indemnity agreement in this case by noting the inclusion of specific "good faith" language).

asset owned by a contractor, such as a bulldozer. In a typical surety arrangement in the construction arena, if the general contractor defaults on a contractual obligation, the bonding company must step in and complete those obligations.[28] Thus, by completing such obligations, the surety is not only protected by his contractual indemnity agreement,[29] but is also subrogated to the rights, remedies, and securities that would otherwise belong to the debtor by and through the common law doctrine of equitable subrogation.[30] If awarded a settlement from a lawsuit regarding the amount the contractor allegedly owed the surety, the surety could then rightfully confiscate the bulldozer belonging to the contractor in an effort to offset the debt owed.[31] Taking

28. *See* State Bank & Trust Co. v. Ins. Co. of the W., 132 F.3d 203, 205 (5th Cir. 1997) (noting that, upon default by the bonded contractor, the surety is obligated to complete the necessary performance under its bond); Associated Indem. Corp. v. CAT Contracting, Inc., 918 S.W.2d 580, 595 (Tex. App.—Corpus Christi 1996) (noting that upon default, "the surety steps in to take over all negotiations and claims of the obligee"), *rev'd on other grounds*, 964 S.W.2d 276 (Tex. 1998).

29. *See* O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 178 (George J. Bachrach ed., 1989) ("[The] indemnity claim is based on a contract . . . and seeks reimbursement for payment made by the indemnitee to a third-party.").

30. *See, e.g.*, *McBroome-Bennett*, 515 S.W.2d at 36 (explaining that subrogation places one person into the position of another in terms of rights to debts and claims).

31. *See* Frymire Eng'g Co., *ex rel.* Liberty Mut. Ins. Co. v. Jomar Int'l, Ltd., 194 S.W.3d 713, 715 (Tex. App.—Dallas 2006, pet. granted) (allowing one who "involuntarily pays another's debt to seek repayment of that debt by the person who in equity and good conscience should have paid it"); *accord* Brown v. Zimmerman, 160 S.W.3d 695, 700 (Tex. App.—Dallas 2005, no pet.); Matagorda County v. Tex. Ass'n of Counties County Gov't Risk Mgmt. Pool, 975 S.W.2d 782, 785 (Tex. App.—Corpus Christi 1998), *aff'd*, 52 S.W.3d 128 (Tex. 2000); Argonaut Ins. Co. v. Allstate Ins. Co., 869 S.W.2d 537, 541–42 (Tex. App.—Corpus Christi 1993, writ denied); *McBroome-Bennett*, 515 S.W.2d at 36; Constitution Indem. Co. of Phila. v. Armbrust, 25 S.W.2d 176, 180 (Tex. Civ. App.—San Antonio 1930, writ ref'd); Galbraith-Foxworth Lumber Co. v. Long, 5 S.W.2d 162, 167 (Tex. Civ. App.—Dallas 1928, writ ref'd); *see also* Independence Indem. Co. v. Republic Nat'l Bank & Trust Co., 114 S.W.2d 1223, 1227 (Tex. Civ. App.—Dallas 1938, writ dism'd w.o.j.) (refusing to exempt a defendant that "does not occupy such a position of innocency from the principles of the broad equitable doctrine" of subrogation); E. Y. Chambers & Co. v. Little, 21 S.W.2d 17, 22 (Tex. Civ. App.—Eastland 1929, writ ref'd) (noting that subrogation is a mode that equity adopts that compels the "payment of a debt by one who, in justice, equity, and good conscience, ought to pay it"); Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 27 (George J. Bachrach ed., 1989) (recognizing that upon an event of default by a bonded contractor, a surety may perfect its interests in assigned contract proceeds and "supplies, tools, plant,

possession of the bulldozer, the bonding company could then sell it for fair market value and credit the contractor for the amount of the sale against its debt.[32]

Relating this typical scenario to the aforementioned hypothetical, the issue resides with what limitations, if any, are instilled upon the surety if he simply wishes to take the bulldozer, permanently destroy it, and refuse to apply any credit for its fair market value against the debt owed by the general contractor. Thus, as the hypothetical presents itself, if this asset is a claim against a material supplier alleged to be the ultimate cause of the general contractor's default, does the surety's power encompass such a claim?

2. Roadmap

This Comment attempts to provide the reader with a basic background of bonded construction projects, focusing on the rights afforded to each party under indemnity agreements and the common law doctrine of equitable subrogation. While acknowledging the arsenal of rights granted to a surety over a defaulted principal through these means, this Comment strives to highlight the ever-present limitations of each, while considering requirements of good faith, commercial reasonableness, and various public policy concerns. This Comment will not only look to Texas law for authority, but will also consider persuasive authority from other jurisdictions and provide a suggestion for Texas courts. Part II provides a general background of both contractual agreements of indemnity and the common law doctrine of equitable subrogation. Part III then analyzes the hypothetical, discussing the limitations prevalent under both the indemnity agreement and the doctrine of equitable subrogation. Finally, Part IV concludes that although the surety's right to protection under indemnity agreements and equitable subrogation is admittedly liberal, Texas should provide greater protection to

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equipment and materials on the job site" by filing the indemnity agreement).

32. *See* U.C.C. § 9-608(a)(1)(B) (2002) (declaring that a secured party must, after accounting for expenses and attorney's fees, apply the cash proceeds of the collection or enforcement to the "satisfaction of obligations secured by the security interest . . . under which the collection or enforcement is made"). Further, it is important to note that "[a] secured party shall account to and pay a debtor for any surplus, and the obligor is liable for any deficiency." *Id.* § 9-608(a)(4).

the principal in the surety context and recognize necessary limitations on the rights afforded by sureties.

II. BACKGROUND

While indemnity agreements outline the respective rights contracted between parties, the common law doctrine of equitable subrogation further supplements those rights when a claim arises or the surety must honor one of the bonds by virtue of a principal's default.[33] This Comment will consider the applications of both, beginning with the contractual agreement of indemnity.

A. *Indemnity Agreements*

1. Overview

Indemnity clauses, also known as "hold harmless" agreements, are included in most construction contracts.[34] Indeed, because indemnity claims invariably follow construction accidents or loss,[35] the model contract forms of the American Institute of Architects (AIA) and the Engineer's Joint Contract Documents Committee (EJCDC) include indemnity agreements as a standard provision,[36] "primarily as a means of allocating the risks of a [construction]

33. *See* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 29 (George J. Bachrach ed., 1989) (explaining that a surety may perfect its interests "by filing under the [UCC], or it may choose instead to stand on its rights under the doctrine of equitable subrogation").

34. Charles M. Pisano, *Judicial Interpretation of Indemnity Clauses*, 48 LA. L. REV. 169, 169 (1987).

35. *See, e.g.,* Roger W. Stone & Jeffrey A. Stone, *Indemnity in Iowa Construction Law*, 54 DRAKE L. REV. 125, 126 (2005) (noting that indemnity claims usually follow "any construction accident or loss"); Cochran v. Gehrke, Inc., 305 F. Supp. 2d 1045, 1047 (N.D. Iowa 2004) (noting the various cross-claims and third-party claims for indemnity, among other things, that "followed in the wake of the construction accident"); Eischeid v. Dover Constr., Inc., 265 F. Supp. 2d 1047, 1055–59 (N.D. Iowa 2003) (construing the indemnification agreement subsequent to a jobsite injury); Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 281–87 (Tex. 1998) (construing indemnity agreement after surety stepped in to correct construction defect).

36. Charles M. Pisano, *Judicial Interpretation of Indemnity Clauses*, 48 LA. L. REV. 169, 169 (1987) (citing 3 STEVEN G.M. STEIN, CONSTRUCTION LAW ¶ 13.17, at 13–122 (1986)).

project among the parties involved."[37] Thus, by establishing liability at the time the contract is formed, parties can anticipate their respective obligations, acquire an appropriate amount of insurance, and accurately assess their apportioned costs related to the venture.[38]

In general terms, indemnity agreements shift liability from the legally responsible party to another party.[39] Thus, "[i]n a contract of indemnity the indemnitor, for a consideration, promises to indemnify and save harmless the indemnitee against liability of the indemnitee to a third person, or against loss resulting from such liability."[40]

"Like the contract of suretyship, the contract of indemnity has as its purpose security of the promisee against loss."[41] The difference between suretyship contracts and indemnity contracts, however, "lies in the character of the promisee."[42] In discussing the differences between suretyship and indemnity, the Georgia Court of Appeals acknowledged:

> In suretyship the promise runs to an obligee or creditor, present or prospective. In indemnity the promise runs to an obligor or debtor present or prospective. In suretyship the promisee has or is about to extend credit to a third person, the principal, and the promise is made to protect the promisee creditor in case the principal fails to perform. In indemnity, the promisee owes or is about to assume an obligation to a third person, the creditor, and the promisor agrees to save him harmless from loss as a result of his assuming that obligation.[43]

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37. *Id.*

38. *Id.*

39. Roger W. Stone & Jeffrey A. Stone, *Indemnity in Iowa Construction Law*, 54 DRAKE L. REV. 125, 126 (2005).

40. Thomasson v. Pineco, Inc., 328 S.E.2d 410, 411 (Ga. Ct. App. 1985) (citing Nat'l Bank of Monroe v. Wright, 48 S.E.2d 306, 308 (Ga. Ct. App. 1948)); *accord* McNally & Nimergood v. Neumann-Kiewit Constructors, Inc., 648 N.W.2d 564, 570 (Iowa 2002) (quoting II E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 6.3, at 108 (2d ed. 1998)); *see also* Delta Eng'g Corp. v. Warren Petrol. Inc., 668 S.W.2d 770, 773 (Tex. App.—Houston [1st Dist.] 1984, writ ref'd n.r.e.) (relating an indemnity agreement to an insurance agreement where the parties "voluntarily enter into a contract whereby one party conditionally agrees to accept the responsibilities of the other").

41. Rankin v. Smith, 147 S.E.2d 649, 652 (Ga. Ct. App. 1966) (quoting LAURENCE P. SIMPSON, SURETYSHIP § 17, at 28 (1950)).

42. *Id.*

43. *Id.*

Thus, a surety joins the principal debtor's obligation such that he becomes directly liable with the principal.[44] "[S]uretyship involves a tripartite relationship between a surety, its principal, and the bond obligee, in which . . . the surety is intended to supplement an obligation of the principal owed to the bond obligee."[45]

Essentially a form of restitution,[46] "[i]ndemnity . . . is founded on equitable principles; it is allowed where one person has discharged an obligation that another person should bear; it places the final responsibility where equity would lay the ultimate burden."[47] Combining contract and tort law—as well as a variety of equitable and public policy considerations—the official comment of the Restatement Second provides:

> The unexpressed premise has been that indemnity should be granted in any factual situation in which, as between the parties themselves, it is just and fair that the indemnitor should bear the total responsibility, rather than to leave it on the indemnitee or to divide it proportionately between the parties by contribution.[48]

Indemnity is thus a claim for reimbursement by someone who has paid for a loss or liability against someone who should reimburse the payor due to an agreement.[49]

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44. *Id.* at 651 (quoting Durham v. Greenwold, 3 S.E.2d 585, 586 (Ga. 1939)).

45. Associated Indem. Corp. v. CAT Contracting, Inc., 918 S.W.2d 580, 604 (Tex. App.—Corpus Christi 1996) (Dorsey, J., dissenting), *rev'd on other grounds,* 964 S.W.2d 276 (Tex. 1998).

46. McNally & Nimergood v. Neumann-Kiewit Constructors, Inc., 648 N.W.2d 564, 570 (Iowa 2002) (quoting Iowa Elec. Light & Power Co. v. Gen. Elec. Co., 352 N.W.2d 231, 236 (Iowa 1984)); *see also* RESTATEMENT (SECOND) OF TORTS: INDEMNITY BETWEEN TORTFEASORS § 886B cmt. c (1979) ("The basis for indemnity is restitution, and the concept that one person is unjustly enriched at the expense of another when the other discharges liability that it should be his responsibility to pay.").

47. Roger W. Stone & Jeffrey A. Stone, *Indemnity in Iowa Construction Law*, 54 DRAKE L. REV. 125, 127 (2005) (quoting Hunt v. Ernzen, 252 N.W.2d 445, 447–48 (Iowa 1977)); *see also* McCarthy v. J.P. Cullen & Son Corp., 199 N.W.2d 362, 371 (Iowa 1972) (noting that the "purpose of indemnity is to place the loss on the one or ones who should rightfully or equitably bear it"); WILLIAM PROSSER, TORTS § 51, at 313 (4th ed. 1971) ("Indemnity is a shifting of responsibility from the shoulders of one person to another; and the duty to indemnify will be recognized in cases where community opinion would consider that in justice the responsibility should rest upon one rather than the other.").

48. RESTATEMENT (SECOND) OF TORTS: INDEMNITY BETWEEN TORTFEASORS § 886B cmt. c (1979).

49. Roger W. Stone & Jeffrey A. Stone, *Indemnity in Iowa Construction Law*, 54 DRAKE L. REV. 125, 126–27 (2005); *see also* O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL

It is helpful to note that indemnity clauses fall into three general categories depending on the extent of responsibility the contractor assumes.[50] In the basic, most limited indemnity clause, the contractor only assumes costs attributed to the indemnitee that were incurred because of the contractor's own negligence.[51] In the second type, the contractor additionally consents to assume liability for damages resulting from the combined negligence of the contractor and owner.[52] Finally, the third and broadest type of indemnity agreement includes the assumption of responsibility for all damages, even those exclusively caused by the owner's negligence.[53]

2. Construing Indemnity Agreements

"A contract for indemnity is read as any other contract."[54] Therefore, it is well recognized that indemnity agreements are similarly governed by the laws of contracts, and the principles and rules followed in contract construction.[55] The "primary goal, of

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APPLICATIONS BY THE SURETY 173, 178 (George J. Bachrach ed., 1989) (noting that the indemnity claim is based on a contract and seeks reimbursement for a payment made by an indemnitee to a third-party).

50. Charles M. Pisano, *Judicial Interpretation of Indemnity Clauses*, 48 LA. L. REV. 169, 169 (1987).

51. *Id.*

52. *Id.*

53. *Id.*

54. Associated Indem. Corp. v. CAT Contracting, Inc., 918 S.W.2d 580, 589 (Tex. App.—Corpus Christi 1996) (citing Safeco Ins. Co. of Am. v. Gaubert, 829 S.W.2d 274, 281 (Tex. App.—Dallas 1992, writ denied)), *rev'd on other grounds,* 964 S.W.2d 276 (Tex. 1998).

55. *See* McClish v. Niagara Machine & Tool Works, 266 F. Supp. 987, 989 (S.D. Ind. 1967) ("The right to indemnity and the corresponding obligation to indemnify generally spring from contract, express or implied, and in the absence of an express or implied contract a right to indemnity generally does not exist."); TLB Plastics Corp. v. Procter & Gamble Paper Products Co., 542 N.E.2d 1373, 1377 (Ind. Ct. App. 1989) (noting that indemnity agreements are contracts that are subject to the principles and rules of contract construction); Kruse Classic Auction v. Aetna Cas. & Sur., 511 N.E.2d 326, 328 (Ind. Ct. App. 1987) ("[I]ndemnification agreements are contracts and, as such, are governed by the law of contracts."); Bell v. Commonwealth Land Title Ins. Co., 494 N.E.2d 997, 999 (Ind. Ct. App. 1986) (construing indemnity agreements as a form of contract, and thus, "according to the rules and principles of the law of contracts"); Kegerreis v. Auto-Owners Ins. Co., 484 N.E.2d 976, 983 (Ind. Ct. App. 1985) (noting that courts will utilize the general rules that govern the interpretation and construction of other contracts when construing an indemnity agreement and when determining the parties' rights and liabilities); State v. Daily Express, Inc., 465 N.E.2d 764, 767 (Ind. Ct. App. 1984) (stating

course, is to determine the parties' intent."[56] Thus, if the language of the indemnity agreement is not ambiguous, the words are construed given their "legal, natural, and ordinary meaning."[57]

that indemnity agreements are governed by contracts law); Zebrowski & Assoc. v. City of Indianapolis, 457 N.E.2d 259, 261 (Ind. Ct. App. 1983) (noting that actions on agreements of indemnity are "governed by contract law"); Am. States Ins. Co. v. Williams, 278 N.E.2d 295, 299 (Ind. Ct. App. 1972) (acknowledging that "the right of indemnification is generally derived from contract and for the right to exist absent a contract, there must be such a relationship that liability will be imposed by law"); Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 284 (Tex. 1998) (citing Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415, 427 (Tex. 1995)) (declaring that indemnity agreements are construed "under the normal rules of contract construction"); Mitchell's, Inc. v. Friedman, 157 Tex. 424, 429, 303 S.W.2d 775, 778 (1957) ("In determining the rights and liabilities of the parties . . . their intention will first be ascertained by rules of construction applicable to contracts generally."), *overruled on other grounds by* Ethyl Corp. v. Daniel Constr. Co., 725 S.W.2d 705 (Tex. 1987); Harlandale Indep. Sch. Dist. v. C2M Constr., Inc., No. 04-07-00304-CV, 2007 WL 2253510, at *2 (Tex. App.—San Antonio, Aug. 8, 2007, no pet.) (mem. op.) (noting that Texas courts "construe indemnity agreements under the normal rules of contract construction"); *Safeco Ins.*, 829 S.W.2d at 281 (stating that indemnity agreements are construed "[u]nder principles of contract law"); Sun Oil Co. v. Renshaw Well Serv., Inc., 571 S.W.2d 64, 68 (Tex. Civ. App.—Tyler 1978, writ ref'd n.r.e.) ("The rules relating to the construction of contracts in general are applicable to indemnity contracts.").

56. *Associated Indem. Corp.*, 964 S.W.2d at 284; *see also* City of Pinehurst v. Spooner Addition Water Co., 432 S.W.2d 515, 518 (Tex. 1968) ("It is the general rule of the law of contracts that where an unambiguous writing has been entered into between the parties, the [c]ourts will give effect to the intention of the parties as expressed or as is apparent in the writing."); Fox v. Thoreson, 398 S.W.2d 88, 92 (Tex. 1966) ("Interpretation of a written instrument is always a quest for the intention of the parties to it."); United Founders Life Ins. Co. v. Carey, 363 S.W.2d 236, 243 (Tex. 1962) ("There is no stronger rule for construing a contract of doubtful meaning than that which gives effect to the parties' own interpretation."); Harlandale Indep. Sch. Dist., 2007 WL 2253510, at *2 ("Our primary goal is to ascertain and give effect to the intentions of the parties as expressed in the instrument."); *Safeco Ins.*, 829 S.W.2d at 281 ("[C]ourts must ascertain and give effect to the intentions of the parties as expressed in the instrument.").

57. *See* Miller v. Dilts, 463 N.E.2d 257, 265 (Ind. 1984) (stating that if there is no ambiguity in the language of an insurance contract, the language "should be given its plain and ordinary meaning"); *TLB Plastics Corp.*, 542 N.E.2d at 1377 (noting that when the words of an indemnity agreement are unambiguous and clear, they are to be construed by their "plain and ordinary meaning"); Anderson v. State Farm Mut. Auto. Ins. Co., 471 N.E.2d 1170, 1172 (Ind. Ct. App. 1984) (recognizing that when a court does not find ambiguity in a contract, the language "will be given its plain and ordinary meaning"); Am. States Ins. Co. v. Aetna Life & Cas. Co., 379 N.E.2d 510, 516 (Ind. Ct. App. 1978) (noting that "an unambiguous insurance policy must be enforced according to its terms, even those which limit the insurer's liability," and the court cannot extend the coverage enumerated in such policy, or rewrite the policy's clear and unambiguous language); Utica Mut. Ins. Co. v. Ueding, 370 N.E.2d 373, 376 (Ind. Ct. App. 1977) (recognizing that a court cannot extend the coverage delineated by language that is clear and unambiguous); Vernon Fire & Cas. Co. v. Am. Underwriters, Inc., 356 N.E.2d 693, 696 (Ind. Ct. App. 1976) (holding that the mere existence of a controversy in the meaning of the policy does

Accordingly, courts are limited to enforcing unambiguous indemnity agreements as written—using the plain and ordinary meanings of the words in the instrument.[58] Indeed, in Texas, "[a]n unambiguous contractual right to indemnification on a settlement is absolute, unless the principal raises and proves an affirmative defense such as fraud."[59]

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not constitute an ambiguity; rather, the language was clear and unambiguous and thus did not necessitate a reversal); Harlandale Indep. Sch. Dist., 2007 WL 2253510, at *2 (quoting *Safeco Ins.*, 829 S.W.2d at 281) ("When the contract is unambiguous, we must determine the rights and liabilities of the parties by giving legal effect to the contract as written."); 41 AM. JUR. 2D *Indemnity* § 15 (2006) ("[I]f the words of an indemnity agreement are clear and unambiguous, they are to be given their plain and ordinary meaning.").

58. *See* Wilkie v. Auto Owners Ins. Co., 664 N.W.2d 776, 782 (Mich. 2003) (advocating against judges attempting to interpret contract parties' reasonable expectations). The court stated:

> This approach, where judges divine the parties' reasonable expectations and then rewrite the contract accordingly, is contrary to the bedrock principle of American contract law that parties are free to contract as they see fit, and the courts are to enforce the agreement *as written* absent some highly unusual circumstance, such as a contract in violation of law or public policy. . . . The notion, that free men and women may reach agreements regarding their affairs without government interference and that courts will enforce those agreements, is ancient and irrefutable.

Id. (emphasis added); *see also* DaimlerChrysler Corp. v. G Tech Prof'l Staffing, Inc., 678 N.W.2d 647, 649 (Mich. Ct. App. 2003) ("An unambiguous contract must be enforced according to its terms."); *Mitchell's, Inc.*, 157 Tex. at 429, 303 S.W.2d at 778 (refusing to extend indemnity agreement beyond its terms); Harlandale Indep. Sch. Dist., 2007 WL 2253510, at *2 (quoting *Safeco Ins.*, 829 S.W.2d at 281) ("When the contract is unambiguous, we must determine the rights and liabilities of the parties by giving legal effect to the contract as written."); English v. Century Indem. Co., 342 S.W.2d 366, 369 (Tex. Civ. App.—San Antonio 1961, no writ) (limiting the court's analysis to "liability under the express terms of an agreement of indemnity entered into by [the parties]"); Cent. Sur. & Ins. Corp. v. Martin, 224 S.W.2d 773, 776 (Tex. Civ. App.—Beaumont 1949, writ ref'd) ("That the nature of an indemnitor's liability upon an indemnity contract must be determined by its provisions seems to be the settled law of this State."); Russell v. Lemons, 205 S.W.2d 629, 631 (Tex. Civ. App.—Amarillo 1947, no writ) ("The nature of appellee's liability on an indemnity contract must be determined by its provisions, following the familiar maxim of the law that, as a man binds himself, so shall he be bound."); 41 AM. JUR. 2D *Indemnity* § 15 (2005) ("[A]n unambiguous-written indemnity contract must be enforced according to the plain and ordinary meaning of the words used in the instrument.").

59. Old Republic Sur. Co. v. Palmer, 5 S.W.3d 357, 362 (Tex. App.—Texarkana 1999, no pet.); *see also* Safeco Ins. Co. of Am. v. Gaubert, 829 S.W.2d 274, 282 (Tex. App.—Dallas 1992, writ denied), *rev'd on other grounds,* 964 S.W.2d 276 (Tex. 1998) (noting that defendant failed to raise affirmative defense of "bad faith"—thus, it was not an issue in the case); Ford v. Aetna Ins. Co., 394 S.W.2d 693, 698 (Tex. Civ. App.—Corpus Christi 1965, writ ref'd n.r.e.) (recognizing that bad faith may be raised as a defense).

Governing the parties' rights and obligations, it is helpful to note that "indemnity agreements are strictly construed in favor of the indemnitors."[60] Nonetheless, Texas courts have acknowledged that "[w]hether the surety or his principal is liable on the bond paid by the surety is generally immaterial to whether the principal must indemnify the surety."[61] Further, as "an arms-length transaction entered into for the parties' mutual benefit," the Texas Supreme Court has concluded that indemnity agreements alone do not create a fiduciary duty.[62] Therefore, Texas courts have failed to impose a blanket common law duty of good faith in the surety context.[63] However, under certain circumstances,[64] Texas has recognized that in order to *recover* under the indemnity agreement, the indemnitee that settles must prove its "potential liability" as well as good faith and reasonableness of the settlement between himself and the obligee.[65]

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60. *Associated Indem. Corp.*, 918 S.W.2d at 589 (citing *Safeco Ins.*, 829 S.W.2d at 281).

61. *Id.* at 588 (citing *Ford*, 394 S.W.2d at 698); *see also* Hess v. Am. States Ins. Co., 589 S.W.2d 548, 551 (Tex. Civ. App.—Amarillo 1979, no writ) (recognizing that a contractor's liability on a bond default "is not a condition precedent to the [surety's] right of recovery on the indemnity agreement").

62. Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 288 (Tex. 1998) (discussing the lack of a special relationship that is created by an indemnity agreement that is sufficient to carry a fiduciary duty).

63. *See id.* at 282 (citing Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415, 418 (Tex. 1995)) (relying on the finding in *Great American* that the surety owes no duty of good faith to the obligee).

64. *Id.* at 284 (citing Fireman's Fund Ins. Co. v. Commercial Standard Ins. Co., 490 S.W.2d 818, 823 (Tex. 1972)) (distinguishing indemnity agreements that lack an express right to settle clause or a good faith provision); *accord* Sira & Payne, Inc. v. Wallace & Riddle, 484 S.W.2d 559, 561 (Tex. 1972); Gulf, Colo. & Santa Fe Ry. Co. v. McBride, 159 Tex. 442, 446, 322 S.W.2d 492, 495 (1959); Mitchell's, Inc. v. Friedman, 157 Tex. 424, 430, 303 S.W.2d 775, 779 (1957), *overruled on other grounds by* Ethyl Corp. v. Daniel Constr. Co., 725 S.W.2d 705 (Tex. 1987); Sun Oil Co. v. Renshaw Well Serv., Inc., 571 S.W.2d 64, 67 (Tex. Civ. App.—Tyler 1978, writ ref'd n.r.e.); Mo. Pac. R.R. Co. v. S. Pac. Co., 430 S.W.2d 900, 904 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref. n.r.e.); Md. Cas. Co. v. R & L Constr. Co., 368 S.W.2d 134, 135 (Tex. Civ. App.—Eastland 1963, writ ref'd n.r.e.).

65. *Associated Indem. Corp.*, 918 S.W.2d at 589; *see also* Fireman's Fund Ins. Co. v. Commercial Standard Ins. Co., 490 S.W.2d 818, 823–24 (Tex. 1972) (recognizing that Texas courts have held "it is sufficient for the settling indemnitee to show a potential liability and that his settlement was reasonable, prudent and in good faith under the circumstances"); *Gulf, Colo. & Santa Fe Ry. Co.*, 159 Tex. at 446, 322 S.W.2d at 495 (restating the necessity that the petitioner establish from its standpoint that the settlement was reasonable and made in good faith); *Mitchell's, Inc.*, 157 Tex. at 430, 303 S.W.2d at 779 (stating that it is necessary for a petitioner to establish that the settlement was reasonable

3. Relationship to Bonds

In Texas, and in most other jurisdictions, state and federal law requires bonds for government construction projects.[66] Additionally, bonds are generally required on most large, privately owned projects.[67] Thus, in consideration of a reasonable premium and the execution of an indemnity agreement, a corporate surety will execute a bond on the contractor's (principal's) behalf, for the benefit of the owner (obligee).[68]

There are two types of bonds that a surety may execute: performance and payment bonds.[69] A performance bond protects the project owner for the amount of the contract and is "conditioned on the faithful performance of the work in accordance with the plans, specifications, and contract documents."[70] A

and prudent under the circumstances and made in good faith); *Sun Oil Co.*, 571 S.W.2d at 67 (requiring petitioner to establish that settlement was made in good faith and that it was reasonable under the circumstances); *Mo. Pac. R.R. Co.*, 430 S.W.2d at 904 (requiring railroad company only to prove that it "[m]ight have been liable . . . to the extent that it was reasonable to settle"); *Md. Cas. Co.*, 368 S.W.2d at 135 ("If it acted in good faith, Maryland had the right to make a reasonable settlement. Having made the settlement, Maryland assumed the responsibility of showing that the settlement was made in good faith and that it was a reasonable and prudent settlement.").

66. *See* TEX. GOV'T CODE ANN. § 2253.021(a) (Vernon Supp. 2006) (requiring a governmental entity that contracts for a public works project to execute "(1) a performance bond if the contract is in excess of $100,000; and (2) a payment bond if the contract is in excess of $25,000" prior to commencement of the work); *id.* § 2253.021(d) (noting that in the case of projects with a state entity, the bond "must be executed by a corporate surety"); *Associated Indem. Corp.*, 918 S.W.2d at 594 (recognizing that in the case of public works projects, "[t]he contractor's situation is quite simple; he must be bonded or he will be unable to work on these jobs"); Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 33 (George J. Bachrach ed., 1989) ("[L]enders on government projects should know that bonds are required by state and federal law.").

67. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 33 (George J. Bachrach ed., 1989) (citing Transamerica Ins. Co. v. Barnett Bank, 524 So. 2d 439, 451 (Fla. Dist. Ct. App. 1988) (Sharp, C.J., dissenting), *vacated*, 540 So. 2d 113 (Fla. 1989)).

68. *See id.* at 6 (outlining basic surety practice); *see also* TEX. PROP. CODE ANN. §§ 53.172(5)(B), 53.202(4)(B) (Vernon 2007) (requiring bonds in construction contracts to be executed by a licensed and authorized corporate surety).

69. *See, e.g.*, TEX. GOV'T CODE ANN. § 2253.021 (Vernon Supp. 2006) (describing the two types of bonds that are required in construction projects).

70. *See id.* § 2253.021(b) (addressing the protections afforded to the state or

payment bond, on the other hand, protects the bond beneficiaries "who have a direct contractual relationship with the prime contractor or a subcontractor to supply . . . labor or material" for the contract amount.[71] As previously mentioned, a surety will generally write these bonds on its principal's behalf—relying on an indemnity agreement that is valid and enforceable in its favor.[72] "The existence of the indemnity agreement is a salient characteristic differentiating suretyship from insurance."[73]

Notably, although contractors frequently handle varied business interests and ostensibly exercise capable judgment, the specific language included in the indemnity agreements and bonds they must execute are determined almost entirely by the surety and the owner.[74] Again, because drafted by the surety, indemnity agreements are subject to the rule of *contra proferentum*, and thus ambiguous language is construed "in favor of the indemnitors."[75]

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governmental entity under a performance bond); Commercial Union Ins. Co. v. Spaw-Glass Corp., 877 S.W.2d 538, 540 (Tex. App.—Austin 1994, writ denied) (recognizing that Texas law requires prime contractors on certain projects to purchase a performance bond to protect the owner of the project); Parliament Ins. Co. v. L.B. Foster Co., 533 S.W.2d 43, 46–47 (Tex. Civ. App.—Corpus Christi 1975, writ ref'd n.r.e.) ("Ordinarily a performance bond protects the principal for the full performance of the contract.").

71. *See* TEX. GOV'T CODE ANN. § 2253.021(c) (Vernon Supp. 2006) (addressing the protections afforded to the payment bond beneficiaries in public work projects); *Commercial Union Ins. Co.*, 877 S.W.2d at 540 (recognizing that Texas law requires prime contractors on certain projects to purchase a "payment bond to protect suppliers of labor or materials"). The court goes on to note that "[t]here is no dispute that [Texas law] governs unpaid claims of suppliers brought against the prime contractor and its surety." *Commercial Union Ins. Co.*, 877 S.W.2d at 540; *see also Parliament Ins. Co.*, 533 S.W.2d at 47 ("The payment bond is generally for the sole benefit of laborers and materialmen to guarantee payments for work, labor and materials that were furnished and that went into the job.").

72. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 6 (George J. Bachrach ed., 1989).

73. *Id.* at 7.

74. *See* TEX. GOV'T CODE ANN. § 2253.021(e) (Vernon Supp. 2006) (requiring approval on the form of the bond by the attorney general or "awarding governmental entity"); Associated Indem. Corp. v. CAT Contracting, Inc., 918 S.W.2d 580, 594 (Tex. App.—Corpus Christi 1996) (recognizing the lack of bargaining power "between a surety and a principal"), *rev'd on other grounds,* 964 S.W.2d 276 (Tex. 1998). *But see* Fireman's Fund Ins. Co. v. Murchison, 937 F.2d 204, 209 (5th Cir. 1991) (finding no disparity in bargaining power where indemnitors were "sophisticated businessmen").

75. O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 181–

4. Events of Default

Indemnity agreements serve to supplement common law rights given to sureties, such as equitable subrogation.[76] Many of the rights and remedies that a surety holds through indemnity agreements are triggered by an "event of default."[77] These events of default act as conditions precedent to many of the provisions of the indemnity agreement and generally include: "breach of, or refusal to perform, any bonded contract; failure to pay obligations incurred under any bonded contract; failure to comply with the terms of the Agreement of Indemnity; and the failure to discharge any other indebtedness of the principal to the surety."[78] If a possible event of default does indeed occur, the surety then "steps in to take over all negotiations and claims of the obligee."[79] The surety can then perfect its interests and obtain rights in the earnings of the assigned contracts—as well as the tools and materials on the job site in which the principal holds an interest—to secure its collateral.[80]

82 (George J. Bachrach ed., 1989).

76. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 7 (George J. Bachrach ed., 1989); *see also* O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 181 (George J. Bachrach ed., 1989) ("[U]nder the written indemnity agreement, the surety's rights are explicit and 'legal' rather than implied and 'equitable.'").

77. *See* Indem. Ins. Co. of N. Am. v. S. Tex. Lumber Co., 19 S.W.2d 913, 915 (Tex. Civ. App.—Galveston 1929) (recognizing that a statutory bond requires the surety to pay only in the "event of default by the contractor"), *modified*, 29 S.W.2d 1009 (Tex. Comm'n App. 1930, judgm't adopted); *see also* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 25–26 (George J. Bachrach ed., 1989) (noting that the rights and remedies of a surety do not commence until an event of default).

78. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 26 (George J. Bachrach ed., 1989).

79. *E.g.*, *Associated Indem. Corp.*, 918 S.W.2d at 595.

80. *See* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 27 (George J. Bachrach ed., 1989) (recognizing the

5. UCC Filing

Additionally, the indemnity agreement may also allow the surety the right to record the agreement "as a financing statement in accordance with the [UCC]."[81] Filing a financing statement establishes the surety's priority over potential competing claims by third-party creditors.[82] Perfecting security interests under the UCC on unbonded jobs is essential; however, for security interests in proceeds of bonded contracts, the surety has the additional protection afforded by its rights under the common law doctrine of equitable subrogation.[83]

B. *Equitable Subrogation*

1. Overview

Stemming from the common law, the right of equitable subrogation comes into existence any time a surety is called upon to pay a debt accrued by a bonded company; it is independent of contractual agreements between the parties.[84] "Equitable

remedies available to a perfected surety upon a default by a contractor to contract proceeds and other collateral).

81. *See id.* ("[T]he surety may deem it to be in its best interest to file the Agreement of Indemnity in order to perfect its interest in the proceeds of the contracts to which it has been assigned."); *see also* U.C.C. § 9-310 (2002) (requiring the filing of a financing statement to perfect a security interest in collateral asserted through the laws of secured transactions). *But see* Gen. Ins. Co. of Am. v. Mezzacappa Bros., Inc., No. 01-CV-7394(FB), 2003 WL 22244964, at *4–5 (E.D.N.Y. Oct. 1, 2003) (rejecting the argument that indemnity agreements can be filed as financing statements under UCC; instead the court held that courts have consistently applied a good faith standard to a surety's settlement of its principal's affirmative claims, and thus the UCC has no application).

82. *See* U.C.C. § 9-322 (2002) (granting priority to perfected security interests over conflicting unperfected security interests); Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 29 (George J. Bachrach ed., 1989) (recognizing that recording the indemnity agreement for purposes of perfecting a security interest should not be taken lightly, as it is important to establishing priority over possible third party claims to the same collateral).

83. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 28–29 (George J. Bachrach ed., 1989).

84. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136 (1962) ("Traditionally sureties compelled to pay debts for their principal have been deemed entitled to

subrogation prevents the unjust enrichment of the debtor."[85] Texas courts have characterized the doctrine of equitable subrogation as "pure equity."[86] The doctrine "allows one who involuntarily pays another's debt to seek repayment of that debt by the person who in equity and good conscience should have paid it."[87] As such, a surety who incurs a debt or loss is subrogated to

reimbursement, even without a contractual promise."). The Court went on to explain that subrogation is not a contract right, but rather a "creature of equity" that is enforced to accomplish substantial justice. *Id.* at 136 n.12 (citing Memphis & L.R.R. Co. v. Dow, 120 U.S. 287, 301–02 (1887)).

85. Frymire Eng'g Co., *ex rel.* Liberty Mut. Ins. Co. v. Jomar Int'l, Ltd., 194 S.W.3d 713, 716 (Tex. App.—Dallas 2006, pet. granted); *see also* First Nat'l Bank of Kerrville v. O'Dell, 856 S.W.2d 410, 415 (Tex. 1993) (noting that the purpose for the doctrine of equitable subrogation "is to prevent the unjust enrichment of the [debtor] who owed the debt that is paid"); Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 337 (Tex. 1980) ("Equitable subrogation may be invoked to prevent unjust enrichment when one person confers upon another a benefit that is not required by legal duty or contract."). Further, the Restatement of Restitution on subrogation provides:

> Where property of one person is used in discharging an obligation owed by another or a lien upon the property of 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 or lien-holder.

RESTATEMENT (FIRST) OF RESTITUTION: SUBROGATION § 162 (1937).

86. *See* McBroome-Bennett Plumbing, Inc. v. Villa Fr., Inc., 515 S.W.2d 32, 36 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.) (noting that Texas courts recognize subrogation as a "wholesome rule of equity," and "belonging to an age of enlightened policy and refined, although natural justice"); E. Y. Chambers & Co. v. Little, 21 S.W.2d 17, 22 (Tex. Civ. App.—Eastland 1929, writ ref'd) (noting Judge Story's characterization of subrogation as "a doctrine belonging to an age of enlightened policy and refined, although natural, justice"); O'Brien v. Perkins, 276 S.W. 308, 315 (Tex. Civ. App.—Amarillo 1925), *aff'd sub nom.*, Shelton v. O'Brien, 285 S.W. 260 (Tex. Comm'n App. 1926, judgm't adopted) ("Subrogation is a pure equity, and will be enforced, with due regard to the legal, as well as the equitable, rights of others.").

87. *Frymire Eng'g Co.*, 194 S.W.3d at 715; *accord* Brown v. Zimmerman, 160 S.W.3d 695, 700 (Tex. App.—Dallas 2005, no pet.); Matagorda County v. Texas Ass'n of Counties County Risk Mgmt. Pool, 975 S.W.2d 782, 785 (Tex. App.—Corpus Christi 1998), *aff'd*, 52 S.W.3d 128 (Tex. 2000); Argonaut Ins. Co. v. Allstate Ins. Co., 869 S.W.2d 537, 541–42 (Tex. App.—Corpus Christi 1993, writ denied); *McBroome-Bennett*, 515 S.W.2d at 36; Constitution Indem. Co. v. Armbrust, 25 S.W.2d 176, 180 (Tex. Civ. App.—San Antonio 1930, writ ref'd); Galbraith-Foxworth Lumber Co. v. Long, 5 S.W.2d 162, 167 (Tex. Civ. App.—Dallas 1928, writ ref'd); *see also* Independence Indem. Co. v. Republic Nat'l Bank & Trust Co., 114 S.W.2d 1223, 1227 (Tex. Civ. App.—Dallas 1938, writ dism'd w.o.j.) (refusing to exempt defendant that "does not occupy such a position of innocency" from the "broad equitable doctrine" of subrogation); *E. Y. Chambers & Co.*, 21 S.W.2d at 22 (noting that subrogation is a mode that equity adopts that compels the "payment of a debt by one who, in justice, equity, and good conscience, ought to pay it"). The Eleventh Court of Appeals (Eastland) went on to quote the Supreme Court of Arkansas, which when considering the theory of subrogation, opined:

the rights otherwise belonging to the debtor.[88] Thus, "a surety is [considered] a special kind of secured creditor" because "its claim against the principal is secured by its right of subrogation to the remedies of the creditor which it has been compelled to pay."[89]

It is important to note that "Texas courts have always been particularly hospitable to the right of subrogation and have been in the forefront of upholding it."[90] Although courts of other

> Its phases are various, but it preserves its characteristic features throughout. It is the machinery by which the equity of one man is worked out through the legal rights of another. . . . It rests upon the maxim that no one shall be enriched by another's loss, and may be invoked wherever justice and good conscience demand its application, in opposition to the technical rules of law which liberate securities with the extinguishment of the original debt. This equity arises when one not primarily bound to pay a debt, or remove an [e]ncumbrance, nevertheless does so; either from his legal obligation, as in case of a surety, or to protect his own secondary right; or upon the request of the original debtor, and upon the faith that, as against the debtor, the person paying will have the same sureties for reimbursement as the creditor had for payment. And this equity need not rest upon any formal contract or written instrument.

Id. (quoting S. Cotton Oil Co. v. Napoleon Hill Cotton Co., 158 S.W. 1082, 1084 (Ark. 1913)).

88. *See McBroome-Bennett*, 515 S.W.2d at 36 (stating that subrogation substitutes one person into the place of another, and "he who is substituted succeeds to the rights of the other in relation to the debt or claim"). The court additionally stated that "[b]y subrogation, a court of equity, for the purpose of doing exact justice between parties in a given transaction, places one of them, to whom a legal right does not belong, in the position of a party to whom the right does belong." *Id.* (citing 53 TEX JUR 2d, *Subrogation* § 1 (1964)); *see also E. Y. Chambers*, 21 S.W.2d at 22 (recognizing that subrogation substitutes a person into the place of a creditor in which such person succeeds); RESTATEMENT (FIRST) OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 162 cmt. a (1937) ("A court of equity may give restitution to the plaintiff and prevent the unjust enrichment of the defendant . . . by creating in the plaintiff rights similar to those which the obligee or lien-holder had before the obligation or lien was discharged"); BLACK'S LAW DICTIONARY 1467 (8th ed. 2004) (defining subrogation as "[t]he substitution of one party for another whose debt the party pays, entitling the paying party to rights, remedies, or securities that would otherwise belong to the debtor").

89. Am. Sur. Co. of N.Y. v. Bethlehem Nat'l Bank, 314 U.S. 314, 317 (1941); *see also* RESTATEMENT (FIRST) OF RESTITUTION: QUASI CONTRACTS & CONSTRUCTIVE TRUSTS § 162 cmt. b (1937) ("[W]here the plaintiff is not officious, and he uses his property or his property is used in discharging the obligation of another or a lien upon another's property, he is entitled to the reimbursement and is entitled to the remedy of subrogation to obtain reimbursement."). The Restatement goes on to provide that a plaintiff "is not officious where he was under a duty to make the payment, as for example where he was a surety." *Id.* § 162 cmt. b.

90. *McBroome-Bennett*, 515 S.W.2d at 36. The court went on to restate that "[p]erhaps the courts of no other state have gone further in applying the doctrine of subrogation than has the court of this state . . . ." *Id.* (citing Faires v. Cockerill, 88 Tex.

jurisdictions require additional elements,[91] Texas courts considering equitable subrogation claims only require the claimant to prove (1) the main liability for the debt rested with the party that benefited and (2) such debt was not paid voluntarily.[92] Like Texas, California courts have applied this doctrine liberally:

> The doctrine of [] subrogation is not a fixed and inflexible rule of law or of equity. It is not static, but is sufficiently elastic to take within its remedy cases of first instance which fairly fall within it. Equity first applied the doctrine strictly and sparingly. It was later liberalized, and its development has been the natural consequence of a call for the application of justice and equity to particular situations. Since the doctrine was first ingrafted on equity jurisprudence, it has been steadily expanding and growing in importance and extent, and is . . . now broad and expansive and has a very liberal application.[93]

428, 437, 31 S.W. 190, 194 (1895)).

91. *See* Am. Nat'l Bank & Trust Co. v. Weyerhaeuser Co., 692 F.2d 455, 461–63 (7th Cir. 1982) (requiring a party claiming subrogation to show that (1) the claim or debt must have been paid in full, (2) the party paid the claim or debt in which a third party was primarily liable, (3) the subrogor possesses a right that he could enforce against the third party, and the subrogee seeks to enforce that right, and (4) that the potential subrogee did not act as a volunteer in paying the claim or debt); Caito v. United Cal. Bank, 576 P.2d 466, 471 (Cal. 1978) (requiring potential subrogee to show that (1) payment was made to protect his own interest, (2) subrogee did not act as volunteer, (3) the debt was not one in which the subrogee was primarily liable, (4) the entire debt was paid, and (5) that subrogation will not work an injustice to others).

92. *See Frymire Eng'g Co.*, 194 S.W.3d at 716 (recognizing that in order to establish an equitable subrogation claim "the claimant [must] prove both that the benefited party was primarily liable on the debt and that the debt was paid involuntarily"); *Argonaut Ins. Co.*, 869 S.W.2d at 541 (stating that subrogation includes claims "in which one person, not acting voluntarily, has paid a debt for which another was primarily liable"); *McBroome-Bennett*, 515 S.W.2d at 36 (noting that Texas courts require the debt payer to involuntarily pay a debt they are not primarily liable for, for a subrogation claim to succeed); Forney v. Jorrie, 511 S.W.2d 379, 386 (Tex. Civ. App.—San Antonio 1974, writ ref'd n.r.e.) ("The doctrine of subrogation is given a liberal application, and is broad enough to include every instance in which one person, not acting voluntarily, has paid a debt for which another was primarily liable."); Lusk v. Parmer, 114 S.W.2d 677, 680 (Tex. Civ. App.—Amarillo 1938, writ dism'd) (holding that a wife was subrogated to one-half interest in land by having paid debt in good faith, with separate funds, "notwithstanding [that] she was mistaken as to the title of the property and the interest she held therein," as the payment was not voluntary).

93. *In re* Estate of Johnson, 50 Cal. Rptr. 147, 149 (Cal. Ct. App. 1966); *see also Caito*, 576 P.2d at 471 (noting that equitable subrogation is a broad equitable remedy, not limited to circumstances where the "five factors" are met, but rather appropriate whenever "'one person, not acting as a mere volunteer or intruder, pays a debt for which another is primarily liable, and which in equity and good conscience should have been discharged by the latter'" (quoting *In re* Kemmerrer, 114 Cal. App. 2d 810, 814 (Cal. Ct. App. 1952))); *cf. McBroome-Bennett*, 515 S.W.2d at 36 (expressing that in Texas the

2. Application

Under a typical tripartite relationship in a construction project, the surety bonds a contractor's obligations with the project owner.[94] Upon default by the bonded contractor, the surety is obligated to complete the necessary payment or performance, securing an "'equitable right' to indemnification out of a retained fund."[95] The surety is also then "subrogated to the rights of the project [owner] so that the retained contract price inures to the completing surety's benefit."[96] Further, it has been held that a surety that completes the job and pays all the bills is not solely limited to the rights of the project owner, but is also subrogated to other bonded parties' rights that were involved in the project as well.[97] Thus, a surety that completes a defaulting contractor's obligations is entitled "to the rights of (1) [t]he contractor, insofar as it is due receivables, (2) the materialmen and laborers who may have been paid by the surety, and (3) the owner for whom the project was completed."[98]

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doctrine "is always given a liberal interpretation"); Independence Indem. Co. v. Republic Nat'l Bank & Trust Co., 114 S.W.2d 1223, 1227 (Tex. Civ. App.—Dallas 1938, writ dism'd w.o.j.) (recognizing Texas's liberal construction of "rights by subrogation" in overruling the defendant's questioning of the plaintiff's ability to recover as a surety); Galbraith-Foxworth Lumber Co. v. Long, 5 S.W.2d 162, 167 (Tex. Civ. App.—Dallas 1928, writ ref'd) (noting the broad application of the doctrine of equitable subrogation).

94. State Bank & Trust Co. v. Ins. Co. of the W., 132 F.3d 203, 205 (5th Cir. 1997).

95. *Id.*; *see also* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 138 (1962). In *Pearlman* the Court reasoned:

> [T]he laborers and materialmen had a right to be paid out of the fund; . . . the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund[,] and . . . the surety . . . is entitled to . . . all [the] rights to the extent necessary to reimburse it.

Id. at 141.

96. *State Bank & Trust Co.*, 132 F.3d at 205; *see also* Trinity Universal Ins. Co. v. Bellmead State Bank, 396 S.W.2d 163, 168 (Tex. Civ. App.—Dallas 1965, writ ref'd n.r.e.) ("It is . . . well settled in our law that the surety whose funds go to discharge the contractor's obligations is thereby subrogated to the rights of the owner to apply the contract balances to the completion of the project and payment of bills incurred in that connection.").

97. *See* Nat'l Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843, 845 (1st Cir. 1969) (noting the confusion created by a tendency to think of the surety as standing in only the shoes of the contractor, when in cases like this, the surety is entitled to "step into three sets of shoes"). "When, on default of the contractor, [the surety] pays all the bills of the job to date and completes the job, [the surety] stands in the shoes of the contractor[,] . . . the laborers and material men[,] . . . [and] the government." *Id.*

98. *State Bank & Trust Co.*, 132 F.3d at 205 n.5 (citing *Nat'l Shawmut Bank*, 411 F.2d

It is important to note that while Texas admittedly allows a liberal interpretation of the doctrine of equitable subrogation, its courts have long recognized that it shall not "be used as an instrument of injustice to defeat a superior equity or overthrow a legal title."[99] Further, although considered a favored doctrine, subrogation is not an absolute right that another may enforce at will, but rather one that is "granted or withheld as the equities of the case may demand."[100] Other jurisdictions have widely recognized limitations to the theory of subrogation as well—refusing to utilize it when it would serve a manifest injustice,[101]

at 845); *see also* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 38–39 (George J. Bachrach ed., 1989) (recognizing that a surety is equitably subrogated not only to the rights of the prime contractor, but to the rights of the subcontractors and materialmen it pays under its payment bond).

99. O'Brien v. Perkins, 276 S.W. 308, 315 (Tex. Civ. App.—Amarillo 1925), *aff'd sub nom.*, Shelton v. O'Brien, 285 S.W. 260 (Tex. Comm'n App. 1926, judgm't adopted).

100. Compania Anonima Venezolana De Navegacion v. A. J. Perez Export Co., 303 F.2d 692, 697 (5th Cir. 1962).

101. *See* Dade County Sch. Bd. v. Radio Station WQBA, 731 So. 2d 638, 647 (Fla. 1999) (holding that recovery on the basis of equitable subrogation was only proper if parade sponsors paid the entire debt incurred from parade spectator's claims, obtained a release from the board, and if the board had not already settled its claims with the spectators, so as to not serve an injustice); Hoopes v. Hoopes, 861 P.2d 88, 91 (Idaho Ct. App. 1993) (recognizing that relief through equitable subrogation must not work an injustice to others); Dix Mut. Ins. Co. v. LaFramboise, 597 N.E.2d 622, 626 (Ill. 1992) (holding that "an insurer [cannot] subrogate against its own insured or any person or entity who has the status of a co-insured under the insurance policy" as that would offend the reasonable expectations of the parties and the principles of equity and good conscience); Wine v. Globe Am. Cas. Co., 917 S.W.2d 558, 561 (Ky. 1996) (acknowledging that in order to recover under a theory of subrogation, it "must not work any injustice to the rights of others"); United Carolina Bank v. Beesley, 663 A.2d 574, 576 (Me. 1995) (asserting that as itself a creature of equity, subrogation "must be enforced with due regard for the rights, legal or equitable, of others" and "should not be invoked so as to work injustice, or defeat a legal right, or to overthrow a superior or perhaps equal equity, or to displace an intervening right or title"); Lyon v. Colonial U.S. Mortgage Co., 91 So. 708, 709 (Miss. 1922) (holding that it would be inequitable to subrogate a party who was required to pay another's debt when the reason he was required to pay that debt was that he caused the debt by his own wrongful conduct); State-Planters Bank & Trust Co. v. Pollard & Bagby Inv. Corp., 42 S.E.2d 287, 291 (Va. 1947) (allowing subrogation only "in a clear case and where it works no injustice to others"); Buskirk v. State-Planters Bank & Trust Co., 169 S.E. 738, 740 (W. Va. 1933) (holding that beneficiaries of a junior trust deed which secured tax payments were not entitled to be subrogated to state's tax lien against the beneficiary under a senior trust deed as the trust deed furnished the exclusive remedy, and thus to allow subrogation would serve an injustice). "Subrogation cannot 'be invoked to override and displace the real contract of the parties.'" *Buskirk*, 169 S.E. at 740 (quoting Union Mortgage, Banking & Trust Co. v. Peters, 18 So. 497, 500 (Miss. 1895)).

cause innocent people to suffer,[102] or contradict public policy.[103]

Courts must analyze limitations such as these, considered in combination with those restrictions placed on indemnity agreements, in order to determine the applicability to such situations as those previously presented in the hypothetical.

III. ANALYSIS

A. *Issue*

From the aforementioned hypothetical, the ultimate issue is whether the surety—by and through the rights afforded by the operation of (1) the indemnity agreement or (2) the common law doctrine of equitable subrogation—holds the right to assert ownership of the defaulted contractor's counterclaim against the material supplier, such that it could (a) refuse to pursue the claim, (b) refuse to let the contractor pursue the claim, and (c) further demand that the claim be dismissed with prejudice.

B. *Arguments Under the Indemnity Agreement*

By refusing to pay the full amount owed to the material supplier

The West Virginia court went on to note that admittedly, in the case of payments, a presumption in favor of subrogation is natural; however, that "presumption subsides when there is evidence of an intention to the contrary." *Id.* at 739.

102. *See* Universal Title Ins. Co. v. U.S., 942 F.2d 1311, 1315–20 (8th Cir. 1991) (preventing the insurer from subrogating itself to the rights of lienholders who were senior to the federal tax lien, stating that "subrogation cannot be invoked where it would . . . result in harm to innocent third persons"); *see also* LaSalle Bank, N.I. v. First Am. Bank, 736 N.E.2d 619, 626 (Ill. App. 2000) (recognizing that equity effectuates subrogation only when there is no injury done to an innocent party). An innocent party is not harmed when the party is left in the same position that he was in upon first contracting to purchase the subject premises. *Id.*

103. *See Universal Title Ins. Co.*, F.2d at 1315 (recognizing that subrogation cannot be invoked if it would "violate sound public policy"); *In re* Estate of Scott, 567 N.E.2d 605, 607 (Ill. App. 1991) (noting that in Illinois, subrogation is applied according to "equity, good conscience, and public policy considerations"); *A. J. Perez Export Co.*, 303 F.2d at 697 (noting that subrogation is an equitable remedy and is, therefore, limited by public policy); Bank IV Wichita, Nat'l Ass'n v. Arn, Mullins, Unruh, Kuhn & Wilson, 827 P.2d 758, 765 (Kan. 1992) (holding that public policy prohibited subrogation of legal malpractice claim against attorney where debtor's and creditor's interests had potential to diverge); William Burford & Co. v. Glasgow Water Co., 2 S.W.2d 1027, 1028 (Ky. 1928) (stating that subrogation should never be applied if it would work an injustice or if the results would be "inimical to sound public policy").

for the allegedly defective admixture, the contractor in our hypothetical is undoubtedly in default on the bonded contract,[104] triggering many of the rights and remedies held by the surety.[105] Pursuant to its payment bond,[106] it is uncontested that the surety in our hypothetical paid money to the material supplier on the contractor's behalf, and thus has a claim for reimbursement against the contractor under its indemnity agreement.[107] Therefore, although the contractor contends the material supplier caused the default, we must construe the indemnity agreement under contract law principles.[108]

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104. *See* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 26–27 (George J. Bachrach ed., 1989) (noting that an event of default usually includes "failure to pay obligations incurred under any bonded contract").

105. *See, e.g.*, Indem. Ins. Co. of N. Am. v. S. Tex. Lumber Co., 19 S.W.2d 913, 915 (Tex. Civ. App.—Galveston 1929, writ granted) (recognizing that a statutory bond requires the surety to pay only in the "event of default by the contractor"); *see also* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 25–26 (George J. Bachrach ed., 1989) (noting that the rights and remedies of a surety do not commence until an event of default).

106. *See* TEX. GOV'T CODE ANN. § 2253.021(c) (Vernon Supp. 2006) (stating that a payment bond protects the bond beneficiaries "who have a direct contractual relationship with the prime contractor or a subcontractor to supply . . . labor or material" for the contract amount).

107. *See* Roger W. Stone & Jeffrey A. Stone, *Indemnity in Iowa Construction Law*, 54 DRAKE L. REV. 125, 126–27 (2005) (commenting that indemnity is a claim for reimbursement by someone who has paid for a loss and is based on an agreement, duty, or relationship); O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 178 (George J. Bachrach ed., 1989) (noting that the indemnity claim "seeks reimbursement for payment made by the indemnitee to a third-party").

108. *See* Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 284 (Tex. 1998) (citing Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415, 427 (Tex. 1995)) ("We construe indemnity agreements under the normal rules of contract construction."); Mitchell's, Inc. v. Friedman, 157 Tex. 424, 429, 303 S.W.2d 775, 778 (1957) (applying contract rules in order to ascertain the parties' rights and liabilities), *overruled on other grounds by* Ethyl Corp. v. Daniel Constr. Co., 725 S.W.2d 705 (Tex. 1987); Harlandale Indep. Sch. Dist. v. C2M Constr., Inc., No. 04-07-00304-CV, 2007 WL 2253510, at *2 (Tex. App.—San Antonio, Aug. 8, 2007, no pet.) (mem. op.) (recognizing that Texas courts follow the rules of contract construction in construing indemnity agreements); Safeco Ins. Co. of Am. v. Gaubert, 829 S.W.2d 274, 281 (Tex. App.—Dallas 1992, writ denied) (noting that indemnity agreements are construed "[u]nder principles of contract law"); Sun Oil Co. v. Renshaw Well Serv., Inc., 571 S.W.2d 64, 68 (Tex. Civ. App.—Tyler

The plain and ordinary meaning of the contract's language grants the surety the right to determine whether a claim brought against the contractor upon any bond should be settled.[109] However, while the agreement specifically assigns all of the contractor's rights under the contract to the surety—including the rights to all connected subcontracts—it does not *specifically* authorize the surety "to assert and prosecute any right or claim,"[110] much less *specifically* allow the surety to dismiss the contractor's counterclaim with prejudice.[111] Nonetheless, an argument that the surety does not at least own the rights to the claim is likely tenuous.[112] Moreover, it is important to keep in

1978, writ ref'd n.r.e.) (applying rules of contract construction to indemnity agreements).

109. *See* Wilkie v. Auto Owners Ins. Co., 664 N.W.2d 776, 781–82 (Mich. 2003) (stating that where a contract is written unambiguously, it must be enforced using the plain and ordinary meanings of the words used in the contract); DaimlerChrysler Corp. v. G Tech Prof'l Staffing, Inc., 678 N.W.2d 647, 649 (Mich. Ct. App. 2003) (acknowledging that, where a contract is unambiguous, it "must be enforced according to its terms"); *Mitchell's, Inc.*, 157 Tex. at 429, 303 S.W.2d at 778 (refusing to extend indemnity agreement beyond its terms); 41 AM. JUR. 2D *Indemnity* § 15 (2005) (restating that "an unambiguous-written indemnity contract must be enforced according to the plain and ordinary meaning of the words used in the instrument").

110. *Cf.* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 55–56 (George J. Bachrach ed., 1989) (construing an example indemnity agreement including language authorizing the surety "to assert and prosecute any right or claim hereby assigned, transferred or conveyed in the name of the [p]rincipal"). However, while discussing the surety's rights, the author notes that "[t]he surety succeeds to claims of the principal not only under the Agreement of Indemnity, but also through principles of equitable subrogation." *Id.*

111. *But see* Travelers Prop. & Cas. Ins. Co v. Triton Marine Constr. Corp., 473 F. Supp. 2d 321, 327 (D. Conn. 2007) (recognizing, nevertheless, that there is "no provision in the indemnity agreement that imposes on the surety the duty to pursue any particular claim or appeal").

112. *See* Harlandale Indep. Sch. Dist., 2007 WL 2253510, at *2 (recognizing that the contractor's right to bring a breach of contract claim against a school district was assigned to the sureties under the language of the indemnity agreement). In this case, the Fourth Court of Appeals (San Antonio)—in an interlocutory appeal for a plea to the jurisdiction—held that C2M Construction lacked standing to bring its claim for breach of contract against Harlandale Independent School District because the indemnity agreement's unambiguous language assigned all of the contractor's "rights 'growing in any manner out of' the construction contract . . . to the Sureties." *Id.* It is important to note, however, that the agreement in this case also "provided that C2M could request the Sureties to litigate its wrongful termination claim against HISD." *Id.* Indeed, the court noted that the sureties were *obligated* to litigate such claim "if: (1) C2M made a request; and (2) C2M deposited cash or collateral satisfactory to the Sureties to be used in paying any judgment or judgments rendered, with interest, costs, expenses and attorney's fees,

mind that the agreement in our hypothetical lacks the protection of any specific good faith language[113] or specific duty for the surety to settle as it sees "reasonable under the circumstances."[114] Therefore, we must look to what, if any, protections are afforded to principals when the contract's indemnity agreement fails to delineate any specific limitations.

1. Good Faith in General

When examining a surety's rights under an indemnity agreement, courts may consider "the unwritten provisions in all contracts[, including] the implied covenant of good faith and fair dealing."[115] In fact, "[m]ost American courts have recognized that every contract contains an implied covenant of good faith and fair dealing."[116] Due to the potential of abuse by sureties, an

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including those of the Sureties." *Id.* Noting that "[t]he record [did] not contain any evidence that either the request or the deposit was made by C2M," the court seemed to suggest that the contractor was not completely precluded from the opportunity to seek a remedy. *Id.* Thus, the indemnity agreement construed in this case at least provided the contractors with an opportunity to obligate the surety to litigate its claim, an option not contemplated by the hypothetical in this Comment. Further, the surety in this case had not already demanded that the claim be dismissed with prejudice, a distinguishing factor that invokes good faith and equitable considerations in our hypothetical.

113. *See* Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 282–87 (Tex. 1998) (holding that the surety was not entitled to indemnity based on specific language provided in the indemnity agreement that required surety's actions to be "made in good faith").

114. *See* Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 55–56 (George J. Bachrach ed., 1989) (considering an example indemnity agreement that included language requiring the surety to settle or compromise "any . . . claim on such terms as it considers reasonable under the circumstances").

115. *Id.* at 77 (pointing out that any court may subject the surety's exercise of its rights to "course of dealing and the implied covenant of good faith and fair dealing" when examining the surety's actions); *see also Travelers Prop. & Cas.*, 473 F. Supp. 2d at 330 ("The implied covenant of good faith and fair dealing applies in the context of a surety indemnity agreement.").

116. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 78 (George J. Bachrach ed., 1989); *see also* O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 189 (George J. Bachrach

indemnity agreement "will typically provide, or the court will *imply* as a condition of recovery, that the surety act reasonably or in good faith."[117] However, the duty of good faith and fair dealing presents at least two troubling issues for sureties—distinguishing good faith from "bad faith" conduct, and the effect of this duty on the rights obtained by the surety under the indemnity agreement.[118]

While equating bad faith with a lack of good faith may be "conceptually sound,"[119] the Texas Supreme Court has admitted this application "potentially obscures the burden of proof on the good faith issue."[120] Additionally, courts are split as to "whether good faith requires pure motives, commercial reasonableness or both."[121] In Texas, the *Associated Indemnity* court held that good faith—in the surety agreement before the court—referred to conduct that was "honest in fact, [and] free of improper motive or willful ignorance of the facts at hand."[122] It further went on to limit its scope, stating that good faith does not extend to "require proof of a 'reasonable' investigation by the surety."[123] Thus, the court concluded that bad faith, therefore, "means more than merely negligent or unreasonable conduct; it requires proof of an

ed., 1989) (expressing that indemnitors are generally held to the reimbursement provisions in the indemnity agreement, however, this obligation is subject to fraud and bad faith on the surety's part).

117. John W. Hinchey, *Surety's Performance Over Protest of Principal: Considerations and Risks*, 22 TORT & INS. L.J. 133, 143 (1986) (emphasis added) (citing Hess v. Am. States Ins. Co., 589 S.W.2d 548 (Tex. Civ. App.—Amarillo 1979, no writ)).

118. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 78 (George J. Bachrach ed., 1989).

119. Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 283 (Tex. 1998) (citing Fid. & Deposit Co. v. Wu, 552 A.2d 1196, 1199 n.4 (Vt. 1988)) (declaring that "bad faith" and "lack of good faith" are interchangeable).

120. *See Associated Indem. Corp.*, 964 S.W.2d at 283 (noting that the burden of proving "good faith" should rest with the *surety* wishing to recover under the contract, versus erroneously placing the burden on the *contractor* to prove bad faith).

121. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 78 (George J. Bachrach ed., 1989); *see, e.g.*, *Associated Indem. Corp.*, 964 S.W.2d at 284–85 (construing the convoluted language and standards applied in several appellate court decisions regarding indemnity agreements).

122. *Associated Indem. Corp.*, 964 S.W.2d at 285.

123. *Id.*

improper motive or willful ignorance of the facts."[124] Some courts, however, will simply apply the covenant of good faith to limit the exercise of rights that "offend the court's view of fairness."[125]

In considering how courts treat the covenant of good faith and fair dealing under indemnity agreements, it is helpful to compare how courts have treated this issue in the many cases dealing with the rights of the surety to recover attorney's fees. Courts have generally followed three lines of approach.[126] The first approach, and the most favorable for the surety, holds that the burden of proof rests with the principal in showing bad faith on the surety's part.[127] This approach grants the surety the discretion to incur any expense the surety decides is reasonably necessary.[128] The second approach also allows the surety to seek reimbursement for reasonably necessary expenses incurred in good faith, but requires the surety to establish good faith and reasonable necessity.[129] It is

124. *Id.*

125. Stephen J. Trecker et al., *The Agreement of Indemnity—The Surety's Handling of Contract Bond Problems: Administration and Resolution of Performance Bond and Payment Bond Claims, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 5, 78 (George J. Bachrach ed., 1989).

126. O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 188 (George J. Bachrach ed., 1989).

127. *Id.* at 189 (citing U.S. Fid. & Guar. Co. v. Hittle, 96 N.W. 782, 783 (Iowa 1903)).

128. *Id.*; *see also U.S. Fid. & Guar. Co.*, 96 N.W. at 783 (expressing that unless the principal shows bad faith by the surety, all expenses the surety incurs are recoverable under the indemnity agreement).

129. *See* Cent. Towers Apartments, Inc. v. Martin, 453 S.W.2d 789, 799–800 (Tenn. Ct. App. 1973) (discussing the facts that "will have a bearing on the reasonable necessity of action and good faith"). The court went on to reason that:

> [T]he facts which will have a bearing on the reasonable necessity of action and good faith under the circumstances include, but are not limited to, such matters as the amount of risk to which the surety was exposed; whether the principal was solvent; whether the surety has called on the principal to deposit with it funds to cover the potential liability; whether the principal on demand by the surety to deposit with it the amount of the claim has refused to do so; whether the principal was notified of the action and given opportunity to defend for itself and the surety; whether the principal hired the attorney for both himself and the surety; whether the principal notified the surety of the hiring of the attorney; the competency of the attorney hired by the principal; the diligence displayed by the principal and his attorney in the defense; whether there is a conflict of interest between the parties; the attitude and cooperativeness of the surety; and the amount charged and diligence of the attorney hired by the surety.

important to note that one of the factors considered in deciphering whether the fees were "reasonably necessary" involves the *solvency* of the principal.[130] Because an insolvent principal poses significant concerns to the surety at the time of suit, the financial health of the principal should be a significant factor when considering the reasonableness of the surety's actions.[131] Finally, the third approach requires a "surety act reasonably, in good faith and with due diligence."[132] This approach represents a middle ground between the first two approaches—rejecting the reasonable necessity test—yet requiring more than simply the absence of bad faith.[133] However, the common thread generally present in all three of these approaches is that the court will consider all of the facts and balance the equities in each case to determine whether the surety's acts were reasonable and made in good faith.[134] In *Jackson v. Hollowell*,[135] the Fifth Circuit recognized that "an indemnity agreement is not a blank check," and held that a surety's attorney's fees were only reimbursable if they were reasonable and incurred in good faith—regardless of what the indemnity agreement provided.[136]

2. Good Faith in Texas

In Texas, the *Associated Indemnity* court—relying on a prior

Id.

130. *See* O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 190 (George J. Bachrach ed., 1989) (referring to the factors weighed by the court in *Central Towers*).

131. *See id.* at 190–91 (noting that whether the principal was solvent at the time of suit was "[o]ne of the more significant factors considered by the court"). The author went on to discuss the "real and significant concerns" that an insolvent principal poses to a surety, including the principal's ability to respond to adverse judgments and its interest in defending itself aggressively in protecting the surety's interest. *Id.* at 190.

132. *Id.* at 191; Fid. & Cas. Co. of N.Y. v. Mauney, 116 S.W.2d 960, 962 (Ky. 1938) ("It would seem unnecessary to say that under such a contract of indemnity the indemnitee must act reasonably and in good faith and with due diligence.").

133. O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 191–92 (George J. Bachrach ed., 1989).

134. *Id.* at 192.

135. Jackson v. Hollowell, 685 F.2d 961 (5th Cir. 1982).

136. *Id.* at 966.

finding concerning the relationship between a surety and the *obligee* (owner)—held that a surety does not owe a blanket common law duty of good faith to its *principal* (contractor).[137] Indeed, Texas courts have declared that "not every contractual relationship gives rise to a duty of good faith."[138] The Texas Supreme Court has only imposed such a duty in "certain special relationships, such as that between an insurer and its insured."[139] Thus, because the relationship between a surety and an obligee does not present the same considerations that are present in the insurance arena, the Texas Supreme Court has declined to extend a duty of good faith and fair dealing to the surety context.[140]

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137. Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 280 (Tex. 1998) (citing Great Am. Ins. Co. v. N. Austin Mun. Util. Dist. No. 1, 908 S.W.2d 415, 418 (Tex. 1995)).

138. *Id.* at 280; *Great Am. Ins. Co.*, 908 S.W.2d at 418; *see also* English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983) (declaring that a covenant of good faith and fair dealing "concept is contrary to our well-reasoned and long-established adversary system which has served us ably in Texas for almost 150 years"). The court went on to reason:

> Our system permits parties who have a dispute over a contract to present their case to an impartial tribunal for a determination of the agreement as made by the parties and embodied in the contract itself. To adopt the laudatory sounding theory of "good faith and fair dealing" would place a party under the onerous threat of treble damages should he seek to compel his adversary to perform according to the contract terms as agreed upon by the parties. The novel concept . . . would abolish our system of government according to settled rules of law and let each case be decided upon what might seem "fair and in good faith," by each fact finder. This we are unwilling to do.

Id. at 522.

139. *Associated Indem. Corp.*, 964 S.W.2d at 280; *see also* Arnold v. Nat'l County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987) (recognizing "that a duty of good faith and fair dealing may arise as a result of a special relationship," like in the insurance context). In finding such a special relationship, the court recognized:

> In the insurance context a special relationship arises out of the parties' unequal bargaining power and the nature of insurance contracts which would allow unscrupulous insurers to take advantage of their insureds' misfortunes in bargaining for settlement or resolution of claims. In addition, without such a cause of action insurers can arbitrarily deny coverage and delay payment of a claim with no more penalty than interest on the amount owed. An insurance company has exclusive control over the evaluation, processing and denial of claims.

Id.

140. *See Associated Indem. Corp.*, 964 S.W.2d at 280 (finding no duty of good faith and fair dealing in the relationship between a surety and its principal); *Great Am. Ins. Co.*, 908 S.W.2d at 418–20 (concluding that there is no duty of good faith and fair dealing between a surety and an obligee). *But see* Brief for Associated Builders & Contractors of Tex. as Amicus Curiae Supporting Respondents, Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276 (Tex. 1998) (No. 96-0387) (illustrating the extent of power a surety possesses over its principal—making a compelling argument in favor of

Although admitting there are several arguments in favor of recognizing a special relationship between a surety and its principal, when considering an argument made by the contractor comparing its unequal bargaining position in the formation of the indemnity agreement to that present in the insurance context, the *Associated Indemnity* court reasoned that this fact, by itself, did "not justify imposing a special duty."[141] The court reasoned that indemnity agreements of such nature are "critical in enabling sureties to perform efficiently," noting the reluctance of sureties to settle claims when they are required, as many jurisdictions do, "to prove that the principal was in fact liable on the claim."[142] This dilemma thus led to the widespread use of indemnity agreements such as the one in *Associated Indemnity*, which expressly include a good faith condition precedent,[143] and allow the surety to be reimbursed only for settlement amounts that are "paid in good faith, regardless of whether the principal is ultimately determined to be liable to the obligee."[144] The Texas Supreme Court, nevertheless, while claiming to "express no opinion on th[e] issue," did recognize that some jurisdictions have found that a surety can never recover from its principal unless it exercised good faith, whether the indemnity agreement's terms specifically impose this condition or not.[145] This Comment advocates that Texas courts—

mandating a general duty of good faith in the surety context).

141. *Associated Indem. Corp.*, 964 S.W.2d at 281.

142. *Id.* at 281 & n.2 (citing John W. Hinchey, *Surety's Performance Over Protest of Principal: Considerations and Risks*, 22 TORT & INS. L.J. 133, 141–43 (1986)).

143. *See id.* at 283 (declaring that good faith is a condition precedent for recovery in indemnity agreements that specifically include such language); *see also* Centex Corp. v. Dalton, 840 S.W.2d 952, 956 (Tex. 1992) (noting that a condition precedent "must happen . . . before a right can accrue to enforce an obligation"); Criswell v. European Crossroads Shopping Ctr., Ltd., 792 S.W.2d 945, 948 (Tex. 1990) (stating that language such as "if" indicates a condition that must happen prior to a right accruing).

144. *Associated Indem. Corp.*, 964 S.W.2d at 281 n.2 (citing John W. Hinchey, *Surety's Performance Over Protest of Principal: Considerations and Risks*, 22 TORT & INS. L.J. 133, 141–43 (1986)).

145. *Id.* at 281 n.3 (citing Hartford v. Tanner, 910 P.2d 872, 878–80 (Kan. Ct. App. 1996)). The court also acknowledged several other jurisdictions that impose good faith duties in the surety context, yet discounted them—reasoning that they did "so either because they impose such duty in all contracts, . . . or because they equate suretyship with the business of insurance." *Id.* at 282 (citing Windowmaster Corp. v. Morse/Diesel, Inc., 722 F. Supp. 1532, 1534–35 (N.D. Ill. 1988); Loyal Order of Moose, Lodge 1392 v. Int'l Fid. Ins. Co., 797 P.2d 622, 626–27 (Alaska 1990); Dodge v. Fid. & Deposit Co., 778 P.2d 1240, 1241–42 (Ariz. 1989) (en banc); Tonkin v. Bob Eldridge Constr. Co., 808 S.W.2d 849, 854 (Mo. Ct. App. 1991); City of Portland v. George D. Ward & Assocs., Inc., 750 P.2d 171,

in an effort to clarify the convoluted case law surrounding standards applied in indemnity agreements—should be willing to adopt a good faith requirement for *settlements* of all bond claims.

Texas court decisions involving the limitations on the surety in *settling* claims can be split into three categories: (1) those cases where the indemnity agreement does not "expressly vest the indemnitee with authority to settle claims . . . [or] impose 'good faith' as the standard for indemnity[;]" (2) those where the indemnitee is expressly given the "authority to settle claims in 'good faith[;]'" and (3) those where the indemnity agreement expressly vests "the surety with the exclusive right to determine whether claims under the bond should be settled."[146]

Under the first line of cases, in which there is no express right to settle clause or good faith standard, courts have applied "common law indemnity principles, under which the indemnitee is required to show that the settlement was not only made in good faith, but that it was also 'reasonable considering the risk involved.'"[147] Under the second view, "where the indemnitee is given express

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174 (Or. Ct. App. 1988)).

146. *See* Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 284–85 (Tex. 1998) (discussing several Texas court decisions regarding standards in indemnity, separating them into three categories based on their various terms and requirements).

147. *Associated Indem. Corp.*, 964 S.W.2d at 284 (Tex. 1998) (quoting Fireman's Fund Ins. Co. v. Commercial Standard Ins. Co., 490 S.W.2d 818, 823 (Tex. 1972)) (recognizing that the Texas courts have held "that it is sufficient for the settling indemnitee to show a potential liability and that his settlement was reasonable, prudent and in good faith under the circumstances"); *accord* Sira & Payne, Inc. v. Wallace & Riddle, 484 S.W.2d 559, 561 (Tex. 1972) (requiring the settlement to be reasonable—taking the risks into consideration—and made in good faith), *overruled on other grounds by* Ethyl Corp. v. Daniel Constr. Co., 725 S.W.2d 705 (Tex. 1987); Gulf, Colo. & Santa Fe Ry. Co. v. McBride, 159 Tex. 442, 446, 322 S.W.2d 492, 495 (1959) (quoting Mitchell's Inc. v. Friedman, 157 Tex. 424, 431, 303 S.W.2d 775, 779 (1957)) (restating the necessity that the petitioner establish from its standpoint that the settlement was reasonable and made in good faith,), *overruled on other grounds by* Ethyl Corp. v. Daniel Constr. Co., 725 S.W.2d 705 (Tex. 1987); Sun Oil Co. v. Renshaw Well Serv., Inc., 571 S.W.2d 64, 67 (Tex. Civ. App.—Tyler 1978, writ ref'd n.r.e.) (quoting *Mitchell's Inc.*, 157 Tex. at 431, 303 S.W.2d at 779) (requiring petitioner to establish that settlement was made in good faith and that it was reasonable under the circumstances); Mo. Pac. R.R. Co. v. So. Pac. Co., 430 S.W.2d 900, 904 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref. n.r.e.) (requiring the railroad company only to prove that it "[m]ight have been liable . . . to the extent that it was reasonable to settle . . . ."); Md. Cas. Co. v. R & L Constr. Co., 368 S.W.2d 134, 135 (Tex. Civ. App.—Eastland 1963, writ ref'd n.r.e.) (stating that a bonding company had a right to settle if reasonable and in good faith, however it "assumed the responsibility of showing that the settlement was made in good faith and that it was a reasonable and prudent settlement").

authority to settle claims in 'good faith,'" courts have recognized a different standard.[148] Under this view, courts have allowed "the indemnitee discretion 'limited only by the bounds of fraud.'"[149] Surprisingly, such a broad discretion has been said to further public interest rather than upset public policy.[150] Finally, in the third type of case, where the surety simply has the exclusive right to settle, the Fourteenth Court of Appeals (Corpus Christi) specifically determined that "[c]ommon law principles concerning a surety who claims reimbursement for amounts paid out by it do not apply."[151] Instead, the court limited the surety only by "bad faith, which exceeds negligence or even gross negligence," and has, as an essential element, improper motive.[152]

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148. *Associated Indem. Corp.*, 964 S.W.2d at 284.

149. *Id.* (quoting Cent. Sur. & Ins. Corp. v. Martin, 224 S.W.2d 773, 776 (Tex. Civ. App.—Beaumont 1949, writ ref'd)).

150. *Associated Indem. Corp.*, 964 S.W.2d at 284; *Cent. Sur. & Ins. Corp.*, 224 S.W.2d at 776–77 (quoting Fid. & Cas. Co. of N.Y. v. Harrison, 274 S.W. 1002, 1004–05 (Tex. Civ. App.—Fort Worth 1925, writ ref'd)).

> [The *Associated Indemnity* court] held that this broad discretion did not violate public policy, but rather advanced the public interest:
>
> > There is nothing wrong or unreasonable, or against public policy, in this stipulation. Parties sui juris may lawfully make such stipulations, and are bound by them . . . . The expense, delay, trouble, and risk of loss to the guarantee company is a sufficient safeguard against an unwarranted payment; and, without such a stipulation as complained of here, guarantee companies could not safely do business anything like as cheaply as they do, and to the evident advantage of the parties and of the general public.

Associated Indem. Corp., 964 S.W.2d at 284 (quoting Cent. Sur. & Ins. Corp. v. Martin, 224 S.W.2d 773, 776–77 (Tex. Civ. App.—Beaumont 1949, writ ref'd)).

151. *Id.* (quoting Ford v. Aetna Ins. Co., 394 S.W.2d 693, 698 (Tex. Civ. App.—Corpus Christi 1965, writ ref'd n.r.e.)).

152. *Id.* (construing *Ford*, 394 S.W.2d at 698). The court noted that such improper motive "may be shown by a 'wilful disregard of and refusal to learn facts when available and at hand.'" *Id.* (quoting *Ford*, 394 S.W.2d at 698). The Court went on to recognize that such approach was consistent with its previous definition of bad faith in other circumstances, quoting its reasoning in the commercial paper context:

> Knowledge of facts merely sufficient to cause one of ordinary prudence to make inquiry, with failure to make such inquiry, is not evidence of bad faith . . . . Even gross negligence is not the same thing as bad faith, although it may be evidence tending to prove bad faith . . . . To constitute evidence of bad faith, the facts known to the taker must be such as reasonably to form the basis for an inference that in acquiring the instrument with knowledge of such facts he acted in dishonest disregard of the rights of the defendant . . . . Wilful ignorance is the equivalent of bad faith and bad faith may be shown by a willful disregard of and refusal to learn the facts when available and at hand.

3. Applying Texas Law to the Hypothetical Indemnity Agreement

Because our hypothetical indemnity agreement expressly granted the surety the right to determine whether a claim brought against the contractor upon any bond should be settled—and failed to contain any specific good faith language—it is likely that a Texas court would construe the case under the third view mentioned above.[153] Therefore, instead of applying common law principles to the claims for reimbursement, a court construing this indemnity agreement would likely only limit the surety to "bad faith, which exceeds negligence or even gross negligence."[154] Such a broad application admittedly favors the surety. In our hypothetical, the surety has refused to pursue the counterclaim, refused to let the contractor pursue the counterclaim, and *affirmatively* demanded that such claim be dismissed with prejudice. Without additional facts, these acts seem so unjustified that the surety's actions may indeed exceed "negligence or even gross negligence," and thus may be sufficient to constitute bad faith.[155] Additionally, a court may consider the surety's failure to allow the contractor to pursue the counterclaim, and subsequent demand for the contractor to dismiss the claim with prejudice, to amount to "wilful disregard of and refusal to learn facts when available at hand."[156] Consequently, such a finding may amount to a showing of improper motive, which is "an essential element of bad faith."[157] Even with such egregious behavior as that presented by the hypothetical, the enormous power vested in sureties over the rights of a defaulted principal admittedly presents a daunting shield.

Id. (quoting Citizens Bridge Co. v. Guerra, 152 Tex. 361, 370, 258 S.W.2d 64, 69–70 (Tex. 1953)).

153. *See* Associated Indem. Corp. v. CAT Contracting, Inc., 964 S.W.2d 276, 284 (Tex. 1998) (citing *Ford*, 394 S.W.2d at 698) (distinguishing the indemnity agreement as vesting "the surety with the exclusive right to determine whether claims under the bond should be settled").

154. *Id.*

155. *See id.* (reviewing *Ford*, 394 S.W.2d at 698) (limiting the surety's actions only by a showing of "bad faith, which exceeds negligence or even gross negligence").

156. *See id.* (quoting *Ford*, 394 S.W.2d at 698) (recognizing evidence that would suffice to show improper motive).

157. *See id.* (construing *Ford*, 394 S.W.2d at 698) (concluding that a showing of "improper motive is an essential element of bad faith").

4. Commercial Law Standards

Although the only limitation that seems to restrict the surety in the indemnity agreement construed in the hypothetical relies upon a showing of bad faith, the *Associated Indemnity* court also recognized a clear limitation under existing commercial law duties that seem to apply directly to those actions sought by the surety in our hypothetical. In dicta, the court noted that "[e]xisting commercial law duties prohibit a surety from disposing of collateral—including *causes of action*—in a commercially unreasonable manner."[158] Looking to Article 9 of the UCC, the court acknowledged that some provisions apply to security interests in "general intangibles," which include "things in action."[159] The court then went on to recognize, parenthetically, that "a secured party must use reasonable care to protect collateral"—and "must dispose of collateral in a commercially reasonable manner."[160] Thus, while purporting to "express no opinion on whether the indemnity agreement at issue [there] would have allowed [the] [s]urety to release these claims without any further action from [the] [c]ontractor,"[161] the court concluded that due to the aforementioned commercial law protections, an independent duty of good faith is not warranted.[162] Therefore, in

158. *See Associated Indem. Corp.*, 964 S.W.2d at 282 (emphasis added) (explaining that a proposed argument imposing common law duties on sureties is not justified even where an "unscrupulous surety . . . simply release[s] the principal's valid counterclaim"—alluding that existing commercial law duties prohibit such actions). *But see* Gen. Ins. Co. of Am. v. Mezzacappa Bros., Inc., No. 01-CV-7349, 2003 WL 22244964, at *4–5 (E.D.N.Y. Oct. 1, 2003) (rejecting argument under UCC as "specious"—recognizing instead that courts have consistently applied a good faith standard to a surety's settlement of its principal's affirmative claims—which is contrary to Texas law), *aff'd*, 110 Fed. App'x 183 (2d Cir. 2004).

159. *See Associated Indem. Corp.*, 964 S.W.2d at 282 (interpreting sections of Article 9 of the UCC as codified in the Texas Business and Commerce Code); *see also* U.C.C. § 9-102(a)(42) (2000) (defining general intangibles as "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction").

160. *Associated Indem. Corp.*, 964 S.W.2d at 282; *see also* U.C.C. § 9-207(a) (2000) ("[A] secured party shall use reasonable care in the custody and preservation of collateral in the secured party's possession . . . . In the case of chattel paper or an instrument, reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed."); U.C.C. § 9-610(a), (b) (2000) (requiring every aspect of disposition of collateral after a default to be commercially reasonable).

161. *Associated Indem. Corp.*, 964 S.W.2d at 282 n.4.

162. *Id.* at 282.

our hypothetical—where the surety is essentially attempting to throw away what is considered to be a valid counterclaim—the surety's action seems to be barred by existing commercial law duties, which mandate that a secured party "dispose of collateral in a commercially reasonable manner."[163]

Thus, although the *Associated Indemnity* court did not express an opinion on the indemnity agreement at issue there, its recognition of commercial law duties that apply to indemnity agreements, in dicta, suggest a favorable outcome for our hypothetical contractor. However, the *Associated Indemnity* court did not speak to arguments ostensibly available to the surety under its right to subrogation.

C. *Arguments Under Equitable Subrogation*

Independent of any such contractual relations, it is uncontested that the doctrine of equitable subrogation is triggered once the surety is called upon to pay the debt accrued by the contractor.[164] Because the contractor was primarily liable on the debt, received the primary benefit, and the surety was forced to pay off such debt involuntarily, the surety in our hypothetical will likely be able to establish a claim for equitable subrogation against the contractor in Texas.[165] Accordingly, once the surety paid the debt through

163. *Id.* (interpreting TEX. BUS. & COM. CODE § 9.504 (current version at TEX. BUS. & COM. CODE ANN. § 9.610 (Vernon 2002)) as requiring every aspect of disposition of collateral, which includes "things in action," to be commercially reasonable after a default).

164. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136 (1962) (noting that subrogation does not rely on contract, but is rather a "creature of equity" enforced for substantial justice).

165. *See* Frymire Eng'g Co., *ex rel.* Liberty Mut. Ins. Co. v. Jomar Int'l, Ltd., 194 S.W.3d 713, 715–16 (Tex. App.—Dallas 2006, pet. granted) (acknowledging that to bring a claim for equitable subrogation, "the claimant [must] prove both that the benefited party was primarily liable on the debt and that the debt was paid involuntarily"); Argonaut Ins. v. Allstate Ins. Co., 869 S.W.2d 537, 541–42 (Tex. App.—Corpus Christi 1993, writ denied) (recognizing subrogation where "one person, not acting voluntarily, has paid a debt for which another was primarily liable"); McBroome-Bennett Plumbing, Inc. v. Villa Fr., Inc., 515 S.W.2d 32, 36 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.) (noting that Texas courts recognize subrogation claims in which "one person, not acting voluntarily[,] has paid a debt for which another was primarily liable"); Forney v. Jorrie, 511 S.W.2d 379, 386 (Tex. Civ. App.—San Antonio 1974, writ ref'd n.r.e.) (declaring that subrogation is liberally applied and includes instances where "one person, not acting voluntarily, has paid a debt for which another was primarily liable" (quoting 53 TEX. JUR. 2d *Subrogation* § 5 (1964))); Lusk v. Parmer, 114 S.W.2d 677, 680 (Tex. App.—Amarillo 1938, writ dism'd w.o.j.)

its performance bond, it is entitled to the rights that would have otherwise belonged to the contractor[166] so as to not allow the contractor to be unjustly enriched.[167] "Simply stated, the right of subrogation of the surety is founded solely upon the equitable principle of having paid, pursuant to a bound obligation so to do, what in equity should have been paid by the contractor . . . ."[168] Therefore, because the counterclaim in the hypothetical likely constitutes a right of the contractor, the surety is most likely entitled to such claim.

1. UCC Standards Not Applicable

While not dependent upon assignment, lien, or contract, the majority of courts—including those in Texas—have held that a surety's subrogation rights are different from a security interest, and thus are "not subject to the Uniform Commercial Code . . . ."[169] Thus, as the Fifth Court of Appeals (Dallas) recognized,

(recognizing subrogation claim where money was involuntarily paid, in good faith, for primarily liable party).

166. *See McBroome-Bennett*, 515 S.W.2d at 36 ("[H]e who is substituted succeeds to the rights of the other in relation to the debt or claim . . . ."); E. Y. Chambers & Co. v. Little, 21 S.W.2d 17, 22 (Tex. Civ. App.—Eastland 1929, writ ref'd) (recognizing that subrogation substitutes a person into the place of a creditor).

167. *See Frymire Eng'g Co.*, 194 S.W.3d at 716 (citing First Nat'l Bank of Kerrville v. O'Dell, 856 S.W.2d 410, 415 (Tex. 1993)) (recognizing that equitable subrogation precludes the debtor's unjust enrichment); *see also id.* (citing purpose for equitable subrogation as preventing "the unjust enrichment of the debtor who owed the debt that is paid"); Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 337 (Tex. 1980) ("Equitable subrogation may be invoked to prevent unjust enrichment when one person confers upon another a benefit that is not required by legal duty or contract."); RESTATEMENT (FIRST) OF RESTITUTION: SUBROGATION § 162 (1937) (providing that where one person discharges another's obligation, they are subrogated to the rights of the obligee to prevent unjust enrichment).

168. Interfirst Bank Dallas, N.A. v. U.S. Fid. & Guar. Co., 774 S.W.2d 391, 397 (Tex. App.—Dallas 1989, writ denied) (quoting Trinity Universal Ins. Co. v. Bellmead State Bank, 396 S.W.2d 163, 168 (Tex. Civ. App.—Dallas 1965, writ ref'd n.r.e.)).

169. *See* Canter v. Schlager, 267 N.E.2d 492, 494 (Mass. 1971) (citing several authorities from multiple jurisdictions to support the court's conclusion that subrogation rights do not fall within the meaning of security interests under Article 9 of the UCC). The court, in coming to its conclusion, noted that Article 9 applies to security interests created by contract, and thus, as subrogation rights do not arise out of contract formation, they are not governed by the UCC. *Id.*; *see also* French Lumber Co. v. Commercial Realty & Fin. Co., 195 N.E.2d 507, 510 (Mass. 1964) (stating that no provision of the UCC "purports to affect the fundamental equitable doctrine of subrogation"); *Interfirst Bank*, 774 S.W.2d at 398 ("[A] surety's subrogation rights are not security interests within the purview of Article Nine.").

"the promulgation of the [UCC] and the enactment of its progeny (such as the Texas Business and Commerce Code) do not adversely affect the pre-Code subrogation rights traditionally afforded to sureties."[170] Therefore, because the surety additionally acquired the contractor's rights under the theory of equitable subrogation, the surety is arguably not constrained by the commercial reasonableness standards of the UCC for the settlement of its claims.[171]

2. Equitable Considerations

It is important to keep in mind that while Texas courts follow a liberal interpretation of the doctrine of equitable subrogation, they have also held that subrogation shall not "be used as an instrument of injustice to defeat a superior equity or overthrow a legal title."[172] Thus, this limitation by the Texas courts may preclude the acts of the surety in our hypothetical, as the surety is using the doctrine to dismiss the counterclaims that are sought by the contractor—effectively "defeating" a legal claim that is considered valuable.[173] Facing insolvency from the accrued debt, the contractor's right to at least assert the counterclaim is surely considered a "superior equity" when compared with the surety's right to throw it away. Consequently, the surety's refusal to pursue the contractor's claims, coupled with the demand that they be dismissed with prejudice, arguably uses the equitable doctrine as an "instrument of injustice," and should therefore be barred.[174]

Further, the Fifth Circuit recognized that "subrogation is not an absolute right" that another may enforce at will, but rather one

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170. *Interfirst Bank*, 774 S.W.2d at 398.

171. *See* Nat'l Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843, 849 (1st Cir. 1969). When considering whether a surety should be subjected to the standards of the UCC, the First Circuit opined:

> It may well be—although we express no opinion—that to subject sureties to the filing requirements of the Code would improve and rationalize the system of financing public contracts. But equitable subrogation is too hardy a plant to be uprooted by a Code which speaks around but not to the issue.

Id.

172. O'Brien v. Perkins, 276 S.W. 308, 315 (Tex. Civ. App.—Amarillo 1925), *aff'd sub nom.*, Shelton v. O'Brien, 285 S.W. 260 (Tex. 1926).

173. *See id.* (declaring that subrogation "will never be used . . . to defeat a superior equity").

174. *Id.*

that is "granted or withheld as the equities of the case may demand."[175] Because the surety in our hypothetical is not asserting control over the counterclaims for the purpose of seeking reimbursement of its debt—rather, simply demanding that the claims be dismissed with prejudice—granting subrogation is not "demanded" by the equities of the case.[176]

As previously mentioned, other jurisdictions have recognized similar limitations to relief under equitable subrogation in such cases where it would serve a manifest injustice,[177] where innocent people would suffer,[178] or where the result would be contrary to public policy.[179] Rooted in theories of equity, Texas courts should

175. Compania Anonima Venezolana De Navegacion v. A. J. Perez Export Co., 303 F.2d 692, 697 (5th Cir. 1962).

176. *See id.* (granting subrogation only where equity demands).

177. *See* Dade County Sch. Bd. v. Radio Station WQBA, 731 So. 2d 638, 647 (Fla. 1999) (allowing recovery on the basis of equitable subrogation only if no injustice is served); Hoopes v. Hoopes, 861 P.2d 88, 91 (Idaho Ct. App. 1993) (acknowledging that equitable subrogation must not work an injustice to others); Dix Mut. Ins. Co. v. LaFramboise, 597 N.E.2d 622, 626 (Ill. 1992) (recognizing limitations to subrogation where it would offend the principles of equity and good conscience); Wine v. Globe Am. Cas. Co. 917 S.W.2d 558, 561 (Ky. 1996) (acknowledging that recovery under subrogation "must not work any injustice to the rights of others"); United Carolina Bank v. Beesley, 663 A.2d 574, 576 (Me. 1995) (asserting that subrogation "should not be invoked so as to work injustice, or defeat a legal right, or to overthrow a superior or perhaps equal equity"); Lyon v. Colonial U.S. Mortgage Co., 91 So. 708, 709 (Miss. 1922) (refusing to subrogate party where debt was caused by his own wrongful conduct); State-Planters Bank & Trust Co. v. Pollard & Bagby Inv. Corp., 42 S.E.2d 287, 291 (Va. 1947) (allowing subrogation only "in a clear case and where it works no injustice to others"); Buskirk v. State-Planters Bank & Trust Co., 169 S.E. 738, 740 (W. Va. 1933) (refusing to allow subrogation because it would serve an injustice). "Subrogation cannot 'be invoked to override and displace the real contract of the parties.'" *Buskirk*, 169 S.E. at 740 (quoting Union Mortgage, Banking & Trust Co. v. Peters, 18 So. 497, 500 (Miss. 1895)). The court went on to note that admittedly, in the case of payments, a presumption in favor of subrogation is natural; however, that "presumption subsides when there is evidence of an intention to the contrary." *Id.*

178. *See* Universal Title Ins. Co. v. United States, 942 F.2d 1311, 1315–20 (8th Cir. 1991) ("[S]ubrogation cannot be invoked where it would . . . result in harm to innocent third persons."); LaSalle Bank, N.I. v. First Am. Bank, 736 N.E.2d 619, 626 (1st Dist. 2000) (recognizing that equity will effectuate subrogation only when there is no injury done to an innocent party).

179. *See Universal Title Ins.*, 942 F.2d at 1312 (recognizing limitation to subrogation where it would "violate sound public policy"); *A. J. Perez Export Co.*, 303 F.2d at 699 (refusing to subrogate agent that knew the freight forwarder was not keeping its promise and failed to provide the shipper with notice); *In re* Estate of Scott, 567 N.E.2d 605, 605 (Ill. App. Ct. 1991) (applying subrogation according to "equity, good conscience, and public policy considerations"); Bank IV Wichita, Nat'l Ass'n v. Arn, Mullins, Unruh, Kuhn & Wilson, 827 P.2d 758, 760 (Kan. 1992) (prohibiting subrogation claim where it

be amenable to these additional limitations. While the extent of equitable considerations taken into account are admittedly circumstantial, the surety's attempted use of the doctrine in our hypothetical would permit a potentially valuable claim to be dispensed with, despite the insolvency of the debtor.[180] This cannot be said to comport with justice or public policy concerns.[181]

As recognized by the Fifth Circuit, subrogation "is now a mechanism so universally applied in new and unknown circumstances that it is easy to overlook that it originates in equity."[182] "Every facet, whether substantive or procedural, is controlled by the equitable origin and aim of subrogation."[183] By declining to pursue the counterclaim, taking the further action of refusing to let the debted contractor pursue the counterclaim, and demanding its dismissal with prejudice, the surety is effectively wasting a potential offset to its own recovery. Indeed, precluding

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offended public policy); William Burford & Co. v. Glasgow Water Co., 2 S.W.2d 1027, 1027 (Ky. 1928) (refusing to apply subrogation if the results would be contrary to public policy).

180. *See* O. Linwood Perry, Jr. & Henry J. Wallach, *Salvage—The Surety's Right to Reimbursement Under the Indemnification Provisions of the Agreement of Indemnity, in* THE AGREEMENT OF INDEMNITY, PRACTICAL APPLICATIONS BY THE SURETY 173, 190–91 (George J. Bachrach ed., 1989) (stating that the principal's solvency at the time of suit is "[o]ne of the more significant factors considered by the court").

181. *See Hoopes*, 861 P.2d at 91 (recognizing that relief through equitable subrogation must not work an injustice to others); *Wine*, 917 S.W.2d at 561 (acknowledging that in order to recover under a theory of subrogation, it "must not work any injustice to the rights of others"); United Carolina Bank v. Beesley, 663 A.2d 574, 576 (Me. 1995) (commenting on subrogation being a creature of equity).

> Subrogation, as a creature of equity, must be enforced with due regard for the rights, legal or equitable, of others. It should not be invoked so as to work injustice, or defeat a legal right, or to overthrow a superior or perhaps equal equity, or to displace an intervening right or title.

Id.; *see also Lyon*, 91 So. at 709 (holding that it would be inequitable to subrogate a party who was required to pay another's debt when the reason he was required to pay that debt was that he caused the debt by his own wrongful conduct); *State-Planters Bank & Trust Co.*, 42 S.E.2d at 291 (allowing subrogation only "in a clear case and where it works no injustice to others"); *Universal Title Ins. Co.*, 942 F.2d at 1312 (recognizing that subrogation cannot be invoked if it would "violate sound public policy"); In re *Estate of Scott*, 567 N.E.2d at 607 (noting that in Illinois, subrogation is applied according to "equity, good conscience, and public policy considerations"); William Burford & Co. v. Glasgow Water Co., 2 S.W.2d 1027, 1027 (Ky. 1928) (stating that subrogation should never be applied if it would work an injustice or if the results would be "inimical to sound public policy").

182. *A. J. Perez Export Co.*, 303 F.2d at 697.

183. *Id.*

the contractor from asserting his claim against the material supplier limits the surety's chances of repayment as the contractor will undoubtedly be left bankrupt with no other available remedies. This result certainly does not seem to serve the common law spirit of equity which the doctrine of equitable subrogation was created to preserve.

IV. CONCLUSION

Under the current landscape of surety law in Texas, because the hypothetical indemnity agreement did not specifically contain a good faith requirement—as did the agreement in *Associated Indemnity*—the surety would likely only be limited by a showing of bad faith. Therefore, because this is a difficult evidentiary standard to overcome, the principal in our hypothetical may be forced to rely on "commercial reasonableness" standards that are provided under existing commercial law. However, this argument may be thwarted by the surety's right to equitable subrogation, which is not limited by the provisions of the UCC. Consequently, the final resolution to our hypothetical would likely rest upon the common law theories of equity. Without any controlling law on this factual situation in Texas, the question remains—what is equitable?

Although Texas courts have recognized at least some limitation to the surety's admittedly vast amount of power granted over a defaulted principal's rights, these limitations, and their respective scope, are far from clear and unequivocal. Because of the potentially severe consequences that may accompany a default in the surety context, Texas needs to adopt a clear standard under which the parties must operate. Even if Texas courts persist in refusing to apply a blanket duty of good faith upon the *entire* suretyship relationship, such confusion may be remedied if Texas would recognize a good faith standard in *settlements*—regardless of the language provided in the indemnity agreement. Further, considering the additional—and widely accepted—limitations on equitable subrogation that have become prevalent in other jurisdictions, Texas courts should not hesitate to recognize such limitations where necessary to curb the harsh inequities posed by our hypothetical.

While the right to freely contract in America is admittedly "ancient and irrefutable," this notion will constantly compete with the necessary limitations presented by public policy.[184] Therefore, while not to suggest the over regulation of contractual obligations, Texas must recognize that much of the success of the economy relies upon reasonable and good faith relations in the marketplace. Despite the indisputable necessity for contractual freedoms, the ever-present covenant of good faith and fair dealing that is implied in most contracts is often essential to the efficient and productive allocation of economic resources.

184. *See* Wilkie v. Auto Owners Ins. Co., 664 N.W.2d 776, 782 (Mich. 2003) (acknowledging that the right to free contract is a "bedrock principle of American contract law"—subject, however, to public policy).