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New Jersey Court of Errors and Appeals

Between

JOHN B. GROVER, *et al.*,

Appellees.

and

THE BOARD OF EDUCATION OF FRANKLIN TOWNSHIP, *et al.*,

(METROPOLITAN CASUALTY INSURANCE COMPANY OF NEW YORK),

Appellant.

On Appeal From Chancery.

Brief for Appellees.

On July 9, 1926, Gilbert Stout entered into a contract with the Franklin Township Board of Education to build a school in Middlebush, Somerset County.

Grover & Gulick furnished materials to Stout which were used in the building, and not having received payment of their account of $6,890.53, filed a lien claim with the Board on October 20, 1926.

On October 30, 1926, the Board paid Stout about $10,836.47 on account of his contract, and thereafter Stout defaulted and did not complete the building, with about $53,000.00 still unexpended by the Board.

Appellant Metropolitan Casualty Insurance Company gave its bond to the Board on July 22, 1926, for

$72,185.00, securing not only the Board, but all persons for lawful claims for material furnished in the "carrying forward, performing or completing of the contract," and the surety company stipulated that its bond should be for the "benefit of any materialmen having just claims."

On September 26, 1926, Stout, being indebted to Grover & Gulick on an open account for more than $30,000.00 including the Middlebush school job, paid to Grover & Gulick $8,000.00 out of his payment of September 25, 1926, and Grover & Gulick applied that $8,000.00 to their open account, having received no request from Stout as to any specific application of his payment.

Grover & Gulick knew that the fund from which Stout's check for $8,000.00 was drawn was taken from the Middlebush school payment of September 25, 1926.

On December 20, 1926, the surety company contracted with a Perth Amboy company to finish the job, and in its contract with that contractor, the surety company expressly agreed to pay the Grover & Gulick debt of $6,890.53. (Case p. 96).

The surety company now asks that Grover & Gulick be decreed to apply the $8,000.00 payment to the Middlebush account, on the theory that as surety, its right to direct the application of the payment is superior to the right of Grover & Gulick to appropriate it as they saw fit.

Grover & Gulick had no knowledge of the surety company's decision to finish the contract, when they got their payment of $8,000.00. There was no intimation to them at that time that Stout would later abandon his work and the surety company be obliged to complete it. No one knew in September, 1926, that the surety company would elect to take over the work.

So the case develops into two written promises made by the surety company to pay Grover & Gulick, one on the bond, and the other in the contract with the Perth Amboy company, with no evidence that the surety company did not know that Grover & Gulick were paid $8,000.00 in September, when the surety company made its second promise to pay the Grover & Gulick debt.

It was, to say the least, incumbent on the surety company to show that it had no knowledge of the payment of $8,000.00 to Grover & Gulick when it agreed on December 20, 1926, to pay their claim.

In *Benson vs. Reinshagen,* 75 Eq. 358, it was held that the court can "only apply the money where the debtor and creditor fail to direct its application to a particular indebtedness."

The Court of Appeals, in *Terhune vs. Colton,* 12 Eq. at page 320, cites with approval the English case of *Simson vs. Ingham,* 2 *Barn & Cress,* 65, where the creditor was permitted to apply the payments to debts other than those guaranteed by sureties.

This court, in *Feldman vs. Gamble,* 26 Eq. 494, refused to divert to a just debt a payment previously applied to an illegal debt.

"Payments made by the obligor on a bond to the obligee were unavailable in favor of the sureties on the bond, in the absence of any proof that the payments were made on account of the bond." *Bishop vs. Smith,* 57 Atl. (N. J.) 874.

In the annotation to *Wait vs. Homestead Bldg. Asso.* 21 A. L. R., beginning on page 704, it is said, with many authorities cited in support, that:

"It is well settled that a surety or guarantor cannot, in the absence of an agreement or of special equity in his favor, direct or control the application by the principal and the creditor, or either of them, of payments made by the principal from his own funds; in other words, the mere fact that one of the

debts in question is covered by the obligation of a guarantor or surety does not defeat the right of the principal debtor in the first instance, or, in case of his failure, the right of the creditor, to apply the payment to another debt due from the principal."

An examination of the cases on the surety company's brief discloses that no one of them deals with the situation in the case at bar created by the surety company's bond expressly providing for the payment of complainant's claim, and the surety company's contract with the Perth Amboy company also expressly providing for the payment of the claim.

"Subrogation is pure equity; it is sometimes spoken of as a benevolence; it will never be decreed at the expense of a legal right, or when it will work injustice." *Wyckoff vs. Noyes,* 36 Eq. at p. 230.

In *B. F. Sturtevant Co. vs. Fidelity & Deposit Co.* 92 Wash. 52, 158 Pac. 740, annotated in L. R. A. 1917-C page 630, it was held that a surety company could not have the payment applied to its debt, where the creditor receiving the payment had no notice to apply it, or was without knowledge of the source of the payment. In the annotation to this case in L. R. A. it is pointed out that the law is not so considerate of paid sureties as of voluntary sureties. In the case at bar, the appellant was paid a substantial premium. (Case p. p. 89 and 90).

The Sturtevant case is nearly parallel with the case at bar, the only difference being in respect to knowledge of the source of the payment: In the instant case, Grover & Gulick knew that the money came from the Middlebush school job, while in the Sturtevant case, there was no knowledge on the part of the creditor that the payment came from the school funds.

The legislature evidently did not contemplate the right of the surety to participate in the fund, be-

cause no provision is made in section 9 of the Municipal Lien Act for making the surety a party defendant to the claimant's suit in Chancery to enforce his lien.

Appellant argues on page 10 of the brief, that by virtue of the assignment in Exhibit D-2, page 89 of the case, it was subrogated to the contractor's right to the fund, but this contenion is answered by Section 6, of the Municipal Liens Act (Cum. Sup. of 1924 p. 1861) which reads as follows:

> "The lien of any laborer, or of any person, persons or corporation furnishing any material hereafter filed under the act to which this is a supplement, shall have priority over any assignment by a contractor or subcontractor to any third person or persons of any money due or to grow due to such contractor or subcontractor for any labor or material furnished for any public improvement referred to in said act, notwithstanding such assignment may have been made prior to the filing of notice by any such laborer, or any such person, persons or corporation furnishing any material, provided such money shall not have been paid to such assignee at the time of the filing of such notice. (L. 1918, c. 280, p.1044)."

It does not seem necessary to go so far afield as appellant goes for authorities ruling the question at issue, for in *Pierson vs. Haddonfield* 66 Eq. 180, it was held that there is no subrogation such as the surety claims here. And in at least one respect, the case at bar is exactly similar to the Pierson-Haddonfield case, in that the surety company here did not prove that it had no other recourse than the fund to save it from loss. That part of the court's opinion

in the Haddonfield case, beginning on page 192, has a direct application to the matters here in issue, and is as follows:

> "It is also to be considered that the right of a surety to be subrogated is not an absolute one, which the surety may enforce at will. All the circumstances which might affect the equities of the parties should be presented. In the present case, while there is proof that the expenditures of the City Trust Company in completing the contract are in excess of the portion of the contract price paid to that company, it is not shown that this will necessarily result in an actual loss to the City Trust Company, for there is no proof that that company has no other fund, or security from Quinlan to which it may have recourse. In the *Hewitt Case,* 10 C. E. Gr. 210, this court declared that whether the surety should have all the remedies which the creditor might have enforced depends on whether it is necessary to the protection of the surety that it should be so. The defendant company which undertook this suretyship knows whether it is otherwise protected. It is its duty (when it asks the court to award to it by subrogation a special fund of its principal on which other creditors rely for payment) to prove that it has no other recourse than this fund to save it from loss. No such evidence has been offered.
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> Whatever may be the equities of the parties touching the question of subrogation, the principles which in my view must control and determine their rights in this dispute are to be found in the effect and operation of the statute of 1892 above cited upon the matters here under consideration. The defendants' exten-

sive citations of the decisions in other states upon their statutes are of little aid in determining this cause, which is controlled by the terms of the statute of this state.

The transaction was within the scope of that statute, a public improvement being constructed by a municipality of this state under a contract for work to be done and materials to be furnished. The municipality, the contractor and his surety must be held to have made their contract with knowledge of the fact that this public statute gave to persons who might perform work for or furnish material to the contractor for such an improvement a right of lien upon moneys which might be due or grow due to the contractor under the contract, and that persons who supplied such work and material might rely upon that right of lien to secure payment of their claims. The City Trust Company having with this knowledge accepted its responsibilities as surety, cannot now equitably withstand the enforcement of the statutory lien subject to which it entered into its contract of suretyship. Any other construction of the statutory lien would make the statute a baited trap, inviting workmen and materialmen to give credits to contractors erecting public improvements upon the assurance that the payment of their claims would be secured, but depriving them of their security by the enforcement of a latent equity, to the creation of which they were not parties, and of which they knew nothing when they gave their credits, which in fact came into existence (if it ever did arise) because of circumstances happening long after the claimants' liens had attached.''

As to the contention in appellants' brief that Grover & Gulick do not come into court with clean hands, it is only sufficient to point out that at the time they received the payments from Stout and applied them to his old account, they knew nothing of the subsequent taking over of the work by the surety company. Had Stout, at the time of the last payment to Grover & Gulick defaulted on his building contract, and Grover & Gulick had knowledge of it, and then deliberately applied the payment to their old account, there might be some merit in appellant's argument. But the record is otherwise.

It is therefore respectfully submitted that the decree of the Court of Chancery should be affirmed.

LOUIS GERBER,
Solicitor of Appellees.

JAMES J. McGOOGAN,
Of Counsel.