The Rationale of Corporate and Non-Corporate Suretyship Decisions, Pt.3

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IV. DEFENSES, RIGHTS AND REMEDIES OF THE CORPORATE SURETY.

A. Defenses.

Cases involving rights, remedies and defenses of the corporate surety have not been as numerous as those involving questions of interpretation or construction of the contract between the surety and the party secured. The preponderance of cases of the latter type is no doubt due in part to the success of the courts in construing the terms of the contract "liberally" enough to avoid the question of modification or variation. But the cases that have dealt with substantive defenses have disclosed an unmistakable trend in the direction of modifying the absolute defenses which have been allowed generally to the private surety. On the whole the modifications have been consonant

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91 In U. S. Fidelity and Guaranty Co. v. U. S., for use, etc., (1903) 191 U. S. 416, a creditor who had furnished materials to the contractor had extended time of payment by accepting 30 and 60-day notes from the contractor. The surety claimed a release on the ground of extension of time. The court disposes of this contention as a question of interpretation.

"The guarantor is ignorant of the parties with whom the principal may contract, the amount, the nature, and the value of the materials required, as well as the time when the payment for them will become due. These particulars it would probably be impossible for the principal ever to furnish, and it is to be assumed the surety contracts with knowledge of this fact. Not knowing . . . . when the bills for them will mature, it can make no difference to him whether they were originally purchased on credit of 60 days, or whether, after materials were furnished, the time for payment is extended 60 days, and a note given for this amount, maturing at that time. If a person deliberately contracts for an uncertain liability he ought not to complain when the uncertain becomes certain."

92 Lumpkin, J., in Bethune v. Dozier, (1851) 10 Ga. 234 furnished a classic expression of the rule, as well as the theory back of it, which gives the private surety an absolute defense when changes are made in the principal obligation without his consent.

"No principal of law is better settled at this day, than that, the undertaking of surety, being one strictissimi juris, he cannot, either by law or in equity, be bound farther or otherwise, than he is by the very terms of his contract: and that if the parties to the original contract think proper to change the terms of it without the consent of the surety (which it is not
with sound principles of contract law and, in so far as they mark a change from the rules applied to the liability of private sureties, are justified by changes in the facts out of which the suretyship relation arises.93

1. Extension of time.

In no situation has the private surety's absolute right to stand on the letter of his contract been more universally recognized than in the case of extension of time to the debtor by the creditor. The rule which allowed an absolute discharge in case of an extension of time was first applied to contracts to pay money. Here an extension of time represented a material change in the whole contract. In theory, at least, it always increased the risk and deprived the surety of his right to pay at maturity and thus interfered with his right of subrogation.94

What had been an equitable defense, allowed at the discretion disputed they have a right to do) the surety is discharged. He is not bound by the old contract, for that has been abrogated by the new; neither can it be split into parts, so as to be his contract to a certain extent and not for the residue; he is either bound in toto, or not at all.

"Neither is it of any consequence that the alteration in the contract is trivial, nor even that it is to the advantage of the surety. Non haec in foedera veni, is an answer in the mouth of the surety from which the obligee can never extricate his case, however innocent or by whatever kind intentions to all parties he may have been actuated."

93 Frequently it is not clear whether the corporate surety is being held by reason of a construction of the contract in favor of the party secured or by a denial to the corporate surety of a defense ordinarily allowed to a non-corporate surety. For example, whether the court means that by construing the contract "most strongly in favor of the obligee" the "extension of time" is not a breach, or, granting it is a breach, that it will not be a defense to the surety unless there is damage caused by the extension."

Fidelity and Deposit Co. v. John Gill & Sons, (1925) 270 S. W. 700, 705, 706.

94 The non-existence in actual experience of any basis for this rule has been pointed out.

"We are not aware of any instance in which a surety ever in practice exercised this right (i. e., to apply to creditor and pay him off); certainly the cases in which a surety uses it must be very rare. Nevertheless, the surety has the right, and if the creditor bonds himself not to sue the principal debtor, for however short a time, he does interfere with the surety's theoretical right to sue in his name during such period. It has been settled by decisions that such an interference with the rights of the surety—in the immense majority of cases not damaging him to the extent even of a shilling—must operate to deprive the creditor of his right of recourse against the surety, though it may be for thousands of pounds. But though it seems—if it may be permitted to speak in such terms of the doctrine sanctioned by very great lawyers—consistent with neither justice nor common sense, it has been long so firmly established that it can only be altered by the legislature." Cockburn, J., in Swire v. Redmon, 1 Q. B. D. 536.
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of the chancellor came to be a hard and fast rule of law applied to any case of extension without reference to injury to the surety and without regard to the nature of the contract.95

Whatever technical reasons may be adduced for the rule in the case of ordinary promises to pay money, these reasons would seem to lose their force when the extension of time does not actually involve an extension of the time for the performance of the original obligation. For example, in Murray City v. Banks et al.,96 the defendant surety company was surety on the bond of a bank official who defaulted in his accounts, and upon the discovery of the shortage the bank took a note for the amount payable in six months. Defendant claimed release on two grounds: (1) payment by the note; (2) extension of time on the obligation sued on. The court found that the note had not been taken in payment and announced unqualifiedly:

"We hold that the extension of time of payment, unless resultant harm is shown, does not discharge a paid surety."

The court quotes an earlier case97 to the effect that "to allow such companies to collect and retain premiums for their services, graded according to the nature and extent of the risk, and then to repudiate their obligations on slight pretexts that have no relation to the risk, would be most unjust and immoral, and would be a perversion of the wise and just rules designed for the protection of voluntary sureties." One readily agrees with the sentiment of the excerpt but the result can be rested upon more tangible grounds. There was no change in the principal contract; there was no increase in the risk, i. e., no increase in the probability of the happening of the contingency upon which the surety company's liability to respond rested; it had already happened. The transaction came within the rule governing acts of the creditor which affect the interest of the surety, such as release or exchange of securities, and which must be injurious to the surety to constitute a defense, and even then, only pro tanto. On principle the same result should be reached in the case of a private surety.

95 Cf. "But such an agreement between the principal parties is perfectly valid and legal; and until some method can be devised for depriving the principal of the benefits of a valid agreement, or of binding the surety to an agreement to which he never acceded (a work hitherto thought not to be within the powers of either courts or legislatures) the discharge of the latter must ensue." Ranney, J., in Ide v. Churchill, 14 O. S. 383.

96 (1923) 62 Utah 296, 219 Pac. 246.

In Philadelphia etc. v. Fidelity & Deposit Co. the surety company became surety on a contractor's bond to secure payment to subcontractors and others for materials and labor furnished for the prosecution of the work. The use plaintiffs furnished materials and labor, and at the time, or before, the debt came due, accepted a note which was renewed and never paid. During the running of the note the city paid over a balance due to the contractor, and at a time when he was probably insolvent. This suit was brought within the period limited in the bond. Judgment against the defendant company was affirmed. The reasons of the court are indicated in the following:

"In its nature the obligation was more of a contract of insurance than of suretyship: so long as the extensions of credit did not go beyond the two year limit for suit fixed in the bond, and in the absence of fraud or unfair dealing on the part of the subcontractors to the prejudice of the surety, or of material harm actually suffered, the surety was not released. . . . We find no direct averment in the affidavits of defense that the surety was actually harmed by the extensions granted to the contractors, and the facts stated herein are not sufficient in themselves to raise such a presumption. For all that appears, the contractor may have paid every cent of the cash received to other material men or mechanics who did work on the building. In a case of this kind there is no presumption that the surety company is harmed, the prejudice must be made to appear, and the suggestions of mere contingencies or possibilities is not enough."

Almost all cases, of which the foregoing is an example, which involve the giving of time by a materialman to a contractor, are treated by the courts as if they presented a variation of the terms of the principal contract, consisting of an extension of time for performance of the principal's obligation. But in no case has the surety's contract, or the principal contract, required that the indebtedness between contractor and materialmen be evidenced on any particular form; nor has either contract set an ultimate date of maturity for these obligations, except as might be implied from the usual clause limiting the time within which suit must be brought on the surety's contract. There is ordinarily nothing in the principal contract to regul-

99 "We hold that the extension of time of payment, unless resultant harm is shown, does not discharge a paid surety in a bond such as is before us. It is not found that the surety suffered harm from the extension." Standard Salt & Cement Co. v. Surety Co., (1916) 134 Minn. 121, 158 N. W. 802.

In People for use, etc., v. Traves, (1915) 188 Mich. 345, 347, 348, 154 N. W. 120, the court "recognized as applicable to the facts of this case" the rule that a surety company is not released by an extension of time in the absence of proof of injury to the surety."
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late the form of agreement between the contractor and his creditors and these extensions of time, even under the rules applied to private suretyship, should be assimilated to transactions between creditor and surety rather than considered variations of the principal contract. The courts, however, have assimilated them to the old category of "extension of time" and we may conclude that in all cases of extension of time of the payment of the very obligation secured these modifications of the former rules will be applied in the case of a corporate surety.\textsuperscript{100}

The cases uniformly hold that a mere extension of time will not as a matter of law discharge the surety; some injury must result. In all the cases I have examined there was no showing of harm to the surety as a result of the extension, and consequently no holding directly on the effect of an extension plus injury to the surety. The statements of the courts justify the inference that if harm actually results, the corporate surety will be discharged, not merely allowed to recoup in damages.\textsuperscript{101}

The decisions agree also that no harm is presumed and that the surety must plead and prove the injury.

If the rule becomes established that the corporate surety is released by a showing of a harm resulting from an extension of time, that would only be applying a rule which many agree to be too liberal even in case of private surety. There is no convincing reason why a good faith extension made for the purpose of enabling the principal debtor to discharge the obligation should be availed of by a corporate surety for more than a pro tanto defense. If the extension transaction is purely a voluntary extension transaction amounting in effect to a new loan, it ought to be considered the same as a discharge of the

\textsuperscript{100} In Southern Surety Co. v. Guaranty State Bank, (1925) 275 S. W. 436, 442, the court notes that these extensions of time of payment for materials do not modify the principal contract. The Court says:

"... it was the original contract between H. & P. and the county that fixed the liability of the appellant surety company and not the extension of payment of the note, and the agreement of June 1, 1922, which was in no way related to the original contract with the county. The time for the performance of the contract with the county was never changed or extended by the agreement of June 1st or by the taking of the notes." (Italics mine.)

\textsuperscript{101} To explain and justify this radical modification of the orthodox rule there is constant insistence that the corporate surety's contract is one of insurance. Cf. "In its nature the obligation was more of a contract of insurance than of suretyship. ... Philadelphia, etc. v. Fidelity & Depart Co., supra, p. 284.

\textsuperscript{102} See supra, p. 284, and note 99.
principal obligation and consequently a complete release of the surety, corporate or private.

2. Modifications of the Principal Contract.
   (a) Modifications by agreement in limine.

One material consideration in determining the effect of a change in the terms of the principal contract is the time at which the change is made. Frequently it is at the time when the principal contract becomes binding and subsequent to the offer of the surety. If the entering into the principal contract constitutes an acceptance of the offer of the surety and if the terms of the principal contract as changed vary in the slightest from the requirements of the offer, the surety never becomes bound, for his offer is not accepted. Page v. Kreky\textsuperscript{103} is an excellent illustration. The surety made an offer of a series of unilateral contracts of guaranty and included in his offer the exact terms of the principal transactions which he would guarantee. The offer was not accepted.

Modifications of the principal contract which are made in good faith, in the course of performance, for the purpose of expediting or of more effectively or even of more satisfactorily accomplishing the general object of the contract, involve different considerations than modifications in the terms of the contract deliberately made for the sole purpose of changing the general object provided for in the terms of the contract. It is not unreasonable to expect that in the course of performance changes will be made, due to unforeseen developments, or to mistaken understanding of the terms of the contract: often to help the principal obligor stave off default. But it is not reasonable for the party secured and the creditor to deliberately modify the terms of the principal contract, while they are free from the pressure of circumstances, for the sole purpose of changing the effect of the contract. There is no reason why a corporate surety is not entitled to his contract to the same extent as contracting parties generally. Changes in the principal contract made before performance by the principal and party secured, are from the standpoint of the surety analogous to breaches in limine in bipartite contracts. In contracts law a breach in limine need not be as substantial, in order to release the non-offending party, as a subsequent breach in course of performance.\textsuperscript{104}

\textsuperscript{103} Supra, p. 125.

\textsuperscript{104} "It is sometimes said that any breach in limine will excuse the other party; and at least in the law of sales of personal property this
On the analogy of breach in limine a corporate surety ought to be released by a change in the terms of the principal contract amounting to considerably less than a substitution of a new contract, if made before performance, even though it can not be shown that the surety was injured or that there was an increase in the chance of non-performance on the part of the principal. In *Matthew v. Hill*\(^{105}\) the surety was released on the ground of “substitution of a new contract.” In this case the sole modification consisted of dispensing with two bronze tablets on the sides of a memorial monument, with a consequent reduction in cost of only five hundred dollars out of ten thousand dollars. The change was made by agreement between principal and obligee before the principal began work on the monument. While there was a substantial change made in the original contract, and made in limine, it would seem to do considerable violence to the facts as well as to the intent of the parties to say there was a substitution of a new contract. That a change in limine must be one in substance, and not merely nominal is illustrated by the case of *Sokoloff v. Fidelity & Casualty Co.*\(^{106}\) The surety’s bond purported to cover twelve notes of equal amount identified in the bond by amount and date of maturity. Instead of twelve notes, one aggregating the total amount was given, but with a schedule of twelve payments corresponding to the due dates appearing in the bond. In holding that the surety company was not released the court distinguishes from *Burdette v. Walsh*,\(^{107}\) in which no note was given, although the bond recited that it was given as security for a note.

(b) Modifications Destroying the Identity of the Contract.

As already suggested the stock justification for discharge of the private surety, when any changes in the terms of the principal contract, or variation therefrom have been made, is summed up in “non haec in foedera veni”. The assumption that there is a new contract is usually not consistent, with the facts, or with the intention of the parties, and as between principals the same amount of variation in an ordinary contract would be considered a breach and not an abandonment. But in case of continued departures a point must be reached at which it can not be said that the contract is in any true sense being performed. When this point is reached, the non-offending party is released

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\(^{105}\) (1926) (Mo. App.) 287 S. W. 789.

\(^{106}\) (1927) (Pa.) 35 Atl. 746.

\(^{107}\) *Supra*, p. 204.
from his obligation to perform instead of being compelled to accept compensation for the deviations of the other party. No one would insist that a surety company should be held for the performance by its principal of a contract admittedly distinct from the one intended to be secured even though the contracts involved substantially the same type and extent of obligations. It seems equally clear that the surety should not be held to respond for default of his principal if, by successive changes, or, by one big change, either before or after performance has started, a new contract has in effect been substituted for the original. On principle, then, a surety should be released if the principal contract has been in effect abandoned, whether this results from changes in the terms of the contract expressly made by consent of the party secured and the principal, or from repeated departures assented to in the course of performance.

The opinion in *Matthew v. Hill* assumes that a new contract was substituted "for the original contract by the mutual agreement of the parties thereto", and if this assumption is supported by the facts the surety was properly released. The surety was a private surety but the decision did not rest on that fact. It is a fair inference that the court intends its reasoning to include a corporate surety. Distinguishing this case from a corporate surety case, in which the surety was not released, the court said:

"There was no substitution of a new contract for the original contract by the mutual agreement of the parties thereto (as in the case at bar), but, to the contrary, the changes which were made in the plans and specifications were made merely at the request of the contractor and with the acquiescence of the city."

After referring to an earlier case in which statements were made to the effect that a corporate surety would be discharged only in case variations were such as would increase its burdens,

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108 A surety guaranteed that his principal, as purchaser, would pay the plaintiff, seller for "a steam engine of twelve inch bore and twenty inch stroke: two cylinder boilers, each thirty feet long and twenty-five inches in diameter; and all the shafts, pulleys, and iron necessary . . . ."

By agreement of the vendor and vendee an engine with three boilers, and of greater capacity and power and with changes in accessories, was substituted at an increased price. Such considerable changes affecting the entire subject matter of the principal contract would justify a discharge of the surety on the ground of substitution of a new contract. *Grant v. Smith*, (1871) 46 N. Y. 93.

109 *Supra*, p. 287.

110 *City of Kenneth v. Construction Co.*, 273 Mo. 279; 202 S. W. 558.
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either in cost of construction or in the extension of time for performance, the opinion makes the following distinctions:

“This language, however, affords no support for plaintiff's contention in the case at bar. The ultimate test is whether there has been a substitution of a new contract for an old one. In the city of Kennett case there had been no such substitution. Upon the contractor's request, the city had merely acquiesced in his deviation from the plans and specifications, but the original contract had been retained. In such a case whether the surety remains bound depends upon whether the changes are so extensive as to destroy the identity of the original contract.”

One might imply from the statement in Matthew v. Hill that changes in the terms of the principal contract “made by the mutual agreement of the parties thereto” might be given the legal effect of substitution of a new contract whereas these same changes “made merely at the request of the contractor and with the acquiescence of the city” would not “destroy the identity of the original contract”. If, as suggested above, it is sound to resort to the analogy of breach in limine, then the time at which, and not the method by which, the change in the original contract is made, should be the distinguishing fact. After performance has been started, however, no greater legal effect should be given to changes made in the contract by mutual consent, which result in deviations from the original contract, than to deviations consented to which result in changes from the original contract. In either case the surety should remain bound unless the changes are “so extensive as to destroy the identity of the original contract” or have the result of substantially increasing the chance of non-performance by the principal.1

In Matthew v. Hill there was manifestly no increase of burden for the surety, but frequently the change in, or deviation from, the terms of the principal contract may involve an increase of hazard for the surety. This was true in Commercial Nat. Bank v. Indemnity Co.12 The plaintiff bank and the principal entered into a contract by the terms of which the plaintiff obligated itself to advance money to the principal to enable it to finance the purchase of automobiles for retail. By the terms of the contract the plaintiff bank agreed to advance to the principal, M. Company, eighty per cent of the value of each car, and the principal was to give the plaintiff a chattel mortgage on each car, and a note bearing 6 percent interest, the bank to be paid out of the proceeds of the sale of each car. The defendant

111 Infra, p. 292 et seq.
112 (1925) Court of Appeals D. C. 10 Fed. 2d 641.
surety company gave its bond to secure performance by the principal. The principal defaulted and the bank sued the surety on its bond. The surety company demurred to the complaint on the ground that the complaint showed the principal had advanced more than eighty per cent of the value of the cars, and that the notes called for eight percent interest instead of six percent. Demurrer sustained and on appeal this judgment was affirmed. The court's reasons were as follows:

"It appears, accordingly, that the transactions which gave rise to the alleged indebtedness of the motor company to the bank were not such as came within the scope of the bond. Consequently the security was not bound to answer for them."

In this case there was no mutual consent to change the terms of the contract followed by a deviation, but the change took the form of deviation in performance. The change, however, at least as respects the first transaction, was in limine. This case, then, includes: a substantial change in limine, an increase in the burden of the surety, and a performance which was "not such as came within the bond". The principal contract was purely a loan and repayment agreement, and a change in both the amount of the principal and interest would seem to justify the holding that the transaction did not come within the scope of the contract, in other words, that there was a substitute contract.

(c) Minor Modifications and Variations or Transaction Affecting the Principal Contract.

Granting that modifications or variations in a particular case do not change the identity of the contract, they may affect the interest of the surety by:

1. Increasing the expense to the surety in case of default by the principal, especially by interfering with his remedies for reimbursement.

2. Increasing the chance of non-performance by the principal.

Inequitable conduct in the form of transactions between the creditor and the principal, or by the creditor independently of the principal, which affect the interests of the surety, also belongs here. The principal contract may frequently be practically unchanged and yet transactions between the creditor and the principal or conduct by the creditor may increase substantially the actual loss of the surety. In these cases as in the cases of extension of time, the courts say there must be injury in order to justify the release of the corporate surety. New Amsterdam Casualty Co. v. Construction Co.\textsuperscript{113} is in point. The plaintiff

\textsuperscript{113} (1926) 12 Fed. 2d 972.
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sublet to M a certain piece of road construction and the surety company became surety to plaintiff for performance by M. The contract between plaintiff and M. which was approved by the defendant was typewritten on two sheets of paper. After the bond had been executed the plaintiff and M. agreed that M. should do certain additional work and provisions covering the additional work were typewritten on a third sheet of paper, each party signing at the bottom of the page, and this sheet was inserted between the two sheets of the original instrument. Extra payment was provided for the additional work. The court said:

"A contract may be modified by adding provisions which do not change the legal effect of those contained in the original contract. Under the evidence the defendant properly could be held liable for M's failure to perform the work first contracted for; the change made in the original contract not being such as materially varied the contract, so far as the compensated surety agreed to be responsible for performance of it, or as involved harm to such surety; the existence, whether before or after the date of the making of the bond sued on, of M's obligation to do work other than that described in the bond, not having the effect of altering essentially the obligation for which the defendant agreed to become bound."

Clearly the intention of the parties was to add to the original contract and it was thereby changed, and changed in limine. The court concluded that there had not been a material change in the original contract. There was apparently no appreciable increase in the risk of non-performance by the principal and no showing that the surety suffered any loss. The court points out that the surety was not responsible for the principal's performance of the additional work, and, in the absence of a showing of any interference with the principal's performance of the original contract, the result is sound. The court treats the additional agreement as an independent contract supported by its own separate consideration.

One of the commonest modifications or deviations which has come before the courts consists of making payments to the principal in excess of the amount provided for in the principal contract. In *Pickens County v. National Surety Company*114 the obligee had made excessive payments, but in order to help the principal carry on. Apparently the excess payments had been applied to the performance of the principal's obligation. In concluding that the surety was not entitled to relief the court said:

"... it (surety company) must show that it has suffered some injury by reason of departure from the strict terms of the contract, before it can

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114 (1926) 13 Fed. 2d 758.
for that reason be discharged from its liability. And payments to a con-
tractor in advance of the time specified in the contract are expressly held
not to be such a departure from or change of the terms of the contract as
will discharge from liability a bonding company which has guaranteed
its performance, in the absence of a showing that the bonding company
has suffered injury therefrom."

In an Iowa case of *Hileman & Gint v. Faus et al.* the facts
on record disclosed that all the advancements had gone to ma-
terialmen, whose claims were covered by the bond. In passing
on the appeal the court stated the rule as to presumption of
injury as follows:

“When money is paid to the contractor the surety might be prejudiced
because the contractor might use the money for his own separate pur-
poses and leave the surety to pay for the labor and materials to complete
the building. The presumption referred to is open to rebuttal.”

*Pickens County v. National Surety Company*, supra, would ap-
parently put the burden of showing injury on the surety and in-
fierentially holds that when injury is shown the surety company
will be released. The Iowa case is not so clear on the extent
of the defense allowed to the suerty company, but presumes in-
jury from the advancements subject to rebuttal.

A case much cited for the doctrine that a corporate surety
is an insurer is *Young v. American Bonding Co.* But the sig-
nificant holding in the case is that a corporate surety is released
by any change in the principal contract which increases the
chance of non-performance by the principal obligor. The re-
viewing court does a real service in pointing out the significance
of an increase in the chance of non-performance by the principal
as distinguished from injury or actual loss. The court assumes
that the business of surety companies “is in all essential particu-
lars that of insurance” and bases its discussion on that assump-
tion. The reasoning of the court is just as applicable to the case
of a private surety, however, for fundamentally the understand-
ing of the surety, the principal, and the party secured, is that the
surety’s assuming the chance of nonperformance by the prin-
cipal is the very essence of any surety’s promise; and conse-
quently any conduct by the party secured or transactions be-

115 (1916) 178 Ia. 644, 158 N. W. 597.
116 (1910) 228 Pa. St. 373, 77 Atl. 623.
117 This has been obscured in the case of the private surety for the
reason that any variation of the principal contract was sufficient to re-
lease the surety without making any distinctions between variations that
(1) increased the risk of non-performance, (2) caused loss to the surety,
(3) did neither. *Foley's Adm'r. v. Robertson's Guardian*, (1927) (Ky.) 268
tween the part secured and the principal which materially interfere with performance by the principal— i.e., increase the risk of the surety—should give an absolute defense to the surety. The corporate surety decisions have been regularly distinguishing between cases in which the modifications have caused no actual loss and those in which modifications have caused loss to the surety, but the facts usually have not required a distinction between cases in which the change imperiled the surety by an increase in the risk and those in which the change clearly did not increase the risk of the surety, but caused actual loss to him. In Young v. American Bonding Company a modification in the original contract deprived the principal of the possibility of utilizing "by anticipation" certain securities. The court sums up the points as follows:

"To that extent it increased the hazard of his accomplishing what he had undertaken to do, and correspondingly increased the risk the appellee had underwritten."

"It follows there is but one way by which it is to be determined whether the variance complained of was a material variance. The test is to be found in the answer to the question whether it substantially increased the chances of the loss insured against. . . . It is not a question whether the variance actually caused the breach of the bond, but whether it was such a variance as a reasonably careful and prudent person undertaking the risk would have regarded as substantially increasing the chances of loss."

The court decided that the change substantially increased the chances of loss and affirmed the judgment of the lower court discharging the surety company. The case not only points out the materiality to the surety of an increase in risk, but indicates a standard for the determination of "material variance" as applied to risk. I suggest the following statement of the standard in suretyship phraseology:

"Was the variance complained of such as a reasonably careful and prudent person, about to become bound as surety, would have regarded as substantially increasing the chances of non-performance by the principal?"

Hamilton v. Republic Casualty Co. et al. furnishes a clear distinction between an advance payment of unauthorized sums to the principal which may merely increase the amount of loss of the surety, and an advancement under such circumstances as to increase materially the chance of non-performance by the principal. The bond in question had the usual ten per cent reserve clause. The principal under a different contract had previously built two houses for the plaintiff, and unpaid materialmen were threatening to file liens on these buildings. The plain-

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118 (1926) 102 W. Va. 32; 135 S. E. 259.
tiff loaned the principal enough to pay these claims and took his note. Later, out of money due the principal under the present contract, the obligee with the consent of the principal applied approximately three thousand dollars on the note. The principal defaulted and in a suit against the surety company the plaintiff recovered judgment in the lower court. In reversing this judgment the reviewing court gave the following reasons:

"The surety had not guaranteed the payment of obligations not assumed under the contract. In making his collection from the estimate, the plaintiff imposed on the contract of June 11 obligations of the construction company incurred in former contracts. The contract of June 11 could not carry the added burden. This burden was not assumed by the casualty company, and was such an added risk as released it from liability. . . . Any change in the contract made by the owner and the contractor, to which the surety is not a party, and which works a material injury to the surety, discharges the surety."119

The improper transaction between the principal obligor and the plaintiff substantially increased the chance of non-performance by the principal. The case discloses the unsoundness of restricting the surety to a pro tanto defense in cases of variations which do not amount to a destruction of the identity of the principal contract. Leaving out of consideration the plaintiff's contribution to the default of the principal, and assuming that there was not sufficient departure from the contract to justify a discharge of the surety on the theory of a substituted contract, the surety could only claim a recoupment of three thousand dollars and would be compelled to make good for the default of the principal at an expenditure of a much greater sum. But when the facts show that the plaintiff's transaction with the principal materially contributed to, if it did not wholly cause, the default of the principal, to compel the surety to answer for this default would impose a burden that was not assumed by the surety and result in a grossly unjust enrichment of the plaintiff.120

119 The court distinguishes between cases in which no prejudice is caused the surety company, such as loans to enable the surety to carry on the work. Cf. Monroe v. Surety Co., 47 Wash. 488, 92 Pac. 280; Museum Fine Arts v. Am. Binding Co., 211 Mass. 124, 97 N. E. 633.

120 In Justice v. Empire State Surety Co., (1913) 209 Fed. 105, the party secured had advanced two thousand dollars more than was due at the time of the default. The court said this was "a material variance which relieved without proof of injury. . . . When it (clause providing for retention of 10 per cent.) is not observed, and advances and overpayments are made, it is so obviously to the prejudice of the surety that it operates as a discharge as a matter of law." Also see Fidelity & Deposit Co. v. Agnew, (1907) 152 Fed. 955.
In *Maryland Casualty Company v. Eagle etc. District* it was admitted that payments were made without architect's certificates, and in excess of the ninety per cent limitation and that various irregular transactions had occurred before the principal defaulted. But there was no showing of an increase in the chance of non-performance by the principal, and the court held the surety had neither an absolute nor pro tanto defense.

The following excerpts are from the opinion of the court:

"It would seem, too, that not every circumstance prejudicial to the interests of the surety should work a total discharge of the surety, without any reference or consideration to the extent to which the interests of the surety were in fact prejudiced by such circumstances."

"There can be no injustice in requiring a paid surety, when in the business for profit, to prove that alleged delinquencies or misconduct on the part of the indemnified resulted, not only in damages to the surety, but the extent of such damage. That is nothing more or less than a rule applied with reference to contracts generally, except perhaps cases where the breach of a contract is so material as to justify the other party in rescinding the contract. *We must not be understood as saying that there can be no conduct on the part of the indemnified which will result in the absolute discharge of the paid surety; but we say, that, as a general proposition, considerations of justice are fully met when the surety is recouped to the extent of the losses actually sustained by reason of misconduct on the part of the indemnified.*" (Italics mine.)

"It is apparent that the contractor would have been obliged to throw up his job long before he did, had he not received this financial assistance. A departure from the terms of the contract in these various aspects kept the contractor on the job."

"The school district and the contractor in good faith sought to work out the situation, and to make it possible for the contractor to complete the work. This might not have resulted to the benefit of the surety, but it by no means appears in this case that the surety suffered any damage by reason of this conduct, and by failing to show that it was damaged it has failed to prove a cause of action, or that it was released from the obligation which it had voluntarily assumed."

The last case, on its facts, is in accord with the majority of decisions. The court presupposes:

1. that all departures were made in good faith to enable the principal to carry out his obligation.
2. that no damages was actually caused to the surety.
3. that the chance of default decreased.

No recent decision has allowed a corporate surety a defense, absolute, or pro tanto on the above facts. The instant case expressly denies any intention of holding the position that there can be no conduct by the party secured which would release the surety company. The court properly refers the question of the

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121 (1925) 188 Wis. 520, 205 N. W. 926. Cf. *Hartford etc. Co. v. State* (Ind. App. Dec. 1927), 159 N. E. 21, in which surety company was discharged by irregularities which included payment "out of the ditch fund" of an unauthorized claim, "thereby increasing appellant's liability."
defense to rules of contracts law, but might have noted that
whether the breach is "so material as to justify" a rescission
depends on the special suretyship relations of the parties.

(d) Representations and Warranties, Duty of Disclosure.

In the case of the private surety the problem of formal repre-
sentations and warranties is practically non-existent. As else-
where suggested there is seldom any direct negotiations between
the prospective obligee and the surety-obligor, the preliminary
matters being settled by the creditor and the principal. If there
is a bond or other instrument of security separate from the
instrument embodying the principal obligation, it is regularly
prepared by the obligee and for very human reasons does not
contain formal representations and warranties. By reason of
the absence of direct dealings between the surety and the party
secured, and the absence, ordinarily, of any reliance by the
surety on the creditor in the preliminary negotiations, there is
no basis in fact, and no justification in law, for any implication
of representations and warranties, and none is implied. In re-
spect to a duty of disclosure it was early established that an
insurer was more of a favorite of the law than the private
surety. The insurer-insured contract was said to be uberrimae
fidei and a very broad duty of disclosures of all facts material
to the risk was imposed upon the insured. No such general duty
rested upon the party secured.\textsuperscript{122} In absence of an application
by the prospective surety to the creditor for information, and
an undertaking by the latter to give information, the creditor-
obligee could maintain silence respecting many facts affecting
the principal's capacity to perform his obligation, and conse-
quently material to the risk.\textsuperscript{123}

\textsuperscript{122} Davies v. London etc. Co., (1878) 3 Ch. Div. 469; Hamilton v. Wat-
som, (1845) 12 Cl. & F. 117; Lee v. Jones, (1864) 17 C. B. (N. S.) 482;
Domestic Sewing Machine Co. v. Jackson, 15 Lea (Tenn.) 418.

\textsuperscript{123} Non-disclosure of the insolvency of the principal, Ham v. Greve,
(1870) 34 Ind. 18; of present indebtedness to the creditor, Palatine Ins.
Co. v. Crittenden, (1896) 18 Mont. 413, 45 Pac. 555; Domestic etc. Co. v.
Jackson, supra, note 122; Magee v. Manhattan Co., (1875) 92 U. S. 93;
of the fact that the principal was gambling or speculating during prior
Warren v. Branch, (1879) 15 W. Va. 21; Bridges v. Miller, (1926) 150
Md. 1,132 Atl. 271.

For the limitation of this doctrine cf.: "... to receive a surety
known to be acting on the belief that there are no unusual circumstances
by which his risk will be materially increased, well knowing that there are
such circumstances and having a suitable opportunity to make them known
and withholding them, must be regarded as a legal fraud, by which the
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As a result of the assumption by the courts that the corporate surety's contract was a policy of insurance, the foregoing occasioned the courts some concern in the early decisions dealing with the contracts of the surety companies. It was evident that the cumulative effect of an adoption both of the rule of insurance law which required a full and voluntary disclosure of all matters material to the risk, which were known to the insured, and of the rules governing representations and warranties, as then applied in insurance cases, would have been to restrict the liability of the corporate surety to a lesser one than that of the old bond-surety, despite the application of more liberal rules of interpretation and construction. This was clearly recognized in one of the early Federal decisions involving the question, and the warning was given that the courts "should not perplex themselves with regrettable technicalities of law such as have sometimes crept into the older contracts of insurance, and have required statutes for their removal." At another point in the decision the court remarked:

"It would be contrary to public policy to inconsiderately allow the protection afforded by this new insurance to the vast business interests of the country, in public administration as elsewhere, to be endangered by any lesser indemnity than that of the old form of bond, which is being so rapidly displaced, the new contracts being offered by the companies as superior to the old in safety."

The gist of the court's conclusions was that "nothing is to be implied not necessarily indicated by the words used, as might be in other examples of insurance, when the relation of the parties and the character of the risk are different, and where those relations properly breed implications that would import a meaning not admissible when the thing guaranteed is so far disassociated from any duty owing by the assured to the insurer as we find in the subject matter of insurance here;" that the liability of the surety company is as broad as that afforded by the older bond, "except so far as the 'provisos and conditions hereinafter contained' shall have limited that broad liability."

The decisions have generally avoided "the regrettable technicalities of law" applied to insurance contracts as respects both a duty of disclosure and implied representations or warranties. In the treatment of formal representations and warranties the courts follow the decisions of the jurisdiction in insurance cases.

Surety will be relieved from his contract." Bank v. Cooper, (1895) 36 Me. 179, 197.

The "liberal construction" rule often enables the court to reduce an apparent warranty to a representation, but in many cases it is evident that the court is adopting a substantive rule to the effect that warranties, like representations, can not be availed of by the corporate surety unless there is fraud or material increase of the risk of the surety. The use by the surety companies of application blank similar in form and purpose to those used by insurance companies, and the incorporating of stereotyped insurance phrases into warranties have suggested and made easy the application of insurance rules, either by analogy or by the more direct expedient of calling the corporate surety's contract an insurance contract. Statutes defining the effect of representations and warranties made "in the negotiations of insurance" have been construed to apply to contracts of corporate sureties. In view of the traditional reluctance of the courts to enlarge in the slightest a class of persons or transactions covered by a statute one may be inclined to marvel at the ease with which corporate surety companies have been brought within the purview of statutes referring only to insurance companies, and enacted before any surety companies had appeared in the jurisdiction. Obviously the result is desirable, whether reached by judicial construction of a statute referring to insurance companies, or by a literal holding that a surety's contract is a policy of insurance, or by a statute expressly referring to surety companies.

The following is offered as a fair summary of the more important decisions on defenses of the corporate surety:

1. Changes in the principal contract so radical as to amount to a substitution of a new contract give an absolute discharge to the surety, without reference to the question of actual injury to the surety or increase in the risk of non-performance by the principal.

2. On the facts of certain cases, there is support for the position that a substantial change in the terms of the principal contract will release the surety if the change is made in limine,

125 W. A. Thomas Co. v. National Surety Co., (1919) 142 Minn. 460, 172 N. W. 697. The section of the statute in question was as follows: "No oral nor written representation made by the assured, or in his behalf, in the negotiation of insurance, shall be deemed material, or defeat, or avoid the policy or prevent its attaching, unless made to deceive or defraud, or unless the matter misrepresented increased the risk of loss."

See also Champion Ice Co. v. American Bonding Co., (1903) 115 Ky. 863, 75 S. W. 197.
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without regard to actual loss to the surety or increase in the risk.126

3. If the changes in the principal contract, or inequitable transactions by the party secured affecting performance by the principal, substantially increase the chance of non-performance by the principal, the surety is discharged.

4. Changes in the contract and deviations therefrom and transactions by the party secured which result merely in increased expenditure by the surety in making good the default of the principal give the surety a defense pro tanto.

5. Non-prejudicial variations or transactions not coming within (I) and (II) give no defense to the surety.

B. Rights and Remedies of the Corporate Surety.

The real test of whether “corporate suretyship” has ceased to be fundamentally suretyship comes in the cases which involve questions of re-imbursement, subrogation, exoneration and contribution, for these are the peculiar rights and remedies which have characterized the suretyship relation. No case shows a tendency to modify these, and references to insurance are made only to explain that insurance rules can not apply.

In Maryland Casualty Company v. Hjorth127 the surety company sued on a note given to the surety company after the default of the principal. The note was executed by the principal and another and guaranteed by a third person. The surety company made good the loss and in the instant case was suing on the note. The chief defense was no consideration. The surety company contended that the note was given to induce the plaintiff surety company to continue on the bond and that its consent to so continue on the bond constituted a consideration. The trial court submitted this question to the jury:

“Did the plaintiff, in consideration of the execution and delivery of the note in question by the defendants, refrain from cancelling its bond?”

The jury answered “No.” Judgment was rendered for defendants and plaintiff appealed. The Supreme Court reversed the judgment with an order to enter judgment for the plaintiff. The court found the consideration in the obligation of indemnity arising out of the suretyship relation. The following excerpts are from the court’s opinion:

“While it is universally held that the contract of an indemnity company guaranteeing to an employer the fidelity of employees is a contract of

126 No decision expressly on this ground.
127 (1925) 187 Wis. 270, 202 N. W. 665.
insurance, such holdings have generally been in cases involving the rights of the insured against the indemnity company and have related to a construction of the contract of insurance."

"Although there is a dearth of authority upon this question, it would seem that where an employee makes application to an indemnity company to guarantee his fidelity to his employer, the relation of principal and surety, or of principal and guarantor, is created just as much as though the application had been made to a private surety individual and such individual had executed a bond to the employee. We so hold."

"It is well supported by authority that, after the contract of suretyship has been entered into and before a breach, the liability of the surety to pay the principal's debts constitute a sufficient consideration for security turned over to the surety by the principal."

While considering a question of subrogation the Supreme Court of North Dakota\textsuperscript{128} expressly declared that the rights of the corporate surety in this respect were the same as those of a private surety.

"The plaintiff insists that, by reason of the fact that it was a compensated surety, the defendant cannot claim the right of subrogation to which the ordinary surety is entitled. We think, however, that the defendant's right as a surety are to be determined by its legal status as surety and not by the reasons which may have induced it to enter into that status. In other words, the fact that the defendant was a surety for compensation did not deprive it of the rights that it was entitled to under the rules governing the relation of surety and principal. On the other hand the contract of indemnity set out in contracted form that which equity would in any event have given."\textsuperscript{129}

In the very recent case of \textit{Mellette Farmers' Elevator Company v. H. Boehler Company}\textsuperscript{130} the court very distinctly points out that as respects its right of indemnity a corporate surety company has as complete remedy as a private surety. The surety company had paid a judgment against it to the extent of the penalty of its bond and asked to come in as a creditor

\textsuperscript{128} Gilbertson v. Northern Trust Co., (1925) 53 N. D. 502, 207 N. W. 42.

\textsuperscript{129} For other cases recognizing the usual benefits of subrogation see: \textit{State v. Hartford Accident etc. Co.}, 248 Pac. 432; \textit{Hartford Accident & Indemnity Co. v. Federal Construction Co. et al.} (Minn.), 1926, 209 N. W. 911; \textit{Southern Surety Co. v. Holden etc. Company,} 14 F. (2nd) (411), 1926; \textit{Fidelity v. Deposit Co. of Maryland v. Eisien et al.} (Court Civil Appeals Tex.) 1926, 284 S. W. 977; \textit{The Same v. School Board et al.} (District Court W. D. La., 1926) 11 Fed. 2nd 404.

But a surety company is not subrogated to right of obligee against defaulting bank, though paying the full penalty of the bond, where obligee's indebtedness was not satisfied; \textit{Maryland Casualty Company v. Fouts et al.} (Circuit Court Appeals, Fourth Circuit, 1926) 11 F. 2nd, 71.

\textsuperscript{130} (Feb. 11, 1927) District Court D, Minn., Fourth Division, 13 Fed. 2nd 430.
against the receivership of the principal debtor, although other creditors were within the protection of the bond and had not been paid in full. In allowing the claim of the surety company the court said:

"When a contract of suretyship is made there arises, in the absence of an express agreement, an implied contract that the principal will indemnify the surety for any payment that it may be required to make under the contract of suretyship. This implied agreement comes to life when a contract of suretyship is made; from that time on the relation of debtor creditor exists between the surety and principal. The payment of money under the contract by the surety merely fixes the amount of the damages for which the principal is liable, and relates back to the time the contract was entered into."

"If the claim of the surety were based on subrogation, the situation would be different. The rule is that a surety liable for only part of the debt does not become subrogated to collateral or to remedies or rights available to the creditor, unless he pays the whole debt or it is otherwise satisfied."

"The reasons for the diversity of opinion arising out of situations, such as this, appear to be the failure to distinguish between an express or implied contract of indemnity and the right of subrogation, together with the desire to postpone the reimbursement of a paid surety until all the obligees have been paid in full. However natural that desire may be it should not be permitted to override well established principles. If surety bonds are adequate to meet the needs of a situation, the obligees will be paid in full and the surety left to reimburse itself from the assets of the principal so far as possible. Where such bonds are inadequate to meet a situation, there seems to be no logical reason for excluding a surety from participation, as a general creditor, after it has paid the full loss indemnified against."

CONCLUSION.

In respect to rights of indemnity, subrogation, and contribution, the courts have recognized that corporate suretyship is suretyship in the accepted sense. Whatever changes in facts have occurred, it is still true that the corporate surety is obligating itself to answer for the debt, default or miscarriage of another, and is entitled to have the burden ultimately borne by the principal. There is, likewise, no change in the facts which would call for a modification of the rights of subrogation, contribution, and exoneration, and there has been no indication of any tendency to restrict these rights of the corporate surety.

In respect to interpretation and construction of the contract and defenses of the surety, considerable modification of the rules applied in private suretyship cases has occurred. As far as interpretation and construction are concerned, the net result of calling the corporate surety's bond a policy of insurance has been to enable many courts to reach a desirable result by the
slot-machine method instead of by the sounder, but more exacting method of determining what rules, or what modifications of rules, are demanded by the new facts and changed situation. The modifications of the old absolute defenses of the private surety are consistent with rules of contracts law, and are sound, not because the corporate surety is an insurer, but because the contract of the surety company with the party secured and the circumstances under which it is made call for an application of the rules of contracts generally to breaches of contract by the party secured. The corporate surety does not have all the legal advantages given the private surety for the reason that the facts which have made the private surety the "favorite of the law" are not present. The fact that the corporate surety receives compensation and negotiates directly with the party secured, and avowedly upon the basis that there is a chance of non-performance on the part of the principal, and the further fact that the compensation is accepted for the assumption of the risk, do not make it an insurer. These facts simply leave no basis for imposing on the party secured any special duty toward the surety apart from the provisions of the contract. On the other hand, in the case of the private surety, the absence of an express assumption of the risk of non-performance by the principal, the gratuitous nature of the surety's undertaking, the fact that he is in a very true sense at the mercy of the principal and creditor, in short, the whole situation is such as to put on the promisee a duty to avoid any act which might prejudice the interests of the surety. Under cover of the "favorite-of-the-law" fetish, the courts of law and of equity have, in effect, imposed a standard of conduct on the promisee of a surety comparable to that of a fiduciary. He must not only avoid any act which injures the surety, but even any act which might in theory conceivably injure him. A word is changed in the contract!! Metaphysically considered, the old contract is destroyed, dissolved into legalistic air. As for the new contract, non haec in foedera veni! The surety is released not because of injury to himself, but because of the creditor's failure to come up to the high standard of conduct required of him. But any such standard of conduct imposed upon the party secured who deals with the modern corporate surety company would be without any moral or legal justification. The surety company is in the business of assuming risks of non-performance and pays losses out of the proceeds of the business. The creditor and surety meet on a business basis and expectations and standards of conduct incident to business transactions are appropriate. De-
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claring that the corporate surety is not a "favorite of the law" merely means that the facts do not call for an imposition of a fiduciary standard of conduct upon the party secured. Or, putting it another way, when the courts say that the corporate surety does not need the protection of the courts, they merely mean that the facts are no longer such as to throw upon the creditor a special duty of protecting the interests of the surety, which duty, if existing the courts would enforce. The result of all this is a modification of the relational bond that exists between the private surety and the party secured; and consequently, in matters of interpretation and construction of the contract, and to a large extent in matters of breach of contract, the general rules of contracts law must be applied. But the materiality of a breach of the contract, and consequently the determination of whether the surety shall be absolutely discharged, or limited to a pro tanto recoupment, largely depend upon the peculiar character of the surety's obligation and the principal-surety relation.

The statements of the courts vary from the unqualified declaration that the corporate surety is an insurer and engaged in the business of insurance to the more guarded statement that when a surety company becomes obligated on its bond, "the relation of principal and surety, or of principal and guarantor, is created just as much as though the application had been made to a private individual and such private individual had executed a bond to the employer." The positive statements to the effect that the surety company is an insurer are almost exclusively found in the cases dealing with interpretation and construction of the "policy" or with the question whether surety corporations should come within the operation of statutes regulating insurance companies. It can make very little difference to call the corporate surety an "insurer" and his contract a "policy of insurance" when the problem is to interpret or construe the contract. The substantial effect is to get back to general rules of interpretation which should be applied. But the insistence that the surety company is an insurer only confuses the true situation when dealing with the rights, remedies, and defenses, of the surety, which are tied up with the principal-surety relation; and for the treatment of which, rules of insurance furnish no help. For rights, remedies, and defense of the surety company can not be disassociated from the tripartite relation of the party secured, the principal obligor and the party secondarily liable,

181 Maryland Casualty Co. v. Hjorth, supra, p. 299.
even though the latter be called an "insurer." Granting that the contract of the surety company and a policy of insurance have certain features in common, there is still this very essential difference: the contract of the surety company per se creates the relation of suretyship with all its special rights, duties, and liabilities, while an insurance contract in itself never creates a tripartite relation analogous to the suretyship relation. The interests involved in the suretyship relation are far more intricate and more delicately balanced than those in the bipartite relation of insurer and insured. If the insured and insurer agree to modify a contract of insurance, no difficult questions are involved. Neither can modify it without consent of the other, but no third person's interests are involved. Let the party secured and the principal in a suretyship relation modify their contract, however, as they can legally do, and instead of the simple questions of the effect upon their legal relations, there is the more difficult task presented of weighing the effect of these modifications upon the promise of the surety, and of determining what legal results should follow. The sound attitude seems to be: avoidance of categorical treatment, re-examination of the reasons of the rules applied to private suretyship, both in respect to the contract of the surety and to the relational characteristics, and then, retention, modification, or rejection of these rules in the light of the facts and of the proper function of corporate suretyship, as a security device, not as an insurance arrangement. For the true function of corporate suretyship in modern business is not primarily to repair loss but to make contracting parties secure against loss; to supply the element of financial security in transactions, which is the sine qua non of our enormously developed, but delicately balanced, economic system resting, as it does, on credit.
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