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Suretyship in Article 3 of the Uniform Commercial Code

THE UNIFORM COMMERCIAL CODE (UCC) has incorporated many suretyship principles into its provisions and has thereby changed and modified some of the traditional tenets of that field. The purpose of this Note is to compare the provisions of the UCC with corresponding traditional suretyship principles and to note the similarities and differences between the UCC and the *Negotiable Instruments Law* (NIL) in this area. The scope of this discussion will be limited to those suretyship principles which are referred to in Article 3 of the UCC and which bear directly upon the suretyship relation.

I. THE SURETY AND SECTION 3-606 OF THE UCC

A surety or guarantor has been defined as "one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor."¹ The UCC does not define the term "surety" as such, but it does state that the term "Surety" includes guarantor."²

A. *The Meaning of Section 3-606*

Perhaps the most significant provision of the UCC affecting suretyship is section 3-606. This section deals with discharge of parties liable on a negotiable instrument where the holder impairs collateral, or the right of recourse. This section provides in part that:

- (1) The holder discharges any party to the instrument *to the extent* that without such party's consent the holder
 - (a) without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person . . . or

¹ CAL. CIV. CODE ANN. § 2787. The California statute is representative of the generally accepted definition of "surety." See also RESTATEMENT, SECURITY § 82 (1941) [hereinafter cited as RESTATEMENT]; SIMPSON, SURETYSHIP 6-9 (1950) [hereinafter cited as SIMPSON].

² UNIFORM COMMERCIAL CODE § 1-201(40). Citations are to the 1962 official text published by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. [hereinafter cited as UCC]. The UCC adopts the reasoning of the RESTATEMENT § 82, which equates the two terms.

- (b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse. . . .³

At the outset it should be noted that the scope of section 3-606 is quite broad in that it deals with the discharge of any party having a right of recourse and is not limited to persons who are secondarily liable on the instrument. In addition, the right of recourse may arise from *any* transaction. The broad scope of this section can be best shown by the following illustration. Assume that a person gives a negotiable instrument secured by a mortgage and that he subsequently transfers the property to a grantee who assumes the mortgage. This latter transaction places the original mortgagor in the position of a surety and he gains a right of recourse against the grantee. Consequently, if the holder of the negotiable instrument prejudices the mortgagor's right of recourse by any act or agreement set forth in section 3-606, the mortgagor would be discharged.

The "extent" of the mortgagor's discharge is uncertain. Section 3-606 presents an interesting problem of interpretation in this respect. Is the term "extent" used to limit discharge to the extent of injury, or to the extent that consent was not given?⁴ If a holder extends the time of payment for the primary obligor without reserving his rights against the indorser, or without obtaining the indorser's consent to the extension, and if UCC subsection 3-606 (1) (a) is construed to mean that lack of consent will discharge any party having a right of recourse against the party whose duties have been modified or extinguished, the indorser would be discharged. On the other hand, if UCC subsection 3-606(1) (a) is construed to mean discharge to the extent of injury, the indorser would not be discharged unless he could show injury stemming from the extension of the time of payment. The comments to section 3-606 do not help resolve this question.

By interpreting this section in light of suretyship principles, the conclusion could be reached that the term "extent" limits discharge to the extent of injury. Traditional suretyship law principles protect the surety when the principal and creditor modify their con-

³ UCC § 3-606(1). (Emphasis added.)

⁴ It appears that the New York State Law Revision Commission does not agree with the first alternative. The Commission stated that "the Code . . . omits any language limiting the security's discharge to a case where the agreement to suspend rights to enforce against the principal debtor results in prejudice to the surety." 2 NEW YORK LAW REVISION COMMISSION, STUDY OF THE UNIFORM COMMERCIAL CODE 1179 (1955).

tract without the surety's consent. The most rigorous rule was the doctrine of *strictissimi juris* whereby a gratuitous surety was discharged by any modification of the principal's obligation to which the surety did not consent.⁵ This doctrine was relaxed by later suretyship law which provides that where the modification was clearly beneficial to the surety he is not discharged.⁶ In addition, where the modification is collateral and does not affect the surety, there is no discharge.⁷ It should be noted that many cases have held gratuitous sureties liable by resorting to such fictions as implied consent or by construing modifications of the original contract as being merely collateral.⁸ In addition, the suretyship principles applicable to compensated sureties provide full discharge for modification without the surety's consent where the modification materially increases the surety's risk, and provides discharge to the extent of loss for any modification which does not materially increase the risk.⁹ Furthermore, traditional suretyship law treats an extension of the time of payment as a distinct type of contract modification. Under this suretyship principle the creditor could expressly reserve his rights against the surety, thereby preventing his discharge.¹⁰ Failure of the creditor to reserve his rights results in discharge of the surety where he has not consented to the extension of the time of payment.¹¹ Traditional suretyship law also provides that where the creditor im-

⁵ See RESTATEMENT § 128, comment *f*; SIMPSON 330-31.

⁶ *Ibid.*

⁷ *Ibid.*

⁸ *E.g.*, Paulk v. Williams, 28 Ga. App. 183, 110 S.E. 632 (1922); Boston Box Co. v. Rosen, 254 Mass. 331, 150 N.E. 177 (1926); Becker v. Faber, 280 N.Y. 146, 19 N.E.2d 997 (1939). *Contra*, Washington Fin. Corp. v. Glass, 74 Wash. 653, 134 Pac. 480 (1913). See SIMPSON 342-47.

These decisions can be explained by an apparent change in the attitude of the courts toward gratuitous sureties. They apparently are no longer regarded as persons who should be protected by the law from their own imprudence.

⁹ See United States Fid. & Guar. Co. v. Golden Fire Brick Co., 191 U.S. 416 (1903); Gunsul v. American Sur. Co., 308 Ill. 312, 139 N.E. 620 (1923); RESTATEMENT § 128 (b). The rationale upon which these suretyship principles are based is that the surety agreed to answer for a particular duty owed by the principal and for that duty only. Moreover, it provided that the modification had the legal effect of discharging the original contract by mutual rescission and substituting a new contract to which the surety never agreed to be bound. Other courts have held that where the modification increased the principal's burden of performance the surety was discharged because his contract was altered in that his risk was increased without his consent. See RESTATEMENT § 128, comment *d*; SIMPSON 330-31.

¹⁰ See Brocton Sav. Bank v. Shapiro, 311 Mass. 695, 42 N.E.2d 826 (1942); Mutual Life Ins. Co. v. J.H.C. Corp., 187 Misc. 416, 64 N.Y.S.2d 256 (Sup. Ct.), *aff'd mem.*, 271 App. Div. 823, 64 N.Y.S.2d 256 (1946); RESTATEMENT § 129.

¹¹ See Braun v. Crew, 183 Cal. 728, 192 Pac. 531 (1920); Skinner v. D. Sullivan & Co., 227 Ill. 93, 81 N.E. 11 (1907); RESTATEMENT § 129 (1).

pairs collateral and has knowledge of the suretyship relation, the surety is discharged to the extent of injury.¹²

Considering the foregoing suretyship principles and the cases that limit discharge of a surety to the extent of injury,¹³ it would be reasonable to conclude that the term "extent," as used in section 3-606, modifies discharge by limiting it to the extent of injury. Such an interpretation would reflect a change from provisions of the NIL such as subsection 120(6) which provides for *full* discharge of persons secondarily liable where there has been an extension of the time of payment. Perhaps the change has merit since, there is no valid reason for discharge where there has been no injury.

On the other hand, disregarding modern suretyship principles and interpreting the term "extent" solely on the basis of the language of section 3-606, it would appear that the term means discharge to the extent that consent was not given, since the section does not refer to the term injury or to any other words of similar import. This interpretation would, in effect, be a regression to the largely abandoned suretyship principle of *strictissimi juris*, whereby a gratuitous surety was fully discharged by any modification of the principal's obligation.¹⁴ The result would be the discharge of any surety without regard to whether injury or increase in risk has occurred. This interpretation of section 3-606 can be justified by two other provisions of subsection 3-606(1)(a). First, the holder can always protect himself against the surety by expressly reserving his rights.¹⁵ The only exception to this is where the holder unjustifiably impairs collateral; in such instances it is reasonable to permit full discharge of a surety in order to promote due care on the part of the holder. Second, the nature of the agreements referred to in subsection 3-606(1) is such that they materially modify the contract and in most situations would increase the surety's risk. However, in a situation where there has been an extension of the time of payment, the surety may benefit in that the obligor may be given the additional time needed to overcome a period of financial difficulty.

Viewing section 3-606 as intending discharge only to the extent that consent was not given would clearly place an added burden

¹² This result is based upon the theory that by impairing collateral the creditor also impairs the surety's right of subrogation; consequently the surety should be discharged to the extent that the creditor engendered harm to him. See *Morton v. Dillon*, 90 Va. 592, 595, 19 S.E. 654, 655 (1894); SIMPSON 372.

¹³ See note 8 *supra*.

¹⁴ RESTATEMENT § 128, comment f; SIMPSON 330-31.

¹⁵ It should be noted that § 3-606(2) specifically sets forth the consequences of such reservation of rights. See text accompanying notes 29-31 *infra*.

upon the holder. Under subsection 3-606(1)(a), the holder would have to be careful to reserve rights against parties he knew to be sureties and whom he desired to hold liable on the instrument. Under subsection 3-606(1)(b) the holder would have to refrain from unjustifiably impairing collateral or suffer the consequences of full discharge of any party having a right of recourse, regardless of whether he had knowledge of the party's right of recourse.¹⁶

While the most equitable approach would be to limit discharge to the extent of actual injury occasioned by the holder's action to which the party did not consent and in which the holder did not expressly reserve his rights, it might be wiser to permit full discharge of the party in order to promote greater care and prudence on the part of the holder. This appears to be the only reason for arbitrarily discharging a party where he has suffered no injury.

*B. Modification of Suretyship Principles and the NIL by
Section 3-606*

A significant change from the NIL is the substitution of the term "right of recourse" in section 3-606 for the NIL term "persons secondarily liable."¹⁷ Section 3-606 is thereby extended to parties who may be primarily liable, such as an accommodation maker, whereas section 120 of the NIL is limited to persons secondarily liable. In addition, many courts have held that section 119 of the NIL abrogates the traditional suretyship principle and precludes discharge of an accommodation maker where the holder has ex-

¹⁶ It should be noted that § 3-606(1)(a) contains an exception which provides that failure or delay by the holder in effecting any required presentment, protest, or notice of dishonor against a party, does not discharge any party as to whom presentment, protest, or notice of dishonor is effective or unnecessary, even though that party has a right of recourse against the party discharged. An example of this is where there are two indorsers to an instrument, *A* and *B*. Assume that *A* was the first indorser and entitled to presentment and notice of dishonor as provided in § 3-413 of the UCC. Assume further that *B*, the second indorser waives presentment and notice of dishonor. The holder of the instrument fails to give notice of dishonor to either indorser, thereby discharging *A* in accordance with § 3-501(2). Since *B* waived notice of dishonor he is not discharged under § 3-501(2). Moreover, the exception to § 3-606(1)(a) makes it clear that even though *A* is discharged and *B* had a right of recourse against *A* because *A* was a prior indorser, *B* is not discharged.

Subsection 3-606(2) sets forth the consequences of an express reservation of rights by the holder against a party. It provides that the holder preserves all his rights against such a party, and in addition, preserves the right of the party to pay the instrument, and the party's right to recourse against others liable to him. The subsection does not specifically require the holder to give the party notice of the reservation of rights against him.

¹⁷ See UNIFORM NEGOTIABLE INSTRUMENTS LAW § 120 [hereinafter cited as NIL].

tended the time of payment to the principal.¹⁸ Section 3-606, by dealing in terms of parties having a right of recourse, precludes this result since the accommodation maker has a right of recourse against the maker. In this respect it should be noted that under the NIL the prevailing view was that a mortgagor-maker of a negotiable instrument who subsequently transferred the property to a grantee who assumed the mortgage was not discharged if the holder extended the time of payment to the grantee.¹⁹ Under traditional suretyship law the prevailing view was that the mortgagor would be completely discharged.²⁰ Similarly, under section 3-606 of the UCC the mortgagor, who has a right of recourse against the grantee who assumed the mortgage, will be discharged by the extension of the time of payment. As previously discussed, the extent of discharge may present a problem under the UCC.²¹

A further change wrought by the UCC is that section 3-606 eliminates the traditional suretyship distinction between compensated sureties and gratuitous sureties; one rule applies to both. Furthermore, subsection 3-606(1)(b), which deals with impairment of collateral, does not require, as a prerequisite to discharge of the party, that the holder have knowledge of the party's right of recourse whereas traditional suretyship law generally required knowledge by the creditor of the suretyship relation.²² This change imposes a greater burden upon the holder for the consequences of his actions where he has no knowledge of a party's right of recourse. Perhaps this can be justified on the basis that any holder who would be imprudent enough to unjustifiably impair collateral is not entitled to a right of action against such parties. The traditional suretyship requirement of knowledge on the part of the creditor was based on the theory that the surety's subrogation rights are impaired by any impairment of collateral.²³ Thus, under traditional suretyship law the

¹⁸ *E.g.*, *Young v. Carr*, 44 Ariz. 223, 36 P.2d 555 (1934); *Hall v. Farmers' Bank*, 74 Colo. 165, 220 Pac. 237 (1923). See BRITTON, *BILLS AND NOTES* 702-04 (2d ed. 1961).

¹⁹ *E.g.*, *Mortgage Guar. Co. v. Chotiner*, 8 Cal. 2d 110, 64 P.2d 138 (1936); *Washer v. Tontar*, 128 Ohio St. 111, 190 N.E. 231 (1934). See OSBORNE, *MORTGAGES* § 271 (1951).

²⁰ *E.g.*, *Union Mut. Life Ins. Co. v. Hanford*, 143 U.S. 187 (1892). See OSBORNE, *op. cit. supra* note 19, § 270.

²¹ See text accompanying notes 4-15 *supra*.

²² *E.g.*, *Patterson v. Brock*, 14 Mo. 473 (1851); *Parsons v. Harrold*, 46 W. Va. 122, 32 S.E. 1002 (1899). *Contra*, *Templeton v. Shakley*, 107 Pa. 370 (1884). See RESTATEMENT § 114; SIMPSON 373.

²³ *Morton v. Dillon*, 90 Va. 592, 19 S.E. 654 (1894). See SIMPSON 372.

surety was discharged to the extent of injury²⁴ but was not discharged where he was indemnified,²⁵ or when the creditor makes reasonable use of the security to collect from the principal.²⁶ Subsection 3-606(1)(b) does not contain these specific provisions relating to impairment of collateral, but it does provide that the impairment must be "unjustifiable." This term may be somewhat similar to the "reasonable use" proviso found in suretyship law.²⁷ In addition, if the term "extent" as used in section 3-606 is taken as limiting discharge to the extent of injury,²⁸ a surety who is indemnified would not be discharged where the holder impaired collateral — a result identical to that reached under the traditional suretyship principles.

Subsection 3-606(2) of the UCC, which sets forth the rights which are expressly reserved by the holder, is similar to its counterpart in traditional suretyship law.²⁹ Both preserve the holder's rights against the party expressly named, the right of the party to pay the instrument as of that time, and all the rights of the party to recourse against others.³⁰ These consequences under suretyship law were based on the theory that where the creditor agreed not to enforce his rights against the principal and at the same time expressly reserved his rights against the surety, the agreement was in effect a covenant not to sue, and as such, did not affect the rights and duties of the surety.³¹ It can reasonably be assumed that the same line of reasoning was adopted in subsection 3-606(2).

²⁴ *Ibid.*

²⁵ *E.g.*, *Crim v. Fleming*, 101 Ind. 154 (1884). See SIMPSON 374.

²⁶ *E.g.*, *Berlin Nat'l Bank v. Guay*, 76 N.H. 216, 81 Atl. 475 (1911). See RESTATEMENT § 122, comment *d*; SIMPSON 302-04.

²⁷ *Ibid.* It should be noted that comment 5 of § 3-606 of the UCC refers to § 9-207 for aid in defining "unjustifiable impairment of collateral."

²⁸ See text accompanying notes 4-15 *supra*. It is interesting to note that § 3-606(1)(b) provides that the principal may also be discharged when the holder unjustifiably impairs collateral given by the principal or on his behalf. The broad effect of this provision can best be shown by illustration. Assume that a party gives collateral for an instrument on behalf of the principal and in addition, becomes an accommodation party to the instrument. Assume further that the holder unjustifiably impairs the collateral thereby discharging both the surety and the principal in accordance with § 3-606(1)(b) of the UCC. Discharge of the principal would in turn discharge all parties to the instrument under UCC § 3-601(3). In addition, § 3-802(1)(b) which provides that where the underlying obligor is discharged on the instrument he is also discharged on the underlying obligation would work to totally discharge the principal. The effect of these provisions is to leave an imprudent holder-creditor without recourse on the instrument or on the underlying obligation.

²⁹ See note 16 *supra*.

³⁰ See UCC § 3-606(2); *Dean v. Rice*, 63 Kan. 691, 66 Pac. 992 (1901); RESTATEMENT § 122, comment *d*; SIMPSON 302-04.

³¹ *Ibid.*

The NIL, subsections 120(5) and (6), states that a secondarily liable person is discharged where the holder releases the principal debtor or postpones the right to enforce the instrument unless the holder expressly reserves his right of recourse against him. However, the NIL is silent as to the effect of the reservation of rights upon the person secondarily liable although most courts have held that under the NIL the appropriate principles of suretyship are applicable.³²

II. RIGHT OF THE SURETY TO RECOVER PAYMENT UNDER SURETYSHIP PRINCIPLES, THE UCC, AND THE NIL

Suretyship law recognizes three basic rights³³ of the surety who pays or who would otherwise be obliged to perform the principal's obligation: (1) the right of reimbursement;³⁴ (2) the right of subrogation;³⁵ and (3) the right of exoneration.³⁶ The NIL did not change these rights and accordingly, most courts applying the NIL recognized these rights as expounded by traditional suretyship law.³⁷ The UCC, with a few modifications, also accepts these traditional suretyship rights.³⁸

A. *The Right of Reimbursement — Sections 1-103 and 3-415(5) of the UCC*

The right of reimbursement was founded in equity and involves a promise by the principal to reimburse the consensual surety — a promise implied in fact and based on the principal-surety con-

³² See, e.g., *Brill v. Brandt*, 176 Misc. 580, 26 N.Y.S.2d 477 (Sup. Ct.), *aff'd*, 263 App. Div. 811, 31 N.Y.S.2d 674 (1941). See BRITTON, *op. cit. supra* note 18, at 701.

³³ In addition to the three basic rights, suretyship law also recognizes sub-suretyship, *i.e.*, the relationship in which a party is a surety for another surety, and the right of the surety to proceed against the sub-surety. Under suretyship law, such a relationship could arise only by express agreement between the sureties. See *Paul v. Berry*, 78 Ill. 158 (1875); ARANT, SURETYSHIP AND GUARANTY 12 (1931); RESTATEMENT § 146(c). Subsection 3-414(2) of the UCC recognizes the sub-suretyship relation between indorsers of an instrument. It provides that, unless otherwise agreed, an indorser can proceed against prior indorsers. UCC § 3-414(2). See 1 HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 565 (1964). The NIL contains a similar provision in § 66.

³⁴ See *Ford v. Strobridge*, Nelson 24 (Ch. 1632); RESTATEMENT § 104; SIMPSON 225; Loyd, *The Surety*, 66 U. Pa. L. REV. 40, 58 (1917).

³⁵ See, e.g., *Munsey Trust Co. v. United States*, 67 F. Supp. 976 (Ct. Cl. 1946), *rev'd*, 322 U.S. 234 (1947), where it was stated that a consensual surety is one who became a surety with the consent of the principal. See RESTATEMENT § 141; SIMPSON 206.

³⁶ See, e.g., *American Sur. Co. v. Lewis State Bank*, 58 F.2d 559 (5th Cir. 1932). See RESTATEMENT § 112; SIMPSON 198.

³⁷ *Producers' State Bank v. Danciger*, 218 Mo. App. 39, 264 S.W. 1000 (1924). See BRITTON, *op. cit. supra* note 18, at 699-700.

³⁸ See UCC §§ 3-415(5), 3-603(2), 3-201, 1-103.

tract.³⁹ With a nonconsensual surety there is no contract right of reimbursement. Therefore, if such right is to exist, it must be based upon the theory of unjust enrichment.⁴⁰ It should be noted, however, that the nonconsensual surety may have the right of subrogation.⁴¹

The UCC has no specific provisions dealing with the right of reimbursement with the exception of subsection 3-415(5). This section gives an accommodation party a right of recourse on the instrument against the accommodated party and is, in effect, a codification of the suretyship principle giving the accommodation party the right of reimbursement against the accommodated party.⁴² This is an improvement over the NIL in that it eliminates a curious problem that at least one court had in interpreting the NIL. In *Quimby v. Varnum*,⁴³ the Supreme Judicial Court of Massachusetts ruled that although an accommodation indorser who paid on the instrument was remitted to his former rights under section 121 of the NIL,⁴⁴ he was still unable to bring an action against the accommodated party on the instrument because he had no former rights against the accommodated party based on the instrument. Despite the *Quimby* ruling, most courts interpreting the NIL recognized the accommodation party's right to proceed against all prior parties to the instrument, including the accommodated party.⁴⁵

While subsection 3-415(5) of the UCC extends only to accommodation parties, it should be noted that section 1-103 provides that, unless specifically displaced by a provision of the UCC, the principles of equity are to supplement its provisions. Thus, it would seem that under the UCC, the right of reimbursement is still effective as to all sureties other than accommodation parties, who are provided for in subsection 3-415(5). It might also be possible to extend subsection 3-415(5), by analogy, to include all sureties, thereby eliminating the necessity of resorting to equitable principles.

³⁹ *Howell v. Commissioner*, 69 F.2d 447 (8th Cir.), *cert. denied*, 292 U.S. 654 (1934). See RESTATEMENT § 104, comment *d*; SIMPSON 226.

⁴⁰ See *Hecker v. Ohio*, 64 Ohio St. 398, 60 N.E. 555 (1901); RESTATEMENT § 104(2). But see SIMPSON 226 n.71.

⁴¹ See text accompanying notes 46-49 *infra*.

⁴² See UCC § 3-415, comment 5.

⁴³ 190 Mass. 211, 76 N.E. 671 (1906).

⁴⁴ NIL § 121 provides, in part, that "Where the instrument is paid by a party secondarily liable thereon, it is not discharged; but the party so paying it is remitted to his former rights as regards all prior parties. . . ."

⁴⁵ See, e.g., *Lill v. Gleason*, 92 Kan. 754, 142 Pac. 287 (1914). See BRITTON, *op. cit. supra* note 18, at 693.

B. The Right of Subrogation — Sections 3-201 and 3-603(2) of the UCC

The right of subrogation, like the right of reimbursement, originated in equity and constituted an equitable assignment of the creditor's rights to the party who paid or otherwise performed the principal's obligation.⁴⁶ Equity restricted this right to those parties who had an interest in the matter or were legally or morally obligated to pay or perform the principal's obligation; the right did not extend to a mere volunteer.⁴⁷

The UCC makes a significant change in this regard in that subsection 3-603(2) provides that any person, including a stranger or a mere volunteer, who pays or satisfies the instrument is entitled to the rights of a transferee. However, it should be noted that this subsection is modified by section 3-201 which precludes a transferee from improving his position by taking from a later holder in due course where he has been a party to a fraud or illegality affecting the instrument, or where, as a prior holder of the instrument, he had notice of a claim or defense to it. This "clean hands" provision is a carryover from the suretyship principle which denied the assignment of rights where the party was guilty of fraud, illegality, or equivalent misconduct.⁴⁸ The NIL has a similar provision in section 58.⁴⁹ However, subsection 3-603(2) is broader in scope than its NIL counterpart in that it provides that the rights of the transferor are transferred regardless of the status of the parties, whereas section 58 of the NIL is restricted to the situation where the transferor is a holder in due course.

C. The Right of Exoneration — Section 1-103 of the UCC

The right of exoneration also originated in equity and provides that where the principal is able to perform at maturity but does not, the surety may bring an equitable action and obtain a court decree directing the principal to perform.⁵⁰ This right is granted to con-

⁴⁶ See *American Sur. Co. v. Bank of Cal.*, 133 F.2d 160 (9th Cir. 1943). See RESTATEMENT § 141, comment *a*; SIMPSON 206.

⁴⁷ See *Marks v. Baum Bldg. Co.*, 73 Okla. 264, 175 Pac. 818 (1918); SIMPSON 209.

⁴⁸ *Schaeffer v. Sterling*, 176 Md. 553, 6 A.2d 254 (1939). See SIMPSON 209.

⁴⁹ Section 58 of the NIL provides, in part, that "a holder who derives his title through a holder in due course, and who is not himself a party to any fraud or illegality affecting the instrument, has all the rights of such former holder in respect of all parties prior to the latter."

⁵⁰ *Thomas v. St. Paul M.E. Church*, 86 Ala. 138, 5 So. 508 (1889). See RESTATEMENT § 112; SIMPSON 198-99.

sensual sureties only, *i.e.*, sureties who have become such with the consent of the principal.⁵¹ Where the principal has not given his consent to a party to become a surety, no such right exists.⁵² The reason for this limitation is that the right is based upon the principal's duty to hold the surety harmless, and consequently, where the principal has not given his consent, no duty exists.

The NIL is silent on the surety's right of exoneration. It appears, however, that the suretyship principle remained in effect under that act.⁵³ The UCC does not contain any specific provision dealing with the surety's right of exoneration. Nevertheless, it appears that under section 1-103 the right exists as it does in suretyship law.⁵⁴

D. Voluntary Impleader — Section 3-803 of the UCC

Section 3-803 of the UCC provides a useful tool to a surety in enforcing his rights of recourse against parties liable to him. This section permits the surety to implead the party liable to him where an action is brought on the instrument against the surety. If the party fails to appear, he is bound by any determination of fact common to the present litigation and any subsequent litigation between the surety and himself.⁵⁵

III. OTHER PROVISIONS OF THE UCC AFFECTING SURETYSHIP

Subsection 3-415(2) significantly changes both suretyship law and the NIL in regard to the element of consideration. This section provides that an accommodation party is liable to any person who takes the instrument for value and before it is due, even though he may have signed the instrument subsequent to its issuance by the principal. This provision is novel in that no additional consideration is necessary to bind the party. Under suretyship law, a person who became a surety subsequent to the principal's promise was not

⁵¹ See RESTATEMENT § 112; SIMPSON 201.

⁵² *Ibid.*

⁵³ It should be noted that the right of exoneration deals solely with the surety's right against the principal and in no way affects the rights of the creditor. The UCC incorporates this principle into § 3-416(1) dealing with a party who guarantees payment, and § 3-415(2) which provides that an accommodation party is liable in the capacity in which he signed; an accommodation maker would be liable without resorting to the principal. See SIMPSON 199.

⁵⁴ Section 1-103 of the UCC provides, in effect, that the principles of law and equity supplement the UCC unless they are displaced by a specific provision of the UCC.

⁵⁵ See UCC § 3-803.

bound unless a prior agreement had been made or unless additional consideration was given by the creditor.⁵⁶

The NIL accepts the suretyship principle on this point⁵⁷ although at least one commentator has advocated that the surety's subsequent promise should be binding under section 25 of the NIL, without additional consideration.⁵⁸ In any event, subsection 3-415 (2) of the UCC clarifies the matter by providing that additional consideration is not necessary. This position is merely an extension of the principle that an antecedent obligation is consideration, as set forth in section 3-408 of the UCC⁵⁹ and section 25 of the NIL.⁶⁰

*A. Limitation on the Rights of an Accommodation Party —
Subsection 3-415(3) of the UCC*

Subsection 3-415 (3) provides that an accommodation party cannot introduce oral evidence of the accommodation against a holder in due course who did not have notice of the accommodation at the time he took the instrument. This provision prohibits the accommodation party from taking advantage of any surety defenses he might otherwise have available. An example of such a situation would be where the holder unjustifiably impairs collateral. Under subsection 3-606(1) (b), the surety would be discharged even though the holder had no knowledge of the accommodation; however, if the holder were a holder in due course, the accommodation party would not be discharged unless the holder in due course had notice⁶¹ of the accommodation, or unless the accommodation party had a right of recourse against the party who gave the collateral and who was discharged by operation of 3-606(1) (b). In that case,

⁵⁶ First Nat'l Bank v. Hawkins, 73 Ore. 186, 144 Pac. 131 (1914). See SIMPSON 75.

⁵⁷ See Ann Arbor Constr. Co. v. Glime Constr. Co., 369 Mich. 669, 120 N.W.2d 747 (1963); McAfee v. Jeter, 147 S.W.2d 884 (Tex. Civ. App. 1941) (decided under NIL § 29 dealing with accommodation parties); *but see* Parkin v. Sykes, 203 Minn. 249, 280 N.W. 849 (1938). See Jackson v. Lancaster, 213 Ala. 97, 104 So. 19 (1925); Gage v. Van Dusen, 156 Minn. 332, 194 N.W. 769 (1923) (decided under NIL § 25 dealing with consideration).

⁵⁸ See BRITTON, *op. cit. supra* note 18, at 230. NIL § 25 provides, in part, that "An antecedent or pre-existing debt constitutes value; and is deemed such whether the instrument is payable on demand or at a future time."

⁵⁹ See UCC § 3-415, comment 4.

⁶⁰ See note 58 *supra*. In addition, it should be noted that § 3-415 (2) of the UCC achieves the same result as §§ 63 and 64 of the NIL by using the general statement that the "accommodation party is liable in the capacity in which he has signed even though the taker knows of the accommodation" instead of the detailed provisions of the NIL.

⁶¹ Note that § 3-415 (3) requires notice (defined in § 1-201 (25)) as distinguished from knowledge (defined in § 1-201 (25)).

the accommodation party would be discharged by operation of subsection 3-606(1) (a).

Subsection 3-415(3) is analogous to the traditional suretyship principle requiring knowledge on the part of the creditor of the suretyship relation.⁶² However, there is a significant difference between the suretyship principle and subsection 3-415(3). Suretyship law requires knowledge on the part of the creditor whereas subsection 3-415(3) requires only notice to the holder in due course. This change made by the UCC is in keeping with the requirement of good faith that prevails throughout the UCC⁶³ and with the basic concept of granting special treatment only to those individuals whose conduct is so exemplary as to be worthy of such protective consideration.

The NIL, unlike the UCC, deals in terms of persons primarily and secondarily liable on the instrument.⁶⁴ Section 63 of the NIL provides that an accommodation party may bind himself in any capacity. Sections 119 and 120 of the NIL provide for discharge of the instrument and discharge of persons secondarily liable. An accommodation maker under the NIL would be a party primarily liable since his liability is unconditional;⁶⁵ therefore the special suretyship defenses⁶⁶ would not be available to him under section 119, which provides for discharge of the instrument as the only means of discharging a party primarily liable on the instrument.⁶⁷ However, an accommodation indorser is a party secondarily liable on the instrument, since his liability is conditional,⁶⁸ and under sec-

⁶² See *Stewart v. Parker*, 55 Ga. 656 (1876); *St. Maries v. Polleys*, 47 Wis. 67, 1 N.W. 389 (1879); RESTATEMENT § 114; SIMPSON 367. *But see* *American Blower Co. v. Lion Bending & Sur. Co.*, 178 Iowa 1304, 160 N.W. 939 (1917); SIMPSON 298. These authorities state that where the creditor releases the principal debtor, the surety is discharged even though the creditor was not aware of the suretyship relation. See also RESTATEMENT § 132.

⁶³ UCC § 1-203.

⁶⁴ NIL § 63.

⁶⁵ NIL § 192.

⁶⁶ See text accompanying notes 5-12 *supra*.

⁶⁷ NIL § 119 provides that:

A negotiable instrument is discharged:

1. By payment in due course by or on behalf of the principal debtor;
2. By payment in due course by the party accommodated, where the instrument is made or accepted for accommodation;
3. By intentional cancellation thereof by the holder;
4. By any other act which will discharge a simple contract for the payment of money;
5. When the principal debtor becomes the holder of the instrument at or after maturity in his own right.

⁶⁸ See NIL § 192.

tion 120 of the NIL he receives three of the special defenses conferred upon a surety under suretyship law.⁶⁹

B. Discharge of a Surety Other than Under Section 3-606 of the UCC

(1) *Discharge of Parties.*—Subsection 3-601(1) of the UCC contains an index to sections within Article 3 that deal with discharge of parties. Those sections that peculiarly affect a surety will be noted in the following discussion, but only to the extent that they affect the discharge. Subsection 3-601(3) provides that the liability of all parties is discharged when a party having no right of action or recourse on the instrument "(a) reacquires the instrument in his own right" or "(b) is discharged by any provision of . . . Article [3]" This subsection makes no significant changes over any corresponding suretyship principles, but it does clarify certain problems relating to terminology that exist under subsection 119(5) of the NIL.⁷⁰ Suretyship law provides that where the principal's duty to the creditor is discharged, by performance of the principal or by another on his behalf, the surety's obligation is similarly discharged.⁷¹ It appears that both subsection 3-601(3) of the UCC and subsection 119(5) of the NIL agree substantially with this principle except that under the UCC and the NIL, where a third party performs for the principal, neither he nor the surety is discharged unless the principal acquires the instrument.⁷² It should be noted that sub-

⁶⁹ Section 120 of the NIL provides that a person secondarily liable is discharged by discharge of a prior party, by release of the principal debtor where there is no express reservation of rights, and by an extension of the time of payment where there is no express reservation of rights by the holder or consent by the secondarily liable person. The NIL does not refer to either notice or knowledge by the holder of the secondary liability as a condition of discharge. Any such reference would appear to be unnecessary since a person secondarily liable would have to clearly identify himself as such or be deemed a person primarily liable and not entitled to the discharge, in which case the holder would either have knowledge of the secondary capacity or be entitled to the presumption that the party is primarily liable and not subject to discharge under § 120 of the NIL.

⁷⁰ The problem is primarily that of defining the meaning of "principal debtor" as used in §§ 119(1), (5) of the NIL. See AIGLER & STEINHEIMER, *CASES ON BILLS AND NOTES* 600 (1962).

⁷¹ See, e.g., *Bridges v. Blake*, 106 Ind. 332, 6 N.E. 833 (1885). See *RESTATEMENT* § 115; *SIMPSON* 313.

⁷² UCC § 3-601(3) provides that:

The liability of all parties is discharged when any party who has himself no right of action or recourse on the instrument

- (a) reacquires the instrument in his own right; or
- (b) is discharged under any provision of this Article except as otherwise provided with respect to discharge for impairment of recourse or collateral (Section 3-606).

NIL § 119(5) provides for discharge of the instrument, "When the principal debtor becomes the holder of the instrument at or after maturity in his own right."

section 3-601(3)(b) does not permit discharge of the surety where the principal is discharged by operation of law other than by the provisions contained in Article 3. Such an interpretation is consistent with existing suretyship principles and the Bankruptcy Act,⁷³ which provide that discharge of the principal in bankruptcy does not discharge the surety's obligation to the creditor even though it destroys the rights of both the surety and the creditor against the principal.⁷⁴ This is a logical result since it probably was the risk of insolvency or bankruptcy of the principal that prompted the creditor to insist upon a surety to the obligation.

Suretyship law also provides that the surety is not discharged where the creditor loses his right against the principal because of the running of the statute of limitations.⁷⁵ It appears that the UCC also agrees with this principle.⁷⁶ It should be noted that under suretyship law the surety who performs the obligation is entitled to reimbursement from the principal if the principal's defense is not available against him.⁷⁷ Generally, the statute of limitations will not have expired against the surety since it does not begin to run until the surety gains his right of action which is not until he performs the obligation.⁷⁸ The UCC does not specifically provide for this result but section 1-103 does state that the principles of equity supplement the UCC unless specifically displaced by one of its provisions.

(2) *Payment or Satisfaction.*—This subsection provides that the liability of any party is discharged to the extent of his payment or satisfaction to the holder.⁷⁹ This provision is somewhat different from suretyship law which provides that where the duty owed to the creditor is discharged by performance by the principal or by another on his behalf, the obligation of the surety is also discharged.⁸⁰ Where the principal performs, subsection 3-601(3) operates to discharge

⁷³ Bankruptcy Act § 16, 30 Stat. 550 (1898), 11 U.S.C. § 34 (1964); SIMPSON 308.

⁷⁴ Bankruptcy Act § 17, 30 Stat. 550 (1898), as amended, 11 U.S.C. § 35 (1964).

⁷⁵ See *Manchester Sav. Bank v. Lynch*, 151 Minn. 349, 186 N.W. 794 (1922); *Fidelity & Cas. Co. v. Lackland*, 175 Va. 178, 88 S.E.2d 306 (1940). *Contra*, *Hayward v. Sencenbaugh*, 141 Ill. App. 395 (1908); *Auchanpaugh v. Schmitt*, 70 Iowa 642, 27 N.W. 805 (1886); *Johnson v. Success Brick Mach. Co.*, 93 Miss. 169, 46 So. 957 (1908). See also RESTATEMENT § 130.

⁷⁶ See UCC § 1-103.

⁷⁷ *Sibley v. McAllaster*, 8 N.H. 398 (1836). See RESTATEMENT § 103; SIMPSON 227.

⁷⁸ *Thayer v. Daniels*, 110 Mass. 345 (1872). See SIMPSON 230-31.

⁷⁹ See UCC § 1-201(20) for definition of a "holder."

⁸⁰ See note 71 *supra*.

the surety, but where another performs on behalf of the principal, neither the principal nor the surety is discharged by operation of subsection 3-601(3) unless the principal acquires the instrument.⁸¹ It is within this context that subsection 3-603(2) should be read. As previously noted,⁸² this subsection permits any party to pay or satisfy the instrument but it does not discharge any obligors. An illustration of this is where *A* is liable to *B* on a negotiable instrument to which *C* is a surety. If *D*, a stranger, pays *B*, he succeeds to *B*'s rights and neither *A* nor *C* is charged by the payment. The effect of such payment or satisfaction appears to be the same as if the instrument were purchased, since the performing party succeeds to the rights of the transferor and no discharge results. This interpretation is supported by comment 5 to section 3-603 which reiterates that payment discharges only the liability of: (1) the party making it; (2) parties having a right to recourse against the payor; (3) intervening parties where the instrument is reacquired; and (4) all parties only when the payor has no right of recourse on the instrument.

Section 3-603 of the UCC significantly changes the corresponding NIL provisions. First, it eliminates the concept of payment in due course⁸³ and deals with discharge of parties to the instrument rather than discharge of the instrument as provided in section 119 of the NIL. This change does not affect the rights and liabilities of a surety, except that under the UCC it is clear that payment by the surety does not discharge the principal, whereas under section 121 of the NIL some confusion exists where the surety is a primarily liable person.⁸⁴ Second, subsection 3-603(2) eliminates the concept of payment for honor⁸⁵ by providing that any person may pay the instrument with the consent of the holder.⁸⁶

(3) *Tender of Payment*.—Subsection 3-604(2) provides that where tender of full payment is made to the holder by any party to the instrument when or after the instrument is due, and payment is re-

⁸¹ See note 72 *supra* and accompanying text.

⁸² See text accompanying notes 47-49 *supra*.

⁸³ See NIL §§ 51, 88, 119. See also UCC § 3-601(3) which provides that payment by a party who has no right of recourse on the instrument discharges all parties.

⁸⁴ See NIL § 121 which provides that where a party secondarily liable pays the instrument he is "remitted to his former rights . . ." Subsection 3-603(2) eliminates the problem presented by the quoted language. See text accompanying notes 43-45 *supra*.

⁸⁵ See NIL §§ 171-77 which state the procedure that must be followed for payment of a bill of exchange "for honor" where the bill has been protested for non-payment.

⁸⁶ See text accompanying notes 47-49 *supra*.

fused by the holder, any party who has a right of recourse against the party making tender is wholly discharged. It should be noted that this subsection makes no reference to notice or knowledge of the right of recourse on the part of the holder. By eliminating the necessity of notice, subsection 3-604(2) makes a significant change from the ordinary suretyship principle which provides that the surety is not discharged where the creditor reasonably believes him to be a principal.⁸⁷ It should be emphasized that section 3-602 precludes discharge as to a subsequent holder in due course unless he had notice of the discharge at the time he took the instrument. To this extent, the UCC agrees with traditional suretyship law.

Subsection 120(4) of the NIL contains a provision similar to subsection 3-604(2) of the UCC. The only significant change made by the UCC is that it includes parties having a right of recourse whereas the NIL is restricted to persons secondarily liable.

(4) *Material Alteration.*—Subsection 3-407(2)(a) of the UCC provides that any party is discharged as against any person other than a subsequent holder in due course where there is an alteration of the instrument by the holder which is fraudulent, material, and changes the contract of the party.⁸⁸ Where there is an alteration of an instrument which meets the requirements set forth in section 3-407 a surety would be discharged. Moreover, if the principal was discharged by operation of section 3-407, the surety would likewise be discharged in accordance with subsection 3-601(3).⁸⁹ Thus, section 3-407 combined with subsection 3-601(3) reaches the same result that is reached by the suretyship principles which discharge the surety when the instrument is materially altered without his consent,

⁸⁷ See RESTATEMENT § 116. Suretyship law proceeded on the theory that it would be inequitable to the creditor for the tender to have any greater effect than it would have where the creditor reasonably believed that the surety was a principal. The UCC rejects this theory, apparently, in favor of the theory that since the creditor could have obtained payment it would be inequitable to hold the surety since the surety's undertaking was not to protect the creditor against loss that may result after his refusal to accept payment.

⁸⁸ This section also contains a provision that where the party assents to the alteration or is precluded from asserting the defense there is no discharge. In addition, it has been suggested that the use of the term "the holder" in § 3-407(2) may restrict its applicability to the "holder at the time claim is made and the defense of alteration is asserted." AIGLER & STEINHEIMER, *op. cit. supra* note 70, at 533 n.78. While this result could be reached by some courts, it appears from a reading of the first sentence of § 3-407(2) that an alteration by any holder would discharge the party affected. The sentence provides that discharge would be effective "As against *any person* other than a subsequent holder in due course." UCC § 3-407(2) (Emphasis added.) In addition, comment 3 of § 3-407 supports this conclusion. It indicates that all that is excluded by § 3-407(2) is "spoliation by any meddling stranger"

⁸⁹ See text accompanying note 70 *supra*.

or when the principal is discharged because of an alteration of the instrument by the creditor.⁹⁰ The theory underlying this result appears to be the same under suretyship principles, *i.e.*, fraudulent alterations by the holder are attempts to impose an obligation upon the principal and surety that neither ever accepted.

The NIL in section 124 contains a provision similar to subsection 3-407(2) of the UCC. The changes made by the UCC are set forth in comment 3 of section 3-407.⁹¹

(5) *Statute of Frauds.*—Subsection 3-416(6) of the UCC dealing with guarantees provides that “any guaranty written on the instrument is enforceable notwithstanding any statute of frauds.” This subsection is designed to avoid the effect of statutes of fraud such as the suretyship statute, which provides that no promise to answer for the debt, default or miscarriage of another is enforceable unless it is evidenced by a writing which states the consideration for the promise.⁹² It is not the current commercial practice to state consideration when a guaranty is added to a signature on a negotiable instrument, and this subsection precludes the occurrence of any unfavorable consequences from this practice. The NIL does not contain a provision comparable to subsection 3-416(6) of the UCC relating to guarantors.

(6) *Notice of Dishonor.*—Subsection 3-416(5) provides that “when words of guaranty are used presentment, notice of dishonor and protest are not necessary to charge the user.” This would include situations where an indorser also signs as a guarantor,⁹³ so that a surety who signs in the capacity of a guarantor, whether of collection or of payment, is not entitled to presentment, or notice of dishonor. This is a significant change from the law of suretyship which requires that the creditor give notice to the party that guaranteed collection of his inability to obtain performance from the principal.⁹⁴ It should be noted that under suretyship law notice of

⁹⁰ See *Schuster v. Weiss*, 114 Mo. 158, 21 S.W. 438 (1893); RESTATEMENT § 127; SIMPSON 330-31.

⁹¹ UCC § 3-407, comment 3 provides that the changes from the NIL § 124 are as follows: (1) material alteration must be made by the holder; (2) material alteration must be for a fraudulent purpose; (3) the discharge is a personal defense, and any person whose contract is not affected by the alteration is not discharged; (4) where the alteration is not both material and fraudulent there is no discharge.

⁹² See UCC § 3-416.

⁹³ *Ibid.*

⁹⁴ See *Ruben v. Jelin*, 131 N.J. Eq. 299, 25 A.2d 276 (1942); RESTATEMENT § 137; SIMPSON 172.

mere default is not necessary⁹⁵ nor is notice necessary to a party who has guaranteed payment.⁹⁶ Under suretyship law failure to give the required notice would result in discharge of the surety to the extent of injury.⁹⁷

The NIL does not contain any provisions dealing with notice to a guarantor, but section 89 provides that notice must be given to a drawer as well as an indorser so that if a guarantor is also an indorser it appears that he is entitled to notice under section 89. In this respect, subsection 3-416(5) of the UCC, providing that notice is not necessary, changes the NIL.

In this context it should be noted that subsection 3-501(2) of the UCC requires notice of dishonor to charge all indorsers unless such notice is excused. Failure to give notice would result in discharge of the indorser⁹⁸ except as to a subsequent holder in due course without notice of the discharge at the time he took the instrument.⁹⁹ This provision, providing for discharge of the indorser, appears to be a codification of the law developed under section 89 of the NIL and the law merchant.¹⁰⁰ In addition, subsection 3-501(2) requires that notice be given to all drawers and to acceptors of drafts payable at a bank. Failure to give the requisite notice discharges these parties only to the extent of pecuniary injury resulting from insolvency of the drawee or payor bank.¹⁰¹ This is a change from section 89 of the NIL which completely discharges a drawer where proper notice of dishonor is not given. This change recognizes the drawer as a secondary party but precludes the unjust enrichment which might result if he were completely discharged without suffering injury.¹⁰²

⁹⁵ See *Thomas v. Woods*, 4 Cow. 173 (N.Y. Sup. Ct. 1825); RESTATEMENT § 137; SIMPSON 172.

⁹⁶ See *Roberts v. Hawkins*, 70 Mich 566, 38 N.W. 575 (1888); RESTATEMENT § 137; SIMPSON 165-66.

⁹⁷ See note 94 *supra*. The law of suretyship proceeded on the theory that it would be inequitable to hold the surety to his obligation for an indefinite period after the creditor has failed to obtain performance where the surety has been injured by failure to receive notice. The UCC abandons this theory in favor of the commercial understanding of the meaning and effect of words of guaranty. See UCC § 3-416.

⁹⁸ UCC § 3-502(2).

⁹⁹ UCC § 3-602.

¹⁰⁰ See 1 HAWKLAND, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 499 (1964).

¹⁰¹ UCC § 3-502(1)(b).

¹⁰² See 1 HAWKLAND, *op. cit. supra* note 100, at 500.

IV. CONCLUSION

While it is evident from the foregoing discussion that Article 3 of the UCC modifies both suretyship law and the NIL in favor of modern commercial practices, it appears equally evident that the UCC has incorporated into Article 3 many of the basic principles and concepts of both suretyship law and the NIL.

In summary, the UCC has provisions which change or modify both traditional suretyship law and the NIL in the areas of discharge, rights of reimbursement and subrogation, notice of dishonor, and liability of accommodation parties. In addition, the UCC eliminates the concept of payment in due course and payment for honor that existed under the NIL.

In dealing with discharge, the UCC provides for discharge of parties rather than discharge of the instrument. Furthermore, the UCC presents an interesting problem regarding the extent of discharge under section 3-606(1).

In dealing with notice of dishonor the UCC provides that such notice need not be given to guarantors of an instrument. It further provides that failure to give notice of dishonor to a drawer or to an acceptor of an instrument payable at a bank, may not fully discharge such parties, as was the result under section 89 of the NIL. The UCC provisions affecting the rights of subrogation and reimbursement are somewhat more extensive than the corresponding provisions under the NIL. Moreover, a significant change is wrought by section 3-415(2) of the UCC in dealing with the liability of one becoming an accommodation party after the instrument is initially issued by the principal obligor.

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