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A CREDITOR'S RIGHTS IN SECURITIES HELD
BY HIS SURETY

BY EDWARD G. JENNINGS*

IN words bearing, in addition to the weight of their authorship, the further weight of judicial decision, Dean Pound has said that "it is elementary that a creditor is entitled to enforce for his own benefit any securities which the principal debtor has given his surety by way of indemnity."¹ On the other hand, the author of the most recent American textbook on the law of suretyship has concluded that the proposition so stated is not only unsupportable by sound reasoning or analogy, but in its results "appears to violate the intent of the contracting parties, and, in addition, gives the particular creditor to whom the surety is liable an advantage that may be unfair either to the principal's other creditors or to the surety or to both."² The problem that provokes at the outset such a head-on clash has not yet been the subject of direct judicial decision in Minnesota.³ The ensuing discussion seeks to trace its historical development and anticipatorily to suggest a correct solution.⁴

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¹Harlan County v. Whitney, (1902) 65 Neb. 105, 106, 90 N. W. 993, opinion by Dean Pound, then commissioner of the supreme court of Nebraska. See also the statement by Deemer, J., in Nourse v. Weitz, (1903) 120 Iowa 708, 714, 95 N. W. 251, 253: "These doctrines are very well understood, and are sustained by the unbroken voice of authority."

²Arant, Handbook of the Law of Suretyship and Guaranty 376. See also Merrill, Nebraska Suretyship, (1932) 10 Neb. L. Bull. 405, 444.

³But see the statement by Gilfillan, C. J., in Felton v. Bissel, (1878) 25 Minn. 15, 19: "If a surety takes security for a debt, it enures not only to his own protection, but also to that of the creditor; . . . and also to that of his co-sureties" (dictum as regards the creditor). See also 6 Dunnell, Minn. Dig. sec. 9089: "If a surety takes security for the debt, it enures not only to his own protection, but also to that of the creditor and his co-sureties;" Schmidt v. Coulter, (1861) 6 Minn. 492 (Gil. 340, 343) (co-surety).

⁴By way of general references to the problem under discussion see: Arant, Handbook of the Law of Suretyship and Guaranty 369-376; 1 Brandt, The Law of Suretyship and Guaranty, 3d ed., 679-685; Colebrooke, Treatise on the Law of Collateral Securities, 2d ed., 395-398; 1 Hilliard, The Law of Mortgages, 4th ed., 344-348; 4 Kent, Commentaries on American Law, 12th ed., 308; 2 Jones, Treatise on the Law of Mortgages of Real Property, 8th ed., 585-587; 2 Jones, The Law of Chattel Mortgages and Conditional Sales, 6th ed., 283-284; 3 Pomeroy, Treatise on Equity Jurisprudence, 4th ed., 2889-2893; 5 Pomeroy, *ibid.*, 5208-5209; Sheldon, The Law of Subrogation 236-255; Stearns, The Law of Suretyship 495-500; 2 Story, Commentaries on Equity Jurisprudence, 14th ed., 123, 240; Story, Commentaries on the Law of Promissory Notes, 4th

1. ENGLISH PRECEDENTS

The doctrine that a creditor may have rights in securities held by one standing in the relation of surety to him for another, as it has taken root and flourished on this side of the Atlantic, has constantly been referred to an English origin, with little attention paid to its later development and limitation in the land of its alleged nativity. The case of *Maure v. Harrison*,⁵ in chancery, was decided in 1692, but apparently remained unreported until 1742.⁶ The brief report of the later date contains but the single statement:

"A bond-creditor shall, in this court, have the benefit of all counter-bonds or collateral security given by the principal to the surety; as if A. owes B. money, and he and C. are bound for it, and A. gives C. a mortgage or bond to indemnify him, B. shall have the benefit of it to recover his debt."

In the date of its decision *Maure v. Harrison* came fifty-five years after the case of *Morgan v. Seymour*,⁷ wherein had been recognized the now commonplace and fully accepted subrogation of the surety, upon discharge by him of the principal obligation, to the benefit of such securities for the performance of that obligation, aside from the personal liability of the surety, as the creditor may have received from the principal debtor. It appears to have been the thought of Sir William Grant, M. R., in *Wright v. Morley*,⁸ that the doctrines attributed to *Maure v. Harrison* and *Morgan v. Seymour* were but the converse sides of the same shield for the protection of the party equitably entitled to the benefit of the securities—but that if either were to be regarded as following from the other in point of logic, it was the surety's subrogation to the creditor's securities that followed from the recognized rights of the creditor, in the converse situation, to the securities held by the surety. For he there said, in reference to a situation typical of the surety's subrogation:

ed., 337-338; 4 Williston, *Treatise on the Law of Contracts*, rev. ed., 3624-3626; Willard, *Right of a Creditor to His Sureties' Securities*, (1880) 14 Am. L. Rev. 839; Scott, *The Creditor's Right to Subject the Securities of the Surety When They Purport to be for Indemnity Merely*, (1885) 19 Am. L. Rev. 867; Williams, *A Creditor's Right to His Surety's Securities*, (1888) 1 Harv. L. Rev. 326. See also Notes, (1912) 12 Col. L. Rev. 351; (1913) 13 Col. L. Rev. 333; (1896) 10 Harv. L. Rev. 64; (1920) 2 Ill. L. Bull. 515; (1936) 43 W. Va. L. Q. 63; (1919) 28 Yale L. J. 706; 27 Am. & Eng. Enc. L., 2d ed., 203; 6 Ann. Cas. 395; 37 Cyc. 437; 19 L. R. A. 367; L. R. A. 1916C 1062; 21 R. C. L. 1094.

⁵(1692) 1 Equity Cases Abridged, (K) (5).

⁶See *In re Walker*, [1892] 1 Ch. Div. 621, 629, note (1).

⁷(1637) 1 Rep. Ch. 120.

⁸(1805) 11 Vesey Jun. 12, 22.

"I conceive that, as the creditor is entitled to the benefit of all the securities the principal debtor has given to his surety, the surety has full as good an equity to the benefit of all the securities the principal gives to that creditor."

The soundness of the subrogation theory, as applied in behalf of the creditor, is reserved for discussion in connection with the American cases purporting to follow that theory. Suffice it to show now that, whereas the surety's subrogation became fully established in England, even as to securities expressly conditioned to be void upon payment of the principal obligation,⁹ the doctrine attributed to *Maure v. Harrison* was doubted by Lord Eldon in *Ex parte Waring, Inglis, Clarke*,¹⁰ decided in 1815, from that time almost wholly displaced by the so-called "rule of *Ex parte Waring*,"¹¹ and finally rejected entirely.

The actual facts of *Maure v. Harrison* remained shrouded in oblivion for two hundred years from the date of its decision. In 1892, in the case of *In re Walker*,¹² an English court for the first time went back to the original registrar's book and the pleadings in *Maure v. Harrison*, and discovered the facts of the earlier case to have been as follows: Thomas Mawer, the plaintiff, was the maternal grandfather of William Harrison, one of the defendants. William Harrison's father had died leaving an estate of one hundred and twenty pounds, to be divided among his three children, all minors. Thomas Mawer, being desirous that William Harrison, although still a minor, be enabled to continue the operation of his father's farm, gave an indemnity bond in the full amount of the estate to his daughter Mary, who was the administra-

⁹Surprisingly, Lord Eldon in the case of *Copis v. Middleton*, (1823) *Turner & Russell* 224, 231, although recognizing the surety's right of subrogation to any mortgage liens held by the creditor, for the reason that "the mortgagor cannot get back his estate again without a conveyance," refused to permit the surety to prove as a specialty creditor by way of subrogation to the creditor's rights under the joint bond executed by the principal debtor in conjunction with the surety, for the reason that the latter was thought to be extinguished by the surety's payment. The decision in *Copis v. Middleton* was inconsistent with that in the prior case of *Morgan v. Seymour*, (1637) 1 *Rep. Ch.* 120, cited in note 7, above, "and was itself abrogated by the Mercantile Law Amendment Act (19 & 20 *Vict.*, ch. 97, sec. 5 [1856]), which saved to the surety a right of subrogation against the principal, and of ratable subrogation against a co-surety, notwithstanding the extinguishment at law of the creditor's right against them by the surety's payment." *Campbell, Cases on Suretyship* 56, note 4; see also *Arant, Handbook of the Law of Suretyship and Guaranty* 364.

¹⁰(1815) 19 *Vesey Jun.* 345, 348-349, 2 *Rose's Bankruptcy Cases*, 182, 2 *Glyn. & J.* 404.

¹¹See *Eddis, The Rule of Ex parte Waring*.

¹²[1892] 1 *Ch. Div.* 621.

trix and William Harrison's mother, so as to enable her to turn the entire estate over immediately to William Harrison, and at the same time be secured against the claims of her other two children. Thereafter one of the other children died, the mother married William Morley, and William Harrison, on becoming of age, purported to disavow his previous receipt of the property from his father's estate and demanded payment of his share. William Morley gave him a bond for the payment of such share, and William Morley with his wife Mary brought suit against Thomas Mawer upon the bond given by him to Mary. Thomas Mawer thereupon brought suit against them and William Harrison to restrain the suit against himself and to have his own bond delivered up and cancelled. The court held that William Harrison had been well paid, that the bond given to him by Morley should therefore be released, and that the suit that had been begun against Thomas Mawer upon the latter's bond be stayed "till *Margaret* [the other child still living] doth release, and when the plaintiff hath procured *Margaret*, who is not a party to the action, to release that bond, then that bond to be delivered up," . . . "but then [in the event that *Margaret* should not release] the plaintiff's bond to be at suit for the recovery of *Margaret's* moiety of £120."

After thus bringing to light for the first time the actual facts of *Maure v. Harrison*, the court in *In re Walker*, through Stirling, J., concluded:

"So that all that was decided in that action was this: that the plaintiff, who had given his bond of indemnity, was not entitled to have it delivered up to be cancelled till all claims had been settled. Under those circumstances, it appears that the point for which it was cited in 1 Equity Cases, Abridged, could not have been decided in that case; and that at most the reported statement amounts to a dictum,¹⁸ in the course of the argument. It is now

¹⁸But if the language of the judgment "till *Margaret* doth release" be construed as referring to the plaintiff's bond, rather than merely to *Margaret's* claim against her mother, it would follow that the rights upon the bond were not alone in the mother, the named obligee, and therefore that the reported statement was after all something more than a dictum. *Maure v. Harrison* conceivably may have stood for much the same proposition as *Dutton v. Poole*, (1678) 1 Vent. 318, 332, T. Jones 102, 2 Lev. 210, allowing a child to sue upon a promise made to her father, but now regarded as having been overruled in England. See 2 Williston, Treatise on the Law of Contracts, rev. ed., 1053. As will appear more fully in the text, the doctrines of a creditor's rights in his surety's securities and of the directly enforceable rights of the creditor-beneficiary of a third-party contract are at least partially analogous; and it may not be entirely accidental that they have fallen together in England and still retain equal vitality in the United States.

The words of the judgment in *Maure v. Harrison* "but then the plain-

nearly 200 years since this case was decided, and the sole authorities on a point which must have been of frequent occurrence are these: a dictum in 1692, a dictum early in the century by Sir *William Grant* in the year 1805,¹⁴ and what appears to me to be the contrary opinion of Lord *Eldon* a little later.¹⁵

"Under these circumstances, it seems to me that there is no real authority for the proposition in question; and upon principle, I cannot see why a surety who takes from the principal debtor a bond or indemnity at once becomes a trustee of that for the principal creditor. . . ."¹⁶

As the result of the decision in *In re Walker* the doctrine of *Maure v. Harrison*, which had been in effect supplanted ever since 1815 by another doctrine, the so called "*rule of Ex parte Waring*," has now been erased entirely from English law. *In re Walker* itself was a proceeding to administer the estate of Hugh Walker, deceased, in which the Sheffield Banking Company was claiming the benefit of securities in the form of a mortgage and title deeds that had been deposited by one Arthur Spencer and his wife "to indemnify the testator in respect of his guarantee" of the current account of Spencer Brothers, a co-partnership of which Arthur Spencer was a member. The decision of the court was that the Sheffield Banking Company, as a creditor of the account for which the testator had been guarantor, "must simply be left to prove against the estate of the testator for what is due them, without having the exclusive benefit of these securities in respect of which payments have been made to the estate."¹⁷

No distinction was made by the court between the mortgage given by Arthur Spencer himself, who was one of the principal debtors, and the title deeds deposited by his wife, who was a stranger to the principal obligation. It would seem therefore to be clear that by the present law in England the creditor has no direct rights of his own accruing by operation of law or equity in securities held by the surety for his own indemnity, whether such securities proceed from the principal debtor or from another. The securities remain for the purpose alone of effectuating the intent

tiff's bond to be at suit for the recovery of *Margaret's moiety*" are equivocal—they may refer merely to the recovery by Mary, the mother, of the amount of Margaret's moiety, since she was apparently already damnified in that amount.

¹⁴In *Wright v. Morley*, (1805) 11 Vesey Jun. 12, 22, cited in note 8, above.

¹⁵In *Ex parte Waring*, Inglis, Clarke, (1815) 19 Vesey Jun. 345, 348-349, cited in note 10, above.

¹⁶[1892] 1 Ch. Div. 621, 629.

¹⁷[1892] 1 Ch. Div. 621, 629.

of the indemnity agreement as between the principal debtor or indemnitor and the surety, which was solely for the latter's protection. The creditor receives all for which he actually bargained, which was the personal liability of both the principal debtor and the surety; and, without further facts appearing, the significance of which will presently be considered, he is not entitled upon any theory of subrogation to insist upon the enforcement for his benefit of the surety's own rights in the securities.

The court in *In re Walker* also specifically negated the possibility upon any other theory of a trust having arisen for the creditor's benefit. Lord Eldon appears once to have held that "where a security had been given to a surety upon trust to apply the proceeds in paying off the creditor," the latter became the cestui que trust and could enforce the application of the proceeds accordingly.¹⁸ There is of course nothing in the position of a surety that would necessarily prevent him from acting also as trustee, for the person to whom he owes the debt, of securities appropriated to its payment. But under a specific appropriation of the securities to the payment of the debt, as distinguished from the purpose of merely personal indemnity to the surety, it was held in *Wilding v. Richards*¹⁹ that creditors without notice of the appropriation derived no direct rights thereunder. Such a result is of course consistent with the English rule to the effect that even an express assignment by a debtor for the benefit of his creditors vests no direct rights as cestuis que trust in the creditors, but operates instead as a continuing offer to the creditors made through the assignee as agent of the debtor, which therefore becomes irrevocable as soon as the creditors properly manifest their assent thereto.²⁰

But the theory of a continuing offer to the creditor does not appear to have been applied by the English courts in any case of securities deposited by an ordinary debtor with his surety for the payment of the debt; nor have the English courts extended to the creditor in this situation the same liberality with trust principles that they have at times displayed in favor of the beneficiary of an ordinary third-party contract.²¹ In fact the case applying the so-called "*rule of Ex parte Waring*," to be con-

¹⁸*Ex parte Rushforth*, (1805) 10 Vesey Jun. 409, 421. See Rowlatt, *The Law of Principal and Surety*, 3d ed., 201.

¹⁹(1845) 1 Coll. 655.

²⁰See 2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1036.

²¹See 2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1055-1056.

sidered presently, require exactly such a specific appropriation of the securities for the payment of the debt;²² yet it is the underlying assumption of all such cases, as will be shown, that the creditor acquires no direct rights of his own in the securities, even after receiving notice and assenting.²³

If in such a case of the specific appropriation of the securities to the payment of the debt the creditor can show a trust for his benefit to have been expressly intended by the parties to the security agreement, or is himself a party to such agreement, he may of course acquire the same rights that would have been his had the securities been given directly to him in the first place.²⁴ But otherwise, as regards the existence of direct rights in the creditor, nothing seems to turn in England upon whether the securities held by the surety have been deposited merely for his own indemnity for loss actually suffered through payment by him of the principal debt or a part thereof, or instead have been appropriated specifically to the payment of the debt itself. To the extent that the two problems are at least partially analogous, the English courts are in this respect consistent with their refusal to accord either direct or derivative rights to the beneficiaries of third-party contracts.²⁵

As already intimated, the case of *Ex parte Waring, Inglis, Clarke*,²⁶ decided in 1815, gave rise to a doctrine all of its own, effectively supplanting *Maure v. Harrison* long before the latter doctrine was finally repudiated in its entirety. The facts of *Ex parte Waring, Inglis, Clarke* were as follows: Brickwood & Company were bankers in London, and Bracken & Company were manufacturers in Lancashire and customers of Brickwood &

²²See *Ex parte Dever*, (1885) L. R. 14 Q. B. D. 611, 623; *City Bank v. Luckie*, (1870) L. R. 5 Ch. App. 773, 777; *In re New Zealand Banking Corporation*, (1869) L. R. 7 Eq. 449, 454-455; *In re Belfast Warehouse Co.*, [1897] 1 Ir. Rep. Ch. Div. 124, 131-133; and see below, pp. 330-331 of text, notes 47-50 inclusive.

²³See *Royal Bank of Scotland v. Commercial Bank of Scotland*, (1882) L. R. 7 App. Cas. 366, 384; *In re General Rolling Stock Co.*, (1869) L. R. 4 Ch. App. 423, 429; *In re Joint Stock Discount Co.*, (1868) L. R. 6 Eq. 491, 495-496; *In re Richview Brickworks Co., Ltd.*, [1897] 1 Ir. Rep. Ch. Div. 176, 183; *Bank of Ireland v. Perry*, (1871) L. R. 7 Exch. 14, 20; and see below, pp. 327-329 of text, notes 37-42 inclusive.

²⁴Compare the statement of the English law contained in the 1936 edition of Rowlatt, *The Law of Principal and Surety* 200-201: "A creditor can derive no benefit from securities given by the principal to the surety unless he can show a direct interest in them by contract or under a trust, or unless both principal and surety are bankrupt, and the rule in *Ex parte Waring* is found applicable."

²⁵See 2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1053-1056.

²⁶(1815) 19 Vesey Jun. 345.

Company. By a typical "loan of credit" arrangement, Bracken & Company were accustomed to draw drafts for Brickwood & Company's acceptance, having deposited securities in advance to cover the amount of such acceptances. Brickwood & Company thus stood in a relation in the nature of a surety, secured against damnification, for Bracken & Company. Brickwood & Company were not restricted to using the securities to recoup payments actually made by them on Bracken & Company's account, but were entitled to use the securities for the purpose of meeting their acceptances for Bracken & Company as they fell due. Brickwood & Company became bankrupt on July 7th, 1810, and Bracken & Company on August 2nd, 1810. As of the former date Brickwood & Company were under acceptances for Bracken & Company in an amount of £24,000, and had in their hands, deposited with them by Bracken & Company "as a security against their acceptances," £21,645 and 10 shillings of short bills, and title deeds of premises in London which later produced on sale approximately £2,961. Also Brickwood & Company were indebted to Bracken & Company in a cash balance of approximately £6,766.

The holders of the acceptances proved against both estates in bankruptcy, thereby obtaining from Brickwood & Company's estate approximately £3,412. They thereupon petitioned that the assignees of Brickwood & Company be directed to pay over the proceeds of the short bills and title deeds, plus the sum of approximately £3,353 which represented the difference between the credit balance of £6,766 owing to Bracken & Company and the £3,412 that had been paid to the petitioners as a dividend from Brickwood & Company's estate, in order that the separate sums so obtained might be used for the payment of the petitioners in full.

The order of Lord Eldon in granting relief to the petitioners, although not altogether clear as to the disposition to be made of the credit balance owing from Brickwood & Company to Bracken & Company,²⁷ provided that the proceeds of the short bills and the title deeds be devoted to the payment of the petitioners in full, any surplus remaining to be restored to Bracken & Company's es-

²⁷It does not specifically appear from the facts that the credit balance had previously been specifically appropriated to the payment of the acceptances, as had the short bills and title deeds. Later cases apparently hold that the "rule of *Ex parte Waring*" has no application to an ordinary debt owing by the acceptor's to the drawer's estate, unless specifically appropriated beforehand to the payment of the acceptances. *Ex parte Dickin*, (1878) L. R. 8 Ch. Div. 377, 385-386. See the discussion below, at pp. 328-329 of the text.

tate. Should the securities prove insufficient, the billholders were to be allowed to prove against each bankrupt estate only for the amount of the unpaid balance.²⁸

In reaching this result Lord Eldon expressly refused to base it upon either the doctrine of *Maure v. Harrison* or the dictum in *Wright v. Morley*, both of which had been pressed by counsel, and said:

"With regard to that case [*Maure v. Harrison*], or cases in general, I desire it to be understood, that I forbear to give any opinion upon that point; but I see nothing in this transaction, which, supposing a bankruptcy had not occurred, would entitle those, who are creditors by the acceptances of the bankers, having these deposits, to maintain an equity upon them: the effect of which would be, that from the moment of that deposit the bankers became trustees for those creditors; and could not come to any new arrangement with those, whose debts are to be so discharged."²⁹

But he continued:

"That doctrine therefore not being applicable to this case, the view I have taken of it in other respects is this. The first consideration is, what was the nature of the demand of *Bracken* and Co. who did not become bankrupt until *August*, upon *Brickwood* and Co. at the moment of their bankruptcy, on the 7th of *July*. If these billholders are to have payment in preference to the other creditors, it must be by the effect of an equity between these two houses, rather than by any demand directly in their own right upon any funds in the hands of *Brickwood* and Co. With regard to the demand of *Bracken's* house upon the 7th of *July*, it is impossible to deny, that if they had either paid, or undertaken to pay, i.e. to relieve *Brickwood's* house from those acceptances, the short bills and the mortgage must have been restored to them. It is on the other hand equally clear, that they never could have raised any demand against the house of *Brickwood* in respect of either the cash balance,³⁰ the short bills, or the mortgage, without bringing in the amount of those acceptances; admitting, that what the house

²⁸Lord Eldon thus treated the acceptance-holders as secured creditors within the "bankruptcy" as distinguished from the "chancery" rule as to the extent of proof that will be permitted of secured creditors who do not waive their security rights. By the Judicature Act of 1873 the "bankruptcy" rule became applicable to all liquidations in England, whether through bankruptcy or equity. See Glenn, *The Law Governing Liquidation* 758. The majority American state rule is otherwise, see Glenn, *idem*. At least one American case has similarly limited a creditor's right of proof by virtue of his interest in his surety's indemnifying securities. In *re Jerome B. Fickett*, (1881) 72 Me. 266. The securities are treated as having for this purpose been realized at either the moment of insolvency or the date of maturity of the bills. See *In re Barned's Banking Co.*, (1874) L. R. 19 Eq. 1, 10.

²⁹(1815) 19 Vesey Jun. 345, 348-349.

³⁰But see note 27, above.

of *Brickwood* had of their property in short bills, &c. must be applied to the discharge of those acceptances, for the sake, not of the billholders, but of the house of *Brickwood*; who had become liable to them; and had a right to have that liability cleared away, before any demand could arise for the *Brackens*.

"That then being the equity between these houses in the interval between their respective bankruptcies, it does not appear to me varied by the bankruptcy of the *Brackens* in *August*; supposing their assignees to have put the estate of *Brickwood* in the same situation as the house they represent, if solvent, must have done, to entitle themselves to the short bills; and, having regard to the demands of all the creditors and the bankrupts, in this circuitous way, I think, the billholders must be paid, not as having a demand upon these funds in respect of the acceptances they hold, but as the estate of *Brickwood* and Co. must be cleared of the demand by their acceptances; and the surplus, after answering that demand, must be made good to *Bracken* and Co. . . ."³¹

It appears at first to have been thought that, despite Lord Eldon's language, the "rule of *Ex parte Waring*" was after all only the doctrine of *Maure v. Harrison* in new raiment. For in *Ex parte Prescott*,³² involving practically the same facts as *Ex parte Waring*, *Inglis*, *Clarke*, it was said by Sir G. Rose:

"I always understood, that the principle on which *Ex parte Waring* was founded, was this, . . . that where the original intention of the parties was to appropriate property to a certain purpose; in such a transaction, bankruptcy would not affect that intention, nor deprive third parties of the benefit of it."³³

But it has since been clearly recognized that the insolvency of both the drawer and acceptor, or of those standing in the relation of principal and surety as it were, instead of failing to affect the operation of the "rule of *Ex parte Waring*," is absolutely indispensable to the operation of the rule at all.³⁴ It became established that double bankruptcy, in the technical sense of both estates

³¹(1815) 19 Vesey Jun. 345, 349-350.

³²(1834) 3 Deacon and Chitty 218, 230.

³³As late as 1847 an English writer on the law of suretyship stated the law to be: "A creditor is entitled to the benefit of all securities which the principal debtor has given to his surety, as well as those which were given to the creditor by the principal," citing *Maure v. Harrison* and *Wright v. Morley* but without citing *Ex parte Waring*, *Inglis*, *Clarke*. Burge, *Commentaries on the Law of Suretyship* 324.

³⁴In *re New Zealand Banking Corporation*, (1867) L. R. 4 Eq. 226, 231-232 ("rule of *Ex parte Waring*" has no application where either drawer or acceptor is not insolvent); see also *In re Joint Stock Discount Co.*, (1868) L. R. 6 Eq. 491, 495. The rule has likewise been held to have no application to the case of acceptances guaranteed by a third person at the request of the drawer, although both guarantor and acceptor have become insolvent. See *In re Barned's Banking Co.*, (1868) L. R. 3 Ch. App. Cas. 753, 756.

being in the course of administration by a court of bankruptcy, was not essential; but that double insolvency, plus the fact of both estates having been brought into some form of forced judicial administration, was sufficient.⁸⁵ The requirement of some form of forced judicial administration of both estates explains the theory of the rule. It is that a supposedly insoluble impasse would otherwise be created. Up to the moment that the control over his own estate is taken from him, the one standing in the position of an indemnified surety has the power to pay the creditor and then realize upon the securities for his own reimbursement; and he has also, in all instances of the specific appropriation of the securities to the payment of the debt, or to the exoneration of the surety as well as his reimbursement, the right to realize upon the securities in the first instance for the very purpose of using their proceeds to pay the creditor. But the creditor's right against the surety being by hypothesis in personam and unsecured, the moment that forced administration of his own estate intervenes the surety's power to pay the creditor in full is at an end, and the creditor is remitted to come in along with the surety's other unsecured creditors. The surety's power to touch the securities at all, even if they have been provided for the express purpose of giving him the wherewithal to pay the debt in question, now depends upon the ascertainment of the extent to which he will be required to respond to his in personam obligation to pay that debt. This will not ordinarily occur until the surety's final discharge. In the meantime his security right is not a general asset of his own estate available to his general creditors. Only after and to the extent that he has been damnified through dividends declared from his own estate against the principal obligation do the securities become an asset of that estate available for the benefit of his creditors generally.

On the other hand he who stands in the position of principal debtor has also, by the forced administration of his estate, lost the power of paying the creditor in full, which is the only

⁸⁵*Powles v. Hargreaves*, (1853) 3 De Gex, MacNaughten and Gordon, 430, 449 et seq.; see also *In re Barned's Banking Co.*, (1874) L. R. 19 Eq. 1, 7. But unless there is a forced administration of both estates, the mere fact of double insolvency will not bring the "rule of *Ex parte Waring*" into operation. *In re Belfast Warehouse Co.*, [1897] 1 Ir. Rep. Ch. Div. 124. Since the Judicature Act of 1873 the "rule of *Ex parte Waring*" may be applied by a court of law upon an interpleader issue, see *Engelback v. Nixon*, (1875) L. R. 10 C. P. 645, 654-655; but the billholders must be joined as necessary parties, see *Ex parte Dickin*, (1878) L. R. 8 Ch. Div. 377, 387.

act by which he can relieve the surety of the risk of loss and thus entitle himself to the return of the securities. The securities are in the estate of the surety impressed, not with a trust for the benefit of the creditor, but with a special purpose either of indemnifying the surety or of exonerating him by paying the creditor to the extent of the surety's damnification, which cannot be ascertained until the surety's final discharge; and except for this purpose they remain in the estate of the principal debtor, but incapable of immediate realization by him or for the benefit of his creditors generally.³⁶

Thus it was pointed out by Lord Romilly, M. R., in *In re Joint Stock Discount Company*,³⁷

"that *Ex parte Waring*, and all that class of cases, in which Lord Eldon laid down the law very distinctly, amount to nothing more than this, that where there is a double bankruptcy, or insolvency . . . , and there are bills which one bankrupt is entitled to claim against the other, that must be set right as between the two estates, the consequence of which is, that the billholders, though they get the benefit of any security that has been given for the bills, as Lord Eldon says, indirectly, have no species of right to the security itself."

And as stated by the Lord Chancellor, Lord Selborne, in *Royal Bank of Scotland v. Commercial Bank of Scotland*,³⁸

"It is conceded (and it has always been so laid down by all the English authorities) that billholders cannot claim to have securities, deposited by the drawers with the acceptors for the acceptors' indemnity, applied in payment of the bills by virtue

³⁶In *Ex parte Manchester Bank*, (1879) L. R. 12 Ch. Div. 917, 925-926, the "rule of *Ex parte Waring*" is said by Bacon, C. J., to be based upon the same principle as the one applicable in working out the respective rights of creditors of two partnerships, one of which has succeeded the other by virtue of the death of a partner or other change in membership. See also the same suggestion by counsel in the Maryland case of *Kunkel v. Fitzhugh*, (1865) 22 Md. 567, 570. But the two situations are believed to be dissimilar, in that partnership succession involves only the segregation of the assets of the dissolved partnership, and the ascertainment of its creditors, as of the moment of dissolution. Common creditors of both partnerships are not thereby given preferences over all other partnership creditors in respect of particular assets. For a thorough discussion of the problems of partnership liabilities and the administration of partnership assets, see Warren, *Corporate Advantages Without Incorporation* 33-140, 275-292.

Obviously the "rule of *Ex parte Waring*" can have no application where the person to whom securities have been given for the acceptance of bills did not in fact accept the bills. *Vaughan v. Halliday*, (1872) L. R. 9 Ch. App. Cas. 561, 568. Since the security holder is not in fact liable, the drawer is entitled to the immediate return of the securities to his general assets.

³⁷(1868) L. R. 6 Eq. 491, 495-496.

³⁸(1882) L. R. 7 App. Cas. 366, 384.

of any right or title of their own to the benefit of those securities. They can, at the utmost, only claim to come in under a *ius tertii*, availing themselves of the administration of the insolvent estates (in which they have the ordinary *locus standi* of creditors), to ask that the securities, which would be assets of the one estate but for the lien and right of indemnification belonging to the other, but which cannot be realized until that lien and right of indemnification is discharged, may be so applied as to give effect to the contract between the drawers and the acceptors, in the way most conveniently practicable."³⁹

The billholders by hypothesis having no direct rights of their own in the securities, but being merely the beneficiaries of the means adopted to promote judicial convenience in adjusting the equities between the two insolvent estates, it follows that up to the moment of forced administration as applied to both estates, the drawer and acceptor may change the purpose of the securities as they see fit, without requiring the concurrence of the billholders.⁴⁰ It was further suggested by Lord Watson, in *Royal Bank of Scotland v. Commercial Bank of Scotland*,⁴¹ that even after double bankruptcy has occurred a compromise may still be arranged between the trustees of the respective estates, with the approval of the court. And if, without a strict novation in the purpose of the securities having been effected prior to bankruptcy, the acceptor has nevertheless disposed of the securities otherwise than by their application to the purpose of the indemnity agreement, there is

³⁹See also *Ex parte Dever*, (1885) L. R. 14 Q. B. Div. 611, 623-624 (opinion by Cotton, L. J.): "As I understand the principle of the rule it is this—the Court finds in the hands of a bankrupt certain property, which has been remitted to him by another person also become bankrupt to secure him against a liability which he has undertaken upon bills drawn upon him by that person. The property cannot be applied in paying the general creditors of the acceptor, because it was in his hands impressed with a trust; nor can it go to pay the general creditors of the drawer, because he was not entitled to have it back without meeting the acceptances. The Court thereupon applies the property in such a way as will carry out as far as possible the equities between the two estates, i. e., in paying the acceptances to cover which it was sent. The rule assumes that the property which was in the hands of the acceptor is not his own absolute property; if it was, it would go to pay his creditors generally. . . .;" *Bank of Ireland v. Perry*, (1871) L. R. 7 Exch. 14, 20 (opinion by Baron Cleasby): "Such a right is a peculiar one, for it is not founded upon any interest the billholder has in the agreement between the drawer and acceptor; for he has none but that which arises afterwards in consequence of the enforced administration of the assets of both estates."

⁴⁰In *re General Rolling Stock Co.*, (1869) L. R. 4 Ch. App. Cas. 423, 429 (opinion by Selwyn, L.J.): "Until that state of circumstances has arisen the two persons who are the parties to the contract have a perfect right to deal with the securities which one of them has deposited with the other in any manner they see fit."

⁴¹(1882) L. R. 7 App. Cas. 366, 398.

authority to the effect that the deposit of securities for a special purpose has been transformed into an ordinary debt owing by the acceptor's to the drawer's estate, with the result that the "rule of *Ex parte Waring*" becomes inapplicable.⁴² This would seem to show that the rule has not been regarded in England as applicable to the credit balance owing by the acceptor's to the drawer's estate that was involved in the facts of *Ex parte Waring, Inglis, Clarke* itself.⁴³

If, on the other hand, it be assumed that there is a credit balance owing by the drawer's to the acceptor's estate, which is

⁴²In *Ex parte Dickin*, (1878) L. R. 8 Ch. Div. 377, 385-386, the facts were as follows: "Goods, the property of *Pollard & Co.*, were sent by them to *Murrell & Crisfield* for sale, under an arrangement by virtue of which the goods were in effect made a security to *Murrell & Crisfield* for the payment of bills of exchange which they had accepted for the accommodation of *Pollard & Co.* After *Pollard & Co.* had filed their liquidation petition *Murrell & Crisfield* sold the goods, for the purpose of repaying themselves the amount of one of the bills which they had already paid, and of providing themselves with funds to meet the other bills which were soon to become due." Thereafter *Murrell & Crisfield* failed, leaving three of the bills unpaid. In holding the "rule of *Ex parte Waring*" to be inapplicable, Jessell, M. R., stated: ". . . the whole of the proceeds of the sale had been disposed of by *Murrell & Crisfield* before they filed their petition. This being so, it is clear that the demand of *Pollard & Co.*'s trustee against *Murrell & Crisfield* for the proceeds of the sale is a demand for a debt. The property of the goods is not in him. The goods are no longer in existence as the goods of *Pollard & Co.* The proceeds of the sale are gone too; they were not earmarked in any way, and at the most the trustee's demand against *Murrell & Crisfield* is a demand for a debt equal to the amount produced by the sale, less what they have paid to the bill-holders." In *Ex parte Banner*, (1875) L. R. 2 Ch. Div. 278, the "rule of *Ex parte Waring*" was held to be inapplicable where goods had been consigned by an agent to his principal, into whose hands both possession and title had passed—for the reason that the security was gone, and only a debt remained. And according to Brett, M. R., in *Ex parte Dever*, (1885) L. R. 14 Q. B. D. 611, 622, "if the person to whom the securities are sent does use the proceeds for his own purposes, and credits the sender with interest upon the amount of the proceeds, and the sender does not object, then, so far as the securities are thus used, they are taken out of the rule of *Ex parte Waring*, because to that extent the security is gone."

But to the extent that by misappropriating the securities the acceptor has committed a breach of trust as against the drawer, it would seem that the ordinary rules as to tracing trust funds ought to be applicable, and the "rule of *Ex parte Waring*" therefore also applicable to the extent that by such rules the proceeds of the securities can still be traced in the acceptor's general assets.

With the above cases compare *In re New Zealand Banking Corporation*, (1867) L. R. 4 Eq. 226, 230-231, holding the "rule of *Ex parte Waring*" to be inapplicable to the extent that there is a credit balance owing by the drawer's to the acceptor's estate, although not specifically covered by the securities, and the criticism of the latter result contained in the opinion by Cotton, L. J., in *Ex parte Dever*, (1885) L. R. 14 Q. B. D. 611, 623-624; for which see below, at p. 330 of the text, notes 44-46 inclusive.

⁴³See above, notes 27 and 30.

not specifically covered by the securities, the "rule, of *Ex parte Waring*" has here again been held to be inapplicable.⁴⁴ This result seems to have been based upon the proposition that the securities have become for all purposes a part of the acceptor's estate, to be shared by his creditors generally and by the billholders only as such. But such a result is believed to be manifestly unsound, in that it changes the purpose of the securities, converts an unsecured debt owed by the drawer to the acceptor into a fully or partially secured one, and favors the general creditors of the acceptor, other than the billholders, at the expense of the general creditors, other than the billholders, of the drawer. It may likewise unduly prejudice the billholders, wherever the acceptor's estate pays smaller dividends than does the drawer's, and the two together fail to pay the billholders in full.⁴⁵ Such a result cannot be sustained on any theory of the set-off of mutual debts, for the reason that the acceptor's obligation to return to the drawer any excess of the securities over the amount necessary for his indemnification is much more than an ordinary unsecured debt owing from the acceptor's to the drawer's estate. As so aptly pointed out by Cotton, L. J., in *Ex parte Dever*,⁴⁶

"The question is whether in the events which have happened—at the moment of the bankruptcy—the bankrupt was entitled to apply the remitted bills which were then in his hands to any purpose he pleased. It may well be that, so long as he is solvent, the holder of remittances made to him in this way is, by mercantile usage or the course of dealing between the parties, entitled to apply the proceeds of the remittances for his own benefit in any way he pleases. But that does not show that, at the moment when he can no longer meet his acceptances, the remitted bills, if they remain in specie, are not subject to any equity in favor of the drawer of the bankrupt's acceptances, enabling him to require them to be applied in meeting the acceptances."

There is some confusion in the English cases as to the extent of the specific appropriation necessary in order to bring the "rule of *Ex parte Waring*" into operation. It was held, however, in

⁴⁴In *re New Zealand Banking Corporation*, (1867) L. R. 4 Eq. 226, 230-231.

⁴⁵This does not assume the existence of any rights in the billholders under the "rule of *Ex parte Waring*." To the extent, in the situation hypothesized by the statement in the text, that the acceptor's estate is thus given the benefit of the securities without having been damnified in their full amount by dividends to the billholders, the latter, who are also creditors of the drawer's estate, are being prejudiced along with all other general creditors of that estate.

⁴⁶(1885) L. R. 14 Q. B. D. 611, 623-624.

City Bank v. Luckie,⁴⁷ that the securities need not have been specifically appropriated to the payment of the very bills in question, but that it is sufficient if they have been specifically appropriated to a general cash credit upon which such bills are in fact drawn and accepted. And as pointed out by Cotton, L. J., in *Ex parte Dever*,⁴⁸ "if there has been a general appropriation of securities to meet the bills drawn by A. upon B., the securities must be applied in accordance with the rule in *Ex parte Waring*."⁴⁹ But the "rule of *Ex parte Waring*" has been said to be inapplicable where the securities have been deposited not for the purpose of meeting the bills, or in other words for the surety's exoneration, but merely to secure the right of reimbursement for payments made in respect of them.⁵⁰

⁴⁷(1870) L. R. 5 Ch. App. Cas. 773, 777 (opinion by the Lord Chancellor, Lord Hatherley): "It is said, however — and this seems to have been the view of the Vice-Chancellor in the Court below—that the security is only for the balance of a cash account. It seems to me utterly immaterial what is the form which the debt assumed, if, amongst other things, you find upon investigating the account that the creditor who claims the balance of the cash account has pledged his credit for the purpose of having that cash advanced, which he seeks to be paid. It is a cash advance in whatever way it be advanced, and in effect cash was advanced upon the security of *Kynaston, Sutherland, & Co.*; and *Kynaston, Sutherland, & Co.* being the persons who have thus made themselves liable, and taken this mode of advancing the money, cannot be called upon to part with the securities until they have been completely indemnified."

⁴⁸(1885) L. R. 14 Q. B. D. 611, 623.

⁴⁹But compare *In re Belfast Warehouse Co.*, [1897] 1 Ir. Rep. Ch. Div. 124, 131-133, in which Vice-Chancellor Chatterton based his refusal to apply the "rule of *Ex parte Waring*" in part upon the following grounds: "The indemnity is general against all sums of money which should from time to time be owing to the Company from Carmichael in account current with the Company for or in respect of all bills theretofore or thereafter drawn by him upon the Company, and accepted and paid, or drawn and indorsed or otherwise secured by the Company for him, and for all cash advances, loans, discounts, credits, advances, and payments of every description by the Company to, or for the accommodation or at the request of, Carmichael. The deed was, in fact, an ordinary banker's mortgage. I fail to see that the bill-holders, now seeking to establish a lien on the mortgaged premises, have any equity entitling them to have a sum realized on foot of this security applied specifically to their demands. Every creditor of the Company, no matter when and how his demand became payable by Carmichael, and for which the Company became liable on their guarantees, would have the same equity in respect thereof as the bill-holders now claim. . . . On these grounds I must hold that these bill-holders have not established either in law or in fact the right to apply the sum in question in payment of these bills."

⁵⁰*In re New Zealand Banking Corporation*, (1869) L. R. 7 Eq. 449, 454-455 (opinion by Lord Romilly, M. R.): ". . . the securities were not deposited to provide for the payment of the bills now in question, but of other bills (all of which had been paid), and what should be owing on a general account, and that the money due on the bills now in question fell under the latter description. The case of *Ex parte Waring* had no application; the trustees of *Levi & Co.* had no right to call on the corporation

The "rule of *Ex parte Waring*" is apparently still the law of England, although no cases applying it have been reported since 1897.⁵¹ The rule is no doubt of wider application than solely to cases of securities specifically appropriated by the drawer to the exoneration of the acceptor of a bill of exchange. The following statement of the rule was made by an English text writer in 1936.⁵²

"There seems no reason to doubt that the rule in *Ex p. Waring* would apply to every case of principal and surety where the surety is liable to the creditor for immediate unconditional payment, by whatever machinery that relation may have been constituted, if it would have been applicable had the credit been obtained by means of accommodation acceptances. Therefore where both principal and surety are insolvent, and their estates under forced administration in bankruptcy or otherwise, if the surety holds security from the principal for his indemnity against that specified debt, and the state of affairs between the two is such that the estate of the surety is not entitled to retain that security after the debt guaranteed has been liquidated, nor the estate of the principal to recover it unless that debt has been liquidated, then the security will be applied by the court in liquidating the debt guaranteed. This having been done, the creditor will be entitled to prove for the balance, as if the security had been so applied in the first instance."

Of the "rule of *Ex parte Waring*" it was said by Lord Blackburn in *Royal Bank of Scotland v. Commercial Bank of Scotland*:⁵³

"This rule has the unquestionable advantage of being easily worked. The objection to it is that it alters the distribution of the estate from that which it would be if no such arbitrary rule were introduced, which can only be justified on the ground of

to apply the securities in payment of these bills; on the contrary, the corporation were entitled to hold them as security for any balance which might be due from *Levi & Co.*" It affirmatively appeared, however, that there was nothing else owing on general account by *Levi & Co.* than in connection with the unpaid bills in question.

⁵¹The most frequently quoted statement of the "rule of *Ex parte Waring*" is the one by Brett, M. R., in *Ex parte Dever*, (1885) L. R. 14 Q. B. D. 611, 620: "Where, as between the drawer and acceptor of a bill of exchange, a security has, by virtue of a contract between them, been specifically appropriated to meet that bill at maturity, and has been lodged for that purpose by the drawer with the acceptor; then, if both drawer and acceptor become insolvent, and their estates are brought under a forced administration, the bill-holder, though neither party nor privy to the contract, is entitled to have the specifically appropriated security applied in or towards payment of the bill." This statement of the rule is quoted with approval in *Eddis, The Rule of Ex parte Waring* 5; and in 2 *Halsbury's Laws of England*, 2d ed., 229, note (i).

⁵²Rowlatt, *The Law of Principal and Surety*, 3d ed., 311-312.

⁵³(1882) L. R. 7 App. Cas. 366, 392.

necessity, or such practical inconvenience in working the administration of the estates as to amount to necessity."

Without conceding that the "rule of *Ex parte Waring*" is either easily understood or easily worked, the merit of Lord Blackburn's criticism in respect to the application of the rule to particular situations may be easily demonstrated—keeping in mind the hypothesis upon which the rule is based, namely, that the acceptance-holders are unsecured creditors having no direct rights of their own in the securities, being merely the beneficiaries of judicial convenience in the administration of the two insolvent estates.

If it be assumed that the securities either exceed or exactly equal the amount of the bills, and also that by proving against both estates the billholders may receive payment in full, it is apparent that the "rule of *Ex parte Waring*" in no way alters the natural distribution of the insolvent estates or prejudices anyone.⁵⁴ Payment of the billholders out of the securities in such a situation relieves the general creditors of both estates of the billholders' competition in proof, and saves the acceptor's estate from being damnified, which is all that its general creditors are entitled to ask. On the other hand the general creditors of the drawer's estate are prejudiced no more than they already were by virtue of the indemnifying agreement. The intent of that agreement has been exactly fulfilled, the same as though the parties to it had remained solvent.

But in the above situation there is no pressing need for the "rule of *Ex parte Waring*," and it is not usually determinable in advance that the billholders may receive payment in full by proving against both estates. And if it be assumed that the securities either exceed or exactly equal the amount of the bills, but that by proving against both estates the billholders will not receive payment in full, it is now apparent that the "rule of *Ex parte Waring*," although still in no way prejudicing the general creditors of the acceptor's estate, does materially prejudice the general creditors, other than the billholders, of the drawer's

⁵⁴"No doubt, the holder of the bills, if he lost the benefit of the security, could prove on both estates; and if each paid say ten shillings in the pound, the security being equal to the debt, the result would be the same. But such a state of things must be uncommon; and in the majority of cases the holder of the bills must receive an undue preference. This, however, is the very thing which in my view of it *Ex parte Waring* does; and it is of course too late to re-open the question." Porter, M. R., in *re Richview Brickworks Co., Ltd.*, [1897] 1 Ir. Rep. Ch. Div. 176, 183.

estate. For in this situation, to the extent that the amount paid the billholders out of the securities exceeds the amount that would have been paid to them as dividends from both estates, the effect of the "rule of *Ex parte Waring*" is to give to the billholders, who by the hypothesis of the English rule are unsecured creditors, a preference over the other general creditors of the drawer's estate.⁵⁵ The size of the preference will of course vary inversely with the degree of solvency of the drawer's estate, but it will never completely vanish until the point is reached at which the dividends from both estates would be sufficient to pay the billholders in full.

If it be assumed in the third place that the securities are less than the amount of the bills, the "rule of *Ex parte Waring*" now becomes prejudicial to the general creditors, other than the billholders, of both the acceptor's and the drawer's estates.⁵⁶ For payment to the billholders of the full amount of the securities will leave them free to prove against both estates for the unpaid balance of their claims,⁵⁷ at the same time depriving the other general creditors of the acceptor's estate of the benefit of the indemnity against these obligations for which the acceptor bargained. On the other hand, the billholders may have also received a preference over the other general creditors of the drawer's estate, to the extent, if any, that the amount paid to them out of the securities exceeds the amount that would have been paid to them as dividends from both estates. In *Royal Bank of Scotland v. Commercial Bank of Scotland*,⁵⁸ Lord Selborne therefore suggested that the "rule of *Ex parte Waring*" is practicable only in cases where the securities are in excess of the amount of the bills, and pointed out that *Ex parte Waring, Inglis, Clarke* was itself such a case. The first application of the rule to a situation in which the securities were less than the amount of the bills was in the case of *Powles v. Hargreaves*,⁵⁹ in 1853. The decision of the House of Lords in the *Royal Bank Case* was that, in so far as the extension of the rule in *Powles v. Hargreaves* "is a posi-

⁵⁵"If the proceeds of the security are more than enough to pay the bills the application of the rule makes no difference in the amount of the dividend payable to the creditors of the estate who at the time of the sequestration holds the bills, . . .; but the bill-holders receive 20s. in the pound on their bills, and are so much the better at the exclusive loss of the creditors of the other estate." Lord Blackburn, in *Royal Bank of Scotland v. Commercial Bank of Scotland*, (1882) L. R. 7 App. Cas. 366, 392.

⁵⁶See above, note 54.

⁵⁷See above, note 28.

⁵⁸(1882) L. R. 7 App. Cas. 366, 385-387.

⁵⁹(1853) 3 De Gex, MacNaughten and Gordon. 430.

tive rule of administration, and not the necessary result of equitable principles, it cannot be held to be of force in Scotland merely because it is so in England."⁶⁰

Where, the securities being less than the amount of the bills, it turns out that the acceptor's estate alone is able to pay to the billholders in dividends an amount in excess of the securities, it has been held that they will be remitted to their proof, and that the "rule of *Ex parte Waring*" becomes inapplicable.⁶¹ This is merely to hold that where the acceptor's right of indemnity out of the securities is thus readily ascertainable, and exceeds the amount of the securities, such right will receive preference in accordance with the indemnity agreement, and the securities therefore become general assets of the acceptor's estate. But the same result has been said to follow wherever, the securities being less than the amount of the bills, it turns out that the two estates together are able to pay to the billholders in dividends an amount in excess of the securities.⁶² As a general proposition, however, this is believed unduly to favor the general creditors of the acceptor's estate at the expense of the general creditors of the drawer's estate, to whatever extent the acceptor's estate has not

⁶⁰(1882) L. R. 7 App. Cas. 366, 387.

⁶¹In *re* Belfast Warehouse Co., [1897] 1 Ir. Rep. Ch. Div. 124, 133 (opinion by Vice-Chancellor Chatterton): "The assets of the Company have already paid over 1900 pounds to these bill-holders on foot of the guaranty for Carmichael's bills, and will immediately pay a like amount. These payments will exceed the amount of the proceeds of the mortgaged premises, and as the 3500 pounds was properly applicable in the first place to repay to the assets of the Company the sums paid on foot of Carmichael's bills guaranteed by them, that sum must now be dealt with as assets of the Company for the discharge of its liabilities, and I direct the liquidator to so apply it."

⁶²See *In re* Joint Stock Discount Co., (1868) L. R. 6 Eq. 491. The Joint Stock Discount Company had guaranteed 35,000 pounds in bills accepted by the Contract Corporation, and had taken from the latter an assignment of the securities that it held for the payment of the bills. Both companies being in process of winding up, the billholders, who had no notice of the securities, proved against both estates for the full amount of their claims, and thereby recovered £21,000 from the Joint Stock Discount Company, and £5,250 from the Contract Corporation. Thereafter the securities produced £23,500. It was held that the proceeds belonged entirely to the estate of the Joint Stock Discount Company, and were divisible among all its creditors, including the billholders, in dividends.

But it is believed that the above result cannot be justified as to the difference of 2,500 pounds between the proceeds of the securities and the amount of the Joint Stock Discount Company's original damnification, except to the extent that such excess would be absorbed by further damnification of the Joint Stock Discount Company through repeated dividends to the billholders, as under the Scottish rule, for which see below, pp. 336-338 of the text. The English court was not consciously applying the Scottish rule, however, but was purporting to introduce an entirely arbitrary exception to the "rule of *Ex parte Waring*."

in fact been damnified in the full extent of the securities. The English court was not consciously applying the Scottish rule, presently to be considered, under which, in similar circumstances, the extent of the surety's damnification would not be restricted to the amount of the dividends declared to the billholders from his other assets, but instead was purporting to introduce a purely arbitrary exception to the "rule of *Ex parte Waring*." The result, it is submitted, may become worse than that which the application of the rule to such a situation would produce—since the billholders, who would be favored by the application of the rule, are at least creditors of the drawer's estate, to which the securities in excess of the amount necessary to indemnify the acceptor's estate are supposed to belong, whereas the other general creditors of the acceptor may not normally be assumed to be creditors of both estates, as are the billholders. The smaller the contribution of the acceptor's estate to the dividends that from both estates exceed the amount of the securities, the greater becomes the prejudice to the general creditors of the drawer's estate, including the billholders, that may result from the non-application in this situation of the "rule of *Ex parte Waring*."

Such vagaries in the application of the "rule of *Ex parte Waring*," together with the possibilities of prejudice and unnatural devolution inherent in the rule itself, led the House of Lords in *Royal Bank of Scotland v. Commercial Bank of Scotland*⁶³ to sustain a different rule in its application to Scotland. In this case the Royal Bank was the holder of £16,000 of bills drawn by Ramsay and accepted by Saunders upon the security of goods belonging to Ramsay in Saunders' hands, which at the date of

⁶³(1882) L. R. 7 App. Cas. 366. Other cases also have expressed dissatisfaction with the "rule of *Ex parte Waring*." See the statement by Porter, M. R., in *In re Richview Brickworks Co., Ltd.*, [1897] 1 Ir. Rep. Ch. Div. 176, 183: "I confess for myself that with all the deference which a lawyer must feel for the considered view of so great a master as Lord Eldon, I have always been unable to see the necessity or the justice or even the expediency of any such rule as that in *Ex parte Waring* at all. The holder of the bills has by contract no right to the benefit of the security. That is conceded on all hands, and expressly recognized or decided by Lord Eldon in the leading case. He is, apart from bankruptcy (or its equivalent) simply an unsecured creditor. Why, when bankruptcy supervenes, he should be converted into a secured creditor, and so obtain a preference over other creditors equally meritorious with himself, it is hard to understand. No doubt the rule in question is simple and saves trouble in some cases. It seems, however, to be root and branch opposed to the principles now regarded in distributing the assets of bankrupt estates. It is the law, however, in England and in Ireland."

double bankruptcy amounted to approximately £4,000, the amount for which they were later sold. The Commercial Bank was the holder of approximately £10,000 of bills drawn by Saunders and accepted by Ramsay without security, and as such was resisting the appropriation of the proceeds of Ramsay's goods in Saunders' hands to the exclusive benefit of the Royal Bank. The Court of Session, rejecting the "rule of *Ex parte Waring*,"⁶⁴ proceeded upon the theory that Ramsay's goods in Saunders' hands were an asset of a peculiar nature in Saunders' estate, unavailable for dividends until damnification had occurred in the form of dividends already declared in favor of the billholders from the other assets of Saunders' estate, but thereupon ripening to that extent into an asset for general distribution.

In its application the Scottish rule proceeds by first declaring dividends from the acceptor's general assets not including the securities, in which dividends the billholders share as general creditors of the acceptor's estate. To the extent that the billholders share in such dividends, the securities become available for the declaration of a further dividend, in which the billholders again share as general creditors. The process is continued until either the securities are exhausted or the last possibility of damnification to the acceptor's estate has been eliminated, whichever occurs first. The elimination of risk to the acceptor's estate would in turn be accomplished at either of two points, whichever occurs first: (1) the point at which the billholders will have received payment in full in dividends from both estates; or (2) the point at which the other creditors of the acceptor's estate will have received in dividends an amount equal to that to which they would have been entitled out of the acceptor's separate assets without the competition of the billholders, which is all to which they are entitled by virtue of the indemnity agreement. The second point may be reached rather quickly in cases in which the acceptor's general assets are small.

Any excess of the securities remaining after either point is reached is of course restored to the drawer's estate. To the extent that by dividends paid to the billholders the acceptor's estate is damnified in excess of the amount of the securities, it of course retains an unsecured claim for reimbursement against the drawer's estate. Wherever, the securities being less than the amount

⁶⁴In affirming, the House of Lords was somewhat influenced by the fact that the securities involved were less than the amount of the bills. See above, p. 334 of the text.

of the bills, it turns out that the acceptor's estate alone will be able to pay in dividends to the billholders an amount in excess of the securities, it should follow, under the Scottish rule as much as under the "rule of *Ex parte Waring*," that the securities have become in all respects general assets of the acceptor's estate.⁶⁵ Conversely, where it would take the dividends to the billholders from both estates to equal the amount of the securities, that result would have no more basis under the Scottish rule than under the "rule of *Ex parte Waring*," except to the extent that the excess of the securities over the amount of the acceptor's damnification through dividends declared to the billholders from his other assets would be absorbed by the repetitive process of the Scottish rule.⁶⁶

The Scottish rule has received the strong approbation of at least one American commentator,⁶⁷ although it has acquired no following in this country. Accepting the hypothesis upon which both the Scottish rule and the "rule of *Ex parte Waring*" are based, namely, that no direct rights accrue by operation of law or equity to creditors in their sureties' securities, it would seem to follow that the Scottish rule accomplishes a more natural division of the securities, in fuller accord with the assumed intent of the parties, than does the "rule of *Ex parte Waring*," and that in a practical manner it resolves by lapse of time an impasse that the English courts apparently thought insoluble. Taking again as the premise of both rules that no direct rights would exist in the creditor in the absence of the forced administration of both estates, the only criticism that can be directed at the Scottish rule would seem to be that it does not accomplish the surety's exoneration—a purpose as much within the intent of the usual indemnity agreement as is his reimbursement.⁶⁸ To the extent of the realiza-

⁶⁵See above, p. 335 of the text.

⁶⁶See above, pp. 335-336 of the text, note 62.

⁶⁷See Williams, A Creditor's Right to His Surety's Securities, (1888) 1 Hary. L. Rev. 326, 337.

⁶⁸See Chambers v. Prewitt, (1898) 172 Ill. 615, 620, 50 N. E. 145, 146; Baltimore & O. R. Co. v. Trimble, (1878) 51 Md. 99, 113-114; O'Neill v. State Savings Bank, (1906) 34 Mont. 521, 87 Pac. 970, 971; Merchants & Manufacturers' Nat'l Bank v. Cumings, (1896) 149 N. Y. 360, 364-365, 44 N. E. 173, 174; Matthews v. Joyce, (1881) 85 N. C. 258, 266; Henderson-Achert Lithographic Co. v. John Shillito Co., (1901) 64 Ohio St. 236, 250, 60 N. E. 295, 297; Breedlove v. Stump, (1830) 3 Yerg. (Tenn.) 257, 263; Hauser v. King, (1882) 76 Va. 731, 733-734. That the securities are for the purpose of the surety's exoneration as well as his reimbursement is of course presupposed by the "rule of *Ex parte Waring*." See the cases cited in notes 22 and 50, above. That the purpose of the securities will be more strictly construed in favor of third-party indemnitors than in the

ble value of the securities the "rule of *Ex parte Waring*" does accomplish the purpose of the surety's exoneration—at the sacrifice, however, of his security for the right of reimbursement whenever the exhaustion of the securities leaves the surety's estate still liable for the deficiency. As between the two purposes of the securities, it should be obvious that the surety and his other creditors would much prefer that the purpose of exoneration be sacrificed, if either needs be sacrificed. The forced judicial administration of the estates of both the principal debtor and the surety frequently makes such a choice necessary. Still keeping in mind the premise upon which both rules are based, it would seem that the Scottish rule makes the sounder choice, and is preferable to the "rule of *Ex parte Waring*." Attention is turned in the next section to the American cases, which more or less articulately proceed upon a different premise, requiring a different rationalization.

II. THE AMERICAN CASES

The doctrine attributed to *Maure v. Harrison* was set forth in the first American edition of Bacon's New Abridgment of the Law,⁶⁹ published in 1811, and received its first American application from Chancellor Kent in the case of *Moses v. Murgatroyd*,⁷⁰ decided in 1814, a year before the decision in *Ex parte Waring, Inglis, Clarke* in England. In that case the defendant's testator had indorsed notes for one Ogden, and had subsequently received securities from Ogden as indemnity against his indorsements.⁷¹ The securities were not specifically found to have been appropriated to the payment of the principal debt as distinguished from the purpose of merely personal indemnity to the indorser.⁷² No such

case of securities provided by the principal debtor, see *O'Neill v. State Savings Bank and Henderson-Achert Lithographic Co. v. John Shillito Co.*, both cited above in this note.

⁶⁹5 Bacon, A New Abridgment of the Law, 1st Am. ed., Title Obligations, D (4).

⁷⁰(1814) 1 Johns. Ch. (N.Y.) 119.

⁷¹The securities had been given by way of absolute assignment, but parol evidence was admitted to show that they were intended for indemnity purposes only. For the extent to which other cases have admitted parol evidence to show the purpose of securities held by the surety, see below, text at notes 85-88 inclusive.

⁷²But see Scott, *The Creditor's Right to Subject the Securities of the Surety When They Purport to be for Indemnity Merely*, (1885) 19 Am. L. Rev. 867, 873, where the author bases a different interpretation of the case upon the testimony of witnesses set forth at 124-125 of 1 Johns. Ch., and upon the language of the court in denying a petition for rehearing at 476 of 1 Johns. Ch. In the opinion, however, at pp. 128-129 of 1 Johns. Ch., Chancellor Kent accepted the testimony of the witness Ogden that he had

distinction was suggested as being of significance. Nor did it appear that the defendant's testator was insolvent, and apparently no significance was attached by the chancellor to the fact of Ogden's insolvency. In holding that the note holders were entitled to have the securities applied for their benefit, Chancellor Kent cited *Maure v. Harrison* and added:

"These collateral securities are, in fact, trusts created for the better protection of the debt; and it is the duty of this court to see that they fulfil the design. And whether the plaintiffs were apprized, at the time, of the creation of this security, is not material. The trust was created for their benefit, or for the better security of their debt, and when it came to their knowledge, they were entitled to affirm the trust, and to enforce its performance."⁷³

It has been said that "It may be safely asserted that the whole doctrine of the creditor's equitable trust lien upon the securities given the surety for his indemnity had its foundation in *Moses v. Murgatroyd*."⁷⁴ Chancellor Kent gave still further currency to such a doctrine by stating in his Commentaries:

"Collateral securities given by a debtor to his surety, are considered as trusts for the better security of the creditor's debt; and chancery will see that their intention be fulfilled."⁷⁵

Story, on the other hand, states the proposition of *Maure v. Harrison* not so much as a trust principle as an aspect of the doctrines of subrogation and marshalling.⁷⁶ *Maure v. Harrison* has been cited without challenge or analytical discussion through fourteen successive editions of Story.

Upon either the trust or the subrogation theory, or upon a more

made the assignment "to indemnify S. Murgatroyd against the endorsement of the notes in question," . . . "for that specific purpose, and for no other," and prefaced the statement quoted below in the text with the finding "that the assignment . . . was intended, by the parties to it, to be a security only to the intestate for his endorsement of the notes in question."

⁷³(1814) 1 Johns. Ch. 119, 129.

⁷⁴Willard, *Right of a Creditor to his Sureties' Securities*, (1880) 14 Am. L. Rev. 839, 845.

⁷⁵Kent, *Commentaries on American Law*, 1st ed., 307; 8th ed., 321-322; 12th ed. by O. W. Holmes, Jr., 308.

⁷⁶2 Story, *Commentaries on Equity Jurisprudence*, 14th ed., 123 (in section on subrogation): "On the other hand if a surety has a counter bond or security from the principal, the creditor will be entitled to the benefit of it, and may in equity reach such security to satisfy his debt;" 2 Story, *Commentaries on Equity Jurisprudence*, 14th ed., 240 (in section on marshalling): "And on the other hand if the principal has given any securities or other pledges to his surety, the creditor is entitled to all the benefit of such securities or pledges in the hands of the surety, to be applied in payment of his debt." Both quotations are in the original text of Story. See also Story, *Commentaries on the Law of Promissory Notes*, 4th ed., 337-338.

general appeal to the requirements of natural equity judicially interpreted, the American cases are unanimous in according to creditors certain rights, at least under some circumstances, in their sureties' securities. The conditioning circumstances and extent of such rights depend to a very considerable extent upon the theory applied.

A. *Where the Securities Are for the Payment of the Principal Debt.*—According to one commentator a source of much confusion in the American cases has been “the neglect of a clear distinction between securities given directly for the payment of the debt, and those given purely for the indemnity of the surety, with the consequent uncertainty as to the rights or obligations derived from these respectively; . . . because exactly similar instruments have been regarded by different courts as falling under each of these classes.”⁷⁷

But assuming for the time being that the securities in question are found to have been deposited with the surety for the express purpose of payment of the principal obligation, the American cases are practically unanimous both in according the maximum rights in the securities to the creditor, and in placing the result upon Chancellor Kent's trust theory.⁷⁸ To the extent that in such cases the courts have also used the language of subrogation, it has not affected the result achieved. In a few such cases the trust result has been reached in third-party-beneficiary contractual language.⁷⁹ In emphasizing the importance of the securities having

⁷⁷Willard, *Right of a Creditor to His Sureties' Securities*, (1880) 14 Am. L. Rev. 839, 840.

⁷⁸*Magill v. Brown*, (1899) 20 Tex. Civ. App. 662, 674, 50 S. W. 143, 149: “. . . there appears to be practical unanimity of authority upon the proposition that when the principal debtor has provided a fund in the hands or subject to the control of the surety for the payment of the debt, . . . the creditor can claim the benefit of such contract, foreclose the lien thereby created, and have the property applied to the payment of his debt. Property thus placed under the control of the surety is impressed with a trust in favor of the creditor; . . .”; *Morrill v. Morrill*, (1880) 53 Vt. 74, 80, 38 Am. Rep. 659, 660; “Where it is given as security for the debt as well as indemnity, there would seem to be little doubt that the creditor, whether cognizant of the assignment and its purpose or not at the time of the assignment, could, when it came to his knowledge, avail himself of it as effectually, on maturity of his debt, as he could, had it been assigned to him directly” (but the court here reached the same result in the case of merely indemnifying securities); *Johnson v. Martin*, (1915) 83 Wash. 364, 368, 145 Pac. 429, 430: “The only thing standing in the way of the due execution of the contract is a competent trustee. It is a primary rule that equity will not permit a trust to fail for the want of a trustee.”

⁷⁹See *Continental State Bank of Beckville v. Reed*, (Tex. Civ. App., 1926) 284 S. W. 265, 267, reversed, in favor of the creditor, in *Reed v. Continental State Bank of Beckville*, (Tex., 1928) 2 S. W. (2d) 426: “When a deposit is made with the surety on an obligation for the express purpose of securing the same, as well as the surety, the creditor holding

been specifically appropriated to the payment of the principal obligation, as distinguished from the more restricted purpose of merely personal indemnity to the surety, the courts for the most part have assumed that the question is entirely one of the intent of the parties to the security agreement. According to Dean Arant, "That an interest in the creditor should be recognized, when the security is given for the expressed purpose of paying the debt due him, is not questionable."⁸⁰

In determining whether the securities have been specifically appropriated to the payment of the principal obligation, as distinguished from the more restricted purpose of merely personal indemnity to the surety, the courts will look to all the terms of the security instrument.⁸¹ Whether there can be said to be a

such obligation has upon acceptance a contractual right to have it so applied." In Louisiana the giving of securities to the surety for the payment of the principal debt is said to be in the nature of a "stipulation pour autrui" in favor of the creditor, see *King v. Harman's Heirs*, (1834) 6 La. 607, 618, 26 Am. Dec. 485, 487. To the extent that a trust for the creditor's benefit in securities held by the surety for the payment of the principal debt is recognized in Mississippi, it is placed upon a rather strict contractual basis, see *Osborn v. Noble*, (1872) 46 Miss. 449, 454; but in *Carpenter v. Bowen*, (1868) 42 Miss. 28, a result was reached that is entirely inconsistent with a contractual basis of the creditor's right. In that case the creditor was seeking to levy execution against the principal debtor's equity of redemption in property mortgaged by him to the surety for the payment of the debt. The court refused to allow him to do so, holding at 42 Miss. 53-54 that "To allow a sale of the equity of redemption upon legal process, emanating from a judgment for the debt secured by mortgage or deed of trust, would be in contravention of the *contract of the parties*, as understood in a court of equity, by which the debtor had a right to redeem. And the court will not allow him to be deprived of that right in this summary way. . . . If the creditor is not satisfied with his security, he may resort to other property of his debtor; but against the estate on which he has taken a security, he ought not to act, but upon the footing of that security, and according to its terms, in their established sense." But since the creditor did not control or in any way participate in the taking of the security by the surety, it is rather hard to justify the result reached by the court on contractual grounds, as it apparently sought to do. No other cases upholding the creditor's right upon the trust principle go so far as to preclude his disaffirmance of it.

⁸⁰Arant, *Handbook of the Law of Suretyship and Guaranty* 371.

⁸¹*King v. Harman's Heirs*, (1834) 6 La. 607, 617-618, 26 Am. Dec. 485, 486-487; *Osborn v. Noble*, (1872) 46 Miss. 449, 454; *Cooper v. Middleton*, (1886) 94 N. C. 86, 95.

In *Forrest's Executors v. Luddington*, (1880) 68 Ala. 1, 6, 14, the security had been taken by the state of Alabama against its guaranty of railroad bonds, and in holding a trust for the creditors' benefit to have arisen the court looked also to the terms of the statute requiring the taking of the security, which provided that it should stand "for the payment of all of said bonds indorsed for the company as provided in this act, and for the interest accruing on said bonds." The court recognized that had the state exercised its own rights by taking possession of the security, the relief asked by the creditors would have been impossible, so long as the state was not and could not be made a party. But the state had disclaimed

presumption of intent one way or the other is doubtful. In *Chambers v. Prewitt*,⁸² the supreme court of Illinois stressed the absence of words expressly limiting the purpose of the securities to the surety's personal indemnity as a factor of significance in construing them to have been given for the payment of the principal obligation; but in *Osborn v. Noble*,⁸³ the supreme court of Mississippi asserted the stricter and—if the question is entirely one of the intent of the parties to the security agreement—more logical rule that

“Where the conveyance is made to or for the security [surety?] of property not by the terms of the instrument specifically bound to the creditor, the primary intent apparent on the face of the writing is that the property is not pledged to him for the debt.”⁸⁴

Parol evidence is held to be admissible to show a deed to the surety, absolute on its face, to have been intended nevertheless for the security of a particular debt for which the surety was liable on behalf of the principal debtor;⁸⁵ to show that the securities were

all liability upon the bonds and all interest in the security, and the court held that “Not asserting any rights, and disclaiming all liability, does not revoke, or extinguish, or destroy the trust fastened by the statute for the payment of the bonds. The failure or refusal of the state to execute, or aid in the execution of the trust, is only an additional reason for the interference of a court of equity, which will not suffer trusts to fail for the want of a trustee to execute them, or because the trustee refuses to recognize them. When a state has rights and interests commingled with the rights and interests of individuals, and cannot be made a party to a litigation springing out of them, the jurisdiction of courts is not suspended. If, as in the present case, no decree or judgment is sought against the state, the freedom from suit attaching to her sovereignty is a sufficient reason for dispensing with her presence.” But compare *Branch v. Macon & B. R. Co.*, (C.C. S.D. Ga., 1875) 2 Woods 385, Fed. Cas. No. 1808, in which the federal court was influenced to refuse relief to the creditors upon somewhat similar facts, for the reason that the surety was the state of Georgia, beyond the jurisdiction of the court.

⁸²(1898) 172 Ill. 615, 623, 50 N. E. 145, 147. See also *Forrest's Executors v. Luddington*, (1880) 68 Ala. 1, 12.

⁸³(1872) 46 Miss. 449, 454.

⁸⁴At 46 Miss. 454, 458, the court continued: “The owner has a right (if he does no fraud, or violates no prohibition of law) to dispose of his property at pleasure. Courts enforce contracts, or give redress for the violation of them, as made by the parties. By construction, they cannot enlarge them beyond their fair intent and meaning, nor, on the other hand, so limit them as to fall short of that. . . . The decisions in this court have, with more clearness than elsewhere, observed the distinction between a security given to a surety, to save him against loss from being compelled to pay, or doing so voluntarily, and those which, while providing for that, affix to the property a trust for the payment of the debt, in such wise as that it is designed to be also a security for the debt.”

⁸⁵*Moses v. Murgatroyd*, (1814) 1 Johns. Ch. (N.Y.) 119, 128; *Seibert v. True*, (1871) 8 Kan. 52, 60. This is of course entirely in accord with a familiar exception to the parol evidence rule. See 4 Wigmore, Evidence, 3435-3437.

given for the payment of the principal debt as distinguished from merely personal indemnity to the surety;⁸⁶ and to show which creditors are entitled to share in the proceeds of the securities;⁸⁷ but not, according to the court of civil appeals of Texas, so as to vitiate the trust effect of an instrument construed on its face to have been given for the payment of the principal debt.⁸⁸

Where the securities have not by clear language been specifically appropriated to the payment of the principal debt, the chief factors that the courts have emphasized in finding nevertheless that this was their purpose rather than merely personal indemnity to the surety, are (1) the fact that the security instrument is conditioned upon the payment by the principal debtor of the principal obligation at its maturity;⁸⁹ or (2) that it is conditioned to be void

⁸⁶*Chambers v. Prewitt*, (1898) 172 Ill. 615, 621-622, 50 N. E. 145, 147; *Dowell v. Woodsides*, (1894) 16 Ky. L. Rep. 325, 27 S. W. 853; *Albion State Bank v. Knickerbocker*, (1900) 125 Mich. 311, 315-316, 84 N. W. 311, 312-313.

⁸⁷*Albion State Bank v. Knickerbocker*, (1900) 125 Mich. 311, 315-316, 84 N. W. 311, 312-313. In this case the written instrument provided "that this mortgage is given to the said party of the second part to indemnify and secure him against all notes and obligations made by said William B. Knickerbocker, and indorsed by said party of the second part or signed by him, as accommodation maker or otherwise, . . . such notes and obligations amounting to said sum of \$31,500." The surety was in fact liable for the principal debtor upon notes totalling \$48,500. Parol evidence was permitted not only to show that the security was intended for the payment of the notes, but also to show that it was intended for the payment of three particular notes, totalling \$31,500, of which the complainants' was one. See also *Seibert v. True*, (1871) 8 Kan. 52, 60; *Chambers v. Prewitt*, (1898) 172 Ill. 615, 623, 50 N. E. 145, 147.

⁸⁸*Magill v. Brown*, (1899) 20 Tex. Civ. App. 662, 675, 50 S. W. 143, 150: "The purpose to provide a fund for the payment of appellees' debt being clearly shown by the certain and unambiguous terms of the trust deed executed June 6, 1894, parol evidence was not admissible to show that the intention of the parties was otherwise; . . ." The "clear and unambiguous terms" of the security instrument had authorized the sale by the surety of the security "for the purpose, among others, of paying appellees' debt." But in *Morrill v. Morrill*, (1880) 53 Vt. 74, 79, 38 Am. Rep. 659, the court said that "The true character of this mortgage may be shown, notwithstanding it purports to be given as security for a promissory note. It may be shown that it was given for indemnity only." The court refused, however, to attribute any legal significance to the distinction.

⁸⁹*Durham v. Craig*, (1881) 79 Ind. 117, 121: "Where property is mortgaged to a surety, and the condition of the mortgage is that the mortgagor will pay the note which the surety has signed and indemnify the surety, the mortgage and mortgaged property are held in trust for the creditor and for the payment of the debt, and the creditor has a right in equity to have the property applied to the payment of the debt." See also *Forrest's Executors v. Luddington*, (1880) 68 Ala. 1, 12-13; *Daniel v. Hunt*, (1884) 77 Ala. 567, 570; *Eastman v. Foster*, (1844) 8 Metc. (Mass.) 19, 23; *Demott v. Stockton Paper Ware Mfg. Co.*, (1880) 32 N. J. Eq. 124, 131; *People v. Metropolitan Surety Co.*, (1911) 148 App. Div. 503, 132 N. Y. S. 829, 831; *Paris v. Hulet*, (1854) 26 Vt. 308, 312.

But compare *First Congregational Society in Becket v. Snow*, (1848) 1

upon payment by him;⁹⁰ or (3) that it contains an express agreement by him to perform the principal obligation;⁹¹ or (4) the fact that the securities have been expressed to be for the exoneration of the surety as well as his reimbursement;⁹² or (5) what amounts to the same thing, the existence in the surety of a power of sale or other power to realize upon the securities upon nonpayment by the principal debtor of the principal obligation at its maturity, in advance of actual payment by the surety;⁹³ or (6)

Cush. (Mass.) 510, 518; *Bibb v. Martin*, (1850) 14 Smedes & Marshall (Miss.) 87; *Miller & Stiger v. Wack*, (1831) 1 N. J. Eq. 204, 208.

⁹⁰*Carpenter v. Bowen*, (1868) 42 Miss. 28, 54: "The conveyance was intended not only to indemnify Lum against his liabilities as surety for Forbes, but manifestly to secure the payment of the debts therein specified. It was to be void on the condition that the notes and liabilities therein mentioned were paid at maturity, otherwise not." See also *Durham v. Craig*, (1881) 79 Ind. 117, 120-121; *Plaut v. Storey*, (1891) 131 Ind. 46, 48, 30 N. E. 886-887; *Moore v. Moberly*, (1847) 7 B. Mon. (Ky.) 299, 300-301; *Cooper v. Middleton*, (1886) 94 N. C. 86, 94-95; *Saylors v. Saylors*, (1871) 3 Heisk. (Tenn.) 525, 530; *Brown & Heywood Co. v. Ligon*, (C. C. Mo. 1899) 92 Fed. 851, 855-856.

But compare *Dyer v. Jacoway*, (1905) 76 Ark. 171, 88 S. W. 901; *Jones v. The Quinnipiack Bank*, (1860) 29 Conn. 25; *Thompson v. White*, (1881) 48 Conn. 509; *Bibb v. Martin*, (1850) 14 Smedes & Marshall (Miss.) 87; *Bush v. Stamps*, (1853) 26 Miss. 463; *Pool v. Doster*, (1881) 59 Miss. 258; *Fagan v. Thompson*, (C. C. Mo. 1889) 38 Fed. 467.

⁹¹*Griffis v. First Nat'l Bank of Connersville*, (1907) 168 Ind. 546, 552, 81 N. E. 490, 492: "The general rule with respect to indemnity mortgages is that, where the instrument contains a promise to pay the obligations for which the mortgagee is liable as surety, the mortgage creates a trust, and an equitable lien for the full benefit of the principal creditor." See also *Durham v. Craig*, (1881) 79 Ind. 117, 121-122.

⁹²*Merchants & Manufacturers' Nat'l Bank v. Cumings*, (1896) 149 N. Y. 360, 364-365, 44 N. E. 173, 174: "It turns upon a distinction between a contract to indemnify against liability, and a contract to indemnify against damage resulting from a liability. . . . mere liability, without more, is not damage within the distinction mentioned." In this case John Cumings had indorsed the note of Joseph Cumings and had taken "as collateral security for his indorsement" a note of Joseph Cumings indorsed by Ira Cumings, in the same amount and payable on the same day as the first note. The second note was held to be for the exoneration of John Cumings against all liability on the first note, for the following reasons: (1) that John Cumings had refused to assume liability on the first note until the second was given; (2) that the second was payable on the same day as the first, in the same amount; and (3) that the second note recited it was given as collateral security for the indorsement of the first. The holder of the first note was therefore held to be entitled to enforce the second for its own benefit, although John Cumings had as yet paid nothing on the first.

⁹³*Smith v. Gillam*, (1886) 80 Ala. 296, 299: "The nature of this security does not admit of any doubt. It is not only one of indemnity to the surety, but it was given to secure the debt. It provides that the mortgagee may sell the lands conveyed in the event of the mortgagor's failure or refusal to pay the mortgage debt. A trust fund was thus created for the payment of the debt, to the benefit of which the creditor was entitled, by way of subrogation, whether the surety was actually damnified or not." See also *Ohio Life Ins. & Trust Co. v. Ledyard*, (1846) 8 Ala. 866, 872; *Branch*

the specification in the security instrument of the particular debt on which, or creditor to whom, the surety is liable on behalf of the principal debtor.⁹⁴

It is believed that the emphasis upon such provisions of the security instrument as indicative of intent is but reasoning by fiction toward a result desired by the courts from other motives.⁹⁵

Bank at Mobile v. Robertson, (1851) 19 Ala. 798, 801-802; Cullum v. Branch Bank at Mobile, (1853) 23 Ala. 797, 799-800; Daniel v. Hunt, (1884) 77 Ala. 567, 570; Cooper v. Middleton, (1886) 94 N. C. 86, 94-95; Magill v. Brown, (1899) 20 Tex. Civ. App. 662, 675, 50 S. W. 143, 150.

But compare Bush v. Stamps, (1853) 26 Miss. 463; Osborn v. Noble, (1872) 46 Miss. 449; Clay v. Freeman, (1896) 74 Miss. 816, 20 So. 871; Williams v. Gallick, (1884) 11 Or. 337, 3 Pac. 469; Branch v. Macon & B. R. Co., (C.C. Ga. 1875) 2 Woods 385, Fed. Cas. No. 1,808.

⁹⁴In *Ten Eyck & Brinckerhoff v. Holmes*, (1846) 3 Sandf. Ch. (N.Y.) 428, 430, complainants held the notes of one Wilber, indorsed by Holmes. They secured a judgment therefor against Holmes, who thereafter, having also a demand of his own against Wilber for \$857, obtained from him a bond and mortgage for \$1,350, "of which \$500 was inserted to secure him on his indorsement of the above notes, and \$850 for his own demand." Holmes assigned the mortgage for the benefit of his own creditors. Complainants were held entitled to priority out of the proceeds of the mortgaged property, the court finding that "the terms of payment, placing the \$500 first in order, leads to the inference that the parties actually had in view, the effect which the law attaches to the transaction, viz.: the discharge of the complainants' debt out of the first moneys received on the mortgage."

But compare *First Congregational Society in Becket v. Snow*, (1848) 1 Cush. (Mass.) 510, 518, where Adams, who owed Snow \$71 and the plaintiff \$329 for which Snow was surety, gave to Snow a mortgage conditioned "that Adams should pay the note for \$329, on which Snow was surety, to the plaintiffs, and the note for \$71, to Snow." The court held: "Certainly there was no express trust; it was a mortgage from Adams to Snow to secure him a debt of \$71, and to indemnify him against his liability as surety on the note, in virtue of which the complainants now seek to charge the land. Such a trust is not necessarily implied from the fact of giving the mortgage, and it is expressly denied by the answer. . . . How can anybody, having a mere equitable lien or claim, take the property out of the hands of one who has an equity, accompanied by the legal title, in any other mode than by redeeming?"

⁹⁵But see *Scott, The Creditor's Right to Subject the Securities of the Surety When They Purport to be for Indemnity Merely*, (1885) 19 Am. L. Rev. 867, 869-870: "When the instrument of indemnity is conditioned that the maker of the indemnity shall pay the debt, and in every way save the surety from all trouble and expense; or that the debt is to be paid out of the proceeds; or that the indemnity is to be void in case the maker pays the debt, and if he fails that the indemnity shall be enforced; we think the better doctrine is that the intent to secure the debt itself should be held to exist, even although the only expressed purpose be the personal protection of the surety."

In *Eastman v. Foster*, (1844) 8 Metc. (Mass.) 19, 28-29, one of the cases finding a trust for the creditor's benefit on the basis of the securities being conditioned for the payment of the principal debt, the court expressly emphasized, however, that "The original and primary object of taking the securities was to indemnify the surety;" and for that reason the court protected the surety to the extent of giving priority out of the proceeds of the securities to the only note upon which the surety was still liable, the period of limitations having run in his favor upon all the others.

For without such express provisions of the first two types mentioned above, and under a security instrument restricted in the clearest terms to the surety's indemnification, the right of the surety to realize upon the securities is ordinarily subject to the condition precedent of the nonpayment by the principal debtor of the principal obligation at its maturity, and to the resolutive condition of payment by him, in which event the surety's legal title to the securities will become at least voidable. Nor does the principal debtor's promise in the security instrument to perform the principal obligation add anything to the liability which by hypothesis he has already incurred.

Furthermore, since the obligation already incurred by the principal debtor includes by legal implication the surety's exoneration, except as specifically negated by the contract between them, it follows that even in the absence of express provisions of the fourth and fifth types mentioned above, securities furnished to the surety by the principal debtor will normally be construed to have been given for the surety's exoneration as well as his reimbursement, so that he may realize upon them as soon as he has been damnified by his liability having become absolute through the nonpayment by the principal debtor of the principal obligation at its maturity, and may use the proceeds to pay the creditor.⁹⁸ Finally, the specification in the security instrument of the particular debt on which, or creditor to whom, the surety is liable on behalf

⁹⁸O'Neill v. State Savings Bank, (1906) 34 Mont. 521, 87 Pac. 970, 971: "The rule rests upon the principle of natural equity, which requires that property, in whatever form it may be, of him who is primarily liable for the payment of the debt shall be applied to the payment of the debt to the exoneration of one who is only secondarily liable." See also Chambers v. Prewitt, (1898) 172 Ill. 615, 620, 50 N. E. 145, 146; Baltimore & O. R. Co. v. Trimble, (1878) 51 Md. 99, 113-114; Merchants & Manufacturers' Nat'l Bank v. Cumings, (1896) 149 N. Y. 360, 364-365, 44 N. E. 173, 174; Matthews v. Joyce, (1881) 85 N. C. 258, 266; Henderson-Achert Lithographic Co. v. John Shillito Co., (1901) 64 Ohio St. 236, 250, 60 N. E. 295, 297; Breedlove v. Stump, (1830) 3 Yerg. (Tenn.) 257, 263; Hauser v. King, (1882) 76 Va. 731, 733-734. Since the surety's right of exoneration arises by legal implication, even in the absence of an express provision therefor, it ought to follow that the indemnifying securities, the same as all other property of the principal debtor, may be made to answer that purpose, except to the extent that the right of exoneration is entirely precluded by the contract between the parties. But since the surety's right of exoneration from a third-party indemnitor does not arise by legal implication, the purpose of indemnifying securities will naturally be construed more strictly in favor of third-party indemnitors than in the case of securities provided by the principal debtor. See O'Neill v. State Savings Bank and Henderson-Achert Lithographic Co. v. John Shillito Co., both cited above in this note; and see also Clay v. Freeman, (1896) 74 Miss. 816, 20 So. 871; Hasbrouck v. Carr, (1914) 19 N. M. 586, 145 Pac. 133; Morgan v. Francklyn and Butler, (1873) 55 How. Pr. (N.Y.) 244.

of the principal debtor is in no way to be deemed an expression of intent inconsistent with the securities being restricted in their purpose to the surety's personal indemnification; for it is but perfectly natural that the security instrument should in every case specify with particularity that against which the surety is indemnified.

The fictitious character of these factors upon which so many American courts have found an intent specifically to appropriate the securities to the payment of the principal indebtedness will become of further significance in discussing the cases that reach the trust result even in the absence of such factors.⁹⁷ The two groups of cases are thus brought onto more common ground in respect of their need of a proper rationale for the common result achieved by both.

Once the securities are found, however, on the basis of whatever factors are thought by the courts to be indicative of intent, to have been specifically appropriated to the payment of the principal obligation, their trust effect is held not to be vitiated by the fact that they may also have been expressed to be for indemnity purposes.⁹⁸ And once a trust for the creditor's benefit is therefore held to have arisen, on the basis of the intent of the parties to the security agreement, it ought logically to have the following consequences, not all of which, however, are carried out to their full extent by the courts in applying the trust principle.

It should follow, and is generally held to follow, that the creditor need not have known beforehand of the existence of the securities, nor relied upon them, his acceptance of the trust for his benefit being presumed or at least sufficiently evidenced by his mere filing of suit:⁹⁹ that the prior exhaustion of his legal

⁹⁷See the discussion below, beginning at p. 370 of the text.

⁹⁸*Brogan v. Ferguson*, (1931) 101 Fla. 1311, 1317, 133 So. 317, 320 (on rehearing); *Griffis v. First Nat'l Bank of Connersville*, (1907) 168 Ind. 546, 552, 81 N. E. 490, 492; *Loehr v. Colborn*, (1883) 92 Ind. 24, 25-26; *Union Nat'l Bank v. Rasch*, (1895) 106 Mich. 319, 64 N. W. 339, 341.

But compare the facts and result in *Burnett v. Gainesville Nat'l Bank*, (1922) 28 Ga. App. 255, 110 S. E. 753; and the statement in *Pool v. Doster*, (1881) 59 Miss. 258, 263: "And even if the security is conditioned for the payment of the debt, but stipulates for its enforcement in a specified contingency, it will be held to be a mere indemnity to the surety, and only enforceable as such according to its terms."

⁹⁹*Forrest's Executors v. Luddington*, (1880) 68 Ala. 1, 12; *Plaut v. Storey*, (1891) 131 Ind. 46, 49, 30 N. E. 886, 887; *Seibert v. True*, (1871) 8 Kan. 52, 63; *Demott v. Stockton Paper Ware Mfg. Co.*, (1880) 32 N. J. Eq. 124, 131; *Curtis v. Tyler & Allen*, (1842) 9 Paige Ch. (N.Y.) 432, 435-436; *Moses v. Murgatroyd*, (1814) 1 Johns. Ch. (N.Y.) 119, 129; *Rice's Appeal*, (1875) 79 Pa. St. 168, 206; *Kramer & Rahm's Appeal*, (1860) 37 Pa. St. 71, 77; *Johnson v. Martin*, (1915) 83 Wash. 364, 145 Pac. 429, 432; *Magill v. Brown*, (1899) 20 Tex. Civ. App. 662, 676, 50 S. W. 143, 151.

remedies upon the principal obligation is not an essential prerequisite to his remedy in equity against the securities;¹⁰⁰ and that the securities follow the principal obligation without separate assignment,¹⁰¹ and include all renewal notes evidencing the same.¹⁰²

It should follow that the interest of the surety in the securities is subordinated to that of the creditor,¹⁰³ who is the "real party in interest."¹⁰⁴ It has therefore been held that a surety who has partially paid the creditor is not entitled to share in the proceeds of the securities until the creditor has received payment in full.¹⁰⁵ But some courts, although purporting to apply the trust principle, have nevertheless held that to whatever extent payment has already been made by the surety, he is "entitled to occupy the place and enjoy the right of the particular creditor, receiving his pro rata share of the indemnity."¹⁰⁶ In the absence of an expressed intention otherwise, all creditors whose debts are secured in this manner share ratably in the proceeds of the securities;¹⁰⁷ and the

¹⁰⁰*Daniel v. Hunt*, (1884) 77 Ala. 567, 570; *Saffold v. Wade's Executors*, (1874) 51 Ala. 214, 218-219; *Demott v. Stockton Paper Ware Mfg. Co.*, (1880) 32 N. J. Eq. 124, 131.

¹⁰¹*Arnett v. Salyersville Nat'l Bank*, (1931) 242 Ky. 216, 219, 46 S. W. (2d) 124, 126; *Boyd v. Parker & Co.*, (1875) 43 Md. 182, 198; *Haven v. Foley & Papin*, (1854) 19 Mo. 632, 636; *Curtis v. Tyler & Allen*, (1842) 9 Paige Ch. (N.Y.) 432, 435-436.

¹⁰²*Cullum v. Branch Bank at Mobile*, (1853) 23 Ala. 797, 800.

¹⁰³*Ferrell-Michael Abstract & Title Co. v. McCormac*, (Tex. Civ. App., 1915) 184 S. W. 1081, 1084; *Belcher v. The Hartford Bank*, (1843) 15 Conn. 381, 383; *Seibert v. True*, (1871) 8 Kan. 52, 64; *Ten Eyck & Brinckerhoff v. Holmes*, (1846) 3 Sandf. Ch. (N.Y.) 428, 430.

¹⁰⁴*Arnett v. Salyersville Nat'l Bank*, (1931) 242 Ky. 216, 219, 46 S. W. (2d) 124, 126.

¹⁰⁵*Kelly v. Herrick*, (1881) 131 Mass. 373.

¹⁰⁶*Moore v. Moberly*, (1847) 7 B. Mon. (Ky.) 299, 301-302. See also *Branch Bank at Mobile v. Robertson*, (1851) 19 Ala. 798, 802; *Roberts v. Colvin*, (1846) 3 Gratt. (Va.) 358, 364.

¹⁰⁷*Saffold v. Wade's Executors*, (1874) 51 Ala. 214, 218-219; *Branch Bank at Mobile v. Robertson*, (1851) 19 Ala. 798, 802; *Moore v. Moberly*, (1847) 7 B. Mon. (Ky.) 299, 301-302; *Kramer & Rahm's Appeal*, (1860) 37 Pa. St. 71, 77; *First Nat'l Bank of Bellville v. Wheeler*, (Tex. Civ. App., 1897) 41 S. W. 376, 377; *Hausser v. King*, (1882) 76 Va. 731, 735.

In *Courier-Journal Job-Printing Co. v. Schaefer-Meyer Brewing Co.*, (C.C.A. 6th Cir. 1900) 101 Fed. 699, an agreement had been executed whereby certain persons agreed to be sureties for the brewing company for a four-year period upon any indebtedness that it might incur up to a total amount of \$25,000, the brewing company giving to them a mortgage, in the amount of \$25,000, conditioned upon its payment of the principal indebtedness. The sureties in fact signed notes for the brewing company in a total amount of \$35,000. The lower court held that the note-holders should share in the proceeds of the security in the order in which they acquired their claims, which left the petitioner out, since he fell within the final \$10,000 of the indebtedness incurred. In reversing such ruling the circuit court of appeals, composed of Taft, Lurton, and Day, JJ., stated through Lurton, J., at 101 Fed. 705-706: "We have, however, concluded that every debt indorsed by one or more of the mortgagees, within the time limit of the mortgage, is

same principle of ratable equality ought to apply in behalf of the surety himself wherever a separate claim of his own against the principal debtor is secured along with the one for which he is surety.¹⁰⁸

It should follow that the surety cannot at any time, without the concurrence of the creditor, release the securities to the principal debtor, or, with or without the concurrence of the principal debtor, otherwise dispose of them to any other purpose than the payment of the principal obligation, except to bona fide purchasers for value of the legal title;¹⁰⁹ that the acquisition by the surety of

entitled to share equally in the distribution of the indemnity provided by the mortgage. The mortgagor did not intend to secure any particular indorsements. . . . When the creditors holding such paper came to secure the appropriation of the collateral deposited by the debtor with the surety, justice is best obtained by equality of right. . . . Any creditor coming with a debt made within four years after the date of the mortgage, and secured by one or more of the mortgagees, is within the restrictions of the mortgage and within its equity." See also *Albion State Bank v. Knickerbocker*, (1900) 125 Mich. 311, 315-316, 84 N. W. 311, 312-313, the facts of which have been stated in note 87, above.

¹⁰⁸*Haggarty v. Pittman*, (1828) 1 Paige Ch. (N.Y.) 297, 299, 19 Am. Dec. 434, 435: "But the defendant, Pittman [the surety], is not required to pay over the money actually collected by him under the assignment, except so far as it exceeds the amount of his own debt." See also *Roberts v. Colvin*, (1846) 3 Gratt. (Va.) 358, 364.

But compare the opposing results reached in *Ten Eyck & Brinckerhoff v. Holmes*, (1846) 3 Sandf. Ch. (N.Y.) 428, 430, and *First Congregational Society in Becket v. Snow*, (1848) 1 Cush. (Mass.) 510, 518; for which see note 94, above. Also compare the result reached in *Eastman v. Foster*, (1844) 8 Metc. (Mass.) 19, 28-29, for which see note 95, above.

¹⁰⁹*Dyer v. Jacoway*, (1905) 76 Ark. 171, 176, 88 S. W. 901, 902: "If the conveyances are made to the surety for the purpose of securing the payment of the debt, the creditor has an interest therein which the surety cannot destroy" (dictum); *Durham v. Craig*, (1881) 79 Ind. 117, 121-122 ("after acceptance by the creditor the surety cannot satisfy it, release it or otherwise dispose of it, without the consent of the creditor"); *McCracken v. German Fire Ins. Co.*, (1876) 43 Md. 471, 477: "The release of the mortgage by the association, as his trustee, without the payment of the debt, was a breach of trust, totally unauthorized, and did not destroy his lien on the property;" *Osborn v. Noble*, (1872) 46 Miss. 449, 455: "The fund or property at once takes on a trust character, and the surety can do no act which will discharge the trust or release the property from the burden, to the prejudice of the creditor" (dictum); *Logan v. Mitchell*, (1878) 67 Mo. 524, 528: ". . . if the securities are originally taken, not only to indemnify the sureties but to secure the creditor, any action of theirs would be powerless to affect him" (dictum); *Magill v. Brown*, (1899) 20 Tex. Civ. App. 662, 676, 50 S. W. 143, 151: ". . . whatever may have been the rights of the Snyders and Magill to change the terms of the contract prior to such acceptance by Brown Bros., they could not thereafter without the latter's consent, so change it as to affect their rights."

Upon the hypothesis of a trust for the creditor's benefit having been expressly intended, it is difficult to understand why the surety should have any greater power to release the securities prior to the creditor's acceptance, as seems to be the inference of the language of the Indiana and Texas cases quoted above, unless the creditor's non-acceptance with knowledge

the principal debtor's equity of redemption in the securities does not merge and thereby destroy the creditor's rights therein;¹¹⁰ and that a recording of the security instrument, unless it be in the form of a deed absolute, charges purchasers with notice of the rights of the creditor thereunder.¹¹¹

It should follow that it is not an essential prerequisite to the enforcement of the creditor's rights in the securities that the surety have been damnified,¹¹² or even that he be liable upon the principal obligation. Logically, if the question be entirely one of the intent of the parties to the security agreement, the specific appropriation of the securities to the payment of the principal obligation may produce the trust result wherever the securities have been given to the surety by a third person not a party to the principal obligation, with as much reason as though they had been given to him by the principal debtor.¹¹³ But the courts have been less

should be held to constitute an implied disclaimer by him of the trust for his benefit.

Supporting the statement in the text see also: *Whitehead v. Henderson*, (1899) 67 Ark. 200, 56 S. W. 1065; *Loehr v. Colborn*, (1883) 92 Ind. 24, 30; *Thornberry v. Thixton*, (1883) 4 Ky. L. Rep. 825; *In re Ellington Planting Co.*, (1912) 131 La. 653, 60 So. 25, 27; *Boyd v. Parker & Co.*, (1875) 43 Md. 182, 198-199; *Owens v. Miller & Mayhew*, (1868) 29 Md. 144, 161; *Kunkel v. Fitzhugh*, (1865) 22 Md. 567, 577-578; *Eastman v. Foster*, (1844) 8 Metc. (Mass.) 19, 23-24; *Union Nat'l Bank v. Rich*, (1893) 116 Mich. 414, 74 N. W. 659; *Union Nat'l Bank v. Rasch*, (1895) 106 Mich. 319, 64 N. W. 339; *Carpenter v. Bowen*, (1868) 42 Miss. 28; *Haven v. Foley & Papin*, (1853) 18 Mo. 136; *Ten Eyck & Brinckerhoff v. Holmes*, (1846) 3 Sandf. Ch. (N.Y.) 428; *Clark v. Ely*, (1844) 2 Sandf. Ch. (N.Y.) 166; *Blanton v. Bostic*, (1900) 126 N. C. 418, 35 S. E. 1035; *Ijames v. Gaither*, (1885) 93 N. C. 358; *Saylors v. Saylors*, (1871) 3 Heisk. (Tenn.) 525, 531-532.

¹¹⁰*Durham v. Craig*, (1881) 79 Ind. 117, 120-121; *Oak Creek Valley Bank v. Helmer*, (1899) 59 Neb. 176, 187-188, 80 N. W. 891, 895.

¹¹¹*Boyd v. Parker & Co.*, (1875) 43 Md. 182, 200; *Eastman v. Foster*, (1844) 8 Metc. (Mass.) 19, 25; *Oak Creek Valley Bank v. Helmer*, (1899) 59 Neb. 176, 187-188, 80 N. W. 891, 895; *Holt v. Penacook Savings Bank*, (1883) 62 N. H. 551, 554; *Ijames v. Gaither*, (1885) 93 N. C. 358, 362; *Ferrell-Michael Abstract & Title Co. v. McCormac*, (Tex. Civ. App., 1915) 184 S. W. 1081, 1083-1084.

¹¹²*Forrest's Executors v. Luddington*, (1880) 68 Ala. 1, 12: "Nor is it important whether the surety has been damnified or not, nor whether his liability continues, or is lost by the want of diligence on the part of the creditor in taking the necessary steps to preserve it, or in consequence of a discharge in bankruptcy. So long as the debt is unextinguished, the trust remains and will be enforced;" *Ohio Life Ins. & Trust Co. v. Ledyard*, (1846) 8 Ala. 866, 872: "The right of the holder to the benefit of this security, does not depend upon the liability of the surety to be damnified; it is because it is a trust created for the better security and protection of the debt."

¹¹³*Magoffin v. Boyle Nat'l Bank of Danville*, (1902) 24 Ky. L. Rep. 585, 586, 69 S. W. 702, 703, distinguishing *Taylor v. Farmers' Bank of Kentucky*, (1888) 87 Ky. 398, 9 S. W. 240, on the ground that in the earlier case the securities deposited by a stranger to the principal obli-

prone in such cases to find, upon the basis of fictitious indicia of intent, that the securities have been appropriated to the payment of the principal obligation, as distinguished from the purpose of merely personal indemnity to the surety, so that a trust for the creditor's benefit is less likely to be held to have arisen.¹¹⁴ And in several cases of securities furnished by the principal debtor, the courts have emphasized, as the reason for their refusal to hold a trust for the creditor's benefit to have arisen, that the surety himself had never at any time been liable upon the principal obligation.¹¹⁵ But the creditor's rights in the securities are generally held to be governed by the period of limitations applicable to security instruments, so that they may still be enforced although the period of limitations applicable to the personal obligation has expired in favor of both the principal debtor and the surety;¹¹⁶ and they

gation had been for the surety's indemnity only, whereas in the Magoffin Case they were found to be "for the payment of the debt;" *Black v. Kaiser*, (1891) 91 Ky. 422, 427, 16 S. W. 89, 90-91 (dictum); *King v. Harman's Heirs*, (1834) 6 La. 607, 26 Am. Dec. 485; *Henderson-Achert Lithographic Co. v. John Shillito Co.*, (1901) 64 Ohio St. 236, 251, 60 N. E. 295, 298 (dictum); *Brown & Heywood Co. v. Ligon*, (C.C. Mo. 1899), 92 Fed. 851, 855-856.

¹¹⁴*Seefeldt v. Wilgen*, (1915) 193 Ill. App. 315, 317 (personal indemnitor): "To entitle appellant to recover, it must appear that the contract was entered into directly and primarily for her benefit;" *Clay v. Freeman*, (1896) 74 Miss. 816, 20 So. 871; *Hasbrouck v. Carr*, (1914) 19 N. M. 586, 145 Pac. 133; *Henderson-Achert Lithographic Co. v. John Shillito Co.*, (1901) 64 Ohio St. 236, 60 N. E. 295. See also note 96, above.

¹¹⁵*Constant v. Matteson*, (1859) 22 Ill. 546; *Bibb v. Martin*, (1850) 14 Smedes & Marshall (Miss.) 87; *Hopewell v. Cumberland Bank*, (1839) 10 Leigh (Va.) 206; *Fagan v. Thompson*, (C.C. Mo. 1889) 38 Fed. 467. These can probably all be classified, however, as cases of merely indemnifying securities.

In *Van Orden v. Durham*, (1868) 35 Cal. 136, Hopkins had purchased hotel furniture from Bird, giving his notes secured by a real estate mortgage given by Durham, who was in turn secured by a chattel mortgage on the hotel furniture, with power of sale. In holding that the note-holders were entitled to foreclose upon one mortgage or the other, but not upon both, the court relied largely upon the fact that Durham was never at any time personally liable upon the notes.

¹¹⁶*Cullum v. Branch Bank at Mobile*, (1853) 23 Ala. 797, 799-800 (the period of limitations had run upon the personal liability both of the surety, George Cullum, and the principal debtor, Charles Cullum): "Nor does it make the slightest difference, that the note is barred by the statute of limitations. So far as George Cullum is concerned, the creditor's right to the security does not depend upon the liability of the surety to be damaged, but upon the fact that the assignment was made to protect the debt. . . . The security is not impaired as to Charles Cullum, for the reason that the statute of limitations, in cases of contract, affects the remedy only, without discharging the debt;" *Alexander v. West*, (1931) 241 Ky. 541, 546, 44 S. W. (2d) 518, 521 (the seven-year period of limitations applicable to the surety's liability had expired, but the period applicable to the principal debtor's liability was fifteen years, which had not yet expired; and the court applied the rule that "unless a mortgage contains words of promise, it will be

are also held not to be defeated by the existence of other defenses personal to the surety,¹¹⁷ or of the principal debtor to the enforcement by the surety of his own rights in the securities.¹¹⁸

barred by the same limitation as the debt it secures," which was therefore fifteen years); *People v. Metropolitan Surety Co.*, (1911) 148 App. Div. 503, 132 N. Y. S. 829, 830-831 (contractual time limitation applicable to surety's liability had already expired); *James v. Gaither*, (1885) 93 N. C. 358 (surety's liability barred). Of course the fact that the surety's liability alone is barred does not preclude him from voluntarily paying the principal obligation and thereafter realizing upon his own rights in the securities; but in *Hooker v. Yellowley*, (1901) 128 N. C. 297, 38 S. E. 889, 890, the creditor was held to be entitled to the securities although the surety had already successfully pleaded the defense of the statute of limitations to his personal liability.

Compare *Eastman v. Foster*, (1844) 8 Metc. (Mass.) 19, 28-29, where, although the security had been given equally for the payment of several notes, the surety was nevertheless held entitled to insist upon its application towards the note upon which he was still liable, the period of limitations having run upon his liability for the others: "We think it quite clear, that so far as the creditors stand alike, in their legal and equitable rights, it would not be competent for the mortgagee, by any voluntary act of his own, to give a preference to one over another. We think he could not, by voluntarily paying one in full, apply the proceeds to indemnify himself, leaving the others unpaid. So if all were barred by the statute of limitations, he could not create a preference by waiving the statute as to one, insisting on it as to the others. But the question is, whether if he be discharged from one, and held liable on the others, by operation of law, without any act or voluntary forbearance of his own, he is not entitled first to apply the fund so as to indemnify himself, and hold the balance only for the other creditors. . . . I am inclined to think he would have a right to be fully indemnified by paying in full the notes for which he is thus liable. The original and primary object of taking the securities was to indemnify the sureties [although the court had found a trust to have arisen for the creditor's benefit, the securities being conditioned that the mortgagors "shall pay said notes"]. For this purpose he had a legal right to the property, which might have been enforced at law by a foreclosure. An indemnity against the whole was an indemnity against each part; so that when Henry's note was paid, the whole of the property was applicable to the other four. Their claims, as amongst themselves, were equal, and it is not on their account that Dickinson's note is entitled to payment in full. But it is on account of the surety, who appears to me not only to have a superior equity, but to stand upon the ground of another rule of law, viz., that when two or more have equal claims in equity, and one has a legal title, the legal title shall prevail."

In *Smith v. Gillam*, (1886) 80 Ala. 296, 302, it was properly held that adverse possession operating to bar the surety would bar the creditor also: "When the title of the trustee is barred, so also is that of the cestui que trust."

¹¹⁷*Plaut v. Storey*, (1891) 131 Ind. 46, 52, 30 N. E. 886, 888 (here the court held it to be entirely immaterial that the surety was the wife of the principal debtor, so that her suretyship obligation was therefore voidable); *Loehr v. Colborn*, (1883) 92 Ind. 24, 29-30 (here the sureties had assigned the securities to the creditor in consideration of his releasing them from their personal obligation; without determining the question whether the assignment of that to which the creditor was already entitled was adequate consideration for his release of the sureties, the court held the creditor to be fully entitled to foreclose); *Crosby v. Crafts*, (1875) 5 Hun (N.Y.) 327,

It should follow that the solvency or insolvency of neither the principal debtor nor the surety is at all material to the existence or enforcement of the creditor's rights in the securities.¹¹⁹ In at least two cases, however, the thought has been expressed that the insolvency of the principal debtor and the surety causes the transfer of the securities to the surety to partake of the nature of a fraudulent conveyance.¹²⁰ But if this alone were the basis

330 (held to be immaterial that the surety's liability as joint debtor had been discharged by death).

Compare the following Connecticut cases, in which, however, the court had refused to find a trust for the creditor's benefit to have been the intent of the security transaction: *Jones v. Quinnipiack Bank*, (1860) 29 Conn. 25, 46: "So, too, it is not easy to see how the County Bank can claim any interest in the property through Barnum, given as it was to indemnify him against his indorsements, since the bank had released him from the indorsements. . . . As to him therefore, and all claiming under him, the mortgage would seem to have become inoperative;" *Thompson v. White*, (1881) 48 Conn. 509, 519: "If the indorsement had been discharged by the laches of the holder the security was gone, and no waiver by the indorser could revive it."

¹¹⁸*Plaut v. Storey*, (1891) 131 Ind. 46, 52, 30 N. E. 886, 888 (the court held it also to be immaterial that the mortgage from the husband as principal debtor to the wife as surety may have been given with a secret intent to defraud the husband's other creditors): "It is not disputed but that the indebtedness of James H. Arnold to the appellee [the principal creditor] is bona fide, nor claimed that the appellee was a party to or had any knowledge of the fraud. We are of the opinion that the appellee does not claim through or under the mortgagee in any such sense as to be affected by the frauds or secret equities between her and her husband;" *Rice's Appeal*, (1875) 79 Pa. St. 168, 206 (the court here recognized that the surety may not have been entitled to claim any benefit from the securities because of his fiduciary relation as promoter of the corporate principal debtor; the creditor was nevertheless held to be entitled).

Compare *Lowry Banking Co. v. Empire Lumber Co.*, (1893) 91 Ga. 624, 17 S. E. 968, 970-971, a case of merely indemnifying securities, given by an insolvent corporation to its directors to secure them against their prior indorsements of its notes, in which the court held that the transaction was "a plain, naked effort by an insolvent corporation to prefer and secure members of its own body against impending loss about to be occasioned by reason of their suretyship for the corporation," and that "inasmuch as these sureties have no rights whatever, under these mortgages, the creditors referred to can take nothing by subrogation."

In *Alexander v. Ellison*, (1880) 79 Ky. 148, 153, the principal debtor was both a minor and under coverture, and it was held "not to be a material circumstance that the person furnishing the security is not himself liable for the debt, nor is it material that the security is one which the debtor has by operation of law rather than by contract."

¹¹⁹*Seibert v. True*, (1871) 8 Kan. 52, 63-64 (surety's solvency or insolvency immaterial); *Hauser v. King*, (1882) 76 Va. 731, 734 (same); *Magill v. Brown*, (1899) 20 Tex. Civ. App. 662, 676, 50 S. W. 143, 150 (principal debtor's solvency or insolvency immaterial). The Alabama court apparently attached no significance to the fact that both the principal debtor and the surety were insolvent in *Ohio Life Ins. & Trust Co. v. Ledyard*, (1846) 8 Ala. 866, or to the fact that the principal debtor was insolvent in *Branch Bank at Mobile v. Robertson*, (1851) 19 Ala. 798.

¹²⁰*Haggarty v. Pittman*, (1828) 1 Paige Ch. (N.Y.) 297, 298, 19 Am. Dec. 434, 435: "This court will never for a moment sanction the idea

for the creation of a trust, it should redound equally to the benefit of all the creditors of the principal debtor, rather than create a preference in favor of the particular creditors to whom the insolvent surety is also liable. In a few other cases, although the securities were found to have been given for the payment of the principal obligation, the courts nevertheless appeared to attach some significance to the fact that either the principal debtor or the surety, or both, were insolvent.¹²¹ But it may safely be surmised that in most of the cases in which the creditor is proceeding against the securities, rather than against the principal debtor or the surety personally, it is because either one or the other or both are in fact insolvent; and the general lack of emphasis upon this factor, in cases where the securities are construed to have been given for the payment of the principal obligation, indicates its immateriality.

There have also been held to follow such incidental consequences as that the creditor loses his right to levy execution, under a judgment against the principal debtor for the principal obligation, upon the latter's equity of redemption in the mortgage security;¹²² that the creditor may lose his right to prove in bankruptcy or insolvency proceedings for the full amount of the principal obligation;¹²³ that a national bank may validly acquire in this way a mortgage upon real estate;¹²⁴ that the principal debtor may become entitled to deduct the amount of the principal obligation from the assessed valuation of the mortgage security;¹²⁵ and that a trust for the benefit of the particular creditor may be enlarged into a general assignment for the benefit of all the principal

that debtors in failing circumstances shall be permitted to put their creditors in the power of an insolvent assignee, by a voluntary assignment of their property to him, although it is expressed to be for the payment of their debts, or for his indemnity against prior responsibilities;" In re Ellington Planting Co., (1912) 131 La. 654, 659, 60 So. 25, 27: "It would be inequitable to permit a joint debtor, who is insolvent, to divert a fund from a creditor, to whom he owes it, into his own irresponsible pocket."

¹²¹See *McCracken v. German Fire Ins. Co.*, (1876) 43 Md. 471, 477; *Oak Creek Valley Bank v. Helmer*, (1899) 59 Neb. 176, 189-190, 80 N. W. 891, 895; *First Nat'l Bank of Bellville v. Wheeler*, (Tex. Civ. App., 1896) 33 S. W. 1093, 1095, *aff'd*, *Wheeler v. First Nat'l Bank of Bellville*, (Tex. Civ. App., 1897) 41 S. W. 376; *Johnson v. Martin*, (1915) 83 Wash. 364, 145 Pac. 429, 432.

¹²²*Carpenter v. Bowen*, (1868) 42 Miss. 28, 53-54; see note 79, above.

¹²³In re *Jerome B. Fickett*, (1881) 72 Me. 266; see note 28, above.

¹²⁴*Magoffin v. Boyle Nat'l Bank of Danville*, (1902) 24 Ky. L. Rep. 585, 587, 69 S. W. 702, 703; *Commonwealth Life Ins. Co. v. Combs*, (1933) 251 Ky. 540, 65 S. W. (2d) 696; *Mathews v. Abbott*, (D.C. Me., 1878) 2 Hask. 289, Fed. Cas. No. 9,275.

¹²⁵*State v. Campbell*, (1896) 59 N. J. L. 378, 35 Atl. 788.

debtor's creditors ratably, by virtue of a statute providing that the conveyance of property by an insolvent debtor to a particular creditor, for the purpose of securing any demand other than his own antecedent debt, shall automatically be so enlarged.¹²⁶

Finally, to the extent that the holding of a trust for the creditor's benefit to have been the intent of the security instrument results in the subordination of the interest of the surety in the securities to that of the creditor,¹²⁷ it ought logically to follow that the surety is released from his personal liability to the creditor by any change in the contract between the latter and the principal debtor, unconsented to by the surety, or by any release by the creditor of his rights in any other securities given by the principal debtor for the payment of the principal obligation, if that would be the effect of such action apart from the holding of the securities by the surety as trustee.¹²⁸ For on the hypothesis that he holds them only as trustee, his own interest being subordinated to that of the creditor, the reason for the rule that a fully indemnified surety is not released from his personal liability by such action on the part of the creditor¹²⁹ falls to the ground.

¹²⁶*Pendery v. Allen*, (1893) 50 Ohio St. 121, 132, 33 N. E. 716, 719: ". . . Emerson, in accepting the mortgage as indemnity against loss in the performance of his promise to pay the bank, became, within the meaning of section 6343, Rev. St., an assignee of the property covered by the mortgage in trust for the benefit of the bank, and, as a consequence of the provisions of that section, held it in trust for all the creditors of Allen, according to the amount of their respective demands. . . . For this indebtedness he was not previously liable as surety; and . . . the statute cannot be evaded by assuming a liability as surety for the insolvent debtor, as part of the transaction by which the mortgage is given."

¹²⁷See above, p. 349 of the text, note 103.

¹²⁸Apparently no case enunciating the theory of a trust for the creditor's benefit has at the same time had occasion to hold that the surety is not released from his personal liability by the creditor's release of the principal debtor or of other securities held directly by him for the payment of the principal obligation. With respect to indemnifying securities generally, according to Dean Arant, "No case has been noted where an indemnified surety urged the release of security as a defense. [See, however, *Crim v. Fleming*, (1884) 101 Ind. 154, 156-159, apparently holding that such a surety is not released by the creditor's release of other security.] But such a surety is not discharged by a release of the principal debtor. *Jones v. Ward*, 71 Wis. 152, 36 N. W. 711 (1888). Nor by an extension of time. *Home Nat'l Bank of Chicago v. Waterman's Estate*, 134 Ill. 461, 29 N. E. 503 (1890); *Smith v. Steele's Estate*, 25 Vt. 427, 60 Am. Dec. 376 (1853); *Fay v. Tower*, 58 Wis. 286, 16 N. W. 558 (1883). It is generally assumed that such a surety would not be discharged by a release of security. 21 R. C. L. 1054." Arant, *Handbook of the Law of Suretyship and Guaranty* 221, note 13; Arant, *Why Release of Security Discharges a Surety*, (1930) 14 MINNESOTA LAW REVIEW 725, 727, note 13.

¹²⁹It is difficult to accept Dean Arant's statement that "The basis of this view is the generally conceded right of the creditor to utilize for the payment of his debt any security given to the surety by the principal." Arant,

The surety who is held to hold the securities merely as trustee for the creditor is not in fact fully indemnified.¹³⁰

B. *Where the Securities Are Merely for the Personal Indemnity of the Surety.*—It has already been seen that in the case first enunciating the theory of a trust arising for the creditor's benefit in securities given by the principal debtor to the surety,¹³¹ Chancellor Kent drew no distinction between securities appropriated to the payment of the principal obligation and securities restricted in their purpose solely to the surety's indemnification; nor were the securities involved in the case itself specifically

Handbook of the Law of Suretyship and Guaranty 237; Arant, *Why Release of Security Discharges a Surety*, (1930) 14 MINNESOTA LAW REVIEW 725, 743. If such be the proper basis the same result would follow a fortiori in all cases holding a trust for the creditor's benefit to have been the specific intent of the security transaction. But obviously, under no circumstances does the creditor have any greater rights in securities held by the surety than in securities received and held by himself, without the surety's interposition. Yet the release by the creditor of his securities of the latter type is held to discharge an unindemnified surety. The only basis for holding that it does not so discharge an indemnified surety is the assumption that "no matter what the creditor did with the collateral securities, he [the surety] could lose nothing." See *Crim v. Fleming*, (1884) 101 Ind. 154, 158-159. Yet in the type of cases now under consideration, finding a trust for the creditor's benefit to which the interest of the surety may be subordinated, such an assumption may frequently prove unfounded.

¹³⁰Except wherever the securities are so ample "that there is no chance that what the principal gave him may not produce as much money as he is required to pay the creditor." Arant, *Handbook of the Law of Suretyship and Guaranty* 237; Arant, *Why Release of Security Discharges a Surety*, (1930) 14 MINNESOTA LAW REVIEW 725, 744. But even in such a case, except for the burden of suit, the surety is certainly no more fully indemnified than he is by virtue of his right of subrogation to the securities held by the creditor, if they are equally ample. Dean Arant contends that the release by the creditor of the principal debtor or of other securities should operate to discharge even an indemnified surety, because of "the burden of paying the creditor and later realizing upon whatever he had that caused the court to say that he was 'indemnified.' . . . since the indemnity is usually in the form of a bond, pledge or mortgage, involving the probable inconvenience of a suit, sale or foreclosure, it is obvious that the burden is not negligible." In this instance Dean Arant's conclusions sustain the writer's, although upon somewhat different reasoning.

In *Blackstone Bank v. Hill*, (1830) 10 Pick. (Mass.) 128, 132, the court assumed "that an extension of credit . . . given to the principal without the consent of the surety, if made out, would be a good defence" to the personal liability of an indemnified surety, but held that the defense was not made out. In *Livingston v. Moore*, (1897) 15 App. Div. 15, 44 N. Y. S. 125, appeal dismissed, *Livingston v. City of Albany*, (1900) 161 N. Y. 602, 56 N. E. 148, the same sureties whose indemnifying securities were unsuccessfully sought to be appropriated to the payment of the principal obligation in *City of Albany v. Andrews*, (1898) 29 App. Div. 20, 52 N. Y. S. 1129, were held to have been discharged from their personal obligation by virtue of a change in the contract between the creditor and the principal debtor, the court in no way alluding to the fact that the sureties were indemnified.

¹³¹*Moses v. Murgatroyd*, (1814) 1 Johns. Ch. (N.Y.) 119, 129.

found to have been given for the broader purpose. Many courts, however, have emphasized such a distinction, in respect both to the existence of rights in the creditor and to the conditioning circumstances, extent, and consequences thereof.¹³² The chief factors that have been emphasized by the courts in finding the particular securities to have been given for the broader purpose of payment of the principal obligation, even though in terms given for the surety's indemnity, have already been noted.¹³³ Assuming, however, that the particular securities are found to have been given solely for the more restricted purpose of the surety's indemnity, the American cases fall generally into the following three categories: (1) those that work out the creditor's rights through so-called subrogation to the exact position of the surety; (2) those that make the existence of rights in the creditor depend upon the insolvency of the principal debtor or the surety or of both; and (3) those that reach the trust result the same as though the securities were found to have been specifically appropriated to the payment of the principal obligation.¹³⁴

There are numerous statements in the American cases reminiscent of the excerpt already quoted from the opinion of Sir William Grant, M. R., in *Wright v. Morley*¹³⁵—to the effect that subrogation of the surety and subrogation of the creditor are but the converse sides of the same shield for the protection of the party thought by the court to be the one equitably entitled to

¹³²See *Forrest's Executors v. Luddington*, (1880) 68 Ala. 1, 7-8; *Daniel v. Hunt*, (1884) 77 Ala. 567, 569-570; *Dyer v. Jacoway*, (1905) 76 Ark. 171, 176, 88 S. W. 901, 903; *Constant v. Matteson*, (1859) 22 Ill. 546, 556; *Chambers v. Prewitt*, (1898) 172 Ill. 615, 623, 50 N. E. 145, 147; *Durham v. Craig*, (1881) 79 Ind. 117, 120-121; *Tilford v. James*, (1847) 7 B. Mon. (Ky) 336; *Macklin v. Northern Bank of Kentucky*, (1885) 83 Ky. 314, 318; *Black v. Kaiser*, (1891) 91 Ky. 422, 427, 16 S. W. 89, 90-91; *Magoffin v. Boyle Nat'l Bank of Danville*, (1902) 24 Ky. L. Rep. 585, 586, 69 S. W. 702, 703; *King v. Harman's Heirs*, (1834) 6 La. 607, 26 Am. Dec. 485; *Blackstone Bank v. Hill*, (1830) 10 Pick. (Mass.) 128, 133; *Albion State Bank v. Knickerbocker*, (1900) 125 Mich. 311, 317, 84 N. W. 311, 314; *Osborn v. Noble*, (1872) 46 Miss. 449, 454-455; *Logan v. Mitchell*, (1878) 67 Mo. 524, 528; *Nilkin v. Silverman*, (1924) 95 N. J. Eq. 396, 397, 123 Atl. 531, 532; *Keene Five Cents Savings Bank v. Herrick*, (1882) 62 N. H. 174, 175; *Ohio Life Ins. & Trust Co. v. Reeder*, (1849) 18 Ohio 35, 46; *Henderson-Achert Lithographic Co. v. John Shillito Co.*, (1901) 64 Ohio St. 236, 252, 60 N. E. 295, 298; *Fertig v. Henne*, (1901) 197 Pa. St. 560, 567-568, 47 Atl. 840.

¹³³See above, text at notes 89-94 inclusive.

¹³⁴See Note, (1896) 10 Harv. L. Rev. 64-65: "The cases are in a hopeless state of confusion as to what circumstances, if any, give a creditor the right to have securities deposited under a contract of naked indemnity applied in payment of the debt to him."

¹³⁵(1805) 11 Vesey Jun. 12, 22; see above, at p. 318 of the text.

the benefit of the securities. Thus the supreme court of Nebraska stated as the basis of its decision in *Meeker v. Waldron*:¹³⁶

"Had the principal creditors possessed collateral security and the personal surety had paid the indebtedness it would hardly be doubted that he would be entitled to be subrogated to the rights of the creditors to such collateral security; and on a parity of reasoning, we can see no difference in principle as to the right of the principal creditors to be subrogated to the rights of the surety upon his inability or failure to respond to his obligation."¹³⁷

In reply to such reasoning Dean Arant has pointed out that the surety's right of subrogation requires the burdensome act on his part of payment of the principal obligation or of a part thereof, and does not occur until the creditor holding the securities has been paid in full, and therefore cannot possibly be prejudiced.¹³⁸

"Nor can the other creditors of the principal object, since they are no worse off when the creditor is forced to assign his security to the surety than they would have been if he had utilized all of his priorities and securities, and resorted to the principal for payment instead of the surety."¹³⁹

This does not entirely explain, however, why the paying surety, who without the aid of the doctrine of subrogation is by hypothesis an unsecured creditor in respect of his rights of exoneration and reimbursement from the principal debtor, should be converted into a secured one by the aid of that doctrine. As an original proposition, if not foreclosed by authority, it would seem at least plausibly arguable that the doctrine of marshalling ought to require a creditor with personal security as well as a mortgage lien from the principal debtor, to exhaust the first before striking the second, for the benefit of junior encumbrancers whose only security is in the mortgaged property.¹⁴⁰ The doctrine of the surety's

¹³⁶(1901) 62 Neb. 689, 695, 87 N. W. 539, 541.

¹³⁷For other similar statements see also *Saffold v. Wade's Executor*, (1874) 51 Ala. 214, 218-219; *Union Nat'l Bank v. Rasch*, (1895) 106 Mich. 319, 328, 64 N. W. 339, 342; *Bibb v. Martin*, (1850) 14 Smedes & Marshall (Miss.) 87, 92-93; *Osborn v. Noble*, (1872) 46 Miss. 449, 453-454; *Kinsey v. McDearmon*, (1868) 5 Coldw. (Tenn.) 392, 396; *Hauser v. King*, (1882) 76 Va. 731, 733-734.

¹³⁸Arant, *Handbook of the Law of Suretyship and Guaranty* 370.

¹³⁹Arant, *Handbook of the Law of Suretyship and Guaranty* 359.

¹⁴⁰Of course the answer to the suggestion in the text is that the obligation of the surety, although security for the debtor, is not the property of the debtor, and the subrogation of the surety to the creditor's preferences over junior encumbrancers is justified by the fact that "in this way the creditor is denied the power of throwing the ultimate payment of the debt in one way or another as suits his caprice." 4 Williston, *Treatise on the Law of Contracts*, rev. ed., 3620.

subrogation is after all a creature of "natural equity."¹⁴¹ judicially conceived, whereby the courts keep alive the creditor's securities, even after technical extinguishment of the creditor's own rights in them, for the benefit of the party thought to be most equitably entitled to them.

Nor is it entirely accurate to say that the surety's burdensome act of payment of the principal obligation is in all cases absolutely essential to the enforcement of what the courts at least have called his right of subrogation. In *Harmon v. Weston*¹⁴² the principal debtor was himself one of the creditors, in that he was one of the beneficiaries of the trust estate which as trustee he had largely dissipated. In a suit for the benefit of the trust estate against Weston as principal and the American Surety Company as surety, upon Weston's trustee's bond, it was held that the judgment against the surety company should be diminished in the proportion of Weston's interest in the trust estate, the court saying:

"It is of course true that the right to subrogation strictly so called does not arise in favor of a surety until he has paid the debt for which he is bound, and there is no occasion to cite authority for the rule; but it is also true that to avoid circuity of action equity will protect those who by an enforced payment will become at once entitled by subrogation to indemnity from the one who is to receive that payment."¹⁴³

Of course it may be said that the court in the above case was confusing the surety's right of subrogation with its right of exoneration, and that all it did was to enforce by way of set-off the right of exoneration. But if the basis and content of a principle and the results achieved by it are more important than the name by which it is called, it is believed that the court was applying in behalf of the surety much the same principle upon which the creditor's so-called right of subrogation is based—namely, that in order to avoid circuity of action equity will give aid to those who upon an enforced realization of the indemnifying securities will become immediately entitled to the proceeds thereof.

¹⁴¹See *Taylor v. Farmers' Bank of Kentucky*, (1888) 87 Ky. 398, 401-402, 9 S. W. 240, 241; *Dowell v. Woodsides*, (1894) 16 Ky. L. Rep. 325, 327, 27 S. W. 853, 854; *Osborn v. Noble*, (1872) 46 Miss. 449, 453-454; *South Omaha Nat'l Bank v. Wright & Baldwin*, (1895) 45 Neb. 23, 27-28, 63 N. W. 126, 127-128; *Henderson-Achert Lithographic Co. v. John Shillito Co.*, (1901) 64 Ohio St. 236, 251, 60 N. E. 295, 298. "Subrogation does not depend upon contract, but on the equities of the situation." 4 Williston, *Treatise on the Law of Contracts*, rev. ed., 3620.

¹⁴²(1913) 215 Mass. 242, 102 N. E. 470.

¹⁴³(1913) 215 Mass. 242, 247-248, 102 N. E. 470, 473.

The majority of cases basing the creditor's rights in the surety's indemnifying securities upon the subrogation theory restrict the creditor to the surety's own rights therein, and therefore require, as an essential prerequisite to their enforcement, that the surety already have been damnified through his liability having become absolute.¹⁴⁴ This is normally the event that first enables the surety himself to realize upon the securities. Even although the indemnity is against "loss" rather than against "liability," "loss" may be held to occur when the principal debtor defaults, the surety remaining liable,¹⁴⁵ or at least when judgment is entered against the surety.¹⁴⁶ Up to the moment of the surety's damnification he may release the securities to the principal debtor, or may effect a novation in their purpose by a new agreement with the principal debtor, in neither event requiring the concurrence of the creditor.¹⁴⁷ Until then the interest of the surety

¹⁴⁴*Morris v. Bowman & Brown*, (1928) 175 Ark. 1073, 1076-1077; *Van Orden v. Durham*, (1868) 35 Cal. 136, 145-146; *Henry Clews & Co. v. First Mortgage Bondholders of the Brunswick & A. R. Co.*, (1875) 54 Ga. 316; *Lowry Banking Co. v. Empire Lumber Co.*, (1893) 91 Ga. 624, 633, 17 S. E. 968, 971; *Constant v. Matteson*, (1859) 22 Ill. 546, 556; *Nourse v. Weitz*, (1903) 120 Iowa 708, 714, 95 N. W. 251, 253; *Tilford v. James*, (1847) 7 B. Mon. (Ky.) 336; *Bibb v. Martin*, (1850) 14 Smedes & Marshall (Miss.) 87, 93; *Osborn v. Noble*, (1872) 46 Miss. 449, 454; *Logan v. Mitchell*, (1878) 67 Mo. 524, 528; *City of Albany v. Andrews*, (1898) 29 App. Div. 20, 24, 52 N. Y. S. 1129, 1131; *Ohio Life Ins. & Trust Co. v. Reeder*, (1849) 18 Ohio 35, 46; *Henderson-Achert Lithographic Co. v. John Shillito Co.*, (1901) 64 Ohio St. 236, 251, 60 N. E. 295, 297; *Waller v. Oglesby*, (1887) 85 Tenn. 321, 322-324, 3 S. W. 504; *Willard v. Worsham*, (1882) 76 Va. 392, 402; *Courier-Journal Job-Printing Co. v. Schaefer-Meyer Brewing Co.*, (C.C.A. 6th Cir. 1900) 101 Fed. 699, 705.

¹⁴⁵*Daniel v. Hunt*, (1884) 77 Ala. 567, 571: "When this happened, there was, in legal contemplation, a loss to the surety, who was personally bound for the payment of the debt. It is plain that the word 'loss,' here, means nothing more than legal damage, detriment, or forfeiture;" *Loehr v. Colborn*, (1883) 92 Ind. 24, 29-30: "There are many cases, however, in which the mortgagee, in an indemnifying mortgage, may foreclose before he sustains actual loss or damage." See also note 96, above, and the cases there cited.

But compare *Taylor v. De Camp*, (1933) 132 Cal. App. 640, 644, 23 Pac. (2d) 61, 62; and *City of Albany v. Andrews*, (1898) 29 App. Div. 20, 24, 52 N. Y. S. 1129, 1131.

¹⁴⁶See *Burnett v. Gainesville Nat'l Bank*, (1922) 28 Ga. App. 255, 110 S. E. 753; and *Bibb v. Martin*, (1850) 14 Smedes & Marshall (Miss.) 87, 93-94.

¹⁴⁷*Dyer v. Jacoway*, (1905) 76 Ark. 171, 88 S. W. 901; *Jones v. Quinpiack Bank*, (1860) 29 Conn. 25; *Thompson v. White*, (1881) 48 Conn. 509; *Horsey v. Stockley*, (1861) 2 Del. Ch. 290; *McIntyre v. Tenny*, (1882) 4 Ky. L. Rep. 259; *Taylor v. Farmers' Bank of Kentucky*, (1888) 87 Ky. 398, 9 S. W. 240; *Woodville v. Reed*, (1866) 26 Md. 179, 191; *Chanter v. Reardon*, (1875) 32 Mich. 162; *Osborn v. Noble*, (1872) 46 Miss. 449; *Logan v. Mitchell*, (1878) 67 Mo. 524; *Stone v. Furber*, (1886) 22 Mo. App. 498; *Miller v. Stiger & Wack*, (1831) 1 N. J. Eq. 204; *Fertig v. Henne*, (1901) 198 Pa. St. 560, 47 Atl. 840; *Henderson-Achert Litho-*

in the securities, and consequently that of the creditor, is contingent rather than absolute.

At the moment of damnification within the terms of the indemnity agreement, however, the surety's interest in the securities becomes absolute and presently realizable by him. Such interest is a genuine, presently-available asset of his estate, in exactly the same sense that the promise to pay the debt of another in the ordinary third-party creditor-beneficiary situation is upon maturity a genuine, presently-available asset of the promisee's estate.¹⁴⁸ And, likewise in the same sense as the promise to pay the debt of another, it is an asset of the surety's estate of a peculiar and unique character—peculiar and unique in that, unless the surety has already paid the creditor and in the absence of complications of insolvency, realization will necessarily redound to the benefit of the particular creditor to the exclusion of the surety's other creditors, whose only interest is that to the extent of the indemnifying securities the surety's other assets not be depleted by the payment of the particular obligation against which he is indemnified.¹⁴⁹

As pointed out by the Supreme Court of Louisiana in *King v. Harman's Heirs*,¹⁵⁰ it would be unthinkable for a court of equity to permit the surety, after damnification but before actual payment by him of the principal obligation, to realize upon the securities "without requiring security that it should be paid over to the original creditors."¹⁵¹ Such a requirement is necessary for the

graphic Co. v. John Shillito Co., (1901) 64 Ohio St. 236, 60 N. E. 295; Waller v. Oglesby, (1887) 85 Tenn. 321, 3 S. W. 504.

But compare *Boyd v. Parker & Co.*, (1875) 43 Md. 182, 199-200, in which the court in a dictum discounted the previous dictum by the same court in *Woodville v. Reed*, cited above in this note, and expressed the opinion that the surety may not so release securities given for his indemnity only; *Union Nat'l Bank v. Rich*, (1898) 116 Mich. 414, 74 N. W. 659, in which the court held it to have become *res adjudicata* as the result of the former case involving the same parties, *Union Nat'l Bank v. Rasch*, (1895) 106 Mich. 319, 64 N. W. 339, that the surety could not so release the securities, although in the former case the court had purported to accept the contention of counsel that the securities were a mere personal indemnity only, "as it clearly appears that it was not the intent of the mortgagors to create by this security a fund out of which to pay the note;" *Magill v. Brown*, (1899) 20 Tex. Civ. App. 662, 676, 50 S. W. 143, 150-151, in which the court expressed the opinion that the trust result would have followed, precluding the surety from releasing the securities, even though they had been construed to have been given for the surety's indemnity only.

¹⁴⁸2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1058.

¹⁴⁹2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1059-1060.

¹⁵⁰(1834) 6 La. 607, 622, 26 Am. Dec. 485, 490.

¹⁵¹See also *McConnell v. Scott*, (1846) 15 Ohio 401, 403; *Kramer &*

protection of the principal debtor, who might otherwise be left to pay the creditor without effective recourse against the surety for the return of the securities.

As a presently-available asset of the already damnified surety, the realization of which will necessarily redound to the benefit of the particular creditor exclusively, the surety's interest in the securities may be reached by the particular creditor at least to the same extent that he may reach any other asset of the surety not so restricted in its purpose. In cases in which judgment already has been rendered against the indemnified surety and execution thereon has been returned unsatisfied, the courts in according direct rights to the particular creditor in the indemnifying securities are merely enforcing the typical process of equitable execution.¹⁵² The courts that do not require that a judgment already have been rendered against the surety, and that execution thereon have been returned unsatisfied, merely are taking a short-cut to the same result for the purpose of avoiding circuitry and multiplicity of actions.¹⁵³

If it be objected that the surety should control the time of realization upon his own indemnifying securities, in order that they may not be sold at a sacrifice and the surety left liable for a deficiency without further indemnity,¹⁵⁴ it may be replied that we are dealing by hypothesis with a surety who is already in default upon the principal obligation; so that by not paying the creditor the surety has lost his exclusive control over the realization of this particular asset at least to the same extent that he has lost his exclusive control over the realization of any other asset that is subject to execution for the principal indebtedness. Dean Arant's answer that the creditor should not have an enforceable interest in the securities without the surety's consent "unless

Rahm's Appeal, (1860) 37 Pa. St. 71, 77; Breedlove v. Stump, (1830) 3 Yerg. (Tenn.) 257, 263; Kirkman & Luke v. Bank of America, (1865) 2 Coldw. (Tenn.) 397, 407.

¹⁵²McConnell v. Scott, (1846) 15 Ohio 401, 403: "He has his judgment, and may take out his execution at pleasure; but if he has not collected his money of the surety, and the surety has made it out of the property or credits of the principal, equity will decree its application in discharge of the creditor's judgment against the surety."

¹⁵³Nourse v. Weitz, (1903) 120 Iowa 708, 714, 95 N. W. 251, 253; South Omaha Nat'l Bank v. Wright & Baldwin, (1895) 45 Neb. 23, 27, 63 N. W. 126, 127; Keene Five Cents Savings Bank v. Herrick, (1882) 62 N. H. 174, 178; Union Nat'l Bank v. Rasch, (1895) 106 Mich. 319, 64 N. W. 339, 342; and see Ohio Life Ins. & Trust Co. v. Reeder, (1849) 18 Ohio 35, 46-47.

¹⁵⁴See Arant, Handbook of the Law of Suretyship and Guaranty 372.

he acquires it by recourse to ordinary legal proceedings"¹⁵⁵ is an argument merely against the equitable short-cut rather than against the result ultimately accomplished. And it should also follow that the surety's other unsecured creditors are hardly in any better position to object than is the surety himself, since the particular creditor might equally have brought about a forced realization of the surety's other available assets—although by a less direct procedure—for which the indemnifying securities would be equally insufficient to compensate.

It should be remembered in this connection that in the state of New York the decision in *Lawrence v. Fox*¹⁵⁶ was preceded by decisions holding that the assuming grantee of a mortgagor's equity of redemption becomes directly liable to the mortgagee, upon the theory of his promise to pay the mortgage debt having constituted an indemnifying agreement with the original mortgagor, who now stood in the position of a surety for the principal indebtedness.¹⁵⁷ Professor Corbin has recognized that the doctrine of subrogation "has no doubt been very beneficial in spite of fiction and artificiality," and appears to approve the result reached wherever "it is used only as against one who is already legally indebted in order to secure the fulfillment of that legal duty;" but he also has pointed out that in cases of an assuming grantee from a mortgagor who is not himself personally liable upon the principal indebtedness "it has been used to confer new security and new rights upon a creditor, as a gift out of a clear sky."¹⁵⁸ To this day a number of the courts applying the suretyship analogy to the case of an assuming grantee of mortgaged property base a distinction in result upon whether or not the immediate grantor was himself personally liable for the principal indebtedness—holding that in the former case the grantee becomes directly liable to the mortgagee, whereas in the latter he does not.¹⁵⁹ For

¹⁵⁵Arant, *Handbook of the Law of Suretyship and Guaranty* 372.

¹⁵⁶(1859) 20 N. Y. 268.

¹⁵⁷*Curtis v. Tyler & Allen*, (1842) 9 Paige Ch. (N.Y.) 432, 435-436; *Vail and Vail v. Foster*, (1850) 4 N. Y. 312, 313-314.

¹⁵⁸Corbin, *Contracts for the Benefit of Third Persons*, (1918) 27 Yale L. J. 1008, 1016.

¹⁵⁹*Dussault v. Wellman*, (1927) 130 Misc. Rep. 614, 224 N. Y. S. 321, 324: "The test is whether the defendants were personally responsible for the payment of the indebtedness. If they are not liable, the covenant of their grantee did not place the latter in the position of a surety for the grantors, and, the grantors being under no liability to the creditor, the covenant could not inure to his benefit. When the grantor, however, in such a conveyance is personally liable for the payment of the incumbrance, the grantee becomes the principal debtor by such an agreement, and the grantor stands in the situation of a mere surety for him as to the payment

him to become directly liable to the mortgagee in the latter case, the result must be based upon third-party-beneficiary contractual principles rather than upon the suretyship analogy.¹⁶⁰

The immediately preceding discussion has assumed the absence of complications of insolvency. The ordinary *Lawrence v. Fox* third-party creditor-beneficiary situation is in no way affected by the insolvency of either the promisee or the promisor, other than by the reduction of the beneficiary's recovery proportionately, since his right against both is presumably in personam only, and in no way preferred over either's other general creditors. Nor do the courts following *Lawrence v. Fox* purport to make the beneficiary's rights depend in any way upon the insolvency of either the promisee or the promisor. As already intimated, however, several American courts have purported to base the creditor's rights in indemnifying securities held by his surety upon the insolvency of the principal

of such incumbrance, so as to give the holder of the incumbrance a right in equity to resort to the grantee for payment if the premises upon which it is a lien should prove insufficient for that purpose." See also Minnesota Annotations to the Restatement of the Law of Contracts, sec. 136: "Where a mortgagor who is personally indebted sells his interest in the property to a transferee who assumes the payment of the debt the mortgagee clearly is a creditor beneficiary, and the Minnesota decisions uniformly permit him to sue the transferee-promisor. *Follansbee v. Johnson*, (1881) 28 Minn. 311, 9 N. W. 882; *Wood v. Johnson*, (1912) 117 Minn. 267, 135 N. W. 746; *Marshall State Bank v. Buesing*, (1929) 179 Minn. 77, 228 N. W. 348; see *Scanlan v. Grimmer*, (1898) 71 Minn. 351, 74 N. W. 146, 70 Am. St. Rep. 326. Where the transferor is not personally indebted, but nevertheless an assumption clause is included in the deed, the Minnesota cases deny recovery. *Brown v. Stillman*, (1890) 43 Minn. 126, 45 N. W. 2; *Nelson v. Rogers*, (1891) 47 Minn. 103, 49 N. W. 526; *Kramer v. Gardner*, (1908) 104 Minn. 370, 116 N. W. 925, 22 L. R. A. (N.S.) 492; *Clement v. Willett*, (1908) 105 Minn. 267, 117 N. W. 491, 17 L. R. A. (N.S.) 1094, 127 Am. St. Rep. 562, 15 Ann. Cas. 1053." The Minnesota cases, however, have not based the distinction expressly upon the suretyship analogy, but rather upon the fact that the mortgagee, in the case of an assuming grantee from a grantor who is not himself personally liable upon the mortgage indebtedness, is a mere donee- rather than a creditor-beneficiary; Minnesota having accorded somewhat greater rights to creditor- than to donee-beneficiaries. See Minnesota Annotations to the Restatement of the Law of Contracts, secs. 135 and 136.

¹⁶⁰See 2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1123-1124: "Where, however, the grantor exacts or the grantee undertakes an assumption of the mortgage debt in the belief, which later proves to be erroneous, that the grantor is liable therefor, the mortgagee is a creditor beneficiary and may recover from the grantee unless there was such a mutual mistake on the part of the grantor and the grantee as to render the contract of assumption voidable. . . . It follows that the creditor beneficiary's right of action is not dependent upon an actual obligation owing to him by the promisee, but it is sufficient if there is a bona fide supposed or asserted obligation which the promisor has undertaken to perform." See also *Restatement, Contracts*, sec. 144.

debtor or the surety, or of both. Thus the supreme court of West Virginia stated in *New Martinsville Bank v. Hart*:¹⁶¹

"The decisions in some of the states, notably those of Mississippi, hold that the creditor will not ordinarily be entitled to the benefit of securities given by the principal debtor to indemnify the surety, unless they are also made subject to the payment of the debt. . . . Most, if not all, of the courts adhering to the Mississippi doctrine, recognize an exception in cases where the debtor is insolvent."¹⁶²

But the above most certainly is not an accurate statement of the conclusion to be drawn from the Mississippi cases, which distinguish securities appropriated to the payment of the principal obligation from securities restricted to the personal indemnification of the surety, only for the purpose of confining the rights of the creditor in the latter situation to those of the surety, upon the theory of subrogation, rather than according to him paramount rights in the securities upon the theory of a trust having been intended for his benefit.¹⁶³ Where the surety himself has no pres-

¹⁶¹(1927) 103 W. Va. 290, 293-294, 137 S. E. 222-223.

¹⁶²See also *Dyer v. Jacoway*, (1905) 76 Ark. 171, 176, 88 S. W. 901, 903: "But if the conveyance to the surety is only to indemnify him, then such security does not, in the first instance, attach to the debt, and whatever equity may arise in favor of the creditor with regard to the security arises afterwards, and in consequence of the insolvency of the parties principally liable for the debt;" *McIntyre v. Tenny*, (1882) 4 Ky. L. Rep. 259 (insolvency of both principal debtor and surety emphasized); *Albion State Bank v. Knickerbocker*, (1900) 125 Mich. 311, 314, 84 N. W. 311, 313 (same, although the securities were construed to have been given for the payment of the principal obligations); *Meeker v. Waldron*, (1901) 62 Neb. 689, 694-695, 87 N. W. 539, 541 (some emphasis upon surety's insolvency); *Keene Five Cents Savings Bank v. Herrick*, (1882) 62 N. H. 174, 177: "In this case it appears that the principal debtor and the sureties are all insolvent, and under such circumstances the creditor, according to all the authorities, is entitled to the benefit of the security held by the sureties;" *Ijames v. Gaither*, (1885) 93 N. C. 358, 362-364 (insolvency of both principal debtor and surety emphasized); *Ohio Life Ins. & Trust Co. v. Reeder*, (1849) 18 Ohio 35, 46-47 (insolvency of principal debtor apparently thought necessary); *Brown & Heywood Co. v. Ligon*, (C.C. Mo. 1899) 92 Fed. 851, 856 (presence of same factor emphasized); *Mathews v. Abbott*, (D.C. Me. 1878) 2 Hask. 289, Fed. Cas. No. 9,275 (insolvency of both principal debtor and surety apparently thought necessary). In *Willard, Right of a Creditor to His Sureties' Securities*, (1880) 14 Am. L. Rev. 839, 857, the author's contention is that the creditor's equity should first arise out of the fact of the surety's insolvency; and in *Scott, The Creditor's Right to Subject the Securities of the Surety When They Purport to be for Indemnity Merely*, (1885) 19 Am. L. Rev. 867, 877, the insolvency of both principal debtor and surety is emphasized as operating "inequitably, to the obstruction of his [the creditor's] legal remedies."

¹⁶³See *Osborn v. Noble*, (1872) 46 Miss. 449, 454-455: "If a mortgage or other security is given to the surety, not to secure the debt or to provide a fund for its payment, but to save harmless from a contingent liability or loss, that contingency must come, or the injury be sustained before a right to the indemnity inures to the creditor. Where the contract is for the

ently realizable rights in the securities given for his indemnification, by virtue of his not yet having been damnified within the terms of the security agreement, the supreme court of Mississippi has expressly denied that the fact of anyone's insolvency is at all material for the purpose of creating rights in the creditor that would not otherwise exist. Thus in *Bush v. Stamps*,¹⁶⁴ in which both the principal debtor and the surety were discharged bankrupts, it was held that

"Shelby [the surety] had no right, before his bankruptcy, to order the trustees to sell the property under the deed, and that the creditor must be confined to the rights which Shelby then had."

And in *Pool v. Doster*¹⁶⁵ the same court stated:

"In none of our cases is any mention made of the insolvency of the surety to whom a security for his indemnity was given as affecting the rights of the parties. . . . Upon the principle of our cases as to securities as mere indemnity to the surety, his supervening insolvency could not create a right in the creditor which he would not otherwise have to resort to the security given to the surety."

Certainly it is not readily apparent why the insolvency of either the principal debtor or the surety, or of both, should be the point of significance in creating rights in the creditor that would not otherwise exist, with the effect of giving him a preference in the securities at the very time that their appropriation exclusively to him first becomes prejudicial to others. The analogy of the "rule of *Ex parte Waring*" has no doubt had some influence upon the American courts; and of course, to a court that feels that the creditor's remedies at law should be shown to be inadequate before permitting him to proceed against the securities, the insolvency of the principal debtor or the surety, or of both, might be used to supply the necessary inadequacy of the legal remedies.¹⁶⁶

personal benefit of the surety, in opposition to the idea of a pledge for the debt, or providing means for its payment, the creditor can claim only such rights and remedies as the surety had. If he has not been damnified, and the conditions of the mortgage or other contract of indemnity are unbroken, the surety himself could assert no remedy, nor could the creditor claiming through him and in his stead have substitution."

¹⁶⁴(1853) 26 Miss. 463, 467.

¹⁶⁵(1881) 59 Miss. 258, 262-263.

¹⁶⁶In *Ohio Life Ins. & Trust Co. v. Reeder*, (1849) 18 Ohio 35, 46-48, the court apparently thought it necessary, both that the principal debtor be insolvent, and that judgment already have been rendered against the surety with execution thereon returned unsatisfied, for the purpose of showing the inadequacy of the creditor's legal remedies: "The substitution of a creditor, to the indemnities of the surety, is a high exercise of chancery powers, and will not be resorted to unless in cases where the ordinary remedies have failed." See also Scott, *The Creditor's Right to*

But even so, such inadequacy of the legal remedies is not of itself a sufficient ground in equity for the creation of new substantive rights that would not otherwise exist; and insolvency as a form of inadequacy of the legal remedies is not ordinarily a basis for the creation of preference rights.¹⁶⁷ It would seem instead, without the aid of further principles yet to be developed, that in the circumstances in which the fact of insolvency becomes at all material, it should work in exactly the opposite direction—that is, with the effect of barring whatever direct rights might otherwise be held to lie in the particular creditor for the purpose of preventing needless circuitry or multiplicity of actions.

If the principal debtor alone is insolvent, that fact should have no effect at all upon whatever rights in the creditor would otherwise be held to exist, since the surety's preference right in the securities is still a presently realizable asset of his estate, as available as any other to execution by the particular creditor. Similarly the surety's insolvency, to the extent that it is not accompanied by a forced judicial administration of his estate and does not preclude a race in diligence among his creditors for the appropriation of his assets, should not have the effect of barring rights of the particular creditor in the securities that he would otherwise be held to have. In a situation in which the surety alone is insolvent and the securities are sufficient for the payment in full of the principal obligation, it is equally apparent that no one will be injured by the appropriation of the securities to the payment of that obligation; and this would seem likewise to be true wherever, both the principal debtor and the surety being insolvent and the securities being sufficient for the payment in full of the principal obligation, the particular creditor might also receive payment in full by proving against both insolvent estates.¹⁶⁸

But to the extent that it has become certain because of his insolvency that he will not be called upon to respond in full to his liability under the principal obligation, it would seem that the surety has not been damnified;¹⁶⁹ and to the extent that he has

Subject the Securities of the Surety When They Purport to be for Indemnity Merely, (1885) 19 Am. L. Rev. 867, 877.

¹⁶⁷See McClintock, Handbook of Equity 68: "Where the granting of specific relief against an insolvent defendant would give plaintiff a preference over other creditors to which he is not equitably entitled, relief may be refused for that reason, though it be admitted that the remedy at law is inadequate."

¹⁶⁸See above, text at note 54.

¹⁶⁹Though compare *Johnson v. Martin*, (1915) 83 Wash. 364, 145 Pac. 429, 432: "This case being between the principal debtor and the creditor

not been damnified he has himself no presently realizable asset in the securities, available, under the subrogation theory, to execution by the particular creditor. And once damnification has occurred in the form of dividends declared from the surety's other assets in favor of the particular creditor, it would seem that his interest in the indemnifying securities should become presently realizable for the benefit of his other general creditors as well as the particular one. Without the aid of further principles yet to be developed, it would seem that the only logical application that can be made of the fact of the surety's insolvency by courts purporting to follow the subrogation theory should be to preclude rights that might otherwise be held to exist in the particular creditor—because of the surety's lack of damnification—rather than to create them. To this extent the subrogation theory, standing alone, breaks down, and is impeded rather than aided by the fact of the surety's insolvency.

If it be assumed that both the principal debtor and the surety are insolvent, and that the particular creditor would be unable to receive payment in full by proving against both estates, it also follows that such creditor may be given a preference over the other unsecured creditors of the principal debtor, to whose estate any excess of the securities over the amount necessary for the surety's indemnification is assumed to belong.¹⁷⁰ Why a preferential equity in the securities should first arise in the creditor by virtue of the very circumstances in which others may be thereby prejudiced would seem, offhand, to be beyond comprehension. It should be noted that the American cases attributing significance to the fact of the insolvency of the principal debtor or the surety, or of both, although no doubt influenced by it, have not expressly adopted the rationale of the "rule of *Ex parte Waring*," with its limitations.

But it is equally obvious that the very circumstances of both the principal debtor's and the surety's insolvency are usually the motivating factors from the creditor's point of view in seeking to proceed in equity directly against the securities; and it is believed that it may be safely assumed that in most of the cases according to

on the contract and the bond, it can make no difference whether the surety has discharged its obligation (suffered loss or damage) or not; for equity will treat it as discharged in virtue of the insolvency of the surety, and will make all assets in its hands available for the discharge of the principal debt."

¹⁷⁰See above, text at notes 54 and 55.

the creditor preferential rights in the securities the parties personally liable were in fact insolvent. This raises the question whether it may not be only the subrogation theory that is deficient, rather than that the result achieved is unsound, and whether there may not be still some other basis for according to the particular creditor paramount rights, even in merely indemnifying securities, that the circumstances of insolvency do not affect. It has been said that

"The great weight of authority . . . is against the proposition, that the creditor's right is rooted in the doctrine of subrogation. . . . The clear deduction from the cases is, that, an assignment of the securities by the principal to his surety for indemnity merely, raises an implied trust in favor of the creditor, which, on maturity of his debt, he may enforce, whether the surety has been damnified or not, and irrespective of the question whether the surety or the principal, either or both, are insolvent."¹⁷¹

An impressive number of American cases reach the trust result regardless of whether the securities were specifically appropriated to the payment of the principal indebtedness or were given

¹⁷¹Morrill v. Morrill, (1880) 53 Vt. 74, 80-81, 38 Am. St. Rep. 659, 660. The court also stated: "The assignment of security by the principal to his surety is an appropriation of funds for the ultimate discharge of the debt, for which he is holden. The surety has the right to apply the security directly to the payment of the debt. If the surety pays with his own funds, *he keeps his principal's debt on foot* against him, and then applies the security to its payment. Thus in any event the funds of the principal are made to satisfy the principal's debt, and this accords with the purpose of the principal, when he gave the security. . . . Here the principal and surety are both insolvent, and the liability of the surety has been fixed by judgment; but we regard these facts as important, only as they seem to intensify the equity of the oratrix."

See also Swift & Company v. Kortrecht, (C.C.A. 6th Cir. 1900) 112 Fed. 709, 714: "The rule has long been settled that all securities given by the debtor for the payment of his debt inure to the benefit of the creditor. It is not necessary that they be given directly to the creditor or in express terms contain an agreement to pay the debt. If given to a surety to secure him, equity treats it as collateral to the debt. Some of the decided cases suggest a distinction which would exclude from the operation of the rule those cases where the language of the securing instrument indicates only a purpose to indemnify a surety, and does not indicate any agreement to pay the principal debt. But it does not appear to us that there is any solid ground for this distinction. It rests upon the idea that the creditor's right can be no larger than that of the surety, which is measured by the terms of his security. But, when the debtor procures his surety to become liable for the debt, an implied obligation immediately falls upon the debtor to pay the debt himself. And this obligation is of so distinct and positive a character that, if the debtor fails to meet it, the surety may file a bill in equity to compel him to do so. . . . The obligation is equally effective as if it were literally expressed. How else shall the debtor save his surety harmless than by satisfying the obligation? There is therefore no enlargement of the debtor's obligation by subrogation of the creditor."

merely for the surety's personal indemnification; although it is believed to be impossible to determine the actual numerical weight of authority, owing to the generality of the language used by the courts, to the existence of inconsistent utterances by courts of the same jurisdiction, and to the unemphasized presence, in many cases using broad language, of the same factors thought by other courts to be indicative of a specific appropriation of the securities to the payment of the principal indebtedness. Such cases have held that securities given merely for the surety's personal indemnification may nevertheless be appropriated by the creditor to the exclusion of the surety, even though the surety has not yet been damnified and has himself no presently realizable interest in the securities, and regardless of the possibilities of prejudice to the surety or to the principal debtor's other creditors or to both.¹⁷² The Kentucky cases, originally emphasizing the significance of the securities having been specifically appropriated to the payment of the principal obligation, have more recently been tending to hold that "A security given by the principal debtor to his surety is a security for the debt, as well as the ultimate protection of the surety, and operates *eo instanti* for the benefit of the creditor."¹⁷³

¹⁷²Harlan County v. Whitney, (1902) 65 Neb. 105, 107, 90 N. W. 993; Fields v. Letcher State Bank, (1934) 256 Ky. 592, 594, 76 S. W. (2d) 908, 909.

¹⁷³Alexander v. West, (1931) 241 Ky. 541, 545, 44 S. W. (2d) 518, 520 (italics supplied). See also Commonwealth Life Ins. Co. v. Combs, (1933) 251 Ky. 540, 545, 65 S. W. (2d) 696, 698; Fields v. Letcher State Bank, (1934) 256 Ky. 592, 594, 76 S. W. (2d) 908, 909.

The following cases appear by their language to lend further support to the broader doctrine announced by the cases already cited in notes 171-173 inclusive: Whitehead v. Henderson, (1899) 67 Ark. 200, 205, 56 S. W. 1065, 1067; Van Orden v. Durham, (1868) 35 Cal. 136, 145-147; Belcher v. The Hartford Bank, (1843) 15 Conn. 381, 383; Plaut v. Storey, (1891) 131 Ind. 46, 49-50, 30 N. E. 886, 887; Seibert v. True, (1871) 8 Kan. 52, 63; In re Jerome B. Fickett, (1881) 72 Me. 266, 267-268; Owens v. Miller & Mayhew, (1868) 29 Md. 144, 161; Boyd v. Parker & Co., (1875) 43 Md. 182, 199-200; Baltimore & O. R. Co. v. Trimble, (1878) 51 Md. 99, 113-114; Union Nat'l Bank v. Rasch, (1895) 106 Mich. 319, 328, 64 N. W. 339, 342; Union Nat'l Bank v. Rich, (1898) 116 Mich. 414, 416-417, 74 N. W. 659, 660; Lindsay v. Morse, (1902) 129 Mich. 350, 353, 88 N. W. 881, 882; Haven v. Foley & Papin, (1853) 18 Mo. 136, 139; Thornton v. National Exchange Bank, (1878) 71 Mo. 221, 232; O'Neill v. State Savings Bank, (1906) 34 Mont. 521, 87 Pac. 970, 971; Richards v. Yoder, (1880) 10 Neb. 429, 432, 6 N. W. 629, 630; Holt v. Penacook Savings Bank, (1883) 62 N. H. 551, 553; Barton v. Croyden, (1885) 63 N. H. 417, 418; People v. Metropolitan Surety Co., (1911) 148 App. Div. 503, 132 N. Y. S. 829, 831; People v. Metropolitan Surety Co., (1911) 148 App. Div. 512, 132 N. Y. S. 835, 836, *aff'd*, People v. Metropolitan Surety Co., (1912) 205 N. Y. 135, 98 N. W. 412; Sexton v. Fensterer, (1913) 154 App. Div. 542, 139 N. Y. S. 811, 816-817, *aff'd*, Sexton v. Fensterer, (1914) 213 N. Y. 641, 107 N. E. 1085; Matthews v. Joyce, (1881) 85 N. C. 258, 266; James v. Gaither, (1885)

If such cases are based only upon false precedent and unsound reasoning, at least the names of Pound¹⁷⁴ and Smith¹⁷⁵ have joined those of Kent and Story among the ones deceived.

It is believed that Dean Arant weakened the force of his argument against a creditor's rights in merely indemnifying securities when he conceded it to be unquestionable that an interest in the creditor should be recognized whenever "the security is given for the expressed purpose of paying the debt due him."¹⁷⁶ For even in such cases it is submitted that the primary object of the parties to the security transaction is normally to secure the surety rather than the creditor, and to give the surety rather than the creditor control over the realization of the securities.¹⁷⁷ Else why were not the securities given directly to the creditor in the first place? He chose rather to rely for his security upon the surety's solvency, and to the extent that his reliance was misplaced it is not for courts of equity, for that reason alone, to make a new and better bargain for him upon the pretext of a presumed intent found in the security instrument.¹⁷⁸ The specious character of the factors emphasized by so many American courts in finding the securities to have been specifically appropriated to the payment of the principal obligation, as distinguished from the purpose of merely personal indemnity to the surety, has already been noted.¹⁷⁹ In other words, the results reached by practically all of the American courts, if sound, have yet to be explained upon some common ground other than either the theory of subrogation or

S. E. 1035-1036; *Green v. Dodge and Cogswell*, (1834) 6 Ohio 80, 85, 25 Am. Dec. 736, 740; *Kramer v. Farmers & Merchants' Bank of Steubenville*, (1846) 15 Ohio 254, 262-263; *Pendery v. Allen*, (1893) 50 Ohio St. 121, 130-132, 33 N. E. 716, 718-719; *Kramer & Rahm's Appeal*, (1860) 37 Pa. St. 71, 76-77; *Field v. Pelot*, (1842) McMullan (S.C.) 370, 378-379; *Breedlove v. Stump*, (1830) 3 Yerg. (Tenn.) 257, 262-264; *Kinsey v. McDearmon*, (1868) 5 Coldw. (Tenn.) 392, 395-396; *McRady v. Thomas*, (1885) 16 Lea. (Tenn.) 173, 175; *Magill v. Brown*, (1899) 20 Tex. Civ. App. 662, 675, 50 S. W. 143, 150; *Reed v. Continental State Bank of Beckville*, (Tex. Civ. App., 1928) 2 S. W. (2d) 426, 428-429; *Hauser v. King*, (1882) 76 Va. 731, 733-734; *Johnson v. Martin*, (1915) 83 Wash. 364, 145 Pac. 429, 431-433; *Haynes v. United States Fid. & G. Co.*, (D.C. Okla. 1934) 6 F. Supp. 272, 275.

93 N. C. 358, 362-364; *Blanton v. Bostic*, (1900) 126 N. C. 418, 421, 35

¹⁷⁴In *Harlan County v. Whitney*, (1902) 65 Neb. 105, 90 N. W. 993.

¹⁷⁵In *Holt v. Penacook Savings Bank*, (1883) 62 N. H. 551.

¹⁷⁶Arant, *Handbook of the Law of Suretyship and Guaranty* 371.

¹⁷⁷See *Eastman v. Foster*, (1844) 8 Metc. (Mass.) 19, discussed in notes 95 and 116, above.

¹⁷⁸Compare *Fertig v. Henne*, (1901) 197 Pa. St. 560, 567, 47 Atl. 840: "His [the surety's] solvency was and continues to be the creditor's security."

¹⁷⁹See above, pp. 346-348 of the text.

the theory of a trust having been intended for the creditor's benefit, standing alone.

There is another doctrine of bankruptcy and of equity which forbids a surety, who has only partially performed his obligation to the creditor, to prove his claim for reimbursement against the insolvent principal's estate in competition with the creditor until the latter has been fully paid.¹⁸⁰ The Supreme Court of the United States has held this doctrine to be equally applicable to the case of a surety for only a part of the principal indebtedness who has fully performed to the extent of his own obligation.¹⁸¹ "The rule is the same, and for like reasons, where the basis of the claim is the debtor's promise to indemnify, if the debtor is insolvent when the promise is enforced."¹⁸² And according to Mr. Justice Stone, speaking for a unanimous court in *Jenkins v. National Surety Company*:¹⁸³

"Similar reasoning underlies the requirement of equity that the surety who holds the security of an insolvent debtor must give the benefit of it to the creditor for whom he is surety, until the debt is fully paid."

In the case of *American Surety Company of New York v. Westinghouse Electric Manufacturing Company*,¹⁸⁴ decided by the Supreme Court of the United States in 1935, one Gray had entered into a contract with the United States for the drilling of a well at the Naval Air Station at Pensacola, Florida, for a total contract price of \$13,133.36. To secure performance on his part a bond was executed by Gray as principal and the American Surety Company as surety, in the penal sum of \$3,940. Payments towards the contract price were to be made in accordance with approved estimates as the work progressed, but the contracting officer was required to retain ten per cent of the amount of the estimates "until final completion and acceptance of all work covered by the contract." Gray completed the work as required by the contract, but went into bankruptcy without having paid all the

¹⁸⁰See 4 Williston, Treatise on the Law of Contracts, rev. ed., 3634-3635, 3639.

¹⁸¹*United States v. National Surety Co.*, (1920) 254 U. S. 73, 76, 41 Sup. Ct. 29, 30, 65 L. Ed. 143; *Jenkins v. National Surety Co.*, (1928) 277 U. S. 258, 266-267, 48 Sup. Ct. 445, 447, 72 L. Ed. 874; *American Surety Co. v. Westinghouse Electric Mfg. Co.*, (1935) 296 U. S. 133, 137, 56 Sup. Ct. 9, 11, 80 L. Ed. 105; see also *First Nat'l Co. v. State-Planters Bank & Trust Co.*, (1936) 164 Va. 491, 503-506, 180 S. E. 281, 285-286.

¹⁸²*American Surety Co. v. Westinghouse Electric Mfg. Co.*, (1935) 296 U. S. 133, 137, 56 Sup. Ct. 9, 11, 80 L. Ed. 105.

¹⁸³(1928) 277 U. S. 258, 267, 48 Sup. Ct. 445, 447, 72 L. Ed. 874.

¹⁸⁴(1935) 296 U. S. 133, 56 Sup. Ct. 9, 80 L. Ed. 105.

persons furnishing labor and materials who were held to fall within the protection of the bond.¹⁸⁵ The surety company thereupon paid the full amount for which it was liable, which was insufficient, however, to satisfy the claims of the obligees of the bond. The controversy in the case was between the surety company and the obligees of the bond with respect to the sum of \$2,724.23, which represented the ten per cent of the estimates as the work progressed that had been retained by the contracting officer in accordance with the terms of the contract. The surety company claimed this amount by way of subrogation to the rights of the laborers and materialmen to whom it had paid the full amount of its bond,¹⁸⁶ and also by virtue of a covenant of indemnity received from Gray which the court assumed amounted "to a specific appropriation of the percentages reserved or of any other assets." The Supreme Court not only rejected the surety company's claim to the entire amount, but also refused to permit it to participate ratably therein, in competition with the laborers and materialmen who had not yet received payment of their claims in full. Mr. Justice Roberts alone dissented, contending that the surety company should be permitted to share ratably.

In the majority opinion Mr. Justice Cardozo, after calling attention to the principles just stated, quoted from *Jenkins v. National Surety Company*¹⁸⁷ as follows:

¹⁸⁵Laborers and materialmen, together with the government, are obligees or beneficiaries of a bond so given (*Equitable Surety Co. v. United States*, (1914) 234 U. S. 448, 34 Sup. Ct. 803, 58 L. Ed. 1394; *Illinois Surety Co. v. John Davis Co.*, (1917) 244 U. S. 376, 37 Sup. Ct. 614, 61 L. Ed. 1206; *Brogan v. National Surety Co.*, (1918) 246 U. S. 257, 38 Sup. Ct. 250, 62 L. Ed. 703, L. R. A. 1918D 776), though the claims, if any, of the government are to have priority of payment." *American Surety Co. v. Westinghouse Electric Mfg. Co.*, (1935) 296 U. S. 133, 135, 56 Sup. Ct. 9, 10, 80 L. Ed. 105.

¹⁸⁶See *Henningsen v. United States Fid. & G. Co.*, (1908) 208 U. S. 404, 28 Sup. Ct. 389, 52 L. Ed. 547. But much confusion has arisen from the fact that, in deciding that case, "the Supreme Court did not make it clear whether the surety, who had paid labor and material claims and whose rights were held to be superior to those of a general creditor holding an assignment from the contractor, was subrogated to the rights of laborers and materialmen or subrogated to the rights of the contractor as of the time the bond was written, and whether, if the surety was subrogated to the rights of laborers and materialmen, such rights extended beyond retained percentages and included all deferred payments due upon the completion of the contract. It is to be hoped that in a proper case the Supreme Court will take occasion to clarify the situation, so that it may be definitely known what equitable rights laborers and materialmen have in addition to their rights under a public contractor's bond, and whether such rights, if any, are limited to retained percentages or apply to progressive payments as well." Sanborn, J., in *Martin v. National Surety Co.*, (C.C.A. 8th Cir. 1936) 85 Fed. (2d) 135, 140.

¹⁸⁷(1928) 277 U. S. 258, 267, 48 Sup. Ct. 445, 447, 72 L. Ed. 874.

"Wherever equitable principles are called in play, as they pre-eminently are in determining the rights and liabilities of sureties and in the distribution of insolvents' estates, they likewise forbid the surety to secure by independent contract with the debtor indemnity at the expense of the creditor whose claim he has undertaken to secure."

He then continued:

"This is surely so unless the contract of indemnity has the effect of a specific lien. . . . We are told in effect that the displacement of a lien is an exercise of power more drastic and far-reaching than the marshalling of assets where there has been no agreement for a lien. The distinction might be important if the contest were between the surety and creditors not covered by the bond or between the surety and later assignees of the security so promised. . . . Such is not the situation here, even though we assume in aid of the petitioner that the promise to indemnify, obscure in its terms, is to be read as amounting to a specific appropriation of the percentages reserved or of any other assets. The contest in this cause is between the surety on the one hand and on the other hand creditors of the class it has undertaken to protect."¹⁸⁸

It is true that Mr. Justice Cardozo also emphasized that the bond involved was one required by law, and added: "What considerations may govern after payment of the penalty in full where the bond is altogether a voluntary security we do not need to inquire." And he might well have further emphasized that the effect of the legal requirement of withholding ten per cent of the payments toward the contract price until final completion of the work was really to impose a trust upon the funds thus withheld, for the benefit of the laborers and materialmen, prior in point of time to the lien upon the same funds given by the principal obligor to the surety by way of indemnity.¹⁸⁹ But the rationale of the decision was in no way made to depend upon the latter proposition. And after calling attention to a group of cases involving the problem of the rights of creditors in their sureties' indemnifying securities, Mr. Justice Cardozo emphasized that such cases, "though they suggest an analogy, do not control [in the solution of the problem before the court], even in principle, *for there the surety was in default upon his obligation to the creditor.*"¹⁹⁰ Certainly the ground upon which Mr. Justice

¹⁸⁸(1935) 296 U. S. 133, 138, 56 Sup. Ct. 9, 11, 80 L. Ed. 105.

¹⁸⁹See note 186, above.

¹⁹⁰(1935) 296 U. S. 133, 139, 56 Sup. Ct. 9, 12, 80 L. Ed. 105 (italics supplied). The cases cited were *Keller v. Ashford*, (1890) 133 U. S. 610, 10 Sup. Ct. 494, 33 L. Ed. 667; *Hampton v. Phipps*, (1882) 108 U. S. 260, 2 Sup. Ct. 622, 27 L. Ed. 719; and *Moses v. Murgatroyd*, (1814) 1 Johns. Ch. (N.Y.) 119.

Cardozo thus distinguished the cases of the type now under consideration should logically make the rationale of his opinion still more rather than less applicable in the solution of the problem of those cases than of the one immediately before the court.

Though it may appear so offhand, we have not thus been brought back after all to a proposition that the insolvency of the principal debtor is the point of significance at which the creditor's rights in the surety's indemnifying securities first arise. Obviously it is not the insolvency of the principal debtor, operating through the principle of non-competition by the surety with the as yet unpaid creditor, in assets emanating from the insolvent principal debtor, that *first* gives rise to such rights; for the principle of non-competition would not alone be sufficient to give to the particular creditor a preference in the securities ahead of the principal debtor's other general creditors besides the surety. Rather the creditor's interest must have arisen prior to the insolvency of the principal debtor, either through the surety or independently of him, and the significance of the principle of non-competition by the surety in assets emanating from the insolvent principal debtor is to remove the objection of prejudice to the surety, or to the principal debtor's other creditors, or to both, that might otherwise arise. The non-competitive principle is supplementary rather than of itself the creative origin of the creditor's rights.

By hypothesis the surety has himself a preference right in the securities ahead of the principal debtor's other creditors, so that the securities are beyond the reach of execution by them.¹⁰¹ To the extent that the surety has himself a presently realizable right in the securities, the principal debtor's other creditors will not be further harmed by the enforcement of the surety's own right, with the proceeds passing exclusively to the particular creditor by virtue of the non-competitive principle. To hold otherwise would be either to destroy the non-competitive principle or else the security agreement, restoring the securities to the principal debtor's general assets, and there is no proper basis for doing either. Nor have the surety's own other creditors any higher rights than the

¹⁰¹"When the surety receives security from his principal for the expressed purpose of indemnifying him against loss, he is in the same position as one who is given a mortgage to secure future advances but, as yet, has made none. No one else can acquire a superior claim to the property mortgaged, but, if no advances are ever made, the mortgagee has no enforceable interest in it." Arant, Handbook of the Law of Suretyship and Guaranty 371.

surety himself. And if the surety is himself also insolvent, so that he has not as yet been fully damnified, it nevertheless follows that as rapidly as he is damnified in the form of dividends declared from his other assets in favor of the particular creditor, the non-competitive principle still requires that his now available right of reimbursement from the securities be exercised exclusively in favor of the particular creditor until the latter has received payment in full, rather than that it become an asset of the surety's estate for general distribution among all his creditors as under the Scottish rule.¹⁹²

The non-competitive principle does not cease to operate by virtue of the surety's own insolvency. Furthermore, by virtue of the surety's inability to compete with the particular creditor in the proceeds of the securities until the latter has received payment in full, it follows that despite the realization of the securities to the extent of the surety's damnification he nevertheless remains still damnified in the same amount, which effectively prevents the restoration of the securities to the principal debtor's general assets. The surety's presently realizable interest in the securities, to the extent of his damnification, is therefore not exhausted by a single exercise in favor of the particular creditor. It is simpler to appropriate them from the beginning to the payment in full of the particular creditor, or to the extent that they are sufficient for that purpose, thus satisfying at the same time the surety's own right of exoneration, and restoring any excess to the principal debtor's general assets.

In other words, owing both to the availability of the surety's own interest in the indemnifying securities to execution in favor of the particular creditor, and to the non-competitive principle, the very nature of a surety's indemnifying securities received from the principal debtor is such as effectively to prevent the surety from having exclusive control over the realization of the securities for his own benefit and that of his other general creditors until the particular creditor has received payment in full of the principal obligation. By virtue of the intent of the indemnifying agreement, they may not be restored to the principal debtor's general assets until either the surety has been relieved of risk or they have served their purpose of the surety's indemnification, which, however, by the operation of equitable principles, may not be accomplished over the proper assertion of the particular creditor's interest, until the latter has been paid in full.

¹⁹²See above, pp. 336-339 of the text.

Professor Williston has concluded, although without adequately setting forth the reasoning upon which his conclusion is based, that

"if the agreement . . . is interpreted as not precluding the surety from exonerating himself by resort to the security, then the creditor should be entitled to the security irrespective of the surety's solvency or insolvency, and in the latter event in priority to his general creditors."¹⁹³

On the hypothesis that the creditor's right is strictly "derivative," however, he also contends that if the security agreement "is interpreted as limiting the surety to reimbursement for loss suffered, no right should accrue to the creditor."¹⁹⁴

But the reasoning already advanced is believed equally to sustain, under most circumstances, the existence of rights in the creditor in the latter situation when once "loss," in whatever form, is held to have been suffered by the surety. For even in that situation, the surety's right to recoup from the securities the amount of his loss already suffered is still a presently realizable asset of the surety, available to the exclusive appropriation by the particular creditor at least to the extent that by a race in diligence he is able to secure priority over the surety's other creditors. And once the principal debtor has become insolvent, the non-competitive principle comes into operation to prevent recoupment from the securities by the surety or his other creditors for the loss already suffered, until after the particular creditor has been paid in full. Only where the principal debtor is not insolvent, and the surety's other creditors have by prior action secured priority in the surety's right to recoup from the securities the amount of his loss already suffered, or else have secured equal rights therein by virtue of the forced administration of the surety's own estate, is the second statement quoted from Professor Williston believed to be a necessary logical consequence of his "derivative right" hypothesis.

The theory of the creditor's so-called subrogation, and the non-competitive principle, are together believed to be sufficient to sustain the results reached by a decided majority of the American cases upon their specific facts, since in most of them the principal debtor may be assumed to have been insolvent. The courts achieving the trust result in cases of merely indemnifying securities have emphasized the factor of the securities having

¹⁹³⁴ Williston, *Treatise on the Law of Contracts*, rev. ed., 3624-3625.

¹⁹⁴⁴ Williston, *Treatise on the Law of Contracts*, rev. ed., 3624.

emanated from the principal debtor and thereby having depleted assets to which the particular creditor is equitably entitled in preference to the surety;¹⁹⁵ and they have for the most part refused to reach the same result in cases of indemnifying securities furnished by a stranger to the principal obligation, in which the non-competitive principle is lacking.¹⁹⁶ But to the extent that co-sureties are each liable for the full amount of the principal obligation, so that the non-competitive principle becomes applicable to one co-surety's right of contribution from the insolvent estate of another, it would seem to be erroneous to treat indemnifying securities given by one co-surety to another the same as though given by a stranger to the principal obligation.¹⁹⁷ The creditor's right to indemnifying securities furnished to a surety by one who is himself fully liable for the principal obligation, even though it be regarded as derivative, is nevertheless, because of the non-competitive principle, a right of a much higher order than, and paramount to, the right of one co-surety to the benefit of a ratable proportion of indemnifying securities furnished by the principal debtor to another co-surety;¹⁹⁸ although the two

¹⁹⁵*Union Nat'l Bank v. Rasch*, (1895) 106 Mich. 319, 328, 64 N. W. 339, 342; *Meeker v. Waldron*, (1901) 62 Neb. 689, 694-696, 87 N. W. 539, 541; *Keene Five Cents Savings Bank v. Herrick*, (1882) 62 N. H. 174, 175; *Price v. Trusdell*, (1877) 28 N. J. Eq. 200, 203-205; *Ijames v. Gaither*, (1885) 93 N. C. 358, 362-364; *Breedlove v. Stump*, (1830) 3 Yerg. (Tenn.) 257, 262-264; *Hauser v. King*, (1882) 76 Va. 731, 733-734; *Johnson v. Martin*, (1915) 83 Wash. 364, 145 Pac. 429, 430-433.

¹⁹⁶*Taylor v. Farmers' Bank of Kentucky*, (1888) 87 Ky. 398, 9 S. W. 240; *Black v. Kaiser*, (1891) 91 Ky. 422, 16 S. W. 89; *Clay v. Freeman*, (1896) 74 Miss. 816, 20 So. 871; *O'Neill v. State Savings Bank*, (1906) 34 Mont. 521, 87 Pac. 970; *Hasbrouck v. Carr*, (1914) 19 N. M. 586, 145 Pac. 133; *Morgan v. Francklyn and Butler*, (1873) 55 How. Pr. (N.Y.) 244; *Henderson-Achert Lithographic Co. v. John Shillito Co.*, (1901) 64 Ohio St. 236, 60 N. E. 295; *Hampton v. Phipps*, (1883) 108 U. S. 260, 2 Sup. Ct. 662, 27 L. Ed. 719 (securities furnished to one co-surety by another).

But compare *Magoffin v. Boyle Nat'l Bank of Danville*, (1902) 24 Ky. L. Rep. 585, 69 S. W. 702; *Commonwealth Life Ins. Co. v. Combs*, (1933) 251 Ky. 540, 65 S. W. (2d) 696; *Fields v. Letcher State Bank*, (1934) 256 Ky. 592, 76 S. W. (2d) 908; *King v. Harman's Heirs*, (1834) 6 La. 607, 26 Am. Dec. 485; *Brown & Heywood Co. v. Ligon*, (C.C. Mo. 1899) 92 Fed. 851.

¹⁹⁷As was done by the Supreme Court of the United States in *Hampton v. Phipps*, (1883) 108 U. S. 260, 2 Sup. Ct. 622, 27 L. Ed. 719; contra, supporting the statement in the text, *Seward v. Huntington*, (1882) 26 Hun (N.Y.) 217. On the strict subrogation theory, the decision in *Hampton v. Phipps* may no doubt be supported by the fact that the right of each co-surety to realize upon the securities given to him by the other depended upon his having paid more than one-half of the principal obligation, which contingency had not occurred and could not occur because of the insolvency of both sureties.

¹⁹⁸The paramount character of the creditor's right over that of a

rights are frequently linked together as though having the same basis and being of equal extent.¹⁹⁹

There remains only the final question whether there may not be justification for giving to the creditor a direct rather than a strictly derivative right in indemnifying securities received by the surety from the principal debtor, which the surety may not at any time destroy without the concurrence of the creditor, even prior to damnification or loss having been suffered and while his own interest in the securities is still contingent. If the analogy of the surety's own subrogation, upon payment by him of the principal obligation, to the benefit of securities held by the creditor, were to be regarded as strictly applicable in the converse situation of indemnifying securities held by the surety, it would seem arguable that the surety ought not to be permitted to impair the creditor's interest in the surety's securities, even though derivative and still contingent, any more than is the creditor permitted to impair the surety's interest in the creditor's securities, which is equally derivative and still contingent, without thereby releasing the surety from his personal liability upon the principal obligation. In both situations the interest of the one in securities held by the other is the result of the operation of equitable principles rather than of the intent of the parties to the security agreement, and in both it would seem that the principles capable of creating the interest in the first place should retain sufficient vitality to prevent its impairment. It has already been suggested that there was no inherent necessity of equity's according to a surety, who is unsecured in his right of reimbursement from the principal debtor, the benefit of the creditor's own preferences at the expense of junior encumbrancers.²⁰⁰ It all comes back in both situations to a question of the proper basis and extent of the interest originally created in the one in securities held by the other.

In the ordinary third-party-beneficiary situation Professors Corbin and Williston, and the Restatement of Contracts, representing the prevailing tendency of the American cases, have come at least very close to recognizing the existence of direct rather than strictly derivative rights in creditor- as well as donee-benefici-

co-surety appears to have been recognized by the court in *Belcher v. The Hartford Bank*, (1843) 15 Conn. 381; and in *Price v. Trusdell*, (1877) 28 N. J. Eq. 200, the court appears to work out the co-surety's rights in securities held by another co-surety indirectly by way of subrogation to the creditor's rights.

¹⁹⁹See *Taylor v. Farmers' Bank of Kentucky*, (1888) 87 Ky. 398, 402-403, 9 S. W. 240, 241; see also note 3, above.

²⁰⁰See above, pp. 359-360 of the text.

aries.²⁰¹ This is certainly true to the extent that the promisee is held unable to release the promisor from his obligation to the creditor-beneficiary when once the latter has brought suit, or relied upon it to his detriment, or the situation of the promisee has become such as to render the release by him a fraud against his creditors.²⁰² For it is thereby assumed that the beneficiary has the right to bring suit, or otherwise to rely, upon the promise; and unless the beneficiary has a direct rather than a strictly derivative right, it is difficult to see why the promisee's circumstances being such as to render his release of any asset a fraud on creditors, should result in the beneficiary's thereby being irrevocably enabled to recover more from the promisor than he might recover upon his own original right against the promisee.

Also the restriction of the promisee's own right to enforce the promise to the circumstances in which he has been compelled to perform his own original obligation, or a part thereof, to the beneficiary, and placing his own right upon a theory of subrogation to that of the beneficiary; is a rather far step from a strictly "derivative" right theory.²⁰³ Of course the creditor-beneficiary's rights are "derivative" in the sense that they arise out of the third-party contract, and are subject to all conditions, express or implied, contained therein;²⁰⁴ but in that sense of the term the rights of a donee-beneficiary are equally "derivative." As to the latter the Restatement in section 142 has adopted the view that

²⁰¹Professor Corbin has taken this position more emphatically than has Professor Williston. Corbin, *Contracts for the Benefit of Third Persons*, (1918) 27 *Yale L. J.* 1008, 1022: "He gains this special right because the contracting parties intended that he should have it, or at least that the performance should go direct to him. To apply the 'equitable asset' theory is merely to recognize the third party beneficiary's right under another and mis-descriptive name." While Professor Williston has distinguished the creditor- from the donee-beneficiary, on the ground that the former's right is "purely derivative," see 2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1144, it is believed from the context, and from some of the consequences that he attaches to the creditor's right, that by "purely derivative" he means primarily that the creditor's right is derivative from the assumption contract, and from the promisee's own right against the promisor, rather than from the creditor's original right against the promisee through the equitable execution theory. See also Restatement, *Contracts*, secs. 136, 140, 141, 143, and 144.

²⁰²Restatement, *Contracts*, sec. 143.

²⁰³Restatement, *Contracts*, sec. 141.

²⁰⁴Restatement, *Contracts*, sec. 140: "There can be no donee beneficiary or creditor beneficiary unless a contract has been formed between a promisor and promisee; and if a contract is conditional, voidable, or unenforceable at the time of its formation, or subsequently ceases to be binding in whole or in part because of impossibility, illegality or the present

"Unless the power to do so is reserved, the duty of the promisor to the donee beneficiary cannot be released by the promisee or affected by any agreement between the promisee and the promisor."

In the ordinary third-party-beneficiary situation, as Professor Williston has so aptly pointed out,

" . . . it was no easier to find a principle requiring the promisee to hold as trustee for the beneficiary what he recovered, and for which he had paid the consideration, than to find a principle allowing a direct recovery by the beneficiary against the promisor. . . . The pressing necessity of the situation and the inherent reasonableness of this solution has led the great majority of the American courts frankly to recognize, as does the Restatement of Contracts, that through this travail the common law has given birth to a distinct, new principle of law which takes its own place in the family of legal principles, and gives not only to a donee beneficiary, but also to a creditor beneficiary, the right to enforce directly the promise from which he derives his interest."²⁰⁵

It is believed that the above statement would be still more apposite of the equitable principle enunciated by those cases reaching the result of a trust for the creditor's benefit in merely indemnifying securities received by the surety from the principal debtor. It has already been seen that the indemnifying securities, in the same sense as the promise to pay the debt of another, are an asset of the surety's estate of a peculiar and unique character—peculiar and unique in that their realization will necessarily redound to the benefit of the particular creditor, either directly, or indirectly to the extent that the surety's realization of them for his own exclusive benefit follows his already having paid such creditor. It is true that in the ordinary third-party creditor-beneficiary situation the existence of direct rights in the beneficiary is in no way complicated by the creation of any preferences, will ordinarily in no way prejudice the promisee, and is subject to any conditions, express or implied, contained in the agreement between the promisor and the promisee. But the very nature of securities as necessarily involving preferences, and the fundamental character of the creditor-principal debtor-surety relation, are believed not only to avoid the significance of these distinctions, but to place the creditor's right to indemnifying securities received by the surety from the principal debtor upon a still higher plane than the right of the ordinary third-party creditor-beneficiary.

or prospective failure of the promisee to perform a return promise which was the consideration for the promisor's promise, the right of a donee beneficiary or creditor beneficiary under the contract is subject to the same limitation."

²⁰⁵2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1049.

"The integrity of that relation is in the keeping of the law."²⁰⁶ The duty of the surety not to do anything to impede the creditor in the assertion of his remedies against the principal debtor, and not to compete with the creditor by proof of his claim for reimbursement against the assets of an insolvent principal debtor, brings the surety into a relation with the creditor very near to that of a fiduciary. The surety's unsecured right of reimbursement from a still solvent principal debtor, that exists despite the fact that the creditor has not yet been paid in full, is perhaps not at all inconsistent with the integrity of that relation, since the creditor might by prior action have secured payment in full from the principal debtor and may yet do so. Permitting the surety to assert his right of reimbursement from a still solvent principal debtor as soon as he has himself paid a part of the principal obligation encourages the surety to relieve the creditor of the burden of suit.

But in taking indemnifying securities from the principal debtor the surety necessarily is contemplating the possibility of his unsecured right of reimbursement from the principal debtor proving inadequate—a possibility which, however, if it eventuates before the creditor has received payment in full, will likewise render inadequate the latter's remedies against the principal debtor, and will preclude the surety from competing with him in the principal debtor's assets, including the indemnifying securities. The surety is attempting permanently to withdraw the securities from the principal debtor's assets available to execution by the creditor—and he should be deemed fully cognizant of the fact that in the only circumstances in which he will really need them before having paid the creditor in full, the latter will be to that extent impeded in his remedies against the principal debtor and at the same time entitled to freedom from competition from the surety's right of reimbursement.

In other words, to use an undesirable adjective for the lack of any better one, has not the surety perpetrated a form of "constructive" fraud, in the absence of the further factor of the full performance by him of his own obligation to the creditor? For the absence of such further factor, which, if present, would relieve the transaction of all possible objection, there is no sufficient legal excuse other than the fact of the surety's own insolvency; and he

²⁰⁶Cardozo, J., in *American Surety Co. v. Westinghouse Electric Mfg. Co.*, (1935) 296 U. S. 133, 139, 56 Sup. Ct. 9, 12, 80 L. Ed. 105. Compare the unusual liberality of the courts in allowing rescission of suretyship contracts for nondisclosure. See *Patterson, Cases and Materials on Contracts II*, 163, note (3).

would hardly stand in any stronger position for having contemplated the protection of his other creditors, at the expense of this particular one, in the event of his own insolvency being superimposed upon the circumstances rendering it inequitable for him to impede or compete with the latter in his remedies against the principal debtor. It is no sufficient answer to such reasoning to point out that had the surety not taken the indemnifying securities the principal debtor would have remained free to appropriate them to the benefit of someone else not standing in the relation of surety to the particular creditor, to the exclusion of all possible interest of the latter in them. The fact remains that the surety has taken the securities for the purpose of protecting himself against the very circumstances in which, unless the creditor has been paid in full, the surety is required not to impede or compete with him in his remedies against the principal debtor.

If the possibility of "constructive" fraud has been established, it should follow that the circumstances in which the possibility materializes give rise to a "constructive" trust in favor of the particular creditor, in no way dependent upon the specific intent of the parties to the indemnifying agreement. Is it too much of a further step for equity to impose the "constructive" trust from the very beginning, in order to prevent the conflict of interest from so much as arising in the circumstances in which it will become prejudicial to the creditor? There are other instances in the law—notably in the law of corporate directors—in which the beneficiary of a non-competitive although not fully fiduciary relation is held entitled to the benefits of a violation of that relation, instead of the violation itself being held to be completely void.²⁰⁷ It would not be a satisfactory solution of the present problem to hold that indemnifying securities may not be taken by a surety from one who is himself directly liable to the creditor for the full amount of the principal obligation, and therefore to avoid the security transaction and restore the securities to the latter's general assets, for that solution would also nullify the transaction's perfectly legitimate purpose of securing the surety's indemnification after the particular creditor has been paid in full. It is believed that the most satisfactory method by which equity may vindicate its principles is by decreeing direct and paramount rights in the securities to the particular creditor, from the moment they are taken by the surety until the creditor has been paid in full.

²⁰⁷See Riley, *Corporation's Right to Profits Made by Directors*, (1920) 4 MINNESOTA LAW REVIEW 513.

In the third-party creditor-beneficiary situation the Restatement of Contracts has taken the view in section 136 (d) that, except as modified by section 143, the "whole or partial satisfaction of the promisor's duty to the promisee in any other way than by rendering the promised performance in whole or in part does not limit the promisor's duty to the creditor beneficiary;" and in section 143 that

"A discharge of the promisor by the promisee in a contract or a variation thereof by them is effective against a creditor beneficiary if,

(a) the creditor beneficiary does not bring suit upon the promise or otherwise materially change his position in reliance thereon before he knows of the discharge or variation, and

(b) the promisee's action is not a fraud on creditors."

The Restatement has also, however, taken the view in Section 141 (2) that the promisee's own right to enforce the promise is dependent upon his right of reimbursement or subrogation in the event that the creditor-beneficiary has partially or totally, as the case may be, satisfied his claim "from assets of the promisee without resorting to the promisor's contract."

It is conceded to be arguable, in cases of indemnifying securities received by the surety from the principal debtor, that the recognition of the creditor's paramount rights should depend upon his own assertion of them. From this premise it could reasonably be held to follow that the creditor's knowledge of the fact of the securities having been taken, which the courts have generally held to be unnecessary to the creation of his interest in them,²⁰⁸ might nevertheless, in conjunction with his failure to assert his interest, be held to constitute a waiver of it—unless he is also held entitled to rely upon the effect that the law attaches to the indemnifying transaction in derogation of what he knows to have been the intent of the parties to it. It might also be held that the surety should be permitted to resort to the securities for his own exclusive benefit to the extent that, by having partially paid the creditor, he is entitled to present reimbursement from the assets of a still solvent principal debtor. This would seem to sustain the thought of some courts that up to the time of the principal debtor's insolvency the surety may appropriate the securities exclusively to the purpose of his own reimbursement or release them to the principal debtor as he sees fit.²⁰⁹ It would seem especially

²⁰⁸See the cases cited in note 99, above.

²⁰⁹*Dyer v. Jacoway*, (1905) 76 Ark. 171, 176, 88 S. W. 901, 903; *Jones v. Quinnpiack Bank*, (1860) 29 Conn. 25, 46; *Woodville v. Reed*, (1866)

pertinent in the case of a surety who has paid an installment of a principal obligation, the remainder of which is not yet in default; and much more so in the case of a surety for only a part of the principal obligation who has performed his own part in full, as to whom it is not contended that the principles here developed have any application in the absence of the further factor of the principal debtor's insolvency.²¹⁰ But for the surety under the circumstances of his own default to release securities, destined by their very nature to the particular creditor's benefit, partakes very much of the character of a conveyance fraudulent as to that creditor.²¹¹ It is believed that the surety's right to release the securities or effect with the principal debtor a novation in their purpose, if it be permissible under any circumstances, should in all events end upon a default in the payment of the principal obligation at its maturity.

In cases of merely indemnifying securities, even though not basing the result upon the theory of a trust for the creditor's benefit having arisen, the courts have nevertheless generally held that defenses personal to the surety, such as the expiration of the period of limitations upon his own personal liability, may be raised, if at all, in a proceeding by the creditor to appropriate the securities, only by the surety himself.²¹² This is of course entirely consistent with the rule to the effect that the surety is entitled to waive such defenses personal to himself, and still be able to assert his right of reimbursement from the principal debtor, provided that the liability of the latter has not also been discharged to the surety's knowledge.²¹³

But since the rights of the creditor in the securities have a still stronger basis than the rights of the creditor-beneficiary of a third-party contract, it should follow with at least the same reason as in the latter situation, that the surety should not even be permitted to raise such defenses personal to himself in respect of the principal obligation, to the prejudice of the creditor's interest in

26 Md. 179, 191, doubted in *Boyd v. Parker & Co.*, (1875) 43 Md. 182, 199-200; *McCracken v. German Fire Ins. Co.*, (1876) 43 Md. 471, 477; *Holt v. Penacook Savings Bank*, (1883) 62 N. H. 551, 554.

²¹⁰See *American Surety Co. v. Westinghouse Electric Mfg. Co.*, (1935) 296 U. S. 133, 139, 56 Sup. Ct. 9, 12, 80 L. Ed. 105.

²¹¹*Matthews v. Joyce*, (1881) 85 N. C. 258, 266: "To deprive him of this security without his intelligent assent to the surrender, would be a fraud upon his rights and will not be upheld in a court of equity."

²¹²*Simmons v. Goodrich*, (1882) 68 Ga. 750, 753; *Alexander v. West*, (1931) 241 Ky. 541, 545-546, 44 S. W. (2d) 518, 520.

²¹³*Sibley v. McAllaster*, (1836) 8 N. H. 389; *Henderson v. Locke*, (1925) 153 Tenn. 108, 282 S. W. 193; *Campbell, Cases on Suretyship* 34-41.

the securities.²¹⁴ However, for the reasons that a surety is not ordinarily entitled to pay a debt that has ceased to be legally binding upon both himself and the principal debtor,²¹⁵ that a security ordinarily follows and depends upon the principal obligation, and that the "constructive" trust approach depends largely upon the fact of the principal debtor's own personal liability, it would seem to follow that the creditor's interest in the securities should come to an end with the expiration of his rights against all persons upon the principal indebtedness. In such respects the reasoning that has been developed does not require in their entirety the same results reached by courts purporting to find an express trust for the creditor's benefit to have been the specific intent of the parties to the security agreement.²¹⁶

C. Where the Securities Proceed from a Stranger to the Principal Obligation.—It has been seen that the courts reaching the result of an express trust for the creditor's benefit in cases of securities found to have been specifically appropriated to the payment of the principal obligation, as distinguished from the purpose of merely personal indemnity to the surety, reach it likewise although the securities have proceeded from a stranger to the principal obligation, although without as great emphasis upon fictitious indicia of intent as in cases of securities proceeding from the principal debtor.²¹⁷ The trust result can here be justified only by finding present all the necessary elements of an express trust, since the non-competitive principle is lacking to justify any form of "constructive" trust. But in cases without such elements present the creditor may nevertheless have some rights in the securities of a lower order than as a cestui que trust of either an express or a "constructive" trust.

If either the personal liability or the property of a third-party indemnitor have been given to a surety for the purpose of his exoneration as well as his reimbursement, the third party has in effect placed himself, either personally or through and to the extent of the property pledged, between the surety and the creditor as the one who, next to the principal debtor, should pay the principal indebtedness. Lacking only a direct right in the creditor either against him personally or against the property he has pledged, and of course in no way hindering the creditor's primary right against

²¹⁴Williston, *Treatise on the Law of Contracts*, rev. ed., 1147-1148.

²¹⁵*Henderson v. Locke*, (1925) 153 Tenn. 108, 282 S. W. 193.

²¹⁶See above, pp. 348-357 of the text.

²¹⁷See above, text at notes 113 and 114.

the surety, the third-party indemnitor has become in effect the surety and he who was surety has become in effect a sub-surety. The situation is more exactly analogous to the promise to pay the debt of another than had the security been furnished by the principal debtor—for the latter was by hypothesis already directly liable to the creditor, whereas the third-party indemnitor or the property he has pledged become directly liable to the creditor, if at all, just as does the promisor in the typical third-party beneficiary contract, that is, solely by virtue of his agreement of exoneration.

The personal undertaking of a third-party indemnitor to exonerate the surety creates a typical third-party creditor-beneficiary situation, subject, of course, to the condition of the surety's actual damnification within the terms of the exoneration agreement. Owing to the absence of the non-competitive principle, the creditor's resulting right cannot be of any higher order than the surety's own right would have been in the absence of the interposition of the creditor, and is subject to any conditions, express or implied, contained in the exoneration agreement. If the personal undertaking of the third-party indemnitor is only to reimburse the surety for loss actually suffered in the form of payments already made to the creditor, the situation is somewhat different from the ordinary third-party creditor-beneficiary situation, in that by hypothesis the third party has not undertaken under any circumstances to render his performance directly to the creditor. But the promise of reimbursement is still an asset of the surety's estate which the particular creditor, if he has not yet received payment in full, should be able by prior diligence to appropriate to the exclusion of the surety's other creditors, and should in all events share ratably with them. Allowing the creditor to enforce by direct action the surety's existing right of reimbursement from the third-party indemnitor, to the extent of the surety's loss actually suffered, would require but a slight extension of the third-party creditor-beneficiary principle. By hypothesis the merely personal liability of the third-party indemnitor would create no direct preferences in anyone, over either the indemnitor's or the surety's other creditors, unless secured by prior diligence where that is still permissible.

Nor would it be a much further step from the ordinary third-party creditor-beneficiary principle to allow the particular creditor to proceed directly against securities furnished by a third-party indemnitor, to the extent that the surety's right of exoneration or

reimbursement therefrom already has accrued, and to the extent that an improper preference over the surety's other creditors would not be created thereby. To the extent that the surety's own right to realize upon the securities has already accrued, we need not be concerned about the indemnitor's other creditors. But since the third-party indemnitor is not himself liable upon the principal obligation, and the non-competitive principle is therefore lacking, the surety's right of exoneration or reimbursement from the securities to the extent of his maximum damnification or loss suffered from his other assets belongs equally to his other creditors, and is exhausted by a single complete exercise, so that any excess of the securities over the amount of the surety's maximum damnification or loss from his other assets properly belongs to the indemnitor or to the latter's other creditors.

Without the aid of the non-competitive principle the third-party creditor-beneficiary analogy is not alone sufficient to create preference rights in the particular creditor, except to the extent that he may be permitted to secure them by the exercise of prior diligence. It would also seem to follow that the discharge of the surety's own personal liability upon the principal indebtedness for any other reason than that of his legally required payment of it, to the extent that it would preclude his own right to resort to the securities for the purpose of his exoneration or reimbursement, should therefore bar the creditor likewise; and that the surety should have at least the same right to release the securities that the promisee has to release the promisor from his obligation under the ordinary third-party creditor-beneficiary contract.²¹⁸

²¹⁸Professor Williston contends that "If . . . the security or the contract of the stranger is for the surety's exoneration, it might well be deemed to be an asset of the surety which could be reached by the creditor by a bill for equitable execution or equivalent procedure," on the analogy of the creditor-beneficiary situation and of the similar procedure used to reach a trust estate to satisfy a trustee's liability. 4 Williston, *Treatise on the Law of Contracts*, rev. ed. 3625-3626, note 8. The following cases appear to sustain Professor Williston's contention: *Magoffin v. Boyle Nat'l Bank of Danville*, (1902) 24 Ky. L. Rep. 585, 69 S. W. 702; *King v. Harman's Heirs*, (1834) 6 La. 607, 26 Am. Dec. 485; *Brown & Heywood Co. v. Ligon*, (C.C. Mo. 1899) 92 Fed. 851. In *Henderson-Achert Lithographic Co. v. John Shillito Co.*, (1901) 64 Ohio St. 236, 251, 60 N. E. 295, 298, the court suggests that "where a stranger to the debt, for a sufficient consideration, has agreed to assume and discharge the obligation of the surety," the creditor "may adopt and enforce the promise, for it is the property of his debtor, and its performance includes the payment of the debt." It would seem that the only significance of the indemnitor having received consideration would be in giving validity to his agreement, rather than in making any distinction between compensated and uncompensated indemnitors with respect to the creditor's rights. In *Fields v. Letcher State Bank*, (1934)

CONCLUSION

It would require a too lengthy summary to recapitulate the content of the foregoing discussion. It is believed that enough has been said to show that, if a false precedent in the land of its own nativity has deceived great minds in this country, it has deceived them only to the extent that it is sound in principle. Such a form of evolution is by no means unknown either in equity or the common law. Through much travail another principle "takes its own place in the family of legal principles"²¹⁹—one that is believed to be preferable both to the "rule of *Ex parte Waring*" and to the Scottish rule, and to provide an adequate rationale of the results reached by most of the American cases, regardless of whether the securities received by the surety from the principal debtor are found to have been specifically appropriated to the payment of the principal obligation, or to have been given for the more restricted purpose of the surety's indemnity only. Dean Pound did not without reason, or upon the basis of a false precedent alone, conclude that "it is elementary that a creditor is entitled to enforce for his own benefit any securities which the principal debtor has given his surety by way of indemnity."²²⁰

256 Ky. 592, 76 S. W. (2d) 908. Kelley Fields and his wife, Calliedonia Fields, gave to the sureties of Kelley Fields a note and mortgage to secure them against loss. The court held the principal creditor entitled to the benefit of the note and mortgage, although it was assumed that the sureties were not entitled to enforce the same for the reason that they had not paid the principal indebtedness; and the court did not so much as discuss the significance of the fact, which had appeared upon an earlier appeal, *Fields v. Letcher State Bank*, (1932) 246 Ky. 229, 54 S. W. (2d) 910, that the real estate in question had belonged to Calliedonia Fields, a stranger to the principal indebtedness. See also *Burroughs v. United States*, (C.C. N.Y. 1856) 2 Paine 569, Fed. Cas. No. 2,202.

²¹⁹2 Williston, *Treatise on the Law of Contracts*, rev. ed., 1049.

²²⁰*Harlan County v. Whitney*, (1902) 65 Neb. 105, 106, 90 N. W. 993.