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Sarah Howard Jenkins

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# ABROGATION OF SURETY'S RIGHT OF DISCHARGE ON RELEASE OF THE PRINCIPAL OBLIGOR UNDER REVISED ARTICLE 3: A CREDITOR'S TOOL FOR MAXIMIZING SELF-INTEREST

SARAH HOWARD JENKINS\*

The suretyship relationship is a common one in our society. Despite the admonition in Proverbs,<sup>1</sup> promises to answer for the indebtedness of others are frequently made. When made on a negotiable instrument, article 3 of the Uniform Commercial Code governs the rights and obligations of the parties.<sup>2</sup> Consistent with common law suretyship principles, former article 3 permits a creditor to reach a settlement or to compromise the contractual obligation of the debtor to repay a debt, by accepting a lesser sum than is owed on the instrument or to release the debtor and, at the same time, maintain all rights against the surety as long as the creditor expressly, orally<sup>3</sup> or in writing, reserves its rights against the surety.<sup>4</sup> No notice to the surety

\* Assistant Professor of Law, Memphis State University School of Law. B.A., 1969. Hanover College; M.A., 1970, J.D., 1982, University of Kentucky. The author wishes to thank Professor Frederick H. Miller, George L. Cross Research Professor of Law, University of Oklahoma Law Center; Professor Douglas J. Whaley, James W. Shocknessy Professor of Law, The Ohio State University College of Law; and Professor Peter Winship, James Cleo Thompson Sr. Trustee Professor of Law, Southern Methodist University School of Law, for their comments on prior drafts of this article; William T. Williams, Senior Vice President Metropolitan Banking; Ronald D. Reddin, Senior Vice President Loan Administration, and Charles A. Neale, General Counsel, officers of the National Bank of Commerce, for their insight on practical aspects of the issues and theories discussed in this article; and graduate assistants Beverly White, Memphis State University Cecil C. Humphreys School of Law, J.D., 1991; and Rhonda Carroll, Memphis State University Cecil C. Humphreys School of Law, J.D., 1992, for their assistance.

1. "A man lacking in sense pledges, and becomes surety in the presence of his neighbor." *Proverbs* 17:18 (New American Standard); *see also id.* 6:1-5; 11:15; 17:18; 20:16; 22:26; 27:12-13.

2. U.C.C. § 3-415(1) & comment 1 (1989). For the sake of clarity, pre-revision article 3 refers to the 1989 version, denominated "Commercial Paper."

3. An oral reservation of rights which is followed by a written release that does not include the reservation of rights raises a parol evidence question. In the absence of fraud by the debtor, a claim for reformation of the writing by the creditor, or proof of a condition precedent, a writing intended by the debtor and creditor as a final expression of the release of the debtor should prohibit proof of the oral reservation. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 214, 216 (1979); *Utah Farm Prod. Credit Ass'n v. Watts*, 737 P.2d 154 (Utah 1987) (parol evidence rule barred proof of oral release, subsequent release untimely).

4. Section 3-606 provides:

(2) By express reservation of rights against a party with a right of recourse the holder preserves

- (a) all rights against such party as of the time when the instrument was originally due; and
- (b) the right of the party to pay the instrument as of that time;

of the debtor's release or the settlement between the debtor and the creditor is required. This statement of an intent to recover from the surety any deficiency between what is owed on a promissory note or other instrument and the lesser sum accepted from the debtor, if any, maintains the creditor's right to sue the surety for the deficiency. Likewise, the creditor's express statement of a "reservation of rights"<sup>5</sup> maintains the surety's subrogation rights — a right to stand in the creditor's shoes to recover from the debtor any sums paid to the creditor.<sup>6</sup>

Under the former rules, inherent unfairness resulted to both the debtor and the surety by permitting a creditor to release the principal debtor while expressly reserving rights against the surety. The unfairness was twofold: first, the debtor upon release by the creditor may believe that the settlement with the creditor resulted in a complete discharge of her obligation. However, to the debtor's dismay, she may discover that the surety must be paid.<sup>7</sup> Second, with a statement of reservation of rights, the creditor was permitted under section 3-606(2) to modify the contractual relationship among the parties and to change the risk assumed by another party, the surety, without the surety's consent. Furthermore, the creditor was not required to give the surety notice of the change in the surety's risk before the creditor requested payment or sued the surety. This unfairness troubled the drafters of article 3 in 1947<sup>8</sup> and the revisors of article 3 in 1989.<sup>9</sup>

To alleviate these difficulties, the National Conference of Commissioners on Uniform State Laws and the American Law Institute<sup>10</sup> propose in sections 3-604 and 3-605 of the recommended revisions to article 3<sup>11</sup> to abrogate the doctrine of reservation of rights and to create balance<sup>12</sup> between creditors and sureties by eliminating the right of discharge on *release* of the debtor,

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and

(c) all rights of such party to recourse against others.

U.C.C. § 3-606(2) (1989); *see also id.* § 3-606 comment 4.

5. An express reservation is "one that is clear, definite, explicit, plain, direct, and unmistakable, as opposed to a reservation that is inferred or implied." *Utah Farm*, 737 P.2d at 160.

6. U.C.C. § 3-606(2)(c) (1989).

7. American Law Institute, National Conference of Commissioners on Uniform State Laws, Commercial Code (Group No. 1), Notes and Comments to Tentative Draft No. 2 Article III, ¶(a), at 108 (unpublished draft) (Apr. 25, 1947) [hereinafter Tentative Draft].

8. *Id.*

9. The November 20, 1989, draft of § 3-606 imposed a duty on the creditor to make a written reservation of right and to give the surety notice of the discharge of the principal debtor in order to prevent the discharge of the surety.

10. Campbell, *The Proposed Revision of Articles 3 and 4 of the Uniform Commercial Code*, 70 MICH. B.J. 296 (1991); Miller, *The Benefits of New UCC Articles 3 and 4*, 24 U.C.C. L.J. 99, 101 n.4 (1991); *see* Ballen & Homrighausen, *Revised Articles 3 and 4: Selected Topics*, 24 U.C.C. L.J. 3, 3-6 (1991) (brief review of the drafting of revised articles 3 and 4).

11. "Negotiable Instruments" is the title of revised article 3 and is referred to hereinafter as proposed article 3.

12. Cohen, *Suretyship Principles in the New Article 3: Clarifications and Substantive Changes*, 42 ALA. L. REV. 595, 608 (1991).

yet in other instances recognizing the right of discharge in varying degrees. For example, if the creditor grants the debtor additional time to pay without the surety's consent, and the surety proves it sustained a loss, the surety is discharged to the extent of the loss proven.<sup>13</sup> However, if the creditor, without the surety's consent, agrees to any other material modification of the debtor's obligation, the surety is entitled to a discharge equivalent to its right of recourse against the debtor unless the creditor establishes that no loss was sustained or that the loss sustained was less than the surety's rights against the debtor.<sup>14</sup>

Under the former rules, the doctrine of reservation of rights empowered the holder of an instrument to release or to grant an extension in time for paying the instrument to a party, while at the same time retaining all rights against other parties to the instrument who had a right of recourse against the party who was granted the extension or release.<sup>15</sup> For example:

Son-in-law requests a loan from Friendly National Bank to expand his business. Because Son-in-law has a history of slow repayment and delay in satisfying prior loans and obligations, Friendly is unwilling to lend any of its funds to Son-in-law without a co-maker on the instrument. Father-in-law, a man of excellent credit, agrees to sign Debtor's promissory note as a surety. After Son-in-law defaults on the note, Friendly releases him from his obligation on the note when he pays one-fourth of the remaining balance three months before maturity. Two years later, Friendly sues Father-in-law.

Applying former article 3, Father-in-law is discharged — has no obligation to pay — because Friendly failed to expressly notify Son-in-law of its intent to recover from Father-in-law. The outcome is different, however, under revised article 3. The creditor's release of the debtor without reserving rights against the surety is effective. To the debtor's surprise, the creditor, Friendly, may recover the deficiency from the surety, and the surety is entitled to compel the debtor to pay, if solvent. Although the surety was aware at the time of contracting of his duty to pay if Son-in-law did not pay, the surety learns at the time of suit that the debtor was released two years earlier.

Thus, upon release the inherent unfairness remains and only the creditor benefits from the change, because the creditor no longer needs to give the debtor notice that the settlement does not end the matter by using language that communicates an intent to preserve rights against the surety.<sup>16</sup> The effects of the doctrine of reservation of rights remain without the formality. The goal of achieving balance between the creditor and surety is a laudable one. However, the proposed revision creates an opportunity for creditors

13. U.C.C. § 3-605(c) (Final Draft 1990).

14. *Id.* § 3-605(d).

15. U.C.C. § 3-606(2) (1989). *See supra* note 4.

16. *Wilmington Trust Co. v. Gesullo*, 29 U.C.C. Rep. Serv. (Callaghan) 144 (Del. Super Ct. 1980).

to maximize self-interest.<sup>17</sup> Requiring the creditor to give notice to the surety of the release or formulating the rules to allocate the burden of proof based on the significance of the change in the original relationship or obligation might have achieved the balance desired more effectively.<sup>18</sup>

This article examines the inequities inherent in the former and revised rules on reservation of rights and proposes, for consideration by legislative bodies that enact revised article 3, that unless the surety consents, expressly or implicitly by conduct,<sup>19</sup> to the debtor's release, before or after such release,<sup>20</sup> or unless the creditor gives<sup>21</sup> notice of the release within ten days, the surety should be discharged to the extent of the release.<sup>22</sup> This article begins with a brief description of the suretyship relationship, identifies substantive changes proposed by the drafters, and discusses the rationale of protecting the surety's rights of reimbursement and subrogation as the historical basis for discharging the surety.

Second, this article suggests, as a modern justification for discharging the surety upon release of the debtor, that the creditor's duty of good faith performance imposes, at a minimum, a duty to obtain the surety's consent or to give notice to the surety to prevent discharge of the surety. The article concludes with a recommendation that in the absence of consent or notice, the surety should be discharged to the extent of the release rather than the amount of loss established.

### I. *The Suretyship Relationship*

The following hypothetical situation<sup>23</sup> is an illustration of the typical suretyship relationship and will be used throughout the article:

Son-in-law (Debtor) requests a loan from Friendly National Bank to expand his business. Because Debtor has a history of slow repayment and delay in satisfying prior loans and obligations, Friendly is unwilling to lend any of its funds to Debtor

17. See also Cohen, *supra* note 12, at 609-11.

18. See *infra* notes 108-13 and accompanying text.

19. *A. J. Armstrong, Inc. v. Janburt Embroidery Corp.*, 97 N.J. Super. 246, 234 A.2d 737 (Super. Ct. Law Div. 1967) (accommodation indorser's involvement in the negotiations of an extension agreement and signature of agreement constituted consent to release of debtor on prior obligation); *Katz v. Haskell*, 196 Cal. App. 2d 144, 16 Cal. Rptr. 453 (Dist. Ct. App. 1961) (guarantor's participation in transaction and request of creditor's waiver of acceleration constituted consent to release of debtor from the obligation to pay balance on acceleration).

20. *Rauch v. First Nat'l Bank*, 244 Ark. 941, 428 S.W.2d 89 (1968) (consent given at time guaranty agreement executed); *First Nat'l Bank v. Energy Equities, Inc.*, 91 N.M. 11, 569 P.2d 421 (Ct. App. 1977) (agreement expressly provided for release by payee).

21. See *infra* note 108 and accompanying text.

22. See *infra* notes 110-12 (recommended statutory language).

23. This hypothetical situation is offered as a paradigm of the surety-creditor-debtor relationship. This relationship may arise in the acquisition of goods by a consumer whose neighbor serves as a gratuitous surety or where a stockholder serves as a surety for a corporation. In the latter case, personal guarantees, collateral to the instrument taken, may also be employed as a part of the transaction as well as standardized waivers and consents in the instrument.

without a co-maker on the instrument. Father-in-law, a man of excellent credit, agrees to sign Debtor's promissory note as a surety. Although Father-in-law is available to Son-in-law for consultation, he is not actively engaged in the Debtor's business affairs and does not receive any portion of the loan proceeds.<sup>24</sup> After Debtor defaults on the note, Friendly, without Father-in-law's consent,<sup>25</sup> releases Debtor from his obligation on the note when Debtor pays one-fourth of the remaining balance three months before maturity. Two years later, Friendly sues Father-in-law.

#### A. *The Surety-Creditor Relationship*

Under the provisions of former article 3, Father-in-law is an accommodation party or surety,<sup>26</sup> one who engages to pay the indebtedness of another.<sup>27</sup> Although Father-in-law is liable in the capacity in which he signs,<sup>28</sup> as a maker, Father-in-law's engagement under pre-code rubric is a collateral one, one made with the expectation that another (Debtor) will perform.<sup>29</sup> Whether Father-in-law signed as a maker or indorser, his function as a surety, one providing "additional assurance"<sup>30</sup> for the performance owed by another, results in a collateral promise.

However, Father-in-law's promise, in this case, is also primary and unconditional. It is primary<sup>31</sup> because it is an absolute undertaking.<sup>32</sup> Although former article 3 does not classify an obligor's undertaking as primary or secondary, section 3-413(1) imposes on a maker the duty to pay without resort to other parties. The proposed revision maintains this duty.<sup>33</sup> Unless words guaranteeing collection<sup>34</sup> accompany Father-in-law's signature, cred-

24. The proposed revisions limit accommodation status to those who do not receive a direct benefit from the transaction, thereby rejecting case authority holding that those who receive only an indirect benefit, such as corporate officers or stockholders, do not qualify for accommodation status. *See, e.g., Zax v. Coast Properties Co.*, 411 S.W.2d 370, 372 (Tex. Civ. App. 1967); *see* Cohen, *supra* note 12, at 600 (discussion of the difficulty in distinguishing direct and indirect benefit).

25. In some cases, the note will provide consent, or the creditor may obtain consent at the time of the release.

26. U.C.C. § 3-415 comment 1 (1989). *See generally* Noble, *The "Surety" and Article 3: A New Identity for an Old Friend?*, 19 DUQ. L. REV. 245 (1981).

27. *See* L. SIMPSON, HANDBOOK OF THE LAW OF SURETYSHIP § 1 (1950) [hereinafter SIMPSON].

28. U.C.C. § 3-415 (1989).

29. SIMPSON, *supra* note 27, § 2.

30. RESTATEMENT OF SECURITY § 225 (1941).

31. Existing article 3 deleted references to primary and secondary liability and refers to secondary parties, drawers and indorsers. *But see* UNIFORM NEGOTIABLE INSTRUMENTS LAW § 192 (1900). However, the principle of primary and secondary liability remains applicable under the provisions on liability for makers, acceptors, drawers, and indorsers under section 1-103 of the Uniform Commercial Code. *See* U.C.C. §§ 1-103, 3-413, 3-414 (1989).

32. SIMPSON, *supra* note 27, § 3.

33. *See* U.C.C. § 3-412 (Final Draft 1990).

34. If words guaranteeing collection accompany the signature, a creditor may only enforce

itor may sue the Father-in-law without first seeking recovery from Debtor on Debtor's failure to pay. Father-in-law's promise is also unconditional because no condition precedent, such as presentment or dishonor, must be satisfied before his duty to pay arises. As one primarily liable,<sup>35</sup> Father-in-law's contractual engagement provides security against loss to Friendly in the event of Debtor's default.<sup>36</sup> Creditor is the recipient of two promises — one from Debtor and one from Father-in-law — for the one desired performance, which is the repayment of the borrowed funds.

### B. *The Surety-Debtor Relationship*

As between Father-in-law and Debtor, Father-in-law has two grounds for direct recovery<sup>37</sup> from Debtor should Father-in-law be required to pay the Creditor — a right of reimbursement and a right to enforce Debtor's promise to pay as one subrogated to Creditor's position. At common law, the right of reimbursement resulted from either an express agreement between the surety and the debtor, or, more often, an agreement implied in fact from the debtor's request for the surety's presence on the instrument.<sup>38</sup> This right of reimbursement entitled the surety to recover not only the amount he paid to the creditor but also any reasonable expenses incurred as a result of the debtor's default. However, if the surety signed the instrument at the creditor's request and without the debtor's consent, the surety's right of reimbursement — to recover from the principal debtor — was one of restitution to prevent unjust enrichment.<sup>39</sup> As such, recovery was limited to the amount actually paid to the creditor.

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the instrument against the surety after efforts to enforce a judgment against the debtor are fruitless or it is apparent that pursuing the debtor initially would prove fruitless. U.C.C. § 3-419(d) (1990).

35. If Father-in-law had indorsed the note, Father-in-law under existing article 3 is a secondary party (under pre-code rubric one secondarily liable) because certain conditions precedent, unless waived, such as dishonor and notice of dishonor, must be satisfied before liability arises. Even here, Father-in-law's engagement provides assurance that the debtor's promised performance will occur if the conditions are satisfied.

36. For an interesting historical review of the role of a surety, see Loyd, *The Surety*, 66 U. PA. L. REV. 40 (1917). Unlike his predecessors, Father-in-law will not be placed in prison or in Friendly's custody pending Debtor's payment of the obligation on default. See also Morgan, *The History and Economics of Suretyship*, 12 CORNELL L.Q. 153 (1927) (history of the contract of suretyship from 2750 B.C. to 1720 and early corporate suretyship from 1720 to 1875); Paglin, *From "Favorite of the Law" to "Intermediate Surety": A Transformation in the Law of Suretyship*, 23 NEW ENG. L. REV. 67, 71-81 (1988).

37. See *infra* notes 47-48 and accompanying text (discussion of surety's right to compel the debtor to pay the creditor).

38. RESTATEMENT OF SECURITY § 104 comment f; see *Leslie v. Compton*, 103 Kan. 92, 172 P. 1015 (1918) (stating the general rule and distinguishing between the rights of subrogation and reimbursement in the context of a guaranty embodied in a separate writing rather than on the instrument); *Marsh v. Hayford*, 80 Me. 97, 13 A. 271 (1888) (stating the rule of reimbursement on an oral guaranty of payment).

39. RESTATEMENT OF SECURITY § 104(2); see also *Investors of Nevada Realty v. Nevada State Bank*, 98 Nev. 33, 639 P.2d 554 (1982) (estate of decedent who became a surety by

Although not expressly recognized in former article 3, the right of reimbursement is not displaced by the provisions of article 3 and should, therefore, be available under section 1-103.<sup>40</sup> Furthermore, the former body of law does not limit accommodation status to those who appear on the instrument with the debtor's consent. No mention is made in former article 3 of accommodation parties that appear on the instrument at the creditor's request without the debtor's consent. Thus, the right of reimbursement available under the former statute is essentially limited to the common law right recognized in the individual jurisdiction. When the debtor does not consent to the surety's presence on the instrument, only the amount paid to the creditor may be recovered.<sup>41</sup>

In contrast, the right of subrogation vested the surety with all the contractual rights held by the creditor. If the contractual relationship provided for recovery of attorneys' fees or recourse to collateral, these rights inured to the surety's benefit. Pre-revision sections 3-415(5) and 3-603(2) recognized the equitable right of the subrogation. The surety stood in the creditor's shoes and enforced the instrument against the principal debtor after the surety paid the creditor.<sup>42</sup>

The language of proposed section 3-419 grants accommodation status to any party to the instrument if the party signs to incur liability without being a direct beneficiary of the value given for the instrument. In the hypothetical transaction, Father-in-law signs to incur liability, engaging to pay the sum advanced by Friendly, without receiving any of the loaned funds. Additionally, the facts do not show that Father-in-law received any other direct benefit, such as payment of his mortgage or other contractual obligation. Hence, debtor's consent is not necessary to achieve accommodation status.<sup>43</sup> Any party who attains accommodation status is entitled to both rights — a right of reimbursement and a right of subrogation.<sup>44</sup> Because of this

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operation of law entitled to reimbursement to prevent unjust enrichment when credit life insurance proceeds were used to pay debtor's obligation).

40. Section 1-103 provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchants and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions." U.C.C. § 1-103 (1989). See generally Summers, *General Equitable Principles Under Section 1-103 of the Uniform Commercial Code*, 72 Nw. U.L. Rev. 906 (1978).

41. RESTATEMENT OF SECURITY §§ 104(2), 108(2) (1941); RESTATEMENT OF RESTITUTION §§ 76, 80 (1937); Hecker v. Mahler, 64 Ohio St. 398, 60 N.E. 555 (1901); Powers v. Nash, 37 Me. 322 (1853).

42. See U.C.C. § 3-415 comment 5 (1989).

43. Professor Boss distinguishes and provides excellent examples of two-party suretyship transactions (obligee seeks and obtains surety without debtor's consent) and three-party suretyship transactions (debtor seeks and obtains surety) in her article, *Bringing Suretyship into the 21st Century: ALI to Draft Restatement of Suretyship*, 11 Bus. Law. UPDATE, March/April 1991, at 3, 6. Although three-party suretyship transactions are customary for negotiable instruments, revised article 3 does not limit the applicability of section 3-419 to three-party transactions.

44. The Bankruptcy Code also recognizes both a right of reimbursement and the right of



express recognition of the right of reimbursement, a surety, on the instrument with or without the debtor's consent, should in all cases be entitled to reimbursement for all reasonable expenses, including attorneys' fees incurred in satisfying the principal's obligation. The right of reimbursement should not be limited to recovery of the sums paid to the creditor, even if the surety's presence is without the debtor's consent. However, this change may benefit a compensated surety engaged in an ongoing business relationship with the creditor or that is a closely associated business entity. Here, the revision offers an opportunity for abuse. To minimize the opportunity for abuse — recovering income generating fees or charges — reimbursement against a nonconsenting debtor should be limited to the amount paid to the creditor, if such fees exceed in amount or kind those imposed in arm's length transactions between principal debtors and compensated sureties. When the surety and the creditor are closely associated or maintain an ongoing business relationship, the surety should bear the burden of proof on both the reasonableness of the *imposition* of any fee and the amount of such charges.

## II. *Historical and Modern Theories for Notice of Release*

Father-in-law's presence on the instrument reduces the risk of nonpayment assumed by Friendly and provides Son-in-law with the means of obtaining vital funds for his business. With the surety's involvement in the transaction, the transaction is an optimal or efficient one<sup>45</sup> — a change in this transaction will make two of the parties, Debtor and Creditor, worse rather than better. The omission of the surety increases Friendly's risk in the transaction and may eliminate Debtor's chances of obtaining the needed funds.

As an efficient transaction, the law historically employed a number of devices to protect the surety from prejudicial conduct by the creditor. The underlying policy of these tools was that of "encourag[ing] cooperation in mercantile transactions by reducing to a minimum the risk of the accessory [the surety]"<sup>46</sup> and to discourage self-interested maximizing behavior.<sup>47</sup> Thus, historical tools protected the surety against unanticipated risks and forced creditors to balance their self-interested desires with the potential increased costs to the surety and to commerce. Consequently, suretyship, and thereby commerce, flourished.

The right of exoneration was such a tool. This tool granted the surety an equitable right to compel the debtor to pay the creditor at maturity. Exoneration permitted the surety to avoid the expense of liquidating assets

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subrogation. However, the surety must elect between these alternatives. See 11 U.S.C. §§ 502 (e)(1)(B)-(C), 509 (1988). The claim secured by debtor's assets should be selected.

45. A. ALCHIAN & W. ALLEN, *EXCHANGE & PRODUCTION: COMPETITION, COORDINATION, & CONTROL* 76 (3d ed. 1983); A. POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 7-10 (2d ed. 1989); R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.2 (3d ed. 1986).

46. Loyd, *supra* note 36.

47. For a discussion of the need for legal rules to encourage socially optimal behavior and discourage self-interested maximizing behavior, see C. GOETZ, *LAW AND ECONOMICS* 329 (1984).

to make payment and the expense of litigation. Its primary function was that of giving the surety a means of removing the "cloud" or threat of liability to the creditor and to prevent loss to the surety. The surety's right of exoneration was extinguished after the lapse of the statute of limitation against the surety.<sup>48</sup>

Another tool employed to protect sureties, the one most relevant to a debtor's release, was the rule of discharge of the surety. If the creditor released<sup>49</sup> the debtor or made even the most trivial modification in the debtor's obligation<sup>50</sup> without the surety's consent, the surety was discharged. The act of releasing the debtor discharged the duty owed by the debtor and likewise the surety's obligation to answer for the duty previously owed. Because no duty was owed by the debtor as a result of the release, the surety was no longer obligated.<sup>51</sup> However, reservation of rights, a nineteenth-century innovation, was later employed as a mechanism to prevent the surety's discharge and minimize unfairness to the creditor.<sup>52</sup>

At common law, if Friendly released Debtor from one installment or the balance of the outstanding obligation without, at least, making an oral statement to Son-in-law of its intent to hold Father-in-law to the Father-in-law's obligation, Father-in-law would be completely discharged.<sup>53</sup> Under former section 3-606(1), Father-in-law would be discharged to the extent of the release.<sup>54</sup> With a statement of its intent to enforce Father-in-law's engagement, both the common law and former article 3 hold the surety to the obligation even though the original contractual relationship among the parties was modified without one party's consent upon reservation of rights by the creditor.<sup>55</sup>

48. For a discussion of other protective tools, see generally D. WHALEY, *PROBLEMS AND MATERIALS ON COMMERCIAL LAW* 371 (2d ed. 1990).

49. The rule was also applied if the creditor extended the time for payment or made other modifications in the debtor's obligation.

50. See *infra* note 53.

51. RESTATEMENT OF SECURITY § 122 comment b (1941); *Continental Bank & Trust Co. v. Akwa*, 58 Wis. 2d 376, 206 N.W.2d 174, 182 (1973) (discussing the effect of a release); *Kitsap County Credit Bureau v. Richards*, 52 Wash. 2d 381, 325 P.2d 292 (1958) (guarantor of open account discharged upon settlement and release of principal debtor).

52. RESTATEMENT (SECOND) OF CONTRACTS § 295 comment c (1979).

53. See *Loyd*, *supra* note 36, at 53 (even a trivial modification of the debtor's obligation resulted in a complete discharge of the surety).

54. Section 3-606 provides:

(1) The holder discharges any party to the instrument to the extent that without such party's consent the holder

(a) without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person, except that failure or delay in effecting any required presentment, protest or notice of dishonor with respect to any such person does not discharge any party as to whom presentment, protest or notice of dishonor is effective or unnecessary . . . .

U.C.C. § 3-606(1)(a) (1989).

55. *Hallowell v. Turner*, 95 Idaho 392, 509 P.2d 1313 (1973); *Ramsey v. First Nat'l Bank & Trust Co.*, 683 S.W.2d 947 (Ky. Ct. App. 1984).

Several concerns motivated the drafters to abrogate both the doctrine of reservation of rights and the rule of discharge. First, the doctrine of reservation of rights was an ineffective tool for communicating to the debtor its continued liability.<sup>56</sup> Second, under the doctrine, failure to adhere to formalities resulted in hardship to the creditor by discharging the surety; and, third, settlement between the debtor and creditor benefitted all parties by reducing the amount of the outstanding indebtedness.<sup>57</sup> However, in view of the historical goals of (1) protecting the surety from unanticipated risks, such as the absence of creditor's pressure on debtor and the loss of debtor's incentive to maintain a good relationship with the creditor as stimuli for debtor's performance, and (2) stimulating commerce through suretyship, additional consideration should have been given to the unfairness to the surety inherent in the reservation-of-rights doctrine. While encouraging settlement, the drafters should have taken the additional step of requiring notice to provide an equitable balance between the surety and creditor.<sup>58</sup> If some theory other than protecting the surety's rights of reimbursement or subrogation supports the rule of discharge on release, then notice should be required.

#### A. *Protecting the Surety's Rights of Reimbursement and Subrogation*

Several theories have been argued as the basis for the surety's discharge when the creditor failed to reserve its rights: (1) the creditor's release of the debtor impairs the surety's rights to reimbursement and subrogation;<sup>59</sup> (2) the creditor violates an equitable duty owed the accommodation party, a duty derived from good conscience;<sup>60</sup> (3) release of the debtor increases unforeseeable risks not contemplated by the surety at the time of contracting;<sup>61</sup> and (4) releasing the debtor breaches an implied-in-fact agreement not to release the debtor.<sup>62</sup>

Historically, however, the primary justification for discharging the surety upon release of the principal debtor was that of protecting the surety's rights on release of the debtor — the rights of reimbursement and subrogation should the surety be compelled to pay.<sup>63</sup> Because the surety's obli-

56. Tentative Draft, *supra* note 7.

57. U.C.C. § 3-605 comment 3 (Final Draft 1990).

58. See also Cohen, *supra* note 12, at 609.

59. See *infra* notes 62-72 and accompanying text.

60. Hilpert, *Discharge of Latent Sureties on Negotiable Instruments Because of Release or Extension of Time*, 50 YALE L.J. 387, 388 (1941). Hilpert urges this theory as a basis of justifying the discharge of latent sureties, those parties signing instruments as makers and acceptors who do not add words describing their accommodation status to the instrument, under the Uniform Negotiable Instrument Law. See, e.g., *American Blower Co. v. Lion Bonding & Sur. Co.*, 178 Iowa 1304, 160 N.W. 939 (1917); *Pooley v. Harradine*, 7 E. & B. 431, 433 (Q.B. 1857); *Bailey v. Edwards*, 4 B. & S. 761 (Q.B. 1861); *Ewin v. Lancaster*, 6 B. & S. 571 (Q.B. 1865).

61. H. ARANT, SURETYSHIP & GUARANTY 183 (1931).

62. Hilpert, *supra* note 60, at 397; SIMPSON, *supra* note 27, § 63, at 300.

63. Former Dean Arant believed this view to be unpersuasive. He argued that if the debtor expressly or impliedly requested the surety's presence on the instrument, the debtor remained

gation to pay was an accessory one — one collateral to the debtor's main obligation even though primary, no preliminary resort to the debtor required as a condition — release of the main obligation also released the accessory one.<sup>64</sup> If the main obligation was satisfied, no obligation remained for the surety to perform and the debtor's discharge could be raised as a defense to payment by the surety.<sup>65</sup> Furthermore, permitting a surety who paid the creditor after the release to seek reimbursement from the debtor was deemed unjust. The releasing creditor was thereby permitted to reach the debtor indirectly, contravening the prior release.<sup>66</sup> Thus, the surety's right of reimbursement was impaired<sup>67</sup> and, consequently, the surety was discharged. However, if the debtor assented to a settlement or release conditioned upon the creditor's reservation of rights against the surety, the debtor was deemed to have consented to the surety's continued right of indemnification or reimbursement.<sup>68</sup> No injustice resulted when the surety subsequently recovered from the debtor, and the right of reimbursement was unimpaired. Reservation of rights was employed to encourage settlements between the debtor and creditor without an impairment in either the creditor's right to recover from the surety or the surety's right to be indemnified by the debtor.

Likewise with the right of subrogation, release hindered the surety's right to assert the creditor's claim against the debtor. When sued by the surety, the debtor merely asserted his release by the creditor as a defense to the surety's claim. However, if the creditor released the debtor, reserving rights against the surety, the release was construed as a covenant not to sue the principal debtor and the debt was not extinguished.<sup>69</sup> More importantly, a covenant not to sue did not bar the creditor or its subrogee from suing the principal debtor,<sup>70</sup> and the release could not be used defensively in court by the debtor.<sup>71</sup> Thus, reservation of rights was the methodology employed in the nineteenth century to encourage settlements and to preserve the surety's rights of reimbursement and subrogation.<sup>72</sup>

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obligated to indemnify or reimburse the surety after the debtor's release if the surety paid the creditor without knowledge of the prior release or knowledge of facts terminating debtor's request for the surety to perform. H. ARANT, *supra* note 61, § 49. *See also* text accompanying notes 48-52.

64. A. STEARNS, *THE LAW OF SURETYSHIP* § 6.42 (5th ed. 1951); *RESTATEMENT OF SECURITY* § 122 comment b (1941).

65. Except those particular defenses such as infancy or insolvency which the surety's presence was designed to insulate the creditor against, defenses available to the principal debtor may be resorted to by the surety. STEARN, *supra* note 64, § 6.42. *See also* U.C.C. § 3-305(d) (1990).

66. *RESTATEMENT OF SECURITY* § 122 comment b (1941).

67. A. STEARNS, *supra* note 64.

68. H. ARANT, *supra* note 61, at § 50.

69. *Id.*; A. STEARNS, *supra* note 64, § 6.42.

70. *RESTATEMENT OF SECURITY* § 122 comment d (1941); U.C.C. § 3-606(2) (1989); H. ARANT, *supra* note 61, § 50.

71. H. ARANT, *supra* note 61, § 50.

72. *RESTATEMENT (SECOND) OF CONTRACTS* § 295 comment c (1979).

If the sole justification for discharging the surety is protecting these two rights, the resolution of the issue of discharge and notice is a simple one and the drafters found it. Proposed sections 3-419<sup>73</sup> and 3-605<sup>74</sup> protect both of these rights. First, proposed section 3-605(b) expressly abrogates the right of the surety's discharge if the debtor is released.<sup>75</sup> Second, under proposed section 3-419, a surety, who is a party to the instrument with or without the debtor's consent, has a right of reimbursement that is independent of a right of subrogation — a right to stand in the creditor's shoes and sue the debtor. Third, proposed section 3-419 empowers the accommodation party with a right to enforce the instrument. This right of enforcement is not based on the creditor's right to recover from the debtor. Unlike comment 5 to existing section 3-415, the

73. Section 3-419 provides:

(a) If an instrument is issued for value given for the benefit of a party to the instrument ("accommodated party") and another party to the instrument ("accommodation party") signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument, the instrument is signed by the accommodation party "for accommodation."

(b) An accommodation party may sign the instrument as maker, drawer, acceptor, or endorser and, subject to subsection (d), is obliged to pay the instrument in the capacity in which the accommodation party signs. The obligation of an accommodation party may be enforced notwithstanding any statute of frauds and whether or not the accommodation party receives consideration for the accommodation.

(c) A person signing an instrument is presumed to be an accommodation party and there is notice that the instrument is signed for accommodation if the signature is an anomalous indorsement or is accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument. Except as provided in Section 3-605, the obligation of an accommodation party to pay the instrument is not affected by the fact that the person enforcing the obligation had notice when the instrument was taken by that person that the accommodation party signed the instrument for accommodation.

(d) If the signature of a party to an instrument is accompanied by words indicating unambiguously that the party is guaranteeing collection rather than payment of the obligation of another party to the instrument, the signer is obliged to pay the amount due on the instrument to a person entitled to enforce the instrument only if (i) execution of judgment against the other party has been returned unsatisfied, (ii) the other party is insolvent or in an insolvency proceeding, (iii) the other party cannot be served with process, or (iv) it is otherwise apparent that payment cannot be obtained from the other party.

(e) An accommodation party who pays the instrument is entitled to reimbursement from the accommodated party and is entitled to enforce the instrument against the accommodated party. An accommodated party who pays the instrument has no right of recourse against, and is not entitled to contribution from, an accommodation party.

U.C.C. § 3-419 (Final Draft 1990).

74. Section 3-605 provides: "Discharge, under Section 3-604, of the obligation of a party to pay an instrument does not discharge the obligation of an indorser or accommodation party having a right of recourse against the discharged party." *Id.* § 3-605(b).

75. *Id.*

proposed section makes no mention of subrogation to the creditor's right. The condition precedent to the exercise of this right — payment of the creditor — remains. The debtor cannot raise its release by the creditor as a defense to payment in the surety's action to enforce the instrument. However, the surety obtains rights to any security given as collateral<sup>76</sup> and enjoys any priority that the creditor enjoyed.<sup>77</sup> Consequently, this "right to enforce" is window dressing for the prior right of subrogation. Within the applicable statute of limitations, the surety may assert either the right of reimbursement or the right to enforce the instrument. For time notes and for demand notes if demand has been made, subsections 3-118(a) and 3-118(b) impose a six-year statute of limitation for rights of action to enforce the obligation or engagement to pay an instrument such as the "right to enforce." In contrast, subsection 3-118(g) provides a shorter three-year statute of limitation for rights arising under proposed article 3 that do not involve enforcement of the instrument. Unless other state law preempts subsection 3-118(a) by imposing a different limitation period for indemnity, the shorter three-year statute of limitation is applicable to the right of reimbursement for sureties and the right of contribution for co-makers and co-sureties.<sup>78</sup> The drafters have addressed the historical justification for discharge of the surety. However, if another theory justifies the discharge of the surety, at the very least, notice should be required.

#### *B. Breach of the Duty of Good Faith and Fair Dealing*

General contract law and theory recognize that every contract imposes a duty of good faith and fair dealing on each party in the performance of a contract.<sup>79</sup> Although former article 3 is silent on the issue of good faith performance, article 1 imposes an obligation of good faith in the performance of contracts or duties within the scope of the Uniform Commercial Code, including article 3.<sup>80</sup> Revised article 3, however, includes a definition

76. U.C.C. § 3-419 comment 5 (Final Draft 1990).

77. H. ARANT, *supra* note 61, § 79; RESTATEMENT OF SECURITY § 141(a)(b) (1941); RESTATEMENT OF RESTITUTION § 162 (1937). *See supra* note 44.

78. The right of reimbursement is distinguishable from the right of subrogation not only for the shorter limitations period but also because proof of the instrument is not a condition to recovery. To enforce the instrument, the requirements of former § 3-307 or proposed § 3-308 must be met.

79. U.C.C. § 1-203 (1989); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979); *see* Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980) [hereinafter Burton, *Breach of Contract*]; *Division of Triple T Serv. v. Mobil Oil Corp.*, 60 Misc. 2d 720, 304 N.Y.S.2d 191 (1969), *aff'd*, 34 A.2d 618, 311 N.Y.S.2d 961 (App. Div. 1970) (franchise and distributor agreement); *Wiita v. Thomas M. Cooley Law School*, No. L89-10001CA, W.D. Mich. (Apr. 5, 1989, Hon. D. Hillman) (law school owes student a duty of good faith, no evidence of lack of good faith shown); *Crooks v. Chapman Co.*, 124 Ga. App. 718, 185 S.E.2d 787, 789 (Ct. App. 1971) (good faith applies to all commercial transactions).

80. U.C.C. § 1-203 (1989). Good faith, for the purposes of articles 1 and 3, is defined as honesty in fact. *Id.* § 1-201(19). *See generally* Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666

of good faith for the article that is broader than the standard imposed under article 1, section 1-201(19). Defined as honesty in fact and the observance of reasonable commercial standards of fair dealing, the good faith standard of revised article 3 imposes both a subjective and an objective standard. Thus, good faith performance mandated by article 1 requires under revised article 3 honesty in fact and the observance of reasonable commercial standards of fair dealing.<sup>81</sup>

Delineating the scope of good faith performance has challenged commentators<sup>82</sup> and courts.<sup>83</sup> Good faith in performance has been defined as a control on discretionary conduct permitted by the contract that prevents recapturing foregone opportunities<sup>84</sup> and as a control over conduct necessitated by a gap in the parties' agreement<sup>85</sup> — a gap resulting from unforeseen circumstances or foreseeable circumstances that the parties failed to adequately address. The requirement of good faith performance sets parameters for conduct and limits maximization of self-interest by one party when the contract is silent on the subject.<sup>86</sup> As a general concept and explicit requirement, good faith performance is a tool used by the courts to police bargains to insure cooperation by one party so that the other may obtain the expected benefits of the contract.<sup>87</sup> Conduct that is consistent with the reasonable expectations of the parties is good faith performance. Consequently, an evaluation of the requirement of good faith performance in any contract must be made on a case-by-case basis to determine if the challenged conduct is faithful to the agreed common purpose or is consistent with the *justified* expectations of the other party.<sup>88</sup> The facts and circumstances at

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(1963) (discussion of the history behind the adoption of the "honesty in fact" definition of good faith and the resulting limitations).

81. U.C.C. § 3-103(4) (Final Draft 1990).

82. Andersen, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299, 325-26 (1988); Burton, *Breach of Contract*, *supra* note 79; Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1 (1981); Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984); Farnsworth, *supra* note 80; Summers, *The General Duty of Good Faith — Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982) [hereinafter Summers, *General Duty*]; Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968) [hereinafter Summers, "Good Faith"].

83. See, e.g., *Bain v. Champlin Petroleum Co.*, 692 F.2d 43, 47 (8th Cir. 1982); *In re Roman Crest Fruit, Inc.*, 35 B.R. 939, 946 (Bankr. S.D.N.Y. 1983); *Diagnostic Laboratory v. PBL Consultants*, 136 Ariz. 415, 666 P.2d 515, 519 (Ct. App. 1983); *Covington v. Robinson*, 723 S.W.2d 643, 645 (Tenn. Ct. App. 1986).

84. Burton, *Breach of Contract*, *supra* note 79, at 373; Andersen, *supra* note 82, at 325.

85. Farnsworth, *supra* note 80, at 672; Andersen, *supra* note 82, at 325; Summers, *General Duty*, *supra* note 82, at 812.

86. For an in-depth discussion of tools for limiting advantage taking or opportunistic behavior, see Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981). See also Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Towards a New Cause of Action*, 44 VAND. L. REV. 221, 228-32 (1991).

87. Farnsworth, *supra* note 80.

88. RESTATEMENT (SECOND) OF CONTRACTS § 205 comment a.

the time of contracting, the express terms of the agreement, the performing party's motives, and the community standard of fairness or reasonableness must be considered to distinguish good faith performance from bad faith performance.<sup>89</sup> However, if the challenged conduct is governed by an express term and is consistent with the express term, the implied covenant of good faith performance should not be used to expand the rights or duties of the parties.<sup>90</sup> The express term controls.<sup>91</sup> Nonetheless, good faith may be used to minimize the exercise of the express right contrary to the expectations of the parties, if the motive or purpose in exercising the right is inconsistent with the parties' expectations.<sup>92</sup> However, if one party is granted absolute or uncontrolled discretion and the other has no reasonable expectation of protection, good faith performance may be irrelevant.<sup>93</sup>

In our hypothetical agreement, Creditor did not bargain for and was not given an express right to release Debtor. Father-in-law neither consented to a release nor waived a right to consent to a release of Son-in-law. No express term addressed modification of Debtor's duties under the contract or release of Debtor. However, the expectation of the parties — Father-in-law, Debtor, and Creditor — at the time of contracting was that Debtor would perform his undertaking by repaying the loan according to its terms. Father-in-law expected to secure the following benefits from the contract: some sense of satisfaction in helping Son-in-law acquire the needed funds, not having to perform, or if performance became necessary, reimbursement from Debtor. Father-in-law's assurances to the Creditor were based on the belief that Creditor would take no action to impair, hinder, or prevent the Debtor's performance. Moreover, Father-in-law's expectation included a reasonable belief that Creditor in its relationship with Debtor would stimulate, monitor, and encourage Debtor's performance. Thus, the cooperation needed — the implied good faith performance necessitated — should include maintaining a relationship with Debtor that serves as an incentive for Debtor's continued performance or immediate notification if that relationship is materially changed so that adequate protective measures can be pursued. These expectations were defeated by the release of the Debtor without notice.

Professor Burton suggests that the expectation interest of parties to a contract comprises the property, services, or money to be received by the promisee and the expected cost of performance to the promisor.<sup>94</sup> This

89. See Summers, "Good Faith," *supra* note 82, at 199-207 (good faith best determined by identifying relevant forms of bad faith). But see Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984) (distinguishing excluder analysis from the concept of discretion in performance).

90. Mantese, *The UCC and Keeping the (Good) Faith*, 70 MICH. B.J. 270, 273-74 (1991).

91. *McDonald's Corp. v. Lloyd David Barnes*, No. A91-067 (D. Alaska May 8, 1991) (covenant of good faith limits conduct if terms are omitted or ambiguous, or discretionary).

92. See generally Mantese, *supra* note 90, at 270; *Big Horn Coal Co. v. Commonwealth Edison Co.*, 852 F.2d 1259, 1269 (10th Cir. 1988); *Conoco Inc. v. Inman Oil Co.*, 774 F.2d 895, 908-09 (8th Cir. 1985); *Baker v. Ratzlaff*, 1 Kan. App. 2d 285, 564 P.2d 153 (1977).

93. *Big Horn Coal*, 852 F.2d at 1268.

94. Burton, *Breach of Contract*, *supra* note 79, at 369.



expected cost of performance should also include risks which are foreseeable, even though unidentified by the parties.<sup>95</sup> However, the cost of performance should not include unforeseeable risks that materially alter the nature and scope of a party's undertaking. In our hypothetical agreement, upon Debtor's release Father-in-law has not only been economically disappointed in his nonpecuniary interest by not receiving the expected performance — Creditor's conduct in its relationship with Debtor — but he also has had his cost of performance increased through the addition of an unforeseeable risk<sup>96</sup> — Creditor's settlement with the Debtor without notice until, as it often occurs, Debtor is hopelessly insolvent.<sup>97</sup> Practically speaking, if Debtor is released before or at maturity and without notice, Father-in-law cannot without notice exercise his right to pay Creditor immediately and to seek protective measures such as injunctive relief to prevent transfer, liquidation, or dissipation of assets, or the imposition of a prejudgment garnishment or attachment to insulate and protect the value of the rights of reimbursement or enforcement. Given Debtor's deteriorating financial condition, timely action by Father-in-law is essential. A right to compensation in theory is meaningless in fact, if Debtor has dissipated its assets or is otherwise judgment-proof.

Not only is the surety's expectation interest injured by the release of the debtor without notice, but the creditor has also recaptured an opportunity forgone in the bargaining process<sup>98</sup> — the right to excuse or modify debtor's agreed performance without the surety's consent. A creditor's motive in releasing the debtor is often simply to obtain available cash without the delay of notifying or suing the surety. This action is often taken with knowledge that the surety is unlikely to consent.<sup>99</sup> Maintaining debtor as a party to the transaction may only have the practical effect of additional pressure on the debtor. However, it should be the surety, the one who has the right to recover from the debtor, who should decide if the additional pressure is unnecessary.

In seeking to achieve some balance and flexibility between the surety and the creditor, the drafters provide for the discharge of the surety, to the extent the surety proves loss if the creditor grants the debtor an extension in time for payment but no discharge upon complete release of the debtor. Unlike the granting of an extension in time for payment, releasing the debtor directly conflicts with the intentions of the parties as they existed at

95. See, e.g., U.C.C. § 2-615 & comments 4, 8 (1972); RESTATEMENT (SECOND) OF CONTRACTS § 89 (1979).

96. H. ARANT, *supra* note 61, § 50, at 185.

97. See, e.g., Merchants Nat'l Bank v. Blass, 282 Ark. 497, 669 S.W.2d 195 (1984); Hall v. Capital Bank, 71 Ga. 715 (1883); Lauman, Hedges & Co. v. Nichols, 15 Iowa 161 (1863).

98. Burton suggests that when a contract permits the exercise of discretion by one party such discretion must be exercised for legitimate or good faith reasons. A bad faith reason is that of recapturing opportunities forgone upon contracting. Burton, *Breach of Contract*, *supra* note 79, at 373. Here, no discretion was granted in the contract. Rather, Creditor has violated the common purpose of the agreement — Debtor is to pay at maturity.

99. Tentative Draft, *supra* note 7.

the time of contracting. An extension in time is, at least, an attempt to assist the debtor in achieving its stated goal of payment and an attempt to put the debtor in a better position to pay. An extension seeks to facilitate performance by the debtor rather than the surety. A release, however, is in direct contravention of the intent of the parties — that the debtor rather than the surety make full payment to the creditor. Yet the drafters have chosen to prevent discharge of the surety when the debtor is completely released, while providing for discharge for an extension in time if loss results to the surety.<sup>100</sup>

The rationale for according the release of the debtor distinct treatment is the stated goal of encouraging settlement. The drafters correctly state that any partial payment received by the creditor benefits the surety and reduces the surety's obligation.<sup>101</sup> Should a preference be given to settlement rather than the exercise of the surety's right of exoneration? Upon notice of default or release, the surety could immediately exercise its right of exoneration. No loss results to the creditor if settlement does not occur; the surety must answer for the unpaid balance. Settlement could occur, coupled with notice and the immediate exercise of the right of exoneration. Just as delay may result in a loss of value in the rights of reimbursement or enforcement, delay in receiving notice of the debtor's default or release impacts on the viability of the exercise of the right of exoneration. Without notice, the surety alone, from the time of debtor's release to the lapse of the statute of limitations, bears the risk of the debtor's declining financial condition — a financial position that was not strong enough at contract formation for the creditor to assume willingly the risk of debtor's nonperformance.

The drafters recognized that some prejudice may result to the surety when the agreement is materially modified. Section 3-605(d) discharges the surety to the extent of its right against the debtor on material modification of the agreement without the surety's consent unless the creditor proves that no loss was sustained.<sup>102</sup> Not including actions identified in section 3-605 — release of the debtor, extending time for payment, or impairment or substitution of collateral — several other actions by the creditor should be deemed material. These should include modification in the principal or dollar amount; a change in interest rate from, for example, fixed to variable or an increase in the previously fixed rate; or alteration of a repayment term without a change in maturity or dollar amount, for example, from monthly payments to quarterly. If the drafters accept the premise that prejudice results upon a material modification such as a change in rate and if the goal of recognizing surety defenses is to prevent prejudice, then a release of the principal debtor should be accorded the same treatment as a material modification or at the very least as an extension in time.

100. U.C.C. § 3-605(c) (Final Draft 1990). For other law addressing the issue of modification, see *RESTATEMENT (SECOND) OF CONTRACTS* § 89 (1979) and U.C.C. § 2-209 & comment 2 (1972).

101. U.C.C. § 3-605 comment 3 (Final Draft 1990).

102. *Id.* § 3-605(d).

One counter consideration merits attention. Given the surety's position as an accessorial obligor, the surety may have some obligation to monitor the continuing relationship among the parties if for no other reason than to protect its interest.<sup>103</sup> This, some might argue, negates the need for notice. If the goal of suretyship defenses is to encourage suretyship and commerce, the question becomes who is in the better position to monitor the status of the debtor's performance at the least cost. Certainly, the creditor is in the better position. As a general practice, creditors have a monitoring system that records payments, delays, late charges, and generates notices to the debtor. For the surety, especially in the gratuitous family or consumer suretyship, no monitoring system may exist other than direct contact with the debtor who is likely to give continued assurance of his desire to pay. Imposing a duty on the surety to monitor the debtor's payment activity and the relationship between debtor and creditor to avoid loss will increase the surety's cost and discourage suretyship.<sup>104</sup> Increasing the creditor's duty to generate one notice at settlement to the surety appears nominal — the cost of postage, an envelope, and stationery — when compared with the cost of requiring the surety to develop a monitoring system, especially given the benefit accruing to commerce from the surety's presence in the transaction. If notice or immediate suit were required, the unfairness to the surety would be ameliorated and the creditor's conduct appears less onerous.

Finally, the creditor has, in contracting without obtaining the surety's prior consent to release the debtor, represented to the surety that the debtor will not be released absent full satisfaction of the obligation. The revised article 3 permits a creditor to represent an intent to require full performance and, at the same time, change its mind without extracting that right contractually. The creditor in effect promises to receive payment, maintain the contractual relationship with the debtor, and not to prevent or hinder performance, "unless I decide to release the debtor." In the absence of the proposed statute, a term of this nature in an agreement between the parties would be illusory,<sup>105</sup> and might, in family or consumer accommodation transactions without notice, be unconscionable. Granted, statutory law can sanction rights that private contracts could not authorize.

### III. Recommendations

The doctrine of reservation of rights had little to offer.<sup>106</sup> The only benefit was notice to the debtor of the surety's continued liability and any indirect notice the surety might have received from a debtor who in good conscience shared with his surety the fortuitous release. Abrogating the obligation of reserving rights was only a first step in resolving the problems inherent in the existing rules. Notice should also be required.

103. *Proverbs* 6:4 (New American Standard).

104. See generally Rubin, *Efficiency, Equity, and the Proposed Revisions to Articles 3 and 4*, 42 ALA. L. REV. 351, 361-64 (1991).

105. RESTATEMENT (SECOND) CONTRACTS § 77 (1979).

106. U.C.C. § 3-605 comment 3 (Proposed Final Draft Apr. 12, 1990).

Requirements other than ten-day<sup>107</sup> notice, such as a good faith basis for release or a legitimate commercial reason for the release, add uncertainty to a relationship forged by the parties in an attempt to alleviate the risk of nonpayment. Furthermore, the creditor's duty should be limited to *giving* notice, taking those steps reasonably required to inform the surety of a change in the contractual relationship. Requiring more, such as the actual receipt of notice, is an unnecessary burden on the creditor.<sup>108</sup> Notice sent to the address disclosed by the surety at the time of contracting unless later modified by the surety should be sufficient. Providing changes in address is a reasonable monitoring responsibility that the surety should assume even if not required by the creditor.

Notice permits immediate action by the surety at nominal cost to the creditor. No notice adversely affects the likelihood of the surety's recovery from the debtor, increasing the risks assumed and contemplated by the surety at the time of contracting.

In the absence of notice, the surety should be discharged to the extent of release rather than to the extent of loss suffered.<sup>109</sup> Discharge to the extent of release places the risk of loss on the creditor — the party breaching the duty of good faith or statutory performance. Permitting discharge to the extent of loss encourages litigation by the more commercially sophisticated party, the creditor, especially in the context of a family accommodation, and imposes on the surety transaction costs such as attorneys' fees that may not be recoverable from an insolvent debtor.

To minimize self-interested conduct by creditors and to encourage good faith performance of the contractual obligations of the parties, the following statutory language imposing notice should be adopted by state legislatures for proposed section 3-605(b) of revised article 3:

(b) Discharge, under Section 3-604, of the obligation of a party to pay an instrument also discharges, to the extent of the release or other discharge under Section 3-604, the obligation of an indorser or accommodation party having a right of recourse against the discharged party, unless the person entitled to enforce the instrument gives notice to the party having a right of recourse within 10 days of the discharge under Section 3-604.

Although the scope of this article is limited to the abrogation of the surety's right of discharge on release of the principal obligor, the following language is recommended for consideration by legislative bodies desiring to incorporate the creditor's good faith duty to provide notice for extensions in time and other material modifications:

(c) If a person entitled to enforce an instrument agrees, with or without consideration and without notice to an indorser or ac-

107. See, e.g., U.C.C. § 3-606(b) (Proposed Final Draft Oct. 1, 1989).

108. U.C.C. § 1-201(26) (1989); see also U.C.C. § 2-201(2) (1972) (merchant who receives a signed confirmatory memorandum has an obligation to give notice of objection).

109. Cf. U.C.C. § 3-605(c) (Final Draft 1990).

accommodation party, to an extension of the due date of the obligation of a party to the instrument, the extension discharges an indorser or accommodation party having a right of recourse against the party whose obligation is extended to the extent the extension causes loss to the indorser or accommodation party with respect to the right of recourse. The loss suffered by the indorser or accommodation party as a result of the extension is equal to the amount of the right of recourse unless the person enforcing the instrument proves that no loss was caused by the extension or that the loss caused by the extension was an amount less than the amount of the right of recourse.

(d) If a person entitled to enforce an instrument agrees, with or without consideration and without notice to an indorser or accommodation party, to a material modification of the obligation of a party other than an extension of the due date, the modification discharges the obligation of an indorser or accommodation party having a right of recourse against the person whose obligation is modified to the extent the indorser or accommodation party proves that the modification caused loss to the indorser or accommodation party with respect to the right of recourse.

When coupled with proposed section 3-605(i),<sup>110</sup> the language proposed above imposes on the creditor the duty to obtain consent or to give notice to the surety of the release of the principal debtor<sup>111</sup> and other material changes in the original obligation.

In the absence of notice or consent, the extent of discharge authorized and the burden of proof allocated in the recommended language corresponds to the degree the creditor alters the obligation contrary to the original undertaking of the parties at the time the surety engaged to answer for the debtor's indebtedness. The magnitude of discharge correlates to the degree the modification frustrates the parties' expectation that as between debtor and surety, the debtor rather than the surety should pay. If the debtor is completely released without notice or consent, the surety is discharged to the extent of the release. For an extension in time without notice or consent, the surety is discharged to the extent of loss caused by the creditor's action. Unless the creditor establishes that no loss resulted, it is presumed that a loss equivalent to the right of recourse is incurred.<sup>112</sup> However, for other

110. U.C.C. § 3-605(i) provides: "A party is not discharged under this section if (i) the party asserting discharge consents to the event or conduct that is the basis of the discharge, or (ii) the instrument or a separate agreement of the party provides for waiver of discharge under this section either specifically or by general language indicating that parties waive defenses based on suretyship or impairment of collateral." U.C.C. § 3-605(i) (Final Draft 1990).

111. Proposed section 3-605(h) should also be modified to reference subsection 3-605(b): "An accommodation party is not discharged under subsection (b), (c), (d), or (e) unless the person entitled to enforce the instrument knows of the accommodation or has notice under Section 3-419(c) that the instrument was signed for accommodation." *Id.* § 3-605(h).

112. *See id.* § 3-605(d).

material modifications such as changes in interest rate or method of repayment, the surety is discharged only to the extent the surety establishes a loss.<sup>113</sup> Giving effect to the creditor's duty of good faith performance achieves balance between the surety and creditor, promotes settlement, and negates ineffective formalities without increasing the risk assumed by the surety or discouraging suretyship.

#### *IV. Conclusion*

In 1947, the banking industry opposed requiring the surety's consent before the debtor could be released or discharged. In the industry's view, the surety would rarely acquiesce. The likelihood that today's sureties would object remains. The creditor, the party with the stronger bargaining position in consumer and small business transactions, should seek the right to release the debtor without notice. Granted, the creditor may be able to impose such a term. However, a consumer or small businessperson is unlikely to be able to extract a notice provision. If the creditor can require consent or waiver as a condition to obtaining the needed loan funds, the creditor does not need the protection of article 3. Historically, recognition of suretyship defenses suggests that protection of the surety and stimulation of commerce were primary goals. Section 3-605 should be designed to protect these primary goals.

Without a contractual right to release the debtor, the creditor has a duty to perform consistent with the reasonable expectations of the parties. If the debtor cannot pay and is released, the surety should be given timely notice of the creditor's action of settlement or release. Without notice or consent, the surety should be discharged to the extent of the release to give effect to the reasonable expectations of the parties and to minimize and discourage self-interested behavior by creditors.

113. *See, e.g., id.* § 3-605(c).

