University of Dayton Law Review

Volume 12 | Number 3 Article 2

4-1-1987

Impairment of Collateral under Section 3-606 of the Uniform Commercial Code

Carolyn Edwards
Marquette University

Follow this and additional works at: https://ecommons.udayton.edu/udlr

 Part of the Law Commons

Recommended Citation

Edwards, Carolyn (1987) "Impairment of Collateral under Section 3-606 of the Uniform Commercial Code," *University of Dayton Law Review*: Vol. 12: No. 3, Article 2.
Available at: https://ecommons.udayton.edu/udlr/vol12/iss3/2

This Article is brought to you for free and open access by the School of Law at eCommons. It has been accepted for inclusion in University of Dayton Law Review by an authorized editor of eCommons. For more information, please contact mschlangen1@udayton.edu, ecommons@udayton.edu.

UNIVERSITY OF DAYTON LAW REVIEW

VOLUME 12 SPRING 1987 NUMBER 3

IMPAIRMENT OF COLLATERAL UNDER SECTION 3-606 OF THE UNIFORM COMMERCIAL CODE

Carolyn Edwards

I. INTRODUCTION

A creditor who is reluctant to rely only on the promise of a debtor to repay an obligation may insist that a third party, a surety,[1] also agree to be answerable for the debt.[2] Suretyship contracts formed between a creditor and a surety have been recognized by the courts for centuries.[3] It is surprising, therefore, that disagreement exists over what rights and duties each party to the agreement ought to have.[4] The controversy flows from the tension which is created between the two parties to the contract. To the extent that the law recognizes and enforces the rights of the surety it will impose specific obligations on the lender. If the lender fails to satisfy these obligations and the surety is exposed to a risk of loss different from the one covered by the contract,

---

1. Suretyship has been defined as "the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform." RESTATEMENT OF SECURITY § 82 (1941).

2. A comment to the Restatement of Security observes:

> The surety's obligation assumes a variety of forms, most of which fall into a comparatively few categories. For example, a surety may be bound on the same instrument with his principal, or on a separate instrument. The surety's obligation may be coextensive with that of his principal or may be less, as where the debt is $10,000 and the surety has guaranteed only $5000. The surety may be bound to the creditor on the maturity of the principal's obligation, on the principal's default, or only after certain attempts have been made to obtain payment from the principal.

Id. § 82 comment g.

3. The history of suretyship is discussed in: Morgan, *The History and Economics of Suretyship*, 12 CORNELL L.Q. 153 (1927).

4. The question of whether the principles of part 5 of article 9 of the Uniform Commercial Code protect a guarantor who has signed a non-negotiable instrument of guaranty which contains a waiver clause has divided the courts. *Compare* United States v. Lang, 621 F. Supp. 1182 (D. Vt. 1985)(protections afforded by part 5 of article 9 may not be waived by the guarantor in advance of default) *with* United States v. Lattauzio, 748 F.2d 559 (10th Cir. 1984)(guarantor may waive in advance of default the duties imposed on a secured party by part 5).

Published by eCommons, 1986

the surety is discharged.[5] The creditor, on the other hand, who has bargained for the surety's promise and relied upon it to extend credit to the principal obligor, is naturally reluctant to accept any legal rule which provides for discharge of liability before the debt is fully satisfied. The law must decide, therefore, how to balance the interests and expectations of the creditor with the rights of the surety. Unfortunately, the law has not achieved a balance which is acceptable to both parties, and controversy over the allocation of rights and duties continues unabated.[6]

This debate reaches into article 3 of the Uniform Commercial Code.[7] Article 3[8] governs the rights and obligations of the surety who signs a negotiable instrument[9] such as a promissory note. The Code defines a surety to include both an "accommodation party" and a "guarantor."[10] The controversy has focused at least in part on section 3-606.[11] This section recognizes that a holder[12] of an instrument dis-

---

5. For a discussion of discharges available to the surety under common law, see A. STEARNS, THE LAW OF SURETYSHIP §§ 6.1–6.55 (5th ed. 1951).

6. *See generally* cases cited *supra* note 4.

7. All references to the "Code," the "Uniform Commercial Code," or the "U.C.C." are to the current official edition of the Uniform Commercial Code, which is variously referred to as the "1977" version and the "1978" version. An extensive discussion of surety rights and obligations under article 3 is contained in Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833 (1968).

8. Article 3 covers commercial paper, including drafts, checks, certificates of deposit and notes. It does not apply to money, documents of title or investment securities. *See* U.C.C. §§ 3-103(1); 3-104 (1978).

9. The Code defines "instrument" to mean a "negotiable instrument." *Id.* § 3-102(1)(e). Section 3-104 sets out the requisites for a negotiable instrument. It must be signed by the maker or drawer, contain an unconditional promise or order to pay a sum certain in money, provide for payment on demand or at a definite time, and be payable to order or to bearer. *Id.* § 3-104(1)(a)–(d). Writings that comply with the above requirements are set out in the subsection that follows. *Id.* § 3-104(2).

10. *See id.* §§ 3-415 comment 1; 1-201(40).

11. Section 3-606 states:

> (1) The holder discharges any party to theinstrument 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 to 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 affecting 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; or (b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.
>
> (2) By express reservation of rights against a party with a right of recourse the holder preserves
>
> (a) all his 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 the time; and
>
> (c) all rights of such party to recourse against others.

https://ecommons.udayton.edu/udlr/vol12/iss3/2

charges any party to the instrument to the extent that, without such party's consent, the holder "unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse."[13] The section does not define "unjustifiable impairment of collateral" nor does it indicate the scope of the discharge.[14] Uncertainty in the definition and in the scope has encouraged litigation and made it difficult to evaluate the risks and benefits of the surety relationship. Today, it is apparent that lenders who are aware of the debate hesitate to accept the promise of an accommodation party or guarantor unless a waiver of the right to claim discharge is given in advance.[15]

It is the purpose of this article to examine the impairment of collateral discharge, and to discuss the impact which the controversy surrounding section 3-606 has had on the rights of the article 3 accommodation party and guarantor.

II. THE SURETY AND ARTICLE 3

Suretyship creates a tripartite relationship between the debtor, the lender, and the surety.[16] The law has developed and applied two different and separate sets of principles to govern this relationship. The first set applies in the event that the surety's promise to pay is evidenced by an informal contract with the creditor.[17] Under these circumstances, common law provides most of the suretyship rules.[18] These rules are

---

Id. § 3-606.

12. A holder is defined as "a person who is in possession of a document of title or an instrument or a certified investment security drawn, issued, or endorsed to him or his order or to bearer or in blank." *Id.* § 1-201(20).

13. Either real or personal property may serve as collateral to secure payment of a loan. In the event that the lender is given a security interest in personal property or fixtures, article 9 of the Code governs the creation, perfection, and enforcement of the security interest. *Id.* § 9-102.

14. A comment to the Code observes:

> The words "any party to the instrument" remove any uncertainty arising under the original section. The suretyship defenses here provided are not limited to parties who are "secondarily liable," but are available to any party who is in the position of a surety, having a right of recourse either on the instrument or dehors it, including an accommodation maker or acceptor known to the holder to be so.

Id. § 3-606 comment 1.

15. *See, e.g., In re* Estate of Williams, 109 Ill. App. 3d 828, 441 N.E.2d 412 (1982).

16. RESTATEMENT OF SECURITY § 82 (1941).

17. For a discussion of the nature and construction of this contract, *see* A. STEARNS, *supra* note 5, §§ 2.1–2.13.

18. The common law may not always provide the surety with the protections afforded by article 3. *See* Crown Life Insurance Co. v. LaBonte, 111 Wis. 2d 26, 42–43, 330 N.W.2d 201, 209 (1983) (a guarantor of payment who has signed a non-negotiable instrument of guaranty is not within the scope of section 3-606, nor is he entitled, under common law rules, to a discharge for impairment of collateral). Although the common law provides the principal source for surety rules, statutory principles may also govern the relationship. Virtually every state has enacted the

Published by eCommons, 1986

supplemented by principles of equity and justice, which recognize that the surety is entitled to the benefit of certain rights. These rights flow from the notion that the surety is a favorite of the law[19] and include exoneration,[20] reimbursement,[21] and subrogation.[22] They impose upon the lender a duty to deal in good faith with the obligation, as well with any collateral held by him to secure payment of the debt.[23]

The second set of rules is derived from the negotiable instruments law and applies when the surety's promise to pay is evidenced by his signature on a negotiable instrument. This set of principles is not coextensive with traditional rules which govern at common law. The most important objective of negotiable instruments law is to protect the marketability of commercial paper.[24] In order to accomplish this objective, conventional principles which provide for discharge upon breach of the duty of good faith must give way, at least under certain circumstances, to rules which protect negotiability and safeguard the rights of the holder in due course.[25] Many courts which were called upon to inter-

---

Statute of Frauds which recognizes that an oral contract to answer for the debt of another is unenforceable unless there is a written memorandum or an applicable exception. RESTATEMENT (SECOND) OF CONTRACTS § 110 (1979).

19. The notion that the surety is a favorite of the law whose obligation is to be construed *strictissi juris*, or of the strictest law, was designed to protect the "gratuitous surety." The notion has lost some of its strength with the appearance of the compensated surety. RESTATEMENT OF SECURITY § 82 comment i (1941).

20. Where the surety is under a present obligation to the creditor, he may bring an action in equity to compel the principal to satisfy the debt. *Id.* § 112.

21. Where the surety makes a payment or otherwise performs on default by the principal, he is entitled to reimbursement from the principal. *Id.* § 104. *But see* section 3-415(5) of the Code which states: "An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party." U.C.C. § 3-415(5) (1978).

22. The doctrine of subrogation recognizes that the surety who pays the debt of the principal succeeds to the creditor's claim against the principal as well as to any security held by him. RESTATEMENT OF SECURITY § 141 (1941). *See also* Reimann v. Hybertsen, 275 Or. 235, 550 P.2d 436 (surety who had paid off the note allowed to bring suit against the original creditor for failure to assign a mortgage securing the note), *modified*, 276 Or. 95, 553 P.2d 1064 (1976).

23. *See, e.g.*, Glass v. Heller, 287 S.W. 871 (Mo. Ct. App. 1926); *LaBonte*, 111 Wis. 2d at 44, 330 N.W.2d at 209. The question of whether a breach of this duty entitles the surety to a full discharge or only to one measured by the extent of loss has been debated for years. *See* STEARNS, *supra* note 5, §§ 6.1–6.55. This debate extends into section 3-606. *See* Wilmington Trust Co. v. Gesullo, 29 U.C.C. Rep. Serv. (Callaghan) 144, 149–53 (Del. Super. Ct. 1980) (court discussion of whether partial or full discharge should be granted where the creditor had extended time for payment).

24. The history and objectives of negotiable instruments law have been favorite topics for discussion by legal commentators. *See, e.g.*, Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441 (1979); Gilmore, *The Good Faith Purchase Idea and The Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605 (1981); Rosenthal, *Negotiability - Who Needs It?*, 71 COLUM. L. REV. 375 (1971).

25. Code section 3-302(1) defines a holder in due course as a holder "who takes the instrument (a) for value; (b) in good faith; and (c) without notice that it is overdue or has been dishon-

https://ecommons.udayton.edu/udlr/vol12/iss3/2

pret the suretyship provisions of the Uniform Negotiable Instruments Law granted almost exclusive protection to purchasers of commercial paper.[26] The wisdom of this interpretation was questioned by scholars.[27] It is not surprising that the drafters of article 3 assumed a more moderate position. The provisions of article 3 are clearly intended to promote negotiability,[28] but they also incorporate and enforce traditional surety rights.[29]

Article 3 begins its analysis with definitions of the "accommodation party" and the "guarantor." These definitions establish the basic contract liability of one who signs a negotiable instrument to answer for the debt of a principal obligor. Section 3-415(1)[30] states that an accommodation party is one "who signs the instrument in any capacity for the purpose of lending his name to another party to it." Thus he

---

ored or of any defense against or claim to it on the party of any person." U.C.C. § 3-302(1) (1978). Section 3-415(3) is the only provision in article 3 which addresses the conflict between surety rights and the rights of a holder in due course. *Id.* § 3-415(3). For a discussion and criticism of this provision, *see* Peters, *supra* note 7, at 862–76.

26. At the turn of the century, most courts refused to discharge accommodation makers and acceptors. Professor Hilpert observed:

> In doing so, the courts frequently parroted the assertions that negotiability, justice and certainly, uniformity, would be promoted by refusing to discharge accommodation makers and acceptors. The mere force of these early cases alone almost invariably precluded the court from an original examination of the provision of the Negotiable Instruments Law or the validity of their justifying assertions.

Hilpert, *Discharge of Latent Sureties on Negotiable Instruments Because of Release or Extension of Time*, 50 YALE L.J. 387 (1941).

27. The issue that prompted debate under the Uniform Negotiable Instruments Law was whether to permit discharge of an accommodation party who signed as a maker or acceptor without adding words which indicated accommodation status. *See id.*, at 387–90. The debate began as early as 1900 with the publication of Ames, *The Negotiable Instrument Law*, 14 HARV. L. REV. 241 (1900).

28. *See, e.g.*, U.C.C. § 3-415(3) (1978).

29. For example, both the Restatement of Security and article 3 protect the surety's right of subrogation by recognizing a claim for discharge based on impairment of collateral. *See* RESTATEMENT OF SECURITY § 132 (1941); U.C.C. § 3-606 (1978). *See also id.* § 3-601.

30. Section 3-415 reads as follows:

(1) An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it.

(2) When the instrument has been taken for value before it is due the accommodation party is liable in the capacity in which he has signed even though the taker knows of the accommodation.

(3) As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharge dependent on his character as such. In other cases the accommodation character may be shown by oral proof.

(4) An indorsement which shows that it is not in the chain of title is notice of its accommodation character.

(5) An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party.

U.C.C. § 3-415 (1978).

Published by eCommons, 1986

may sign as a maker, indorser, drawer, or acceptor.[31] A guarantor whose contract is spelled out in section 3-416[32] differs from an accommodation party by virtue of adding words of guarantee to his signature. When "payment guaranteed" or equivalent words are added, the signer is a guarantor of payment. Section 3-416(1) states that such a guarantor "engages that if the instrument is not paid when due he will pay it according to its tenor without resort by the holder to any other party."[33] "Collection guaranteed" or equivalent words create a guarantor of collection.[34] Section 3-416(2) provides that such words forestall liability until the holder of the instrument has reduced his claim against the principal obligor to judgment and execution has been returned unsatisfied.[35]

One troublesome issue that has flowed from these definitions is whether the guarantor who has signed a non-negotiable contract of guaranty, which is separate from the note executed by the principal

---

31. *See Gesullo*, 29 U.C.C. Rep. Serv. (Callaghan) at 148 (discussion of the tests used to determine whether a party to an instrument has signed as a surety). Comment 1 to section 3-415(1) observes in part:

> Subsection (1) recognizes that an accommodation party is always a surety (which includes a guarantor), and it is his only distinguishing feature. He differs from other sureties only in that his liability is on the instrument and he is a surety for another party to it. His obligation is therefore determined by the capacity in which he signs.

U.C.C. § 3-415 comment 1 (1978).

32. Section 3-416 provides:

> (1) "Payment guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor without resort by the holder to any other party.
>
> (2) "Collection guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor, but only after the holder has reduced his claim against the maker or acceptor to judgment and execution has been returned unsatisfied, or after the maker or acceptor has become insolvent or it is otherwise apparent that it is useless to proceed against him.
>
> (3) Words of guaranty which do not otherwise specify guarantee payment.
>
> (4) No words of guaranty added to the signature of a sole maker or acceptor affect his liability on the instrument. Such words added to the signature of one of two or more makers or acceptors create a presumption that the signature is for the accommodation of the others.
>
> (5) When words of guaranty are used presentment, notice of dishonor and protest are not necessary to change the user.
>
> (6) Any guaranty written on the instrument is enforceable notwithstanding any statute of frauds.

Id. § 3-416.

33. *Id.* § 3-416(1).

34. *Id.* § 3-416(2). The term "guarantor of payment" and "guarantor of collection" are used to describe and distinguish the liability of both the common law and the article 3 guarantor. *See* Ligran, Inc. v. Medlawtel, Inc., 86 N.J. 583, 588–89, 432 A.2d 502, 505 (1981) (discussion of the differences between the guarantor of payment and the guarantor of collection under article 3).

35. It is not always clear whether words create a guarantee of payment or guarantee of collection. *See, e.g., In re* Estate of Melvin, 5 Ill. App. 3d 463, 466, 283 N.E.2d 303, 305 (1972).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

obligor, falls within the scope of article 3's provisions. Section 3-606 may offer in some circumstances the benefit of discharges which are not available to a guarantor of payment whose rights and duties are determined by common law principles.[36] The majority of courts have refused article 3 protection to the guarantor who has executed a separate and non-negotiable contract.[37] This refusal is based upon the language contained in sections 3-416 and 3-606. In *Crown Life Insurance Company v. LaBonte*[38] the Supreme Court of Wisconsin explained how the language excludes the common law guarantor.

> In order for a guarantor to be a "party to the instrument," the guarantor must sign the instrument. This is made clear by sec. 403.416, Stats., which deals with contracts of guaranty that are within the code. "The word 'signature' as used in Section 673.3-416(1) [sec. 403.416(1)] means a signature made upon an instrument . . . ." Sec. 403.416 clearly requires that the guaranty must be written on the instrument in order to bring it within the UCC. A guarantor who simply guarantees an instrument in a separate contract has not engaged in a transaction within the UCC and is not entitled to the "suretyship defenses" of sec. 403.606.[39]

A minority of courts have reached the opposite conclusion and determined that if the guaranty was executed as part of the same transaction as the note signed by the principal debtor then the guarantor is a "party to the instrument" within the scope of section 3-606 and entitled to claim the benefit of its discharges.[40] This conclusion rests upon the application of a principle of contract law which provides that documents executed as part of the same transaction should be interpreted together to determine the intent of the parties and to establish their rights and obligations.[41]

The use of this traditional contract rule serves to mitigate the

---

36. The question of whether the article 3 guarantor of payment is entitled to assert discharge under section 3-606 has also troubled the courts. Many courts have denied the common law guarantor of payment the benefit of discharge for impairment of collateral because the obligation is regarded as absolute. *See, e.g., LaBonte*, 111 Wis. 2d at 43, 330 N.W.2d at 209. Whether the drafters of article 3 intended to incorporate this view is discussed in Murray, *Secured Transactions-Defenses of Impairment and Improper Care of Collateral*, 79 COM. L.J. 265, 274-78 (1974). Today, most courts appear to have resolved the issue in favor of the article 3 guarantor. *See, e.g.*, Langeveld v. L.R.Z.H. Corp., 74 N.J. 45, 56–57, 376 A.2d 931, 936–37 (1977).

37. *See, e.g.*, Union Planters Nat'l Bank v. Markowitz, 468 F. Supp. 529, 535 (W.D. Tenn. 1979); Consolidated Roofing & Supply Co. Inc. v. Grimm, 140 Ariz. 452, ____, 682 P.2d 457, 461 (1984); *LaBonte*, 111 Wis. 2d at 41, 330 N.W.2d at 208.

38. 111 Wis.2d 26, 330 N.W.2d 201 (1983).

39. *Id.* at 42–43, 330 N.W.2d at 208–09 (citing Fewox v. Tallahassee Bank & Trust Co., 249 So. 2d 55, 57 (Fla. Dist. Ct. App. 1971)) (footnote omitted).

40. *See, e.g.*, Commerce Bank v. Wright, 645 S.W.2d 17, 21 (Mo. Ct. App. 1982); Provident Bank v. Gast, 57 Ohio St. 2d 102, 106, 386 N.E.2d 1357, 1359 (1979).

41. RESTATEMENT (SECOND) OF CONTRACTS § 202(2) (1979).

Published by eCommons, 1986

harsh impact of the common law view which denies the guarantor of payment discharge for unjustifiable impairment of collateral.[42] However, application of this rule is inconsistent with the language contained in sections 3-606 and 3-416 and with the emphasis which article 3 places on formalities.[43] The view that a guarantor must sign a negotiable instrument to be considered a party entitled to the protection of section 3-606 flows from the principles stated in section 3-104[44] and its subsections. These principles set forth formal, even rigid, requirements to determine whether a instrument is negotiable, and therefore, within the scope of article 3. The requirements established in these sections are not designed to reflect the intent of the parties unless such intent is memorialized on the instrument.[45] Moreover, these requirements serve to encourage the circulation of commercial paper by ensuring that a purchaser will know with certainty the party or parties against whom recourse for payment is available. The minority view, which departs from the formalism of article 3, does not enhance negotiability and is, therefore, unlikely to win approval by the majority of courts.

III. DISCHARGE OF THE ARTICLE 3 SURETY

The contracts of the accommodation party and the guarantor which are stated in sections 3-415 and 3-416 are derived from the law

---

42. A guaranty of payment, as distinguished from a guaranty of collection, is considered absolute. Therefore, in many jurisdictions the common law guarantor of payment is denied the defense of unjustifiable impairment of collateral. *See, e.g.*, United States v. Klebe Tool & Die Co., 5 Wis. 2d 392, ____, 92 N.W.2d 868, 871 (1958).

43. *See* Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1068–72 (1954).

44. U.C.C. section 3-104 sets forth the requirements for an instrument to be negotiable. The instrument must:

> (a) be signed by the maker or drawer; and
>
> (b) contain an unconstitutional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and
>
> (c) be payable on demand or at a definite time; and
>
> (d) be payable to order or to bearer.

U.C.C. § 3-104(1) (1978).

45. A commentator has observed:

> Although the law usually cares little about the form of a contract and looks to the actual understanding of the parties who made it, the form of a negotiable instrument is essential for the security of mercantile transactions. The courts ought to enforce these requisites of commercial paper at the risk of hardship in particular cases. A business man must be able to tell at a glance whether he is taking commercial paper or not. There must be no twilight zone between negotiable instruments and simple contracts. If doubtful instruments are sometimes held to be negotiable, prospective purchasers of queer paper will be encouraged to take a chance with the hope that an indulgent judge will call it negotiable. On the same principle, if trains habitually left late, more people would miss trains than under a system of rigid punctuality.

Chafee, *Acceleration Provisions in Time Paper*, 32 HARV. L. REV. 747, 750 (1919).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

of negotiable instruments. At the time the instrument is signed, the surety expects that the accommodated party will pay the obligation according to its terms and that he will be discharged from his liability on the instrument.[46] However, after the promise to pay has been made, but before the debt is fully satisfied, the creditor may take action with respect to either the debt or the collateral which exposes the accommodation party or guarantor to a risk of financial loss which is different from that assumed or foreseen at the time the obligation was incurred.[47] At this point, two questions arise: What defenses or discharges grounded on creditor conduct or inactivity are available to the accommodation party and guarantor to extinguish, at least to the extent of actual loss, liability on the instrument?[48] Second, are these defenses or discharges available against subsequent holders, including holders in due course? An affirmative answer to the first question requires that the law of negotiable instruments incorporate conventional suretyship principles. The second and more complex question focuses on the marketability of commercial paper and demands that a reconciliation be reached between the objectives of negotiable instruments law and the rights of the surety.[49] Unfortunately, article 3's analysis of these questions is incomplete and the answers provided are often confusing and ambiguous. The attention of the courts has focused primarily on the first question, for only on rare occasions has a holder claimed to be a holder in due course who is not subject to accommodation party discharges.[50]

---

46. *See* U.C.C. §§ 3-601, 3-603 (1978). In Crothers v. National Bank, 158 Md. 587, 149 A. 270 (1930), the court observed: "Since the accommodating party lends his credit by request to the party accommodated upon the assumption that the latter will discharge the debt when due, it is an implied term of this agreement that the party accommodated cannot acquire any right of action against the accommodating party." *Id.* at 593, 149 A. at 273. The surety, however, has recourse against the accommodated party. *See* U.C.C. § 3-415(5) (1978); RESTATEMENT OF SECURITY § 104 (1941).

47. A number of reasons have been given which justify a surety's discharge. The most common are impairment of subrogation and reimbursement rights, and increases in contemplated risk. *See* Hilpert, *supra* note 26, at 388.

48. The question of whether the surety is entitled to raise certain defenses of the principal obligor is not expressly addressed by article 3. U.C.C. section 3-415(3) arguably includes such defenses within the meaning of "discharges dependent on his character as such." Moreover, comment 1 to section 3-415 states: "[S]ubsection [1] recognizes the defenses of a surety in accordance with the provisions subjecting one not a holder in due course to all simple contract defenses, as well as his rights against his principal after payment." U.C.C. § 3-415 comment 1 (1978). *See also, e.g.*, Americana State Bank v. Jensen, 353 N.W.2d 652, 655 (Minn. Ct. App. 1984) (surety could assert contract defenses against the holder and therefore could raise a consumer statute as a defense).

49. For a discussion of article 3's treatment of the holder in due course, who knows that one of the parties to the instrument is a surety but does not have knowledge of particular defenses or discharges, see Peters, *supra* note 7, at 868–76.

50. *See, e.g.*, F.D.I.C. v. Blue Rock Shopping Center, Inc., 766 F.2d 744 (3d Cir. 1985);

Published by eCommons, 1986

Section 3-415(3) provides that an accommodation party[51] may claim "the benefit of discharges dependent on his character as such."[52] Although section 3-415 does not define "discharges dependent upon character" the references which follow include section 3-606. In the decade that followed the adoption of the Code by state legislatures, section 3-606 was applied in scores of cases to determine whether or not a holder of an instrument had unjustifiably impaired either the collateral held to secure payment of the obligation or the right of recourse.[53] At first glance, the section appears to establish a clear and concise statement of events which, absent consent or reservation of rights, will trigger a partial or total release against a holder. However, an examination of the section's provisions reveals that while guidelines are established in subsection (1)(a) for determining what events constitute impairment of recourse,[54] a definition of "impairment of collateral" is lacking.[55] The task of determining what conduct or inactivity of a holder constitutes impairment of collateral fell to the courts. The task was a formidable one, for the courts were called upon to establish a relationship in which the protections afforded the surety did not impose unreasonable burdens which would discourage the issuance of loans.

IV. IMPAIRMENT OF COLLATERAL—ITS DEFINITION

A lender who has obtained the promise of an accommodation

Holcomb State Bank v. Adamson, 107 Ill. App. 3d 908, 438 N.E.2d 635 (1982).

51. The reference in this section to "accommodation party" could be interpreted to exclude the guarantor whose contract is contained in section 3-416 and, therefore, to deny him the benefit of discharges recognized by section 3-606. U.C.C. § 3-415(3) (1978). However, in recent years, this reference has not troubled the courts and section 3-606 has been extended to the article 3 guarantor. *See, e.g.*, Langeveld v. L.R.Z.H. Corp., 74 N.J. 45, 376 A.2d 931 (1977).

52. *See* U.C.C. § 3-415(3) (1978). For the rest of that section, *see supra* note 30.

53. There is a conflict of authority as to whether the term "any party" as found in U.C.C. section 3-606 applies to a primary party, a maker, who does not sign the instrument for the purposes of accommodation. *Compare* Hughes v. Tyler, 485 So. 2d 1026, 1029 (Miss. 1986) ("any party" means any party who does not have a right, title or interest in the security); Bishop v. United Missouri Bank, 647 S.W.2d 625, 628 (Mo. Ct. App. 1983) ("any party" includes a co-maker), *with* Main Bank v. Baker, 86 Ill. 2d 188, 203, 427 N.E.2d 94, 101 (1981) (section 3-606 defenses are not available to a co-maker unless he is in the position of surety).

54. *See, e.g.*, Commercial Credit Equip. Corp. v. Hatton, 429 F. Supp. 997, 1000 (N.D. Tex. 1977); Taines v. Capital City First Nat'l Bank, 344 So. 2d 273 (Fla. Dist. Ct. App. 1977), *cert. denied*, 355 So. 2d 517 (1978); Farmers State Bank v. Cooper, 277 Kan. 547, 608 P.2d 929 (1980); Fithian v. Jamar, 286 Md. 161, 410 A.2d 569 (1979); *Langeveld*, 74 N.J. at 57, 376 A.2d at 137.

55. Section 3-606(1)(a) incorporates the traditional rule that absent consent or reservation of rights a surety should not be bound by his duty if the principal debtor is released or if the principal duty has been modified. U.C.C. § 3-606(1)(a) (1978). It is generally recognized that a binding agreement between the principal obligor and the creditor to extend time for payment falls within the scope of section 3-606(1)(a). *See, e.g.*, Wilmington Trust Co. v. Gesullo, 29 U.C.C. Rep. Serv. (Callaghan) 144, 149 (Del. Super. Ct. 1980).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

party or guarantor may insist that the principal debtor also provide collateral to secure payment of the obligation. A security interest[56] in either real or personal property protects both the lender and the surety. The law has always recognized that when the debt is fully satisfied, the surety, to the extent that he has contributed to this satisfaction, succeeds to the interest which the creditor has in any collateral.[57] The right of subrogation provides the foundation for the rule, incorporated into section 3-606, that the creditor has a duty to protect and preserve the property for the benefit of the surety[58] and that breach of this duty will extinguish, at least to the extent of loss, the obligation to pay.[59]

In the decade that followed the adoption of the Code, most courts relied upon the comments to section 3-606 to establish the definition of "unjustifiable impairment of collateral."[60] The comments observe that section 9-207[61] should be consulted as to when a holder's actions taken

---

56. Although the Restatement of Security contained a summary of the defense of impairment of collateral, this summary was not incorporated into Code section 3-606, nor referred to in its accompanying comments. RESTATEMENT OF SECURITY § 132 (1941).

57. *Id.* § 141.

58. *See, e.g.*, American Sec. Bank v. Clarno 151 Cal. App. 3d 874, 199 Cal. Rptr. 127 (1984)(duty to protect and preserve property for the benefit of the surety arises only where an implied or explicit agreement to secure assets is formed).

59. In Langeveld v. L.R.Z.H. Corp. 74 N.J. 45, 376 A.2d 931 (1977) the court observed:

> If the impairment of collateral can be measured in monetary terms, then the calculated amount of the impairment will ordinarily measure the extent of the surety's discharge. But there are factual situations. . . . where a surety may be able to establish that he has sustained prejudice, but be unable to measure the extent of the prejudice in terms of monetary loss. Where such a situation is presented the surety will normally be completely discharged.

Id. at 56–57, 376 A.2d at 937.

60. U.C.C. § 3-606 comment 5 (1978).

61. Section 9-207 reads:

> (1) A secured party must use reasonable care in the custody and preservation of collateral in his possession. In the case of an instrument of chattel paper reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed.
>
> (2) Unless otherwise agreed, when collateral is in the secured party's possession
>
> (a) reasonable expenses (including the cost of any insurance and payment of taxes or other charges) incurred in the custody, preservation, use or operation of the collateral are chargeable to the debtor and are secured by the collateral;
>
> (b) the risk of accidental loss or damage is on the debtor to the extent of any deficiency in any effective insurance coverage;
>
> (c) the secured party may hold as additional security any increases or profits (except money) received from the collateral, but money so received, unless remitted to the debtor, shall be applied in reduction of the secured obligation;
>
> (d) the secured party must keep the collateral identifiable but fungible collateral may be commingled;
>
> (e) the secured party may repledge the collateral upon terms which do not impair the debtor's right to redeem it.
>
> (3) A secured party is liable for any loss caused by his failure to meet any obligation imposed by the proceeding subsections but does not lose his security interest.
>
> (4) A secured party may use or operate the collateral for the purpose of preserving the collateral or its value or pursuant to the order of the court of appropriate jurisdiction, or

Published by eCommons, 1986

with respect to collateral may be unjustifiable.[62] Section 9-207 imposes a duty on a secured party to use reasonable care in the custody and preservation of collateral in his possession.[63] This duty, which is intended to be identical to the obligation imposed on a pledgee at common law, is limited, with rare exceptions, to the preservation of the physical value of the pledged property.[64] Thus, "impairment of collateral" interpreted in light of section 9-207 and its accompanying comments was narrowly defined to refer to acts or omissions which lessened the physical value of the collateral pledged by the debtor to the lender.[65] This definition offered the article 3 accommodation party and guarantor only minimal protection because in many factual settings, the property which served as collateral remained in the possession of the principal obligor.[66] The definition did recognize, however, the practical difficulties which would be encountered if the requirement of possession by the holder were eliminated altogether. In *Commercial Credit Equipment Corporation v. Hatton*[67] the court determined that a creditor had not unjustifiably impaired collateral by refusing to repossess the property even though the debtor had made late payments and the surety had warned the lender that the property was being used for purposes which would depreciate its value. The court reasoned:

> While this court is frankly concerned about the failure of the plaintiff to repossess under the facts in this case, we are able to understand and agree with the widespread reluctance of courts to impose upon creditors a duty to act affirmatively to prevent the impairment of collateral not in their possession; the imposition of such a duty flies in the face of commercial realities. If a creditor were under a duty to repossess collateral upon the request of a surety, for example, the note holder in an automobile financing transaction might be required to investigate every alloca-

---

except in the case of consumer goods, in the manner and to the extent provided in the security agreement.

Id. § 9-207.

62. Comment 5 to section 3-606 reads in part: "[a]s to when a holder's actions in dealing with collateral may be 'unjustfiable,' the section on rights and duties with respect to collateral in the possession of a secured party (section 9-207) should be consulted." *Id.* § 3-606 comment 5.

63. *Id.* § 9-207(1).

64. Comment 1 to section 9-207 observes: "Subsection (1) states the duty to preserve collateral imposed on a pledge at common law. See Restatement of Security, §§ 17, 18." *Id.* § 9-207 comment 1.

65. *See, e.g.*, Hurt v. Citizens Trust Co., 128 Ga. App. 224, 224–25, 196 S.E.2d 349, 350 (1973).

66. In many factual settings, property is retained by the debtor so that he may use it for his own purposes. Article 9 does recognize that some forms of collateral, accounts and general intangibles are not capable of possession, and that the filing of a financing statement is the only available method of perfecting a security interest in those types of collateral. *See* U.C.C. §§ 9-302; 9-304 (1978).

67. 429 F. Supp. 997 (N.D. Tex. 1977).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

tion by a surety that the debtor in possession of the collateral is not having the vehicle lubricated regularly or has not added antifreeze to the radiator; failure by the creditor to investigate each such allocation and to repossess if necessary could result in discharge of the surety should it later develop that the vehicle is abandoned in worthless condition due to the failure of the debtor to have the vehicle lubricated and protected against freezing. In addition to the practical problems in such a system, it would not appear to be should public policy to encourage creditors and sureties to follow debtors about to insure that the value of collateral in their possession is not deteriorating.[68]

In recent times, a definition of impairment has evolved which departs from the narrow interpretation adopted at the time the Code was enacted. In *White v. Household Finance Corp.*,[69] the focus of attention shifted away from the duty to preserve the physical value of the collateral to the obligation to protect the security interest created by agreement between the secured party and the principal debtor.[70] Article 9 of the Uniform Commercial Code, which governs the creation, perfection, and enforcement of a security interest in personal property and fixtures,[71] establishes formal requirements in section 9-203(1) as conditions to the enforcement of a security interest against the debtor and against third parties.[72] If the secured party fails to satisfy one or more of these requirements, the security interest does not attach to the property and is not enforceable against the debtor.[73] Once these formalities are satisfied, an unperfected security interest is created which is valid between the parties to the agreement. Ordinarily, a secured party will

---

68. *Id.* at 1001. A number of courts have stressed the importance of possession. Kane v. Citizens Fidelity Bank & Trust Co., 668 S.W.2d 564 (Ky. Ct. App. 1984); North Carolina Nat'l Bank v. Sharpe, 35 N.C. App. 404, 405, 241 S.E.2d 360, 361 (1978); First Nat'l Bank v. Helwig, 464 S.W.2d 953, 955 (Tex. Ct. App. 1971). *See also* Bank of Ripley v. Sadler, 671 S.W.2d 454, 457 (Tenn. 1984) (test of whether a holder justifiably impairs collateral not in his possession is that of reasonable care under all the relevant circumstances).

69. 158 Ind. App. 384, 302 N.E.2d 828 (1973).

70. *Id.* at 403–05, 302 N.E.2d at 834–35.

71. U.C.C. § 9-102 (1978).

72. Section 9-203(1) provides:

(1) [A] security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless:

(a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral and in addition, when the security interest covers crops growing or to be grown or timber to be cut, a description of the land concerned;

(b) value has been given; and

(c) the debtor has rights in the collateral.

Id. § 9-203(1).

73. The term "attach" describes the point at which the property becomes subject to the security interest. *Id.* § 9-303 comment 1. *See also id.* § 9-203(2) (security interest attaches when it becomes enforceable).

Published by eCommons, 1986

then take steps to perfect the interest.[74] Perfection, which is usually accomplished by filing a financing statement or by making a pledge of the collateral,[75] is not mandated by the provisions of article 9. It does serve, however, to confer priority of the interest over the rights of most other creditors and over transferees of the debtor.[76] Failure to perfect the security interest may expose the secured party to a loss of priority.[77] Once the security interest is subordinated to the rights of another, the value of the collateral to the secured party and to the surety, as a subrogee, has been reduced, if not destroyed. In *White*, the court determined that the duty imposed by section 3-606 on a holder of a negotiable instrument encompasses protection of a security interest, and that a failure to create an enforceable interest pursuant to section 9-203, or to perfect that interest constituted an unjustifiable impairment.[78] This impairment will discharge the accommodation party or guarantor, to the extent that loss is established.[79]

The case was critical to the development of section 3-606 as a shield against creditor misconduct which damaged the value of the subrogation right, for it recognized that the requirements of possession and diminishment in physical value could be displaced at least in exceptional factual settings.[80] The foundation for the development of a broad definition of "unjustifiable impairment of collateral" had been established. Criticism of the decision is rare.[81] Perfection of a security inter-

---

74. A secured party may take steps to perfect the interest before it attaches to the property. Under these circumstances, the security interest is perfected at the time when it attaches. *Id.* § 9-303(1).

75. In many factual settings, the filing of a financing statement and a pledge of the property are alternative means of perfection. *See, e.g., id.* §§ 9-302; 9-304.

76. *Id.* § 9-312.

77. *Id.* § 9-301.

78. *White*, 158 Ind. App. at 404, 302 N.E.2d at 835.

79. *Id.* at 400, 302 N.E.2d at 832 (citations omitted). The court's discussion of the duty imposed on the secured party makes it clear that reasonable care includes both the creation of an enforceable security interest and the perfection of this interest in the manner provided by article 9. *Id.* at 403–409, 302 N.E.2d at 834–37. *See also* Estate of Voelker, 252 N.W.2d 400, 403 (Iowa 1977) (unjustifiable impairment found where real estate was not described in the financing statement).

80. *White*, 158 Ind. App. at 404, 302 N.E.2d at 834.

81. A number of courts have concluded that an unjustifiable impairment of collateral includes a failure to perfect a security interest if such failure results in loss to the surety as subrogee. *See, e.g.*, Van Balen v. Peoples Bank & Trust, 3 Ark. App. 243, ____, 626 S.W.2d 205, 209–10 (1981) (requiring both a failure to perfect and harm); North Bank v. Circle Investment Co., 104 Ill. App. 3d 363, 369–70, 432 N.E.2d 1004, 1007 (1982); First Bank & Trust Co. v. Post, 10 Ill. App. 3d 127, 132, 293 N.E.2d 907, 910 (1973); Rempa v. LaPorte Production Credit Assoc., 444 N.E.2d 308, 313 (Ind. Ct. App. 1983); Shaffer v. Davidson, 445 P.2d 13, 15 (Wyo. 1968). *But see* Ramsey v. First Nat'l Bank & Trust Co., 683 S.W.2d 947, 955 (Ky. App. 1984) (collateral not unjustifiably impaired where pre-existing and superior interest discoverable by surety).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

est is within the sole control of a secured party and does not impose an unreasonable burden on the secured party to police the conduct of a debtor who retains possession of the collateral. Indeed, the creation and perfection of a security interest requires only a minimum of expense and effort by the secured party.

It should not be surprising that, in time, the narrow definition would be rejected and a standard of reasonable care adopted as the measure of a holder's actions or omissions taken with respect to collateral. One of the leading cases to adopt this view is *Beneficial Finance Co. v. Marshall*.[82] The question at issue was whether the holder of the instrument, who had not obtained the consent of the accommodation party, had impaired the collateral by authorizing its release to the principal debtor for the purpose of sale. The court observed that the comments to section 3-606 should not be interpreted to require possession as a condition precedent which would trigger the holder's duty to protect and preserve property.

> However, we do not read Comment 5 as a limitation upon the scope of Section 3-606. We think that Comment 5 can most properly be considered as an effort by the draftsman to explain that the term "unjustifiable" as used in Section 3-606(1)(b) means that the holder's conduct in regard to the collateral is measured by a standard of reasonable care—whether he is or is not in possession of the collateral. In our opinion such as interpretation comports with the reality of modern commercial practice; a secured party can obviously act in many ways which impair collateral not in his possession, and which result in an increase in the surety's risk. Moreover, there is no reason to assume, without express language to that effect, that either the legislature or the Code draftsman intended that Section 3-606 impairment defense be unavailable to the surety in such instances. We conclude therefore that the impairment of collateral defense of Section 3-606 reaches conduct by a secured party which unjustifiably impairs collateral not in his possession or control.[83]

Once the court eliminated the requirement of possession, it turned its attention to the notion that impairment is limited to diminishment in physical value. This notion, the court stated, must also be rejected.

> The one unifying conclusion that can be drawn from these cases, in our opinion, is that Section 3-606(1)(b) will be interpreted broadly to include, in addition to conduct by the creditor which diminishes the value of the collateral, unreasonable acts which make the collateral unavailable to the surety and thus increase his risk. This view seems to be in accord with both the common law of suretyship and the expectations of

82. 551 P.2d 315 (Okla. Ct. App. 1976).

83. *Id.* at 318 (citation omitted).

Published by eCommons, 1986

the parties to a suretyship agreement.[84]

The court noted that pursuant to section 9-306(2)[85] an authorized sale of the collateral by the principal debtor terminates the security interest which had been granted to the secured party.[86] Once the secured party has lost this interest, he has also lost his right to recover against the property as well. Thus, a voluntary release of collateral to the debtor for the purpose of sale when measured by a standard of reasonable care impairs the right of subrogation and provides the surety with a claim for discharge under section 3-606.[87]

At first glance, the court's rejection of the requirements of possession and diminishment in physical value appears to throw caution to the wind. These requirements had been imposed to ensure that a holder's duty to protect and preserve property did not include unreasonable or impracticable burdens which would discourage the use of sureties in credit transactions. Moreover, these requirements recognized that a surety has the right to protect his own financial interests for he is always entitled to pay off the debt and to be subrogated to the rights of the creditor. Although the narrow definition served the interests of the lender, it did not provide adequate protection for the surety. Its scope, confined to factual settings where property had been pledged, did not offer any safeguards against creditor overreaching which may occur where the debtor retains possession of the collateral. Further, the limited definition placed substantial reliance on the surety to protect his own financial interests. This reliance was unreasonable for a surety may not be aware of conduct or inactivity which impairs collateral until after the injury has occurred. Under these circumstances the value

---

84. *Id.* at 319–20.

85. That section provides:

> Except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale, exchange or other dosposition thereof unless the disposition was authorized by the secured party in the security ageement or otherwise, and also continues in any identifiable proceeds including collections received by the debtor.

U.C.C. § 9-306(2) (1978).

86. *Marshall*, 551 P.2d at 318–19.

87. *Id.* at 320. Whether release of collateral constitutes unjustifiable impairment in a particular factual setting is often difficult to predict. *Compare* Godfrey State Bank v. Mundy, 90 Ill. App. 3d 142, 149–50, 412 N.E.2d 1131, 1138 (1980) (release of insurance proceeds and a mortgage on the property without consent of the surety extinguished the collateral and constituted impairment), *with In re* Estate of Williams, 109 Ill. App. 3d 828, 833, 441 N.E.2d 412, 416 (1982) (return of portion of collateral for company's operating expenses was reasonable and did not constitute impairment). If collateral is replaced by property of at least equal value, no unjustifiable impairment occurs. *See, e.g.*, Hunter v. Community Loan & Inv. Corp., 127 Ga. App. 142, 193 S.E.2d 55 (1972). It is clear that a holder cannot avoid discharge by insisting that a release of collateral was done in good faith. *See, e.g.*, McHenry State Bank v. Y & A Trucking, Inc., 117 Ill. App. 3d 629, 634, 454 N.E.2d 345, 349 (1983).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

of the subrogation right has been lost.

The case represented the high water mark in the interpretation of section 3-606 for the benefit of the article 3 surety.[88] It should not be surprising that creditors reacted quickly to the development of a definition which imposed additional burdens to protect and preserve collateral. An examination of recent cases suggests that in today's commercial setting, lenders often demand that the accommodation party or guarantor consent, in advance, to any conduct or omission, which, absent such consent, would extinguish all or part of the obligation to pay.[89] The comments to section 3-606 state that consent to waive a claim for discharge for impairment does not require consideration, and may be given at the time the instrument is signed or afterwards.[90] The notion that a surety may consent to waive his discharge claim is derived from traditional common law theory which recognizes that rights granted by equity may be displaced by agreement between parties.[91]

The accommodation party and guarantor have in turn challenged consent clauses when called upon by the lender to pay some or all the obligation. In scores of cases, they have claimed that consent was not effective because it was either not informed,[92] or was not clear and unequivocal.[93] With the exception of section 3-118(f),[94] article 3 does not

---

88. *See also*, *Sadler*, 671 S.W.2d at 457 (test of whether a holder unjustifiably impairs collateral not in his possession is that of reasonable care under all the relevant circumstances).

89. *See, e.g.*, *Williams*, 109 Ill. App. 3d 828, 441 N.E.2d 412; Price v. First Nat'l Bank, 41 U.C.C. Rep. Serv. (Callaghan) 1760 (Miss. 1985); Indianapolis Morris Plan Corp. v. Karlen, 28 N.Y.2d 30, 32, 268 N.E.2d 632, 633, 319 N.Y.S.2d 831, 832 (1971); McBurnett v. National City Bank, 142 Ga. App. 505, 506, 236 S.E.2d 179, 180 (1977). *But see* Langeveld v. L.R.Z.H. Corp., 130 N.J. Super. 486, 489, 327 A.2d 683, 684 (1974) (although guarantor agreed to be "principally liable," waiver of right to claim discharge did not occur), *aff'd*, 137 N.J. Super. 557, 350 A.2d 76 (1975), *rev'd on other grounds*, 74 N.J. 45, 376 A.2d 931 (1977).

90. Comment 2 provides: "Consent may be given in advance, and is commonly incorporated in the instrument; or it may be given afterward. It requires no consideration, and operates as a waiver of the consenting party's right to claim his own discharge." U.C.C. § 3-606 comment 2 (1978).

91. RESTATEMENT OF SECURITY § 141 comment a (1941).

92. *See, e.g.*, Maine Nat'l Bank v. Fontaine, 456 A.2d 1273, 1275 (Me. 1983)(consent to an extension of time is not informed if creditor fails to notify surety of facts which materially increase risk that surety assumed).

93. In D.W. Jaquays & Co. v. First Sec. Bank, 101 Ariz. 301, 419 P.2d 85 (1966) the court explained the reason for the requirement that consent be clear: "If the destruction or impairment of such a right [subrogation to unimpaired collateral] is to be waived by a guarantor, it should only be by the most unequivocal language in the guaranty agreement. The right does not originate in contract, and it cannot lightly be destroyed by contract." *Id.* at ____, 419 P.2d at 89. Consent may also be implied from conduct (court rejected the contention that the surety had consented, either expressly or impliedly), *but see* Wilmington Trust Co. v. Gesullo, 29 U.C.C. Rep. Serv. (Callaghan) 144, 149–50 (Del. Super. Ct. 1980). *See also*, Warren v. Washington Trust Bank, 19 Wash. App. 348, ____, 575 P.2d 1077, 1083 (1978) (waiver of presentment, demand, protests and notice does not amount to a waiver of surety defenses), *modified*, 92 Wash. 2d 381, 598 P.2d 201 (1979).

Published by eCommons, 1986

impose standards against which consent is to be measured. Therefore courts have incorporated and applied the conventional common law requirements. These requirements have not been difficult to satisfy and challenges based on them have been successful only in extraordinary factual settings.[95]

Insistence by the creditor that consent be given, coupled with the lack of stringent tests to measure the effectiveness of waiver clauses, have shifted the balance of section 3-606 in favor of the lender. At the time the Code was enacted, the section was praised for the recognition it granted to traditional surety rights.[96] Today, it is apparent that in many factual settings, the protections offered by section 3-606 have been eliminated and that the creditor who takes advantage of the section's consent provision creates a shield against claims of discharge. It should not be surprising that the article 3 surety who is faced with financial loss and with the prospect that a consent clause will constitute an effective waiver of objections to creditor misconduct would have an important stake in limiting the scope of section 3-606.

V. IMPAIRMENT OF COLLATERAL - ITS SCOPE

Section 3-606 does not state the scope of its application. Consequently, the question naturally arises whether the section provides only some or all of the principles which govern a holder's duty to protect and preserve collateral. In the decade that followed the adoption of the Code, the scope issue did not appear to trouble the courts. The focus of attention was on the definition of "unjustifiable impairment," and section 3-606 was applied without discussion to measure the conduct of a holder in both the pre-default and post-default stages of the transaction.[97]

During this same period of time, the common law guarantor, who had executed a non-negotiable instrument of guaranty, claimed that ar-

---

94. Section 3-118(f) reads:

> Unless otherwise specified consent to extension authorizes a single extension for not longer than the original period. A consent to extension, expressed in the instrument, is binding on secondary parties and accommodation makers. A holder may not exercise his option to extend an instrument over the objection of a maker or acceptor or other party who in accordance with Section 3-604 tenders full payment when the instrument is due.

U.C.C. § 3-118(f) (1978). In American Sec. Bank v. Clarno, 151 Cal. App. 3d 874, 199 Cal. Rptr. 127 (1984) the court determined that section 3-606 was not applicable, but discussed and distinguished various waiver clauses. *Id.* at 880–85, 189 Cal. Rptr. at 131–33.

95. *See, e.g., Fontaine*, 456 A.2d at 1275.

96. *See* Clark, *Suretyship in the Uniform Commercial Code*, 46 Tex. L. Rev. 453, 457 (1968).

97. For cases in which section 3-606 was applied in the post default stage of the transaction, see Worthen Bank & Trust Co. v. Utley, 748 F.2d 1269 (8th Cir. 1984); State Bank v. Omega Electronics, Inc., 634 S.W.2d 234 (Mo. Ct. App. 1982).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

ticle 9 part 5, which applies upon default of the principal debtor, imposed specific duties on the secured party to protect collateral for his benefit.[98] Section 9-501[99] states that the express purpose of part 5 is to delineate the rights and remedies of the secured party and the debtor when the debtor is in default under a security agreement. Section 9-105(1)(d) defines a debtor as "the person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral."[100] Section 9-504(3) provides that a debtor is entitled to reasonable notification of the time and place of any sale, and to a disposition of the property which is commercially reasonable in every aspect.[101] These duties, which are imposed upon a secured party,

---

98. *See, e.g.*, United States v. Kukowski, 735 F.2d 1057 (8th Cir. 1984); United States v. Lang, 621 F. Supp. 1182 (D. Vt. 1985); Commercial Credit Corp. v. Lane, 466 F. Supp. 1326 (M.D. Fla. 1979); Connolly v. Bank of Sonoma County, 184 Cal. App. 3d 1119, 229 Cal. Rptr. 396 (1986); Branan v. Equico Lessors, Inc., 255 Ga. 718, 342 S.E.2d 671 (1986); First Galesburg Nat'l Bank & Trust Co. v. Joannides, 103 Ill. 2d 294, 469 N.E.2d 180 (1984). Commentators also have advocated this position. *See, e.g.*, Sachs & Belgard, *Liability of the Guarantor of Secured Indebtedness After Default and Repossession Under the Uniform Commercial Code: A Walk on the Wild Side by the Secured Party*, 5 U. BALT. L. REV. 153, 161 (1976).

99. Section 9-501 provides:

> (1) When a debtor is in default under a security agreement, a secured party has the rights and remedies provided in this Part and except as limited by subsection (3) those provided in the security agreement. He may reduce his claim to judgment, foreclose or otherwise enforce the security interest by any available judicial procedure. If the collateral is documents the secured party may proceed either as to the documents or as to the goods covered thereby. A secured party in possession has the rights, remedies and duties provided in Section 9-207. The rights and remedies referred to in this subsection are cumulative.
>
> (2) After default, the debtor has the rights and remedies provided in this Part, those provided in the security agreement and those provided in Section 9-207.

U.C.C. § 9-501(1)-(2) (1978).

100. That section provides more fully:

> "Debtor" means the person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral, and includes the seller of accounts, or chattel paper. Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires.

Id. § 9-105(1)(d).

101. Section 9-504(3) reads:

> (3) Disposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale other intended disposition is to be made shall be sent by the secured party to the debtor, if he has not signed after default a statement renouncing or modifying his right to notification of sale. In the case of consumer goods no other notification need be sent. In other cases notification shall be sent to any other secured party from whom the secured party has received (before sending his notification to the debtor or before the debtor's renunciation of his rights) written notice of

Published by eCommons, 1986

are intended to maximize the price received for the property and to minimize any deficiency which the debtor is obligated to pay.[102]

Neither section 9-501 nor section 9-504 refers in specific terms to the surety. Nevertheless, a number of courts have concluded that the common law guarantor is a debtor within the meaning of these sections, and is, therefore, entitled to the benefits of notice and commercially reasonable disposition.[103] One of the leading cases is *Ford Motor Credit Co. v. Lototsky*.[104] The court offered the following reasons in support of its conclusion that a guarantor falls within the scope of Part 5.

> To confine the definition of debtor to the principal obligor would permit creditors to circumvent this comprehensive regulatory scheme intended by the Code by the simple expedient requiring a debtor to obtain a guarantor. Upon default the party with the most substantial interest in the collateral would be left unprotected by the Code. The result would be to encourage the very type of economic waste which the Code was designed to minimize.
>
> Moreover, if the functional analysis dictated by the Code is followed, it can be seen that the unconditional guarantor is in a very real sense the debtor. When the probability of deficiency looms after default, the guarantor is the real target of the secured party. It is simply inequitable, therefore, to permit the secured party, who fixes the amount of the guarantor's liability in the first step of the collection effort by repossession and sale, to deny in the face of this economic reality that the guarantor is in fact its debtor. At that point, the guarantor is only debtor. Furthermore, where the debtor and guarantor are in essence the same entity, as the record here discloses, it is equally unjust to allow a creditor to evade the Code duties by merely insisting on a guaranty.[105]

The tide of precedent mounted and only on rare occasions was a contrary view espoused.[106] At the same time, the controversy which had surrounded the definition of impairment of collateral under section 3-

---

a claim of an interest in the collateral. The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale.

Id. § 9-504(3).

102. *See id.* § 9-504 comment 1. *See also* Rushton v. Shea, 432 F. Supp. 468 (D. Del. 1976) (discussion of how these duties function to protect the debtor).

103. *See* cases *supra* note 98.

104. 549 F. Supp. 996 (E.D. Pa. 1982).

105. *Id.* at 1004 (citation and footnote omitted).

106. *See, e.g.*, Rutan v.Summit Sports, Inc., 42 U.C.C. Rep. Serv. (Callaghan) 342, 346 (Cal. Ct. App. 1985) (a common law guarantor is not a debtor within the meaning of section 9-501); A.J. Armstrong, Inc. v. Janburt Embroidery Corp., 97 N.J. Super. 246, 234 A.2d 737 (1967)(accommodation party is not a debtor within the scope of section 9-501).

https://ecommons.udayton.edu/udlr/vol12/iss3/2

606 subsided. However, the attention of the courts was drawn to determining the proper scope of the section. Article 3 does not expressly state that it provides *the only source* for principles which govern the surety's relationship with the holder of the instrument. This omission, coupled with the section's silence as to its scope, offer both the accommodation party and the guarantor the opportunity to argue that extrinsic principles supplement the article's provisions.[107] The article 3 surety, aware that property held as collateral provides at least some protection against financial loss, seized this opportunity. Armed with scores of cases which had extended article 9 protection to the common law guarantor,[108] he argued that the duties of the secured party to provide notice and to dispose of the collateral in a commercially reasonable manner flowed directly to him.

A number of courts have invoked the provisions of part 5 to protect the article 3 surety.[109] Accordingly, section 3-606 does not contain a complete statement of the surety's right to demand that collateral be preserved and protected for his benefit. Upon default of the principal debtor and repossession of the collateral, the provisions of part 5 must be applied to determine whether the holder of the instrument can enforce a deficiency judgment against the surety.[110] Application of part 5 to protect the accommodation party is not surprising. Once collateral is repossessed and disposition is pending, the differences between the common law guarantor and the article 3 surety fade and the prospect of financial loss for each appears inevitable. Part 5 offers all sureties the benefit of specific safeguards which arise during a foreseeable, but unwelcome phase, of the financing transaction. However, application of part 5 does produce uncertainty in the scope of section 3-606 and the question that arises is whether 3-606 is limited in its use to the pre-default stage of the transaction,[111] or is it intended to overlap with the

---

107. Section 1-103 recognizes the applicability to commercial contracts of supplementary principles of law and equity except insofar as they are displaced. U.C.C. § 1-103 (1978). *See also, e.g.*, United Bank & Trust Co. v. Schaeffer, 280 Md. 10, 370 A.2d 1138 (1977) (equity defense of fraud in the factum was defense available to the accommodation party).

108. *See* cases cited *supra* note 98.

109. *See, e.g.*, First Nat'l Bank v. Cillessen, 622 P.2d 598, 601 (Colo. Ct. App. 1980); Stockdale, Inc. v. Baker, 364 N.W.2d 240, 243 (Iowa 1985); Camden Nat'l Bank v. St. Clair, 309 A.2d 329 (Me. 1973); T & W Ice Cream, Inc. v. Carriage Barn, Inc., 107 N.J. Super. 328, ____, 258 A.2d 162, 164 (1969); O'Hara v. First Nat'l Bank, 613 S.W.2d 306 (Tex. Ct. App. 1980).

110. One of the most troublesome questions under part 5 of article 9 is whether a secured party who fails to proceed in accordance with its provision loses the right to a deficiency. *See generally Joannides*, 103 Ill. 2d at 297–302, 469 N.E.2d at 181–83 (court discusses the 'absolute bar' view and the rebuttable presumption standard).

111. *See Lototsky*, 549 F. Supp. at 1005 n. 34 (suggestion that the scope of section 3-606 was limited in application to the pre-default stage of the transaction).

Published by eCommons, 1986

provisions of article 9.[112] This question has a familiar ring. In numerous circumstances, courts have relied upon provisions of more than one article of the Code to resolve disputes between litigants.[113] Such reliance may trigger doubt over the scope of specific sections. Nevertheless, this reliance is not unreasonable *provided* that the rights and obligations of parties are established with certainty and uniformity in the law is not endangered.[114] It would be tempting to conclude at this point that, except for the scope question which has emerged from the provisions of section 3-606, the right to claim discharge for impairment of collateral has been sufficiently defined to permit both the surety and the holder to evaluate the risks and benefits of their relationship. Unfortunately, a examination of cases in which both the article 3 and the common law surety have sought redress for creditor conduct which does not satisfy the mandates of part 5 suggests that one troublesome issue has not been resolved.

VI. WAIVER OF PART 5 OBLIGATIONS

Application of part 5 to the common law guarantor, who has executed an agreement which contains a consent clause, has triggered a debate over whether or not consent given in advance of default is effective to waive the duties of notice and of commercially reasonable disposition which flow from the secured party to the guarantor.[115] The provisions of sections 9-501(3)[116] and 9-504(3)[117] are designed to limit the

---

112. It is interesting to note that comment 4 to section 9-207 states that the section is intended to impose duties on a secured party in both the pre-default and post-default stage of the transaction. U.C.C. § 9-207 comment 4 (1978). The section thus overlaps with the provisions of part 5 of article 9. A similar interpretation could be offered for section 3-606.

113. *See, e.g.*, Dick Hatfield Chevrolet, Inc. v. Bob Watson Motors, Inc., 238 Kan. 41, 708 P.2d 494 (1985)(articles 1, 2, and 9 applied to determine whether a secured party is a good faith purchaser for value); Iverson v. First Bank, 712 P.2d 1285 (Mont. 1985) (articles 3 and 4 applied to determine whether the bank was accountable for the amount of an item held beyond the midnight deadline).

114. Section 1-102(2) states that the purposes and policies of the Code are: "(a) to simplify, clarify and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; (c) to make uniform the law among the various jurisdictions." U.C.C. § 1-102(2) (1978).

115. *Compare* United States v. Lang, 621 F. Supp. 1182, 1184 (D. Vt. 1985) (notice may not be waived) *with* United States v. New Mexico Landscaping, Inc., 42 U.C.C. Rep. Serv. (Callaghan) 1867, 1870 (10th Cir. 1986) (protections of part 5 may be waived.) *See also* Jennings, *Guarantors and the U.C.C.: The Need for Clarification*, 19 U.C.C. L.J. 127 (1986).

116. Section 9-501(3) provides:

> To the extent that they give rights to the debtor and impose duties on the secured party, the rules stated in the subsection referred to below may not be waived or varied except as provided with respect to compulsory disposition of collateral (subsection (3) of section 9-504 and section 9-506) but the parties may be agreement determine the standards by which the fulfillment of these rights and duties is to be measured if such standards are not manifestly unreasonable.

https://ecommons.udayton.edu/udlr/vol12/iss3/2

effectiveness of consent clauses in the post-default stage of the transaction. The comments to section 9-501 explain the reason for this limitation.

> In the area of rights after default our legal system has traditionally looked with suspicion on agreements designed to cut down the debtor's rights and free the secured party of his duties: no mortgage clause has ever been allowed to clog the equity of redemption. The default situation offers great scope for overreaching; the suspicious attitude of the courts has been grounded in common sense.
>
> Subsection (3) of this section contains a codification of this long-standing and deeply rooted attitude: the specific rights of the debtor and duties of the secured party may not be waived or varied except as stated.[118]

A number of courts have concluded that the same reasons which support a finding that the common law guarantor is a debtor within the meaning of sections 9-501 and 9-504 compel the conclusion that he is precluded from waiving in advance of default the protections afforded him by part 5.[119] Other courts, however, have reached the opposite conclusion and have determined that the duties imposed by section 9-504 may be waived by the guarantor.[120] In *National Acceptance Co. of America v. Wechsler*[121] the court offered the following reasons for distinguishing between waiver by the principal obligor and the common law guarantor.

> Nonetheless, the Court does not believe that a guarantor's status as a debtor under section 9-504(3) compels the conclusion that a guarantor may not waive the rights accorded thereunder. First, it should be observed that the collateral in question is not owned by the guarantor. Thus, while it may be unconscionable to permit a secured party such as NAC to dispose unreasonably of a debtor's property, the same cannot be said as to a guarantor, who by definition has a lesser interest in that collateral. Second, the Court must consider the general purpose of guaranty agreements. Such agreements facilitate the issuance of loans by ensuring that the lender has a ready source from which it can collect in the

---

U.C.C. § 9-501(3) (1977).

117. For the text of that section, *see supra* note 101.

118. U.C.C. § 9-501 comment 4 (1978).

119. *See, e.g., Lang*, 621 F. Supp. at 1184; Ford Motor Credit Co., v. Lototsky, 549 F. Supp. 996, 1004–05 (E.D. Pa. 1982); Commercial Discount Corp. v. King, 515 F. Supp. 988, 990 (N.D. Ill. 1981); Connolly v. Bank of Sonoma County, 184 Cal. App. 3d 1119, 229 Cal. Rptr. 396 (1986); Branan v. Equico Lessors, Inc., 255 Ga. 718, 342 S.E.2d 671 (1986).

120. *See, e.g.*, United States v. Lattauzio, 748 F.2d 559, 562 (10th Cir. 1984); United States v. Kukowski, 735 F.2d 1057, 1058 (8th Cir. 1984).

121. 489 F. Supp. 642 (N.D. Ill. 1980). *But see King*, 515 F. Supp. at 991–92 (court rejects *Wechsler* approach).

Published by eCommons, 1986

> event of default by the debtor. To this end, it would not be unusual for a lender to require a guarantor to waive objections to payment that otherwise might be available. The Court does not believe that section [9-504(3)] was intended to preclude such agreements.[122]

The debate which has created conflicting rules to govern the consenting common law guarantor's rights upon default and repossession of collateral reveals the tension which has always existed in the surety relationship. This tension has been intensified, not reduced, by ambiguities in Code provisions which apply to the debtor and by the lack of agreement over what allocation of rights and obligations is necessary to preserve the viability of suretyship as a form of financing. The article 3 surety has, with rare exception, avoided this controversy.[123] Most of the cases in which part 5 has been extended to provide him protection have not involved factual settings where consent to waive part 5 duties had been given in advance.[124] However, in light of the frequency with which consent is demanded by the lender, a confrontation is inevitable. There is no reason to suppose that the article 3 surety will not be exposed to the same division of judicial opinion. One troublesome question that remains is whether or not the consent provision of section 3-606 will be interpreted to establish a general policy which favors waiver of rights by the accommodation party and the guarantor. This interpretation would clearly tip the scales in favor of those who claim that part 5 obligations which flow to the article 3 surety are not absolute. Whether or not such a policy is evident, it is clear that there will be disagreement over the article 3 consenting surety's rights upon repossession of collateral and that litigation will be encouraged. The accommodation party and the guarantor face, unfortunately, an uncertain future.

VII. CONCLUSION

The frequent use of waiver clauses to eliminate the right to claim discharge for impairment of collateral under section 3-606, coupled with the issue of whether or not the provisions of part 5 of article 9 protect a consenting surety, suggest that a balance of rights and duties which compose the surety relationship has not been found. The debate which raged for decades over what protections, if any, the Uniform Negotiable Instruments Law offered to the latent surety has surfaced again, but in a slightly different form. The drafters of article 3 clearly intended to eliminate conflict by establishing principles which offer

---

122. *Wechsler*, 489 F. Supp. at 647–48.

123. *But see*, First Nat'l Bank v. Cillessen, 622 P.2d 598 (Colo. Ct. App. 1980) (notice of sale of collateral may not be waived).

124. *See* cases cited *supra* note 109.

https://ecommons.udayton.edu/udlr/vol12/iss3/2

some protection to the holder, and to the surety. It is apparent, however, that these protections are not compatible and that consent provisions give the lender a powerful tool to use in establishing the terms of the relationship. The efforts of the drafters to reduce the tension which had existed under prior law and to provide the article 3 surety with traditional equitable rights have met with only limited success.

Published by eCommons, 1986