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# DISCHARGE OF SURETIES—IMPAIRMENT OF THE RIGHT OF RECOURSE

## I. INTRODUCTION

The circumstances under which a party may be discharged from his obligation on a negotiable instrument are set forth in the provisions of Part 6 of Article 3 of the Uniform Commercial Code.<sup>1</sup> Among these is section 3-606, which deals with the impairment of a party's right of recourse. Section 3-606 states in part:

- (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 . . . .
- (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 that time; and
  - (c) all rights of such party to recourse against others.

Issues involving the interpretation and scope of section 3-606 have been presented in several recent cases.<sup>2</sup> These issues may be divided into two general, and overlapping categories: (1) Which parties are entitled to the benefit of discharge under this section of the Code, and (2) under which circumstances will discharge be granted or precluded? The purpose of this comment is to analyze and discuss these issues within the context of pre-Code law and underlying Code intent and policy.

## II. PARTIES TO WHICH DISCHARGE IS AVAILABLE UNDER SECTION 3-606—RIGHT OF RECOURSE.

In a recent case, *Kratovil v. Thieda*,<sup>3</sup> the Illinois Supreme Court commented with respect to the parties entitled to discharge under section 3-606.<sup>4</sup>

<sup>1</sup> U.C.C. § 3-601(1) enumerates the sections of Article 3 which govern the extent of discharge of any party from liability on a negotiable instrument. Unless otherwise indicated, all Uniform Commercial Code references are to the 1962 Official Text.

<sup>2</sup> *Kratovil v. Thieda*, 36 Ill. 2d 247, 222 N.E.2d 485 (1966); *A.J. Armstrong, Inc. v. Janburt Embroidery Corp.*, 97 N.J. Super. 246, 234 A.2d 737 (1967); *London Leasing Corp. v. Interfina, Inc.*, 53 Misc. 2d 657, 279 N.Y.S.2d 209 (Sup. Ct. 1967); *Philco Fin. Co. v. Patton*, — Ore. —, 432 P.2d 686 (1967).

<sup>3</sup> 36 Ill. 2d 247, 222 N.E.2d 485 (1966).

<sup>4</sup> *Id.* at 249, 222 N.E.2d at 486.

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The case was decided, however, under pre-Code law because the transactions were completed prior to Illinois' adoption of the Code. The defendants, Mr. and Mrs. Thieda, had signed a promissory note as accommodation makers to secure the obligation of the other maker, who had received the entire proceeds of the loan. Subsequently, the plaintiff, Kratovil, holder of the note, who was aware of the Thiedas' accommodation status, entered into a binding agreement with the other maker whereby the time for payment was extended and the monthly payments reduced. The defendants did not consent to the extension of time nor were they aware of the arrangement which, if binding upon them, would have continued their liability for a period much longer than they had originally anticipated. Shortly thereafter the other maker defaulted, and the plaintiff brought suit against the Thiedas for the balance due on the note. In appealing a default judgment entered against them, the defendants raised the defense that they were in fact sureties and, not having consented to the extension of time granted to the other maker, should accordingly be discharged from their obligation. The court ruled that under the Uniform Negotiable Instruments Act,<sup>5</sup> governing its decision, the extension of time would not result in a discharge of the defendants from their liability on the instrument.<sup>6</sup> The court acknowledged, however, that under the Uniform Commercial Code, the defense of discharge provided by section 3-606 would have been available to the defendants.<sup>7</sup>

Permitting discharge to be available to an accommodation maker as a defense under the circumstances enumerated in section 3-606 represents a significant change from immediately prior law. Under the U.N.I.A., certain parties to an instrument were entitled to discharge under circumstances similar to those provided in section 3-606.<sup>8</sup> However, one who signed an instrument as maker, notwithstanding the holder's knowledge that it was for the accommodation of another, would not have been entitled to discharge under these circumstances.<sup>9</sup> Section 3-606 of the Code appears to revive the

<sup>5</sup> 5 U.L.A. (1943). This act is commonly known as the Negotiable Instruments Law.

<sup>6</sup> 36 Ill. 2d at 251, 222 N.E.2d at 487.

<sup>7</sup> Id. at 249, 222 N.E.2d at 486.

<sup>8</sup> U.N.I.A. § 120 provides:

A person *secondarily liable* on the instrument is discharged:

- (1) By any act which discharges the instrument;
- (2) By the intentional cancellation of his signature by the holder;
- (3) By the discharge of a prior party;
- (4) By a valid tender of payment made by a prior party;
- (5) By a release of the principal debtor, unless the holder's right of recourse against the party secondarily liable is expressly reserved;
- (6) By any agreement binding upon the holder to extend the time of payment, or to postpone the holder's right to enforce the instrument, unless made with the assent of the party secondarily liable, or unless the right of recourse against such party is expressly reserved. (Emphasis added.)

<sup>9</sup> 36 Ill. 2d at 250, 222 N.E.2d at 487. U.N.I.A. § 29 provides: An accommodation party is one who has signed the instrument as maker, drawer, acceptor, or indorser, without receiving value therefor, and for the purpose of lending his name to some other person. Such person is liable on the instrument to a holder for value, notwithstanding that such holder at the time of taking the instrument knew him to be only an accommodation party. See *Night & Day Bank v. Rosenbaum*, 191 Mo. App. 559, 568,

common law principle that such a party would have been discharged if the holder had knowledge that he had signed only for the accommodation of another.<sup>10</sup> The rationale underlying the Code draftsmen's apparent rejection of the rule set forth in the U.N.I.A. and the consequent revival of the common law rule is not immediately clear and, thus, deserves investigation.

At common law, the defendants in *Kratovil*, having signed the note only to secure the debt for the accommodation of the other maker, would have been regarded as "sureties" even though the suretyship relation did not appear on the face of the note. The courts would have recognized the equitable considerations arising from the holder's knowledge of the relationship existing between the defendants and the other maker.<sup>11</sup> The court would have considered it inequitable to permit the plaintiff holder to knowingly prejudice the rights of the defendants as sureties by extending the time for payment without their consent.<sup>12</sup> In the event that a surety should be required to pay the note, he would be subrogated to the rights of the holder and could recover his loss from the party whom he had accommodated.<sup>13</sup> The inequity of nondischarge would arise from the fact that in a situation such as *Kratovil*, the defendants, who would be subrogated to the rights of the plaintiff if they should pay the note, would accordingly be bound by the extension of time granted to the other maker.<sup>14</sup>

Under the U.N.I.A., the Thiedas, although only accommodation makers, were not entitled to a discharge arising from the failure of the plaintiff to obtain their consent to the agreement extending the time for payment.<sup>15</sup> As makers they were considered "primarily" liable on the instrument.<sup>16</sup> Under such circumstances, when an extension of time had been granted to a maker of a note without the consent of any other party to the instrument, discharge was extended to only those parties considered "secondarily" liable, such as an indorser or drawer.<sup>17</sup> Contrary to the common law,<sup>18</sup> the recognition of an accommodation maker's liability as primary was considered to preclude regard for his status as a surety. Under the U.N.I.A., it was stated that "[t]he fact that one is an accommodation maker gives rise to a duty no

177 S.W. 693, 695 (1915); *Farmers' State Bank v. Forsstrom*, 89 Ore. 97, 101, 173 P. 935, 936 (1918).

<sup>10</sup> *Jennings v. Moore*, 189 Mass. 197, 203, 75 N.E. 214, 215-16 (1905); *Guild v. Butler*, 127 Mass. 386, 389 (1879); *Pooley v. Harradine*, 119 Eng. Rep. 1307, 1311 (Q.B. 1857).

<sup>11</sup> Cases cited note 10 supra.

<sup>12</sup> See A. Stearns, *Law of Suretyship* § 6.16 (5th ed. 1951).

<sup>13</sup> *Id.* § 11.1.

<sup>14</sup> *Prudential Ins. Co. v. Bass*, 357 Ill. 72, 76, 191 N.E. 284, 286 (1934); A. Stearns, supra note 12, § 6.16.

<sup>15</sup> 36 Ill. 2d at 250, 222 N.E.2d at 487.

<sup>16</sup> *Id.*, 222 N.E.2d at 486. U.N.I.A. § 192 provides: "The person 'primarily' liable on an instrument is the person who by the terms of the instrument is absolutely required to pay the same. All other parties are 'secondarily' liable." As makers, the Thiedas would be absolutely required to pay, U.N.I.A. § 60, and, therefore, "primarily liable."

<sup>17</sup> U.N.I.A. § 120(6). An indorser or drawer would be liable to pay the instrument only upon presentment and if dishonored. U.N.I.A. §§ 61, 66. Such parties would, therefore, not be absolutely required to pay and thus be only "secondarily" liable under U.N.I.A. § 192.

<sup>18</sup> See, e.g., *Jennings v. Moore*, 189 Mass. 197, 203, 75 N.E. 214, 215-16 (1905).

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less or greater or different to the holder for value than that imposed upon a maker who received value."<sup>19</sup>

The U.N.I.A. did not include any provision specifically relating to discharge of sureties, and the courts, therefore, construed it to have rejected the common law rule based upon the equitable considerations arising from a holder's knowledge that a party, although signing as a maker, was in fact a surety.<sup>20</sup> Under the U.N.I.A., a party was considered to be liable in the capacity in which he signed, whether or not it was for the accommodation of another person.<sup>21</sup> It has been stated that

[t]he act makes no provision for the proof of another and different relation than that expressly undertaken and defined by the tenor of the instrument signed. . . . The result is to render somewhat more rigid the rights of the parties as set forth in the written instruments, and so far as the holder is concerned to establish liability to him upon a firm basis, not easily shaken by parol evidence.<sup>22</sup>

The common law rule with respect to the surety status of an accommodation maker was viewed as a hardship on the payee or holder of the instrument.<sup>23</sup> The fact that a defense might be raised by a maker signing only for the accommodation of another was considered an obstruction or impairment to the negotiability and circulation of a negotiable instrument<sup>24</sup> which would result in "the prejudice and disappointment of innocent holders."<sup>25</sup> Suretyship status was further regarded as "obnoxious generally"<sup>26</sup> and furnishing one of the most vexatious sources of litigation at common law.<sup>27</sup>

The U.N.I.A. was not without criticism for failing to take into account the fact that an accommodation maker was, in reality, a surety and that such status should entitle him to the benefit of discharge when his right of recourse had been prejudiced.<sup>28</sup> In recommending that the U.N.I.A. be amended, it was contended that

[t]he accommodation party does not assert the kind of *defense* of which the currency of commercial paper requires that holders in due course be freed. He claims, however, a *discharge*, by reason of the holder's own conduct subsequent to his having acquired knowl-

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<sup>19</sup> Union Trust Co. v. McGinty, 212 Mass. 205, 207, 98 N.E. 679, 680 (1912).

<sup>20</sup> Prior to the U.N.I.A., decisions interpreting the laws relating to suretyship as it applied to negotiable instruments were at variance. Merchants' Nat'l Bank v. Smith, 59 Mont. 280, 290, 196 P. 523, 525 (1921); Cellers v. Meacham, 49 Ore. 186, 191, 89 P. 426, 428 (1907). In light of this, the U.N.I.A., was viewed as an effort to establish a complete and comprehensive law on the subject. Id. It was concluded that the only manner in which a negotiable instrument might be discharged was as specified by the act. Id. at 191-92, 89 P. at 428-29. See also cases cited notes 9 & 19 supra.

<sup>21</sup> U.N.I.A. § 29.

<sup>22</sup> Union Trust Co. v. McGinty, 212 Mass. 205, 207-08, 98 N.E. 679, 680-81 (1912).

<sup>23</sup> Farmers' State Bank v. Forstrom, 89 Ore. 97, 103, 173 P. 935, 937 (1918).

<sup>24</sup> See Mortgage Guar. Co. v. Chotiner, 8 Cal. 2d 110, 121, 64 P.2d 138, 144 (1936).

<sup>25</sup> Vanderford v. Farmers' & Mechanics' Nat'l Bank, 105 Md. 164, 169, 66 A. 47, 49 (1907).

<sup>26</sup> Goodman v. Goodman, 127 Ohio St. 223, 226, 187 N.E. 777, 778 (1933).

<sup>27</sup> Merchants' Nat'l Bank v. Smith, 59 Mont. 280, 290, 196 P. 523, 525 (1921).

<sup>28</sup> See, e.g., Hilpert, Discharge of Latent Sureties on Negotiable Instruments Because of Release or Extension of Time, 50 Yale L.J. 387 (1941).

edge of the accommodation, from a liability that would otherwise subsist despite the holder's knowledge. Surely, the currency of negotiable instruments does not require that the holder in due course be free, not only from prior defects and defenses, but from the consequences of his own subsequent inequitable conduct as well.<sup>29</sup>

It is significant to note, however, that the suretyship relation has been recognized under the U.N.I.A. in some instances. The makers of notes signed in connection with mortgages subsequently assumed by a grantee have been held entitled to discharge based upon equitable considerations not otherwise allowed by a strict construction of the U.N.I.A.<sup>30</sup> A recent Oregon decision, *Philco Fin. Co. v. Patton*,<sup>31</sup> is illustrative of this exception to U.N.I.A. policy. There, the defendants Patton and Maxwell had initially purchased dry cleaning equipment under a conditional sales contract and had given a note for the balance due. The seller, who had retained a chattel mortgage in the equipment, assigned the note and contract to the plaintiff finance company. The defendants sold and transferred the equipment to the codefendants who assumed and agreed to pay the original note. In order to obtain the plaintiff's consent to the transfer, Patton and Maxwell agreed to remain liable on the note and contract. The plaintiff, without their consent, subsequently agreed with the codefendant transferees to reduce the monthly payments and extend the time for payment. Following several payments under the new agreement the defendant transferees defaulted. The court held that Patton and Maxwell were discharged due to the plaintiff's failure to obtain their consent to the extension of time.<sup>32</sup> In reaching its decision, the court in *Philco* relied upon an earlier Oregon decision, *Hurst v. Merrifield*,<sup>33</sup> which recognized "the operation of equitable principles, upon the relations subsisting between the mortgagor, the grantee and the mortgagee."<sup>34</sup> As the *Hurst* court stated:

As between the mortgagor and the grantee, the grantee becomes the principal debtor primarily liable for the debt, and the mortgagor becomes a surety with all the consequences flowing from the relation of suretyship. As between these two and the mortgagee, although he may treat them both as debtors and may enforce the liability against either, still, after receiving notice of the assumption, he is

<sup>29</sup> *Id.* at 405.

<sup>30</sup> It was concluded by one court that the U.N.I.A. did not deal with this question under circumstances involving mortgages, and, therefore, under U.N.I.A. § 196, the rule of law merchant applied. *Prudential Ins. Co. v. Bass*, 357 Ill. 72, 77-78, 191 N.E. 284, 286-87 (1934). Another court, construing U.N.I.A. § 119(4), held that an extension of time granted to the principal constituted "any other act which would discharge a simple contract for the payment of money." On this basis, the court found that an assigning mortgagor was discharged from his liability on the instrument, thereby avoiding the question of "primary" v. "secondary" liability. *Smith v. Blackford*, 56 S.D. 360, 367-69, 228 N.W. 466, 469-70 (1929).

<sup>31</sup> — Ore.—, 432 P.2d 686 (1967).

<sup>32</sup> *Id.* at —, 432 P.2d at 689-90.

<sup>33</sup> 144 Ore. 78, 23 P.2d 124 (1933).

<sup>34</sup> *Id.* at 85, 23 P.2d at 127.

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bound to recognize the condition of suretyship and respect the rights of the surety in all his subsequent dealings with them.<sup>35</sup>

The rationale underlying *Philco's* recognition of the surety relation arising in mortgage cases involving negotiable instruments closely resembles both that underlying the common law rule and that embodied in the criticism directed at the U.N.I.A. with respect to the discharge of accommodation makers. Furthermore, the accommodation makers in *Kratovil*, and the mortgagors in *Philco*, would have been parties entitled to discharge under Section 3-606 of the Uniform Commercial Code.<sup>36</sup> This suggests that the same rationale may underlie the rule of discharge provided by that section of the Code.

A party to an instrument is discharged from any liability under that instrument to the extent that without such party's consent the holder of the instrument "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 . . . ." An examination of this language reveals that the party subject to discharge is one (a) who is liable in some capacity on the instrument and (b) to the knowledge of the holder (c) has a right of recourse against (d) a person whom the holder has discharged or whose obligation the holder has agreed not to enforce. Beyond this, section 3-606 is not explicit with respect to the nature of parties who may be entitled to the benefit of discharge.

The official comments of the Code draftsmen shed some light in this area. They indicate that any party to an instrument "who is in the position of a surety, having a right of recourse either on the instrument or dehors it"<sup>37</sup> would be entitled to the benefit of discharge under section 3-606. Under the Code a "party" is defined as "a person who has engaged in a transaction or made an agreement within this Act."<sup>38</sup> Under Article 3, the term "instrument" means a negotiable instrument,<sup>39</sup> including a "draft," "check," "certificate of deposit" or "note."<sup>40</sup> A party to an instrument covered by Article 3 would, therefore, include a "maker,"<sup>41</sup> "acceptor,"<sup>42</sup> or "indorser,"<sup>43</sup> each of whom in signing the instrument in his respective capacity engages to pay or honor the instrument according to its tenor<sup>44</sup> or pay the amount of the draft or check if dishonored.<sup>45</sup> An indorser who engaged to pay an instrument upon dishonor would be in the position of a surety, and would have a right of recourse on the instrument against the drawer, maker or any

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<sup>35</sup> *Id.*

<sup>36</sup> 36 Ill. 2d at 249, 222 N.E. 2d at 486; —Ore. at—, 432 P.2d at 689.

<sup>37</sup> U.C.C. § 3-606, Comment 1.

<sup>38</sup> U.C.C. § 1-201(29).

<sup>39</sup> U.C.C. § 3-102(1)(e).

<sup>40</sup> See U.C.C. § 3-104(2) for the Code definition of these terms.

<sup>41</sup> See U.C.C. § 3-413.

<sup>42</sup> See *id.*

<sup>43</sup> See U.C.C. § 3-414.

<sup>44</sup> U.C.C. § 3-413(1).

<sup>45</sup> U.C.C. §§ 3-413(2), -414(1).

prior indorser, and thereby falls within the purview of section 3-606.<sup>46</sup> A maker or acceptor, however, assumes a primary obligation to pay and would ordinarily have no right of recourse on the instrument.<sup>47</sup> The draftsmen's comments, however, indicate that the defenses of section 3-606 are available to "an accommodation maker or acceptor known to the holder to be so."<sup>48</sup> (Emphasis added.) Section 3-415 defines an "accommodation party" as "one who signs the instrument in any capacity for the purpose of lending his name to another party to it." The comments to section 3-415 expressly designate such a party as a "surety."<sup>49</sup> Although an accommodation maker or acceptor "is liable in the capacity in which he has signed even though the taker knows of the accommodation,"<sup>50</sup> and respectively engages either "that he will pay the instrument according to its tenor at the time of his engagement"<sup>51</sup> or that he will honor the draft as presented,<sup>52</sup> he would in either case be a surety since "if he pays the instrument [he] has a right of recourse on the instrument against such party [accommodated]."<sup>53</sup>

The facts in the *Kratovil* case serve to illustrate how an accommodation maker may fall within the purview of section 3-606. The defendants had agreed to sign as makers. The entire proceeds of the loan, however, went to the other maker. Having "loaned" their names to another person, the Thiedas were accommodation makers in the position of sureties.<sup>54</sup> As makers of the note, they agreed to pay the instrument according to its tenor at the time of their engagement<sup>55</sup> even though the plaintiff understood their position as accommodation signers. Since, however, section 3-415(5) provides that accommodation makers have a right of recourse against the other maker, the Thiedas, if required to pay the amount of the instrument to the plaintiff, would have been subrogated to the rights of the plaintiff and could recover their loss from the other maker.<sup>56</sup> As such accommodation makers, they would thus be entitled to the defenses of discharge provided by section 3-606.

<sup>46</sup> An indorser's right of recourse would arise from the maker's or acceptor's engagement to pay the instrument according to its tenor, U.C.C. § 3-413(1), and the drawer's engagement upon notice of dishonor or protest to pay the amount of the draft to any indorser. U.C.C. § 3-413(2). Under U.C.C. § 3-414(2) indorsers are liable to one another in the order in which they indorse.

<sup>47</sup> U.C.C. § 3-413(1).

<sup>48</sup> U.C.C. § 3-606, Comment 1.

<sup>49</sup> U.C.C. § 3-415, Comment 1.

<sup>50</sup> U.C.C. § 3-415(2).

<sup>51</sup> U.C.C. § 3-413(1).

<sup>52</sup> U.C.C. § 3-410(1).

<sup>53</sup> U.C.C. § 3-415(5). A "drawer" is not considered to have the type of "right of recourse" envisioned by section 3-606. Under Article 4, a payor bank may be liable for damages to a drawer of a check or draft if the item is wrongfully dishonored. See U.C.C. § 4-402. The drawer's "right of recourse" under such circumstances does not appear to be a "right of recourse" within the context of section 3-606. The liability of the bank in such a situation is for damages proximately caused by the wrongful dishonor, and arises from the relationship that exists between the bank and its customer, the drawer. See U.C.C. § 4-402, Comment 2. The "right of recourse" within the meaning of § 3-606 arises from a person's obligation on the instrument or de hors it, to pay the amount of the instrument, not damages. See U.C.C. § 3-606, Comment 1.

<sup>54</sup> See U.C.C. § 3-415(1).

<sup>55</sup> See U.C.C. § 3-413(1).

<sup>56</sup> See U.C.C. § 3-415, Comment 5.



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The defenses of section 3-606 would also have been available to the defendants Patton and Maxwell in *Philco* as parties to the instrument, but, however, with a right of recourse "dehors" the instrument.<sup>57</sup> Although they had originally signed the promissory note as makers, their position changed as a result of the sale and transfer of the equipment and concurrent assumption of the note and contract by the transferees. The defendants, therefore, stood in the relation of sureties to the transferees and, if called upon to pay the amount of the note, would have had a right of recourse arising from the transferees' assumption of the note.<sup>58</sup>

### III. CIRCUMSTANCES UNDER WHICH PARTIES WITH A RIGHT OF RECOURSE WILL BE DISCHARGED

If the defendants in either *Kratovil* or *Philco* had "consented" to the extension of time granted to the parties against whom each had a right of recourse, they would not have been entitled to discharge under section 3-606. As stated in a pre-Code case:

It is a rule, long recognized, that an accommodation indorser, or surety, is entitled to have the engagement of the principal debtor preserved, without variation in its terms, and that his assent to any change therein is essential to the continuance of his obligation. The reason of the rule is that his right must not be affected, upon the maturity of the indebtedness, to make payment and, by subrogation to the creditor's place, to, at once, proceed against the principal debtor to enforce repayment.<sup>59</sup>

The issue of what constitutes consent under section 3-606 is presented in two recent cases, *London Leasing Corp. v. Interfina, Inc.*<sup>60</sup> and *A.J. Armstrong, Inc. v. Janburt Embroidery Corp.*<sup>61</sup>

In *London Leasing*, the defendant, a corporate president, signed a note

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<sup>57</sup> The 1952 Official Draft referred only to a party's "right of recourse on the instrument." Pursuant to the 1956 Recommendations of the Permanent Editorial Board, the words "on the instrument" were deleted in the 1957 Official Edition, and it was explicitly pointed out in official comment 1 that the section discharged parties with a right of recourse not only "on the instrument" but also "dehors it." The reason was "to extend the suretyship defense of release of principal to cases of a principal bound otherwise than on the instrument." American Law Institute and National Conference of Commissioners on Uniform State Laws, 1956 Recommendations of the Editorial Board For the Uniform Commercial Code 129 (1957). The Board indicated that the change was pursuant to the New York Law Revision Commission comment that "[t]he express provision of the Code about persons known to be subject to recourse *on the instrument* might be thought to create a negative inference, i.e., that a release or extension, etc., given to a person *not* known to be subject to recourse *on the instrument* would *not* effectuate a discharge." 2 New York Law Revision Commission Report, Study of the Uniform Commercial Code 1178-79 (1955) [hereinafter cited as NYLRCR]. As pointed out by the Commission, it might not cover a situation where a buyer purchases subject to a mortgage or even assumes a mortgage without becoming a party to the instrument. 2 NYLRCR at 1178.

<sup>58</sup> 144 Ore. at 86, 23 P.2d at 127; see U.C.C. § 3-606, Comment 1.

<sup>59</sup> *National Park Bank v. Koehler*, 204 N.Y. 174, 179, 97 N.E. 468, 470 (1912).

<sup>60</sup> 53 Misc. 2d 657, 279 N.Y.S.2d 209 (Sup. Ct. 1967).

<sup>61</sup> 97 N.J. Super. 246, 234 A.2d 737 (1967).

as maker, in his corporate capacity on behalf of the corporation. The note was secured by the personal indorsement of the defendant. Subsequently, the defendant and plaintiff agreed to extend the time for payment. In this later transaction the defendant signed the extension agreement only in his corporate capacity. He did not personally indorse it. In a suit upon the note, the defendant contended, citing section 3-606, that, as a matter of law, he was discharged from his personal liability because he did not "consent" to the extension.

The facts of *Armstrong* are similar to those of *London Leasing*. In *Armstrong*, the defendants, all corporate officers or stockholders, had signed in their corporate capacities as makers and personally indorsed a refinance note consolidating the corporation's indebtedness to the assignor of the plaintiff. Subsequently, an extension agreement was drafted amending the original agreement and slightly increasing the total indebtedness. The defendants again signed in their respective corporate capacities but failed to indorse the agreement personally though requested to do so.

In *London Leasing*, the defendant was, nevertheless, held to have "consented" to the extension agreement, and, accordingly, remained personally liable.<sup>62</sup> The *Armstrong* court concurred with the decision in *London Leasing*.<sup>63</sup>

It has been asserted that "consent" need not be expressly given,<sup>64</sup> and the court in *London Leasing* supported this view in holding that the conduct of the defendant in that case constituted "consent."<sup>65</sup> The court cautioned, however, that "mere knowledge or acquiescence is not, in and of itself, sufficient to prevent discharge . . ."<sup>66</sup> This appears consistent with the underlying intent of section 3-606, which, in order to preclude any possible prejudice to a party's right of recourse, would make it incumbent upon the holder of the instrument to actually obtain such party's consent to any subsequent agreement made with the principal debtor. If mere knowledge or acquiescence were sufficient to constitute "consent," it would in effect shift the burden to the party with the right of recourse, and he would be deemed to have "consented" unless he voiced some objection to the contrary. The facts in *London Leasing* and *Armstrong* led the courts to conclude that the conduct of the defendants constituted more than mere acquiescence in the extension of time.<sup>67</sup> In both cases, the defendants had initially signed the notes in both their corporate and personal capacities. In executing the extension agreements the defendants signed in only their corporate capacities. Section 3-606 does not require such formalities as written consent, and both courts held that as the defendants had been personally involved in negotiating the new agreements the plaintiffs had obtained sufficient "consent" to preclude discharge.<sup>68</sup>

<sup>62</sup> *Id.* at 260, 234 A.2d at 745; 53 Misc. 2d at 660-61, 279 N.Y.S.2d at 213.

<sup>63</sup> 97 N.J. Super. at 259-60, 234 A.2d at 744-45.

<sup>64</sup> A. Stearns, *Law of Suretyship* § 6.13 (5th ed. 1951).

<sup>65</sup> 53 Misc. 2d at 660-61, 279 N.Y.S.2d at 213.

<sup>66</sup> *Id.*

<sup>67</sup> 97 N.J. Super. at 260, 234 A.2d at 745; 53 Misc. 2d at 660-61, 279 N.Y.S.2d at 213.

<sup>68</sup> 97 N.J. Super. at 260, 234 A.2d at 745; 53 Misc. 2d at 660-61, 279 N.Y.S.2d at 213.

## DISCHARGE OF SURETIES

As previously indicated, the necessity for obtaining the consent of a party with a right of recourse to any agreement between the holder and principal debtor is to avoid prejudicing this right which is derived from being subrogated to the rights of the holder.<sup>69</sup> Failure to obtain consent will not provide grounds for discharge if, in any subsequent agreement between the holder and the principal debtor, the holder expressly reserves his rights.<sup>70</sup> The effect of such an express reservation of rights is described in section 3-606:

- (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 that time; and
  - (c) all rights of such party to recourse against others.

In any subsequent agreement between the holder and principal debtor, the legal effect of an express reservation of rights would be to preserve the holder's rights against any other party to the instrument. In turn, it preserves that other party's right of recourse irrespective of the terms of any separate agreement the holder has made with the principal debtor. Therefore, if the holder expressly reserves his rights he can still proceed against the party with a right of recourse according to the original tenor of the note. Likewise, the party with a right of recourse can seek recourse from the principal debtor as of the time when the note was originally due.

The purpose of section 3-606, then, is to entitle a party with a right of recourse to discharge if that right has been impaired or prejudiced. If the party with a right of recourse consents to any act which would otherwise entitle him to discharge, or the holder expressly reserves his rights in any subsequent agreement with the principal debtor, the right of recourse would not be prejudiced. The question remains as to what act on the part of the holder of an instrument, within the purview of section 3-606, will constitute an impairment or prejudice to a party with a right of recourse.

In both *Kratovil* and *Philco*, the agreements to which the defendants had not consented and which the courts indicated would have been a basis for discharge under section 3-606, consisted of a reduction of the monthly payments and a resultant extension of the time for repayment of the entire note. The *London Leasing* agreement also involved an extension of time. In *Armstrong*, the agreement to which the defendants contended they did not "consent" not only extended the time for repayment of the note but even slightly increased the total amount of the indebtedness.

The language of section 3-606 does not explicitly state that an extension of time is a basis for discharge. The predecessor of section 3-606, section 120 of the U.N.I.A., specifically referred to a binding agreement to extend the time for repayment as a basis for discharge, albeit to parties only "secondarily liable." Section 3-606, however, refers more generally to an agreement

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<sup>69</sup> See A. Stearns, *supra* note 64, § 11.1.

<sup>70</sup> U.C.C. § 3-606.

"to *suspend* the right to enforce against such person the instrument . . . ." (Emphasis added.) An agreement to extend the time for payment would appear to be included within this language. At common law, failure to obtain a surety's consent to an extension of time would have been a valid basis for discharge.<sup>71</sup> In their comments to section 3-606, the Code draftsmen refer to the "suretyship defenses here provided,"<sup>72</sup> thus apparently incorporating into section 3-606 such traditional common law suretyship defenses as an extension of time to which there had been no consent.<sup>73</sup>

In order to impair or prejudice the right of recourse and thus invoke the defense of discharge, the extension of time must be a binding agreement between the holder and the principal.<sup>74</sup> Under the U.N.I.A., the claim by an indorser of a note, that forbearance by the payee of the note in verbally agreeing to accept weekly payments against an overdue note entitled him to discharge, was rejected.<sup>75</sup> The court concluded that "[t]here was no valid, binding agreement between the payee and maker of the note which for the time being presented a legal obstacle to the enforcement by the payee against the maker of the original obligation."<sup>76</sup> The reason for discharging an accommodation maker when the holder of a note has entered into a binding agreement to extend the time for payment is that the effect of such an agreement precludes the accommodation maker from immediately paying the amount of the note and recovering from the principal debtor.<sup>77</sup> If the agreement was enforceable against the holder then it would accordingly be enforceable against any party with a right of recourse, who would be subrogated to the holder's rights.<sup>78</sup> On the other hand, if the agreement was not enforceable or binding against the holder, the holder would retain his original rights in regard to the instrument. In this case, the surety's right of recourse would in no way be impaired. Since it is the purpose of section 3-606 to prevent such impairment, it is clear that the agreement in question must be binding and enforceable in order to invoke the section's protection.<sup>79</sup>

The benefit of discharge also extends to circumstances where the holder

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<sup>71</sup> See A. Stearns, *supra* note 64, §§ 6.16, .33.

<sup>72</sup> U.C.C. § 3-606, Comment 1.

<sup>73</sup> The comments to the 1952 Official Draft stated: "The language 'agrees to suspend the right to enforce' is sufficient to cover both an extension of time of payment and a covenant not to sue." U.C.C. § 3-606, Comment 6 (1952 Official Draft). The New York Law Revision Commission also concluded: "Covenants to 'suspend the right to enforce' the instrument or collateral would be simply binding contracts to extend time." 2 NYLRCR at 1177. The Code draftsmen's comment was deleted without explanation in the 1957 Official Edition.

<sup>74</sup> A. Stearns, *supra* note 64, § 6.18.

<sup>75</sup> *Clark v. United Grocery Co.*, 69 Fla. 624, 631, 68 So. 766, 769 (1915).

<sup>76</sup> *Id.*

<sup>77</sup> See A. Stearns, *supra* note 64, § 6.16.

<sup>78</sup> See *id.* § 6.18.

<sup>79</sup> The New York Law Revision Commission noted that § 3-606 did not expressly require a binding agreement, but concluded that under the present law it must be required. 2 NYLRCR at 1179. It was expressly stated in both the *Kratovil* case, 36 Ill. 2d at 298-99, 222 N.E.2d at 486, and the *Philco* case, — Ore. at —, 432 P.2d at 690, that the agreements in question were binding. The issue did not arise in the *London Leasing* and *Armstrong* cases.

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"releases or agrees not to sue . . . or otherwise discharges"<sup>80</sup> the person against whom the party has a right of recourse. The same rationale underlying discharge in circumstances involving an agreement to extend time for payment would apply. If the agreement not to sue is binding upon the holder, it will be binding upon the party with a right of recourse, and accordingly prejudice his right of recourse and entitle him to discharge under section 3-606.<sup>81</sup>

Under section 3-606, there is an exception to the circumstances under which a party will be discharged. If the holder fails or delays in effecting any required presentment, protest or notice of dishonor, section 3-606 provides that this does "not discharge any party as to whom presentment, protest or notice of dishonor is *effective or unnecessary* . . ." (Emphasis added.) The meaning of the words "effective or unnecessary," or how this exception applies, is not immediately clear.

According to section 3-504, "[p]resentment is a demand for acceptance or payment made upon the maker, acceptor, drawee or other payor by or on behalf of the holder." An instrument would be considered dishonored when upon presentment to the person obligated to pay it, acceptance or payment is refused, or the instrument is not duly paid.<sup>82</sup> Unless excused, presentment, protest or notice of dishonor, as provided in section 3-501, are "necessary to charge secondary parties" with liability on the instrument.<sup>83</sup> Under section 3-102 of the Code, a "secondary party" is a drawer or indorser. Section 3-501, in addition, includes an acceptor of a draft or maker of a note payable at a bank as parties with respect to which presentment, protest or notice of dishonor is necessary to charge with liability.<sup>84</sup> Accordingly, in order for the

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<sup>80</sup> U.C.C. § 3-606. In *Armstrong*, the court also considered "novation" to be within the purview of the language "otherwise discharges." 97 N.J. Super. at 259, 234 A.2d at 744.

<sup>81</sup> See A. Stearns, *supra* note 64, § 6.42.

<sup>82</sup> U.C.C. § 3-507(1).

<sup>83</sup> As provided in U.C.C. § 3-509(1): "A protest is a certificate of dishonor made under the hand and seal of a United States consul or vice consul or a notary public or other person authorized to certify dishonor by the law of the place where dishonor occurs. It may be made upon information satisfactory to such person." As indicated by the Code draftsmen, "[p]rotest is not necessary except on drafts drawn or payable outside of the United States." U.C.C. § 3-509, Comment 1.

<sup>84</sup> U.C.C. § 3-121 presents two alternative sections with respect to the definition of an instrument "payable at a bank."

Alternative A—

A note or acceptance which states that it is payable at a bank is the equivalent of a draft drawn on the bank payable when it falls due out of any funds of the maker or acceptor in current account or otherwise available for such payment.

Alternative B—

A note or acceptance which states that is payable at a bank is not of itself an order or authorization to the bank to pay it.

The comments to § 3-121 state with respect to Alternative B:

The note or acceptance payable at a bank is treated as merely designating a place of payment, as if the instrument were made payable at the office of an attorney. The bank's only function is to notify the maker or acceptor that the instrument has been presented and to ask for his instructions; and in the absence of specific instructions it is not regarded as required or even authorized to pay.

In either case, the acceptors of drafts or makers of notes payable at a bank appear to be treated in § 3-501 as drawers.

parties covered by section 3-501 to be held liable, the instrument must be presented and they must receive notice of dishonor.<sup>85</sup> An unexcused delay of the necessary presentment or notice of dishonor will fully discharge an indorser.<sup>86</sup> A drawer, acceptor of a draft or maker of a note payable at a bank, who is deprived of funds because the drawee or payee bank becomes insolvent during the delay, is entitled, when there is unnecessary delay in presentment or notice of dishonor, to discharge his liability by written assignment to the holder of his rights against such bank.<sup>87</sup>

Therefore, as provided by section 3-606, if a person against whom any party to the instrument had a right of recourse was discharged due to a failure or delay in effecting the required presentment, protest or notice of dishonor, the party to the instrument would not be discharged if the required presentment, protest or notice of dishonor was "effective" or "unnecessary" with respect to him. The words "necessary to charge" as used in section 3-501 mean that the necessary proceeding—presentment, protest or notice of dishonor—is a condition precedent to any right of action against the parties enumerated in the section and under the circumstances set out in the section.<sup>88</sup> Referring to the language of section 3-606, if presentment, protest or notice of dishonor was "unnecessary" with respect to the party with a right of recourse, it would appear to mean that it was not a condition precedent to his liability. This would include a secondary party as to whom presentment, protest or notice of dishonor had been waived and, therefore, excused.<sup>89</sup> "Effective" in the context of section 3-606 appears to mean that the necessary presentment was made, and protest or notice of dishonor was given, and, therefore, "effective" to charge the party with a right of recourse, if also a party designated in section 3-501, with liability on the instrument.

The meaning of this provision of section 3-606 can be more clearly illustrated by the following hypothetical. Assume *X*, a maker, executes a note to *Y*, a payee, who in turn indorses and transfers the note to *Z*. Subsequently *Z* indorses and transfers the note to *A* who becomes the holder of the note. Upon maturity of the note and *A*'s presentment, to *X*, *X* fails to pay the amount due. *A* duly notifies *Z* of the dishonor, but fails to notify *Y*. In a subsequent action upon the note, *Y* is discharged from his liability to *A* and *Z* because he was not duly notified of the dishonor by *X*.<sup>90</sup> As an indorser subsequent to *Y*, *Z* would have had a right of recourse against *Y*.<sup>91</sup> Although *Y* is discharged, the notice of dishonor was "effective" to charge *Z* with liability as an indorser and, therefore, he will be discharged. The underlying rationale of the rule precluding discharge to *Z*, as illustrated by the hypothetical, appears to be that *Z* would have in no way been prejudiced except through his own inaction. *Z* could have himself given *Y* notice of the dishonor.<sup>92</sup> If *Z* had waived notice of dishonor, thereby making notice "un-

<sup>85</sup> U.C.C. § 3-501.

<sup>86</sup> U.C.C. § 3-502(1)(a).

<sup>87</sup> U.C.C. § 3-502(1)(b).

<sup>88</sup> U.C.C. § 3-501, Comment 2.

<sup>89</sup> U.C.C. § 3-511(2)(a).

<sup>90</sup> U.C.C. § 3-502(1)(a).

<sup>91</sup> U.C.C. § 3-414(2).

<sup>92</sup> See U.C.C. § 3-508, Comment 1.

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necessary" within the context of section 3-606, he again would not have been prejudiced except through his own act in assuming the risk.

If the purpose of section 3-606 is to provide discharge for parties with a right of recourse when that right has been prejudiced or impaired, the underlying assumption must be that injury may otherwise result. A critic of the U.N.I.A., in proposing that the rule respecting the denial of discharge to accommodation makers be amended, did recognize, however, that "discharge because of release or extension of time may be objectionable on the ground that the accommodation party may not be injured by the extension or release."<sup>93</sup> The same critic suggested:

To avoid permitting the surety to blow hot and cold—remaining silent when an extension is granted, which may the better enable the principal debtor to pay; yet claiming a discharge when, despite the extension, the surety is nevertheless called upon to pay—certain vigilance might be demanded of him on pain of being otherwise deemed to have consented to the extension.<sup>94</sup>

In *Mortgage Guar. Co. v. Chotiner*,<sup>95</sup> decided under the U.N.I.A., the court held an accommodation maker was not released by an extension of time granted to the principal debtor, stating, "[w]e are the less reluctant to so hold because of the fact that the defense of an extension of time is one of the more technical suretyship defenses, the injuries resulting to the surety by reason thereof being more likely to be theoretical than real."<sup>96</sup>

This policy of discharge regardless of actual injury to the party with a right of recourse is retained in section 3-606, the language of which nowhere suggests that discharge will be limited only to the extent of injury.<sup>97</sup> The thrust of the section is obviously on the protection of the party's right of recourse and not on protection conditional on a showing that actual economic injury will result from the impairment of this right. Furthermore, there is no support for such a limitation in the common law precedents to section 3-606. At common law "[t]he rules by which the surety's liability is determined have regard to the fact that usually he derives no benefit from the transaction and he is bound only because he has agreed to be bound . . ."<sup>98</sup> A surety was considered a "favored debtor" and "[h]is contract exactly as made is the measure of his liability; and, if the case against him be not clearly within it, he is entitled to go acquit."<sup>99</sup>

### IV. CONCLUSION

Section 3-606 is not immediately clear as to the parties to whom its provisions apply. Viewed in the light of the basic policy underlying surety dis-

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<sup>93</sup> Hilpert, *Discharge or Latent Sureties on Negotiable Instruments Because of Release or Extension of Time*, 50 *Yale L.J.* 387, 399 (1941).

<sup>94</sup> *Id.*

<sup>95</sup> 8 *Cal. 2d* 110, 64 *P.2d* 138.

<sup>96</sup> *Id.* at 122, 64 *P.2d* at 144.

<sup>97</sup> The court in *Phūco*, after examining the language of the section, noted that § 3-606 permits discharge of a surety "whether or not the extension of time results in injury to him." — *Ore. at —*, 432 *P.2d* at 689 n.7.

<sup>98</sup> *Black v. Albery*, 89 *Ohio St.* 240, 243, 106 *N.E.* 38, 39 (1914).

<sup>99</sup> *Magee v. Manhattan Life Ins. Co.*, 92 *U.S.* 93, 98 (1875).

charge, *i.e.*, protection against any prejudice to a surety's right of recourse, parties entitled to discharge are determined by reference to their relation to other persons who may be obligated to the holder and against whom such party may have a right of recourse. Unlike the U.N.I.A., the Code no longer distinguishes between parties entitled to discharge on the basis of whether their liability is primary or secondary. Discharge under section 3-606 is rather based upon equitable principles which recognize the generally gratuitous nature of the surety-principal relationship.

Section 3-606 is concerned with prejudice to a party's right of recourse that may result from any separate agreement between the holder and the principal debtor. In order to continue the surety's liability, "consent" to any change is required. In order to avoid prejudicing the rights of the surety, such "consent" must be more than mere acquiescence; the party with a right of recourse must clearly manifest his assent to any change in the original obligation. Any subsequent agreement between the holder and principal debtor containing an express reservation of rights but without the surety's "consent" would leave the surety's original obligation unaffected. Such an express reservation would not, however, under section 3-606, impair the surety's right of recourse; therefore, the possibility of prejudice would not exist.

Typical of the circumstances which are considered prejudicial to the rights of a surety are extensions of time granted to the principal debtor by the holder. Section 3-606 also encompasses any other agreement which would release or discharge the principal debtor. However, discharge to any person resulting from a failure or delay in effecting any required presentment, protest or notice of dishonor would not result in the discharge of the surety if the presentment, protest or notice of dishonor was "effective" or "unnecessary" as to him.

To warrant discharge to the surety, any agreement between the holder and the principal debtor must be binding as between those parties and, therefore, affect the surety's rights through subrogation to the rights of the holder. If not binding on the holder, it will not be binding upon the surety, and thus not impair the surety's right of recourse.

Section 3-606 bases discharge only upon the theoretical prejudice that may result to a surety. It does not require that there be consideration of whether the impairment of the right of recourse would in fact result in economic injury. As pointed out by the New York Law Revision Commission, the original purpose in allowing discharge to sureties was one of fairness, but this has developed into a strict rule.<sup>100</sup> Proof of injury, however, may be difficult, and this may explain the evolution of the present rule now represented by section 3-606.

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<sup>100</sup> 2 NYLRCR at 1179.