Winter 1991

Suretyship Principles in the New Articles 3: Clarifications and Substantive Changes

Neil B. Cohen
Brooklyn Law School, neil.cohen@brooklaw.edu

Recommended Citation
42 Ala. L. Rev. 595 (1990-1991)

Suretyship Principles in the New Article 3: Clarifications and Substantive Changes*

*Neil B. Cohen***

I. Introduction

"For some unfathomable reason, the courts have historically taken a particular interest in surety law,"[1] a bankruptcy court judge lamented recently The reason is not so unfathomable, though. Courts have taken a particular interest in suretyship because they have had no choice. Suretyship is a major economic activity which gives rise to frequent litigation.

Moreover, while suretyship may be important economically, courts have had to take a particular interest in surety *law* because, for the most part, nobody else has. Suretyship law has ancient roots and a venerable history[2] but, at least in late twentieth century American law, it has not had much of a present. While the use of suretyship in commercial transactions is expanding rapidly, the availability of source material for the jurist, practitioner, academic or student who seeks an understanding of the area is not keeping pace. Indeed, from the dearth of suretyship materials available, one might draw the conclusion that materials on suretyship law ought to be catalogued and shelved with legal history materials.[3]

** Professor of Law, Brooklyn Law School; Reporter, RESTATEMENT OF THE LAW (THIRD) SURETYSHIP. The views expressed in this Article are those of the author, and not of the American Law Institute.

1. *In re* Murchison, 102 Bankr. 545, 547 (Bankr. N.D. Tex. 1988).

2. *See generally* Loyd, *The Surety*, 66 U. PA. L. REV. 40 (1917).

3. Indeed, it is the surprising truth that the three newest comprehensive sources of suretyship law are all over *forty* years old. The first of these sources is the *Restatement of the Law of Security*, promulgated in 1941. More "recent" are the *Handbook on the Law of Suretyship* by Lawrence Simpson, published in 1950, and the fifth edition of *A. Stearns, The Law of Suretyship* (J. Elder ed.), published in 1951. In sum, current source material on the law of suretyship is virtually nonexistent. *See* RESTATEMENT OF THE LAW OF SECURITY (1941); L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP (1950); A. STEARNS, THE LAW OF SURETYSHIP (J. Elder 5th ed. 1951).

The primary exception to the lack of modern thinking about suretyship law has been the Uniform Commercial Code ("U.C.C." or "Code"). The Code contains a significant amount of law governing suretyship situations, most particularly in Article 3. Article 3, both in its original form and in its current revision, provides a set of rules governing the rights and responsibilities of parties to negotiable instruments who fulfill the economic function of sureties.

Before examining the suretyship rules embodied in Article 3, however, it is helpful to set forth briefly the common law foundation on which those rules rest. Suretyship is a three-party relationship involving the creditor, the principal debtor and the surety.[4] Essentially, the surety's role is to stand behind the debtor's obligation to the creditor.[5] As between the debtor and the surety, the debtor is primarily liable on the obligation.[6] From the creditor's perspective, though, the identity of the party who will ultimately bear the cost of performance is not significant; what matters is that the creditor may demand payment from two different parties—the debtor and the surety—if the obligation is not paid.[7]

The surety has various rights against the principal debtor so that it can be made whole if it is made to pay the obligation. Three legal theories are available to the surety in this situation. First, the surety has the right of "exoneration." Exoneration is essentially an equitable cause of action against the principal debtor to compel it to pay the obligation.[8] Second, the surety has the right of reimbursement; that is, the surety may recover from the principal debtor the amount paid on account of the obligation.[9] Third, the surety has the right to be subrogated to the creditor's rights. The subrogation right is the right to be substituted to the position of the creditor; it is a form of equitable assignment.[10]

Finally, the surety has some special defenses to the duty to stand behind the debtor's obligation. These defenses exist largely

---

4. *See* L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP 2 (1950).
5. *See id.*
6. *See id.* at 6.
7. *See* RESTATEMENT OF THE LAW OF SECURITY § 82 (1941); L. SIMPSON, *supra* note 4, at 2.
8. *See* L. SIMPSON, *supra* note 4, at 198-204.
9. *See id.* at 224-30.
10. *See id.* at 205-06.

to protect sureties in situations where the creditor takes an action that harms the surety's ability to recover from the principal debtor and thereby increases the surety's ultimate economic burden.[11] Suretyship law presumes that the surety has not consented to such an action and, accordingly, the law may release the surety from its obligations if the creditor acts in such a way as to harm the surety's ability to recover from the principal debtor.[12]

One of the most common settings for the suretyship obligation is a negotiable instrument. There are a number of ways in which a surety may embody its obligation on a negotiable instrument. Most commonly, perhaps, the principal debtor is the maker of a note, while the surety is an indorser or guarantor. As an indorser, the surety essentially contracts that it will pay the note if the maker dishonors it.[13] A surety, however, can obligate itself by entering into any of the contracts of a party to an instrument.[14]

When the surety and the principal debtor are both parties to a negotiable instrument, Article 3 of the U.C.C. provides the rules governing the rights and duties of the parties to this three-party relationship. Former Article 3 provides a substantial body of rules in this area. While the rules are workable for the most part, they suffer from the inconsistent drafting that plagues much of former Article 3 and embody an odd mix of new rules and incorporation of the common law. Perhaps the severest critic of the former Article 3 suretyship rules has been Professor Ellen Peters, who is now Chief Justice of the Connecticut Supreme Court. Chief Justice Peters wrote:

> "[T]he principal weakness of the Code's Article 3 sections dealing with suretyship obligations is not so much the absence of definitive solutions but the failure to establish any consistent pattern of legislative intervention. At some points, the sections dictate with fanatical and misguided precision what the suretyship obligation may or may not contain. At other junctures, the sections contain entirely unguided references to large bodies of perhaps inapplicable local law. Only rarely does the Code specify for the parties and the

---

11. *See generally* RESTATEMENT OF THE LAW OF SECURITY §§ 122-24, 126-32 & 135 (1941).

12. *See generally id.*

13. *See* U.C.C. § 3-414 (1989); U.C.C. § 3-415 (1990). [This Article, for purposes of clarity, distinquishes between citations to the former and revised U.C.C. sections by citing, respectively, to the 1989 and 1990 U.C.C.]

14. *See* L. SIMPSON, *supra* note 4, at 32.

courts those degrees of freedom which the Code decided, correctly, to preserve."[15]

This Article compares the treatment of suretyship principles under the former version of Article 3 and under the revised version of Article 3 which was recently promulgated by the National Conference of Commissioners on Uniform State Laws and the American Law Institute.[16] Where the differences are minor, the differences are set forth and explained. Where the differences are more substantial, however, an analysis and critique of the new version is provided.

II. The Scope of Article 3 Suretyship Rules

A. *Background*

Former Article 3 applied suretyship concepts primarily in U.C.C. sections 3-415, 3-416 and 3-606.[17] The analogous sections in the revised version of Article 3 are sections 3-419 and 3-605.[18] Close examination of these sections reveals that the rights and obligations of parties to a suretyship arrangement governed by either version of Article 3 differ in some significant ways from those rights and obligations of parties provided by the general law of suretyship. Accordingly, it is important to note as a preliminary matter that, for the most part, the suretyship principles of Article 3 apply only to situations involving an "accommodation party." An accommodation party is essentially a surety who has effectuated that status by signing the instrument.[19] Typically, then, an accommodation party will be a comaker or indorser, although a guaranty *on the instrument* will also suffice.[20] One can become a surety with respect to an instrument without being an accommodation party, however. One who becomes a surety without signing the instrument—by, for example, signing a separate guaranty—is a surety

15. Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833, 879 (1968).

16. U.C.C. art. 3 (1990).

17. U.C.C. §§ 3-415, 3-416 & 3-606 (1989).

18. U.C.C. §§ 3-419 & 3-605 (1990).

19. *See infra* notes 27-49 and accompanying text.

20. Revised Article 3 makes it clear that such a guaranty is a form of indorsement. U.C.C. § 3-419(d) (1990).

but not an accommodation party.[21] Thus, the rights of parties to a suretyship arrangement with respect to commercial paper may also be governed by general suretyship law, rather than by the principles enunciated in Article 3.[22] While it is sensible for the scope of Article 3 rules to be limited to rights created "on the paper," the result under former Article 3 is that two functionally identical credit enhancements of an item of commercial paper can be governed by two different bodies of law. This situation is undesirable, to say the least.

Did the drafters of former Article 3 intend this anomalous result? It is difficult to say. The 1952 official draft of U.C.C. section 3-415(1) defined an accommodation party as "one who signs the instrument in any capacity as surety for another party to it."[23] The comment to this section indicated that the use of the word surety was "intended to incorporate the entire background of the law of suretyship as applied to negotiable instruments."[24] Yet, as a result of some heated debate before the New York Law Revision Commission, the provision and the comment were deleted.[25] Thus, the intent of the drafters with respect to possible inconsistencies between the suretyship rules in former Article 3 and those in the common law is difficult to discern.

Regardless of the intent of the drafters of the original Article 3 in this area, the drafters of the revised version are apparently comfortable with the idea of limiting the applicability of the revised Article 3 suretyship rules to accommodation parties and leaving other sureties to the common law. Revised Article 3 provides suretyship rules only for accommodation parties, who are defined as, *inter alia*, parties to the instrument.[26]

---

21. U.C.C. § 3-419(a) & comment 1 (1990); *see* U.C.C. § 3-415(1) & comment 1 (1989).

22. *See, e.g.*, Crown Life Ins. Co. v. LaBonte, 111 Wisc. 2d 26, 34-44, 330 N.W.2d 201, 207-09 (1983).

23. U.C.C. § 3-415(1) (1952).

24. *Id.* § 3-415 comment 1.

25. *See* 1 N.Y. STATE LAW REVISION COMM'N, 1954 Report 208-09, 253, 274, 428 & 461 (1954); 2 N.Y. STATE LAW REVISION COMM'N, 1955 Report 1168 (1955); PERMANENT EDITORIAL BOARD FOR U.C.C., 1956 RECOMMENDATIONS 411 (1956).

26. *See* U.C.C. § 3-419(1) (1990); *see also infra* notes 27-49 and accompanying text.

B. Accommodation Parties

While both the former and the revised versions of Article 3 provide special rules for "accommodation parties," the two statutes define that term differently. Former U.C.C. section 3-415(1) defined an accommodation party as "one who signs the instrument in any capacity for the purpose of lending his name to another party to it."[27] While the somewhat archaic language of this provision is suggestive of pseudonyms and aliases, it is clear that the intent was to refer to sureties. Indeed, official comment 1 to former U.C.C. section 3-415 provided 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 surety for another party to it."[28] Despite the awkward language, it does not appear that courts have missed the point.

Revised Article 3 defines "accommodation party" somewhat differently. U.C.C. section 3-419(a) provides:

> If an instrument is issued for value given for the benefit of a party to the instrument ("accommodated party") and another party to the instrument ("accommodation party") signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument, the instrument is signed by the accommodation party "for accommodation."[29]

The drafters improved the definition of "accommodation party" by discarding the perhaps chivalrous concept of lending one's name to another party and by adopting instead the economic concept of incurring liability without being a direct beneficiary of the value given for the benefit of another party. Nonetheless, the drafters could have provided even greater clarity by defining "direct beneficiary," since the meaning of this term is not always as obvious as the official comment to revised U.C.C. section 3-419 suggests.

The comment indicates that the statute simply "distinguishes between direct and indirect benefit," citing as an example of an

---

27. U.C.C. § 3-415(1) (1989).
28. *Id.* § 3-415 comment 1.
29. U.C.C. § 3-419(a) (1990).

indirect benefit a sole stockholder cosigning a note with a corporation for a loan given to that corporation.[30] While the example given by the comment is clearly correct because the stockholder's benefit is only derivative and thus "indirect,"[31] it is not hard to imagine situations where the distinction between direct and indirect benefits is not so obvious. Consider, for example, the following situation: T, a tenant who lives in rented premises with his adult daughter, S, is six months behind on his rent. L, the landlord, is seeking to collect the back rent or, in the alternative, evict T While S lives with her father, only her father is named on the lease and, thus, only he is responsible for the rent and is the defendant in L's action. In order to avoid eviction, T and S cosign a note for the back rent. Is S an accommodation party? Instinct suggests that the answer is yes. After all, the debt was owed by T, not S. But the note was issued in exchange for L's agreement not to proceed with eviction, which would have left T *and S* homeless. Was not S a direct beneficiary of that value? If she was a direct beneficiary, under revised section 3-419(1),[32] S would not be an accommodation party This hypothetical illustrates the potential difficulties with the language of the revision. More guidance from the drafters on the issue of "direct beneficiary" would be helpful here.

Former Article 3 recognized at least five different types of accommodation parties, each with its own contractual obligation. First, an accommodation party could be a maker (or comaker) of the instrument.[33] In such a case, the party accommodated (i.e., the principal debtor) was either another comaker or, perhaps, an indorser. As a maker, the accommodation party entered into the contract of a maker, agreeing to pay the instrument according to its tenor at the time of his or her engagement.[34]

Second, an accommodation party could be an indorser of the negotiable instrument.[35] In that case, the party accommodated was typically the maker or drawer of the instrument. As an indorser, the accommodation party entered into the indorser's contract,

30. *Id.* § 3-419 comment 1.

31. *See id. But see* FDIC v. Blanton, 918 F.2d 524 (5th Cir. 1990).

32. U.C.C. § 3-419(1) (1990).

33. *See* U.C.C. § 3-415 comment 1 (1989); R. ANDERSON, UNIFORM COMMERCIAL CODE § 3-415:27 (3d ed. 1984).

34. U.C.C. § 3-413(1) (1989).

35. *See id.* § 3-415 comment 1; *see also* R. ANDERSON, *supra* note 33, § 3-415:28.

which provided that, upon dishonor and any necessary notice of dishonor or protest, the indorser would pay the instrument.[36]

Third, an accommodation party could be an acceptor of a draft.[37] In that case, the accommodated party would typically be the drawer.

Finally, the accommodation party could be one of two special types of indorser.[38] If the accommodation party added the words "payment guaranteed," or their equivalent, to the indorsement, he or she entered into a variant of the indorser's contract.[39] Under this contract, the indorser engaged 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."[40] Thus, the indorser who guaranteed payment of an instrument essentially waived not only the requirements of dishonor of the instrument and any necessary notice of dishonor and protest, but also all demand whatsoever against the maker or drawee, as a condition of his liability.[41] His liability was, for all practical purposes, that of a comaker.[42]

On the other hand, if the accommodation party added the words "collection guaranteed," or their equivalent, to his indorsement, he entered into a different variant of the indorser's contract. He engaged 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.[43]

Thus, "[a] guaranty of collection likewise waives formal presentment, notice of dishonor and protest, but requires that the holder first proceed against the maker or acceptor by suit and execution, or show that such proceeding would be useless."[44]

---

36. U.C.C. § 3-414(1) (1989).
37. *See id.* § 3-415 comment 1.
38. *See id.* § 3-416.
39. *Id.* § 3-416(1).
40. *Id.*
41. *Id.* § 3-416 comment.
42. *See id.*
43. *Id.* § 3-416(2).
44. *Id.* § 3-416 comment.

Finally, if an indorser added ambiguous words of guaranty to his signature, they were to be interpreted as a guaranty of payment, rather than collection.[45]

Under the revised version of Article 3, there are also several types of accommodation parties, with the liability of each depending on the particular contract entered into by that party. First, the accommodation party can be an "issuer," which is the revised Article's collective term for makers and drawers.[46] Second, the accommodation party may have entered into the contract of an indorser.[47]

Unlike former Article 3, the revision does not contain the concept of a payment guaranty.[48] Apparently, the drafters decided that nothing was accomplished by the payment guaranty that could not also be accomplished by an ordinary indorsement combined with a waiver of presentment and dishonor. "Payment guaranteed" was good shorthand for this package of rights, however, and it is not clear why the drafters of the revised Article 3 chose to eliminate it. Revised Article 3 does, however, retain the concept of a collection guaranty in section 3-419(d).[49]

III. Rights of the Surety Against the Principal Debtor

The rights of a surety as against the principal debtor were set forth in former U.C.C. section 3-415.[50] That section provided that "[a]n accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the

45. *Id.* § 3-416(3).

46. U.C.C. § 3-105(c) (1990).

47. *See id.* § 3-415(a).

48. *See* U.C.C. § 3-416(1) (1989).

49. Revised section 3-419(d) provides:

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

U.C.C. § 3-419(d) (1990).

50. *See* U.C.C. § 3-415 (1989).

instrument against such party."[51] This codified, in a way, the traditional suretyship right of subrogation. Former Article 3 was silent, however, about whether the accommodation party had the rights of reimbursement or exoneration.[52]

A close reading of former U.C.C. section 3-415(5) would seem to lead to the conclusion that Article 3 eliminated the right of exoneration. The section provided recourse only for an accommodation party who "pays" the instrument; no right was given to compel the principal debtor to pay first.[53] Whether the right to exoneration entered the equation through the gate provided by U.C.C. section 1-103[54] was unclear.

Nothing in former Article 3, however, addressed the reimbursement rights of accommodation parties. Nonetheless, commentators have consistently concluded that, under former Article 3, accommodation parties did have the right of reimbursement.[55] The courts have been in agreement, some finding reimbursement rights inherent in former U.C.C. section 3-415(5)[56] and others introducing the concept through U.C.C. section 1-103.[57]

Perhaps former Article 3's silence about the right of reimbursement was conceptually justified. Article 3, for the most part, only governs rights and liabilities relating to the instrument. The right of reimbursement, though, is not a right on the instrument. Even if the silence regarding the right to reimbursement was justified, however, the result, like so much of the interrelationship between Article 3 and suretyship law, was unnecessarily confusing.

The revision of Article 3 resolves the reimbursement issue by explicitly granting the accommodation party who pays an instru-

---

51. *Id.* § 3-415(5).

52. *See generally* U.C.C. art. 3 (1989); *see also id.* § 3-415.

53. *Id.* § 3-415(5).

54. Section 1-103 provides:

> Unless displaced by particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

U.C.C. § 1-103 (1989).

55. *See, e.g.*, J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 13-19, at n.4 (3d ed. 1988); Peters, *supra* note 15, at 869 n.151.

56. *See, e.g.*, Ilg v. Andrews, 10 Wash. App. 936, 520 P.2d 1385 (1974).

57. *See, e.g.*, Warren v. Washington Trust Bank, 19 Wash. App. 348, 575 P.2d 1077 (1978), *modified*, 92 Wash. 2d 318, 598 P.2d 701 (1979).

ment a right of reimbursement.[58] The revised Article, however, maintains its predecessor's silence regarding any right of exoneration which the surety may have.[59]

IV DEFENSES OF THE SURETY

A. *Defenses of the Principal Debtor*

One of the issues left unresolved by the text of former Article 3 was whether an accommodation party could raise the defenses of the principal debtor as a defense against enforcement of the instrument by the holder.[60] Former U.C.C. section 3-306(d) embodied the law's general bias against raising claims or defenses of third parties.[61] That section provided that, with two limited exceptions, "[t]he claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party "[62] That rule was not, however, generally applied to accommodation parties.

Under the common law of suretyship, however, most defenses of the principal debtor could be raised by the surety "[T]he general principle [is] that since the surety's obligation is based upon the existence of a duty of principal and creditor, the creditor cannot recover from the surety when the creditor's conduct gives the principal a defense "[63] Among the defenses of the principal debtor which could not be raised by the surety are the principal's lack of capacity[64] and discharge of the principal in bankruptcy proceedings.[65]

The revision of Article 3 provides an explicit answer to the issue of available defenses for an accommodation party That answer generally parallels the common law:

> In an action to enforce the obligation of an accommodation party to pay an instrument, the accommodation party may assert against the person entitled to enforce the instrument any defense or claim in

58. *See* U.C.C. § 3-419(e) (1990).
59. *See generally id.* § 3-419.
60. *See generally* Peters, *supra* note 15, at 862.
61. U.C.C. § 3-306(d) (1989).
62. *Id.*
63. RESTATEMENT OF THE LAW OF SECURITY § 126 comment a (1941).
64. *See id.* § 125.
65. *See generally* L. SIMPSON, *supra* note 4, at 308-11.

> recoupment under subsection (a) that the accommodated party could assert against the person entitled to enforce the instrument, except the defenses of discharge in insolvency proceedings, infancy, or lack of legal capacity.[66]

The revision provides that the surety can only raise defenses that the accommodated party could assert against the person entitled to enforce the instrument. Thus, if the person enforcing the instrument is a holder in due course, the accommodated party could raise only the real defenses listed in revised U.C.C. section 3-305(a)(1).[67]

B. *Suretyship Defenses*

The bulk of the Article 3 suretyship rules concern the scope of suretyship defenses and the ability of an accommodation party to assert them. Former U.C.C. section 3-606, one of the more opaque provisions of the U.C.C., provided that a holder discharged a surety if the holder, without the consent of the surety, either (a) released or agreed not to sue the principal debtor (whether or not the principal debtor is a party to the instrument) without expressly reserving rights against the surety if the relationship between the principal debtor and the surety was known to the holder, or (b) unjustifiably impaired collateral for the instrument given by a principal debtor.[68] It is notable that there was no reference in former U.C.C. section 3-606 to extensions of time granted by the creditor.[69] Most commentators, however, agree that an extension of time should be treated in the same way as a release.[70]

1. Discharges, Extensions and Modifications.—The revised version of Article 3 makes several major changes in the area of suretyship defenses. Most dramatically, it provides that "[d]ischarge, under Section 3-604, of the obligation of a party to pay an instrument does not discharge the obligation of an indorser

66. U.C.C. § 3-305(d) (1990).

67. *Id.* § 3-305(a)(1).

68. *See* U.C.C. § 3-606 (1989).

69. *See id.* In a minority of jurisdictions, the surety is also discharged if the creditor, after demand by the surety, does not proceed against the debtor. *See* Pain v. Packard, 13 Johns. 174 (N.Y. Sup. Ct. 1816).

70. *See, e.g.*, J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 13-15 (3d ed. 1988).

or accommodation party having a right of recourse against the discharged party."[71]

This would appear, at first glance, to signal a total departure from the venerable doctrine that release of the principal discharges the surety.[72] Yet, closer examination reveals that the change is not as great as it appears. According to the official comment, if the accommodation party pays the holder he can recover from the principal debtor under his right of reimbursement provided in revised U.C.C. section 3-419(e).[73] Thus, it appears that the result flowing from discharge of the principal debtor is the same as would occur under former law if the discharge were accompanied by "reservation of rights" against the surety. Indeed, official comment 3 to revised section 3-605 explicitly repudiates the doctrine of reservation of rights: "The reservation of rights doctrine is abolished in Section 3-605 with respect to rights on instruments."[74]

While the reservation of rights doctrine may, indeed, have outlived its usefulness, it has not yet been generally repudiated in the general law of suretyship. Thus, it is not clear whether this departure from generally applicable surety principles will create an island of inconsistency or will spur the common law to follow suit. In any event, regardless of the wisdom of this apparent change, the change is far from clear from the text of the statute itself.

Standing in contrast to revised U.C.C. section 3-605(b), however, are revised U.C.C. sections 3-605(c) and (d). Those sections provide:

> (c) If a person entitled to enforce an instrument agrees, with or without consideration, to an extension of the due date of the obligation of a party to pay the instrument, the extension discharges an indorser or accommodation party having a right of recourse against the party whose obligation is extended to the extent the indorser or accommodation party proves that the extension caused loss to the indorser or accommodation party with respect to the right of recourse.

---

71. U.C.C. § 3-605(b) (1990).

72. RESTATEMENT OF THE LAW OF SECURITY § 122 (1941) ("Where the creditor releases a principal, the surety is discharged, unless (a) the surety consents to remain liable notwithstanding the release, or (b) the creditor in the release reserves his rights against the surety.").

73. U.C.C. § 3-605 comment 3 (1990). *See id.* § 3-419(e).

74. *Id.* § 3-605 comment 3.

> (d) If a person entitled to enforce an instrument agrees, with or without consideration, to a material modification of the obligation of a party other than an extension of the due date, the modification discharges the obligation of an indorser or accommodation party having a right of recourse against the person whose obligation is modified to the extent the modification causes loss to the indorser or accommodation party with respect to the right of recourse. The loss suffered by the indorser or accommodation party as a result of modification is equal to the amount of the right of recourse unless the person enforcing the instrument proves that no loss was caused by the modification or that the loss caused by the modification was an amount less than the amount of the right of recourse.[75]

Thus, while under subsection (b) a complete discharge of the principal debtor will not release the accommodation party, a mere extension of time may do so under subsection (c), and a material modification of the principal debtor's obligation, which might fall significantly short of an outright discharge, may do so under subsection (d). Moreover, the discharge of the accommodation party under these sections cannot be prevented by the simple expedient of a reservation of rights. The major exception to the discharges under subsections (c) and (d) is provided in revised U.C.C. section 3-605(i), which states that there is no discharge if the accommodation party has consented or waived its rights.[76] Once again, the revised provisions, regardless of their merits, appear to be incongruent with the general law of suretyship.[77]

Revised U.C.C. section 3-605(b), then, can be seen to have given additional flexibility to creditors; they can settle claims against principal debtors for less than their full amount without worrying that the release of the principal debtor will release the surety. Revised U.C.C. sections 3-605(c) and 3-605(d), on the other hand, have taken flexibility away from creditors. Whereas under former law, the creditor who agreed to a change in the principal debtor's obligation can avoid discharge of a surety by reserving rights against the surety,[78] under the revised provisions there is always a chance that an accommodation party who has not consented or waived suretyship defenses will be discharged.

---

75. U.C.C. § 3-605(c) & (d) (1990).
76. *Id.* § 3-605(i).
77. *See* RESTATEMENT OF THE LAW OF SECURITY, §§ 128-29 (1941).
78. *See* U.C.C. § 3-606(1)(a) & (2) (1989).

While the rules in revised section 3-605(b), on the one hand, and in revised sections 3-605(c) and 3-605(d), on the other hand, may further sensible policies and work well separately, their juxtaposition may create incentives which are counterintuitive, arguably counterproductive, and not necessarily anticipated by the drafters. This dissonance becomes most apparent when one contrasts the treatment under revised section 3-605(c) of creditors who extend the time of payment for their debtors with the treatment under revised section 3-605(b) of creditors who release their debtors altogether. It is, quite simply, more risky for a creditor to oblige its debtor by granting it a slight extension of the due date for a payment than it is for the creditor to release the debtor outright.

Consider the plight of Holdco, the holder of a $1 million note issued by Debtco and indorsed by Sureco in order to induce Holdco to make the loan. The note is payable on or before January 15, 1991. On January 10, the president of Debtco contacts Holdco and indicates that Debtco will have trouble paying the note on January 15 and asks for an extension of the time of payment so that it can work out alternative financing. Investigation by Holdco reveals that, in fact, Debtco is having a cash flow shortage; however, if it is given time to liquidate some of its assets not necessary for the carrying on of its business and reschedule some of its indebtedness to other creditors, there is a good chance that Debtco would be able to pay off the entire balance on the note, including interest for the period past the due date, by March 1. Moreover, it appears that even if Debtco is unable to obtain the necessary cash by March 1, its financial picture would be no worse than on January 15. If Holdco does not grant an extension, however, it is quite likely that Debtco's default on the note would also constitute a default on its indebtedness to its other creditors; the likely result, then, of a refusal to grant an extension, is geometrically increasing financial pressures on Debtco which would likely result in Debtco's bankruptcy

Based on this analysis, Holdco would like to give Debtco an extension so that it will have a chance to sell the nonessential assets and reorder its financial affairs. Is it in Holdco's best interests to grant the extension to Debtco?

The answer, somewhat surprisingly, is that it may not be in Holdco's best interests to grant the extension to Debtco. Let us assume for the moment that Sureco is solvent enough to be able to

pay the $1 million indebtedness if necessary If Holdco grants the extension to Debtco, there is a chance that Sureco will be discharged from part of its obligation on the note. According to revised U.C.C. section 3-605(c), Sureco is discharged to the extent that it proves that the extension caused it a loss with respect to its rights of recourse against Debtco.[79] While it may not be likely that Sureco's rights of recourse would be made less valuable by the granting of an extension and while the burden would be on Sureco to demonstrate the harm,[80] there remains nonetheless the possibility that the decision of Holdco to extend the due date of Debtco's payment would cause such harm and would thus discharge Sureco. Moreover, whether Sureco suffered a loss by reason of the extension is, presumably, a question of fact which in litigation would be within the province of a factfinder rather than the court. Thus, summary judgment against Sureco might be all but impossible. If, on the other hand, Holdco gave an even greater indulgence to Debtco—if it released Debtco from its indebtedness altogether—Holdco's claim against Sureco would not be affected. Accordingly, so long as Sureco is clearly solvent, it may be a better strategic decision for Holdco to grant Debtco a total release of its obligations on the note and proceed directly against Sureco than it is to grant Holdco a relatively brief extension.

Even if the ability of Sureco to pay the indebtedness on the note is in question, it is still a risky strategy for Holdco to grant Debtco the extension. Once again, any extension granted to Debtco might result in the total or partial discharge of Sureco. Thus, it is less risky for Holdco to refuse Debtco the extension, pursue its rights against Debtco immediately upon default, and simultaneously proceed against Sureco, than it is to grant Debtco the extension.

The result of the juxtaposition of revised sections 3-605(b) and 3-605(c), then, is to provide a disincentive of sorts for creditors to reach alternate resolutions with troubled debtors. Rather, when the accommodation party/surety is clearly solvent, it is safer to discharge the principal debtor and pursue the surety While such a surety that pays the creditor has immediate rights to reimbursement and/or subrogation against the debtor, the surety may be

79. *See* U.C.C. § 3-605(c) & (d) (1990).

80. *Id.* § 3-605(c) & (d); *id.* § 3-605 comments 4 & 5.

either less inclined or less able to allow the principal debtor time to restructure its affairs. Similarly, when the accommodation party/surety is not clearly able to pay the indebtedness, the incentive provided by the revised section is to pursue the debtor immediately, or at least not to grant any enforceable extensions.

It is difficult to see what social or economic policy is furthered by this comparative disincentive for willing creditors to work with their debtors to facilitate repayment of their indebtedness and a return to financial health. Indeed, the drafters themselves indicated that "[s]ettlement is in the interest of sureties as well as the creditor."[81] While the disincentive is ameliorated by requiring the accommodation party to demonstrate its losses flowing from extensions,[82] the disincentive flows from the comparison of the risk-free alternative of releasing the debtor and pursuing the surety with the fact that there is risk involved in granting an extension to the debtor; the existence of the risk is more important than its magnitude for these purposes. A creditor who grants an extension has a sword of Damocles, of sorts, hanging over it and, as Justice Marshall reminded us, "the value of a sword of Damocles is that it hangs—not that it falls."[83]

Of course, the effect of the questionable incentives put into place by the revised statute is ameliorated by the relatively small number of situations to which they will apply The vast majority of negotiable instruments provide in their boilerplate that all makers, indorsers, and guarantors not only waive presentment, notice of dishonor and protest, but that they also consent to the release of any party, extensions of time, release of any collateral and any other discretionary acts on the part of the payee or other holder. The changes these waivers and consents effect on Article 3 rules that would otherwise apply are authorized by U.C.C. section 1-102(3), which allows parties, by agreement, to change any U.C.C. rules which are not, by their own terms, unchangeable.[84] The only exception is that obligations of good faith, diligence, reasonableness and care may not be disclaimed, although they can be defined.[85] Moreover, under the revised Article 3, such waivers and

81. *Id.* § 3-605 comment 3.
82. *See id.* § 3-605(c).
83. Arnett v. Kennedy, 416 U.S. 134, 231 (1973) (Marshall, J., dissenting).
84. U.C.C. § 1-102(3) (1989).
85. *Id.*

consents need not even be carefully drafted. Revised U.C.C. section 3-605(i) provides:

> A party is not discharged under this section if (i) the party asserting discharge consents to the event or conduct that is the basis of the discharge, or (ii) the instrument or a separate agreement of the party provides for waiver of discharge under this section either specifically or by general language indicating that the parties waive defenses based on suretyship or impairment of collateral.[86]

Thus, a simple statement in a note that all parties to it waive all suretyship defenses will be sufficient to eliminate the possibility of discharge under revised section 3-605. Presumably, however, such a statement would not free a party seeking to enforce the instrument against an accommodation party from its obligation to act in good faith.[87]

Most such consents or waivers of suretyship defenses are relatively self-explanatory Consents to extensions of the time for payment were the subject of special statutory rules of interpretation, however. Former U.C.C. section 3-118(f) provided, in part, that "[u]nless otherwise specified consent to extension authorizes a single extension for not longer than the original period."[88] This language was quite straightforward, although there have been occasional cases in which creative arguments have been made as to what constitutes the original term of the instrument.[89]

The revised version of Article 3 has eliminated the rule embodied in former section 3-118(f), and the comments are silent as to why the rule was eliminated.[90] Perhaps the rule was seen as an anachronism in an era of freedom of contract. Parties consenting in advance to extensions are apparently now deemed to be able to protect themselves by limiting the terms of their consent if they so desire.

Finally, the limited scope of the discharges provided by revised section 3-605 does not mean that the rules provided for the instruments to which the section does apply are inconsequential.

86. U.C.C. § 3-605(i) (1990).

87. *See* U.C.C. § 1-203 (1989).

88. U.C.C. § 3-118(f) (1989).

89. *See, e.g.*, Rogers v. Merchants & Planters Bank, 302 Ark. 353, 789 S.W.2d 463 (1990).

90. *See generally* U.C.C. art. 3 & Table of Disposition of Sections in Former Article 3 (1990).

After all, it is for precisely those cases, few though they may be, that revised section 3-605 was designed.[91] In addition, it must be remembered that the U.C.C. section 3-605 discharges apply not only to accommodation parties but also to indorsers.[92] While an instrument which is being drafted for use in a situation where it is anticipated that there will be an accommodation party is likely to contain waivers of suretyship defenses, a relatively informally drafted instrument for an "IOU" type of situation may not. Yet, once a simple note of that sort acquires indorsers, there is the possibility that the suretyship defenses of revised section 3-605 will come into play

2. *Impairment of Collateral.*—Among the more frequently litigated rules in the suretyship sections of the former Article 3 are the rules governing the impairment of collateral defense to the surety's obligation. The theory behind this defense was quite simple: to the extent that the value of collateral for the debtor's obligation is impaired, the subrogation rights of the surety have been made less valuable.[93]

To further this policy, former U.C.C. section 3-606 provided that an accommodation party was discharged to the extent that 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."[94] The former U.C.C., however, provided no definition for "impairs" or "unjustifiably," terms which are hardly self-defining.

The official comments were of little help in this area. The only guidance was that, "[a]s to when a holder's actions in dealing with collateral may be "unjustifiable," the section on rights and duties with respect to collateral in the possession of a secured party (Section 9-207) should be consulted."[95] U.C.C. section 9-207, however, is not very illuminating. Essentially, it provides that "[a] secured party must use reasonable care in the custody and preservation of collateral in his possession."[96]

91. *See* U.C.C. § 3-605 comment 2 (1990).
92. *See id.* § 3-605(b).
93. *See id.* § 3-605 comment 6.
94. U.C.C. § 3-606(1)(b) (1989).
95. *Id.* § 3-606 comment 5.
96. U.C.C. § 9-207(1) (1989). *See id.* § 9-207 comment 1 ("[Section 9-207(1)] states the duty to preserve collateral imposed on a pledge at common law. [T]he duty to exercise reasonable care may not be disclaimed by agreement, although the parties remain free to

While section 9-207 addresses physical harm to the collateral, the most common situations in which accommodation parties have claimed discharge under former U.C.C. section 3-606(1)(b) have been cases in which the value of the security interest was diminished by the secured creditor's failure to perfect, or maintain perfection of, the security interest.[97] The courts have generally ruled that failure to perfect a security interest does constitute unjustifiable impairment of collateral,[98] but the result is hardly foreordained by the statutory language.

The revised version of Article 3 embodies the impairment of collateral defense in substantially similar substantive terms, but clarifies the concept of impairment. Revised U.C.C. section 3-605(e) provides that:

> If the obligation of a party to pay an instrument is secured by an interest in collateral and a person entitled to enforce the instrument impairs the value of the interest in collateral, the obligation of an indorser or accommodation party having a right of recourse against the obligor is discharged to the extent of the impairment. The value of an interest in collateral is impaired to the extent (i) the value of the interest is reduced to an amount less than the amount of the right of recourse of the party asserting discharge, or (ii) the reduction in value of the interest causes an increase in the amount by which the amount of the right of recourse exceeds the value of the interest. The burden of proving impairment is on the party asserting discharge.[99]

This version of the rule quite precisely determines the extent of the accommodation party's discharge if there is an impairment of the value of the collateral. Two formulas are provided, and the formula to be applied in a particular case is decided by examining the relationship between the value of the collateral before the impairment and the amount of the accommodation party's right of recourse.[100] If, prior to the impairment of collateral, the value of the collateral exceeded the obligation accommodated but, after the

---

determine by agreement, in any manner not manifestly unreasonable, what shall constitute reasonable care in a particular case.").

97. *See, e.g.*, Security Nat'l Bank v. Temarantz, 6 U.C.C. Rep. Serv. (Callaghan) 157 (N.Y Sup. Ct. 1969); Shaffer v. Davidson, 445 P.2d 13 (Wyo. 1968).

98. *See, e.g.*, Shaffer v. Davidson, 445 P.2d 13, 15 (Wyo. 1968).

99. U.C.C. § 3-605(e) (1990).

100. In most circumstances, it would appear that the amount of the right of recourse is the amount of the debt for which the accommodation party is responsible, because if the

impairment, the value of the collateral was less than the accommodation, the amount of the impairment is the amount by which the debt exceeds the post-impairment value of the collateral.[101] In other words, if the accommodation party's right of recourse was over-secured[102] before the impairment but undersecured after the impairment, the extent of the impairment is the amount of post-impairment undersecuredness.

If, on the other hand, the value of the collateral before impairment was less than the debt, the extent of impairment is the increase in the difference between debt and the value of the collateral.[103] In other words, if the accommodation party's right of recourse was undersecured before the impairment and is rendered even more undersecured by the impairment, the extent of the impairment is this increase in the amount of undersecuredness.

While the proposed statutory formula is articulated with great complexity, it appears to do no more than spell out the amount of damage suffered by an accommodation party when collateral has been impaired. As such, it is consistent with former law.[104]

More important, perhaps, is revised U.C.C. section 3-605(g). According to that section:

> [I]mpairing value of an interest in collateral includes (i) failure to obtain or maintain perfection or recordation of the interest in collateral, (ii) release of collateral without substitution of collateral of equal value, (iii) failure to perform a duty to preserve the value of collateral owed, under Article 9 or other law, to a debtor or surety or other person secondarily liable, or (iv) failure to comply with applicable law in disposing of collateral.[105]

By providing this list, the revised section has gone beyond the suggestion in the former section that impairment of collateral referred only to preserving the value of the collateral.[106]

---

accommodation party pays that amount, he has a right of recourse against the accommodated party to recover it. *See* U.C.C. § 3-419 (1990).

101. *Id.* § 3-605(e).

102. Over-secured, as it is used here, means that the value of the collateral to which the accommodation party would succeed through its subrogation rights exceeds the claim against the accommodation party on its obligation on the instrument.

103. *See* U.C.C. § 3-605(e) (1990).

104. *See* U.C.C. § 3-606(i)(b) (1989).

105. U.C.C. § 3-605(g) (1990).

106. *See* U.C.C. § 3-606(1)(b) & comment 5 (1989).

Of particular interest is the fourth example of impairment: "failure to comply with applicable law in disposing of the collateral."[107] This is a reference to the rules in Part 5 of Article 9. U.C.C. section 9-504, for example, requires that "every aspect of the disposition [of collateral] including the method, manner, time, place and terms must be commercially reasonable."[108] It has not always been clear to courts that the disposition of collateral could give rise to an impairment of collateral claim.[109]

The reference to the Article 9 rules on disposition of collateral also sets up an interesting conflict. U.C.C. section 9-501(3) provides that a debtor generally cannot waive the protections of Part 5 of Article 9.[110] Many courts have held that guarantors and other accommodation parties qualify as "debtors" for purposes of the protections granted by sections 9-501 and 9-504.[111] Yet, revised U.C.C. section 3-605(i) provides that the defense of impairment of collateral can be waived.[112] Does that rule take precedence over Article 9 with respect to accommodation parties who qualify as debtors? If the answer is yes, a surety who guarantees an instrument by signing a separate guaranty has greater rights than one who guarantees on the instrument. The former guarantor is not an accommodation party and would not, therefore, be governed by Article 3;[113] thus, the unwaivable rules of U.C.C. section 9-504(3) would prevail. The latter guarantor, however, would be able to waive his or her rights pursuant to revised U.C.C. section 3-605(i).

C. Suretyship Defenses for Sureties Who Are Not Accommodation Parties

Revised U.C.C. section 3-605 also provides an interesting rule governing one common law suretyship situation which does not involve either accommodation parties or indorsers. If two parties are

107. U.C.C. § 3-605(g) (1990).

108. U.C.C. § 9-504(3) (1989).

109. *See, e.g.*, FDIC v. Coleman, 795 S.W.2d 706 (Tex. 1990).

110. U.C.C. § 9-501(3) (1989) (detailing those protections which can and cannot be waived by a debtor).

111. *See, e.g.*, First Ala. Bank of Montgomery, N.A. v. Parsons, 390 So. 2d 640 (Ala. Civ. App. 1980), *rev'd on other grounds*, 426 So. 2d 416 (Ala. 1982). *See also* U.C.C. §§ 9-501 & 9-504 (1989).

112. U.C.C. § 3-605(i) (1990).

113. *See supra* notes 21-22 and accompanying text.

jointly and severally liable for an obligation and, as between themselves, each one is responsible for a portion of the obligation, then each party is a surety to the extent that he or she is liable to the obligee for that portion of the obligation for which the other is primarily responsible.[114] Thus, comakers of a note, for example, are common law sureties for each other even if neither has signed as an accommodation party.[115]

Revised U.C.C. section 3-605(f) governs one possible suretyship defense in this context. The section provides, in part, that

> [i]f the obligation of a party is secured by an interest in collateral not provided by an accommodation party and a person entitled to enforce the instrument impairs the value of the interest in collateral, the obligation of any party who is jointly and severally liable with respect to the secured obligation is discharged to the extent the impairment causes the party asserting discharge to pay more than that party would have been obliged to pay, taking into account rights of contribution, if impairment had not occurred.[116]

While this language is somewhat turgid, it yields its meaning when attacked with perseverance. Let us say, for example,[117] that Michael and Martha are comakers of a $1000 note. According to revised U.C.C. section 3-116(a), they are jointly and severally liable on their contracts as issuers of a note.[118] As between themselves, however, Michael and Martha are each liable for one-half of the $1000, or $500. Let us further assume that Martha has given collateral worth at least $1000 to secure the debt but the payee failed to perfect the security interest before Martha's bankruptcy. The payee's failure would, of course, constitute impairment of collateral under revised U.C.C. section 3-605(g), and would render the security interest unenforceable against Martha's bankruptcy trustee.[119]

---

114. This is a suretyship situation because two parties owe the obligation to the obligee who is entitled to only one performance and, as between the two obligors, one is primarily responsible for the obligation. *See* RESTATEMENT OF THE LAW OF SECURITY § 82 (1941).

115. Under revised section 3-116(a), comakers are jointly and severally liable on the instrument. If one of the comakers signed the instrument for the purpose of incurring liability without being a direct beneficiary of the value given for the instrument, of course, that comaker is an accommodation party. U.C.C. § 3-116(a) (1990).

116. *Id.* § 3-605(f).

117. This example draws heavily from official comment 7 to revised section 3-605. *See id.* § 3-605 comment 7.

118. *See id.* §§ 3-116(a) & 3-412.

119. *See* 11 U.S.C. § 544(a) (1988).

If the payee succeeded in collecting the full $1000 from Michael, Michael would be subrogated to the payee's rights against Martha to the extent of his right to contribution from her. Martha, however, is bankrupt. Had the payee perfected the security interest, Michael would have been able to recover the $500 contribution that Martha owed him from the collateral. Instead, Michael is left with whatever pittance he will get from the trustee. Thus, Michael was damaged to the extent that his recovery from the trustee falls short of $500.

Revised U.C.C. section 3-605(f) compensates Michael for this harm by discharging him from liability on the instrument to the extent that his loss of subrogation rights against the collateral would result in him paying more money with respect to the instrument.[120] Thus, if Martha's estate has no assets, Michael has been harmed by $500, and his liability on the instrument would be reduced by $500.

Matters get more complicated, however, if Martha's estate has some assets. Assume, for example, that Martha's estate has $5000 and, in addition to the indebtedness owed with respect to the note with Michael, there are claims totalling $9,500. If the payee tries to collect the entire $1000 owed on the note from Michael, what are Michael's rights? He would have a $500 claim against Martha's estate for contribution, bringing the total claims against her to $10,000. Since the total assets available for distribution in Martha's estate are $5000, or 50% of $10,000, it would appear that Michael could recover 50% of $500, or $250. Thus, there would be a $250 shortfall in his contribution claim.[121] By operation of revised U C.C. section 3-605(f), it would appear that Michael would be discharged to the extent of $250. Yet, there are more complications. First, if the payee can recover only $750 from Michael, he will have a claim against Martha's estate for the remaining $250, throwing off some of the earlier calculations as to the payments made by Martha's estate. In addition, if Michael only pays $750 on the note, shouldn't his claim for contribution be only $375? If so, this would also affect the earlier calculations. The drafters appear to have been only vaguely aware, if they were aware at all, of these complications. The official comment merely states that "[i]f some

120. U.C.C. § 3-605(f) (1990).
121. $500 − $250 = $250.

amount is payable on unsecured claims, the loss is reduced by the amount receivable by [Michael]."[122] Apparently the bankruptcy courts will be left to sort this problem out.

As stated above, Michael, who is a party to the instrument, is a surety but not an accommodation party The drafters of revised Article 3 have chosen to codify Michael's defense of impairment of collateral. What about other suretyship defenses of comakers such as Michael, who are sureties but not accommodation parties? None of the other discharges in revised U.C.C. section 3-605 are available to such parties because they are not accommodation parties. Does this mean that if the payee granted Martha an extension of the due date for her obligation on the note that Michael would not have the benefit of any suretyship defenses?

Most likely, the opposite is true. With the exception of revised section 3-605(f), the U.C.C. does not provide rules governing suretyship defenses of parties who are sureties but not accommodation parties. A strong case can therefore be made that such parties are protected by the common law of suretyship. The common law, of course, can be imported by application of U.C.C. section 1-103.[123] Since revised Article 3 deviates considerably from the common law of suretyship, however, there is the potential for some dissonance here. For example, Michael, as a surety who is not an accommodation party, would be discharged to the extent of his suretyship obligation ($500) if the payee discharged Martha without Michael's consent and without reserving rights against him. If Michael were an accommodation party for Martha, however, he would not be discharged by her discharge.[124] It is doubtful that the drafters intended or desired such anomalies.

D. *Against Whom May Suretyship Defenses Be Asserted?*

Under both former and revised Article 3, suretyship defenses of an accommodation party are not available against the actions of

122. U.C.C. § 3-605 comment 7 (1990).

123. Section 1-103 provides:

> Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

U.C.C. § 1-103 (1989).

124. *See* U.C.C. § 3-605(b) (1990). *See also supra* notes 71-74 and accompanying text.

certain innocent holders.[125] Under former Article 3, suretyship defenses could not be asserted against a holder in due course without notice of the accommodation.[126] There were two ways under former Article 3 that an accommodation party could demonstrate that the holder in due course had notice of the accommodation. First, the accommodation party could prove whatever facts were necessary in order for the holder's state of knowledge to qualify as "notice" under U C.C. section 1-201(25).[127] Second, and much easier, the accommodation indorser could show that his indorsement "shows that it is not in the chain of title;" such an indorsement was statutorily deemed to give notice of its accommodation character.[128]

The revised version of Article 3 continues the protection of innocent holders and extends it even further. Under the revised Article, an accommodation party cannot be discharged by application of suretyship defenses "unless the person entitled to enforce the instrument knows of the accommodation or has notice under Section 3-419(c) that the instrument was signed for accommodation."[129] Note that *anyone* seeking to enforce the instrument—not just a holder in due course—is protected against suretyship defenses. Not only has the class of protected parties been widened from holders in due course to all holders, but it is more difficult for the accommodation party to exclude a holder from that protection. While the former Article excluded all holders in due course with *notice* of the accommodation,[130] the revised Article only excludes a holder or other enforcer of the instrument if he or she "*knows* of the accommodation or has notice under Section 3-419(c)."[131]

---

125. Of course, to the extent that a suretyship defense is also available to indorsers, and the accommodation party is an indorser, the suretyship defense will be available in any event.

126. Former section 3-415(3) provided, in part, that: "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 discharges dependent on his character as such." U.C.C. § 3-415(3) (1989). Comment 1 to that section indicated that "oral" proof was probably intended to include all parol proof including, apparently, contemporaneous writings apart from the instrument. *Id.* § 3-415 comment 1.

127. *See* U.C.C. § 1-201(25) (1989).

128. U.C.C. § 3-415(4) (1989).

129. U.C.C. § 3-605(h) (1990).

130. *See* U.C.C. § 3-415(3) & comment 1 (1989).

131. U.C.C. § 3-605(h) (1990) (emphasis added). Revised U.C.C. section 3-419(3) provides, in part, that:

> A person signing the instrument is presumed to be an accommodation party and there is notice that the instrument is signed for accommodation if the signature is an

The change to protecting *all* parties seeking to enforce an instrument, not just holders in due course, against unwitting discharge of an accommodation party is a good step. The policy decision under former Article 3 to limit protection against nonobvious accommodation parties to holders in due course was not well reasoned. Rather, it appears it was a knee-jerk application of the principle that ordinary holders are subject to all defenses of the parties to an instrument.[132] The question here, however, is not whether the holder is free of a particular suretyship defense but, rather, whether the holder's conduct creates the defense. The distinction—between holders in due course and those to whom we do not give that favored status—makes sense to determine when a holder *takes* free of defenses created by the acts of others. It makes less sense, though as a basis to distinguish between holders in due course and other parties seeking to enforce an instrument as to whether their later conduct unwittingly *creates* a defense. The failure of a holder to fulfill the criteria for holder in due course status does not have any obvious relevance in determining the consequence of later innocent conduct by that holder. That, of course, is the subject of revised section 3-605(h).[133] Thus, the elimination of the holder in due course requirement is a good decision.

The second change from former U.C.C. section 3-415(3) to revised section 3-605(h) is that under the former section a holder in due course was subject to the U.C.C. suretyship defenses of the accommodation party if the holder in due course had *notice* of the accommodation status of that party As elaborated above, an indorsement out of the chain of title was deemed to give the holder notice of the accommodation status of the indorsement.[134] Moreover, an accommodation party was free to demonstrate that the holder "from all the facts and circumstances known to him [had] reason to know" that the accommodation party was such.[135]

> anomalous indorsement or is accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument.

Id. § 3-419(3). Revised U.C.C. section 3-205(d), in turn, defines an "anomalous indorsement" as one "made by a person that is not the holder of the instrument." *Id.* § 3-205(d).

132. *See* U.C.C. § 3-306 (1989).

133. U.C.C. § 3-605(h) (1990).

134. *See id.* § 3-415(4) (1989).

135. U.C.C. § 1-201(25)(c) (1989).

This state of facts is, of course, the primary U.C.C. definition of "notice."[136]

Under revised U.C.C. section 3-605(h), though, plain ordinary garden-variety notice is insufficient to subject one seeking to enforce an instrument to defenses based on a party's accommodation status. Rather, the holder or other enforcer is subject to the suretyship defenses of the accommodation party only if the holder either *knows* of the accommodation status or has a narrow species of statutorily defined notice in revised U.C.C. section 3-419(c).[137] "Knowledge," of course, is "actual knowledge,"[138] a higher standard than "reason to know." Revised U.C.C. section 3-419(c) provides, in relevant part:

> A person signing an instrument is presumed to be an accommodation party and there is notice that the instrument is signed for accommodation if the signature is an anomalous indorsement or is accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument.[139]

The distinction is important. Consider, for example, a $5000 term note with two comakers, Lex Docent and his mother, Ida Docent, payable to the order of the University of Alabama. The note, bearing the blank indorsements of the University of Alabama and Deep South Collections, a collection agency, is now in the possession of Ginco, an independent debt collector specializing in difficult cases. When Ginco obtained the note from Deep South Collections, he learned only one fact about it—Lex was a student at the University of Alabama Law School at the time the note was issued. Based on these facts, the note probably represents the repayment obligation on a student loan and Ida is probably an accommodation maker. Accordingly, it is probably accurate to say that Ginco had "reason to know" of Ida's status as an accommodation party. But did Ginco "know" that Ida is an accommodation party? Certainly not. After all, as far as Ginco knows, Lex and Ida could have had some sort of joint obligation to the university or some other reason to issue a note as comakers. While Ginco has

---

136. *See id.*
137. U.C.C. § 3-605(b) (1990). *See id.* § 3-419(c).
138. *See* U.C.C. § 1-201(25) (1989).
139. U.C.C. § 3-419(c) (1990).

"reason to know" that Ida is an accommodation party, it would be inaccurate to say that he "knows" it. Thus, Ginco would not discharge Ida, even if she is an accommodation party, by taking any of the actions described in revised U.C.C. section 3-605 which discharge accommodation parties.[140]

As indicated above, a holder or other party seeking to enforce an instrument is also subject to an accommodation party's defenses if the holder has notice under revised U.C.C. section 3-419(c).[141] Section 3-419(c) seems straightforward. A party is deemed to have notice that an instrument was signed as an accommodation if it bears an anomalous indorsement or if a signature is "accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument."[142] A signature accompanied by words of suretyship or guaranty obviously gives subsequent parties notice of its accommodation status, but the concept of anomalous indorsements is not as obvious.

Revised U.C.C. section 3-205(d) defines an anomalous indorsement as one "made by a person that is not the holder of the instrument."[143] This definition is similar, but not identical, to the former Article 3 concept of an indorsement out of the chain of title.[144] The difference can be important, though, as some examples will illustrate.

First, consider an easy example—a note issued by Mayco to the order of Patton. The back of the note bears the blank indorsements of Garrison and Patton, in that order; Howell now has possession of the note. Garrison's indorsement is an anomalous indorsement because Garrison was not the holder at the time of indorsement—until Patton indorsed, only Patton could be a holder.[145] Therefore, there is notice of Garrison's status as an accommodation party under revised U.C.C. section 3-419.[146] Similarly, Garrison's indorsement was out of the chain of title and,

---

140. *See id.* § 3-605.
141. *See id.* §§ 3-605(h) & 3-419(c).
142. *Id.* § 3-419(c).
143. *Id.* § 3-205(d).
144. *See* U.C.C. § 3-415(4) (1989).
145. *See* U.C.C. § 1-201(20) (1989).
146. *See* U.C.C. § 3-419(c) (1990).

therefore, would give notice of its accommodation status under former U.C.C. section 3-415.[147]

Not all examples are so easy, however. Consider the following cases:

(a) A note was issued by Miller to the order of Becker. The back of the note contains Becker's blank indorsement[148] followed by the blank indorsements of Anderson and Thompson. The current holder, Pines, purchased the instrument from Thompson, who did not tell Pines anything about Anderson.

(b) A bearer note[149] was issued by Spero. The back of the note contains the blank indorsements of Romanick and Bona. The current holder, Dorsky, purchased the instrument from Bona, who did not tell Dorsky anything about Romanick.

Are the indorsements of Anderson and Romanick anomalous indorsements? Remember, an anomalous indorsement is one made by a party who was not a holder.[150] Thus, these indorsements were anomalous if Anderson and Romanick were not holders at the time of their indorsements. Were these indorsements made by holders? Unlike the case with respect to Garrison's indorsement in the previous example, this question cannot be answered simply by examining the instruments. At the time of the indorsements in question, both instruments were "bearer paper." As a result, anyone in possession of one of the instruments was a holder. Thus, Anderson and Romanick *may* have been holders of the notes (they were holders if they ever had possession of the notes) but they may not have been holders of the notes (if they never had possession of them). The question cannot be answered solely from examination

147. *See* U.C.C. § 3-415(4) (1989).

148. *See id.* § 3-204(2) ("An indorsement in blank specifies no particular indorsee."); U.C.C. § 3-205(b) (1990) ("If an indorsement is made by the holder of an instrument and it is not a special indorsement, it is a 'blank indorsement. When indorsed in blank, an instrument becomes payable to bearer and may be negotiated by transfer of possession alone until specially indorsed.").

149. *See* U.C.C. § 3-111 (1989) ("An instrument is payable to bearer when by its terms it is payable to (a) bearer or the order of bearer; or (b) a specified person or bearer; or (c) 'cash' or the order of 'cash, or any other indication which does not purport to designate a specific payee."); U.C.C. § 3-109(a) (1990) ("A promise or order is payable to bearer if it: (1) states that it is payable to bearer or otherwise indicates that the person in possession is entitled to prepayment; (2) does not state a payee; or (3) states that it is payable to cash or otherwise indicates that it is not payable to an identified person.").

150. U.C.C. § 3-205(d) (1990).

of the instruments. Thus, a holder cannot tell if Anderson and Romanick were anomalous indorsers solely from examining the instruments.

The ambiguous status of the indorsements reflects the ambiguity of the underlying situation. Perhaps, in the first example, Becker negotiated the note to Anderson who added his valid but unnecessary indorsement and negotiated the note to Thompson. In such case, Anderson was not an accommodation party and, because he was a holder, his indorsement was not anomalous. On the other hand, perhaps Becker had sought to discount the note to Thompson,[151] who had refused to go through with the transaction unless Anderson also became liable on the instrument by indorsing it.[152] In that case, Anderson was an accommodation party and, because she was not a holder at the time of her indorsement, her indorsement was anomalous.

If, as in the second scenario described above, Anderson's indorsement was anomalous, then Pines is deemed by revised section 3-419(c) to have notice that Anderson indorsed as an accommodation party Notice of Anderson's accommodation status under section 3-419(c), in turn, subjects Pines to Anderson's suretyship defenses under revised U.C.C. section 3-605.[153] But did Pines really have notice that Anderson was an accommodation party? For all Pines could tell from the note, Anderson could have been a holder who obtained the instrument from Becker and negotiated it to Thompson. Must Pines do independent investigation off the face of the instrument to determine her rights vis-a-vis Anderson? Especially if she is a holder in due course, this seems unfair. Should she guess? Should she assume the worst?

The definition of "anomalous indorsement" is not up to the task at hand here. Perhaps the statute would have been better crafted if it defined an anomalous indorsement as an indorsement "(a) of an order instrument by a party other than one to whose order the instrument is payable, or (b) which the party seeking to enforce the instrument has notice was made by a party who was not a holder of the instrument." Part (a) of that definition would

151. In other words, Becker sought to negotiate the note to Thompson in exchange for consideration less than the amount payable. In such a transaction, Becker would receive less than he would if the note were paid, but he would receive it earlier.

152. *See* U.C.C. § 3-414 (1989); U.C.C. § 3-415 (1990).

153. *See* U.C.C. § 3-605 (1990).

resolve most situations, while in the unusual situations part (b) would subject subsequent holders to suretyship defenses only if they knew, or had reason to know, that the indorser was not a holder.

V. CONCLUSION

Revised Article 3 makes significant changes in the law governing sureties on negotiable instruments. Many of the changes are designed to clarify a body of law which has been confusing and unnecessarily complicated. For the most part, these changes are successful, although there is occasionally still some room for uncertainty. A few of the changes make substantive changes in the rights of creditors and sureties. The changes, especially in the area of "suretyship defenses," are bold and innovative. At times, however, unintended consequences of the drafters' choices may prove troublesome. Nonetheless, as a whole, the revised provisions appear to represent significant improvement over former law. As suretyship continues to be utilized in an ever-increasing number of credit transactions, the new rules will be frequently tested. The performance of the revised rules on those tests will be their true evaluation.