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## Suretyship Under Article 3 of the Uniform Commercial Code

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A borrower in search of credit may encounter resistance from the money market if all that he is prepared to offer is his own unsupported promise to repay. Today, one alternative for such a borrower is to tender a security interest in any or all of his property, present and future. The Uniform Commercial Code in Article 9 makes such a secured transaction easy to arrange,<sup>1</sup> but it does not necessarily make it advisable. A borrower may well have misgivings both about the notoriety and about the controls which a secured transaction is likely to entail. The Code minimizes these drawbacks, but it cannot eliminate them: a secured creditor must still perfect, in order to prevail over competing third parties,<sup>2</sup> and perfection will ordinarily take the form of a financing statement placed on a public record;<sup>3</sup> a secured creditor must still police, for maximum protection in the event of his debtor's bankruptcy, and policing must, despite the comforting repeal of *Bene-*

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1. Article 9 covers secured transactions in all kinds of personal property, "including goods, documents, instruments, general intangibles, chattel paper, accounts or contract rights . . ." Section 9-102(1)(a). The parties are free to structure their security agreement in any way they deem advisable, Section 9-201, as long as they comply with the minimal formalities of Article 9's Statute of Frauds provision, Section 9-203.

2. Unperfected security interests are subordinated, by Section 9-301(1), to a variety of innocent competitors including a lien creditor; since a trustee in bankruptcy has the status of a lien creditor under Section 70(c) of the Bankruptcy Act, 11 U.S.C. § 110(c) (Supp. II 1965-66), unperfected security interests automatically lose their lien status when it is most crucial to maintain it.

3. Perfection by filing is required unless the secured party takes possession of the secured collateral or is entitled to one of the special exemptions relating to temporary perfection or certain classes of collateral catalogued in Section 9-302. Part 4 of Article 9, especially Section 9-402, describes the Article's notice filing system. See Section 9-203.

*dict v. Ratner*,<sup>4</sup> encompass at least the proceeds from collateral<sup>5</sup> and perhaps even the acquisition of collateral.<sup>6</sup> No well advised secured creditor will be likely to forego these protective maneuvers, and their execution involves real costs to the borrower. Not only must he bear the expenses of administration inherent in a secured transaction,<sup>7</sup> but he must also run the risk that the filing of a financing statement may impede the flow of unsecured credit from independent suppliers and servicers.<sup>8</sup>

Perhaps ironically, the Code's de-emphasis of formal requisites, its reduction of legal impediments to secured transactions, serves to emphasize the irreducible economic costs of collateral security arrangements which remain. And, as a matter of fact, in the same years that the Code was struggling for enactment, the financial community was already exploring more attenuated forms of security, such as negative pledges and subordination agreements,<sup>9</sup> as less cumbersome devices for credit. These security devices, often accompanied by creditor participation in the debtor's business through a voice on the board of directors, were designed to substitute a greater measure of residual control for day-by-day supervision of the debtor's business. Presumably, such arrangements fall outside the scope of Article 9,<sup>10</sup> thus avoiding its in-

4. Section 9-205 declares, contrary to *Benedict v. Ratner*, 268 U.S. 353 (1925), that a security interest is "not invalid or fraudulent against creditors" by reason of the debtor's free exercise of dominion over secured collateral and its proceeds.

5. Section 9-306(4) limits even a perfected security interest in commingled cash proceeds to those amounts received by the debtor in the last 10 days before the institution of insolvency proceedings; the last days before bankruptcy usually are periods of rapid cash outflow rather than of cash accretions.

6. A security interest in after-acquired property cannot be fully perfected, under Section 9-303, until the security interest has attached under Section 9-204. Attachment cannot occur until the debtor has "rights in the collateral," but possibly the debtor's acquisition of such rights, and hence the perfection of the security interest, can be accelerated by consensual agreements providing for early identification and passage of title under Article 2. See Sections 2-501(1) and 2-401. The earlier that the security interest is perfected, the less is the risk that intervening and superior claims may be asserted against the after-acquired collateral.

7. Typically, the secured transaction will involve the expenses of additional record keeping and surveillance; how heavy these costs will be will depend not only on the demands of the secured lender but also on the extent to which the debtor, for independent reasons, has or has not been systematic in its own business operations.

8. The potential conflict of interest between secured and unsecured lenders may in fact be less important than it is often thought to be. A noted commentator has argued that the secured lender may often supply advances, even over-advances, so that trade creditors operating on open credit may be paid, and an essentially sound business may be continued, despite temporary shortages of operating capital. I P. COOGAN, W. HOGAN & D. VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 1.06 (1967).

9. For a comprehensive discussion of these alternative security devices, see 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY chs. 36, 37 (1965).

10. The Permanent Editorial Board for the Uniform Commercial Code in its most recent report has proffered, for optional amendment, a new Section 1-209 declaring that a subordination agreement "does not create a security interest as against either the common debtor or a subordinated creditor." The Section goes on to provide, perhaps optimistically, that it "shall be construed as declaring the law as it existed prior to the enact-

herent disadvantages of public disclosure and policing; but they substitute for these known disadvantages unknown factors of uncertainty and risk as to status and priority in and out of bankruptcy. And the borrower, even under this least confining type of collateral security device, must still contemplate the probability of extended outside scrutiny of his internal business operations.

Any secured transaction which focuses on collateral, then, has potential drawbacks from the borrower's point of view, drawbacks which may persuade him to investigate other sources of support for his loan application. His most likely alternative is the suretyship contract, which offers security to the creditor in the financial responsibility of the surety rather than in the property and business operations of the debtor.<sup>11</sup> Suretyship can take a variety of forms, from the commercial bond of a professional surety company, complete with painstaking elaboration of terms and conditions, to a signature—with or without qualifying legend—on a negotiable instrument, to an informal assumption of responsibility for the debts of another.

Interestingly, the institution of suretyship has so far escaped the elaborate statutory regulation which has attended collateral security devices.<sup>12</sup> The Uniform Commercial Code goes further toward setting operative guidelines than has ever been done before, but even the Code's regulation is remarkably skeletal. The commercial surety bond, insofar as it includes in its boilerplate an assignment of contract rights, may or may not fall within Article 9.<sup>13</sup> The informal surety arrangement is left to the mercy of local interpretation of local Statutes of Frauds. But Article 3 purports to take on, in a manner less super-

ment of this section and not as modifying it." REPORT NO. 3 OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 11-12 (1967). New York had previously enacted an amendment to this effect. N.Y.U.C.C. § 1-209 (McKinney Supp. 1967). Section 9-311 may inadvertently validate negative pledge clauses. See 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 38.5 (1965).

11. Suretyship and pledge or mortgage have been available as security devices since the days of antiquity. See Lloyd, *The Surety*, 66 U. PA. L. REV. 40 (1917); Wigmore, *The Pledge Idea: A Study in Comparative Legal Ideas*, 10 HARV. L. REV. 321, 339 (1895), 11 HARV. L. REV. 18 (1897).

12. The American Law Institute did sponsor a RESTATEMENT OF THE LAW OF SECURITY (1941) regarding pledges and suretyship, but this Restatement has not had the impact which some of the other Restatements have enjoyed.

13. The ambiguity arises out of Section 9-104(f), which excludes from the coverage of Article 9 "a transfer of a contract right to an assignee who is also to do the performance under the contract." Arguably, a surety who has the option to complete construction under a performance bond is therefore outside of Article 9. In addition, *Jacobs v. Northeastern Corp.*, 416 Pa. 417, 206 A.2d 49 (1965), held that the surety could avoid Article 9 if he relied on his right to subrogation, instead of on an express assignment; pointing to Article 9's limitation to security interests created by contract (§ 9-102(2)), the court held subrogation rights to be not contractual but "created by law to avoid injustice." See 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY ch. 36 (1965).

ficial than that of the Negotiable Instruments Law which it replaces, the rights and obligations of sureties who appear on short-term commercial paper.

The proper relationship between the law of suretyship and the law of negotiable instruments has long been troublesome,<sup>14</sup> and it is therefore no accident that the draftsmen of the Code felt called upon to provide some clarification in this area. This article will examine the extent to which the enlightenment provided by Article 3 allows a borrower to choose rationally between suretyship and other security devices.

### I. The Surety and Article 3: Creation of the Relationship

Broadly defined, a surety is a party to a contract who agrees to pay the obligation of another under some circumstances.<sup>15</sup> A surety may be an individual or a corporation, a widow or a bank president, a virtuous citizen motivated by charity or a calculating schemer after financial gain. The availability of any surety for any particular borrower depends on many disparate circumstances, but at least one factor is the accessibility to the surety of some reasonably reliable basis for assessing the risks of his undertaking.

Article 3 of the Code deals with the surety who commits himself to short term negotiable paper, to negotiable instrument (or instruments) as that term is defined in Article 3.<sup>16</sup> It does so by a general statement of the obligations of some parties to such instruments and by other

14. Ames, *The Negotiable Instruments Law*, 14 HARV. L. REV. 241, 255 (1900) took immediate issue with that statute's treatment of surety makers; Eaton, *The Negotiable Instruments Law: Its History and Practical Operation*, 2 MICH. L. REV. 260 (1904) defended it. Other commentators joined in the fray. See, e.g., Turner, *Revision of the Negotiable Instruments Law*, 38 YALE L.J. 25, 45-49 (1928); Hilpert, *Discharge of Latent Sureties on Negotiable Instruments Because of Release or Extension of Time*, 50 YALE L.J. 387 (1941); J. BRANNAN, *NEGOTIABLE INSTRUMENTS LAW* 1120-27 (7th ed. F. Beutel 1948); W. BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* § 301 (2d ed. 1961).

15. "The term surety is very often used in the broad sense as including both technical surety and guarantor, i.e., all obligations in which the promisor is answering for a loan or extension of credit from the creditor to the principal debtor." L. SIMPSON, *HANDBOOK ON THE LAW OF SURETYSHIP* 6-7 (1950).

16. Section 3-104 and the sections which follow it spell out the requisites for a negotiable instrument within Article 3; such instruments must be signed by maker or drawer, must contain an unconditional promise or order to pay a sum certain in money, must provide for payment on demand or at a definite time, and must be payable to order or to bearer. Section 3-102(1)(e) stipulates that "instrument" presumptively means "negotiable instrument." Article 3, in contrast to the Negotiable Instruments Law, does not claim to be the exclusive fountainhead of all negotiable paper, but only to govern paper which falls within its ambit. Section 3-802 recognizes a category of quasi-negotiable paper, and Article 8 deals with long-term investment securities.

sections which refer specifically to suretyship concepts and obligations. Even in the latter cases, however, the text of Article 3 now eschews the language of suretyship<sup>17</sup> and speaks instead of accommodation parties,<sup>18</sup> guarantors<sup>19</sup> and others who have "a right of recourse."<sup>20</sup> By contrast, Article 1 includes among its many definitions in Section 1-201(40): "'surety' includes guarantor."<sup>21</sup> Directly and indirectly, Article 3 expands upon this non-definition to make a great variety of distinctions among potential sureties on negotiable paper, distinctions which are important because they draw statutory inferences about the scope of suretyship liability from the form of suretyship engagement on the instrument.

One class of signers of negotiable instruments who appear to have the major attributes of suretyship are those who sign instruments without clear indication of capacity or intention. Any such signatory automatically becomes an indorser by virtue of Section 3-402;<sup>22</sup> and any such indorser makes the engagement of Section 3-414 that he will pay if the instrument to which he has subscribed is dishonored by its designated payor.<sup>23</sup> The indorser's liability is conditioned on certain formal procedures, such as due presentment and proper notice,<sup>24</sup> but these formalities are within easy reach of any careful holder. The indorser who pays ordinarily has a right of recourse on the instrument against those before him, including the debtor who was to have paid.<sup>25</sup> This description of the obligations and remedies of the indorser applies evenhandedly to any indorser, regardless of the circumstances which motivated the indorsement: it covers the negotiating indorsement of a transferor of negotiable paper as well as the irregular indorsement of

17. The most central section, Section 3-415 dealing generally with accommodation parties, formerly described such a party as "surety for another party," but the draftsmen were persuaded in 1956 that this referent, which continues in comment, was somehow inaccurate. See 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 113. Anachronistically, Section 3-802(2) still speaks of the "discharge of a surety."

18. Section 3-415.

19. Section 3-416.

20. Section 3-606.

21. There is an especially illuminating comment: "New."

22. Section 3-402 provides: "Unless the instrument clearly indicates that a signature is made in some other capacity it is an indorsement."

23. Section 3-414(1) states: "Unless the indorsement otherwise specifies (as by such words as 'without recourse') every indorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to its tenor at the time of his indorsement to the holder or to any subsequent indorser who takes it up, even though the indorser who takes it up was not obligated to do so." A similar provision under the Negotiable Instruments Law was its Section 66.

24. These procedures are detailed in Part 5 of Article 3.

25. Section 3-414(1) and Section 3-413(2) provide for reimbursement of the paying indorser by earlier indorsers and by the drawer.

the intentional surety. All indorsers, then, are a species of the genus surety;<sup>26</sup> but not all sureties need be indorsers.

A surety may appear on a negotiable instrument as an "accommodation party" who, pursuant to Section 3-415(1), signs "in any capacity for the purpose of lending his name to another party to it."<sup>27</sup> "In any capacity" means that an accommodator may sign as maker, drawer, acceptor or indorser; but the last words of the definition require that the accommodator act for a debtor who is himself on the instrument. Thus, a sole maker who is in fact acting as surety for another is apparently entitled to the benefits of his accommodation character if the debtor is on the instrument as payee or indorser, but not if the paper is, without an irregular indorsement, made directly payable to the creditor. This is an odd qualification. Other parts of Section 3-415<sup>28</sup> sensibly look to notice rather than capacity in deciding when accommodation defenses are available. But the requirement that the debtor appear on the instrument can hardly serve the interests of disclosure, since the presence of the debtor as payee will not automatically reveal the true relationship between the parties. An alternate explanation might rest on some notion of inherent inconsistency between the unconditional obligation of a sole maker and the qualified undertaking of the surety. But if that is the objection, it is hard to see how it is cured by the appearance of the debtor on the instrument in some ambiguous capacity; moreover, it is an objection expressly waived elsewhere in Article 3. Under Section 3-606(1),<sup>29</sup> suretyship defenses relating to dis-

26. Occasionally, for private reasons, one who has apparently signed as indorser may in fact be the underlying debtor; in such a case, of course, he is not, despite the appearance of the paper, a surety, nor does he have any rights of recourse. See Sections 3-415(5) and 3-414(2).

27. The Section in its totality reads as follows:

Section 3-415. Contract of Accommodation Party.

- (1) An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it.
- (2) When the instrument has been taken for value before it is due the accommodation party is liable in the capacity in which he has signed even though the taker knows of the accommodation.
- (3) As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharges dependent on his character as such. In other cases the accommodation character may be shown by oral proof.
- (4) An indorsement which shows that it is not in the chain of title is notice of its accommodation character.
- (5) An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party.

28. Compare the wording of subsection (3).

29. Section 3-606(1) reads as follows:

Section 3-606. Impairment of Recourse or of Collateral.

- (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

charges of the principal debtor are available to anyone who is known to have a right of recourse, either on the instrument or outside it.<sup>29</sup> A literal reading of Section 3-415(1) might even, perversely, serve to deny the accommodation maker his right of recourse if he fails to insist on his debtor's signature on the instrument. A better way out would be to ignore, as a draftsman's oversight,<sup>31</sup> a qualification which is pointless (and which in fact was deleted as erroneous from Section 3-606).<sup>32</sup>

Finally, a surety may expressly qualify his signature on the instrument to which he subscribes so as to fall within the contract of guaranty described in Section 3-416.<sup>33</sup> That section distinguishes between guarantors of payment and guarantors of collection, a distinction turning

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; or

- (b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.

30. Comment 1 to Section 3-606 is explicit on this point:

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

31. The analogous provision of the Negotiable Instruments Law, Section 29, avoided this problem by providing simply:

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 a person is liable on the instrument to a holder for value, notwithstanding such holder at the time of taking knew him to be only an accommodation party.

32. Earlier versions of Section 3-606 limited its protection to those known to have a right of recourse on the instrument. The change was effected in 1957, on the advice of the New York Law Revision Commission. See 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 128-29 (1957).

33. The text of Section 3-416 states:

Section 3-416. Contract of Guarantor.

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

The section is new, having no counterpart in the Negotiable Instruments Law.

upon the nature of the preconditions which trigger the guarantor's liability. While a guarantor of payment may be required to pay upon maturity of the instrument, a guarantor of collection may not be called upon until the claim against maker or acceptor has been reduced to judgment and execution has been returned unsatisfied. In neither form of guaranty may the guarantor insist, unless he does so explicitly in the guaranty contract, upon the formalities of demand, presentment, and notice;<sup>34</sup> this waiver of procedural rights is significant, because a guarantor who indorses remains an indorser for some purposes.<sup>35</sup> By contrast, the ordinary accommodation indorser guarantees payment without automatically waiving procedural rights, and thus occupies a stance in this respect intermediate between guaranty of payment and of collection.<sup>36</sup>

All this is clear sailing until one probes a little. Section 3-416 seems to contemplate a guarantor who dutifully follows statutory instruction and uses words of guaranty to describe his status. Suppose some misguided soul should inadvertently indorse an instrument "Joe Smith, surety." If he is to be considered an indorsing surety but not a guarantor, he is entitled to presentment, notice, and perhaps protest; if he is a guarantor, he is not. Section 3-416(3) tells us only that words of guaranty or "equivalent words" are presumed to be guaranties of payment; it says nothing about words of suretyship. Article 1's definition, that surety includes guarantor,<sup>37</sup> is not much more helpful and rather suggests that some sureties are guarantors and others are not. This is the kind of ambiguity which an Official Comment might help to resolve, but the comment to Section 1-201(40) is a monosyllabic "New"; and the comment to Section 3-416 tells us only that the section purports to state the commercial understanding of words of guaranty—hardly a startling improvement on the text.<sup>38</sup> Probably the fairest read-

34. See Section 3-416(5).

35. Under Section 3-202(4), "Words of . . . guaranty . . . and the like accompanying an indorsement do not affect its character as an indorsement."

36. Pre-Code courts regularly held that even an accommodation indorser could not be held without alleging presentment and notice or their waiver. See, e.g., *Gelman v. Pub. Nat'l Bank*, 377 F.2d 166 (D.C. Cir. 1967); *Congress Fin. Corp. v. J-K Coin Op Equip. Co.*, 353 F.2d 683 (7th Cir. 1965); *Ribac v. S & B Parts Mfg. Equip. Corp.*, 202 N.Y.S.2d 448 (Sup. Ct. 1960). Comment 1 to Section 3-415 indicates that the Code preserves these formal rights. If the accommodation party signs as drawer, a less prevalent form of accommodation status but one certainly still within the "in any capacity" language of Section 3-415(1), he is still entitled to presentment and notice under Section 3-501. But a drawer can complain of delay in these formalities only if the delay is prejudicial in the sense that funds maintained with the drawee were lost because of the drawee's becoming insolvent during the period of delay. Section 3-502(1)(b).

37. Section 1-201(40).

38. The only statutory presumption on this point, in Section 3-416, is irrelevant: it is



ing of the language itself is that the special contract of guaranty is to be limited to those who use the magic word, with perhaps some leeway for variant spellings. After all, the negotiable instruments law has long been addicted to magic words: commercial paper to be fully negotiable must be payable "to order or to bearer";<sup>39</sup> and it must not be "subject to" any other agreement.<sup>40</sup> On the other hand, the commercial sense of such a construction is doubtful. Whatever the merits of a distinction between surety and guarantor, the suretyship obligation is the one that has been generally characterized as the broader, the more primary, the less conditional of the two undertakings.<sup>41</sup> It is therefore surprising to discover that to sign "Joe Smith, surety" implies less liability than to sign "Joe Smith, guarantor." One way to avoid this result would be to find a contract of guaranty whenever suretyship status of any kind is expressly stipulated by the addition of some appropriate words added to a signature. Thus the co-maker or the indorser who adds some legend of guaranty or suretyship to indicate, on the instrument itself, that he is signing for the purpose of lending his name to another, makes the guaranty contract, while the surety who merely affixes his signature to the instrument without indication of special status is an accommodation party, in the language of the Code.

Such a reading of "words of guaranty" to encompass all visible sureties would not only comport with general commercial sense, but would also furnish a link now missing between the section on accommodation parties and the provision concerning guarantors. Nowhere in the latter section is it made explicit that the special rights and privileges of accommodation status<sup>42</sup> are available to those who enter into a contract of guaranty. Certainly those who take on extra responsibilities should have at least the benefits of those who do not. The broader reading of "words of guaranty" results in a balance of the equities in which

subsection (3) that "words of guaranty which do not otherwise specify guarantee payment."

39. Section 3-104(1)(d), amplified by Sections 3-110 and 3-111.

40. An instrument, to be negotiable within Article 3, must contain an unconditional promise to pay, Section 3-104(1)(b), and promises "subject to . . . any other agreement" are not unconditional, Section 3-105(2)(a).

41. See L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP §§ 5 and 6 (1950): the liability of the surety is primary, while that of the guarantor is conditional and secondary. Neither the common law, nor modern English law, distinguishes between guaranty and suretyship, as American courts have done. Radin, *Guaranty and Suretyship*, 17 CALIF. L. REV. 605, 18 CALIF. L. REV. 21 (1929). Radin summarizes the American distinction in the following way: "the surety promises to pay if the principal does not; the guarantor, if he cannot." 17 *Id.* 620. Most commentators have deplored the distinction, and the RESTATEMENT OF SECURITY § 82 & Comment g (1941) uses the two terms synonymously.

42. For example, the right to special grounds of discharge, recognized by Section 3-415(3).

the visible surety waives formal conditions to his liability in exchange for the preservation of suretyship defenses and subrogation rights, while the latent surety (at least if he signs as an indorser) preserves his right to procedural niceties but loses the benefits of special defenses against a holder in due course who has no knowledge of his suretyship status.

Other limitations placed by Section 3-416 on the contract of guaranty are not so easily explained away. Under the definition of Section 3-416(2),<sup>43</sup> it is apparently impossible to guarantee the collection of a check or draft if it is the liability of the drawer, rather than that of the acceptor, which is being guaranteed. Why not, if collection from a maker can be guaranteed?<sup>44</sup> Surely, this must be simply an oversight. Despite the apparently limiting phraseology, the reference to the underlying obligor as maker or acceptor should be read as illustrative only. Further, although guaranty of the debt of a co-maker or co-acceptor is permissible under Section 3-416(4),<sup>45</sup> such a guaranty only *presumptively* creates accommodation status. If not accommodation status, what then? What would rebut the presumption? A generic distinction between guaranty and accommodation is particularly hard to generate under the circumstances stipulated. Neither the accommodation co-maker nor the guarantor co-maker nor any other maker is entitled to presentment or notice of default; all makers are equally liable when the instrument becomes due. The non-distinction which the Code sets up turns on signing as maker, not on the form of the suretyship undertaking. If the draftsmen meant only that the guaranteeing co-maker would presumptively be entitled to reimbursement from the underlying obligor, the clause would be unnecessary surplus-

43. The subsection states:

(2) "Collection guaranteed" or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor, but only after the holder has reduced his claim against *the maker or acceptor* to judgment and execution has been returned unsatisfied, or after the maker or acceptor has become insolvent or it is otherwise apparent that it is useless to proceed against him (emphasis added).

44. The Code makes much less of a distinction between drawer and maker than did earlier law. Although the drawer's liability (but not the maker's) is still technically conditional upon due presentment and notice, Section 3-501(1)(c), the drawer is discharged by procedural lapses only in the event of loss of funds maintained with an insolvent drawee, today an unlikely event. Section 3-502(1)(b). Furthermore, the maker of domiciled paper is absolutely assimilated to the drawer in the presentment sections of Part 5 without being withdrawn from the accommodation and guaranty sections of Part 4.

45. Subsection (4) provides:

(4) No words of guaranty added to the signature of a sole maker or acceptor affect his liability on the instrument. Such words added to the signature of one of two or more makers or acceptors create a presumption that the signature is for the accommodation of the others.

age: any guarantor as one species of accommodation party automatically has such a claim. Finally, in the first part of Section 3-416(4),<sup>46</sup> as in Section 3-415, the draftsmen had qualms about allowing a guarantor his special status if he was the sole maker of the instrument; but here he can retain his special status only by putting the debtor onto the paper as co-maker, not merely by making him an indorser. Once again, there seems no reason not to allow accommodation or guaranty paper to take whatever form the parties choose, so long as their understanding is adequately communicated. To insist upon the signature of the debtor as co-maker when in fact the creditor is relying upon the credit of the guarantor is to elevate form over substance.

One final drafting quirk in Section 3-416 is worthy of brief mention. In an effort to reverse the occasional case holding an explicit contract of guaranty to be within the Statute of Frauds provision about contracts to answer for the debt of another,<sup>47</sup> Section 3-416 adopts what is universally thought to be the better position, that a negotiable instrument is a sufficient writing, without express statement of consideration, to satisfy all the legitimate purposes of the Statute.<sup>48</sup> There is no mention of the effect of the Statute of Frauds on other forms of suretyship commitment, presumably because the existing case law exempted negotiable instruments from the Statute.<sup>49</sup> It would, however, be an unfortunate mistake for a court to conclude that contracts of suretyship, by some negative inference from Section 3-416(6), must now meet the technical requirements of the Statute.

In summary, then, Article 3 permits the assumption of suretyship status in three ways. Suretyship may flow incidentally from the ordinary rights and privileges of a negotiating indorser. The intentional surety may sign a negotiable instrument in any capacity, with or without words expressly describing his status. If he merely signs without more, he is in the language of the Code an accommodation party; if he signs with identifying legend, he should be deemed to have made the special contract of a guarantor.

46. The opening sentence of Section 3-416(4) reads as follows:

No words of guaranty added to the signature of a sole maker or acceptor affect his liability on the instrument.

47. See, e.g., *M.J. Wallrich Land & Lumber Co. v. Ebenreiter*, 216 Wis. 140, 256 N.W. 773 (1934).

48. The wording is to be found in subsection (6) of Section 3-416:

(6) Any guaranty written on the instrument is enforceable notwithstanding any statute of frauds.

49. "The statute of frauds is applicable only to informal contracts. Among those to which it is not applicable are contracts under seal, recognizances, and negotiable instruments." 2 A. CORBIN, *CONTRACTS* § 360, at 251 (1950); see also *id.* § 280, at 24.

## II. The Engagement of the Surety

Once suretyship status on a negotiable instrument has been achieved, what is the extent of the surety's undertaking? Of course, although the point continues to be litigated,<sup>50</sup> suretyship per se is an engagement and not a defense, a commitment to pay and not an excuse for nonpayment. The surety is bound in whatever capacity, and with whatever qualifications, he has affixed his signature to the negotiable instrument in suit; notice of his suretyship status neither defeats due course holding nor insulates the surety from liability.

### A. Takers

To whom is the surety liable? He must pay "takers."<sup>51</sup> "Taker" is a term undefined in the Code, but presumably is intended to include those physically in possession of a negotiable instrument who do not qualify as holders.<sup>52</sup> Since "holder" is generously defined in Section 1-201(20) as a "person who is in possession of . . . an instrument . . . drawn, issued or indorsed to him or to his order or to bearer or in blank," the residual class is not large. A payee, for example, is clearly a holder, and under Section 3-302(2) may even be a holder in due course.<sup>53</sup> But an indorser who is forced to take up an instrument upon default of the maker or drawer may be a mere transferee if he lacks the indorsement of the person whom he has paid.<sup>54</sup> Such an indorser is and ought to be entitled as a "taker" to hold a prior surety.<sup>55</sup>

50. The litigation reflects a basic confusion between the defense, "I am only a surety and therefore not liable," and the defense, "I am a surety and therefore entitled to special defenses not available to other parties to negotiable instruments." For examples of the first type of defense, *see, e.g.*, *G.E. Conkey Co. v. Bochmann*, 220 F. Supp. 284 (N.D. Iowa 1963); *Civic Fin. Co. v. Meintzer*, 137 Colo. 572, 328 P.2d 379 (1958); *Conn v. Boulevard Nat'l Bank*, 148 So. 2d 758 (Fla. App. 1963); *Seelig v. Brusso*, 121 So. 2d 28 (La. App. 1960); *Sun Oil Co. v. Redd Auto Sales Inc.*, 339 Mass. 384, 159 N.E.2d 111 (1959); *Welbilt Concrete Constr. Co. v. Kornicki*, 26 App. Div. 2d 661, 272 N.Y.S.2d 422 (1966); *Macy v. Oswald*, 198 Pa. Super. 435, 182 A.2d 94 (1962).

51. Section 3-415(2) defines the surety's liability as follows:

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

By contrast, under Section 3-415's antecedent in the Negotiable Instruments Law, Section 29, accommodation parties were liable to holders for value, a position intermediate between liability to takers and liability to holders in due course.

52. Compare the definition of a transferee in Section 3-201(1):

(1) Transfer of an instrument vests in the transferee such rights as the transferor has therein, except that a transferee who has himself been a party to any fraud or illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course.

53. Section 3-302(2) states flatly: "A payee may be a holder in due course."

54. Section 3-603(2) provides:

(2) Payment or satisfaction may be made with the consent of the holder by any person including a stranger to the instrument. Surrender of the instrument to such a person gives him the rights of a transferee (Section 3-201).

55. In *James Talcott, Inc. v. Fred Ratowsky Associates*, 38 Pa. D. & C.2d 624, 84 Dauph.

## Suretyship Under Article 3 of UCC

Must the surety pay any and all takers? An answer to this question involves a construction, possibly a reconstruction, of Section 3-415(2). The subsection provides: "*When the instrument has been taken for value before it is due* the accommodation party is liable in the capacity in which he signed even though *the taker* knows of the accommodation" (emphasis added). Does this mean that only a taker who has himself taken the instrument for value before it is due can sue the surety? Or do the introductory words, the "when" clause, describe instead conditions for valid issue *ab initio*? Comment 3<sup>56</sup> indicates that the value phraseology was designed to avoid problems of past consideration, so that the timing of the procuring of the surety's signature would not be determinative of his liability; and that the "before it is due" language was designed to accommodate a principle of suretyship law "by which the obligation of the surety is terminated at the time limit unless and in the meantime the obligation of the principal has become effective." So while the phrasing of the text, particularly the rhythm of "taken" and "taker," looks toward qualification of the individual claimant, the drift of the comment is toward conditions of initial validation.

Perhaps the best way to arrive at a sound construction is to test these alternatives in the context of a series of typical hypothetical cases. Suppose, first, that *A* is an accommodating co-maker for *B* on a promissory note for \$10,000 payable to the order of *C*, due six months after date. *C* correctly pays the \$10,000 consideration to *B*, who promptly disappears, physically or financially. If *C* holds the paper until maturity, there is no doubt that *C* can recover from *A*. But suppose that *C* negotiates the paper to *D*, who in turn negotiates it to *E*, who holds it until maturity. When *E* discovers that *B* will not pay, he is likely to have recourse to *D*.<sup>57</sup> What is the situation if *D*, the paying indorser, having

258 (C.P. 1965), the plaintiff failed to qualify as a holder since one of the indorsements necessary to his title was on a separate piece of paper insufficiently attached to the principal note to qualify as an allonge. Nonetheless, the court held that the plaintiff, as a taker for value before the instrument was due, was entitled to recover from an accommodation party. In most instances, the paying indorser can avoid the qualification problem, since he is entitled to cancel intermediate indorsements not necessary to his title and thus to resume his former status as holder. See Section 3-208.

56. Comment 3 states:

The obligation of the accommodation party is supported by any consideration for which the instrument is taken before it is due. Subsection (2) is intended to change occasional decisions holding that there is no sufficient consideration where an accommodation party signs a note after it is in the hands of a holder who has given value. The party is liable to the holder in such a case even though there is no extension of time or other concession. This is consistent with the provision as to antecedent obligations as consideration (Section 3-408). The limitation to "before it is due" is one of suretyship law, by which the obligation of the surety is terminated at the time limit unless in the meantime the obligation of the principal has become effective.

57. *D* will be liable to *E* if he has indorsed the paper without qualification, under Section 3-414(1); even if he has indorsed the paper "without recourse" he might still be liable for breach of one of the warranties of Section 3-417(2), but this is an unlikely source of liability under the facts here stipulated.

satisfied *E*, now wants to hold the surety, *A*, responsible? Although *D* has taken the instrument for value from *E*, nonetheless, by paying *E* he has himself taken it after maturity. In order to protect *D*'s right of recovery, which seems eminently reasonable and totally consistent with *A*'s commitment to negotiable paper, it seems preferable to adopt a construction of the "when" clause which attributes its stipulations to conditions of issue. So read, *C*'s timely taking shores up *D*'s claim, whereas on the alternate reading *D*, taking solely in his own right, might be time-barred.

Case 2 is a simple variant of the Case 1 model. Suppose *D*'s trouble stems not from post-maturity taking, but rather from lack of value. *D* is a donee, who was given the instrument by *C* in a sudden burst of generosity. Does *C*'s generosity, intended to benefit *D*, in fact serve to release *A*? Again, if the "when" clause is read to contain only conditions of issue, the preferable result is obtained; *i.e.*, *C* can make the gift without accidentally relieving *A* of his commitment.

Case 3 is a reverse twist on Case 1. Suppose *C*, having taken the note described, negotiates it to *D* without ever paying *B* one cent. Unless *D* is a holder in due course, the example is trivial.<sup>58</sup> But if *D* has taken the instrument for value, in good faith, and without notice of *C*'s misconduct, *D* should ordinarily be able to enforce the instrument. After all, what defenses are more typically "personal," and hence unavailable against a holder in due course, than failure of consideration or condition?<sup>59</sup> As long as *A*'s accommodation status is not known to *D*—if, for example, *A* has simply signed as co-maker without identifying legend—it is clear that even if the "when" clause describes conditions of issue, non-fulfillment of these conditions is no impediment to *D*'s right of recovery. Of course, *D* could just as easily himself qualify as a taker "for value and before it is due"; a holder in due course is all that and more.<sup>60</sup> So this case is neutral, and can be resolved correctly whichever interpretation of the subsection is adopted.

58. If *D* is an ordinary holder, he is subject, under Section 3-306(c), to the maker's defense of absence of consideration.

59. See Section 3-305(2) & Comment 3.

60. Compare the qualifications of Section 3-415(2) with those of Section 3-302. The principal omissions relate to qualifications of innocence: the holder in due course must take in good faith and without notice of defenses. Whether some good faith implications might not be read into Section 3-415 is an open question. Arguably, actual knowledge of some conduct beyond the scope of the contemplated accommodation status, which still might not qualify as a "discharge" under the terms of Section 3-415(3), would defeat the rights of a particular taker. After all, good faith is an obligation which attaches to every contract or duty under the Code, under Section 1-203. Under analogous circumstances, Article 9 draws a distinction between knowledge of the existence of a security interest, and knowledge of its violation. See Section 9-307(1).

This brings us to Case 4, in which, as in Case 3, *C* wrongfully negotiates to *D*, a holder in due course, an instrument for which *C* has never paid *A* or *B*. In this case, however, *A* has signed with the words "co-maker and surety." Now *D*, although still innocent of *C*'s failure to pay *B*, although still purchasing an apparently regular and valuable instrument, has notice of *A*'s accommodation status. And *D* may now be vulnerable to another subsection of Section 3-415, subsection (3), which relates to *A*'s ability to invoke "the benefit of discharges dependent on his character" as an accommodation party. Subsection (3) can hurt *D* if it means that suretyship discharges are a defense against even a holder in due course who is alerted to the presence of a surety, and if *C*'s fraudulent conduct is a basis of discharge for a surety. Whatever the merits of such an expansive reading of the discharge provisions, and I think they are very few,<sup>61</sup> the discharge provisions put *D* in jeopardy only if the "when" clause refers to conditions of issue, since if the clause relates, instead, to *D*'s own qualifications as in Case 3, he clearly has more than met its specifications.

To summarize, the position that the surety must pay any taker if that taker gave timely value for the instrument finds support in the case of the paying indorser and of the donee, and is consistent with protection for the holder in due course of paper on which the surety is latent. But it may entail difficulties for a holder purchasing paper with a visible surety. It should not, even there, cause trouble if the discharge section is narrowly read, but it may at the very least give rise to uncertainty and hence to litigation.

There may be an avenue of escape from even this limited uncertainty, a way to protect both the paying indorser and the donee, and the holder in due course of an instrument with a visible surety. If the "when" clause describes the characteristics of the taker rather than conditions of issue, why must it be limited to the personal characteristics of the taker who sues on the note? Obviously, if he is a holder in due course, he needs no further assistance. But the paying indorser in Case 1 is a taker whose credentials are, *prima facie*, not so secure; nevertheless, he should be able to use the "shelter" doctrine to inherit *E*'s timely taking, so that his taking becomes vicariously timely. Under Section 3-201, "[t]ransfer of an instrument vests in the transferee such rights as the transferor had therein,"<sup>62</sup> and payment to a holder is a

61. See pp. 863-67 & notes 129-44 *infra*.

62. Section 3-201(1) in its totality reads as follows:

Transfer of an instrument vests in the transferee such rights as the transferor has therein, except that a transferee who has himself been a party to any fraud or

transfer under Section 3-603(2).<sup>63</sup> The shelter principle would equally protect *D* as direct purchaser of an overdue instrument from *C*—or as *C*'s donee—as long as *C* had properly given value to *B* before the paper expired. In other words, the shelter doctrine is a bridge between conditions of issue and qualifications of claimants. If the suretyship contract has once become totally and correctly operative, subsequent takers in good faith acquire adequate qualifications by transfer. But if the suretyship contract was defectively formed, it can only be enforced in the hands of, or through shelter under, a taker whose qualifications are self-acquired, such as, notably, the holder in due course.

This resolution still leaves some takers unprotected. The donee of an imperfect suretyship instrument has received a worthless gift and must put up with his disappointment. The purchaser of an overdue instrument from a defrauding payee has failed to heed the warnings said to inhere in overdue paper.<sup>64</sup> But what about the taker who meets the literal requirements of taking for value before maturity, but who is not a holder in due course, say because he is missing an indorsement or because he had notice of some claim or defense entirely unrelated to the surety? As to him, may the surety who has signed as co-maker, with or without legend, raise personal defenses such as failure of consideration or breach of condition on delivery, or is the accommodation party unconditionally liable in the capacity in which he has signed? While Section 3-415(2) seems to opt for liability in this situation, the outcome is by no means clear.

#### B. *Parol Evidence*

The conclusion that the surety is responsible to a great many potential takers does not as yet define the scope of his undertaking to this large class. Two factors important to the surety's commitment have already been identified: the capacity in which the surety signed the negotiable instrument, and the presence or absence of any legend on the instrument limiting or enlarging the surety's obligation. Is the surety's liability conclusively defined by these two determinants, or may

illegality affecting the instrument or who as a prior holder had notice of a defense or claim against it cannot improve his position by taking from a later holder in due course.

63. Section 3-603(2) provides:

Payment or satisfaction may be made with the consent of the holder by any person including a stranger to the instrument. Surrender of the instrument to such a person gives him the rights of a transferee (Section 3-201).

64. See Chafee, *Rights in Overdue Paper*, 31 HARV. L. REV. 1104 (1918); Morrison, *Equities of Ownership and Equities of Defence in Overdue Paper*, 5 TULANE L. REV. 287 (1931).



it be altered by special agreement dehors the instrument? That is, can the contracting parties effectively condition or extend the surety's engagement without detailing their agreement on the instrument itself? To some extent, this question is subsumed under the principle of protection for due course holding: no holder in due course of a bona fide negotiable instrument is bound by any special arrangements of which he is innocent. To a holder in due course, a surety is and must be that which he appears to be upon inspection of the instrument.<sup>65</sup> But the issue may arise in the context of a taker who is not as exceptionally qualified as a holder in due course and who may yet not be one of the immediate parties to the negotiated deal. The question then becomes one of the applicability of the parol evidence rule, a question on which Article 3 of the Code, in contradistinction to Article 2,<sup>66</sup> is remarkably reticent.

The decision of the draftsmen not to codify the relationship between the parol evidence rule and negotiable instruments law<sup>67</sup> is easy to understand. Seventy years ago, Thayer introduced his famous discussion of the parol evidence rule with the observation that "Few things are darker than this, or fuller of subtle difficulties."<sup>68</sup> If the reported cases are any guide, the state of the law has not improved. Even a cursory examination of recent appellate litigation discloses widespread inconsistency and confusion.<sup>69</sup> The one thing that is eminently clear is that the problem is not about to fade away.

65. See 3 A. CORBIN, CONTRACTS § 597, at 510-14 (1960) and Section 3-119.

66. See Section 2-202.

67. Comment 1 to Section 3-119 states categorically:

This Article does not attempt to state general rules as to when an instrument may be varied or affected by parol evidence, except to the extent indicated by the comment to the preceding section.

Section 3-118 provides rules of construction for ambiguous instruments, and its comment indicates that these rules are not subject to variation (other than by reformation) "by any proof that any party intended the contrary." Despite the comment, the text may provide some openings for parol evidence through its preconditions relating to ambiguity.

68. J. THAYER, EVIDENCE 390 (1898).

69. The sponsors of the Uniform Commercial Code have, with some regularity, taken the position that they would not codify where state law was in marked conflict. For example, Article 2 has been noticeably reticent about problems of privity; even last year, with the privity battle essentially won, the Permanent Editorial Board could not bring itself to provide more than optional variants for Section 2-318. UNIFORM LAWS ANNOTATED, UNIFORM COMMERCIAL CODE § 2-318 (Supp. 1967). Similarly, Article 6 takes no position on the important question whether the bulk sales buyer should have any responsibility in the disbursement of proceeds of the bulk transfer, see optional Section 6-106, and Article 3 remains cautiously neutral about the consequences of domiciling negotiable paper, see Section 3-121. These are all questions of substance, entirely unlike the variant filing systems under Article 9, see Section 9-401, which merely allow local option to regulate the place of filing. Perhaps excessive codification would have jeopardized widespread enactment, or stimulated even more wholesale local amendments than the Code has already received. Still, it is not easy to demonstrate that the parol evidence rule had achieved substantially greater consensus as it affected the law of sales than as it dealt with negotiable instruments.

The response of the draftsmen to these complexities was to intervene intermittently, to allow some parol evidence some of the time by statutory fiat, and to leave the rest to judicial ingenuity. Article 3 contains only one provision addressing itself generally to the parol evidence rule, Section 3-119(1),<sup>70</sup> which authorizes variation of the terms of an instrument by resort to a *written* agreement executed as part of the same transaction. To this extent, the Code recognizes explicitly that negotiable instruments are often merely partial integrations, precluded by the formal requisites of negotiability from containing a complete and detailed statement of the contracting parties' total agreement.

Several points about Section 3-119 are noteworthy. Admissible agreements are not restricted to those which add supplementary terms consistent with the instrument; instead, the instrument may be modified or otherwise "affected," presumably a polite word for "altered," by the contents of the written agreement. Furthermore, no special presumptions or burdens of proof devalue the written agreement where it conflicts with the negotiable instrument. The written agreement is admissible only insofar as it was "executed as part of the same transaction," but this requirement of contemporaneous execution has a fair amount of free play within it. Finally, the written agreement is effective only between "the obligor and his immediate obligee or any transferee" or a holder in due course with "notice of the limitation when he took the instrument." This limitation is clear enough when it protects the innocent holder in due course, but what does it mean for a holder not in due course (but not a mere transferee), for example a post-maturity purchaser for value? Is such a holder, like a mere transferee, bound by conditions of which the negotiable instrument gives him no warning and of which he otherwise has no notice? Literally read, the section allows him to enforce the instrument as written; in "transferee" the draftsmen were using a term of art not synonymous with "holder."<sup>71</sup> As a matter of commercial sense, however, this distinction is not entirely persuasive. Nothing in the presence or absence of an endorsement is specifically responsive to the issue of the admissibility of parol evidence, unless the process of transfer without negotiation is to be con-

70. Section 3-119 reads as follows:

- (1) As between the obligor and his immediate obligee or any transferee the terms of an instrument may be modified or affected by any other written agreement executed as a part of the same transaction, except that a holder in due course is not affected by any limitation of his rights arising out of the separate written agreement if he had no notice of the limitation when he took the instrument.
  - (2) A separate agreement does not affect the negotiability of an instrument.
71. The status of a transferee is defined in Section 3-201.

sidered so atypical and uncommercial as to be uniquely suspect and hence hypervulnerable to any arguably legitimate defense. But elsewhere Article 3 takes neither a particularly dim view of transferees nor an especially exalted view of holders not in due course.<sup>72</sup> A resolution which treats ordinary holders like transferees, for this purpose, in order to effectuate the original intent of the contracting parties, is therefore to be preferred. A court could arrive at this result, either by disregarding the technical limitations on the definition of a transferee, or by considering the holder not in due course as a *casus omissus*, to be treated like the transferee by analogy. Since the ambit of the section is in any case carefully confined to contemporaneous and written intrusions on the negotiable instrument, a somewhat expanded reading of what parties are affected by outside agreements is not inappropriate.

Article 3's remaining provisions about the admissibility of parol evidence are more episodic. Only Section 3-415(3)<sup>73</sup> refers to the problem in text; and it provides only that the surety may introduce "oral proof" to demonstrate his accommodation character against anyone but a holder in due course without notice of the accommodation to obtain "the benefit of discharges dependent on his character as such." The scope of the beneficial discharges is left undefined. A number of sections invite the parties to vary by special agreement<sup>74</sup> the statutory

72. Compare Section 3-306 with Section 3-201.

73. The text of the entirety of Section 3-415(3) reads as follows:

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. In other cases the accommodation character may be shown by oral proof.

74. Article 1 provides, for all of the Code, in Section 1-102:

- (1) This Act shall be liberally construed and applied to promote its underlying purposes and policies.
- (2) Underlying purposes and policies of this Act are
  - (a) to simplify, clarify and modernize the law governing commercial transactions;
  - (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties;
  - (c) to make uniform the law among the various jurisdictions.
- (3) The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.
- (4) The presence in certain provisions of this Act of the words "unless otherwise agreed" or words of similar import does not imply that the effect of other provisions may not be varied by agreement under subsection (3).
- (5) In this Act unless the context otherwise requires
  - (a) words in the singular number include the plural, and in the plural include the singular;
  - (b) words of the masculine gender include the feminine and the neuter, and when the sense so indicates words of the neuter gender may refer to any gender.

presumptions which attach to such diverse subjects as indorsement, assignment, presentment, capacity and recourse. Thus the parties may determine privately who is entitled to an indorsement<sup>75</sup> and who is liable to an indorser<sup>76</sup> when a check or a draft is an assignment;<sup>77</sup> when presentment, notice of dishonor, or protest are required;<sup>78</sup> whether to qualify ambiguous representations of personal liability;<sup>79</sup> whether to consent to extension of payment terms, or impairment of collateral.<sup>80</sup> Although none of these sections explicitly refers to parol evidence, it would certainly be wrong to interpolate into them limitations on the permissible form of variance which they do not themselves contain.<sup>81</sup> They should all be read to permit oral or written modification.

One other group of sections could also be construed to invite parol

75. Section 3-201(3) provides:

Unless otherwise agreed any transfer for value of an instrument not then payable to bearer gives the transferee the specifically enforceable right to have the unqualified indorsement of the transferor. . . .

76. Under Section 3-414(2):

Unless they otherwise agree indorsers are liable to one another in the order in which they indorse, which is presumed to be the order in which their signatures appear on the instrument.

77. Section 3-409(1) provides:

A check or other draft does not of itself operate as an assignment of any funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until he accepts it.

78. Section 3-511(2)(a) states:

Presentment or notice or protest as the case may be is entirely excused when

- (a) the party to be charged has waived it expressly or by implication either before or after it is due . . . .

Furthermore, under Section 3-503, the time for presentment is "determined by the nature of the instrument, any usage of banking or trade and the facts of the particular case. . . ."

79. Section 3-403 deals with the availability of parol evidence to a signatory who claims that he signed only in a representative capacity without personal liability. Its subsection (2) lays down the following guidelines:

An authorized representative who signs his own name to an instrument

- (a) is personally obligated if the instrument neither names the person represented nor shows that the representative signed in a representative capacity;
- (b) except as otherwise established between the immediate parties, is personally obligated if the instrument names the person represented but does not show that the representative signed in a representative capacity, or if the instrument does not name the person represented but does show that the representative signed in a representative capacity.

80. Section 3-606 allows consent to vitiate the defenses it provides against impairment of recourse or collateral; it states, in subsection (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, protests or notice of dishonor with respect to any such person does not discharge any party as to whom presentment, protest or notice of dishonor is effective or unnecessary; or
- (b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.

81. In several instances, comment accompanying the relevant section makes this abundantly clear. Comment 6 to Section 3-201 states that "the understanding [about the type of indorsement] may be implied from conduct, from past practice, or from the circumstances of the transaction." Comment 3 to the presentment section, 3-511, says that

testimony where relevant. These are the sections that spell out the various defenses available to those called upon to pay a negotiable instrument. Certainly the so-called real defenses, which are effective even against a holder in due course, will rarely arise out of written documents.<sup>82</sup> And the personal defenses, to which a holder not in due course is subject, may equally be provable by oral testimony insofar as they qualify as “defenses . . . available in an action on a simple contract” or as “want or failure of consideration, non-performance of any condition precedent, non-delivery, or delivery for a special purpose.”<sup>83</sup> Finally, defenses which arise out of incorrect completion or material alteration are presumably provable by whatever evidence, oral or written, indicates the original intention of the contracting parties.<sup>84</sup>

“[t]he waiver may be express or implied, oral or written, and before or after the proceeding waived is due.” The comment to Section 3-402 spells out the circumstances under which parol evidence is admissible to clarify whether a signature in an ambiguous capacity is that of an indorser. And Comment 4 to Section 3-414 permits parol evidence to show the order of liability among indorsers.

82. Of course the parol evidence rule does not immunize so flawed an integration from parol attack. *See* § A. CORBIN, *CONTRACTS* § 580 (1960).

83. Section 3-306 stipulates:

Unless he has the rights of a holder in due course any person takes the instrument subject to

- (a) all valid claims to it on the part of any person; and
- (b) all defenses of any party which would be available in an action on a simple contract; and
- (c) the defenses of want or failure of consideration, non-performance of any condition precedent, non-delivery, or delivery for a special purpose (Section 3-403); and
- (d) the defense that he or a person through whom he holds the instrument acquired it by theft, or that payment or satisfaction to such holder would be inconsistent with the terms of a restrictive indorsement. The 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.

Section 3-408, in turn, provides, in a section titled “Consideration”:

Want or failure of consideration is a defense as against any person not having the rights of a holder in due course (Section 3-305), except that no consideration is necessary for an instrument or obligation thereon given in payment or as security for an antecedent obligation of any kind. Nothing in this section shall be taken to displace any statute outside this Act under which a promise is enforceable notwithstanding lack or failure of consideration. Partial failure of consideration is a defense pro tanto whether or not the failure is in an ascertained or liquidated amount.

84. The alteration section is Section 3-407:

- (1) Any alteration of an instrument is material which changes the contract of any party thereto in any respect, including any such change in
  - (a) the number of relations of the parties; or
  - (b) an incomplete instrument, by completing it otherwise than as authorized; or
  - (c) the writing as signed, by adding to it or by removing any part of it.
- (2) As against any person other than a subsequent holder in due course
  - (a) alteration by the holder which is both fraudulent and material discharges any party whose contract is thereby changed unless that party assents or is precluded from asserting the defense;
  - (b) no other alteration discharges any party and the instrument may be enforced according to its original tenor, or as to incomplete instruments according to the authority given.
- (3) A subsequent holder in due course may in all cases enforce the instrument according to its original tenor, and when an incomplete instrument has been completed, he may enforce it as completed.

Equipped with all these various sections which deal directly or indirectly with aspects of the parol evidence rule, it would seem that the contracting parties and the courts should have fairly adequate guidance in this complex field. Perhaps the Article 3 solution is not as neat as that of Article 2, but that is a mere stylistic quibble. To be sure, it may take a lawyer a little longer to find an Article 3 answer to a question about the admissibility of a particular piece of evidence, but then a little good hard research is what lawyers are for. If an answer is ultimately forthcoming, the draftsmen cannot be seriously faulted.

Unfortunately, however, when Article 3's provisions are tested against the issues actually raised by recent case law, they seem to avoid rather than to illuminate those areas in which the cases are most in conflict. Some 60 cases in the last ten years discuss the impact of the parol evidence rule on negotiable instruments signed by sureties.<sup>85</sup> The cases show marked differences in approach from one state to another, as well as considerable subtlety within many courts in distinguishing closely related fact situations. These are obviously cases which courts, torn between protecting a well-meaning surety and a legitimate creditor, have sought to handle cautiously and carefully. The Code will not do much to help them.

The cases uniformly permit the surety to introduce parol evidence on two issues. First, he may argue orally about the identity of the party accommodated in order to defeat his liability to such a party regardless of apparent commitments on the negotiable instrument.<sup>86</sup> Courts rarely believe that the payee was the beneficiary of accommodation by the co-maker, but they are open to persuasion. Section 3-415 in subsections (3) and (4) is clear that accommodation status may be proved orally and that the accommodating surety is not liable to the party accommodated, but it does not expressly make the link that the identity of the accommodated party is an integral aspect of accommodation status and hence provable by parol evidence. Still, buttressed by the uniformity of the

85. Part of the research design for this article consisted of reading, seriatim, all of the cases involving sureties on negotiable instruments which the West system had recently collected in the *Seventh Decennial Digest* and in the first 3 volumes of the subsequent *General Digest*, principally under the heading of Bills and Notes. This process unearthed some 200 cases, and while it was undoubtedly not exhaustive, it was at the very least an illustrative cross-section of the litigation in this area. How much the sample is skewed by reliance primarily on appellate court reports, and by the selectivity inherent in the West system of indexing, is hard to evaluate.

86. See, e.g., *Colamatteo v. Schenkenberger*, 163 F. Supp. 693 (E.D. Wis. 1958); *Giberson v. Moore*, 35 Ill. App. 2d 175, 182 N.E.2d 767 (1962); *Town & Country Shocs Fed. Credit Union v. Cramer*, 350 S.W.2d 281 (Mo. App. 1961); *Claremont Paper Corp. v. Wilson*, 166 N.Y.S.2d 125 (Sup. Ct. 1957); *Corn Exchange Nat'l Bank & Trust Co. v. Burkhardt*, 401 Pa. 535, 165 A.2d 612 (1960); *Blackpipe State Bank v. Grass*, 78 S.D. 551, 105 N.W.2d 442 (1960); *Ward v. Vaughn*, 298 S.W.2d 862 (Tex. Civ. App. 1957).

prior decisions under a provision of the Negotiable Instruments Law which was no better drafted and by the admissibility of parol evidence under other similar circumstances, courts should continue to hear extrinsic evidence on the question of the identity of the accommodated party.<sup>87</sup> Second and similarly, although the surety gains no immunity from his own lack of compensation, he can rightfully rely on any evidence, written or oral, to complain to a holder not in due course that no one ever gave consideration to anyone connected with the instrument.<sup>88</sup> Here again, the result reached by the case law<sup>89</sup> is consistent with the text of Section 3-415 (and confirmed by the accompanying cross reference to Section 3-408), although not literally commanded by the text.

Where the case law is divided, the Code's backhanded treatment of parol evidence is more likely to give trouble. Consider the case of the surety who alleges that he signed the instrument only because of a special understanding that he would never be held personally liable. Of course, if he neither knew nor had reason to believe that he was undertaking a commitment on a negotiable instrument, there has been a fraud in the factum, a real defense against any taker, and hence the evidence of special inducement is admissible.<sup>90</sup> But if that threshold

87. One court has so held, without appreciable difficulty. *United Refrigerator Co. v. Applebaum*, 410 Pa. 210, 189 A.2d 253 (1963).

88. See discussion at p. 845 *supra*.

89. See, e.g., *Hopper v. American Nat'l Bank*, 309 F.2d 244 (10th Cir. 1962); *Colorado Nat'l Bank v. Bohm*, 286 F.2d 494 (9th Cir. 1961); *Brice v. Herrman*, 128 A.2d 790 (D.C. Mun. App. 1957); *Jook v. Worak*, 131 Ind. App. 36, 169 N.E.2d 128 (1960); *Howell v. Ablah*, 188 Kan. 244, 361 P.2d 872 (1961); *Hutchison v. Boney*, 72 N.M. 194, 382 P.2d 525 (1963); *Perry v. Riske*, 2 Wis. 2d 377, 86 N.W.2d 429 (1957).

90. In the period covered by my research, I found no cases alleging such fraud, but parol evidence was allowed in support of a related defense, duress and illegality, in a case in which accommodation makers alleged that they had been coerced into signing a note because of a threat that their brother would otherwise be prosecuted and jailed for check kiting. *Bank of Tucson v. Adrian*, 245 F. Supp. 595 (D. Minn. 1965), *aff'd*, 351 F.2d 949 (8th Cir. 1965).

The substantive provision of the Code is Section 3-305, providing:

To the extent that a holder is a holder in due course he takes the instrument free from

- (1) all claims to it on the part of any person; and
- (2) all defenses of any party to the instrument with whom the holder has not dealt except
  - (a) infancy, to the extent that it is a defense to a simple contract; and
  - (b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and
  - (c) such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
  - (d) discharge in insolvency proceedings; and
  - (e) any other discharge of which the holder has notice when he takes the instrument.

For a discussion of the pre-Code case law, see W. BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* § 130 (2d ed. 1961).

question is resolved against the surety, will he be allowed to testify that he signed with the intention of taking on no liability?

There are a surprising number of cases like this, involving less stereotyped defendants than the familiar little old lady in distress. Sometimes the surety argues that he signed simply to evidence his receipt of notice of loans to the principal obligor,<sup>91</sup> or that for some other reason short of fraud in the factum he did not fully understand the nature of his commitment.<sup>92</sup> At other times, the surety alleges that he was induced to sign on the strength of blanket assurances of immunity.<sup>93</sup> Occasionally, sureties seek to explain why they believed such inherently implausible promises of immunity: the surety's signature was requested in order to give the co-maker a sense of responsibility;<sup>94</sup> the surety would not have to pay because there was adequate outside collateral<sup>95</sup> or because he would be responsible only for the collateral<sup>96</sup> or because someone else would pay.<sup>97</sup> The surety may try finally to escape liability by describing as fraudulent the promises that induced him to sign.<sup>98</sup> In the reported litigation involving these variants of the plea of "who, me?" the majority of courts have been exceedingly reluctant to permit parol evidence to negate the written commitment to pay. But there are exceptions, among them the not inconsequential courts of Illinois, California and Maryland.<sup>99</sup> The Uniform Commercial Code has noth-

91. See, e.g., *Marinelli v. Weaver*, 187 So. 2d 690 (Fla. App. 1966); cf. *United States v. Farrington*, 172 F. Supp. 797 (D. Mass. 1959) (non-negotiable guaranty).

92. See *General Refrigerator & Store Fixture Co. v. Fry*, 393 Pa. 15, 141 A.2d 836 (1958).

93. See *Colamatteo v. Schenkenberger*, 163 F. Supp. 693 (E.D. Wis. 1958); *United States v. Cahoon*, 151 F. Supp. 584 (E.D.N.C. 1957); *Rosenborough v. Phillips*, 589 S.W.2d 593 (Tex. Civ. App. 1965); *Giberson v. Moore*, 35 Ill. App. 2d 175, 182 N.E.2d 767 (1962).

94. See *Colorado Nat'l Bank v. Bohm*, 286 F.2d 494 (9th Cir. 1961).

95. *Snowden v. Franklin Nat'l Bank*, 338 F.2d 995 (5th Cir. 1964); *Consolidated Vending Co. v. Turner*, 267 N.C. 576, 148 S.E.2d 531 (1966).

96. *Alban Tractor Co. v. Harrison*, 228 Md. 632, 180 A.2d 862 (1962).

97. *United States v. Cahoon*, 151 F. Supp. 584 (E.D.N.C. 1957).

98. He may allege either general misrepresentations about the surety's future liability (see, e.g., *Snowden v. Franklin Nat'l Bank*, 338 F.2d 995 (5th Cir. 1964); *Giberson v. Moore*, 35 Ill. App. 2d 175, 182 N.E.2d 767 (1962)) or specific evasion of relevant inquiries about the debtor's status or prospects, (see, e.g., *Atlantic Bank v. Carnegie Hall Corp.*, 25 App. Div. 2d 301, 268 N.Y.S.2d 941 (1966) (misinformation of contemplated use of proceeds of guaranteed note); *Modern Finance Co. v. Crawford*, 26 Ohio Op. 2d 364, 91 Ohio L. Abs. 245, 192 N.E.2d 70 (1960) (non-disclosure of debtor's default on outstanding loan)). These are all cases of direct dealings; fraud or duress by someone other than the enforcing creditor is no defense for substantive grounds, *United States v. Spice 'N' Nice Inc.*, 262 F. Supp. 627 (S.D.N.Y. 1967).

99. Of the cases cited above in notes 91-98, most refused to admit parol evidence. *Colamatteo* is ambiguous, finding insufficient evidence to support the alleged oral agreement that the defendant would be held harmless. The two cases of specific misrepresentation, *Atlantic Bank* and *Modern Finance* invoke the general inapplicability of the parol evidence rule to integrations flawed by fraud. See 3 A. CORBIN, CONTRACTS § 580 (1960). How wide an exception they provide depends upon how easy it is, under local law, to allege misrepresentation, whether, for example, misrepresentations must be intentionally misleading to be actionable. But the *Bohm* case, under California law, made directly admissible an oral promise that the co-maker would never be asked to pay but was being



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ing to say of direct relevance to this question. Not surprisingly, the two reported Code cases arrive at opposite results. *Deems v. Wilson*<sup>100</sup> found authority in Section 3-415 for admitting testimony of the accommodation co-maker that she had signed merely as witness to the signature of the other maker, a minor; *Held v. Moore*<sup>101</sup> refused to allow a guarantor to testify that he did not understand the capacity in which he signed a note. Both cases rely on prior state law concerning admissibility of evidence.

Pre-Code cases were more sympathetic to the surety who instead of claiming total immunity couched his argument for non-liability in terms of a conditional commitment. The surety has regularly been permitted to contradict by oral testimony his apparently unconditional paper obligation by showing that he delivered the paper to the payee for some express and unfulfilled purpose. The paper may have been delivered so that the payee could discount it,<sup>102</sup> or get a license,<sup>103</sup> or the payee might have been told that the surety would not be liable unless co-signers were obtained,<sup>104</sup> or property released.<sup>105</sup> In some situations, the payee is the party accommodated and is vulnerable to parol evidence on that ground. But in others, he is merely a disappointed creditor whose claim against the surety is a good deal more precarious than an appraisal of the instrument would suggest. The courts admitting parol evidence to defeat the creditor have often relied on Section 16 of the Negotiable Instruments Law, which expressly sanctioned the

asked to sign only to add a sense of responsibility to the other maker. And the Maryland court in the *Alban Tractor Co.* case saw no difficulty in parol testimony of a promise that liability would be limited to return of secured collateral. Perhaps the broadest basis for admission was the court's holding in *Giberson* that:

If there was a misrepresentation, if there was fraud, if there was no consideration, if the note was signed as an accommodation for the payee on the promise that defendant Javancie would never be called upon or forced to pay the note, even though Moore failed to pay, all these matters or any of them go to the requirements for a valid and legal obligation, and although prima facie the note is presumed a legal obligation, parol testimony is admissible to rebut the presumption.

35 Ill. App. 2d at 180-81, 182 N.E.2d at 769-70.

100. 114 Ga. App. 341, 151 S.E.2d 230 (1966).

101. 59 Lanc. L. Rev. 111 (Pa. C.P. 1964).

102. See *Cross v. Miner*, 207 Tenn. 239, 338 S.W.2d 619 (1960); *Heights Sav. Ass'n v. Cordes*, 412 S.W.2d 372 (Tex. Civ. App. 1967).

103. See *Schulte Transp. Co. v. Hewitt*, 299 S.W.2d 568 (Mo. App. 1957); *Parrillo v. Siravo*, 225 A.2d 515 (R.I. 1967).

104. See *McMahon v. Weesner*, 254 F. Supp. 839 (S.D. Fla. 1966); *Associates Discount Corp. v. Washington*, 121 So. 2d 388 (La. App. 1960).

105. See *Evans v. United Benefit Fire Ins. Co.*, 192 So. 2d 87 (Fla. App. 1966); *Greater Valley Terminal Corp. v. Goodman*, 405 Pa. 605, 176 A.2d 408 (1962). But the Texas courts have been more reluctant to permit such testimony: *Hood v. First Nat'l Bank*, 410 S.W.2d 449 (Tex. Civ. App. 1966) (endorser cannot defend that wrong property mortgaged to innocent creditor); *Henslee v. First Nat'l Bank*, 314 S.W.2d 881 (Tex. Civ. App. 1958) (endorser not allowed to testify that his liability was conditional upon surrender of mortgaged property to him).

concept of conditional delivery.<sup>106</sup> Although Section 3-306(c) of the Code is undoubtedly intended to cover the same ground, it is considerably more elliptical and is unlikely to persuade any court to alter its previously stated views.<sup>107</sup>

These two sets of cases mark the outside boundaries of the parol evidence rule problem. The surety will generally not be heard to contradict completely his liability on negotiable paper voluntarily signed; but he may testify to oral stipulations intended to condition the initial validity of the instrument. So far, most courts are in agreement, and the Code does not contradict the consensus at which the courts have arrived.

Suppose, however, that the special agreement of the surety is premised on some condition not tied to the original delivery of the negotiable instrument: the surety's proffered testimony relates to promises of discharge, as where he was not to be held after partial payments by the debtor or some third person;<sup>108</sup> payments were to come out of the debtor's assets or profits;<sup>109</sup> the parties agreed to a date of payment

106. Section 16 of the Negotiable Instruments Law read:

Every contract on a negotiable instrument is incomplete and revocable until delivery of the instrument for the purpose of giving effect thereto. As between immediate parties, and as regards a remote party other than a holder in due course, the delivery, in order to be effectual, must be made either by or under the authority of the party making, drawing, accepting or indorsing, as the case may be; and in such case the delivery may be shown to have been conditional, or for a special purpose only, and not for the purpose of transferring the property in the instrument. But where the instrument is in the hands of a holder in due course, a valid delivery thereof by all parties prior to him so as to make them liable to him is conclusively presumed. And where the instrument is no longer in the possession of a party whose signature appears thereon, a valid and intentional delivery by him is presumed until the contrary is proved.

The Negotiable Instruments Law has now been superseded by the Uniform Commercial Code in every state except Louisiana. The case law under Section 16 is summarized in J. BRANNAN, *NEGOTIABLE INSTRUMENTS LAW* 360-93 (7th ed. F. Beutel 1948); a textual exposition of the parol evidence rule under the Negotiable Instruments Law is contained in W. BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* §§ 51-55 (2d ed. 1961).

107. Section 3-306 defines the defenses available against a holder not in due course to include, in subsection (c) the defenses of want or failure of consideration, non-performance of any condition precedent, non-delivery, or delivery for a special purpose (Section 3-408) . . . . It does not in terms address itself to problems of proof.

108. See *American Nat'l Bank v. Knab Co.*, 158 F. Supp. 695 (E.D. Wis. 1958) (oral agreement that bank would look to another for payment); *Wheeler v. Thomas*, 328 S.W.2d 891 (Tex. Civ. App. 1959) (oral agreement to cancel if obligor paid \$1000 for improvements). *But cf.* *Little River Bank & Trust Co. v. North American Mtge. Corp.* 186 So. 2d 263 (Fla. App. 1966) (oral agreement to credit this obligation with payments made under another note admissible because not a variance).

109. See *Fidelity Sav. Bank v. Wormhoudt Lumber Co.*, 251 Iowa 1121, 104 N.W.2d 462 (1960) (note to be paid solely from profits of described business); *Atlantic Bank v. Carnegie Hall Corp.*, 25 App. Div. 2d 301, 268 N.Y.S.2d 941 (1966) (loan to be paid off from box office proceeds); *Consolidated Vending Co. v. Turner*, 267 N.C. 576, 148 S.E.2d 531 (1966) (note would be covered by outside payments).

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other than that stipulated in the instrument;<sup>110</sup> the creditor promised to pursue the debtor or his collateral as if the surety had merely guaranteed collection despite his signature as co-maker,<sup>111</sup> or, in an occasional reversal, the surety promised in fact to guarantee payment, according to the creditor, even though the surety's capacity on the instrument is that of indorser.<sup>112</sup> In handling these cases courts are often impressed by the fact that the testimony they are asked to consider contradicts some express term of the instrument in suit, and are reluctant to permit such overt variance.<sup>113</sup> Other courts recognize that admitting the defense of conditional delivery provides so pervasive a loophole that it makes little sense to exclude any conditional agreements whatsoever.<sup>114</sup> The Code, by treating conditional delivery as only one of a series of defenses open against a holder not in due course—some of which, like failure of consideration, are clearly provable by parol evidence—seems to support the latter, minority, point of view.

If, however, Section 3-306 is read as a blanket invitation to parol evidence, what is one to make of the various other sections of Article 3 which specifically invite oral testimony? Why should the Code include such references in any of the provisions about indorsement or presentment or assignment if all of these, as agreed-upon conditions, are always provable orally?<sup>115</sup> The language of Section 3-415 is illustrative. Sub-

110. See *Weyerhaeuser Co. v. Gershman*, 324 F.2d 163 (2d Cir. 1963) (oral agreement that no suit would be brought upon due date of note); *accord*, *Schekter v. Michael*, 184 So. 2d 641 (Fla. Sup. Ct. 1966) (no parol evidence to supply due date on promissory note with blank due date, since such a note automatically a demand note; case did not involve accommodation parties).

111. See *Franklin v. Sea Island Bank*, 111 Ga. App. 182, 141 S.E.2d 121 (1965); *Bakelite Co. v. Miller*, 372 S.W.2d 867 (Mo. 1963); *Long Island Trust Co. v. Merz*, 187 N.Y.S.2d 419 (Sup. Ct. 1959). But see *Jordan v. Daniel*, 94 Ga. App. 456, 95 S.E.2d 28 (1956) (not cited in *Franklin, supra*); *Walls v. Leadway Coop Mill*, 176 So. 2d 16 (Ala. 1965); *Texas Gulf Trust Co. v. Notias*, 352 S.W.2d 925 (Tex. Civ. App. 1962), all allowing parol evidence to vary apparent capacity.

112. *Lange v. Shapiro*, 68 Ill. App. 2d 433, 216 N.E.2d 294 (1966).

113. This point is explicitly made by *Franklin Discount Co. v. Ford*, 27 N.J. 473, 143 A.2d 161 (1958). There the indorser alleged that his signature was conditioned upon the understanding that the creditor was going to advance a new line of credit to the debtor. The court said that oral testimony to this effect would be admissible if the note was silent as to its purpose, but not if it stated that its consideration was extension of time for an existing debt owed to the creditor. A collateral issue of alteration of the note's terms gave relevance to the court's alternative statements.

114. See, e.g., the cases allowing parol variation of capacity cited in note 111 *supra*, which may be explicable on this basis. The best exposition of this view of the parol evidence rule, on other facts, is Judge Frank's opinion in *Zell v. American Seating Co.*, 138 F.2d 641 (2d Cir. 1943), *rev'd*, 322 U.S. 709 (1944).

115. Some of the sections which expressly permit parol variation are extraordinarily, perhaps inordinately, precise. For no immediately apparent reason, Section 3-119, relating to contemporaneous writings, permits parol evidence to be introduced against the "immediate obligee or any transferee" (see discussion at pp. 850-51 *supra*) while Section 3-403, relating to representative capacity, allows parol evidence only between "the immediate parties."

section (3) allows oral proof to permit the accommodation party "the benefit of discharges dependent on his character as such." Unless the words after "discharges" are discarded as superfluous, they must import a limitation of some sort; *i.e.*, not all discharges are accommodation discharges, but only those which are somehow uniquely related to accommodation character.<sup>116</sup> But the kind of defenses just considered, namely special agreements about payment and due date and capacity, can and do arise between any parties to negotiable paper and are not peculiarly related to suretyship status. Furthermore, as to capacity, Section 3-415(2) flatly states that the accommodation party "is liable in the capacity in which he has signed," without any suggestion that parol evidence may alter this liability. Characteristically, the comment to Section 3-415 sheds no light on how far oral proof can go.

One resolution of the difficulty is to read Section 3-306 as the dominant section, and to consider the various special sections about oral testimony as merely illustrative of problem areas which needed specific clarification in order to avoid confusion and doubt. Then, whenever paper is in the hands of a holder not in due course, any party can testify as to any special agreement. On this reading, absent a holder in due course, the parol evidence rule no longer has any role in the construction of negotiable instruments, a result which Professor Corbin would certainly have applauded,<sup>117</sup> but which would overturn a great number of existing cases. If the draftsmen contemplated so far-reaching a reform, one would have expected them to reach it by a less circuitous route.

Alternatively, and more plausibly, Section 3-306 may be taken to describe defenses from a substantive rather than from an evidentiary point of view. That is, if provable, the matters there listed are available to defeat a holder not in due course, but the Section has nothing to say about whether they are in fact provable. For the question of provability, some other sections of the Code give guidance in specific terms;<sup>118</sup>

116. See pp. 865-75 *infra*.

117. Professor Corbin states:

Promissory notes and bills of exchange are seldom intended by the parties to be complete integrations of the agreement in pursuance of which they are given. In order that they may be negotiable, the face of the note must contain an unconditional promise to pay a sum of money. As against a holder in due course, proof of extrinsic provisions and conditions has nothing to do with the "parol evidence rule." But, as against anyone not a holder in due course, proof of such extrinsic provisions and conditions should nearly always be permitted, as is in fact done in numberless cases.

3 A. CORBIN, CONTRACTS § 587, at 510 (1960).

118. Of particular relevance to the surety will be the express authorization for oral (presumably parol) proof of his accommodation character against holders not in due course, contained in Section 3-415(3). Interestingly, the subsection is not equally explicit that parol testimony may thereafter be introduced to establish the special defenses arising out of suretyship status, but surely such evidence should be inferentially admissible, at least insofar as it relates to events and conduct subsequent to the creation of suretyship

if there is no provision in Article 3, recourse must be had to the general supplementary principles of law which continue to coexist with the Code,<sup>119</sup> in other words, to the pre-existing non-uniform state law. If this is the correct reading, hopefully the result will not be more restrictive rules: courts should not read negative inferences into the Code's selection of situations in which parol evidence is permitted; and *Pym v. Campbell*<sup>120</sup> can furnish a common law basis for admissibility of such evidence in the conditional delivery cases,<sup>121</sup> to fill the gap left by the repealed Negotiable Instruments Law.

In sum, the surety who trusts to a casual agreement to insulate himself from unwanted liability places himself in a precarious position. Only if he memorializes his special engagement in the form of a writing which he can prove to be contemporaneous with the execution of the central negotiable instrument does the Code afford him any sure protection. None of the reported cases involves a surety with that kind of foresight, and the nature of the informal suretyship contract, born in boundless optimism with little expectation that payment will ever be required, is hardly consistent with this kind of formalism.

### III. The Defenses of the Surety

The surety's undertaking, his basic commitment to creditor and principal, represents the high water mark of the surety's potential lia-

status. The parol evidence rule has never been thought to bar either subsequent modification or subsequent interpretation of performance required by the integrated contract. 3 A. CORBIN, CONTRACTS §§ 574, 579 (1960). The scope of the substantive defenses encompassed by the "benefit of discharges dependent on [accommodation] character" is discussed at length in the next section of this article.

119. Under Section 1-103, supplementary general principles of law are expressly retained:

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.

120. 6 EL. & BL. 370 (1856), *described and discussed*, 3 A. CORBIN, CONTRACTS § 589 (1960).

121. In three post-Code cases, the courts relied on pre-Code case law. In *Dunn v. Orloff*, 420 Pa. 492, 218 A.2d 314 (1966), the court upheld the trial court's exclusion of proffered testimony that the creditor had agreed to return the note upon part payment of \$5000; the court invoked the Pennsylvania doctrine first laid down in *Gianni v. Russell & Co.*, 281 Pa. 320, 126 A. 791 (1924), that an apparent integration can be upset only by clear and convincing evidence of fraud, accident or mistake. Two brief lower court opinions in New York similarly rely on earlier New York cases to exclude parol testimony of special exculpatory agreements about payment of the notes in question. *Marine Midland Trust Co. v. Couphos*, 3 U.C.C. REP. SERV. 66 (N.Y. Sup. Ct. 1965); *Delbrook Associates v. Law*, N.Y.L.J. Apr. 6, 1967, at 20, 4 U.C.C. REP. SERV. 88 (N.Y. Sup. Ct. 1967). In none of the three cases is there any suggestion that the courts considered the Code to be of any relevance to the issues before them; neither *Dunn* nor *Marine Midland* even cites the Code; *Delbrook Associates* refers to Section 3-415 only to establish the general proposition that the accommodation maker of a note is primarily liable to the holder for value in accordance with the terms of the instrument despite the fact that consideration for its delivery was paid to another party.

bility. Other promisors may find their contractual commitments elastically construed, but the surety's contract is *strictissimi juris*,<sup>122</sup> as a favorite of the law, he can safely assume that implied conditions may limit but not extend the scope of his undertaking.

#### A. *Derivative Defenses*

One possible source of limitation for the surety's contract is the surety's ability to adopt as his own the defenses of the principal debtor arising out of the relationship between debtor and creditor. The surety's contract is after all ancillary to that of the debtor, and it is logical to infer that the surety's own liability should be no greater than that of the person whom he is accommodating. By and large, suretyship law has therefore permitted the surety to assert the defenses of his debtor, unless the very purpose of the suretyship was to shift the risk of the asserted defense from the creditor to the surety.<sup>123</sup> Thus the surety may be released if the debtor's consent to the agreement was wrongfully procured,<sup>124</sup> but the surety may continue to be liable if the debtor disaffirms because of his infancy,<sup>125</sup> or, more glaringly, because he has been discharged in bankruptcy.<sup>126</sup>

Do these suretyship principles afford a defense to a surety whose engagement is on an Article 3 instrument? Can the surety who has signed, say, as accommodation maker raise defenses of his co-maker, or even of a debtor not on the instrument at all? To what extent is it relevant whether suit is brought by an immediate party, or an ordinary holder, or a holder in due course; whether the suretyship is latent or visible; whether the defense is real or personal? To these questions, Article 3 provides clues rather than answers, clues scattered in a variety of sections and directed to a few specific cases rather than to the problem in general. The principal guidelines are those sections which describe defenses available against ordinary holders and against holders in due course and, again, Section 3-415, especially its general admonition that an accommodation party to a negotiable instrument is entitled to "the benefit of discharges dependent on his character as such."

122. See L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 29 (1950).

123. *Id.* §§ 52-62; 4 S. WILLISTON, CONTRACTS § 1213 (rev. ed. 1936).

124. See, e.g., *Great Am. Ins. Co. v. O'Neal*, 138 Kan. 617, 27 P.2d 201 (1933). *But see* *Ettlinger v. National Sur. Co.*, 221 N.Y. 467, 117 N.E. 945 (1917).

125. Compare, e.g., *Baker v. Kennett*, 54 Mo. 82 (1873), with *McKee v. Harwood Auto Co.*, 204 Ind. 233, 183 N.E. 646 (1932).

126. See, e.g., *Union Trust Co. v. Willsea*, 275 N.Y. 164, 9 N.E.2d 280 (1937). The Bankruptcy Act § 57(i), 11 U.S.C. § 93(i) (1964), allows a surety to prove his claim in the bankruptcy of the underlying obligor. See 3 W. COLLIER, BANKRUPTCY ¶ 57.21 (14th ed. 1967).

These defenses are not available to a latent surety against a holder in due course, or, perhaps, to a surety who has been so improvident as to fail to get the accommodated party on the instrument.<sup>127</sup>

But even with these two exceptions, the basic choice to admit suretyship defenses as a special category for discharge is a highly significant one. It was frequently argued and held under the Negotiable Instruments Law that principles of negotiability were so pervasive that suretyship in negotiable form should be governed exclusively by the ordinary rules of negotiable paper—that the surety who had elected a negotiable commitment should be considered as no different from any other party to a negotiable instrument.<sup>128</sup> The draftsmen of the Code chose instead to emphasize and preserve suretyship principles except where their application would prejudice innocent holders in due course.

Under Section 3-415(3),<sup>129</sup> whenever negotiable paper indicates that some signer is an accommodation party, that signer may take advantage of suretyship defenses, even against a holder in due course. And when the suretyship is latent, a holder who is not either himself or derivatively a holder in due course is subject to two-step devaluation of his paper, in which the accommodation party first identifies himself as such by parol and then raises his defenses. The vulnerability of the ordinary holder may be relatively unimportant, although the volatility of negotiable paper is easily overestimated and the pre-Code case law denying suretyship defenses regularly involved plaintiffs who were not holders in due course. But the decision to make a bona fide holder in due course subject to suretyship defenses of which he knows nothing other than that a particular signer regards himself as a surety is considerably more troublesome. This result might perhaps be avoided by a disingenuous refusal to draw the negative inference which the text in subsection (3) invites. All that the Section literally dictates is a solution for a limited set of hypothetical cases: evidence of suretyship defenses is *inadmissible* in the case of a latent surety sued by an innocent holder

127. See pp. 838-39 *supra*.

128. See, e.g., *Cellers v. Meachem*, 49 Ore. 186, 89 P. 426 (1907); *Union Trust Co. v. McGinty*, 212 Mass. 205, 98 N.E. 679 (1912); *Kratovil v. Thieda*, 36 Ill. 2d 247, 222 N.E.2d 485 (1966). All these cases involved interpretation of the discharge sections of the Negotiable Instruments Law which contained no relevant provision for the discharge of those who, as makers, were primarily liable. See N.I.L. §§ 119, 120.

129. Section 3-415(3) reads:

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. In other cases the accommodation character may be shown by oral proof.

in due course; evidence of suretyship defenses is *admissible* to protect any surety sued by a holder not in due course, directly if the accommodation status is visible, or otherwise after its oral establishment. Arguably, the subsection means only that ordinary holders, but never holders in due course, will be vulnerable to suretyship defenses. Comment 1 goes no further than, and is thus consistent with, this construction;<sup>130</sup> but it does not in any other way rebut the more obvious interpretation of the text, which would extend vulnerability to all those who deal with negotiable paper bearing visible sureties. If the subsection is given its natural reading, purchasers of negotiable paper who think the instruments they are buying are made more valuable by the presence of a surety may well be sorely disappointed; instead, visible suretyship may, under the Code, be a warning signaling unknown and uncertain defenses hovering around the liability of the surety—may in fact portend substantial impediments to speedy liquidation of the negotiable paper upon its maturity.

It is noteworthy in passing that the shifting of these unknown risks to a holder in due course is inconsistent with the pattern followed elsewhere in Article 3. Typically, the various sources of discharge listed in Section 3-601 (which, interestingly, has no cross-reference to Section 3-415)<sup>131</sup> are personal defenses only, ineffective against subsequent innocent due course holders.<sup>132</sup> Similarly, restrictive indorsements have

130. All that Comment 1 has on this point is:

The subsection recognizes the defenses of a surety in accordance with the provisions subjecting one not a holder in due course to all simple contract defenses, as well as his rights against his principal after payment.

131. Section 3-601, the opening section of Part 6, Discharge, reads as follows:

- (1) The extent of the discharge of any party from liability on an instrument is governed by the sections on
  - (a) payment or satisfaction (Section 3-603); or
  - (b) tender of payment (Section 3-604); or
  - (c) cancellation or renunciation (Section 3-605); or
  - (d) impairment of right of recourse or of collateral (Section 3-606); or
  - (e) reacquisition of the instrument by a prior party (Section 3-208); or
  - (f) fraudulent and material alteration (Section 3-407); or
  - (g) certification of a check (Section 3-411); or
  - (h) acceptance varying a draft (Section 3-412); or
  - (i) unexcused delay in presentment or notice of dishonor or protest (Section 3-502).
- (2) Any party is also discharged from his liability on an instrument to another party by any other act or agreement with such party which would discharge his simple contract for the payment of money.
- (3) The liability of all parties is discharged when any party who has himself no right of action or recourse on the instrument
  - (a) reacquires the instrument in his own right; or
  - (b) is discharged under any provision of this Article, except as otherwise provided with respect to discharge for impairment of recourse or of collateral (Section 3-606).

132. Section 3-602 provides, without qualification:

No discharge of any party provided by this Article is effective against a subsequent holder in due course unless he has notice thereof when he takes the instrument.



only a very limited effect on remote and innocent takers.<sup>133</sup> And, as noted above, collateral writings affecting the negotiable instrument do not bind holders in due course without actual knowledge of their contents.<sup>134</sup> It is hard to discern a reason of policy for treating the suretyship defense case so differently.

But if the effect of Section 3-415 is not totally avoidable as to holders in due course, perhaps it can at least be minimized. For what kinds of circumstances and what sorts of defenses is the Section appropriate? What are the “discharges dependent upon his (the surety’s) character?”

The simplest cases to dispose of are those that relate to merely personal defenses, classically failure of consideration and fraudulent inducement. The cases say repeatedly that conduct of the creditor which totally defeats any possible liability by the principal debtor gives equal immunity to the surety.<sup>135</sup> But the surety’s defense can be viewed either as an adoption of that of his debtor, or as an injury to the surety himself resulting from a material alteration of the conditions for which he has bargained. The creditor’s conduct has substantially increased the chances of the principal debtor’s non-performance and hence materially altered the risk that the surety was prepared to underwrite.<sup>136</sup> Viewed as the debtor’s defense, the surety’s claim runs against the current of modern law, which is opposed to the assertion of a *ius tertii* even as against ordinary holders.<sup>137</sup> Viewed however as a non-performance of a condition precedent—as the surety’s own defense—it is a perfectly familiar personal defense, available against all who do not qualify as holders in due course.<sup>138</sup> None of the cases which purport to lay down suretyship law goes any further,<sup>139</sup> and they should not be gratuitously extended to implicate holders in due course.

133. See Sections 3-206, 3-304(2), 3-603(1)(b).

134. See Section 3-119, discussed pp. 850-51 *supra*.

135. In addition to the cases on total failure of consideration, cited note 84 *supra*, there are cases of partial failure of consideration, such as *Shakro v. Haddad*, 149 Conn. 160, 177 A.2d 221 (1961) and *Broad Wall Corp. v. O’Connor*, 37 Misc. 2d 408, 238 N.Y.S.2d 342, (Sup. Ct. 1962), in which the liability of the surety is scaled down to that of the underlying obligor.

136. Compare RESTATEMENT OF SECURITY § 118, Comment to Subsection (1) with *id.* § 126, Comment a (1941).

137. Under Section 3-306(d), claims of third persons are generally unavailable even against holders not in due course. For a discussion of the problem in general terms, see W. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES §§ 157-60 (2d ed. 1961).

138. Under Section 3-306(c)

Unless he has the rights of a holder in due course any person takes the instrument subject to

.....

(c) the defenses of want or failure of consideration, nonperformance of any condition precedent . . . .

139. None of the cases raising this type of defense involves holders in due course.

This analysis is equally appropriate to the principal debtor's real defenses. The principal debtor may have no liability because his signature was forged, or *ultra vires*, or the product of infancy or some other form of incapacity or illegality.<sup>140</sup> In most cases, these events constitute an alteration of the surety's contemplated risk,<sup>141</sup> and hence a change of conditions and a personal defense. But unless the surety himself was coerced or acting *ultra vires*, as to him the transaction is merely voidable, not void *ab initio*. Again, the relevant suretyship cases and treatises which protect the surety do so only in litigation involving ordinary holders. The few cases involving the forged signatures of co-makers to negotiable instruments have uniformly allowed holders in due course to recover from those whose signatures were genuine.<sup>142</sup> Except for the heinousness of the creditor's fraud, there is no more reason to prefer the surety over the due course holder here than in other instances of fraudulent inducement. As between a surety centrally involved in the initial negotiations and a remote and innocent holder in due course, there can be no doubt as to which has easier access to relevant information or readier channels for self-protection. The mere giving of notice of suretyship should not suffice to shift the risk of these inquiries from surety to due course holder.<sup>143</sup>

140. See, e.g., *Bologna Bros. v. Morrissey*, 154 So. 2d 455 (La. App. 1963), holding that a surety could raise the defense that a contract for the sale of liquor was illegal as to the obligor and therefore also illegal as to the surety himself.

141. For an example of risk-assumption by the surety, see the cases under the California antideficiency statutes which, although they protect the underlying debtor from a deficiency judgment, have been held to provide no defense to the accommodating endorser. See, e.g., *Engelman v. Gordon*, 242 Cal. App. 2d 510, 51 Cal. Rptr. 627 (1966); *Heckes v. Sapp*, 229 Cal. App. 2d 549, 40 Cal. Rptr. 485 (1964); *Stephenson v. Lawn*, 155 Cal. App. 2d 669, 318 P.2d 132 (1957). The California statutes and their relevance to a surety are discussed in *Hetland, Deficiency Judgment Limitations in California—A New Judicial Approach*, 51 CALIF. L. REV. 1, 23-28 (1963).

142. See, e.g., *Schmidt v. Archer*, 113 Ind. 365, 14 N.E. 543 (1887); *Wheeler v. Traders Deposit Bank*, 107 Ky. 653, 55 S.W. 552 (1900); *Morris Plan Co. v. Adler*, 126 Misc. 287, 213 N.Y.S. 227 (Sup. Ct. 1925) (under the N.I.L.). The most important Uniform Commercial Code case to date involved a co-maker contesting her liability to the immediate payee, an ordinary holder. Although she was allowed to demonstrate her accommodation status, she failed to establish her substantive complaint that the transaction was usurious. Under Pennsylvania law, the defense of usury is not available to a corporate borrower; despite the fact that the co-maker was an individual, the court held that, as accommodator, she could not raise a defense which her principal, a corporation, could not pursue. Implicit in the court's holding is the conclusion that if the transaction had been usurious as to the principal obligor, that finding would have furnished a defense to the accommodation party as well. The court does not address itself at all to the holder in due course problem. *Raby v. Commercial Banking Corp.*, 208 Pa. Super. 52, 220 A.2d 659 (1966). *Raby* has recently been followed, under similar circumstances, in New Jersey, *A. J. Armstrong Co. v. Janburt Embroidery Corp.*, 97 N.J. Super. 246, 234 A.2d 737 (1967).

143. Describing the requisites of a holder in due course, the Code in Section 3-302(1)(c) requires that he be without notice. Section 3-304 spells out what constitutes notice to a purchaser. Section 3-304(4) indicates:

Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim

.....

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In sum, the surety who signs a negotiable instrument should be held to the same basic standards as are other signatories of such paper. The surety may justifiably complain that alterations in the debtor-creditor relationship so materially affect his contemplated commitment as to avoid his own obligation, and that any defenses of the principal debtor to which he has not expressly or impliedly agreed involve such alteration. But suretyship law should not be read to require that this legitimate complaint of the surety be differentiated from other legitimate personal defenses of other parties to negotiable instruments. The surety may limit his liability by reference to defenses of the principal debtor only when he is sued by an ordinary holder, not in an action by a holder in due course.<sup>144</sup> Such a resolution is a reasonable compromise

(c) that any party has signed for accommodation . . . .

While this may be merely a restatement of the basic proposition that suretyship status per se is no defense, it is just as plausibly a policy choice of the type suggested. The difficulty in implementing this broader reading is that Section 3-304 may be superseded by the specific provisions of Section 3-415(3), if that subsection is read to apply to holders in due course. That is, Section 3-304(4)(c) at best says only that visible suretyship is not in and of itself inconsistent with due course holding, but Section 3-415(3) arguably subjects even due course holders to certain defenses.

144. Support for this position can be found in the analogous situation arising out of material alteration or incorrect completion of the face of a negotiable instrument. The Code deals with this problem in Section 3-407:

- (1) Any alteration of an instrument is material which changes the contract of any party thereto in any respect, including any such change in
  - (a) the number or relations of the parties; or
  - (b) an incomplete instrument, by completing it otherwise than as authorized; or
  - (c) the writing as signed, by adding to it or by removing any part of it.
- (2) As against any person other than a subsequent holder in due course
  - (a) alteration by the holder which is both fraudulent and material discharges any party whose contract is thereby changed unless that party assents or is precluded from asserting the defense;
  - (b) no other alteration discharges any party and the instrument may be enforced according to its original tenor, or as to incomplete instruments according to the authority given.
- (3) A subsequent holder in due course may in all cases enforce the instrument according to its original tenor, and, when an incomplete instrument has been completed, he may enforce it as completed.

Under Section 3-304, a purchaser who would otherwise qualify as a holder in due course is not easily deemed to have notice of alteration or improper completion. Subsection (1) provides:

The purchaser has notice of a claim or defense if

- (a) the instrument is so incomplete, bears such visible evidence of forgery or alteration, or is otherwise so irregular as to call into question its validity, terms or ownership or to create an ambiguity as to the party to pay. . . .

Subsection (4) adds:

Knowledge of the following facts does not of itself give the purchaser notice of a defense or claim

- . . . .
- (d) that any incomplete instrument has been completed, unless the purchaser has notice of any improper completion. . . .

In these examples of variations from original expectations, the Code is solicitous of the rights of the due course holder, but not of ordinary holders; in the case of incorrect completion, the due course holder can fully enforce the writing as he found it. There is in the suretyship context no easy compromise solution comparable to the enforcement of the materially altered instrument according to its original tenor.

of the potentially adverse claims of the laws of negotiability and of suretyship. It looks to suretyship for a source of implied conditions to the surety's liability, and to negotiability for guidance as to the circumstances under which these implied conditions are to be operative. So limited a reading of the "discharge" language, although not an intuitively obvious interpretation of Section 3-415, has merits of over-all plausibility and workability which the surface reading does not.

### B. *Direct Defenses*

There are, of course, numerous causes for complaint under the law of suretyship which are not tied to infirmities in the negotiation of the original debtor-creditor contract. Does Section 3-415 contemplate that any visible surety be entitled at least to these defenses against all comers as a matter of right?

Three types of potential defenses will suffice to raise the issues. The surety has classically been permitted to assert as a defense the creditor's discharge of the principal debtor, since such a discharge fundamentally undercuts the surety's right to reimbursement.<sup>145</sup> In a frequently litigated subclass of this type of defense, the creditor grants a binding extension of credit to the debtor, thereby temporarily frustrating the surety's opportunity for liquidating the transaction.<sup>146</sup> A second type of defense arises out of the creditor's mishandling of collateral deposited with the creditor for the greater security of all of those who may have a stake in the transaction, including, by way of subrogation, the surety.<sup>147</sup> A third type of defense, available in a substantial minority of states, permits the surety to avoid liability if he has effectively communicated to the creditor an urgent and unheeded request for immediate pursuit of the debtor.<sup>148</sup>

All of these defenses raise the same general complaint: unreasonable and unauthorized alteration of the risks contemplated by the suretyship commitment. In the suretyship law they all typically appear in cases of direct dealings, involving one debtor, one creditor and one surety. When these cases arise in the context of a negotiable instrument, there are at least two additional complicating factors. One involves an assessment of the risk allocation inherent in the choice of a

145. See L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP §§ 63-71, at 296-328 (1950).

146. *Id.* § 73, at 351.

147. *Id.* §§ 74-76, at 370-89.

148. *Id.* §§ 42, 43; Comment, *The Doctrine of Pain v. Packard*, 37 YALE L.J. 971 (1928). In those states in which the doctrine is statutory, it apparently survives enactment of the Uniform Commercial Code. For example, CAL. CIV. CODE § 2845 (West 1957) was not repealed when the Code was enacted.

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negotiable form of commitment, discussed above.<sup>149</sup> As to this, the Code has chosen to abandon conclusive presumptions attributing greater risk-assumption to accommodation co-makers than to accommodation indorsers.<sup>150</sup> But negotiability also invites negotiation, with the possibility that the surety may complain of nefarious conduct by any of a number of possible predecessors of the holder now seeking to enforce the instrument.

Are these defenses, long cherished by sureties as central to their undertaking, the core of substance to which Section 3-415 addresses itself? Do they represent those sources of discharge so inherent in the nature of accommodation character that they are to be specially treated? If so, how?

Again, the ultimate testing ground of the impact of the Section must be the case of the holder who is a holder in due course and whose only warning of suretyship defenses arises out of the identification of one of the parties to the instrument as a surety. The ordinary holder, subject even to conditions which only derivatively impair the surety's security,<sup>151</sup> is certainly subject to those which directly alter the latter's

149. See pp. 863-65 *supra*.

150. Article 3's concern to protect the surety's right to reimbursement is evidenced not only by the preservation of these defenses of suretyship law, which look peculiarly to potential impairment of recourse, but also by Section 3-415(5)'s express provision that the paying surety has a right to sue the party accommodated "on the instrument," with the attendant advantages of favorable presumptions to ease proof and recovery. See Section 3-307. Subsection (5) thus resolves a conflict of the pre-Code law illustrated by *Lill v. Gleason*, 92 Kan. 754, 142 P. 287 (1914), and *Quimby v. Varnum*, 190 Mass. 211, 76 N.E. 671 (1906); see W. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES § 297 (2d ed. 1961). When the surety sues the underlying obligor, he is exercising both the right to reimbursement, to which the surety is entitled by virtue of his own status, and the creditor's right to collect, to which he is subrogated by virtue of paying the creditor. See L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP §§ 47, 48 (1950). Occasionally, reliance on these alternate theories may lead to differences in monetary claims, as when the surety pays off the creditor at a discount: since the creditor could have sued the obligor for the face value of the instrument, the paying accommodator could argue that, subrogated to this claim, he too can hold the obligor to the terms of the instrument; on a reimbursement theory, he would be entitled only to be made whole for the cost of his payment. Although the wording of subsection (5) lends support to the subrogation theory, it is not necessary to read the right to sue "on the instrument" as a right to collect the face value of the instrument. Pre-Code law, with few exceptions, allowed the surety no greater recovery than that to which reimbursement would entitle him; it considered subrogation an aid to enforcement of reimbursement rights rather than a totally alternative substantive remedy. See 4 S. WILLISTON, CONTRACTS § 1285 (rev. ed. 1936). The principal case to the contrary, *Fowler v. Strickland*, 107 Mass. 552 (1871), was disowned in its own jurisdiction in *Merchants Discount Co. v. Federal St. Corp.*, 300 Mass. 167, 14 N.E.2d 155 (1938). Section 3-415(5) cannot have been intended to revive the discredited *Fowler* case and should not be so interpreted.

151. Article 3 contains another section which apparently limits the rights of holders in due course against visible sureties. The section describing the warranty liability of indorsers of negotiable paper is carefully drafted to exclude the accommodating indorser: under Section 3-417(2), only a person who "transfers an instrument and receives consideration" makes warranties. It is doubtful whether this section is effective, against a holder in due course, when the surety's indorsement gives no warning of accommodation

commitment.<sup>152</sup> At the other extreme, the innocent holder in due course has no responsibilities to the entirely latent surety.<sup>153</sup> However, even the holder in due course who belatedly, after acquisition, discovers the true character of one of the signatories must thereafter treat paper and collateral with the caution that Section 3-606 commands.<sup>154</sup> That Section is clear that the holder who knows of rights of recourse may not himself release or agree not to sue the underlying debtor, nor may he impair any collateral against which a right of recourse might be exercised. But Section 3-606, particularly when read with the surrounding sections, is equally clear that the discharge which results from violation of its mandates is only effective between the parties immediately affected, is only a personal defense, and is not an answer to a suit by a subsequent and innocent holder in due course.<sup>155</sup>

status, *i.e.*, in the absence of irregularity of position (*cf.* Section 3-315(4)) or explicit legend of guaranty. Sued by an innocent holder in due course, the surety is likely to find his exclusion demoted to a mere personal defense, and hence unavailable. Such warranty liability may be important in the event of discharge of the indorsement engagement by, for example, unexcused delay in presentment; delays in presentment discharge the indorsement engagement of all accommodation indorsers who do not waive these formal conditions expressly or through a contract of guaranty. *See* Section 3-416(5). The design of Section 3-417(2) was, however, to interdict rather than to preserve the alternative of warranty liability under suretyship circumstances. If the design cannot be totally effectuated, it is at least likely to be invoked to protect the surety who has taken pains to make himself visible; the visible suretyship is in effect a disclaimer of warranty. Disclaimers do not interfere with holder in due course status: it is possible to be such a holder in the face of an indorsement "without recourse" or an indorsement warning of accommodation (*see* Section 3-304(4)(c)). But even the holder in due course cannot pursue the qualified indorser as if he were unqualified, or the visible surety as if he were a negotiating indorser.

152. *See* Section 3-306(c) and pp. 865-67 *supra*.

153. These defenses, dependent upon suretyship status and arising directly out of suretyship law, are, on the one hand, a direct source of discharge against an ordinary holder, under Section 3-415(3), and, on the other hand, represent implied conditions of the suretyship undertaking under Section 3-306(c). Either way, one who is not a holder in due course cannot avoid them.

154. The question of what makes a surety visible is one on which Sections 3-415 and 3-606 do not entirely track. Under Section 3-415(4), "an indorsement which shows that it is not in the chain of title is notice of its accommodation character"; and under Section 3-415(3) a holder is tested as to his "notice of the accommodation." But Section 3-606(1)(a) speaks of the holder's "knowledge" of rights of recourse, while Section 3-606(1)(b) discharges anyone who "has" a right of recourse. Presumably the knowledge criterion of Section 3-606(1)(a) should be imported into (1)(b) so that the entirely latent surety cannot suddenly claim discharge from impairment of collateral; this result might also be achieved by a purposive reading of what impairment is "unjustifiable." But "knowledge" is a less expansive qualification than "notice" under Section 1-201(25). It is therefore possible that the irregular indorser has accommodation status under Section 3-415 but is not necessarily, in the absence of actual knowledge, known to have rights of recourse under Section 3-606. This is not, I think, the better reading of Section 3-606, but the unfortunate use of similar but not identical language in the two sections makes a literal and narrow reading of Section 3-606 possible.

155. Section 3-606 reads as follows:

- (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

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If Section 3-415(3) subjects a non-participating holder in due course to those defenses merely because he knows that one of the parties is a surety, it will of course substantially depreciate the value of instruments bearing such a notation.<sup>150</sup> On the other hand, suretyship is a commercially desirable institution of a type which the Code is clearly designed to support, and its risks ought not casually to be underestimated or extended. And insofar as the mishandling of negotiable paper or collateral occurs while the instrument is in the hands of an intermediate holder, neither surety nor ultimate holder has special access to controls which might avoid the events which give rise to these defenses.

It is of course true that during the 50 years in which the Negotiable Instruments Law was in force, suretyship managed to survive despite

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; or

- (b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.
- (2) By express reservation of rights against a party with a right of recourse the holder preserves
  - (a) all his rights against such party as of the time when the instrument was originally due; and
  - (b) the right of the party to pay the instrument as of that time; and
  - (c) all rights of such party to recourse against others.

The Section is noteworthy in several respects. First, it extends its protection to all those known to have a right of recourse, regardless of their capacity on the instrument or whether they are signatories to the instrument at all. Second, the Section may be avoided by the consent of those who have a right of recourse, a qualification which has been broadly interpreted in *London Leasing Corp. v. Interfina, Inc.*, 53 Misc. 2d 637, 279 N.Y.S.2d 209 (Sup. Ct. 1967), and *A.J. Armstrong, Inc. v. Janburt Embroidery Corp.*, 97 N.J. Super. 246, 234 A.2d 737 (1967), to cover those who participate in renegotiation of a debt whose payment they have guaranteed. But Section 3-118(f) construes narrowly the standard consent clause often contained in the negotiable instrument itself. Third, an alternative avoidance technique, except for the impairment of collateral, is the reservation of rights against an accommodating party. Fourth, the discharge which the Section provides is not necessarily a total discharge but may be only pro tanto. This makes eminently good sense in the case of impairment of collateral, in which the surety has traditionally been protected only to the extent of the security wrongfully released. See L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 74 (1950). But when the surety complains of wrongful release of his debtor, or extension of time for payment, to what extent is the surety then discharged? Under the general law of suretyship, absent consent or reservation of rights, all sureties were totally discharged by release of the underlying obligor, and uncompensated sureties were equally released by extensions; compensated sureties were released in the latter case only to the extent that they could show injury. *Id.* §§ 63, 73. If all those who have a right of recourse must now demonstrate the extent to which their reimbursement rights have been impaired, Section 3-606 will be less useful to them than has generally been thought.

156. Section 3-601 lists Section 3-606 as one of the sources of discharge, in subsection (1)(d); Section 3-602 then goes on to provide flatly:

No discharge of any party provided by this Article is effective against a subsequent holder in due course unless he has notice thereof when he takes the instrument.

fewer defenses than were available during the 19th Century,<sup>157</sup> or than the Code now promises to guarantee. Furthermore, in practice those defenses which were available to secondary parties under the Negotiable Instruments Law were not, as far as is readily discoverable, asserted against later due course holders.<sup>158</sup> Reflection about the operation of these defenses suggests why this confrontation would not readily have arisen. The only suretyship defenses expressly recognized under the Negotiable Instruments Law were those relating to discharge or delay

157. For many years, there was recurrent debate, particularly in academic circles, about the Negotiable Instrument Law's apparent failure to allow suretyship defenses of any kind to accommodation makers. This gap in the Negotiable Instruments Law was discovered by Dean Ames in his initial commentary on the then newly promulgated statute (in whose drafting he had not been invited to participate). Ames, *The Negotiable Instruments Law*, 14 HARV. L. REV. 241, 255 (1900). Dean Ames' article was the opening salvo in what came to be known as the Ames-Brewster controversy, Brewster, as President of the National Conference on Uniform Laws, undertaking with a certain amount of acerbity to defend the Negotiable Instruments Law. See Brewster, *A Defense of the Negotiable Instruments Law*, 10 YALE L.J. 84 (1901); Ames, *The Negotiable Instruments Law. A Word More*, 14 HARV. L. REV. 442 (1901); Brewster, *The Negotiable Instruments Law—A Rejoinder to Dean Ames*, 15 HARV. L. REV. 26 (1901); McKeehan, *The Negotiable Instruments Law (A Review of the Ames-Brewster Controversy)*, 50 AM. L. REV. 437, 499, 561 (1902); Ames, *The Negotiable Instruments Law—Necessary Amendments*, 16 HARV. L. REV. 255 (1903). The early case law almost uniformly read this gap as an intentional omission denying the surety his traditional defenses if he signed a negotiable instrument in the capacity of maker (or acceptor). See, e.g., *Cellers v. Meachem*, 49 Ore. 186, 89 P. 426 (1907); *Vanderford v. Farmers & Mechanics' Nat'l Bank*, 105 Md. 164, 66 A. 47 (1907); *Union Trust Co. v. McGinty*, 212 Mass. 205, 98 N.E. 679 (1912), all involving known sureties precluded from defense against ordinary holders not in due course.

In the late 1920's, there was renewed interest in amendment of the Negotiable Instruments Law to reverse this result. See Turner, *Revision of the Negotiable Instruments Law*, 38 YALE L.J. 25, 48-49 (1928); Turner, *A Factual Analysis of Certain Proposed Amendments to the Negotiable Instruments Law*, 38 YALE L.J. 1047, 1056-58 (1929). No official amendments were ever promulgated on this issue.

The case law under the Negotiable Instruments Law came to be more divided than the earliest interpretations had indicated, but the majority of cases read the Negotiable Instruments Law strictly, literally, and exclusively, to deny the surety-maker at least the defense of unconsented extensions of time. The cases are collected in J. BRANNAN, *NEGOTIABLE INSTRUMENTS LAW* 1120-33 (7th ed. F. Beutel 1948); W. BRITTON, *HANDBOOK OF THE LAW OF BILLS AND NOTES* § 301 (2d ed. 1961), and discussed in an excellent article, Hilpert, *Discharge of Latent Sureties on Negotiable Instruments Because of Release or Extension of Time*, 50 YALE L.J. 387 (1941). Recent examples of cases denying accommodation makers suretyship defenses include *United States v. Birngold Realty Co.*, 211 F. Supp. 934 (S.D.N.Y. 1962), *aff'd sub nom. United States v. Schildhaus*, 316 F.2d 240 (2d Cir. 1963) (per curiam); *Kratovil v. Thieda*, 36 Ill. 2d 247, 222 N.E.2d 485 (1966); *Rose v. Homsey*, 347 Mass. 259, 197 N.E.2d 603 (1964); *James Employment Credit Union v. Hawley*, 2 Wis. 2d 490, 87 N.W.2d 299 (1958); these are all extension cases, except for the Massachusetts case alleging impairment of collateral.

The *Kratovil* case is worthy of special mention, because it was decided under unusually provocative circumstances. The case arose pre-Code, and thus the surety could not claim the protection which the Code, enacted at the time of decision, would have afforded him. But there were no Illinois cases on this issue under the Negotiable Instruments Law, and the 19th Century Illinois case law was consistent with the Code result. Nonetheless, Justice Schaefer for a unanimous court chose to abide by the majority construction of the Negotiable Instruments Law, even though he acknowledged that the decisions under that statute "have not been uniform, either in result or in approach." 36 Ill. 2d at 249, 222 N.E.2d at 486.

158. Research uncovered no case in which a holder in due course was met with this kind of defense.



of the obligation of the principal debtor.<sup>159</sup> But no holder could effectively alter the debtor's obligation<sup>160</sup> without marking the instrument in some way which would make it difficult for a subsequent taker to be without notice.<sup>161</sup>

The same practical considerations limit the scope of the problem under the Code. Releases or agreements not to sue would not protect the debtor against later holders unless the later holder had notice of such limitations when he took the instrument;<sup>162</sup> presumably, such agreements dehors the instrument would therefore be deemed to be mere forbearances and not binding releases. If the instrument reflected the debtor's partial or total discharge, a purchaser would have notice of "any defense against it" and could therefore not qualify as a holder in due course.<sup>163</sup> Failure to pursue the debtor after an appropriate request by the surety can only discharge the surety after the debtor's obligation is due and owing, and hence can arise only on an

159. Under Section 120 of the Negotiable Instruments Law:  
A person secondarily liable on the instrument is discharged:

- . . . .
- (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.

160. Understandably, a good deal of the case law about extensions and releases revolves about the issue of whether or not any effective alteration of the underlying indebtedness was ever consummated. A number of cases have held, for example, that the mere fact that the creditor/holder participates in a bankruptcy or receivership proceeding or in a composition agreement does not mean that he has released anyone. *See, e.g.,* Lamothe & Young, Inc. v. Vehs, 148 Conn. 115, 167 A.2d 709 (1961); Heckman v. National Bank, 201 A.2d 688 (D.C. Mun. App. 1964); F.D. Cline Paving Co. v. Southland Speedways, Inc., 250 N.C. 358, 108 S.E.2d 641 (1959). Nor is the execution of a new note without the surety necessarily conclusive about the continuing validity of the old note retained by the creditor/holder. *Compare* Polk Chevrolet, Inc. v. Vicaro, 162 So. 2d 761 (La. App. 1964) (not a release) *with* Card v. Commercial Bank, 119 So. 2d 404 (Fla. App. 1960) (a binding extension of time, so indorser discharged). Of course, if only the new note were negotiated to a subsequent holder, he could not sue the surety who was not a party to that instrument. If the original note were so negotiated, a case not illustrated by any recent reported litigation, any indication of change in due date would be a visible alteration of the instrument sufficient in itself to avoid it, under Section 124 of the Negotiable Instruments Law, as to non-consenting parties; such a negotiation without a marking of the instrument would indicate that no release or time extension, except as a matter of grace, had been intended.

161. *See* Negotiable Instruments Law §§ 52(4), 56.

162. Under Section 3-602:

No discharge of any party provided by this Article is effective against a subsequent holder in due course unless he has notice thereof when he takes the instrument.

163. Section 3-302(1)(c) requires a holder in due course to be without notice of "any defense against or claim to" the instrument. Under Section 3-304(1)(a), any visible alteration constitutes notice of a claim or defense if it calls into question the instrument's validity, terms or ownership; certainly the validity of the altered instrument against a nonconsenting party is a matter of substantial doubt under Section 3-407. What happens if an alteration is accompanied by a reservation of rights authorized by Section 3-606(1)(a) is not clear. The only Code case finding an effective reservation of rights does not spell out how this was accomplished; nor does it involve a subsequent negotiation. *Priggen Steel Buildings Co. v. Parsons*, 350 Mass. 62, 213 N.E.2d 252 (1966).

instrument which is overdue;<sup>164</sup> such an instrument cannot be taken in due course except in the rare instances in which the instrument's maturity is ambiguous.<sup>165</sup>

However, not all the potential difficulties vanish so readily upon inspection. In particular, the defense of improper handling of collateral security is a peculiarly sensitive point of conflict. Dissipation of collateral is hardly ever likely to be a fact of which a later holder would have notice when he buys a negotiable instrument. Yet loss of such security is both difficult for the surety to foresee or to prevent and inherently prejudicial when it occurs.

How, then, is this conflict to be resolved? One solution would be to read Section 3-415's "discharges dependent on his character" as a closed-end reference to Section 3-606. In other words, Section 3-415 could be simply a general account of the relationship between accommodation status and negotiable instruments, providing some guidance on problems of formation, recourse, and proof, and also a reminder that special defenses may be appropriate under undefined circumstances. For defenses in general, then, one would look to what excuses are appropriate against ordinary holders and holders in due course; for sources of discharge, one would look to the specific discharge provisions of Part 6. The official cross references do in fact include a citation to Section 3-606. Under that Section, the holder with an instrument bearing a visible surety would be disabled from himself prejudicing the surety, but would have no further duty of inquiry about prior dissipation of collateral of which he was innocent.

There are several reasons why such a solution is appealing. First, it gives content to what is otherwise an entirely unguided reference to suretyship law—a reference the more frustrating since suretyship law will not provide answers for negotiable instruments cases, which careful textwriters typically set aside as a special and unconsidered case.<sup>166</sup> To extrapolate from suretyship law the rights of holders in due course versus accommodation parties is to reason from that which does not exist. Furthermore, a closed-end reference to other parts of the Code

164. The doctrine of *Pain v. Packard* is usually put in terms of compelling the creditor to collect from the principal debtor after that debtor's default. See L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 42, at 178-79 (1950). In any case, no possibility of pursuit could arise before maturity of the underlying instrument.

165. Under Section 3-302(1)(c), a holder who otherwise qualifies for due course status is foreclosed not by the fact that he purchased an overdue instrument, but only by his purchase with notice that the instrument is so outdated. Section 3-304(3) elaborates on what constitutes notice that an instrument is overdue. The most obvious example of ambiguity arises out of exercise of an optional acceleration clause.

166. See, e.g., RESTATEMENT OF SECURITY §§ 127, 129 (1941); L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 16 (1950).

would be conducive to the development of the uniform standards and practices which a Uniform Code should foster.<sup>167</sup> Finally, what general suretyship law there is on the creditor's disposition of collateral indicates that this is a defense of the surety which the courts have seen fit to define narrowly, to limit rather than to expand. Most courts view the creditor's access to collateral and surety as two entirely distinct assets, for each of which the creditor is deemed to have bargained, and to each of which he is entitled with a minimum of fuss and bother and judicial second-guessing. For example, California courts have recently refused to extend the benefits of anti-deficiency statutes to sureties,<sup>168</sup> and a Florida court has refused to compel a creditor bank to exercise its rights of lien and setoff on behalf of a surety.<sup>169</sup> Other courts have been similarly unimpressed by the surety's complaint that the creditor should have recorded his collateral interest<sup>170</sup> or enforced it speedily.<sup>171</sup>

Of course, the narrowness of the impairment of collateral defense can also be turned the other way, to support a literal reading of Section

167. A closed-end reference has, of course, implications other than third-party consequences. It means that the only bases for discharge because of accommodation status are those listed in Section 3-606: releases, extensions, impairment of collateral. It means that other defenses are not covered: the derivative defenses just discussed in text, as well as direct defenses such as the doctrine of *Pain v. Packard*, discharging a surety if a creditor neglects to pursue the underlying obligor; *Pain v. Packard*, in that minority of states in which it prevails, has from time to time been successfully invoked by signatories of negotiable instruments. See Comment, *The Doctrine of Pain v. Packard*, 37 YALE L.J. 971, 975 (1928). Exclusion of these suretyship defenses from Section 3-415 need not however signal their total unavailability; although demoted from the category of discharge, they may survive as personal defenses, for breach of implied condition, under Section 3-306(c), to defeat claims of holders not in due course. A closed-end reference would impose national uniformity on discharges, affecting holders in due course, while allowing local option to prevail on what suretyship defenses bind ordinary holders.

168. See, e.g., *Engelman v. Gordon*, 242 Cal. App. 2d 510, 51 Cal. Rptr. 627 (1966); *Heckes v. Sapp*, 229 Cal. App. 2d 549, 40 Cal. Rptr. 485 (1964); *Stephenson v. Lawn*, 155 Cal. App. 2d 669, 318 P.2d 132 (1957); and *Hetland, Deficiency Judgment Limitations in California—A New Judicial Approach*, 51 CALIF. L. REV. 1, 23-28 (1963).

169. *Central Bank & Trust Co. v. Meltzer*, 145 So. 2d 766 (Fla. App. 1962). See also *Bank of Hawaii v. Char*, 43 Hawaii 17 (1958); *Smith v. First Pasadena State Bank*, 401 S.W.2d 123 (Tex. Civ. App. 1966).

170. See *Rose v. Homsey*, 347 Mass. 259, 197 N.E.2d 603 (1964); cf. *United States v. Vince*, 270 F. Supp. 591 (E.D. La. 1967); *Nation Wide, Inc. v. Scullin*, 256 F. Supp. 929 (D.N.J. 1966) (both non-negotiable guaranty cases).

171. Sureties have not been discharged by the creditor's delay in foreclosing, see *United States v. Helena Office Supply Co.*, 256 F. Supp. 53 (D. Mont. 1966); *Fidelity Sav. Bank v. Wormhoudt Lumber Co.*, 251 Iowa 1121, 104 N.W.2d 462 (1960); in repossessing, see *First Nat'l Bank v. G.R. Wood, Inc.*, 89 N.J. Super. 577, 215 A.2d 784 (1965); or in liquidating collateral, see *House of Loans, Inc. v. Matassa Motor Co.*, 115 So. 2d 210 (La. App. 1959). On the other hand, if the creditor's handling of the collateral so violates statutory deficiency and resale procedures as to discharge the underlying debtor, and hence to impair the surety's right to reimbursement, the surety may get off. *Manufacturers Hanover Trust Co. v. Goldstein*, 25 App. Div. 2d 405, 270 N.Y.S.2d 261 (Sup. Ct. 1966); *Economy Sav. & Loan Co. v. Weir*, 105 Ohio App. 531, 6 Ohio Op. 2d 254, 153 N.E.2d 155 (1957). Surprisingly, some recent cases have required greater circumspection about insurance of collateral. In *Woodruff Motors, Inc. v. Commercial Credit Corp.*, 123 Vt. 404, 190 A.2d 705 (1963), indorsers were allowed to use defensively the creditor's failure to notify them of insurance cancellation; and in *United States v. Fyles*, 253 F. Supp. 386 (D. Vt. 1965), the court went even further to suggest circumstances under which the creditor himself might have the obligation to procure insurance.

3-415 which would protect the visible surety. If only very unreasonable (and hence highly prejudicial) conduct triggers the defense, perhaps it is unfair to impose this risk on the surety who has, after all, tried to protect himself by giving warning of his existence. But this argument is persuasive only if major impairment of collateral is easily discoverable by a potential purchaser of negotiable paper and readily distinguishable from what courts would consider minor and permissible infractions. It is the costs of such an inquiry, as well as the judicial risk of misassessment of that which it unearths, against which the holder in due course can legitimately claim immunity.

The strongest case that can be made for a literal reading of Section 3-415 rests on somewhat different, though related, premises. If it becomes well-understood that general suretyship defenses can be raised once suretyship is known, prospective purchasers are likely not to invest in such negotiable paper without inquiring of the surety whether, perchance, he has some defenses. If the surety should reply that he does not or if, having been given a reasonable opportunity to do so, he does not reply at all, presumably he would be estopped from raising the defense at a later date. If, however, the surety is careful to indicate only that he does not presently know of any defenses which he might have, such an estoppel will not lie. But in that event principles of good faith and fair dealing might impose a duty of further investigation on one side or the other, depending upon facts not subject to generalization. The widow-surety and the corporate-officer-surety would predictably be treated differently. In other words, the literal reading of Section 3-415 can be defended as a policy decision to avoid, as unnecessarily arbitrary, legislative rule-making in residual situations for which no particular factual model is clearly discernible.

In the final analysis, the choice between the variant interpretations of Section 3-415 rests on an evaluation of the importance on the one hand of reasonably predictable commercial rules, and on the other of judicial flexibility in administering the variety of relationships which result in accommodation status. How the first court to cope with this problem resolves the conflict of values remains to be seen; it will undoubtedly be influenced as much by the factual patterns before it as by the guidance it has gotten from the Code.

#### IV. Conclusion

The Code's treatment of the negotiable suretyship obligation in Article 3 is a puzzling one. While it is clear that the governing provi-

sions were meant to provide the surety with greater safeguards than he had enjoyed under pre-existing law, the extent of the Code's beneficence is difficult to ascertain. The surety's expectations are most likely to be protected when he is competing with a holder not in due course, but even then he may be limited by the precise terms of his commitment on the instrument. When the surety is faced by a holder in due course, surely a likely adversary on negotiable paper, countervailing policies of unclogged negotiability and inquiry-free transfer make his position highly precarious.

What is curious about Article 3's response to these inevitable conflicts is not its unwillingness to award full priority to the tender sensibilities of the surety, but rather its reluctance to demarcate where suretyship principles should be subordinated to other important commercial considerations. The draftsmen's unmistakable intention to strengthen the institution of suretyship, deriving no doubt at least in part from a felt need to preserve alternatives to the Article 9 security device, is considerably diluted in effect by the Article's failure to spell out operative guidelines for determining the liability of the potential surety.

The Code's failure to deal comprehensively with this problem cannot be explained by a dearth of data or case law. This is not a newly developing field of practice, such as subordination clauses, to which draftsmen should respond at best in gingerly or open-ended fashion.<sup>172</sup> The resolution of conflicts between sureties and creditors and their successors in interest has been familiar ground for litigation for decades.<sup>173</sup>

Nor can it be argued that the Code's draftsmen were oblivious to the commercial importance of providing factual criteria which would allow the contracting parties to predict accurately the scope of their rights and duties without the constant threat of litigation. On the contrary, one of the Code's most salient and most convincing selling points during the enactment process was precisely that it would not only modernize but also make more certain the governing principles for commercial law. Legal consequences are to be stated, according to one of the early comments, so as to avoid "making practical issues between practical men turn upon the location of an intangible something."<sup>174</sup> "The scheme of the Article [Article 9, in fact, but presuma-

172. See Gilmore, *Article 9: What It Does Not Do For the Future*, 26 LA. L. REV. 300 (1966).

173. See, e.g., sources cited note 157 *supra*.

174. Section 2-101, Comment.

bly the rest of the Code as well] is to make distinctions, where distinctions are necessary, along functional rather than formal lines."<sup>175</sup>

Yet the inconclusive resolution of the competing claims of suretyship and negotiability law has its counterpart in other sections of the Code. For example, the position of the seller who, under Article 2, has residual property rights in potential conflict with the interests of purchasers and creditors depends upon time-honored, open-ended criteria such as good faith, voidable title, and lawful possession.<sup>176</sup> Only where such a seller entrusts his goods to a merchant is his priority position clear—and fatal, in most instances.<sup>177</sup> The parallel situation in the suretyship case is the contest between latent surety and innocent holder in due course.

The analogy between the Article 2 quasi-secured seller and the Article 3 accommodation party is an instructive one because in both instances the Code's vagueness reflects an absence of sound factual models upon which to build. The beauty of the common law notion of voidable title was that it could be stretched or contracted to fit a large variety of deceptive deals, depending upon the relative equities of the particular case.<sup>178</sup> Where, out of this mass of potential situations, some recurrent factual patterns such as cash sale, or bouncing checks, or mistaken identity can be identified, the Code removes them from the operative range of the voidable title construct.<sup>179</sup> It is only the unstructured residue which is left open-ended. The problem with the law of negotiable suretyship is that it is all unstructured residue.

It is inherent in the skeletal nature of the negotiable instrument that it can be used for a wide variety of business deals. Superimpose upon this the fact that a surety may be a generous friend, a gullible relative, a corporate director, or a merchant discounting receivables. Consider further that subsequent takers may be either sophisticated commercial credit institutions or sporadic purchasers of investment paper. No fixed set of rules could operate justly in all the unpredictable situations which can arise.

Against this background, the draftsmen's decision to lay down non-rules, or semi-rules, is understandable and defensible, once the judgment to codify at all has been made. And it is now too late to question

175. Section 9-101, Comment.

176. Section 2-403(1).

177. Section 2-403(2).

178. See Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1058-59 (1954).

179. Section 2-403(1)(a)-(d).

the wisdom of so broad a codification as the Uniform Commercial Code presents—despite recurrent feelings of unease about the real-world counterpart to Karl Llewellyn's great vision. If it is occasionally necessary to over-codify some few parts of the law without adequate factual referents in order to preserve the continuity and coverage of the Code as a whole, that may simply be the price to be paid for comprehensive law-making and legislative reform. Still, that price could and should be minimized by indicating with greater clarity than the Code now does when and where issues have deliberately been left open for continued case law development.

What emerges, then, as the 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 courts those degrees of freedom which the Code decided, correctly, to preserve.

The choice of a suretyship form of security will continue, under Article 3, to be a much less formal, a much less structured, a much less confining contractual device than even the free-swinging security interest under Article 9. Only the parties themselves can properly balance the virtue of these freedoms against the concomitant risks of uncertainty which the suretyship arrangement entails.