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History and Background of the Restatement of Suretyship

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HISTORY AND BACKGROUND OF THE *RESTATEMENT OF SURETYSHIP*

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I. INTRODUCTION

The *Restatement (Third) of Suretyship*[1] has been a remarkable project in that people from two diverse groups,[2] with different perspectives and disciplines, have worked together to produce a product that will not only be academically sound, but will also have great utility in practice. At the same time, within each of these two groups, the project reflects the cooperative efforts of people who have known and worked with one another for many years and have jointly contributed their intellect and expertise for the purpose of producing a work of great importance. This Article recounts the history and background of the *Restatement (Third) of Suretyship* and, with some hesitation, also recalls my personal involvement with the project.

Primary credit for the development of the *Restatement of Suretyship* must be given to Professor Geoffrey C. Hazard, Jr.,[3] Direc-

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1. All references to the *Restatement (Third) of Suretyship* are to Tentative Draft No. 1 (Mar. 23, 1992), as modified and supplemented by Tentative Draft No. 2 (Apr. 2, 1993).

2. One group is composed of attorneys who regularly represent commercial lenders and are accustomed to drafting comprehensive guaranty and credit enhancement agreements upon which their clients place great reliance. The second group is made up of attorneys from the "suretyship industry" who regularly represent the issuers of payment bonds, performance bonds, fidelity bonds, and the like. *See infra* text accompanying notes 9-16. These two groups, together with several academics, comprise the Advisers to the *Restatement of Suretyship*.

3. Professor Hazard and I were classmates at Columbia Law School. More recently, we have worked together on the Permanent Editorial Board for the Uniform Commercial Code. There are other significant Columbia Law School connections in this project. Professor E. Allan Farnsworth, the Reporter for the *Restatement (Second) of Contracts*, which contains many provisions dealing with suretyship, is an essential Adviser to the *Restatement of Suretyship*.

tor of the American Law Institute (ALI) and Chairman of the Permanent Editorial Board for the Uniform Commercial Code (Board). Following a discussion at a meeting of the Board, I wrote to Professor Hazard on May 30, 1986, "recommending an ALI study of the law of suretyship with a view to (1) having a *Restatement of the Law of Security 2d* and (2) reviewing and expanding the suretyship rules in the Uniform Commercial Code—possibly in a new Article."[4] The first reference was to the common law of suretyship as presently set forth as Division II of the *Restatement of Security*,[5] which was published in 1941.[6]

This recommendation involved some personal nostalgia. Professor John Hanna of Columbia Law School was the Reporter for the *Restatement of Security* Years later, from 1952-1955, he was the Consultant on Article 9 for the New York Law Revision Commission in its monumental study of the then-proposed Uniform Commercial Code.[7] As his student research assistant on that project, I came to know him very well. Professor Hanna was an outstanding authority on commercial law and authored a number of texts, including his *Cases and Materials on Security*[8] which, in effect, serves as a supplement to the *Restatement of Security* I owe much of my background in commercial law to Professor Hanna

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4. Letter from Donald J. Rapson, General Counsel, C.I.T. Corp., to Geoffrey C. Hazard, Jr., Professor, Yale Law School 1 (May 30, 1986) (on file with author). See *infra* Appendix A for the full text of this letter.

5. RESTATEMENT OF SECURITY §§ 82-211 (1941). Division I deals with pledges which, of course, are presently covered in large part by Articles 8 and 9 of the Uniform Commercial Code.

6. In May 1990, Professor Neil B. Cohen of Brooklyn Law School, who later became Reporter for the *Restatement of Suretyship*, provided a preliminary report in which he noted that "the Restatement of Security has been the second least cited Restatement, having been cited only 963 times from its promulgation through April 1, 1989." Neil B. Cohen, Preliminary Report on a Restatement of Suretyship: A Report to the Director of the American Law Institute 6 (May 1990) (on file with author).

7. *See* NEW YORK LAW REVISION COMM'N FOR 1955, STUDY OF THE UNIFORM COMMERCIAL CODE 2007.

8. JOHN HANNA, CASES AND MATERIALS ON SECURITY (2d ed. 1940). Here, the Columbia Law School connection again appears. Howard Ruda is a nationally known authority on commercial lending and Editor-in-Chief of ASSET BASED FINANCING: A TRANSACTIONAL GUIDE (1993). While a student at Columbia, he served as Professor Hanna's research assistant on the 1954 edition of the casebook. Mr. Ruda, who was my colleague at The CIT Group during the mid-1980s, is an Adviser to the *Restatement of Suretyship* and an important contributor to the analyses of the commercial law issues.

and was very gratified to have the opportunity to refocus on his work.

II. The "Two Worlds" of Suretyship

My perspective in recommending an ALI study of the law of suretyship to Professor Hazard was essentially that of a commercial lending lawyer concentrating on guaranties, recourse arrangements, and other "credit enhancement" devices. Professor Hazard fortunately recognized, however, that another constituency with at least an equal interest and involvement in the subject had to be consulted and involved, namely the "suretyship industry," which issues contract bonds such as payment bonds, performance bonds, fidelity bonds, financial guaranty bonds, and the like.

This industry is a well-represented and active participant in the Fidelity and Surety Law Committee (FSLC) of the Tort and Insurance Practice Section (TIPS) of the American Bar Association. Professor Hazard contacted Hugh D. Reynolds, Jr. of Indianapolis, an authority in the field of suretyship and a past Chairman of FSLC, in order to ascertain the views and interests of that committee with respect to the proposed new *Restatement*. The response was very positive and Andrew C. Hecker, Jr. of Philadelphia, Chairman of TIPS, and James A. Black, Jr. of Baltimore,[9] the new Chairman of FSLC, indicated their willingness to provide assistance and support for the project.

At that point, Daniel Mungall, Jr. of Philadelphia, also a former Chairman and member of FSLC, agreed to act as liaison with the ALI for the purpose of pursuing and participating in the proposed *Restatement of Suretyship*. Mr. Mungall is a recognized authority on suretyship law who has written extensively on the subrogation rights of the contract bond surety[10] As matters developed, he eventually became the Associate Reporter for the *Restatement*.

Professor Hazard then organized a preliminary meeting of representatives from the commercial lending and suretyship industry

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9. Hugh Reynolds and James Black later became Advisers to the *Restatement of Suretyship*.

10. *E.g.*, Daniel Mungall, Jr., The Subrogation Rights of the Contract Bond Surety, 1990 ABA Annual Meeting, Fidelity & Surety Committee (Aug. 7, 1990) (unpublished manuscript, on file with author).

groups, as well as a number of academic authorities such as Professor Peter A. Alces, who at Professor Hazard's request had prepared a memorandum discussing the suretyship issues that arise in commercial transactions.[11] The meeting was held on July 18, 1989 at Mr. Mungall's offices.

Various materials were submitted for consideration at this meeting. Among them was a topical outline or checklist entitled "Main Topics - Suretyship,"[12] which FSLC had been developing for a number of years and which compiled and organized the important topics and issues from the perspective of the contract bond suretyship industry and its attorneys.[13] In addition, at Professor Hazard's request, I prepared a memorandum outlining the scope and major issues concerning commercial financing that might be considered in the proposed *Restatement*, which, in essence, served as the mechanism for eliciting discussion at the meeting.[14]

This meeting of the two groups was fascinating. Although everyone attending was either a practicing commercial lawyer or an active commercial law teacher, the contrasts between the commercial lending and suretyship industry groups was remarkable in terms of background and emphasis. The discussion reflected the complexity of the task ahead in delineating rules of law under the general rubric of "suretyship" that would be acceptable to both groups. Professor Steven L. Harris, in evaluating the substantive views expressed at the meeting, wrote:

> All agree that the Restatement should cover suretyship transactions; however, they disagree over precisely what constitutes suretyship. As was clear from the materials circulated in advance of the July 18 meeting, "suretyship" encompasses at least two different legal worlds. First is the world of the professional surety, for whom the prototypical transaction is a construction

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11. Memorandum from Peter A. Alces to Professor Geoffrey C. Hazard, Jr., Director, American Law Institute (May 3, 1989) (on file with author).

12. A copy of this outline is on file with author.

13. In 1982, Mr. Mungall appointed Bernard L. Balkin, Esq. of Kansas City, Missouri, chairman of a committee to develop an outline providing categories into which the attorneys practicing in the suretyship industry could readily file the many articles, memoranda, cases, and other materials on that subject. FSLC maintains a library of fidelity and surety papers at Mr. Mungall's firm, Stradley, Ronon, Stevens & Young of Philadelphia.

14. Memorandum from Donald J. Rapson, Why a Restatement of Suretyship is Needed (May 30, 1989) (on file with author). See *infra* Appendix B for a copy of this memorandum.

> bond. Second is the world of the commercial lender, for whom the prototypical transaction is a commercial guarantee.[15]

The meeting demonstrated the desire of all concerned to proceed with the project and concluded with a general consensus that a preliminary report or prospectus for the *Restatement* should be prepared and a Reporter appointed.[16] In time, Professor Neil B. Cohen became the Reporter and the first formal meeting of the Reporters and Advisers was held in Philadelphia at the American Law Institute on June 29, 1990.

III. Reexamining Suretyship Law: *Langeveld v L.R.Z.H. Corp*

The organizational background of the *Restatement of Suretyship* having been recounted, it may be useful to explore the circumstances that led me to write to Professor Hazard on May 30, 1986 recommending the project. These recollections are, perhaps, a microcosm of the experiences other attorneys have had in explain-

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15. Memorandum from Steven L. Harris to Geoffrey C. Hazard, Jr. 1 (Aug. 22, 1989) (on file with author). Professor Harris was one of several academic authorities in attendance. He later became Co-Reporter for the Article 9 Study Group of the Board. His views were echoed by Dennis B. Arnold, of Los Angeles, in a letter dated July 20, 1989: "Quite frankly, I found much of the discussion to be quite fascinating, particularly the rather remarkable differences between the 'TIPS-group' and those of us who have a commercial law focus." Letter from Dennis B. Arnold to Donald J. Rapson, Esq. 2 (July 20, 1989) (on file with author). Mr. Arnold, who is an Adviser to the *Restatement of Suretyship*, has lectured and written extensively on suretyship law of California, which is one of the few states having a comprehensive statutory scheme. *See* Cal. Civ. Code §§ 2787-2854 (West 1974). This theme of "two worlds of suretyship" was later reflected in Professor Cohen's preliminary report:

> It often appears that the world of suretyship consists of two wholly distinct worlds. On one hand is the world of credit enhancement, where decisions to extend credit are induced by the agreement of a solvent party to assume the risk of non-payment associated with the extension of credit to the debtor. In this world, the underlying obligation is the payment of money and the instrument effectuating the suretyship is, in substance, a payment guarantee. In the world of construction contracts, on the other hand, decisions to retain a contractor or subcontractor are induced by the agreement of a solvent party to stand behind the principal's obligation to perform. In this world, the underlying obligation is not payment but performance; while the surety may eventually fulfill its duties by paying money, that payment is, typically, more in the nature of damages that [sic] it is contracted-for performance.

Cohen, *supra* note 6, at 10.

16. Memorandum from T. Scott Leo, Notes of Restatement Meeting Held on July 18, 1989, at 5-6 (on file with author). T. Scott Leo is a Chicago attorney and an Adviser to the *Restatement*.

ing how and why a need developed for a review and revision of suretyship law

In 1974, I was retained to handle the appeal by the guarantor in *Langeveld v. L.R.Z.H. Corp.*[17] from the grant of a summary judgment in favor of the creditor.[18] This case became somewhat of a landmark, appearing in numerous casebooks and treatises.[19] Several complex questions of law were involved which necessitated in-depth research and analysis into hoary doctrines of suretyship law It is instructive now to revisit the holding of the New Jersey Supreme Court and then explore the impact, if any, of the changes in suretyship law reflected by the recent revisions to Article 3 of the Uniform Commercial Code[20] and the provisions of the proposed *Restatement of Suretyship.*

A. *The Facts of* Langeveld

The case involved a suit by Langeveld, the payee of a negotiable promissory note in the amount of $57,500 against L.R.Z.H. Corporation, the maker, and Higgins, a guarantor.[21] The guaranty was appended to the foot of the note, thereby making the guarantor an accommodation party[22] As a result, the rights of the parties were governed by former Article 3 of the Uniform Commercial Code.[23]

The obligation of L.R.Z.H. to Langeveld was secured by a third mortgage.[24] The first mortgage was to a savings institution in the amount of $825,000 and the second mortgage was to an individual for approximately $58,000; both mortgages were properly recorded.[25] Higgins' guaranty was unconditional.[26] The note was not paid on its maturity date, at which time it was discovered that the

17. 327 A.2d 683 (N.J. Super. Ct. Ch. Div. 1974), *aff'd per curiam*, 350 A.2d 76 (N.J. Super. Ct. App. Div. 1975), *rev'd*, 376 A.2d 931 (N.J. 1977).

18. *Id.* at 686.

19. *See, e.g.*, VERN COUNTRYMAN ET AL., COMMERCIAL LAW, CASES AND MATERIALS 549 (1982).

20. *See* U.C.C. § 3-605 (1990).

21. *Langeveld*, 327 A.2d at 684.

22. *Id.*

23. U.C.C. § 3-415 (1978) (replaced by U.C.C. § 3-419 (1990)). If the guaranty had been in a separate document, the common law of suretyship would have governed the case and Article 3 of the Uniform Commercial Code would have been inapplicable.

24. *Langeveld*, 327 A.2d at 684.

25. *Id.*

Langeveld mortgage had not been recorded.[27] The guarantor brought this to the attention of Langeveld, who then recorded the mortgage; by this time, however, it was now also subordinate to another recorded mortgage for $100,000 and two mechanic's lien claims in the respective amounts of approximately $112,000 and $13,000.[28] In other words, the Langeveld mortgage, which was executed and delivered as a third mortgage, was now in sixth place.

Shortly thereafter, L.R.Z.H. defaulted on all of the mortgages, and the holder of the fourth mortgage commenced foreclosure proceedings resulting in a final judgment which fixed the amounts due the respective mortgagees and their priorities.[29] Approximately eighteen months later, a sheriff's sale was held and Higgins (acting through a corporation) purchased the property for $1,080,000.[30] By reason of the accrual of interest on the first mortgage, however, the bid amount, although fully satisfying the first mortgage, left only $20,000 to apply to the second mortgage.[31] Thus, a deficiency remained on the second mortgage and nothing, of course, was left for the subsequent mortgages and lien claims.

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26. *Id.* Actually, the guaranty did not use the word "unconditional." However, the guaranty stated that the guarantor was "principally liable" and contained a waiver of "presentment, demand for payment, protest and notice of protest." Langeveld v. L.R.Z.H. Corp., 376 A.2d 931, 935 n.4 (N.J. 1977). The New Jersey Supreme Court later noted that the waiver language was superfluous because the waiver was automatically afforded by former U.C.C. § 3-416(5) by reason of the "words of guaranty." *Id.* at 935. Both the trial court and the New Jersey Supreme Court treated the guaranty as unconditional, the latter stating:

> We think the wording of this guaranty may be fairly equated with language purporting to make a person in defendant's position an "unconditional guarantor." Such language is normally held to permit the creditor to move against the guarantor without first proceeding against the principal debtor or the collateral. It is not customarily interpreted as providing a guarantor with any further rights.

Id.

27. *Langeveld*, 376 A.2d at 933.

28. *Id.*

29. *Langeveld*, 327 A.2d at 684.

30. *Id.*

31. *Id.*

B. *The Suretyship Defense of "Impairment of Collateral"*

Higgins, the guarantor, claimed that he was discharged under former section 3-606(1)(b) of the Uniform Commercial Code,[32] which in pertinent part read:

> 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
>
> (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.[33]

Langeveld disputed Higgins' position on two grounds:

> He urge[d], first, that the guaranty [was] unconditional in form and that this being so, the alleged impairment of collateral in no way affect[ed] the obligation to which the guaranty g[ave] rise. In the second place he contend[ed] that there ha[d] in fact been no impairment of collateral, or at least none that ha[d] caused defendant to suffer loss.[34]

The trial court had held that the unconditional nature of the guaranty did not deprive the guarantor of the right to assert the "impairment of collateral" defense afforded by former section 3-606(1) of the Uniform Commercial Code.[35] The New Jersey Supreme Court affirmed this holding,[36] so the critical issue on appeal became whether there had been an "impairment of collateral" within the purview of former section 3-606(1).[37]

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32. *Id.*

33. U.C.C. § 3-606(1)(b) (1978).

34. Langeveld v. L.R.Z.H. Corp., 376 A.2d 931, 934 (N.J. 1977).

35. *Langeveld*, 327 A.2d at 683. In doing so, the trial court rejected a line of pre-U.C.C. cases holding to the contrary. *E.g.*, Bank of New Jersey v. Heine, 464 F.2d 1161 (3d Cir. 1972); Joe Heaston Tractor & Implement Co. v. Securities Acceptance Corp., 243 F.2d 196 (10th Cir. 1957). The New Jersey Supreme Court later agreed, stating that the impairment-of-collateral defense is only lost "where the instrument of guaranty specifically frees the creditor from liability for such impairment," and held that an unconditional guaranty does not constitute such an "unequivocal waiver." *Langeveld*, 376 A.2d at 935. Almost all subsequent cases agree on this point. *E.g.*, United States v. Vahlco Corp., 800 F.2d 462 (5th Cir. 1986).

36. *Langeveld*, 376 A.2d at 935-36.

37. *Id.* at 934.

The trial court had properly recognized that the impairment-of-collateral defense derived from the right of the surety or guarantor to be subrogated to the collateral given by the principal debtor to the creditor, i.e., the mortgage from L.R.Z.H. to Langeveld, and that "the failure to record a security instrument such as a mortgage discharged the surety or guarantor to the extent that his right of subrogation to the collateral was diminished or his risk of loss was unreasonably increased."[38] The court then went astray, however, when it held that the delay in recording the Langeveld mortgage "occasioned no loss in priority of the mortgage and cannot be said to have impaired the value of the mortgage as collateral nor to have diminished [Higgins'] right of subrogation to the collateral" because "[t]he foreclosure sale result established conclusively that plaintiff's mortgage had no value in fact, and plaintiff's conduct did not cause any loss to the defendant so as to effect either a limited or total discharge under § 3-606."[39]

C. *When Is "Impairment of Collateral" Determined?*

The trial court in *Langeveld* looked to the amounts due on the first two mortgages *at the time of the sheriff's sale* in determining whether the guarantor's right of subrogation to the collateral had been impaired. The trial court was persuaded that the accrual of interest on those two mortgages during the eighteen-month period following the default on the Langeveld mortgage—which was supposed to be the third mortgage—meant that the proceeds of the sheriff's sale were necessarily insufficient to leave any money available for the payment of a third mortgage, thereby precluding any possibility of prejudice to the guarantor.[40]

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38. *Langeveld*, 327 A.2d at 685.

39. *Id.* at 686. In so holding, the trial court was, in effect, taking the position that the $1,080,000 purchase price represented the fair market value of the property. The New Jersey Supreme Court later made note of that point. *Langeveld*, 376 A.2d at 936. Although a rational finding, this is not necessarily always the fact. The successful bid at a foreclosure sale is usually an amount that the bidder believes is less than or equal to the fair market value of the property. The bidder will generally commence its bidding at some amount below fair market value. If no one raises the bid, the successful bidder will have no reason to raise its own bid to the full fair market value.

40. *See Langeveld*, 327 A.2d at 686.

In taking the appeal, my view was that the trial court had made a fundamental error in looking at the time of the sheriff's sale to value the property; it should have looked at the date eighteen months earlier when L.R.Z.H. defaulted on the Langeveld mortgage. It was at that time that Higgins first could have exercised his right of subrogation to the supposed third mortgage by paying off the debt. The critical inquiry should have been: if the Langeveld mortgage had been timely recorded so that Higgins then could have been subrogated to that mortgage with a third-priority position and then foreclosed that mortgage, would there have been any value in the property over and above the first two mortgages sufficient to satisfy or apply to that third mortgage?[41]

The Appellate Division was not at all impressed with this argument and affirmed in a per curiam opinion "essentially for the reasons stated" by the trial court.[42] Thus, the stage was set for the appeal to the New Jersey Supreme Court. As matters turned out, that court unequivocally adopted the guarantor's position:

> In the first place, and most importantly, the factual situation and the respective rights and obligations of the parties should have been assessed and determined not at the time of the sheriff's sale, in August, 1974, but rather at the time the obligation matured, in February, 1973. It was then that defendant was entitled to exercise his rights as surety. Had he paid plaintiff the amount then due—$57,500, together with interest at the rate of 10% from October 15, 1970—he would have stood in plaintiff's shoes as holder of the note and mortgage. Had the mortgage originally been promptly recorded, as it should have been, there would then have been available to him a variety of options, the relative merits of which we are in no position to evaluate at this time and on this record. For instance, as holder of a junior lien (the Langeveld mortgage) he would have had a right to redeem either or both The Howard Savings and Castellane mortgages. He could have foreclosed any mortgage acquired. Other possibilities suggest themselves. The point is that defendant ap-

41. Of necessity, this analysis assumed that Higgins then would have either paid off or assumed and reinstated the first two mortgages before proceeding, as subrogee, to foreclose the third mortgage. Keeping in mind that he paid $1,080,000 at the sheriff's sale eighteen months later, *see id.* at 684, such an assumption was neither unrealistic nor speculative.

42. Langeveld v. L.R.Z.H. Corp., 350 A.2d 76 (N.J. Super. Ct. App. Div. 1975), *rev'd*, 376 A.2d 931 (N.J. 1977).

> pears to have been deprived of the opportunity effectively to exploit his right of subrogation to unimpaired collateral by the failure of plaintiff to record the mortgage given him by L.R.Z.H. Corporation.[43]

D How Is "Impairment of Collateral" Measured?

The appeal also raised an important related issue. If, as the New Jersey Supreme Court held, the facts "should have been assayed to determine their effect, if any, with respect to the alleged impairment of collateral"[44] when the obligation matured, how, as a matter of proof, would this impairment be established? And, if "impairment of collateral" was, as is most likely, an affirmative defense with the burden of proof falling on the guarantor, with what specificity would that burden have to be met? This was a particularly troubling inquiry, because its focal point was "what if?"—i.e., what would have been the result if the Langeveld mortgage had been timely recorded so as to attain a third-priority position?[45]

Should this burden fall upon guarantor? After all, the creditor caused the problem by failing to record the mortgage. Why should the guarantor not be entitled to an automatic discharge for the debt under the doctrine of *strictissimi juris* or, at the very least, be entitled to the benefit of a presumption that it suffered a loss equal to the amount of the debt, which the creditor would have the right to rebut?[46] The New Jersey Supreme Court framed the issue in this fashion:

> The parties express sharply differing views as to the extent to which an impairment of collateral should be held to discharge one secondarily liable. Defendant suggests that the Code has adopted the rule, sometimes referred to as that of *strictissimi juris*, that a surety is completely discharged by any impairment

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43. *Langeveld*, 376 A.2d at 936 (citation omitted).

44. *Id.*

45. *See supra* text accompanying note 41.

46. This would be directly analogous to the so-called "rebuttable presumption" or "shift" rule in which a creditor who fails to comply with Part 5 of Article 9 of the U.C.C. (governing default) must overcome the presumption that a commercially reasonable sale would have realized an amount equal to the amount of the debt. *See, e.g., In re* Excello Press, Inc., 890 F.2d 896 (7th Cir. 1989); Connecticut Bank & Trust Co. v. Incendy, 540 A.2d 32 (Conn. 1988).

> of collateral, whether or not he has sustained loss or prejudice. Plaintiff, on the other hand, contends that the surety should only be released from liability to the extent that actual, calculable monetary loss can be shown to have occurred.[47]

It then, however, enunciated a somewhat amorphous rule:

> We think the statute should be read as adopting a rule somewhere between these extremes. If the impairment of collateral can be measured in monetary terms, then the calculated amount of the impairment will ordinarily measure the extent of the surety's discharge. But there are factual situations—this may or may not be one of them—where a surety may be able to establish that he has sustained prejudice, but be unable to measure the extent of the prejudice in terms of monetary loss. Where such a situation is presented the surety will normally be completely discharged.[48]

The supreme court then remanded the case to the trial court, instructing it to

> determine from all of the evidence presented, to what extent, if at all, plaintiff's failure seasonably to record his mortgage impaired the collateral given by L.R.Z.H. Corporation to plaintiff as security for the indebtedness. The effect of the impairment upon one secondarily liable may or may not be translatable into dollars. There may be clear prejudice without precisely calculable loss. This will normally result in the discharge of the surety. To the extent that such impairment is found, defendant, Higgins will stand discharged of his obligation as guarantor.[49]

These instructions provided both parties and the trial judge with a dilemma as to what exactly was supposed to happen on remand. As a consequence of this uncertainty, with the enthusiastic urging of the trial judge, the parties eventually settled.[50]

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47. *Langeveld*, 376 A.2d at 936-37.

48. *Id.* at 937.

49. *Id.*

50. Judge Conford's concurring opinion in the New Jersey Supreme Court's decision anticipated the problem and took the position that the guarantor had conclusively established prejudice and was entitled to summary judgment without the necessity of a remand.

> Since it is impossible to rerun the course of events and discover to a certainty what defendant, as surety, would have done at maturity of the note if the Langeveld mortgage had been recorded immediately upon execution,

In dealing with this point, the guarantor had the problem of explaining the meaning of the words "to the extent" in former section 3-606(1) of the Uniform Commercial Code.[51] Do these words merely mean "if" in terms of a condition or do they require a quantitative analysis of the dollar amount of the impairment? Put differently, was the failure timely to record the mortgage an impairment per se entitling the surety to a discharge without establishing more, or must the surety prove the amount of damages proximately caused by that failure?

IV EXAMINING THE COMMON LAW OF SURETYSHIP

The attempt to find an answer to this question necessitated an examination of the common law of suretyship,[52] including its formulation in Division II of the *Restatement of Security*[53] That examination proved to be somewhat bewildering and unsettling, and, in retrospect, was a critical factor leading to the recommendation made to Professor Hazard nine years later.[54]

For example, under the common law, a binding agreement between the creditor and the principal debtor to extend the time of payment automatically discharges the surety, without the need to show loss or injury[55] This suretyship defense was incorporated, albeit awkwardly, into former section 3-606(1)(a) of the Uniform Commercial Code as an agreement to "suspend the right to enforce

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> rather than delayed to a date letting in other encumbrances ahead of it, it seems to me that prejudice must be assumed on these facts, as a matter of law, on the basis of what defendant would have had the right to do at that time in protection of his interests. I do not see how any facts plaintiff might conceivably adduce at a hearing could affect the validity of the foregoing observations.

Id. at 939 (Conford, J., concurring in part).

51. *See supra* text accompanying note 33; *infra* text accompanying notes 55-59.

52. The guarantor argued that the common law doctrine of *strictissimi juris*, which afforded the surety a discharge without its having to prove actual prejudice, had not been changed by former U.C.C. § 3-606, and that the doctrine was still viable under U.C.C. § 1-103. The concurring judge in *Langeveld* adopted that position. *See Langeveld*, 376 A.2d at 938-39 (Conford, J., concurring in part).

53. Here, the phrase "pro tanto" is used. *See* RESTATEMENT OF SECURITY § 132 (1941) (entitled "Surrender or Impairment of Security by Creditor"). According to *Black's Law Dictionary*, this means "[f]or so much; for as much as may be; as far as it goes." BLACK'S LAW DICTIONARY 1100 (5th ed. 1979).

54. *See supra* text accompanying notes 4-6.

55. *E.g.*, Bell v. Martin, 18 N.J.L. 167 (1840).

against such person the instrument."[56] The phrase "to the extent"[57] in the statute is also applicable, but what possible meaning can that phrase have in the context of an extension of time? If there is an agreement "to suspend the right to enforce," the modifier "to the extent" seems meaningless. The New Jersey Supreme Court apparently agreed and implied that the automatic discharge afforded by the common law in the case of an extension continued to be the rule under former section 3-606(1)(a) without any need to prove prejudice.[58] The court went on to say, however, that when the surety seeks a discharge based on the suretyship defense of an impairment of collateral, "a quite different situation is presented."[59]

V THE *RESTATEMENT OF SECURITY*

But how and why should there be a difference in the treatment of these two suretyship defenses? Does it automatically follow that an extension of time is inherently more prejudicial to a surety than an impairment of collateral? Indeed, revised section 3-605 of the Uniform Commercial Code rejects any such distinction and provides that the surety is entitled to a discharge for either an extension of time or impairment of collateral only "to the extent" of the loss or "impairment of collateral."[60] Sections 36 and 38 of the *Restatement of Suretyship* are in accord with that position.[61]

The *Restatement of Security* made a valiant effort to create a "golden thread" running through the various suretyship defenses and the effect of those defenses upon the surety's right to discharge. The "thread," however, is often difficult to find and overly complex. A distinction is drawn between a "compensated surety" and "other sureties."[62] This distinction, however, is not completely

56. U.C.C. § 3-606(1)(a) (1978).

57. *See id.* § 3-606(1).

58. Langeveld v. L.R.Z.H. Corp., 376 A.2d 931, 937 n.5 (N.J. 1977).

59. *Id.* This was a response to the concurring opinion which cited the "extension of time" rule in support of its view that in the instant impairment-of-collateral case, the guarantor had already proven prejudice and was entitled to a discharge without any remand. *Id.* at 939 (Conford, J., concurring in part); *see supra* note 50.

60. U.C.C. § 3-605(c), (e) (1990).

61. RESTATEMENT (THIRD) OF SURETYSHIP §§ 36, 38 (Tent. Draft No. 2, 1993).

62. RESTATEMENT OF SECURITY § 82 cmt. 1 (1941). Comment 1 defines "compensated surety" as follows:

satisfactory By limiting the definition of "compensated surety" to those in the business of executing surety contracts for compensation called a premium, the definition excludes many sureties who receive direct or indirect economic benefit[63] and, anomalously, ends up grouping sureties who receive economic benefit with gratuitous sureties.[64]

Although the *Restatement of Security* did not utilize this distinction with respect to the impairment of collateral defense,[65] the distinction is significant if the suretyship defense is based upon an extension of time to the principal debtor. Under section 129 of the *Restatement of Security*, the common law rule of absolute discharge is retained in the case of an uncompensated surety,[66] but

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> The term "compensated surety" is used in the Restatement of this Subject to mean a person who engages in the business of executing surety contracts for a compensation called a premium, which is determined by a computation of risks on an actuarial basis. Compensated sureties are generally incorporated. Other sureties, whether strictly gratuitous or whether receiving some pecuniary advantage, whose surety contracts are occasional and incidental to other business, are not included among compensated sureties.
>
> It is important to distinguish between compensated and other sureties because the rules of suretyship, notably those relating to the defenses of the surety, are not in all respects alike for the two classes. The basis for the distinction is that one engaged in the business of executing surety contracts can be expected to have contemplated and taken account of, in the premium charged, certain elements of risk which are not considered to have been assumed by other sureties.

Id.

63. Compare this definition with revised U.C.C. § 3-419, which defines an accommodation party as one who "signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument." U.C.C. § 3-419(a). Comment 1 explains that even a sole stockholder of a corporation cosigning a note is an accommodation party "if no part of the loan was paid to X or for X's direct benefit." *Id.* § 3-419 cmt. 1.

64. This distinction, drawn by comment 1 to § 82 of the *Restatement of Security*, has been criticized as not accurately reflecting the state of the common law of suretyship. *See* Gary L. Monserud, *Interested Sureties and the Restatement of Suretyship: An Argument Against Tender Treatment*, 15 HAMLINE L. REV. 247, 253 (1992).

65. RESTATEMENT OF SECURITY § 132.

66. But this is wholly undercut and there is no discharge if "the creditor in the extension agreement reserves his rights against the surety." *Id.* § 129(1). The formalities of the reservation-of-rights doctrine are eliminated in U.C.C. § 3-605. *See* U.C.C. § 3-605 cmt. 3.

the compensated surety is "discharged only to the extent that [it] is harmed by the extension."[67]

Section 128 of the *Restatement of Security*, entitled "Modification of Principal's Duty,"[68] also uses the distinction between compensated and uncompensated sureties, but does so somewhat differently than in section 129. Here, the common law rule discharging a surety *strictissimi juris* for any modification is continued for all sureties except compensated sureties, but is relaxed where "the modification is of a sort that can only be beneficial to the surety," in which event the surety remains liable.[69] This relaxation is not a matter of proof in the particular circumstance of a transaction because "[t]he rule does not permit a speculation as to whether the change may or may not have been to the non-compensated surety's advantage. It must be of the sort that by its very nature, in no circumstances, can increase the risk of such a surety."[70]

The rule is even more complex in the case of a compensated surety. There is a discharge "if the modification materially increases [the] risk,"[71] but the compensated surety is not discharged "if the risk is not materially increased, but [the] obligation is reduced to the extent of loss due to the modification."[72] In that circumstance, there needs to be a judicial determination based on the particular facts as to whether the modification has materially increased the risk; if not, then the extent of loss due to the modification must be determined.[73]

VI. Suretyship Under Revised U.C.C. Article 3

As this brief summary demonstrates, it is extremely difficult to rationalize the different formulations in the *Restatement of Security* with respect to the impact of the various suretyship defenses

67. Restatement of Security § 129(2). Note that "to the extent" is used in § 129 as distinguished from "pro tanto" in § 132. Is there a difference? *See supra* text accompanying notes 51-59.

68. Restatement of Security § 128.

69. *Id.* § 128(a) & cmt. e.

70. *Id.* § 128 cmt. e.

71. *Id.* § 128(b)(i).

72. *Id.* § 128(b)(ii).

73. *See id.* § 128 cmt. f.

upon the surety's right to a discharge. In large part, the difficulty in formulating a rationally consistent rule stems from the fact that creditors, sureties, and principal debtors inevitably have different perspectives concerning the impact of the different events that give rise to the suretyship defenses. These differences are reflective not only of their parochial positions, but also of the facts and circumstances of a particular transaction. Thus, in revised Article 3, four different treatments eventually emerged: 1) a release never discharges the surety;[74] 2) an extension discharges the surety only "to the extent [the surety] proves that the extension caused loss";[75] 3) material modification discharges the surety completely unless the creditor "proves that no loss was caused by the modification";[76] and 4) impairment of collateral discharges the surety to the extent there is a reduction in the "value of an interest in the collateral."[77] In drafting the statute, the Drafting Committee discussed the differing perspectives of creditors, sureties, and principal debtors at length, and the resulting variations were, in many respects, the product of compromises the Committee made in order to accommodate these different views and perceptions.[78]

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74. U.C.C. § 3-605(b) (1990). This rule has been criticized. *See* Neil B. Cohen, *Suretyship Principles in the New Article 3: Clarifications and Substantial Changes*, 42 ALA. L. REV. 595, 606-13 (1991); Sarah H. Jenkins, *Abrogation of Surety's Right of Discharge on Release of the Principal Obligor Under Revised Article 3: A Creditor's Tool for Maximizing Self-Interest*, 44 OKLA. L. REV. 661 (1991). I am inclined to agree with these criticisms.

75. U.C.C. § 3-605(c).

76. *Id.* § 3-605(d).

77. *Id.* § 3-605(e).

78. The draft dated April 15, 1990 presented to the Annual Meeting of the American Law Institute on May 18, 1990 in Washington, D.C., treated an extension of the due date as a material modification and provided for discharge of the surety unless the creditor proved the absence of loss:

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

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

Although the formulations under revised Article 3 are more understandable and workable than those under the *Restatement of Security*, the experience with the Article 3 revisions reaffirmed the conclusion made with respect to the *Restatement of Security* during the *Langeveld* case: there was a compelling need to examine, review, and restate the entire body of the law of suretyship.

VII. REVISITING *LANGEVELD* UNDER REVISED U.C.C. ARTICLE 3 AND THE *RESTATEMENT OF SURETYSHIP*

Langeveld whetted my appetite to delve more into the law of suretyship. It was not easy Even though suretyship and guaranties were an increasingly important area of commercial practice, particularly because of the myriad of recourse and "credit enhancement" devices and structures accompanying the rapidly escalating volume of credit extensions by financers, the bench and the bar were gen-

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At that meeting, I moved that extensions receive different treatment from other material modifications; the burden of proving loss arising from an extension should be placed upon the surety, on the ground that granting extensions generally facilitates workouts and out-of-court compositions. Professor Cohen asked whether I wanted to amend the motion to cover modifications also, but I declined in order not to change further the compromises arrived at in the Drafting Committee. The motion was then passed and the subsection was split into present U.C.C. § 3-605(c) and (d), reading as follows:

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

U.C.C. § 3-605(c)-(d) (1990); *see also* Memorandum from Robert L. Jordan & William D. Warren, Reporters to Drafting Committee, on Amendments to Uniform Commercial Code—Current Payment Methods 18 (July 9, 1990) (on file with author) (reflecting these changes in U.C.C. § 3-605(c)-(d)).

erally ignorant on the subject. This ignorance, in large part, is attributable to the fact that suretyship has not been taught in law schools since the 1950s. Commercial law curricula are essentially structured around the Uniform Commercial Code and, except for some incomplete treatment of accommodation parties to Article 3 negotiable instruments,[79] the Code gave scant treatment to suretyship.

As a result of increasing explorations of this area of the law, I began to cover the subject more extensively in my courses at Columbia and New York University Law Schools and was frequently asked to discuss the topic at continuing legal education programs in the late 1970s and 1980s. It was during this time that I met Professor Cohen, an outstanding scholar at Brooklyn Law School. He evinced particular interest in the subject and, eventually, was the logical choice to become the Reporter for the *Restatement (Third) of Suretyship*.[80]

The studies and analyses of suretyship that went first into the revision of U.C.C. Article 3 and later into the *Restatement of Suretyship* undoubtedly have afforded considerable clarity and insight into this difficult area.[81] If the issues in *Langeveld v. L.R.Z.H. Corp.*[82] were to arise today, their resolution would be much easier—particularly if the *Restatement of Suretyship* were accepted as an accurate statement of modern common law

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79. *See* U.C.C. §§ 3-408, -415, -416, -606 (1978); Ellen A. Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833 (1968).

80. Professor Gerald McLaughlin, then a colleague of Professor Cohen at Brooklyn Law School and now Dean of Loyola Law School in Los Angeles, was also at these education programs. He is currently an Adviser to the *Restatement*. As a recognized authority on the law of letters of credit, his presence, together with that of Professor John Dolan of Wayne State Law School, another leading authority in this area, is particularly important because of the sensitive issue of the relationship between suretyship and letters of credit, and the need to distinguish the two bodies of law. For a more complete discussion, see JOHN F DOLAN, THE LAW OF LETTERS OF CREDIT (2d ed. 1991). Section 3(2) of the *Restatement of Suretyship* excludes letters of credit from the coverage of the *Restatement*. RESTATEMENT (THIRD) OF SURETYSHIP § 3(2) (Tent. Draft No. 1, 1992).

81. The other Advisers to the *Restatement of Suretyship*, all of whom have actively participated and contributed to its deliberations, are: Dean Phillip I. Blumberg of Hartford; James F Crowder, Jr. of Miami; C. Allen Foster of Greensboro; Patrick J. O'Connor, Jr. of Minneapolis; Professor Peter Winship of Dallas; and Robert A. Zadek of San Francisco.

82. 376 A.2d 931 (N.J. 1977).

Inasmuch as revised U.C.C. Article 3 does not purport to be a comprehensive statement of suretyship law,[83] the resolution of suretyship issues would still be accomplished by first applying the applicable Article 3 provisions[84] and then supplementing these provisions with the common law as articulated in the *Restatement of Suretyship*.[85] Thus, it would be readily understood that in the absence of a waiver of discharge under revised section 3-605(i) indicating either specifically, or by general language, that the "parties waive defenses based on suretyship or impairment of collateral,"[86] the impairment-of-collateral defense would be available even though the guaranty is "absolute and unconditional."[87]

There would be no difficulty in characterizing the suretyship defense as "impairing [the] value of an interest in collateral,"[88] because that defense, by definition, includes "failure to obtain or maintain perfection or recordation of the interest in collateral."[89] It is also clear that the guarantor has the "burden of proving impairment."[90]

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83. As of the writing of this Article, the Permanent Editorial Board for the Uniform Commercial Code has tentatively approved an amendment to the comment to U.C.C. § 3-605 to this effect.

84. U.C.C. § 3-605 (1990).

85. *See id.* § 1-103 ("Unless displaced by the particular provisions of this Act, the principles of law and equity shall supplement its provisions."). If a guaranty is in a separate writing, Article 3 would be inapplicable and, absent a suretyship statute, common law rules would govern. A court, of course, is not bound to apply the *Restatement of Suretyship*, but hopefully would do so—particularly in light of the obscurity and antiquity of the common law rules.

86. *Id.* § 3-605(i).

87. *See id.* This is explicitly stated in the *Restatement of Suretyship*: "A statement to the effect that the duty of the secondary obligor is absolute or unconditional, however, is ordinarily not specific enough to indicate that the secondary obligor is waiving discharges based on suretyship status." RESTATEMENT (THIRD) OF SURETYSHIP § 42 cmt. d (Tent. Draft No. 2, 1993). Revised § 3-605(i) is somewhat broader in permitting the waiver to be in "general language indicating that parties waive defenses based on suretyship." U.C.C. § 3-605(i). *Langeveld*, however, required language that "specifically frees the creditor from liability for such impairment." Langeveld v. L.R.Z.H. Corp., 376 A.2d 931, 935 (N.J. 1977); *cf.* Connecticut Nat'l Bank v. Douglas, 606 A.2d 684, 691-92 (Conn. 1992) (finding contractual waivers specific enough to be valid).

88. U.C.C. § 3-605(g).

89. *Id.*, RESTATEMENT (THIRD) OF SURETYSHIP § 38(2)(a) (Tent. Draft No. 2).

90. U.C.C. § 3-605(e); *cf.* RESTATEMENT (THIRD) OF SURETYSHIP § 43(2)(a)(i) (Tent. Draft No. 2) (allocating the burden of persuasion to the surety if it receives a "business benefit"). This includes the indirect benefit arising from the surety's status as an owner or officer. *Id.* § 43 cmt. b.

The manner in which impairment must be proven is specifically defined in revised section 3-605(e):

> The value of an interest in collateral is impaired to the extent (i) the value of the interest is reduced to an amount less than the amount of the right of recourse of the party asserting discharge, or (ii) the reduction in value of the interest causes an increase in the amount by which the amount of the right of recourse exceeds the value of the interest.[91]

This formulation clearly rejects *strictissimi juris* and requires proof of monetary loss as distinguished from proof of actual prejudice per se as urged by the concurring judge in *Langeveld*.[92] But does the formulation in revised U.C.C. Article 3 require that in all cases the guarantor prove the impairment of the "value of an interest in collateral" with mathematical certainty in terms of actual dollars? And at what point in time must the guarantor begin measuring impairment? These, of course, were major issues in *Langeveld*.[93]

Revised section 3-605 speaks in terms of the suretyship defenses being raised by a party having a right of recourse against the obligor.[94] Comment 4 refers to the "right of recourse when default occurs."[95] This is consistent with *Langeveld*, which held that "the time the obligation matured" was the time when the guarantor "was entitled to exercise his rights as surety"[96] The *Restatement of Suretyship* is even more precise, making it clear that when the duty of the surety is conditioned on default, it is the surety's per-

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91. U.C.C. § 3-605(e). The definition is in two parts because of the necessity of covering the circumstance in which the right of recourse was undersecured prior to the impairment. This situation is reflected in the second part. Compare § 38 of the *Restatement of Suretyship*, which uses a multipurpose test applicable to all the suretyship defenses and covers both circumstances: "[T]o the extent that such impairment would otherwise increase the difference between the maximum amount recoverable by the secondary obligor pursuant to its subrogation rights (§§ 23-27) and the value of the collateral." RESTATEMENT (THIRD) OF SURETYSHIP § 38(1) (Tent. Draft No. 2). The two tests have the same substantive import.

92. *See* Langeveld v. L.R.Z.H. Corp., 376 A.2d 931, 938 (N.J. 1977) (Conford, J., concurring in part); *supra* note 50.

93. *See Langeveld*, 376 A.2d at 936.

94. *See* U.C.C. § 3-605(b)-(e).

95. *Id.* § 3-605 cmt. 4.

96. *Langeveld*, 376 A.2d at 936.

formance upon that default that gives rise to the surety's right of subrogation.[97]

Although revised section 3-605(e) measures impairment in terms of "the extent of" a reduction in "value of an interest in collateral,"[98] it should not follow that the reduction in value must be translatable into actual dollars in a case involving facts such as those in *Langeveld*. In essence, revised section 3-605(e) would determine "the extent of" impairment in the *Langeveld* scenario by measuring (i) what the value of the right of recourse to the collateral would have been if there had not been a failure timely to record the mortgage so that it would have had a third-priority position against (ii) what that value was in fact as a result of the three liens intervening and attaining priority.[99] The guarantor would have little difficulty in proving the first part of the measurement. That value is simply the "equity" between the fair market value of the property and the amount due on the first two mortgages at the time of default on the third mortgage.

The second part is more problematic because it requires proof of the genuineness, validity, and enforceability of the three intervening liens, and the amounts due and owing on those liens at the time of default on the third mortgage. In *Langeveld*, these were contested issues.[100] If it must prove the value of the three intervening liens in terms of actual dollars in order to prove impairment, the guarantor will have an extremely difficult, if not impossible, burden to meet. Revised section 3-605(e), which does not speak to that specific issue, should not be interpreted as imposing that bur-

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97. RESTATEMENT (THIRD) OF SURETYSHIP § 23 cmt. c (Tent. Draft No. 2, 1993); *id.* § 38 cmt. g ("Accordingly, the value [of the collateral] should not be determined as of a time before the time for performance of the secondary obligation, because that is the earliest time at which the secondary obligor could acquire subrogation rights."); *see also id.* § 36 cmt. i (explaining the rule that permits a surety to perform its obligation in accordance with the original schedule despite the creditor's grant of an extension of time to the principal obligor: "It would be inequitable for the principal obligor and the obligee to have the power to change the terms of that obligation without the consent of the secondary obligor. [T]he secondary obligor may always discharge its obligation by performing the secondary obligation as originally agreed.").

98. U.C.C. § 3-605(e).

99. *See id.*

100. *Langeveld*, 376 A.2d at 936.

den. Instead, the statute should be supplemented via section 1-103 with the principle enunciated in *Langeveld*:

> But there are factual situations—this may or may not be one of them—where a surety may be able to establish that he has sustained prejudice but be unable to measure the extent of the prejudice in terms of monetary loss. Where such a situation is presented the surety will normally be completely discharged.[101]

This principle, however, should be subject to the added caveat that the obligee ought to have the right to prevent or reduce the discharge by proving that the actual amount of prejudice was not the full amount claimed by the intervening liens. This concept is expressed in the *Restatement of Suretyship*.[102]

VIII. Conclusion

Section 1-102 of the Uniform Commercial Code provides that its underlying purposes and policies 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.[103]

By and large the U.C.C. has achieved those goals. Ironically, however, that achievement has had exactly the opposite effect with respect to the law of suretyship, which has "fallen between the cracks" in the last forty years. The move to reverse that trend has been long overdue, particularly because of the ever-increasing importance of suretyship in commercial law and practice.

The revision of U.C.C. Article 3, with its attendant focus on its suretyship provisions, was an important first step. The *Restatement of Suretyship* is of major importance, not only because of its

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101. *Id.* at 937.

102. Restatement (Third) of Suretyship § 43(3) (Tent. Draft No. 2, 1993); *id.* § 43 cmt. d; *id.* § 43 reporter's note, cmt. d (referring to *Langeveld*). It may well be appropriate for the Permanent Editorial Board of the Uniform Commercial Code also to articulate this concept for U.C.C. § 3-605 in a Board commentary.

103. U.C.C. § 1-102(2).

scholarly excellence, but because of its emphasis upon pragmatic issues that are of concern to the commercial world.

Progress must not end, however, with the *Restatement of Suretyship*. Despite its excellence, it is not "the law," but only persuasive authority for the bench and bar. The goal should be to codify the law of suretyship in a new Article of the Uniform Commercial Code. The *Restatement* provides a sound basis for that codification.

In addition, commercial law curricula in the law schools must be revised to give attention to suretyship law so that new lawyers coming onto the scene will no longer be ignorant of this critically important and vital area of commercial practice. The *Restatement of Suretyship* will facilitate that process.

APPENDIX A

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THE CIT GROUP

May 30, 1986

Prof. Geoffrey C. Hazard, Jr.
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Re: Suretyship

Dear Geoff:

This letter is for the purpose of recommending an ALI study of the law of suretyship with a view to (1) having a Restatement of the Law of Security 2d and (2) reviewing and expanding the suretyship rules in the Uniform Commercial Code — possibly in a new Article.

The Restatement of Security was ordered published by the Council at its May 6-9, 1941, meeting. Professor John Hanna was the Reporter. It consists of two Divisions: Pledges and Suretyship. Although a pledge is obviously a form of security and is now covered by UCC Articles 8 and 9, suretyship was also "included in the general field of Security because the obligation of a surety is an additional assurance to the one entitled to the performance of an act that the act will be performed." (Scope Note to Division II, Suretyship p. 225.) It may well be that a new Restatement need only deal with suretyship and be name "Restatement of Suretyship"

At the present time, suretyship rules are essentially in the common law, although some states have comprehensive statutory schemes, e.g. California. There are some suretyship rules in the Uniform Commercial Code, but they are spasmodically stated and, in some cases, not even identified as suretyship provisions. The UCC provisions are 3-415 (Contract of Accommodation Party), 3-416 (Contract of Guarantor), and 3-606 (Impairment of Recourse or of Collateral); and 3-408 (Consideration) has a tangential impact. I am certain that other provisions scattered throughout the UCC also affect sureties.

As Chief Justice (then Professor) Peters has observed:

"Interestingly, the institution of suretyship has so far escaped the elaborate statutory regulation which has attended collateral security devices. The Uniform Commercial Code goes further toward setting operative guidelines than has ever been done before, but even the

> bond, insofar as it includes in its boilerplate an assignment of contract rights, may or may not fall within Article 9 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 superficial than that of the Negotiable Instruments Law which it replaces, the rights and obligations of sureties who appear on short term commercial paper.
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> ***
>
> 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." (Footnotes omitted; Peters, Suretyship Under 3 of the Uniform Commercial Code, 73 Yale L.J 833, 835, 879 (1968)

This dichotomy between the common law and the UCC produces some anomalies. If an obligation is guarantied by an endorsement of an Article 3 promissory note, the Article 3 provisions govern. But, if the same obligation is guarantied by a separate guaranty agreement, the common law rules are applicable. Strange to say, some courts and lawyers apparently do not even know of the common law of suretyship. In Halprin v Frankenberger, 644 P.2d 452, 34 UCC Rep. 189 (Kan. 1982), the supreme Court of Kansas held that the impairment of collateral defense was not available to a continuing guaranty because Article 3 was not applicable, without recognizing that the defense is also set forth in Restatement of Security §132.

Unfortunately the analaguous rules in the Restatement and UCC are sometimes differently stated and, in some cases, substantively different. For example, 3-606 covers the suretyship defenses in subsection (a) of alteration of the underlying debt and in subsection (b) of impairment of collateral. These defenses are covered in Restatement of Security §§128 and 129, and §132, respectively Are these defenses absolute or must actual prejudice be shown? 3-606 speaks in terms of a discharge of "any party to the instrument to the extent ***" Restatement of Security §§128 and 129, however, apply the strictissimi juris principle and provide for complete discharges (except for compensated sureties), which §132 states that the surety's obligation is reduced pro tanto *** " These differences are not readily reconcilable.

As another example, the common law rule requires new consideration for a suretyship agreement given after the obligee has already extended value. Official Comment 3 to 3-415 says that 3-415(2) changes this rule and that the surety is liable "even though there is no extension of time or other compensation." However, I find little, if anything, in 3-415(2) supporting the

Conclusion that this important common law has clearly been changed. See also Steffen & Johns, The After-Acquired Surety· Commercial Paper, 59 Calif. L. Rev 1459 (1971).

There is also the very current controversy as to whether a surety can waive the Article 9 defenses of lack of Notice and failure to conduct a commercially reasonable foreclosure sale. Compare McEntire v Indiana Nat. Bank, 471 N.E. 2d. 1216, 39 UCC Rep. 1804 (Ind. App. 1984) and U.S. v. Lang, 621 F Supp. 1182, 42 UCC Rep. 34 (D. Vt. 1985) waiver precluded under 9-105(1)(d) and 9-501(3)(b)) with U.S. v Lattauzio, 748 F 2d 559, 39 UCC Rep. 1799 (10th Cir. 1984) and Rutan v. Summit Sports, Inc., 173 Cal. App. 3d 965, 42 UCC Rep. 342 (1985) (upholding waivers under general suretyship principles.) As you know, this particular issue is covered by one of our proposed PEB commentaries.

Suretyship is, of course, very important to the practice and business of commercial law. In addition to the traditional uses of guaranties and endorsements, there are a multitude of other recourse arrangements which bring into play the suretyship rules, e.g. repurchase and contingent reserve agreements. Great reliance is placed on the enforceability of these obligations.

In addition, new kinds of commercial arrangements are evolving which involve the use of suretyship concepts. The marketability of corporate commercial paper and governmental bonds is furthered by the backing by of highly-rated financial or insurance institutions through the use of "credit enhancement facilities" These facilities are sometimes structured as either insurance or financial guaranty bonds or standby letters of credit or irrevocable commitments to lend. Although essentially serving the same purpose, different bodies of law (with sometimes dramatically different results) will be applicable. Consider the ongoing controversy about the differences between standby letters of credit and guaranties. Or, try and determine which body of law is applicable to a financial guaranty bond issued by an insurance company -- insurance or suretyship? My point is that the contemplated study should also consider these other bodies of law and, in doing so, analyze whether they should also be encompassed under the general rubric of suretyship or whether the applicability of different concepts based on different labels or structuring of documents is really justified.

Notwithstanding the importance to the commercial world of these suretyship and related doctrines, these subjects receive scant attention in the law schools. As a consequence, the practising bar and judiciary encounter these concepts with increasing ignorance. This was not the case 30 years ago. Hanna's Cases and Materials on Security, (2d ed. 1952) contained 201 pages of tightly compacted and comprehensive material on suretyship. On the other hand, Farnsworth and Honnold, Cases and Materials on Commercial Law, (3 ed. 1984) (which is probably the best of today's casebooks) contains 38 pages and Baird and Jackson, Cases, Problems and Materials on Security Interests in Personal Property, (1st ed. 1984) contains only 18 pages.

The problem is that commercial law has become so complex that survey courses are necessary and only a limited number of courses or seminars focus on

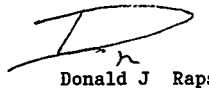
Commercial law in-depth — and then only on the most vital subjects such as sales, secured transactions, bankruptcy and the like. As a result, suretyship is only covered tangentially and in very little detail.

Under these circumstances, it is wholly appropriate, after 45 years to reexamine the suretyship principles set forth in the Restatement of Security; to examine anew the relationship and applicability of the related concepts governing insurance, standby letters of credit, credit enhancement facilities and the like; and to make the Uniform Commercial Code as complete and consistent therewith as feasible.

It seems evident that a study of suretyship and the related doctrines would not only be a great practical importance and interest to the practising bar and judiciary, but also be intellectually stimulating and challenging to the academic community For these reasons, it strikes me that the recommended project is ideal for favorable consideration by the American Law Institute.

If I can be of further assistance, please let me know.

Sincerely,



Donald J Rapson

DJR:MLH

cc: Paul Wolkin, Esq.
Martin Aronstein, Esq.

APPENDIX B

May 30, 1989

Why a Restatement of Suretyship is Needed

by Donald J. Rapson

1. As all forms of financing, commercial and consumer, expand, both in volume and in format, there is an increased risk with a correlative need for additional credit support from third persons. The commercial world often uses the term "credit enhancement" These take various forms, traditional and innovative, e.g..

   a. Accommodation parties to promissory notes and other instruments, negotiable and non-negotiable.
   b. Guaranty Agreements.
   c. Recourse (full and limited) Agreements.
   d. Hypothecation (non-recourse) Agreements.
   e. Vendor Subsidization Agreements.
   f. Financial Guaranty Bonds.
   g. Credit Insurance.
   h. Standby Letters of Credit (sometimes referred to as guaranty letters of credit).

2. At the same time that the importance and use of third party credit supports (hereafter "suretyship") has been increasing, substantive knowledge of the subject among the bench and bar has been decreasing. This is attributable to a number of factors:

   a. Suretyship has not been taught in American Law Schools since the mid-1950's, or, if taught at all, at most for an hour or two in a negotiable instruments (UCC Article 3) course. With the advent of the UCC, commercial law courses were structured upon the content of the UCC, which only treats suretyship sketchily, e.g. UCC 3-415, 3-416, 3-606; and those few provisions only cover a limited

class of sureties, viz. accommodation signers of instruments covered by Article 3.

b. Textual treatment of suretyship is generally obsolete. The Restatement of Security, which covers suretyship in Division II, was published in 1941. Professor Hanna, who was the Reporter, furnished an up-date in his Casebook on Security (2d Ed. 1952), which allots 201 pages to the subject. In contrast, recent casebooks give little attention to the subject, e.g.. Farnsworth and Honnold (3d Ed. 1984) - 38 pages; Baird and Jackson (1st Ed. 1984) - 18 pages; Jordan & Warren (1st Ed. 1983) - 19 pages. The most recent treatises are Arant, Suretyship and Guaranty (1931); Stearns, Suretyship (4th Ed. 1934), and Simpson on Suretyship (1950). Williston on Contracts (3d Ed. 1967) contains a lengthy chapter on suretyship and guaranty (10 Williston on Contracts §§ 1211-1284A), but this chapter is essentially an up-date of earlier editions. The recent treatise by Blumberg, The Law of Corporate Groups, (1985) deals extensively with corporate guaranties (pp. 285-362), but is essentially focused on corporate and fraudulent convenyence law

c. As a consequence, the law of suretyship has, in most jurisdictions, become an obscuré part of the common law Only a few states have comprehensive statutory treatment, e.g. Calif. Civ Code §§ 2785-2855. Inasmuch as all jurisdictions have enacted UCC Article 3, there are often conflicts and inconsistencies between the UCC provisions (albeit sketchy) and the applicable common or statutory law.

3. The relationships to and distinctions among suretyship devices and between other bodies of law and concepts is not clear. Consider the following questions:

a. At one time and even today in some jurisdictions, there has been a purported distinction between suretyship and guaranty Does this distinction make sense and, if so, does it have any present relevance?

b. What is the difference, if any, between suretyship and insurance? It has been said that suretyship involves a three-party relationship, viz. surety, principal and creditor in-

volving a common obligor, whereas insurance is a two-party contractual relationship that is independent of the insured's obligation. Are differing bodies of law applicable? Insurance is highly regulated, but are these regulatory considerations applicable to suretyship? Where does a financial guaranty bond fit in this structure? If the factoring of accounts receivable is viewed as the equivalent of credit insurance, where does it fit? Consider Restatement of Security §117, Comment d.

> (d) The surety, if he desires, may assume a risk greater than that which would be implied from a mere guaranteeing of the principal's performance. The surety may contract not only as a surety but also as an insurer, that is, that he will indemnify the creditor against loss, irrespective of the continuance or even of the existence of a duty on the part of the principal. Such a contract may be stated in specific terms or it may be implied from terms used, interpreted in the light of the circumstances. (underlining supplied)
> ***

c. Are there different classes of suretyship for which there should be differing treatment? Restatement of Security § 82, Comment 1 distinguished between compensated and other sureties. Is this a useful or even a recognized distinction in the cases? What is the difference between a compensated surety and an insurer? If there is economic benefit to the surety, does it become a compensated surety? If the surety is an "insider", e.g. a principal or affiliate company, should that be a separate class? Should there be a difference between the rules for commercial and consumer sureties? If there are meaningful class distinctions to be drawn, what should they be and what legal consequences should flow from those distinctions?

d. Standby-letters of credit (S/L/C/) present a special problem. The traditional view is that these are not suretyship documents, but are governed by a discrete body of law, viz. UCC Article 5 and the Uniform

Customs and Practice for Documentary Transactions (UCP). Consider the following statement:

> "A letter of credit always serves as a guaranty This does not mean that it is a guaranty A letter of credit is an identical twin to a guaranty but the fact that the two things look alike and may be used for the same purpose and are difficult to distinguish from the other, does not mean that there are not differences which, however subtle, are of major importance." Harfield, Code Treatment of Letters of Credit, 48 Cornell L.Q. 92, 93 (1962).

S/L/C/ have also been recognized as the functional equivalents of insurance and the recent Federal Reserve Risk-Based Capital Guidelines refer to a "financial guarantee standby letter of credit" (12 CFR Part 208, Appendix A).

Although there may well be compelling reasons for maintaining the dichotomy between suretyship and letter of credit law, might it be appropriate to apply certain aspects of the former to the latter without impairing the distinctiveness of the S/L/C, e.g. the right of subrogation? Cf. In re Minnesota Kicks, Inc., 48 B.R. 93 (Bankr. D. Minn. 1985) with In re Kaiser Steel Corp., 89 B.R. 150 (Bankr. D. Col. 1988).

4. Suretyship, being a hoary and distinctive body of law, contains a number of concepts which probably should be reanalyzed and evaluated:

   a. The traditional suretyship defenses of (1) impairment of collateral and (2) alteration of the underlying debt are based on the proposition that the surety is entitled to special protection and anything that changes its obligation should result in its discharge under strictissimi juris. The more recent view is that the surety should only be discharged to the extent it has been prejudiced. Cf. Restatement of Security § 122 with § 128.

b. Notwithstanding the imperative nature of the suretyship defenses, the doctrine of "reservation of rights" anomalously permits the surety to agree with the principal to alter the debt and at the same time to unilaterally and without notice reserve its rights against the surety Does this continue to make sense? Cf. Restatement of Security § 122, Comment d.

c. There is a well-established tradition of the surety being able to waive the suretyship defenses. Does a guaranty that explicitly states that it is "absolute and unconditional" effect such a waiver? There is a split of authority with most recent cases holding that "absolute and unconditional" is insufficient and that the waiver must be more specific and expressly refer to the precise defense being waived.

d. Notwithstanding the general perception that suretyship is a contractual relationship governed by the terms of the contract and that waivers are broadly enforceable, there exists today a major deviation with respect to the enforceability of a waiver by the surety of notice of foreclosure of a security interest and the defense of commercial reasonableness under UCC Article 9. This issue has engendered much litigation with the majority of cases holding that such waivers are unenforceable, although there is a significant dissenting view. If the surety can effectively agree to being sued directly without prior resort to the collateral, why shouldn't the surety's waivers with respect to foreclosure of the collateral be enforceable?

e. This issue of the enforceability of suretyship waivers has recently arisen in a new context, i.e. vicarious preference liability under Bankruptcy Code §§ 547 and 550(a) because of the existence of "an insider guaranty" See In re V.N. Deprizio Construction Co., 874 F.2d 1186 (7th Cir. 1989). As a consequence of that decision, lenders will endeavor to resolve the problem by eliminating the guarantor's contingent status as a "creditor" of the principal by having the guarantor waive its right of "subrogation, reimbursement, compensation, contribution and the like" Will

that waiver be enforceable or deemed inimical to the bankruptcy policy against preferences?

f. Although the general rule is that the consideration supporting the obligation of the principal supports the obligation of the surety and that separate, independent consideration is not needed to support the surety's obligation, there is confusion as to whether separate consideration is needed to hold the surety when it becomes liable after the original obligation was incurred. The historic rule required new consideration, but UCC 3-408 and 3-415 purport to change the rule. See Comment 3 to 3-415. Should the rule be broadly changed? What would suffice as new consideration? Should it be a quantitative test?

5. Although suretyship certainly arises out of an express contract, it is essentially a relationship concept that can also be implied from factual situations. See Restatement of Security § 82, Comment h, §83. The consequence is that the special rights, duties and obligations of suretyship law then become applicable. There may be a need to consider whether the suretyship relation and the resulting obligations can also arise in other situations, not heretofore considered under suretyship, particularly in view of the development of different and complex commercial transactions. For example:

a. A participation agreement does, in certain circumstances, impose duties upon the lead with respect to the participant, e.g. the lead assures the participant that its losses will not exceed a stipulated level. Some courts and commentators have taken the position that those duties are of a fiduciary nature. Is there any correlation between such fiduciary duties and suretyship?

b. What is the distinction between guaranty and warranty? If a party makes certain warranties with respect to the obligations or performance of another, is that party a surety entitled to the special rights and protection afforded that status? For example, where one lender sells a portfolio of receivables to another lender, or there is a securitization of that portfolio, do the warranties made by the seller

with respect to the receivables entitle it to the rights of a surety?

c. The so-called "comfort letter" is an attempt by a parent or affiliate company to give assurances to a creditor of the debtor company that will fall short, however, of imposing suretyship liability Where is the bright line? What legal efficacy, if any, is there to these comfort letters? Should the law impose legal consequences on the issuance of such documents, especially where there is intended to be some detrimental reliance by the creditor?

d. Historically and increasingly at present, there have been equitable doctrines imposing duties upon senior lienholders with respect to the rights of junior lienholders, e.g. marshaling, liability for releases of collateral which operate to the detriment of the junior, etc. Is there a relationship between those duties and the duties of a creditor to a surety, such as the rules against impairment of collateral and alteration of the underlying debt?

Conclusion:

After 48 years it is wholly appropriate to reexamine suretyship principles, including those set forth in the Restatement of Security, and to examine anew the relationships and applicability of those principles to the new and complex commercial transactions that have since developed and to related bodies of law and analogous concepts and doctrines.