Striking the Balance: The Evolving Nature of Suretyship Defenses

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I. INTRODUCTION

Suretyship is no longer part of general curriculum in most law schools. When I attended law school in the mid-1970s, the concept of suretyship essentially was absent from the legal canon passed on to law students. Indeed, I believe that I graduated from law school without ever hearing the word "surety." My first memory of hearing that word relates to an experience relatively early in my days of private practice with a law firm that represented several banks. On one occasion, a transaction involving one of the firm’s clients required the preparation of a somewhat unique promissory note—unique enough, at least, that none of the firm’s standard forms quite fit the bill. I was assigned the task of preparing the note. When I finished a draft of the note, I went to see the partner with whom I was working, hoping that the draft would receive his approval. After asking me a few easy questions about my draft, the partner then inquired, "Did you waive all suretyship defenses?" "I don’t know," I responded, "what are they?" The partner answered, "I don’t know either, but I know that you’re supposed to waive them."

Being somewhat uneasy with the idea of drafting a waiver of rights the existence of which I had been unaware until only moments earlier, I decided it was essential that I learn something about the law of suretyship. Accordingly, I decided to examine a treatise on suretyship. I requested the most recent treatise on the subject and was greeted the next morning by a work that was indeed the most recent—and had been published before I was born.

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Today, some fifteen years later, that book¹ is still the most recent treatise.

The intervening fifteen years of economic instability since my first exposure to suretyship law have shown a dramatic growth in the use of suretyship and related credit enhancement devices. Yet, until recently, this growth, like a cruise missile, sailed speedily below the radar of academics. Only in the last few years, since the American Law Institute set out to prepare a Restatement of Suretyship, has the academic world begun to reexamine the law of suretyship.

It is perhaps ironic that the aspect of suretyship law that has changed the most in recent years, and that is the arena for the most significant conceptual battles, is the same area through which my law firm supervisor first introduced me, however glancingly, to suretyship law—the area of “suretyship defenses.” This Article briefly surveys the function of suretyship defenses, sets out the various competing doctrines that have developed to fulfill this function, examines the concepts underlying these doctrines, and suggests directions for the continued evolution of these doctrines.

II. THE FUNCTION OF SURETYSHIP DEFENSES

In a typical two-party contract, the obligor owes a duty to the obligee, and the obligee bears the credit risk that the obligor will be unable to perform that duty. For example, if D borrows $1000 from C, agreeing to repay the loan in ninety days, C, the obligee, bears the credit risk that D, the obligor, will be unable to repay in accordance with the contract. In this case, once the loan is made, only D’s promise to repay is executory. In the case of a bilaterally executory contract, whereby both parties’ obligations are to be fulfilled in the future, the analysis is a bit more complex, but the result is the same. Suppose that B agrees to construct a building for O in exchange for a fixed amount of money. In that case, B, the obligee of O’s promise to pay, bears the credit risk that O will be unable to pay, while O, the obligee of B’s promise to construct the building, bears the credit risk of B’s inability to fulfill that prom-

¹ ARTHUR A. STEARNS, THE LAW OF SURETYSHIP (5th ed. 1951). The most recent “new” treatise was published the previous year. See LAURENCE P. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP (1950).
ise. In each of these cases, the obligee of a promise bears the credit risk that the obligor will be unable to fulfill the promise.

The economic function of suretyship devices is very simple—to free the obligee of all (or at least most) of the credit risk that the obligor will be unable to perform. A number of legal forms can be utilized to bring about this economic result. All of these forms, however, share a core description: the obligee is entitled to performance not only from the principal obligor but also from a third party—the secondary obligor. As between the principal obligor and the secondary obligor, it is the principal obligor who has the ultimate legal duty to perform or bear the cost of performance, but this allocation of ultimate cost is of little concern to the obligee.

In the first example above, assume that $G$ has guaranteed $D$'s duty to repay the $1000 loan. Now, $C$ is entitled to repayment not only

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2. Terminology used to describe suretyship transactions varies widely. This Article uses the terminology adopted by the proposed Restatement of Suretyship. See Restatement (Third) of Suretyship § 1 (Tent. Draft No. 1, 1992). Sections 1 through 45 of the proposed Restatement have been published to date. Sections 1 through 17 are included in Tentative Draft No. 1, published in 1992. Although this draft actually contains §§ 1-20 of the Restatement, only the first 17 sections were considered and approved by the membership of the American Law Institute at its first session in May 1992. Sections 18-20 were reworked slightly and included in subsequent drafts of the Restatement. See Restatement (Third) of Suretyship at xv (Tent. Draft No. 2, 1993). Sections 18 through 45 appear in Tentative Draft No. 2, published in April 1993.

3. Section 1 of the Restatement describes suretyship transactions as follows:

(1) A "secondary obligor" has suretyship status whenever:
   (a) one person (the "principal obligor") owes performance of a duty (the "underlying obligation") to another person (the "obligee"); and
   (b) pursuant to contract, a third person (the "secondary obligor") is subject to a "secondary obligation," whereby either:
     (1) the secondary obligor also owes performance, in whole or in part, of the duty of the principal obligor to the obligee; or
     (2) the obligee has recourse against the secondary obligor or its property:

        (i) in the event of the failure of the principal obligor to perform the underlying obligation; or
        (ii) to protect the obligee against loss arising from potential non-performance by the principal obligor; and
     (c) to the extent that the underlying obligation or the secondary obligation is performed the obligee is not entitled to performance of the other; and
     (d) as between the principal obligor and the secondary obligor, the principal obligor has a duty to perform the underlying obligation or bear the cost of performance.

Restatement (Third) of Suretyship § 1(1) (Tent. Draft No. 1).
from \( D \), the principal obligor, but also from \( G \), the secondary obligor; as between \( D \) and \( G \), it is \( D \) who ought to perform. In the second example, assume that \( S \) has issued a performance bond agreeing, in the event of \( B \)'s default, to construct the building or pay damages up to a fixed sum. Now, \( O \) is entitled to performance from both \( B \), the principal obligor, and \( S \), the secondary obligor; as between \( B \) and \( S \), it is \( B \) who ought to perform. In each of these cases, the presence of a secondary obligor transforms each simple two-party transaction into a more complex, three-party suretyship transaction.

Thus, suretyship is a legal device that largely frees the obligee from the credit risk of a transaction. In a two-party transaction, the obligor has a duty, and the obligee bears the credit risk that the obligor will not fulfill that duty. In a suretyship transaction, the addition of the secondary obligor changes this relationship. Now, the secondary obligor bears the credit risk, because if the principal obligor does not perform, the secondary obligor must do so.

Although the secondary obligor bears the credit risk in a suretyship transaction, still the principal obligor retains the ultimate legal duty to perform or bear the cost of performance. Suretyship law provides several devices to place the ultimate burden on the principal obligor. For example, a secondary obligor who performs the secondary obligation is generally entitled to be subrogated to the rights of the obligee against the principal obligor.\(^4\) Furthermore, in cases in which the principal obligor is charged with notice of the secondary obligation,\(^5\) the principal obligor not only owes a duty that runs directly to the obligee, but it also owes two duties that run to the secondary obligor. First, the principal obligor owes the secondary obligor a duty of performance: \(^6\) the principal obligor must "perform the underlying obligation to the extent that failure to do so would leave the secondary obligor liable for performance" and "refrain from conduct that impairs the reasonable expectation of the secondary obligor that the principal obligor will honor its

\(^4\) Restatement (Third) of Suretyship § 23(1) (Tent. Draft No. 2); see also id. § 24 (enumerating the rights to which the secondary obligor is subrogated).

\(^5\) See Restatement (Third) of Suretyship § 16 (Tent. Draft No. 1).

\(^6\) Id. § 17(1)(a).
duty of performance." Second, in the event that the secondary obligor performs its secondary obligation, the principal obligor must reimburse the secondary obligor for its cost of performance. If the principal obligor is not charged with notice of the secondary obligation, the secondary obligor is entitled to restitution from the principal obligor, a remedy that in practice is nearly identical to reimbursement.

In sum, even if the secondary obligor performs for the obligee, the ultimate legal responsibility for the cost of that performance remains with the principal obligor. Yet, because the principal obligor may be unable or unwilling to perform, the secondary obligor's role is critical. As a result of this assumption of credit risk by the secondary obligor, the symmetrical arrangement of claims and duties present in a two-party transaction is skewed. Although the burdens on, and benefits to, the principal obligor remain essentially unchanged, the balance of burdens and benefits for the obligee improve significantly, with the slack being taken up by the secondary obligor. With the secondary obligor as part of the transaction, the obligee is the ultimate beneficiary of the promises of the principal obligor and the secondary obligor, but the obligee bears little credit risk; the only credit risk that is on the obligee is the risk that neither the principal obligor nor the secondary obligor will perform. The secondary obligor bears the credit risk of the principal obligor's default and, in return, possesses its claims against the principal obligor plus the consideration it received for entering into the secondary obligation.

In any case, the secondary obligation is created by contract and, as in the case of all contracts, the secondary obligor enters into its situation voluntarily. A number of factors can influence the secondary obligor's decision to undertake the credit risk of a transaction. Sometimes the secondary obligor has familial ties to the

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8. Id. § 17(1)(b).
9. See Restatement (Third) of Suretyship § 18 (Tent. Draft No. 2, 1993); see also id. § 19 (providing the measure of reimbursement allowed). In certain instances, the duty to reimburse does not arise. See id. § 20.
10. Id. § 22(a).
11. See Restatement (Third) of Suretyship § 14 (Tent. Draft No. 1) (providing that suretyship status entitles the secondary obligor to recourse against the principal obligor).
12. See id. § 1(1)(b).
principal obligor or is bound to the principal obligor by ties of friendship. In these cases, the secondary obligor receives no benefit from the transaction other than the satisfaction of having made possible the principal obligor's obtaining credit that otherwise would have been unavailable.

In other cases, the secondary obligor expects to reap an indirect pecuniary benefit from the transaction creating the underlying obligation. This can arise in two sorts of cases. In the more common situation, the secondary obligor is an owner (typically a controlling shareholder) of the principal obligor. As an owner of the enterprise obtaining credit as a result of the secondary obligation, the secondary obligor indirectly reaps whatever benefit accrues to the principal obligor as a result of the transaction.

Sometimes, the indirect benefit arises differently, as when one party agrees to be a secondary obligor for a transaction of a principal obligor with whom the secondary obligor does business. A common example is provided by large manufacturers, who often guarantee loans to their suppliers. In these cases, the secondary obligor preserves its own business prospects by strengthening the credit of its supplier. Another example is provided by sellers of goods who help their buyers obtain financing by becoming secondary obligors with respect to the loans taken out by the buyers to finance the purchase price of the goods. A third factor that often induces the secondary obligor to incur the secondary obligation is direct consideration flowing to the secondary obligor. Payment and performance bonds issued by surety bond companies, for example, fall into this category.

Whatever the inducement to enter into the secondary obligation, the determination by the secondary obligor to assume the credit risk inevitably involves an assessment by the secondary obligor of the principal obligor's credit. For if the principal obligor will be unable to fulfill its duties to the secondary obligor and the obligee, the ultimate cost of performance will fall on the secondary obligor.

Thus, the decision to become a secondary obligor essentially entails a cost-benefit analysis in which the secondary obligor must determine whether the expected benefit (direct or indirect) from
entering into the obligation is greater than the expected cost.\textsuperscript{13} The expected cost, of course, is the cost to the secondary obligor of having to perform the secondary obligation multiplied by the probability that the secondary obligor will have to bear that cost. The expected cost depends on a number of factors, almost all of them outside of the control of the secondary obligor. Most of these factors are general economic conditions outside the control of all three parties to the transaction. Some, such as the conduct of the principal obligor’s business affairs, are within the control of the principal obligor and others, it is important to note, are within the control of the obligee.\textsuperscript{14}

Although the principal obligor has the ultimate control of its conduct and thus has the power to engage in activities that lessen the likelihood that it will be able to perform the underlying obligation or simply refuse to perform that obligation, the duties running from principal obligor to secondary obligor\textsuperscript{15} provide at least some incentive for the principal obligor not to take such actions that will increase the expected cost to the secondary obligor. In any event, the existence of the secondary obligation certainly does not increase the incentive for the principal obligor to become judgment-proof. Even if the secondary obligor performs its obligation to the obligee, the principal obligor will owe the same performance.\textsuperscript{16} In such a case, of course, the performance will be owed to the subrogated secondary obligor rather than the obligee, and this duty of performance will likely be augmented by either a duty of reimbursement\textsuperscript{17} (which might even increase the total cost to the principal obligor\textsuperscript{18}) or by the secondary obligor’s right of restitution.\textsuperscript{19}

Furthermore, through the secondary obligor’s so-called \textit{quia

\begin{footnotes}
\item[13] See \textsc{Reformation (Third) of Suretyship} Title B. Suretyship Defenses, introductory note (Tent. Draft No. 2) (discussing the risk assessment performed by a secondary obligor).
\item[14] See infra notes 22-27 and accompanying text.
\item[15] See \textsc{Reformation (Third) of Suretyship} § 14 (Tent. Draft No. 1) (enumerating the rights conferred upon the secondary obligor that are enforceable against the principal obligor).
\item[16] See \textsc{Reformation (Third) of Suretyship} § 19(1) (Tent. Draft No. 2).
\item[17] See id. § 18.
\item[18] The measure of the principal obligor’s duty to reimburse is the secondary obligor’s total cost of performance, \textit{including incidental expenses}. Id. § 19(1).
\item[19] See id. § 22.
\end{footnotes}
timet right to relief from conduct by the principal obligor "that impairs the reasonable expectation of the secondary obligor that the principal obligor will honor its duty of performance," the secondary obligor has an additional weapon against conduct by the principal obligor that increases the secondary obligor's expected cost of performance. Thus, suretyship law provides adequate protection against such conduct by the principal obligor.

There are, however, a number of factors within the control of the obligee that can increase the expected cost of performance of the secondary obligor. The obligee may, for example, release the principal obligor from the underlying obligation (perhaps in exchange for an uncontested partial payment); grant the principal obligor an extension of the time for performance of that obligation or otherwise agree to a modification of it (perhaps in the belief that such an extension or modification will increase the likelihood of ultimate performance by the principal obligor); impair collateral securing the underlying obligation (either intentionally or inadvertently); or engage in a course of conduct that precludes further action against the principal obligor. In each of the above examples, even if the obligee's act reduced the potential recovery from the principal obligor, the obligee's ultimate recovery would be unaffected so long as the secondary obligor is solvent. Yet, the obligee's action reduces the secondary obligor's likely recovery from the principal obligor through reimbursement, restitution, or subrogation. Thus, so long as the secondary obligor is solvent, actions such as those described above would be particularly charmed—the obligee could reap whatever benefit might accrue from them while the loss, if any, would fall on the secondary obligor.

21. Id. § 17(1)(b).
23. Id. §§ 33(2)(b), 36.
24. Id. §§ 33(2)(c), 37.
25. Id. §§ 33(2)(d), 38.
26. See id. §§ 33(2)(e), 39. Examples of such conduct include nonjudicial foreclosure of realty in a state, such as California, with a "one action" rule, see Union Bank v. Gradsky, 71 Cal. Rptr. 64 (Ct. App. 1968), or resale of Article 9 collateral in violation of U.C.C. § 9-504 in a state with an "absolute bar" rule, see C.I.T. Corp. v. Anwright Corp., 237 Cal. Rptr. 108, 111-12 (Ct. App. 1987).
27. Restatement (Third) of Suretyship § 33 cmt. d (Tent. Draft No. 2).
The possibility that the obligee could take actions that are harmless to the obligee (because the secondary obligor performs the secondary obligation) but harmful to the secondary obligor (because the actions interfere with the secondary obligor's ability to be made whole by the principal obligor) has traditionally been seen as unfair. After all, the suretyship bargain—from the perspective of the secondary obligor—is essentially that in exchange for undertaking the secondary obligation, the secondary obligor receives whatever consideration (direct or indirect) is called for in the bargain plus the benefit of the rights of subrogation and restitution and the principal obligor's duties to the secondary obligor. Yet, actions of the sort described in the previous paragraph can either destroy those rights or undermine the practical ability to enforce them. By taking such actions, the obligee would essentially be tampering with the delicate equilibrium of the suretyship transaction, maintaining the benefit of the secondary obligation while harming the position of the secondary obligor.

The doctrines collectively known as "suretyship defenses" have developed to prevent the obligee from unfairly imposing such costs on the secondary obligor. Generally speaking, suretyship defenses operate so that, if the obligee takes certain actions that destroy the equilibrium of the secondary obligor's position, the obligee's rights against the secondary obligor are diminished or eliminated.

While one can imagine the origins of suretyship defenses as being in tort (analogous, perhaps, to causes of action such as interference with advantageous contractual relations) or contract (violation of an implied covenant by the obligee not to interfere with the secondary obligor's rights), suretyship defenses are typically identified as neither, but, rather, simply as doctrines of suretyship law. Perhaps it is this status as conceptual orphan that has contributed to the incoherence of the development of the doctrines as described below.


III. COMPETING REGIMES OF SURETYSHIP DEFENSES.

A. Actions That Give Rise to Suretyship Defenses

As suretyship law has developed over the years, a number of different systems have developed to protect the secondary obligor against actions by the obligee that undermine the secondary obligor's rights vis-à-vis the principal obligor. Although these doctrines are often inconsistent with each other in terms of the implications of the obligee's interference with the equilibrium of the secondary obligor's position, they are relatively consistent with each other in terms of the types of acts that qualify as interference. The acts that typically count as improper interference are the following.

1. Release of Principal Obligor\(^{30}\)

Usually the release of the principal obligor occurs when the obligee accepts partial payment of the underlying obligation in exchange for release of the remainder. Although this can be beneficial to the secondary obligor if the obligee thereby obtains more from the principal obligor than would have been obtained, say, in bankruptcy proceedings had the partial payment not been made, it can be harmful to the secondary obligor if more could have been obtained from the principal obligor in the absence of the release.

2. Extension of Time for Principal Obligor's Performance.\(^{31}\)

Often, the obligee will grant an extension to the principal obligor. This typically occurs when the principal obligor is unable to perform the underlying obligation at the agreed-upon time. The hope is that the principal obligor will obtain the necessary funds by the extended due date. Obviously, if the extension enables the principal obligor to perform (or, at least, perform to a greater extent than would have been possible on the original due date), the extension is beneficial to the secondary obligor. If, however, the principal obligor's assets further dissipate during the period of the extension, the result is clearly harmful to the secondary obligor.

\(^{30}\) Restatement (Third) of Suretyship §§ 33(2)(a), 35 (Tent. Draft No. 2).
\(^{31}\) Id. §§ 33(2)(b), 36.
3. *Other Modification of Underlying Obligation*\(^{32}\)

In some cases, the obligee and the principal obligor will agree to a modification, other than an extension or release, of the underlying obligation. Most often, this occurs when the underlying obligation is not the payment of money but, rather, some other performance such as the construction of a building. Obviously, a modification that makes it more likely that the principal obligor will be able to perform the underlying obligation and, therefore, less likely that the secondary obligor will be called on to perform, can be beneficial to the secondary obligor. On the other hand, a modification that increases the burden on the principal obligor also increases the likelihood that the secondary obligor will be called on to perform. If the increased burden is not accompanied by increased consideration running to the principal obligor, the secondary obligor's ability to be made whole through subrogation is also harmed.

4. *Impairment of Collateral or Recourse Against Others*\(^{33}\)

It is very common for the obligee to obtain assurance of recovery from sources in addition to the secondary obligor. Most often, the obligee will obtain collateral for the underlying obligation. Frequently, however, the obligee will obtain another secondary obligor to agree to perform in the event that the principal obligor does not do so. Although the obligee is entitled to only one recovery,\(^{34}\) the existence of two secondary obligations obviously reduces the obligee's risk even further.

If the relationship between the two secondary obligors is that of cosuretyship, each one will have recourse against the other for contribution in the event of performance. In the less common situation of subsuretyship, the subsurety will have recourse against the secondary obligor with respect to whom he or she is subsurety. Moreover, the subrogation rights of a performing secondary obligor include rights against cosureties and subsureties.\(^ {35}\) If the obligee releases a person against whom a secondary obligor has recourse,

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32. *Id.* §§ 33(2)(c), 37.
33. *Id.* §§ 33(2)(d), 38.
35. *See Restatement (Third) of Suretyship* § 24(1)(b) (Tent. Draft No. 2).
the result is almost certainly harmful to the secondary obligor.  

Similarly, if the obligee releases its interest in any collateral for the underlying obligation, or causes the collateral to diminish in value, the secondary obligor is also harmed. The release or reduction will increase the deficiency sought from the secondary obligor, reduce the secondary obligor's recovery in subrogation, or both.

5. Other Impairment of Recourse

The preceding four categories catalog virtually all actions taken by the obligee that have a detrimental effect on the secondary obligor and, therefore, are generally agreed to give rise to suretyship defenses. Occasionally, however, a case arises in which an obligee has taken an action that does not fall within one of those categories but, nonetheless, clearly impairs either the principal obligor's duty of performance or reimbursement or the secondary obligor's right of restitution or subrogation. In such cases, the courts have not hesitated to declare such an act to give rise to suretyship defenses.

All of the actions described above would disturb the equilibrium of the secondary obligor's position. They either interfere with the principal obligor's likelihood of performance, impair the duty of the principal obligor to reimburse the secondary obligor for the cost of its performance, or destroy the value of the secondary obligor's subrogation rights against the principal obligor. Thus, while the secondary obligor's duties would otherwise remain intact, these actions impair the secondary obligor's recourse against the principal obligor. Accordingly, the proposed Restatement generally labels these actions as "impairments of recourse."

36. Only if complete recovery could be obtained from the principal obligor, or no recovery could be obtained from the released person, would the release be harmless to the secondary obligor.

37. Id. §§ 33(2)(e), 39.

38. See, e.g., Union Bank v. Gradsky, 71 Cal. Rptr. 64 (Ct. App. 1968) (involving a creditor's election to pursue a remedy that destroyed the possibility of the surety's reimbursement).

39. See Restatement (Third) of Suretyship § 33 (Tent. Draft No. 2).
B. Effect on Obligee’s Rights Against Secondary Obligor

The major differences among the various regimes of suretyship defenses appear in the sanctions they impose on an obligee who impairs the secondary obligor’s recourse and, thereby, disturbs the equilibrium of the secondary obligor’s position. At least five models exist.

1. Model 1: Automatic, Complete Discharge

Under this model, the secondary obligor is completely discharged from the secondary obligation if the obligee has impaired the secondary obligor’s recourse against the principal obligor, whether or not the impairment of recourse caused (or might cause) the secondary obligor any loss.40 This is the simplest of all models. Almost no factfinding is required. Once it has been determined that the obligee has done an act constituting an impairment of recourse, the secondary obligor is discharged. Period. The fact that the act was harmless, that it never could cause harm, or, if harmful, that it caused the secondary obligor only a small loss, is irrelevant.

Although many, if not most, releases, extensions, or other modifications are harmful to the secondary obligor’s position, this is not always the case. Upon full examination of the circumstances of a case, one can see that some impairments of recourse, such as a release given to a judgmentproof principal obligor, have no effect on the secondary obligor. Others, such as an extension of time that enables the principal obligor to gather the resources to perform, can even be beneficial. Of course, in those cases, the harmless or beneficial effect of the act impairing recourse can be determined only after doing some factfinding, a process which this model seeks to avoid. Yet, under this model, secondary obligors have been discharged when the impairment of recourse could only be beneficial to them.41 Thus, a desire to avoid factfinding as to harm cannot entirely explain this model.

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40. See, e.g., U.C.C. § 3-606(1)(a) (1989). This approach is not contained in the current U.C.C., as revised in 1990. The new U.C.C. approach to discharge of the secondary obligor’s obligation is found in U.C.C. § 3-605 (1990). See infra notes 43-48 and accompanying text.

41. See, e.g., Driscoll v. Winters, 54 P. 387, 388 (Cal. 1898) (determining that a secondary obligor for a purchaser of milk was discharged when the quantity to be purchased was de-
2. Model 2: Complete Discharge for Harmful Acts

This model is essentially a variation on Model 1, except that there is no discharge of the secondary obligor for acts that can only be helpful to the secondary obligor. Thus, unlike in Model 1, the secondary obligor would not be discharged for a decrease in the interest rate of the underlying obligation or for any other reduction of the principal obligor’s duty. On the other hand, this model does bring about the secondary obligor’s discharge whenever the obligee does an act constituting impairment of recourse that is potentially harmful to the secondary obligor, regardless of whether that act is actually harmful or if the harm is equal to the secondary obligor’s duty. Thus, under this model, an extension of time granted to the principal obligor will always discharge the secondary obligor because the principal obligor’s condition could worsen during the period of extension. Whether the principal obligor’s condition actually does worsen during that time is immaterial under this analysis. Similarly, a release of the principal obligor always discharges the secondary obligor because the principal obligor might have assets that could have been used to fulfill its obligation. As with Model 1, an advantage of this model is that no serious factfinding is required. If the act impairing recourse is of a sort that could be harmful to the secondary obligor, the secondary obligor is completely discharged.

3. Model 3: Ameliorated Complete Discharge

Under this model, which is much more complicated than the previous two, the effect of an act impairing the secondary obligor’s recourse differs depending on the effect of the impairment of recourse and the nature of the secondary obligor. If the secondary obligor is uncompensated (i.e., the secondary obligor receives no direct consideration for entering into the secondary obligation), the effect of an act impairing the secondary obligor’s recourse is the same as it would be under Model 1 or 2—that is, the secondary obligor is discharged. On the other hand, if the secondary obligor is}

creased); Board of Comm’rs v. Greenleaf, 83 N.W. 157, 158 (Minn. 1900) (holding that a reduction of the interest rate from 3% to 2% discharged an uncompensated secondary obligor); Katz v. Leblang, 277 N.Y.S. 850, 853 (App. Div. 1935) (holding that a reduction in lease rent discharged a surety for a tenant).
compensated (i.e., the secondary obligor receives direct consideration for entering into the secondary obligation), he or she is completely discharged only if the act impairing the secondary obligor's recourse was a release of the principal obligor or a modification that materially increased the secondary obligor's risk. Otherwise, if the act impairing recourse is merely an extension of the underlying obligation or a modification that does not materially increase the secondary obligor's risk, the secondary obligor is discharged only to the extent that the impairment of recourse would otherwise cause the secondary obligor to suffer a loss. This is a significant difference from Models 1 and 2 because, in at least some cases, application of the model requires factfinding as to the effect of the impairment of recourse. Model 3 was adopted by the American Law Institute in 1941, when the Restatement of Security was promulgated.\textsuperscript{42}

4. Model 4: No Discharge for Releases; Otherwise, Discharge to Avoid Loss

Under this model, which appears in revised Article 3 of the Uniform Commercial Code,\textsuperscript{43} the rule applied to compensated secondary obligors in Model 3 applies to all secondary obligors. In other words, an act impairing recourse will discharge the secondary obligor only to the extent that the act would otherwise cause the secondary obligor to suffer a loss.\textsuperscript{44} Just as in Model 3, this model treats a release of the principal obligor differently than other acts constituting impairment of recourse. In Model 4, however, the special rule governing releases is almost exactly the opposite of the special rule in Model 3. In Model 3, a release of the principal obligor always discharges the secondary obligor, even if the release causes the secondary obligor no harm (as would be the case for a principal obligor who is left judgmentproof).\textsuperscript{45} In Model 4, by contrast, the obligee's release of the principal obligor never discharges the secondary obligor—even if the result of the release is to put the secondary obligor in a worse position than it would have been

\textsuperscript{42} See Restatement of Security §§ 128-129 (1941).
\textsuperscript{43} See U.C.C. § 3-605 (1990).
\textsuperscript{44} Id. § 3-605(c)-(d).
\textsuperscript{45} Restatement of Security § 110.
in had there been no release. As I have argued previously, this treatment of releases is difficult to justify; Nonetheless, it is incorporated in the official text of revised Article 3 and is now the law of a significant number of states.

5. Model 5: Discharge Only to Avoid Loss

Under this model, adopted by the proposed Restatement of Suretyship, the secondary obligor is discharged as a result of an act impairing recourse only to the extent that the secondary obligor would otherwise suffer loss. Therefore, the secondary obligor always breaks even in the sense that the remedy for an act constituting an impairment of recourse puts the secondary obligor back into the same economic position it would have been in had the act never taken place. Of course, the cost of this break-even approach is that the factfinder has the task not only of determining that an act impairing recourse has occurred, but also of measuring the resulting harm to the secondary obligor.

IV. Reactive Doctrines

Throughout most of the development of suretyship law, the first two models described above held sway. Whatever the merits of those models, they share an important trait—the obligee can lose all of its rights against the secondary obligor as a result of an action that caused the secondary obligor little or no harm. At best, the penalty these doctrines impose on the obligee is quite likely to far exceed the harm caused by the obligee’s act. After all, an obligee is not likely to release a principal obligor who has the wherewithal to perform.

To the extent that a release of the principal obligor causes the secondary obligor a loss at all, such a loss probably will result from the obligee’s failure to squeeze every last nickel from the principal

47. U.C.C. § 3-605(b).
48. As of March 15, 1993, the revised Article 3 was enacted in 20 states. UCC Scorecard, UCC COMMITTEE UPDATE, Mar. 1993, at 18-19.
50. See supra parts III.B.1-.2.
obligor as consideration for the release. The accurate measure of the secondary obligor's loss would therefore equal only the amount that the obligee could have obtained from the principal obligor, but did not. This sum will almost certainly be less than the entire amount of the secondary obligation.

Similarly, an obligee will rarely grant an extension to a principal obligor who is capable of performing on the original due date. An extension typically represents a concession that performance is impossible on the original date, combined with a determination that the extension will enable the principal obligor to improve its financial condition sufficiently to enable full, or at least greater, performance. If the obligee is correct, the extension will have caused the secondary obligor no loss at all and may even have benefited the secondary obligor. If the obligee is wrong, and the principal obligor's position worsens during the extension period, the secondary obligor's loss will be only the amount of the deterioration, not the entire amount of the secondary obligation.

Thus, from the perspective of the obligee, Models 1 and 2 can be characterized as providing capital punishment for relatively minor offenses. From the perspective of the secondary obligor, these models can, and often do, result in windfalls. After all, if the principal obligor is unable to fulfill its obligation to the secondary obligor to perform or bear the cost of performance, the secondary obligor is better off if the obligee does an act constituting an impairment of recourse (such as granting the principal obligor an extension of the time to perform) than if the obligee refrains from such acts. This is because the act impairing the secondary obligor's recourse results in a complete discharge of the secondary obligor. If, on the other hand, the obligee refrained from that act, the secondary obligor would be liable to the obligee for any unperformed portion of the underlying obligation and would be unable to recover fully from the principal obligor.

Not only do these models create undeserved windfalls for secondary obligors, who are left better off by the obligee's act and its penalty than they would have been had the act not occurred, but Models 1 and 2 also create some undesirable disincentives. First, to the extent that the principal obligor's credit alone was insufficient to justify the obligee's risk of a proposed extension of credit, these models, with their easy discharges of secondary obligors, make it
less likely that the addition of a secondary obligor to the equation will change the obligee's credit decision. Second, once such a transaction is entered into, Models 1 and 2 provide a steep disincentive for the obligee to work with the principal obligor to enable the underlying obligation to be performed to the greatest extent possible.\footnote{Cf. U.C.C. § 3-605 cmt. 4 (noting that although an extension of time to pay a note benefits both the principal debtor and sureties, the prior version of the U.C.C. completely discharged the secondary obligor in such cases, regardless of whether the extension was trivial or whether the secondary obligor suffered any loss).}

Not surprisingly, then, the disincentives and windfalls resulting from Models 1 and 2 brought about the development and widespread use of doctrines that ameliorated their deleterious effects. Two such doctrines developed: waiver of suretyship defenses by the secondary obligor\footnote{See RESTATEMENT (THIRD) OF SURETYSHIP § 42 (Tent. Draft No. 2).} and “reservation of rights” by the obligee.\footnote{See id. § 34 & cmt. a.}

A. Waiver

From early on, suretyship law allowed secondary obligors to waive suretyship defenses. This deference to freedom of contract is present in the law of virtually every jurisdiction and is explicitly incorporated into the revised text of Article 3 of the U.C.C.\footnote{See U.C.C. § 3-605(i).} Indeed, waivers are so heavily utilized in some commercial contexts that it is rare to see a suretyship transaction in those contexts that does not contain a waiver of suretyship defenses. This context of nearly uniform waiver explains the story with which this Article begins.

The existence of a waiver doctrine, and its frequent utilization, should come as no surprise. The dire consequences that flow to the obligee under Models 1 and 2 in the event of an impairment of recourse make a secondary obligation a slim reed on which to rely. After all, many of the actions that constitute impairments of recourse and, therefore, give rise to suretyship defenses can occur inadvertently or can result from actions reflecting sound business sense with respect to increasing the likelihood of collection from the principal obligor. As a result, an obligee who will not extend credit to the principal obligor without the existence of a secondary
obligation is only slightly comforted by a secondary obligation that is so easily discharged.

Thus, obligees with sufficient market power—virtually all lenders—are unlikely to extend credit unless the secondary obligor has not only entered into the secondary obligation but also waived all suretyship defenses. Accordingly, it is not much of an exaggeration to say that, at least in certain contexts, suretyship defenses essentially do not exist. As a result, Models 1 and 2, which appear on the surface to give secondary obligors extremely broad protection against impairments of recourse, have brought about a regime in which secondary obligors typically have no protection whatsoever.

B. Reservation of Rights

A second, and more pernicious, doctrine that developed to ameliorate the harshness of Models 1 and 2 was the so-called “reservation of rights” doctrine. Under this doctrine, which persists to this day in the vast majority of jurisdictions, an obligee who takes an action that would otherwise discharge the secondary obligor as an impairment of recourse may prevent that discharge simply by announcing that it is “reserving rights” against the secondary obligor in conjunction with taking the action.

The Restatement of Suretyship provides:

Under [this] doctrine, two consequences followed from the mere act of informing the principal obligor that the obligee was reserving rights against the secondary obligor in conjunction with an act that would otherwise impair the secondary obligor’s recourse. First, by reserving rights against the secondary obligor, the obligee preserved all rights of the secondary obligor as though the conduct had never occurred. Thus, for example, if the obligee granted the principal obligor a one-year extension of the due date of a loan but reserved rights against the secondary obligor, the secondary obligor remained free to pay the loan on the original due date and seek immediate reimbursement from the principal obligor notwithstanding the extension granted to

56. See Restatement of Security § 122(b) (1941); Restatement (Third) of Suretyship § 34 cmt. a (Tent. Draft No. 2).
the principal obligor by the obligee. Second, by reserving rights against the secondary obligor, the obligee prevented discharge of the secondary obligor based on the conduct of the obligee because, according to the doctrine, the preservation of the secondary obligor’s rights as though the conduct had not occurred resulted in that conduct causing the secondary obligor no harm.57

There are two serious problems with this doctrine. First, it results in unfair surprise to a principal obligor who does not realize that, for example, a complete release of its liability to the obligee accompanied by the obligee’s reservation of rights against the secondary obligor does not modify the principal obligor’s duty to the secondary obligor to perform the underlying obligation58 on its original terms or bear the cost of its performance.59 Only the most sophisticated principal obligors would realize that a release, extension, or other modification of their obligation accompanied by the obligee’s incantation of a “reservation of rights” against the secondary obligor could result in the principal obligor’s liability to the secondary obligor based on the underlying obligation’s original terms.60

The Restatement continues:

The justification for the doctrine—that the preservation of the secondary obligor’s rights against the principal obligor that flows from the reservation of rights has the effect of preventing any harm to the secondary obligor resulting from the obligee’s actions—is based on unlikely assumptions about the behavior of secondary obligors.61

In particular, this justification assumes that a secondary obligor is eager to perform on the original terms of the transaction and is likely to do so voluntarily even though the principal obligor has been relieved of its duty to the obligee to perform in accordance with those terms.62

57. Restatement (Third) of Suretyship § 34 cmt. a, at 82 (Tent. Draft No. 2).
58. See Restatement (Third) of Suretyship § 17 (Tent. Draft No. 1, 1992).
59. See id. § 1; Restatement (Third) of Suretyship §§ 18-22 (Tent. Draft No. 2).
60. Restatement (Third) of Suretyship § 34 cmt. a, at 82-83 (Tent. Draft No. 2).
61. Id. at 83.
62. Id.
This justification also assumes a degree of sophistication in monitoring the principal obligor and the underlying obligation that many secondary obligors do not possess. [Indeed, t]he reservation of rights doctrine d[oes] not require the obligee to notify the secondary obligor of the change in the underlying obligation that was accompanied by the reservation of rights. Thus, when the time . . . for performance of the underlying obligation in accordance with its original terms [passes], and the secondary obligor [i]s not called upon to perform by the obligee, the secondary obligor might reasonably believe that the principal obligor ha[s] performed and, therefore, that the secondary obligor [i]s no longer liable.63

Thus, even a secondary obligor who, if he knew about the reservation of rights, would take actions to encourage the principal obligor to perform the underlying obligation or would otherwise act to protect his position, is unlikely to engage in such loss prevention because he will "be ignorant of both the act impairing recourse and the reservation of rights."64

Modern suretyship law, as exemplified by the proposed Restatement of Suretyship, adopts the fifth model described above65 to determine the consequences of acts that impair the secondary obligor's recourse against the principal obligor.66 This model avoids the harsh overreaction to impairments of recourse that mark earlier models, especially Models 1 and 2. As a result, the adopted model removes the pressure on the legal system to devise and allow ameliorating devices such as waiver theories and the reservation-of-rights doctrine. Nonetheless, respecting freedom of contract, the Restatement has retained the possibility of waiver.67

By the same token however, the proposed Restatement concludes that the fictional and formalistic reservation-of-rights doctrine has outlived whatever usefulness it may once have had and, therefore, does "not allow the obligee to prevent the discharge of the secondary obligor . . . merely by reserving rights against the

63. Id.
64. Id.
65. See supra part III.B.5.
67. Id. § 42(1)(b).
secondary obligor. The proposed *Restatement* does, however, allow

the obligee to minimize loss to the secondary obligor by expressly preserving the recourse of the secondary obligor against the principal obligor. When the obligee effectuates such a preservation of recourse, the release or extension granted to the principal obligor does not work a parallel change in the corresponding duties of the principal obligor to the secondary obligor. Thus, the preservation of recourse prevents loss to the secondary obligor that would otherwise result from obviation of the principal obligor's duty to the secondary obligor . . . .

Unlike the reservation-of-rights doctrine, the preservation of recourse is ineffective unless the obligee expressly informs the principal obligor that his or her duties to the secondary obligor continue unchanged. As such, the principal obligor suffers no unfair surprise.

While preservation of recourse by the obligee lessens the risk of the secondary obligor suffering a loss as a result of impairment of recourse, it does not necessarily prevent it. In most contexts, secondary obligors do not seek to enforce their rights against principal obligors until the obligee seeks performance from the secondary obligor. If the secondary obligor first learns of an extension or release (and the accompanying preservation of recourse) a significant time later, the passage of time may rob the secondary obligor's recourse of any practical value if the principal obligor's ability to perform has degenerated during that time. Of course, the obligee can prevent this type of loss simply by informing the secondary obligor promptly of the extension or release and the preservation of recourse.

Nonetheless, even when the secondary obligor is aware of both the release or extension and the preservation of recourse, loss can still occur. The release or extension may, for example, induce behavior on the part of the principal obligor that lessens the principal obligor's ability to perform. Once again, however, the obligee can minimize the likelihood of such a loss by promptly informing the secondary obligor of the release or ex-

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68. Id. § 34 cmt. a, at 83.
69. Id. at 84.
70. See id. §§ 34-35.
tension and the preservation of recourse. Thus informed, the secondary obligor has an incentive to discourage behavior of the principal obligor inconsistent with its obligations to the secondary obligor.\textsuperscript{71}

V. OBSERVATIONS AND LESSONS

The progression of the law governing suretyship defenses from the approach identified in this essay as Model 1 to the approach identified as Model 5 has been incremental and may seem evolutionary. At closer analysis, however, it becomes apparent that this course of development has fundamentally (even if surreptitiously) reconceptualized the law of suretyship defenses.

Basically, the most restrictive doctrines—Models 1 and 2—treat the obligee’s refraining from any action constituting an impairment of recourse as a condition precedent to the secondary obligor’s duty to perform the secondary obligation. Conceptualized this way, the complete discharge given to the secondary obligor as a result of an act by the obligee impairing recourse makes some sense. Under this theory, the secondary obligor’s duty to perform the secondary obligation is subject to the condition precedent that the obligee refrain from acts that impair the secondary obligor’s recourse. If the obligee did not fulfill this condition, the secondary obligor has no duty to perform.\textsuperscript{72} Under this conceptualization, the magnitude of harm (if any) flowing from the act constituting an impairment of recourse is irrelevant. What is important, rather, is that the condition precedent to the secondary obligor’s duty was not fulfilled.

More modern doctrines—Models 4 and 5—on the other hand, treat the acts of the obligee that impair the secondary obligor’s recourse as breaches of the duty to refrain from upsetting the equilibrium of the secondary obligor’s position. As in the case of

\textsuperscript{71} Id. § 34 cmt. b; see id. § 34 illus. 1-2.

\textsuperscript{72} See generally \textit{Restatement (Second) of Contracts} § 235(2) (1981) ("When performance of a duty under a contract is due any non-performance is a breach."); id. § 237 ("[A] condition of each party's remaining duties to render performance ... [is] that there be no uncured material failure by the other party to render any such performance due at an earlier time.").
breaches of duty in both contract\textsuperscript{73} and tort,\textsuperscript{74} the obligee is responsible for the cost of the harm caused by the bad act, but no more. Thus, if the act constituting an impairment of recourse causes the secondary obligor no harm, the secondary obligor is entitled to no relief. The results mandated by Models 4 and 5, then, are entirely consistent with this damages theory of suretyship defenses.

The Restatement proposes adoption of a damages model of suretyship defenses for several reasons. Generally speaking, the damages model is consistent with the remedy theory articulated in the Uniform Commercial Code that remedies should put the innocent party in as good a position (but no better) as that party would have been in had the transgressor acted consistently with its duty.\textsuperscript{75} As noted previously, the condition-precedent model results in windfalls for secondary obligors who are freed from their obligations by acts that cause them little or no harm (balanced by penalties to obligees far in excess of any harm caused by their acts). Although such an unbalanced model is beneficial to secondary obligors and neutral to principal obligors in the short run, in the long run it is harmful to both groups. After all, a well-advised obligee with any degree of bargaining power is likely to shy away from a transaction risky enough to require a secondary obligor if the benefit of a secondary obligation is as ethereal as that existing under the condition-precedent model. The obligee will either insist on contractually eliminating the secondary obligor's protections under the doctrine by insisting on a waiver of suretyship defenses, vigorously utilize irrational loopholes such as the reservation-of-rights doctrine to lessen those protections, or avoid the transaction altogether. At best, the obligee's economically rational decisionmaking will reduce credit available to principal obligors; at worst, it will

\textsuperscript{73} As a general matter, a person found liable for breach of contract must pay damages equal to "the loss in value to [the injured party] of the [breaching] party's performance caused by its failure or deficiency." \textit{Id.} § 347(a).

\textsuperscript{74} Tortfeasors are generally liable for compensatory damages, or an amount "designed to place [the injured person] in a position substantially equivalent in a pecuniary way to that which he would have occupied had no tort been committed." \textit{Restatement (Second) of Torts} § 903 cmt. a (1977).

\textsuperscript{75} \textit{U.C.C.} § 1-106 (1990).
result in secondary obligors with less protection than that afforded by the seemingly less protective models.

Of course, the damages model has one significant disadvantage: it requires proof of facts that are not always obvious. In the condition-precedent model, the only fact that needs to be found in order to determine both the existence and magnitude of the secondary obligor's defense is the occurrence of the act impairing the secondary obligor's recourse. Once that fact is established, the secondary obligor is completely discharged. Under the damages model, however, matters are more complicated. If it is found that the obligee has committed an act constituting an impairment of recourse, a second, less concrete fact must also be determined: how much does that act harm the secondary obligor? It goes without saying that it is far easier to ascertain whether the obligee granted the principal obligor an extension or release than it is to measure the harm such an act caused to the secondary obligor's interests.

Given the difficulties in establishing damages, unsophisticated secondary obligors might prove particularly disadvantaged by a requirement of establishing damages in addition to establishing the existence of the act giving rise to the suretyship defense. Furthermore, when the underlying obligation is other than the payment of money, proof of damages resulting from a release of the principal obligor is particularly problematic. The proposed Restatement addresses these concerns by adjusting the burden of persuasion.\[76\]

Under the Restatement, once the secondary obligor has established that an act constituting an impairment of recourse has occurred, placement of the burden of persuasion as to the amount of harm (if any) resulting from that act varies. If the secondary obligor incurred the secondary obligation for other than financial advantage (i.e., if the secondary obligor is not in the business of entering into secondary obligations, received no direct or indirect business benefit from entering into the secondary obligation, and was not induced to enter into the secondary obligation by separate consideration directly benefitting the secondary obligor),\[77\] the act impairing recourse is presumed to have caused the secondary obli-

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77. See id. § 43(2)(a)(i).
gor a loss equal to its liability under the secondary obligation;\textsuperscript{78} the burden of persuasion is now on the obligee to show the nonexistence, or lesser amount, of such loss.\textsuperscript{79} Thus, the secondary obligor will receive a complete discharge unless the obligee is able to demonstrate that its act caused the secondary obligor less harm. On the other hand, if the secondary obligor incurred the secondary obligation for financial advantage, or if the act impairing recourse is a nonmaterial modification of the underlying obligation, then the burden of persuasion is on the secondary obligor to prove the loss or impairment it sustained as a result of the obligee’s act.\textsuperscript{80}

In some cases, however, it may be relatively easy for the secondary obligor to demonstrate that an act impairing recourse caused some harm and yet quite difficult for the secondary obligor to quantify that harm. The Restatement provides relief in this situation too:

[I]f:

(a) the secondary obligor demonstrates prejudice caused by the impairment of recourse and
(b) the circumstances of the case indicate that the amount of loss is not reasonably susceptible of calculation or requires proof of facts that are not ascertainable,

it is presumed that the act impairing recourse caused a loss or impairment equal to the secondary obligor’s liability pursuant to the secondary obligation and the burden of persuasion as to the lesser amount of such loss is on the obligee.\textsuperscript{81}

As the law of suretyship defenses moves from Models 1 and 2 to Model 5, what other effects may appear? For one, because the obligee’s cost for committing an act constituting an impairment of recourse now is reduced to an amount equal to the harm resulting from that act (and, therefore, the obligee is not assessed a cost when its act is harmless to the secondary obligor), there is less need for the obligee to avail itself of doctrines, such as waiver, that eliminate suretyship defenses altogether. Certainly, under Model 5 an obligee is under less pressure to demand complete waivers of all

\textsuperscript{78} Id. § 43(2)(b).
\textsuperscript{79} Id. § 43(2)(a)(i)-(ii).
\textsuperscript{80} Id. § 43(3)(a)-(b).
suretyship defenses. Moreover, whatever justification existed for the reservation-of-rights doctrine to soften the sharp edges of suretyship defenses under the earlier models is no longer present.

One can even speculate that if the damages model had always predominated, perhaps waivers of suretyship defenses would not be so universally insisted upon (and granted) as they are today. Although it is unrealistic to expect a widespread disappearance of waivers, such actions might become less automatic under the Re-statement model because the obligee’s risk of inadvertently discharging the secondary obligor is dramatically decreased. Secondary obligors with some economic leverage can point out that even without a waiver of suretyship defenses, the obligee will lose its rights against the secondary obligor only to the extent that its acts harm the secondary obligor. If, in fact, waivers become less prevalent, this modern model, which appears less advantageous to secondary obligors than earlier models, will actually yield greater protection for secondary obligors.