An Essay on Independence, Interdependence, and the Suretyship Principle

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AN ESSAY ON INDEPENDENCE, INTERDEPENDENCE, AND THE SURETYSHIP PRINCIPLE

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In this article, Professor Peter A. Alces investigates the tension that exists between the independent and interdependent nature of contractual relations arising in suretyship agreements and letter of credit transactions. This discussion is particularly timely as the American Law Institute is currently revising both the Restatement of the Law of Suretyship and Article 5 of the Uniform Commercial Code, “Letters of Credit.” This article discerns a basic incongruity between the two revisions’ treatment of interrelated multiple party rights and discusses the consequences that this incongruity can be expected to have upon commercial transactions.

I. INTRODUCTION

“Third parties” confound the commercial law, in terms of both its contract and tort elements. The neat consensual (contract)/nonconsensual (tort) continuum devolves into a tension delimited by policies and, often, conjured by power. In a unique way, the resolution of

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1. This challenge was noted with regard to the drafting of original Uniform Commercial Code Article 4, “Bank Deposits and Collections.” See Walter D. Malcolm, Article 4 — A Battle with Complexity, 1952 WIS. L. REV. 265, 272 (“Difficulties in framing the rules governing the process arise from the almost infinite number of combinations of parties and facts . . . .”).

2. See Frederick K. Beutel, The Proposed Uniform [?] Commercial Code Should Not Be Adopted, 61 YALE L.J. 334, 362 (1952) (“In fact, this Article [Article 4] is so one-sidedly drawn in favor of the banking interests that any banker who insisted on exercising the rights given him by this ‘Code’ would probably be under suspicion by the better business bureau.”); Grant Gilmore, The Uniform Commercial Code: A Reply to Professor Beutel, 61 YALE L.J. 364, 376-77 (1952) (“[An] efficient collection system is in the private interest of banks as much as it is in the public interest of customers of banks. . . . Section 4-103 goes far beyond what is wise or permissible in allowing banks to rewrite the law their way whenever things get tough . . . .”); see also Edward Rubin, Efficiency, Equity and the Proposed Revision of Articles 3 and 4, 42 A.L.A. L. REV. 551 (1991) (describing how pressure from financial institutions during the drafting process skewed the balance among the rights of parties to negotiable instruments transactions within the scope of revised Articles 3 and 4 of the Uniform Commercial Code).
third-party problems implicates contextual equities, not merely the immanent justice of the instant controversy. ³ Apply that perspective to this generic hypothetical:

Three parties, A, B, and C, agree that C will provide goods or services to B. B will pay C in return therefor. In the event B does not pay C when the time for payment arrives, A will pay C the amount due.

Does that scenario describe one contract, to which all three transactors are party? Or does it describe three separate contracts, one between C and B (the sale itself), another between A and C (A’s promise to pay C if B does not), and a third between A and B (B’s promise to make A whole in the event A is called upon to pay C)? Further, if the hypothetical does contemplate three contracts, are they independent or interdependent? Should that characterization issue determine substantive consequences? These questions are the focus of this essay. They are also the focus of two important contemporary commercial law initiatives.

Seldom in the law is there the opportunity to observe and appraise the application and elaboration of principle in parallel contexts at the instant of their formulation. Recent developments in the commercial law provide just such an opportunity with the coincident Restatement of Suretyship ⁴ and revision of Uniform Commercial Code Article 5, “Letters of Credit” ⁵ projects. The two efforts are poised on the same precipice of principle: the interrelation of multiple party rights.

Because the challenges confronting the architects of statutory provi-

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Even where a clause speaks of “a separate contract for all purposes,” a commercial reading of the language under the section on good faith and commercial standards requires that the singleness of the document and the negotiation, together with the sense of the situation, prevail over any uncommercial and legalistic interpretation.

U.C.C. § 2-612 cmt. 3 (emphasis added).

⁴. RESTATEMENT (THIRD) OF SURETYSHIP (Tent. Draft No. 1, 1992) [hereinafter RESTATEMENT OF SURETYSHIP]. The goal of the Restatement of Suretyship is to “formulate rules broad enough to govern a wide variety of transactions that are subject to very different practice conventions, yet to maintain clarity.” Id. at foreword ix-x. The Restatement of Suretyship is sponsored by the American Law Institute and the Reporter is Neil B. Cohen of Brooklyn Law School, Brooklyn, New York.

⁵. The Revision of Article 5 is a project co-sponsored by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. The Draft Revision cited in this essay is “Members Consultative Group Draft No. 1” (Sept. 1, 1992). The Reporter is James J. White of the University of Michigan School of Law, Ann Arbor, Michigan. Citations to current Article 5 are to the 1990 Official Text.

⁶. Two representatives of the American Law Institute serve on the Article 5 revision Drafting Committee, Messrs. John P. Burton, of Sante Fe, New Mexico, and Edwin Huddleston III, of Washington, D.C. Four other members of the Drafting Committee are also members of the American Law Institute: Carlyle C. Ring, Jr., of Vienna, Virginia, the Chair; Marion W. Benfield, Jr., of Winston-Salem, North Carolina; The Honorable William C. Hillman, of Boston, Massachusetts; and Frederick H. Miller, of Norman, Oklahoma, the Executive Director of the National Conference of Commissioners on Uniform State Laws.
sions and common law rules are substantial, perfect congruence among the animating principles in parallel commercial contexts is an objective never realized, a grasp frustrating the reach. The objective is worthwhile nonetheless, like the coxswain's recitation of the rhythm. The symmetry is allusive but should not therefore lose its allure. This essay describes the resistance to symmetry in the commercial suretyship law and posits a useful perspective with potential applications beyond the focus of the instant inquiry.

A. Suretyship

Suretyship law orders the interdependent rights and liabilities of three parties inter se: the “Principal Obligor” (debtor), the “Obligee” (creditor), and the “Secondary Obligor” (surety or guarantor). The essence of suretyship is the promise to answer for the duty of another. If the principal obligor does not discharge her duty to the obligee, the secondary obligor will. But that statement, succinct as it is and sufficient to impart the sense of the suretyship situation, is at the same time both under-inclusive and over-inclusive.

Scope issues arise in suretyship cases because the term suretyship can mean two different things. First, it may refer to the suretyship relationship, which recognizes a tripartite, interdependent agreement that there is a performance due to the creditor and that one rather than the other of the two remaining parties should perform. Second, the suretyship label may be alternatively used to describe those transactions in which a party who performs will have rights against one or more of the other parties to the transaction.

Suretyship, then, is both a label describing the rights of “related” contracting parties and a term used to describe the transactions to which those rights generally adhere. To oversimplify for the moment, all suretyship transactions give rise to suretyship rights. However, not all contexts in which suretyship rights might be discovered are traditionally conceived as suretyship transactions. The temptation is great, nonetheless, to infer the existence of a suretyship transaction from the implication of suretyship rights.

The potential for confusion is further exacerbated by the fact that in many suretyship transactions the suretyship rights of the parties may be adjusted by the terms of their contract. That adjustment often takes the form of the secondary obligor’s waiver of certain rights and defenses.

7. Common statutes of frauds use this same terminology. See Restatement (Second) of Contracts § 112 (1979), which states:

A contract is not within the Statute of Frauds as a contract to answer for the duty of another unless the promisee is an obligee of the other's duty, the promisor is a surety for the other, and the promisee knows or has reason to know of the suretyship relation.

8. See Restatement of Suretyship, supra note 4, §§ 13-14.

At some point, arguably reached in more cases than not, the suretyship label becomes more misleading than helpful.

**B. Standby Credits**

Letters of credit are governed by Article 5 of the *Uniform Commercial Code*. In the prototypical standby, or guaranty, letter of credit, there are three parties: the “Issuer,” the “Account Party,” and the “Beneficiary” of the credit. Letter of credit rules, both statutory and

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Guarantors waive any right to require Bank to (a) proceed against Borrowers; (b) proceed against or exhaust any security held from Borrowers; or (c) pursue any other remedy in Bank’s power whatsoever. Guarantors waive any defense arising by reason of any disability or other defense of Borrowers or by reason of the cessation from any cause whatsoever of the liability of Borrowers. Until all indebtedness of Borrowers to Bank shall have been paid in full, even though such indebtedness is in excess of Guarantors’ liability hereunder, Guarantors shall have no right of subrogation, and waive any right to enforce any remedy which Bank now has or may hereafter have against Borrowers, and waive any benefit of, and any right to participate in any security now or hereafter held by Bank. Bank may foreclose, either by judicial foreclosure or by exercise of power of sale, any deed of trust securing the indebtedness, and, even though the foreclosure may destroy or diminish Guarantors’ rights against Borrowers, Guarantors shall be liable to Bank for any part of the indebtedness remaining unpaid after the foreclosure. Guarantors waive all presentments, demands for performance, notices of nonperformance, protests, notices of protest, notices of dishonor, and notices of acceptance of this guaranty and of the existence, creation, or incurring of new or additional indebtedness.


The Uniform Customs [promulgated by the International Chamber of Commerce] address with particularity such matters as communications among issuing, confirming, advising, and negotiating banks; the form of the credit; the conformity of the accompanying documents; and the issuing bank’s duty in connection with those documents. The Customs also contain a number of miscellaneous provisions codifying date and amount rules and also deal with the question of transferring the credit or its proceeds.

11. See Werner Blau & Joachim Jedzig, Bank Guarantees to Pay Upon First Written Demand in German Courts, 23 Int’l L. 725, 725-26 (1989) (“By their legal nature, Guarantees to pay upon first written demand are abstract promissory notes of a bank . . . . [A] Guarantee is similar to a documentary letter of credit, except that . . . in the case of a Guarantee the documents are replaced by a unilateral statement of the beneficiary.”).

12. Additional banks may become involved if they “advise” or “confirm” the credit. The distinction between advising and confirming banks is in the responsibility and liability assumed by each: the confirming bank undertakes the same responsibilities as the issuer while the advising bank merely acts as a conduit for the presentation of the requisite documents. See U.C.C. § 5-103(1)(e) (1990) (defining advising bank as “a bank which gives notification of the issuance of a credit by another bank”) and § 5-103(1)(f) (defining confirming bank as “a bank which engages either that it will itself honor a credit already issued by another bank or that such a credit will be honored by the issuer or a third bank.”).

13. The draft Revision of Article 5 replaces the term account party with the term applicant, defined as “a person who requests an issuer to issue a letter of credit for that person’s account, or a person for whose account a letter of credit is issued.” U.C.C. § 5-103(a)(2) (Proposed Official Draft 1992). Comment 3 to the section explains that the change was made to conform Article 5 with the Uniform Customs and Practice for Documentary Credits.

14. A typical “commercial” letter of credit arrangement might take the following form:

A (Account Party) wishes to purchase sugar from B (Beneficiary) by utilizing a letter of credit issued by *I*bank (Issuer). A applies to *I*bank for the letter of credit in favor of B. After B ships the sugar to A, B will tender documents showing performance to *I*bank in return for payment.

A will then reimburse *I*bank for the amount paid to B at a later date.

15. U.C.C. § 5-114(1) (1990) provides that “[i]n an issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale.” See also Uniform Customs and Practice for Documentary Credits art. 4 (1983) (emphasizing that “[i]n credit operations all parties
common law, endeavor to maintain that the device gives rise to three independent two-party contracts rather than one interdependent three-party contract. First, there is the contract between the account party and the beneficiary, often respectively the seller and the buyer of goods in an international transaction, referred to as the "underlying contract." Second, there is the contract designated the application for the letter of credit between the issuer (generally a financial institution) and the account party. Finally, there is the contract between the issuer and the beneficiary of the letter of credit, the "credit" itself.

The expectation of the parties to the standby credit is that there will never be a draw, that the beneficiary will not demand that the issuer disburse the funds represented by the credit. The credit looks like performance insurance. If the account party does not perform as it is contractually obligated to perform, the beneficiary will have the right to make a demand on the issuer. Once the beneficiary makes that demand, the issuer must pay, whether or not the beneficiary is in fact entitled to the payment, even if the beneficiary's demand is fraudulent. The issuer's obligation is independent of the beneficiary's performance of the underlying contract. If the account party's fraud allegation were to concern a deal in documents, and not in goods, services and/or other performances to which the documents may relate.


17. This arrangement, of course, reverses the posture of the transactors in a commercial credit where the buyer is the beneficiary and the seller is the account party. The difference reflects the different risks that the two devices are designed to address.

18. See U.C.C. § 5-103(1)(c) (1990) ("An 'issuer' is a bank or other person issuing a credit.") and U.C.C. § 5-103(a)(9) (Proposed Official Draft 1992) ("Issuer' means a bank or other person issuing a letter of credit.").


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 one from the other, does not mean that they are the same thing and does not mean that there are not differences, which, however subtle, are of major importance.

The fact that there may be substantial differences between the transactional function of a guaranty and a letter of credit does not mean that both guaranties and credits are not in the nature of suretyship.

20. See DOLAN, supra note 10, ¶ 1.07[2]. Professor Dolan points out that this demand may take one of several forms: no documentation may be necessary at all, see, e.g., Baker v. National Boulevard Bank, 399 F. Supp. 1021 (N.D. Ill. 1975); the beneficiary may have to supply a certificate to the effect that the account party has not performed, see, e.g., Chase Manhattan Bank v. Equibank, 550 F.2d 882 (3d Cir. 1977); the beneficiary may present a statement that the account party has defaulted on a promissory note, see, e.g., Postal v. Smith (In re Marine Distrib., Inc.), 522 F.2d 791 (9th Cir. 1975); the beneficiary may have to do no more than assert that the sum is due, see, e.g., Intraworld Indus., Inc. v. Girard Trust Bank, 336 A.2d 316 (Pa. 1975). Id.
lieve the issuer of the duty to pay, the independence of the credit would be undermined. Once this independence is compromised, once the law relates the issuer's performance to the performance of either of the other two contracts, the commercial utility of the credit device, so the argument goes, is eviscerated.21

The advocates of strict independence in the standby context point out that commercial transactors who do not want to confront the potential harshness, or at least the inflexibility, of independence, can use a guaranty agreement rather than a standby to assure the account party/primary obligor's performance of the underlying agreement with the beneficiary/creditor; the standby is a "commercial specialty" and should not be impaired by courts bent on doing some equity irrespective of the bigger picture.22 Issuers of such credits also are generally in sympathy with that view and for good commercial reason.23 Distinguishing the standby which is independent from the underlying transaction, from the interdependent guaranty increases the options available to commercial transactors; ignoring the distinction between two-party (standby credits) and three-party (guaranty) relationships may be inimical to the interests of commerce.

C. Irreconciliation

Appreciation of the independence-interdependence conflict in the commercial law accommodates synthesis. The thesis of this essay is that the independence-interdependence conflict is insoluble; it is a tension that

21. See Dolan, supra note 10, ¶ 3.06 (citations omitted), which states:
By making unfounded charges of fraud, account parties can seriously weaken the promptness feature of the standby credit. Some account parties have gone further and have attempted to use claims of fraud in the underlying transaction to delay or prohibit payment of the credit. Most courts have rejected these attempts, which, if widely successful, would destroy the standby credit.

Independence of the letter of credit undertaking is also vital in commercial credits. See Boris Kozolchyk, The Legal Nature of the Irrevocable Commercial Letter of Credit, 14 Am. J. Comp. L. 395 (1965). However, it is in the standby context that the consequences of the principle's operation are most profound.

22. See John F. Dolan, Standby Letters of Credit and Fraud (Is the Standby Only Another Invention of the Goldsmiths in Lombard Street?), 7 Cardozo L. Rev. 1 (1985). Professor Dolan has also described the unique characteristics of the standby letter of credit, a two-party undertaking which he argues must not be subject to the operation of suretyship principles:
The letter of credit . . . comes to us from the law merchant and is a creature of merchants and bankers and not of lawyers. Consequently, the letter of credit does not fit well into the law of contract, where common law judges and lawyers are wont to put it. Being a specialty, the letter of credit needs the unique protection that the law merchant customarily has afforded to specialties. That protection consists above all of two features: (1) the principle that the specialty enjoys independence from related transactions that nonspecialties do not enjoy, and (2) the rule that specialties can command punctilious observance of their conditions. The first of these features of the law merchant is the independence principle the second is the strict compliance rule.

Id. at 1.

23. See American Bell Int'l, Inc. v. Islamic Republic of Iran, 474 F. Supp. 420, 426 (S.D.N.Y. 1979) ("Manufacturers faces [sic] a loss of credibility in the international banking community that could result from its failure to make good on a letter of credit.").
must be harnessed. This perspective provides the means to appraise both the crucial scope issues implicated in the suretyship law and the Restatement’s efforts to reconcile the irreconcilable.

This essay argues that the Restatement of Suretyship starts at the wrong place. Suretyship does not arise solely in transactions involving three interrelated parties when the parties have decided to form the suretyship relation. Suretyship also arises when a court examines a transaction and determines that the relation among the parties is interdependent, such that the surety’s liability is determined by reference to the contract between the obligee and the principal obligor. To the extent a court reviewing the issuer’s payment on a standby credit considers the account party’s allegation of fraud in the underlying transaction between the beneficiary and the account party, the court imports suretyship principles to the letter of credit law and sacrifices independence in favor of interdependence.

The attraction to interdependence is quite strong, perhaps irresistible. The Restatement’s failure, even active refusal, to appreciate that circumstance undermines the scope of the Restatement and precludes the real contribution to the law that should be intended by the American Law Institute, the sponsoring organization. It is an opportunity squandered.

Part II of this essay surveys the phases of suretyship, through the variable commercial guaranty agreements to the various other commercial devices that implicate suretyship principles. This survey describes the means that commercial transactors use to elaborate upon the three-party relationship and reveals the fundamental affinity among the extant devices. When that affinity is patent, the independence-interdependence tension emerges in stark relief. Part III then contrasts interdependence in commercial guaranties with conceptions of independence in letters of credit. Part III concludes that the distinction is ultimately ephemeral and, given the nature of the fraud law, cannot be ratcheted otherwise: the independence-interdependence wheel must move in both directions; this motion is fundamental and irresistible. Part IV offers a reconciliation of the competing commercial values to support a definition of suretyship that is considerate of commercial and jurisprudential realities.

II. THE PHASES OF SURETYSHIP

As commercial transactors devise new credit enhancement devices, new ways to assure that if B does not perform, A will, thereby making C whole, the suretyship law metamorphoses. Each contractual undertaking that involves coincident three-party rights and duties may give rise to suretyship. Therefore, an understanding of the scope of suretyship must proceed from a broad perspective that endeavors to be inclusive rather than exclusive. But the job of delimiting scope, by definition, necessarily contemplates exclusion. Therefore, the law must discover the bases of
exclusion to delimit and define, but most effectively does so only after pursuing an analysis that proceeds from an inclusive predisposition. The scope of suretyship is a product of the conflict between that inclusiveness and exclusiveness.

Each of the contexts described in this part implicates suretyship principles. The consequences of this implication, however, may, and generally are, adjusted by the terms of the contract among the affected parties. The possible contours of those terms are, for the most part, beyond the scope of this survey. The focus here is on the interdependence of the three-party rights.

A. Commercial Guaranty Agreements

A rudimentary catalog of the extant variety of commercial guaranty agreements may serve as a glossary and help establish a frame of reference. The forms of commercial guaranty agreements are limited only by the imagination of counsel and the business challenges confronting their clients. Commercial guaranty agreements are categorized in terms of the guarantor's undertaking. Insofar as the contours of that undertaking are fixed by contract, generalization is of limited utility. Furthermore, a single agreement may have the characteristics of more than one "type" of guaranty. In addition, the labels below are generic and may be subject to different usages by different transactors and courts.

1. The Absolute or Conditional Undertaking

In an absolute guaranty, the guarantor agrees to answer for the duty of the debtor, notwithstanding the occurrence or nonoccurrence of any event, whether or not within the contemplation of the parties at the time the guarantor executes the guaranty. The creditor who takes an absolute and unconditional guaranty may require the guarantor's performance, without regard to the existence of the primary obligor's defense to performance of the primary obligor's contract with the creditor.24

The absolute guaranty is distinct from the conditional undertaking, in which the guarantor agrees to answer for the duty of the debtor only upon the occurrence or satisfaction of some prescribed condition. That condition may be the debtor's failure to make a scheduled payment on a loan, an action by the debtor that impairs the interests of the creditor, or nothing more than the sun's rising or not rising one day. The conditional guaranty is just like any other contract that fixes a condition precedent to a party's duty to perform.25 Typically, guaranties in sophisticated commercial transactions are absolute and unconditional: the creditor wants the right to enforce the guaranty free of the guarantor's defense that a condition precedent to enforcement of the guaranty has not been satis-

fied. Existing case law confirms the presumption that guaranties are absolute rather than conditional.26

2. General or Special Guaranty

While a guaranty must, as a matter of logic, be either conditional or unconditional (absolute), the general or special dichotomy is more a matter of degree. The general guaranty is at one extreme and the narrowly circumscribed special guaranty is at the other.

If a guarantor signs a guaranty that substantially states, "I undertake to answer for all debts, obligations, and liabilities of Debtor," that is as close to a general guaranty as the law will recognize. The guarantor assures all who choose to do business with the debtor that if the debtor does not discharge its obligations, the guarantor will do so on the debtor's behalf.

If, on the other hand, a guarantor signs a guaranty that provides the guarantor's assumption of the obligation to answer for specific duties of the debtor, circumscribed further by reference to the particular creditor to whom the obligation is owed, then the guaranty is special rather than general. While some special guaranties are more special than others, most guaranties do not expose the guarantor to liability for absolutely every debt incurred by the debtor. The scope of the debtor's liabilities for which the guarantor must answer is generally determined by the terms of the agreement between the creditor and the debtor.27 An exemplary case captures the importance of the dichotomy.

In New Holland, Inc. v. Trunk;28 a manufacturer sold goods on credit to a dealership, and the dealership's payment was guaranteed by an individual principal of the dealership. When the manufacturer sold its business, it assigned the financing agreement and the guaranty to New Holland. The court considered the Florida law governing the assignment of guaranties and concluded that while general guaranties may be assigned, special guaranties would generally not be assignable.29


27. A typical form might provide: "Guarantor unconditionally guarantees the full and prompt payment of any and all debts, obligations and liabilities currently existing and hereafter arising of [Debtor] to [Creditor] pursuant to the Agreement or any other agreement, document, or instrument to which [Debtor] and [Creditor] are party ("Liabilities")." ALCE ET AL., supra note 9, § 16.18.


29. The court did, however, note a split of authority on the issue, stating four basic approaches:

Some courts hold that the assignment of a special guaranty is effective to collect obligations existing at the time of the assignment . . . others hold that whether a special guaranty can be enforced to collect debts accruing after the assignment is a question of fact to be resolved by reference to the intent of the parties . . . while still others hold that whether a special guaranty is assignable depends on whether the undertaking of the guarantor has been materially altered by
The case involved the assignment of the right to receive payments on account of advances made by the assignor to the primary obligor prior to the assignment. The court reasoned that it would be inconsistent with the terms of the special guaranty to permit the assignee to enforce the guaranty against the guarantor on account of advances made by the assignee to the primary obligor after the assignment.\textsuperscript{30} The court viewed the transactions between the primary obligor and the assignor prior to assignment as a completed transaction. Therefore, a debt had arisen which was collectible by the assignee. Any obligations incurred after the assignment would not be collectible by the assignee due to the material alteration in the circumstances surrounding the specific guaranty agreement entered into by the guarantor prior to assignment.

3. Continuing Guaranty

The practice in many commercial transactions is to establish an ongoing relationship between the creditor and the debtor as opposed to a single, isolated transaction. That practice is accommodated by the uniform personal property security law's provision for collateral interests in presently existing as well as after-acquired property, so-called floating liens,\textsuperscript{31} and for extension of those collateral interests to secure "future advances."\textsuperscript{32} When the creditor and the debtor contemplate such a continuing creditor-debtor relationship, the creditor will require that the guarantor provide a continuing guaranty.\textsuperscript{33}

4. Guaranty of Payment or Collection

The guarantor's obligation may also be determined by reference to that time when the guarantor's performance is required. Some guaran-

\textsuperscript{30} Id. at 217 n.1 (citations omitted).
\textsuperscript{31} U.C.C. § 9-204(1) (1990) provides, in pertinent part, that "[e]xcept as provided in subsection (2), a security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral." Comment 2 to the provision explains that "Article [Nine] accepts the principle of a 'continuing general lien.' . . . This Article validates a security interest in the debtor's existing and future assets, even though . . . the debtor has liberty to use or dispose of collateral without being required to account for proceeds or substitute new collateral."

\textsuperscript{32} U.C.C. § 9-204(3) (1990) provides, in pertinent part, that "[o]bligations covered by a security agreement may include future advances or other value whether or not the advances or value are given pursuant to commitment."

ties allow the creditor to call on the guarantor to perform immediately after the debtor has failed to pay. Other guaranties require the guarantor’s performance only after the creditor’s efforts to collect the debt from the debtor have proceeded through judgment to a *nulla bona* return of the writ of execution. The difference between a guaranty of payment (guarantor pays as soon as debtor defaults) and a guaranty of collection (guarantor pays only after recourse to legal proceedings proves unavailing) is explained clearly in Article 3 of the *Uniform Commercial Code*.34

5. *Limited or Unlimited Guaranty*

The exigencies of a particular transaction, as well as the dynamics among the creditor, debtor, and guarantor, may dictate a form of guaranty that in some way limits the dollar amount of the liability assumed by the guarantor. For example, the creditor may loan the debtor $10,000 and, before doing so, require that the guarantor promise to answer for $5,000 of the debt if the debtor defaults. The creditor may want that $5,000 to be any portion of the debt remaining unpaid, up to $5,000. Thus, if the debtor pays $5,000 of the debt, the creditor might expect that the guarantor pay all of the remaining $5,000. The guarantor, however, might argue that the $5,000 he had guaranteed was the $5,000 that the debtor had already paid, resulting in no additional liability on the guaranty. Careful drafting of the guaranty, however, should resolve any ambiguity.35

The unlimited guaranty is more common and obligates the guarantor to answer for all of the debt owed the creditor by the debtor. While

34. See U.C.C. § 3-416 (1989):
(1) “Payment guaranteed” or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor without resort by the holder to any other party.
(2) “Collection guaranteed” or equivalent words added to a signature mean that the signer engages that if the instrument is not paid when due he will pay it according to its tenor, but only after the holder has reduced his claim against the maker or acceptor to judgment and execution has been returned unsatisfied, or after the maker or acceptor has become insolvent or it is otherwise apparent that it is useless to proceed against him.

The 1990 revision of Article 3 provides only a definition of a collection guaranty; see U.C.C. § 3-419 (1990):
(d) If the signature of a party to an instrument is accompanied by words indicating unambiguously that the party is guaranteeing collection rather than payment of the obligation of another party to the instrument, the signer is obliged to pay the amount due on the instrument to a person entitled to enforce the instrument only if (i) execution of judgment against the other party has been returned unsatisfied, (ii) the other party is insolvent or in an insolvency proceeding, (iii) the other party cannot be served with process, or (iv) it is otherwise apparent that payment cannot be obtained from the other party.

All citations in this essay to U.C.C. Article 3 are to the revised 1990 version unless citation to the 1989 version is expressly indicated.


**LIMITATION OF LIABILITY**

The maximum amount recoverable by obligee from [debtor] pursuant to this guaranty is — Dollars ($ — ), which amount is equal to the total rent due during the initial — year term of the lease. If the aggregate of payments made by [debtor] hereunder reaches the above-mentioned amount, this guaranty shall terminate immediately.
payments made to the creditor by the debtor will reduce the outstanding liabilities and, consequently, the guarantor’s exposure, the guarantor will not be able to establish that its liability was in some way extinguished altogether by a partial payment.

This characterization and construction issue was involved in a Sixth Circuit case, *Memphis Sheraton Corp. v. Kirkley*. There, the guarantors contracted to answer for the *first* $200,000 of a $1.1 million indebtedness. The property securing the debtor’s repayment of the primary obligation was sold at foreclosure for $540,000, more than the amount of the guaranty but substantially less than the total debt.

After noting that guaranty agreements are to be construed against the guarantor and in a manner indulgent of the rights of the creditor under Tennessee law, the court found for the creditor. The holding seemed to rely on the fact that the guaranty agreement stated that the guarantors would guarantee “the first $200,000 independently of [creditor’s] pursuing any action under the deed of trust or the security agreement.”

The foregoing description of the phases of commercial guaranty agreements reveals the suretyship relation captured by the devices: the obligation of the guarantor (secondary obligor) is determined by reference to the rights of the principal obligor. It is that “determined by reference” calculus that is the foundation of suretyship; it is the suretyship principle. The following section reveals the other commercial settings in which the rights of three parties are interrelated and in which the suretyship principle operates, subject to the contours of the contracts’ adjustments of suretyship rights.

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37. The *Kirkley* court’s conclusion reflected the general bias of the Tennessee judiciary against guarantors and the guaranty undertaking: “Tennessee does not favor guarantors and will construe a guaranty against the guarantor as strongly as the language will admit.” Id. at 17 (citing several Tennessee decisions to support its conclusion: Farmers-Peoples Bank v. Clemmer, 519 S.W.2d 801, 805 (Tenn. 1975) (commercial bank transaction); Nashville Elec. Supply Co. v. Kay Indus., Inc., 533 S.W.2d 306, 310 (Tenn. Ct. App. 1975) (guaranty to supply company to answer for debts of purchasing company); First Nat’l Bank v. Foster, 451 S.W.2d 434, 436 (Tenn. Ct. App. 1969) (guaranty to bank to answer for corporate debtor’s obligations); W.R. Grace & Co. v. Taylor, 398 S.W.2d 81, 87 (Tenn. Ct. App. 1965) (guaranty of full performance in commercial setting); Hassell-Hughes Lumber Co. v. Jackson, 232 S.W.2d 325, 329 (Tenn. Ct. App. 1949) (guaranty of product acceptance)).

The illogical, not to mention cynical, character of its observation notwithstanding, the *Kirkley* court’s candor reveals the provocative nature of the commercial guaranty dynamic. Some courts have expressed predispositions diametrically opposed to that of the *Kirkley* court. See, e.g., Texas Commerce Bank v. Capital Bancshares, 907 F.2d 1571, 1574 (5th Cir. 1990) (“A guarantor is a ‘favorite of the law’ and a guaranty is therefore construed strictly in favor of the guarantor.” (quoting McKnight v. Virginia Mirror Co., 463 S.W.2d 428, 430 (Tex. 1971))); Federal Deposit Ins. Corp. v. University Anclote, Inc., 764 F.2d 804, 806 (11th Cir. 1985) (“If a guaranty is free from ambiguity, it is strictly construed in favor of the guarantor.”); Heritage Bank v. Bruti, 141 Ill. App. 3d 107, 108, 489 N.E.2d 1182, 1183, 95 Ill. Dec. 454, 455 (3d Dist. 1986) (“Generally speaking, the guarantor is a favorite of the law.”). Still, the fact remains that the law of guaranties is persistently preoccupied with jurisprudential and even political (in the broader economic sense) ramifications.

B. Other Forms of Commercial Law Suretyship

There are commercial contexts beyond the guaranty agreement setting in which suretyship principles are implicated and in which the courts often proceed from a suretyship perspective.

1. Suretyship in the Uniform Commercial Code

Since the time that the Uniform Commercial Code was promulgated, several provisions of Article 3 have addressed aspects of the relationship among the creditor, debtor, and guarantor. For example, a negotiable instrument, either note or draft, may contemplate a third party whose obligation is determined by reference to the debtor-creditor relationship of two other parties. Two examples are illustrative.

First, a promissory note issued by the issuer and enforceable by the "holder" may also be "signed" by a co-maker, an indorser, or a guarantor. Second, a "check," a form of "draft," may be drawn by a "drawer" and signed by a co-drawer, an indorser, an "acceptor," or a guarantor. While the tripartite relationship that exists in both the note

40. See U.C.C. § 3-105(c) (1990), which defines issuer as including the maker of a note, and § 3-412, which describes the contractual undertaking of the issuer of a note:
   The issuer of a note or cashier's check or other draft drawn on the drawer is obliged to pay the instrument (i) according to its terms at the time it was issued or, if not issued, at the time it first came into possession of a holder, or (ii) if the issuer signed an incomplete instrument, according to its terms when completed, to the extent stated in Sections 3-115 and 3-407. The obligation is owed to a person entitled to enforce the instrument or to an indorser who paid the instrument under Section 3-415.
41. See U.C.C. § 1-201(20) (1990), which states that "[h]older," with respect to a negotiable instrument, means the person in possession if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in possession."
42. See U.C.C. § 1-201(39) (1990), which defines signed as including "any symbol executed or adopted by a party with present intention to authenticate a writing." 
43. See U.C.C. § 3-104(f) (1990), which defines check as "(i) a draft, other than a documentary draft, payable on demand and drawn on a bank or (ii) a cashier's check or teller's check. An instrument may be a check even though it is described on its face by another term, such as 'money order.'"
44. See U.C.C. § 3-104(e) (1990), which defines draft by stating that "[a]n instrument is a 'note' if it is a promise and is a 'draft' if it is an order. If an instrument falls within the definition of both 'note' and 'draft,' a person entitled to enforce the instrument may treat it as either."
45. See U.C.C. § 3-103(c)(3) (1990), which defines drawer as "a person who signs or is identified in a draft as a person ordering payment." The drawer's contract is provided by § 3-414.
46. Acceptance and its consequences are determined by U.C.C. § 3-409 (1990), which provides in part:
   (a) "Acceptance" means the drawee's signed agreement to pay a draft as presented. It must be written on the draft and may consist of the drawee's signature alone. Acceptance may be made at any time and becomes effective when notification pursuant to instructions is given or the accepted draft is delivered for the purpose of giving rights on the acceptance to any person.
   (b) A draft may be accepted although it has not been signed by the drawee, is otherwise incomplete, is overdue, or has been dishonored.
   (c) If a draft is payable at a fixed period after sight and the acceptor fails to date the acceptance, the holder may complete the acceptance by supplying a date in good faith.
and draft setting may or may not give rise to the interdependence of rights and liabilities governed by suretyship law, the policies implicated when a court is sorting out the parties' responsibilities \textit{inter se} may well prove similar to those vindicated by suretyship law generally.

2. \textit{Suretyship-like Arrangements in Financing Transactions}\textsuperscript{47}

A number of common commercial devices and transactions also involve the interdependent three-party undertakings that invoke the operation of suretyship principles. Any formulation of the scope of suretyship must therefore consider the parameters of these devices and transactions.

a. Subordination, Intercreditor, and Loan Participation Agreements

It is not uncommon in commercial transactions for one creditor to expressly subordinate its position to that of another creditor. This is usually accomplished at the insistence of the creditor whose claim is to be granted priority vis-a-vis the subordinating creditor. The Bankruptcy Reform Act of 1978 explicitly sanctions these contractual arrangements.\textsuperscript{48}

A subordination agreement generally involves an undertaking on the part of the subordinated creditor (junior creditor, \textit{JC}) to not accept any payments on the obligation owed to it by the debtor before the creditor in whose favor the agreement operates (senior creditor, \textit{SC}) has received a full satisfaction of its claim against the debtor. In the event the \textit{JC} does receive a payment from the debtor, it is obligated to remit it to the \textit{SC}. If the \textit{SC} is not fully repaid as a result of receiving payments referable to the junior debt, the \textit{JC} will be subrogated to the rights of the \textit{SC} as against the debtor.\textsuperscript{49}

The subordination setting involves a three-party arrangement in which one party, the \textit{JC}, gives something to another party, the \textit{SC}, in order to assure the debtor's payment to that third party \textit{SC}. A subordination agreement gives rise to a three-party relationship that is similar in important ways to other transactions contemplated by suretyship princi-

\textsuperscript{47} The description of commercial suretyship and suretyship-like contexts offered in this section is developed in substantial part from a survey by Howard Ruda, a member of the New York bar and one of the Advisers to the \textit{Restatement of Suretyship} project. \textit{See} Letter from Howard Ruda, of counsel, Han & Hessen, to Neil B. Cohen, Professor, Brooklyn Law School (Nov. 26, 1990) (on file with author).

\textsuperscript{48} \textit{See} BANKRUPTCY CODE § 510, 11 U.S.C. § 510 (1978), which states, in pertinent part: "A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

\textsuperscript{49} \textit{See} GRANT GILMORE, \textit{SECURITY INTERESTS IN PERSONAL PROPERTY} § 37.1 (1965) (discussing types of subordination agreements and situations in which they have been used); \textit{see also} Letter from Howard Ruda to Neil B. Cohen, \textit{supra} note 47, at 4 ("If there are two subordinating creditors, will they have rights of contribution against each other? Does it matter whether they are both parties to the same underlying subordination agreement or are separately subordinating unrelated debts?").
The rights of the JC vis-a-vis the SC are determined by reference to the debtor's performance of its agreement with the SC.

Creditors of a common debtor may also enter into an intercreditor agreement to determine their rights to collateral securing the debtor's payment of the obligations owed to each creditor. Creditor 2, not necessarily later in time than creditor 1, may agree with creditor 1 to not proceed against the common collateral before the debt owed to creditor 1 has been fully satisfied.\footnote{See ALCES ET AL., supra note 9, § 28:68 for a form subordination agreement which reads in part:}

Alternatively, creditor 1 might make a loan to the debtor, and then either simultaneously or subsequently decide to "sell" or "participate" a portion of that loan to creditor 2. The terms of such an intercreditor or loan participation agreement may implicate suretyship principles if creditor 2 takes a junior position vis-a-vis creditor 1. If creditor 2 agrees to be paid only after the portion of the loan owned by creditor 1 is satisfied, creditor 2 is thereby subordinated to creditor 1, and its rights will be determined by reference to the debtor's performance.

b. "Keep Well" Agreements

A keep well agreement looks much like a guaranty. However, rather than guarantying the debtor's repayment to the creditor, the secondary obligor contracts to assure the continued fiscal well-being of the debtor. This is close to a warranty, however, and the Restatement of Security expressly excludes warranties from the scope of suretyship law.\footnote{See LETTER FROM HOWARD RUDA TO NEIL B. COHEN, supra note 47, at II:}

Other examples of lien subordinations are:

(1) The issuer of a CD, which D has pledged to C, agrees not to assert any setoff or security interest against the CD.

(2) A textile processor agrees with C, who has an inventory lien on D's goods which are processed by the processor, that it will not assert its statutory textile processor's lien against the inventory.

(3) A landlord, mortgagee or warehouseman waives its statutory or contractual rights against D's property in which C has a security interest.

52. See RESTATEMENT OF SECURITY § 82 cmt. J (1941):

The word "warranty" has the same philological origin as "guaranty" and in popular usage the two words are often used as synonyms. In this sense, the term "guaranty" is not synonymous with "suretyship." This usage is not employed in the Restatement of [Security].

Without attempting any precise definition of "warranty" as used in respect of conveyances of real property, the sale of goods, assignment of rights, insurance, and contracts, it signifies a representation or promise as to the title, quality or quantity of a thing or of its fitness for a particular purpose, or is a stipulation that something exists or has happened. The term "im-
context gives rise to all of the incidents of suretyship.\(^5^3\)

c. Sale of Accounts Receivable

The sale of accounts receivable, a transaction generally within the scope of U.C.C. Article 9,\(^5^4\) creates a tripartite relationship in which the obligations of one of the parties are determined by reference to the performance of another party. In a typical sale of accounts, a debtor with outstanding accounts receivable sells (or grants a collateral interest in) those accounts to the creditor; thereafter the parties liable on the accounts, account debtors (\(ADs\)), make payments on the accounts directly to the creditor (or a "lock box" within the creditor's control). These \(ADs\), therefore, for the purpose of demonstrating suretyship parallels, are the primary obligors; the creditor expects payment on the accounts from the \(ADs\). As the \(ADs\) make payments on the accounts, those payments are credited to the account of the debtor, gradually retiring the principal indebtedness owed the creditor.

The transaction between the debtor and the creditor may be an outright sale, in which the creditor assumes all of the risk that the accounts will not be paid,\(^5^5\) thus constituting a nonrecourse sale of accounts. However, in the event that the transaction between the debtor and the creditor was a collateral transaction, pursuant to which the debtor did not sell the accounts to the creditor but, instead, granted the creditor only a collateral interest in the receivables, then the debtor would remain liable for any nonperforming accounts and would, concomitantly, be entitled to any surplus.\(^5^6\) The same result may be accomplished by contract even if the debtor-creditor transaction is denominated a sale of accounts.\(^5^7\) This latter form is termed a recourse sale or hypothecation of accounts.

Insofar as the recourse transaction measures the obligation of the debtor by reference to performance of the account debtors, it may be conceived in suretyship terms: the debtor is the guarantor of the \(ADs'\)

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\(^{118}\) See John Hanna, Cases and Materials on Security 349-49 (2d ed. 1940) (distinguishing warranty from suretyship and citing discussion in Solomon Sturges & Co. v. Bank of Circleville, 11 Ohio St. 153, 168 (1860)).

\(^{119}\) See U.C.C. § 9-102(1)(b) (1990): "Except as otherwise provided in Section 9-104 on excluded transactions, this Article applies . . . (b) to any sale of accounts or chattel paper."

\(^{119d}\) See id. § 9-504(2).

\(^{120}\) See id., which states that "[i]f the security interest secures an indebtedness, the secured party must account to the debtor for any surplus, and, unless otherwise agreed, the debtor is liable for any deficiency."

\(^{121}\) Id., stating, "[i]f the underlying transaction was a sale of accounts or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides."
performance. In the event the ADs, or any of them, default, in whole or in part, the creditor will call on the debtor to perform in their stead.

d. "Put Agreements"

When one party agrees to purchase property from another, the creditor, at some future time to be determined by the creditor, the purchaser's obligation may give rise to the suretyship relationship, in that the property represents the obligation of a third party to the creditor. For example, if a creditor buys (perhaps from the payee) a promissory note made by the debtor, with the understanding that the payee will repurchase that note in the event the creditor calls on the payee to do so, that "put agreement" is the type of tripartite arrangement involved in the suretyship law.

The transaction, however, need not contemplate the negotiation of an instrument. A secured creditor not eager to take possession of collateral for foreclosure purposes may cause the debtor to agree with a third party that the third party will purchase the collateral from the secured party. Such an arrangement provides the secured party with a ready, willing, and able buyer for the collateral and also inures to the benefit of all three parties.58 The duty of the third party is determined by reference to the rights of the secured creditor against the debtor.

e. Finance Leases

Article 2A of the U.C.C. includes finance leases within its scope.59

58. The debtor would benefit from the lower interest rate the debtor can obtain as a result of the additional security the surety's undertaking provides, and the surety would benefit from the access to used equipment for resale.

59. U.C.C. § 2A-102 (1990) ("This Article applies to any transaction, regardless of form, that creates a lease."). Section 2A-103(1)(g) defines finance lease as a lease with respect to which:

(i) the lessor does not select, manufacture, or supply the goods;
(ii) the lessor acquires the goods or the right to possession and use of the goods in connection with the lease; and
(iii) one of the following occurs:
(A) the lessee receives a copy of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;
(B) the lessee's approval of the contract by which the lessor acquired the goods or the right to possession and use of the goods before signing the lease contract;
(C) the lessee, before signing the lease contract, receives an accurate and complete statement designating the promises and warranties, and any disclaimers of warranties, limitations or modifications of remedies, or liquidated damages, including those of a third party, such as the manufacturer of the goods, provided to the lessee by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods; or
(D) if the lease is not a consumer lease, the lessor, before the lessee signs the lease contract, informs the lessee in writing (a) of the identity of the person supplying the goods to the lessor, unless the lessee has selected that person and directed the lessor to acquire the goods or the right to possession and use of the goods from that person, (b) that the lessee is entitled under this Article to the promises and warranties, including those of any third party, provided to the lessor by the person supplying the goods in connection with or as part of the contract by which the lessor acquired the goods or the right to possession and use of the goods, and (c) that the lessee may communicate...
A finance lease is similar to a secured transaction, but rather than providing purchase money financing, the financier (finance lessor) buys the property from a supplier and leases it to the lessee. While the general rule of Article 2A provides that certain implied warranties are made by a lessor to a lessee,60 the rule in finance leases is different. The warranties provided by the supplier (the seller) to the finance lessor (the buyer) under Article 2 of the U.C.C.61 "pass through" to the finance lessee.62 In return, the lessee has no warranty of quality rights against the finance lessor and undertakes, come "hell or high water,"63 to make all payments due under the lease to the finance lessor. That is, even if there is some problem with the quality of the leased goods, the lessee must continue to make lease payments to the finance lessor and may bring an action only against the supplier, subject to any limitations in the sales contract. The finance lessor may or may not have a right of recourse against the supplier in the event the lessee does not make a payment, notwithstanding the hell or high water clause.64

with the person supplying the goods to the lessor and receive an accurate and complete statement of those promises and warranties, including any disclaimers and limitations of them or of remedies.

60. Id. § 2A-212(1) provides the implied warranty of merchantability, stating in pertinent part, "[e]xcept in a finance lease, a warranty that the goods will be merchantable is implied in a lease contract if the lessor is a merchant with respect to goods of that kind." Section 2A-213 provides an implied warranty of fitness for particular purpose, stating:

Except in a finance lease, if the lessor at the time the lease contract is made has reason to know of any particular purpose for which the goods are required and that the lessee is relying on the lessor's skill or judgment to select or furnish suitable goods, there is in the lease contract an implied warranty that the goods will be fit for that purpose.

61. See U.C.C. § 2-314 (merchantability), which states, in part, "Unless excluded or modified (Section 2-316), a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind." See also § 2-315 (fitness for particular purpose) which states:

Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is unless excluded or modified under the next section an implied warranty that the goods shall be fit for such purpose.

62. See U.C.C. § 2A-209, which states in part:

(1) The benefit of a supplier's promises to the lessor under the supply contract and of all warranties, whether express or implied, including those of any third party provided in connection with or as part of the supply contract, extends to the lessee to the extent of the lessee's leasehold interest under a finance lease related to the supply contract, but is subject to the terms of the warranty and of the supply contract and all defenses or claims arising therefrom.


64. Credit enhancement devices in the commercial law in effect act as insurance by providing a source of payment should the principal obligor fail to discharge its obligation to the creditor. But strictly speaking, "insurance" does not give rise to the suretyship arrangement; it gives rise to a contract between the insurer and the insured, the performance of which is generally subject to conditions subsequent to the occurrence or nonoccurrence of an event, often including the mis-, mal-, or nonfeasance of a person.

Generally, the suretyship versus insurance issue arises when a court must consider whether one party will have a viable cause of action against the other or a third party, and its resolution depends upon the court's determination of the scope of suretyship law.

The Restatement of Security separately listed and described various forms of fidelity or performance insurance under three headings. First, "Third Party Beneficiaries in Construction Contracts":

Where a surety for a contractor on a construction contract agrees in terms with the owner that the contractor will pay for labor and materials, or guarantees to the owner the promise of the
The Article 2A statutory hell or high water clause changes the inter-relation of rights that would exist were the finance lessor’s rights vis-a-vis the finance lessee subject to defenses that the finance lessee would otherwise have arising from deficiencies in the leased goods. If the finance lessee could avoid liability to the finance lessor because the supplier had breached the warranty of merchantability, then the finance lessor’s rights would, in fact, be determined by reference to the rights of the supplier against the finance lessee. But the statutory hell or high water clause adjusts that interdependence by making the finance lessor’s rights against the finance lessee independent of the finance lessee’s rights against the supplier. The statute merely accomplishes what the parties to finance leases were accomplishing by private contract before the promulgation of Article 2A and probably continue to accomplish by the terms of the lease agreement. Article 2A, then, and the finance lease example demonstrate how a statute can formulate the parties’ rights inter se in terms that do not deny the interdependence of related undertakings but that are attentive to commercial exigencies.

Part II of this essay has surveyed the commercial contexts in which the rights of three parties are interrelated and has demonstrated how the incidents of that interrelation may be determined by (1) the terms of the parties’ agreement(s) and (2) the provisions of apposite statutory law. This presentation accommodates comparison of the suretyship contexts with the letter of credit dynamic.

III. SURETYSHIP AND LETTERS OF CREDIT

Even the most cursory description of standby credits reveals the similarity between some standby credits and the credit enhancement devices described above in part II. In both the various commercial law contracts to pay for labor and materials, those furnishing labor or materials have a right against the surety as third party beneficiaries of the surety’s contract, unless the surety’s contract in terms disclaims liability to such persons.


Where a statute requires a public officer to furnish a bond with surety, the surety’s liability for the officer’s defaults is determined, within the penal sum stated in the bond, by his own undertaking whether more or less extensive than the statutory requirements, unless there is a statutory provision to the effect that an official bond shall be deemed to contain the conditions prescribed by statute.

Id. § 169. And third, “Judicial Bonds”: “A judicial bond is a bond furnished by or on behalf of a party to a judicial proceeding.” Id. § 186.

Professor John Hanna’s Cases and Materials on Security, HANNA, supra note 53, places generic suretyship in opposition to (1) guaranties, see id. at 345, (2) insurance, see id. at 347, (3) warranty, see id. at 348, and (4) indorsement, see id. at 349. A contemporary fidelity insurance lawyer could easily develop a long list of the relatively common forms that involve the suretyship undertaking. See Letter from James A. Black, Jr., of Fidelity and Deposit Company of Maryland and Adviser to the Restatement of Suretyship, to Peter A. Alices, Professor, The College of William & Mary (Oct. 15, 1991) (on file with author) (describing 37 forms of surety bonds). The letter was also submitted to Neil B. Cohen, Professor, Brooklyn Law School, and Reporter, Restatement of Suretyship.

65. Two articles appearing in a recent symposium issue treat the operation of some suretyship rules in the letter of credit context. See Amelia H. Boss, Suretyship and Letters of Credit: Subrogation Revisited, 34 WM. & MARY L. REV. 1087 (1993) (arguing that courts should apply subrogation
credit enhancement mechanisms and standby credits, the interdependence of the third-party payment obligation and the performance responsibilities of the parties to the underlying transaction are manifest. But the parties to the commercial credit enhancement devices understand and intend that interdependence; in the standby credit context, issuers urge the independence of their undertaking and argue that the intended independence in fact defines the credit. So long as that independence is respected, issuers of credits will be able to remain above the fray between the account party and the beneficiary concerning the equities of the underlying transaction. To the extent that interdependence exists, the principal obligor's (letter of credit account party's) fraud allegation will excuse the secondary obligor's (issuer's) payment obligation. If independence is the rule, fraud allegations, no matter how compelling, must fall on deaf ears. The secondary obligor, guarantor, or issuer will be inept to resist payment on account of that fraud.

A. The Fraud Challenge to Independence

There is an important and distinct commercial interest in the certainty of the letter of credit issuer's undertaking in commercial law. The distinctiveness of that interest provides options and serves the important economic interest that a variety of options serves in business law generally. However, that important commercial function is often undermined by the courts' too pedantic, even overzealous, efforts to manipulate formal or transactional requirements to render equity in a particular case sub judice. The battle between that temptation in individual cases and broader contextual concerns has mirrored the independence-interdependence tension; the allegation of "fraud in the transaction" has provided the battleground.

When, in a letter of credit transaction, an account party (analogous to the primary obligor in the suretyship law) wants to resist the beneficiary's (analogous to obligee's) demand that the issuer (analogous to secondary obligor) pay a sum of money represented by the credit, due to the

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principles to determine rights of issuer to recover from account party after issuer honors demand on standby credit); Gerald T. McLaughlin, Standby Letters of Credit and Guaranties: An Exercise in Cartography, 34 WM. & MARY L. REV. 1139 (1993) (suggesting circumstances in which courts should disregard the letter of credit independence principle).

66. Professor Boss recognizes that issuers are only interested in assuming this posture if their interests are not compromised by independence, and she argues that so long as issuers do not compromise the independence of the credit before or at the time of the beneficiary's demand the commercial utility of the standby credit is not undermined. See Boss, supra note 65, at 1120-27.


68. For a consideration of the important commercial purposes served by the provision of transactional alternatives in an analogous context, see Lary Lawrence, Making Cashiers' Checks and Other Bank Checks Cost-Effective: A Plea for Revision of Articles 3 and 4 of the Uniform Commercial Code, 64 MINN. L. REV. 275 (1980). See also Peter A. Alces, A Jurisprudential Perspective for the True Codification of Payments Law, 53 FORDHAM L. REVIEW 83 (1984) (describing benefits realized from delineation of alternative payment media).
beneficiary's failure to perform in accordance with the terms of its contract with the account party, the account party may allege that the beneficiary's demand is fraudulent. Although Uniform Commercial Code subsection 5-114(1) codifies the independence of the issuer's undertaking, subsection 5-114(2) nonetheless recognizes that evidence of "fraud in the transaction" may excuse the issuer from honoring the beneficiary's demand, and, not incidentally, from enforcing an indemnity claim against the account party.69

The courts70 and commentators71 have recognized that an overly facile reliance on this fraud exception impairs the independence of the issuer's undertaking, converts the standby letter of credit into something more akin to a suretyship contract, and compromises the commercial utility of the letter of credit device. Alternatively, others have maintained that the violence done to commercial principles when the letter of credit law facilitates fraud is even more destructive than the occasional dislocation caused by the imposition of a fraud theory.72

To distinguish the case in which the fraud allegation should not be

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69. U.C.C. § 5-114 (1990) provides in part:

(1) An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary. The issuer is not excused from honor of such a draft or demand by reason of an additional general term that all documents must be satisfactory to the issuer, but an issuer may require that specified documents must be satisfactory to it.

(2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certified security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction:

(a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certified security (Section 8-302); and

(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.


This [principle of independence] is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade. One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of the merchandise shipped.

71. See Henry Harfield, Enjoining Letter of Credit Transactions, 95 BANKING L.J. 596, 599 (1978) ("There can be little doubt that an expansive reading and permissive application of Section 5-114(2)(b) could destroy the acceptability of credits established by United States issuers.").

72. See, e.g., Fairfax Leary, Jr. & Michael R. Ippoliti, Letters of Credit: Have We Fully Recovered from Three Insolvency Shocks?, 9 U. PA. J. INT'L BUS. L. 595, 601 (1987) ("[J]ust as the rules for the recovery of payments made have not had a totally adverse effect on the acceptability of negotiable instruments, the few rules permitting recovery of payments made under letters of credit will not destroy the usefulness of this payment-assuring device.").
sufficient to overcome the independence principle from the case in which fraud ought to give way to other commercial and normative concerns, the courts have distinguished among degrees of fraud. The more egregious the fraud, so the analysis goes, the more harsh the result of giving effect to the independence principle. And, the less reason there is for recognizing the independence principle, the more the standby letter of credit looks like a three-party, suretyship undertaking.

A number of cases have focused on recitations of the fraud standard; that quantum of fraudulent animus that must infect a transaction before the good commercial reasons for independence would not be served and the credit should be construed in suretyship terms. The consequence of a conclusion that the interests of independence would not be served, in the context considered here, is that the account party may determine the issuer's right to pay the beneficiary in terms of the sufficiency (or fraudulence) of the beneficiary's actions. The issuer's obligation to pay is determined by reference to the account party's rights (a three-party scenario) rather than by the beneficiary's simple demand (a two-party undertaking).

There is a fundamental incongruity in determining the independence of an undertaking by reference to how compelling the party resisting operation of the independence principle can make its fraud claim. Yet, if the independence principle is designed to serve the interests of commerce, the rule should not operate beyond its commercial reason. Reference to the egregiousness of the alleged fraud is the response to that dilemma. Furthermore, the courts' recognition that mere breach of contract and active fraud are, at some level, distant (and, at times, not so distant) points on the same continuum requires that the alleged (beneficiary) fraud-feasor's maliciousness be a part of the calculus.

There is reason to understand the letter of credit cases as developing the rule that fraud allegations that amount to no more, in the court's view, than breaches of contract will not compel abrogation of the independence principle and the consequent invocation of the general suretyship law. The seminal letter of credit fraud decision, Sztejn v. J. Henry Schroder Banking Corp., had found sufficient evidence of fraud to issue an injunction against the issuer's honor of its letter of credit undertaking. But Asbury Park & Ocean Grove Bank v. National City Bank 77

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74. For a case considering the distinction, such as it is, between breach of contract and fraud, see Asbury Park & Ocean Grove Bank v. City National Bank, 35 N.Y.S.2d 985 (N.Y. Sup. Ct. 1942), aff'd, 52 N.Y.S.2d 583 (1944).


76. In Sztejn, the beneficiary presented documents required for the letter of credit which described the goods shipped as "bristles." Id. at 633. The account party sought to enjoin payment on the credit, alleging that the documents were fraudulent and that the matter actually shipped consisted of cow hair and other worthless materials masquerading as genuine merchandise. Id. The
was decided by the same court just one year later, and there the court found a simple breach of contract instead (the presentation of altered documents), rather than "active" fraud.\textsuperscript{78} One court's active fraud may be the same court's mere breach of contract the next time.\textsuperscript{79}

The Texas appellate court in \textit{GATX Leasing Corp. v. DBM Drilling Corp.}\textsuperscript{80} considered the account party's invocation of the "fraud in the transaction" exception. The standby required that the beneficiary, before drawing on the credit, present a statement that the principal of the account party had failed to comply with the terms of a security agreement between the principal and one of the beneficiaries.\textsuperscript{81} The court concluded that the account party's objection was closer to an allegation of breach of warranty or failure of consideration; it was not the type of allegation that supports application of the fraud exception of subsection 5-114(2).\textsuperscript{82} The court determined that the account party was complaining of no more than the invalidity of the underlying contract.\textsuperscript{83} The account party did not allege the "intentional or unscrupulous conduct which would deprive the [account party] of any benefit of the underlying contract and which would transform the letter of credit . . . into a means
for perpetrating fraud." 84

To the extent that the difference between breach of contract and active fraud is a matter of degree and to the extent that interdependence and independence are likewise matters of degree, it is necessary to plot points on a graph to fully appreciate the application of suretyship principles in the standby letter of credit context. One axis of the graph would measure from the mere breach of contract to the egregious fraud nature of the account party’s allegation and showing; the foregoing formulation of the Sztejn, Asbury Park, and GATX cases posits that continuum.

B. Contractual Interdependence

Developing a sense of the other axis, the one describing the independence/interdependence continuum, is also necessary. Several standby letter of credit cases have considered the terms of the letter of credit itself in determining the extent to which the parties have impaired independence by incorporating the terms of the underlying contract into the letter of credit transaction. That is, the provisions of the letter of credit contract will determine relative dependence. 85 Recall that the various commercial suretyship devices are variously independent or interdependent depending upon their terms and their transaction context.

The account party, the issuer, and the beneficiary of the credit formulate its terms. They establish among themselves the extent to which payment pursuant to the credit depends on the terms of the underlying contract between the account party and the beneficiary. They may draft the credit in a way that compromises independence. For example, if the letter of credit requires that the issuer must pay upon the beneficiary’s mere presentation of a draft drawn on the issuer and referencing the letter of credit, the issuer must pay upon that simple demand. Thus, it is not difficult to discern the independence of that standby letter of credit undertaking. However, if the letter of credit provides that the issuer pay only upon the beneficiary’s presentation of documents establishing the account party’s breach of the underlying contract with the beneficiary, the credit’s independence is definitively impaired and it will not be difficult for a reviewing court to find the three contracts interdependent. The three cases below illustrate effectively the courts’ approach to credits that, by their own terms, violate the independence principle.

In In re Pine Tree Electric Co., 86 the Bankruptcy Court for the Dis-

84. Id. at 183.
85. The Draft Revision of Article 5 includes a Section 5-110(d), pursuant to which “[a]n issuer shall disregard non-documentary conditions and treat them as if they were not stated.” The apposite comment explains: “Where the non-documentary conditions are not ancillary (as for example a condition that would require the issuer to determine in fact whether the beneficiary had performed the underlying contract or the applicant defaulted) their inclusion may remove the undertaking from the scope of Article 5 entirely.” U.C.C. § 5-110 cmt. 5 (Proposed Official Draft 1992).
district of Maine considered the debtor-account party’s prayer for injunctive relief. The account party was to perform certain electrical contracting work for a construction company. The account party’s performance was secured when Northeast Bank issued a letter of credit in favor of the general contractor-construction company. The credit was unartfully drafted, considering the independence principle: it was expressly made subject to the underlying contract between the account party and the beneficiary. It also expressly provided the account party with the right to cure any default before the beneficiary would be entitled to draw on the letter of credit on account of such default.

The court concluded that the injunction could issue if either the standard requisites of injunctive relief were satisfied or if the demand for payment was fraudulent. The court then found that the account party had sufficiently alleged fraud to support issuance of the preliminary injunction. The finding of fraud was a product of the credit’s incorporation of the underlying contract between the account party and the beneficiary.

Similarly, in O’Grady v. First Union National Bank, the parties to the standby credit destroyed its independence by providing that, in order to draw, the beneficiary would have to produce a “[c]ertificate and true photostatic copy of each instrument causing this establishment of credit to [the account party] to be called upon.” The court concluded that the set of documents submitted by the beneficiary was not the set contemplated by the parties to the credit; the beneficiary was aware of that

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87. Id. at 106.
88. Id.
89. Id.
90. Id.
91. Id. at 107. For other decisions to similar effect, see, e.g., Tranarg, C.A. v. Banca Commerciale Italiana, 396 N.Y.S.2d 761 (N.Y. Sup. Ct. 1977) (holding that no injunction could issue where issuing bank had determined that beneficiary had complied with the terms of the letter of credit and issued its check in compliance therewith); Foreign Venture Ltd. Partnership v. Chemical Bank, 399 N.Y.S.2d 114 (N.Y. Sup. Ct. 1977) (where irrevocable letters of credit were apparently solvent and the subject of a lawsuit and damages appeared to be an adequate remedy, there was no ground for granting a preliminary injunction).
92. In re Pine Tree, 16 B.R. at 108.
93. See id. at 106, where the court observed:
   The Letter of Credit expressly states it is “subject to all the terms and provisions of a subcontract between” Gralia and Pine Tree “and to the specific terms and conditions set forth in the attached document, conditions to Letter of Credit, which are incorporated herein by reference.”
95. Id. at 599 (quoting letter of credit at issue). While the parties denominated the credit a "commercial" letter of credit, the court construed it to be a "guaranty" letter of credit, probably meaning a "standby" credit. Id.
fact: "the documents, considered as a whole, are nonetheless fraudulent insofar as the letter of credit was not intended to secure that particular note, and the beneficiary had knowledge of this fact." The court found sufficient evidence of fraud in that "unauthorized" presentation of documents to support imposition of the fraud exception.

Consider also the decision of the United States Court of Appeals for the Eighth Circuit in Bank of Newport v. First National Bank & Trust Co. The case involved the assignment of a nonassignable credit and a demand for payment thereunder. This credit too contained language providing that "[t]he drafts drawn under this Credit should state the reason for the draft." The beneficiary submitted its statement in support of the draw against the credit and alleged that the presentation was "in accordance with the letter of credit purpose." Because the credit required the beneficiary to state the reason for the draw, the court determined that the beneficiary's statement that the draw was in accordance with the purpose of the credit provided the basis to invoke the fraud exception because it was in fact inconsistent with that purpose and the beneficiary knew of that inconsistency. Thus the draft presented by the beneficiary was itself found to be fraudulent.

Those three cases demonstrate the consequences of drafting a credit without considering the independence principle and its fragility. They also illustrate how courts may construe the credit's incorporation of the terms of the underlying contract in a way that directly ties the documentary insufficiency into the "fraud in the transaction" exception. The documents themselves are thereby viewed as sufficiently fraudulent to reveal "fraud in the letter of credit transaction" rather than merely fraud in the underlying transaction. Once the letter of credit is made subject to the parties' performance of the underlying contract, or to a statement of their performance, then an inaccuracy in the statement of that performance makes the demand itself fraudulent. There is, then, not just fraud in the underlying transaction but fraud in the letter of credit transaction as well. And even the most stalwart defenders of the independence principle can rationalize the decision as one involving a credit that by its own terms was not independent of the underlying transaction.

C. Revision of Article 5

Article 5 of the U.C.C. is currently the subject of a comprehensive revision effort. Most pertinent for the instant inquiry, the latest pre-

96. Id. at 601.
97. Bank of Newport v. First Nat'l Bank & Trust Co., 687 F.2d 1257 (8th Cir. 1982).
98. See generally DOLAN, supra note 10, ¶ 3.03[4] (discussing the transferability of credits).
99. Bank of Newport, 687 F.2d at 1259 n.2.
100. Id. at 1264 (quoting endorsement of draft drawn pursuant to parties' letter of credit).
101. Id.
102. See DOLAN, supra note 10, ¶ 7.04[4][d].
103. See supra notes 5-6.
liminary draft revision offers a definition of *fraud*; in fact, it offers alternative definitions:

"Fraud" means a presentment by one who has no colorable basis to be entitled to have the presentment honored.

[or]

"Fraud" means:

(i) the presentment of a document that is forged or materially altered; or

(ii) presentment by one who has no colorable basis to be entitled to have the presentment honored.

[or]

"Fraud" means the presentment of a forged or materially fraudulent document by one who knows of the forgery or fraud.

[or]

"Fraud" means the presentment of a document that is forged or materially fraudulent.

[or]

Omit this subsection.\(^{104}\)

The comment to the definitional alternatives explains that statutory provision of the definition is intended "to clarify and restrict the circumstances in which fraud can be raised as a defense to dishonor of a letter of credit."\(^{105}\) Certainly something would be gained by uniformity; but it is not clear that the independence principle would be vindicated.

The revisers of Article 5 would include language in the official comment to the fraud definition to the effect that "[f]raud in the underlying transaction does not constitute fraud as that term is used in subsection (a)(7)."\(^{106}\) But a distinction between fraud in the credit transaction and fraud in the underlying transaction is specious. In fact, the very case that the drafters of the revision describe as providing the basis for their definition of fraud involved "fraud in the transaction." The drafters' description of the case reveals that coincidence: "The section 5-103(a)(7) definition, as applied in section 5-110, affirms the result in *Sztejn v. J. Henry Shroder Banking Corp.*, . . . which enjoined payment under a letter of credit when the beneficiary shipped worthless rubbish instead of the contracted-for goods but presented documents claiming otherwise."\(^{107}\)

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104. The fraud definition would be pertinent with regard to the operation of U.C.C. § 5-110(e) (Proposed Official Draft 1992):

If a presentment is made that appears on its face strictly to comply with the terms of the letter of credit, but the beneficiary has committed fraud:

1. the issuer shall honor a draft or demand if demanded by:
   1. a person that under a negotiation credit has taken a draft or other demand for value in good faith and without notice of a defense; or
   2. a nominated person that has given value in good faith without notice of a defense; or

2. if the conditions in paragraph (e)(1) are not met, the issuer may honor or dishonor.


106. Id.

107. Id.
The documents in Sztejn were false because they did not properly describe the fraudulently substituted goods.

The decision makes clear, then, that fraud in the credit transaction is the result of fraud in the underlying transaction.\textsuperscript{108} If the only way to discern fraud in the documents is to examine the underlying transaction, all that remains is a quibble: is the fraud in the documents because they misdescribe the underlying (fraudulent) transaction, or does the fraud in the underlying transaction trump the documentary deficiency? The fraud is not in one place or the other; once there is fraud in the underlying transaction there is necessarily fraud in the credit documentation. Any other conclusion would be disingenuous.

So long as the account party's assertion of the beneficiary's fraud\textsuperscript{109} burdens the credit, and compromises the credit's independence, the three parties' relationship becomes interdependent. Interdependence, in turn, defines suretyship. The standby credit and commercial suretyship universes collide; there is no principled way to keep them apart. The fact of that collision, then, means that there is likewise no principled way to keep letters of credit out of the scope of the suretyship restatement. To deny that reality is to establish the very foundation of the suretyship restatement, the scope provision, on quicksand.

D. "Plotting" Fraud

Some commentators, far from extolling without qualification the virtues of the independence principle's operation in the standby context, have instead fashioned both good commercial reason and devices to accomplish the interdependence of the standby and the equities of the underlying transaction. For example, Messrs. Kimball and Sanders have suggested that account parties avoid the harshness of the independence principle by avoiding the so-called suicide credit: a credit "payable upon a simple demand in the form of a draft."\textsuperscript{110} Account parties may realize many of the benefits of interdependence by including detailed documentary demands in the standby, thereby "laying the foundation for a lawsuit."\textsuperscript{111} The fact that some commentators recognize the commercial value of interdependence from the perspective of the account party sup-

\textsuperscript{108} To similar effect, see Peter A. Alces, The Law of Fraudulent Transactions § 3.18[2][c][iii].
\textsuperscript{109} Note that U.C.C. § 5-110(e) (Proposed Official Draft 1992) is premised on the beneficiary's commission of fraud.
\textsuperscript{110} George Kimball & Barry A. Sanders, Preventing Wrongful Payment of Guaranty Letters of Credit—Lessons from Iran, 39 BUS. LAW. 417, 436 (1984).
\textsuperscript{111} Id.
ports the observation that the independence-interdependence tension may be a fact of commercial life; a fact not subject to abrogation in the interest of certainty insofar as that certainty may come at the expense of important commercial values.

Consider, in that regard, the suggestion of Kimball and Sanders:

Recital of the factual basis for the demand (for example, failure to deliver) is important. If payment should later be demanded on the basis of demonstrably false representations, the account party may establish fraud from invoices, shipping records, and similar records of performance. While the issuing bank will not investigate the truth of such a certificate, falsehoods permit the account party to establish not only fraud in the transaction, but fraud in the documents.112

That observation, a recommendation to those who would compromise the independence of the letter of credit undertaking, and the sound case law supporting its efficacy, demonstrate something about the independence-interdependence axis suggested above. Recall that independence-interdependence describes one axis while the mere breach of contract-active fraud inquiry provides the other axis. Cases that fall within the shaded area are those in which the court will be less likely to invoke suretyship principles. Those that fall beyond the shaded area are the cases in which the courts would more likely apply the suretyship law. The ostensible certainty of that graphic illustration is designed to belie the uncertainty, the indeterminacy, of the calculus. It provides the means to line up the cases after the fact, rather than an analysis to guide the courts' certain determination on the basis of predictable, recurring facts.

The axes are not certainly calibrated measures, on which courts can superimpose some conception of the relative points that may be plotted to determine the correct result. Each point along the axes represents a

112. Id. at 437.
court's conclusion, among a range of plausible conclusions, regarding the breach of contract-active fraud and independence-interdependence characterizations. The combinations are limited only by the imaginations of those who draft, those who construe, and those who perform pursuant to the terms of a standby credit. Recognize, as well, that the suggestion of the graph and the argument of commentators such as Kimball and Sanders are in diametric opposition to the position of other commercial scholars; scholars who champion the independence principle as crucial to the certainty that is the raison d'être of the commercial law, particularly the letter of credit law.

From the graphic depiction of the independence-interdependence dynamic, it is not difficult to appreciate that courts deciding standby credit cases may manipulate their conclusions regarding the constituent characterization issues to serve their perception of the underlying equities, at least to an extent considerate of the commercial values identified by the commentators. Therefore, it is crucial to remain cognizant of the stakes: if a court finds sufficient fraud in the transaction, the credit is indistinguishable from a commercial guaranty within the scope of the Restatement of Suretyship. That brings the inquiry full circle, and suggests that courts realize the results that flow from their abrogation of independence in favor of interdependence. Armed with that insight, courts will then characterize the beneficiary's action as fraudulent (rather than as a mere breach of contract) and will conclude that the terms of the credit incorporate the underlying transaction (interdependent rather than independent), thereby providing the issuer suretyship status and all the incidents of that status, whether the issuer is comfortable with that status or not.

IV. RECONCILIATION AND DEFINITION

Suretyship gives rise to interrelated three-party relationships. The performance of the three parties is interdependent: the rights and duties of each are determined by reference to the actions of the other two. In sharp contrast to the three-party suretyship transaction are two-party relationships in which three parties are involved but the rights and responsibilities between each two of the parties are wholly independent of one another. Given that both types of relationships (two- and three-party) involve three parties whose rights are interrelated (factually if not legally), it is not surprising that the courts and commentators have experienced difficulty distinguishing the nature of the three-party transaction from the two-party transaction in a way that is considerate of their fundamental difference.

Professor John Dolan, writing about pending efforts to develop the law of bank guarantees,113 recognized the two-party/three-party tension

in terms of primary (analogous to two-party) and secondary (analogous to three-party) guarantees:

[T]he distinction between primary and secondary guarantees rests on transactional facts, not nomenclature. A bank may call a guarantee “primary” but fasten conditions to it that render it secondary, or the bank may call the guaranty “secondary” but condition it on the presentation of documents that render it primary. Similarly, a bank may designate its guarantee “primary”; but if the obligation is payable only against a finding that the beneficiary is entitled to prevail in an underlying contract dispute, the guarantee is secondary. Courts, furthermore, can destroy the distinction between primary and secondary guarantees by reading into a guarantee conditions that alter its character. A court that permits or forces the guarantor to determine the veracity of the beneficiary’s certification will render secondary what would otherwise be a primary guarantee. 114

The difficulties are exacerbated by the existence of relatively few pure three-party relationships and similarly few pure two-party relationships. The two-party or three-party label is no more than that: a label, “nomenclature,” a conclusion, not an analysis.

It is the distinguishing characteristic of suretyship that the rights and duties of three parties are interdependent. From part II’s survey of extant credit enhancement devices, an operative definition emerges:

Suretyship is the relationship that exists among three parties. One party, the primary obligor, owes primary performance of a duty to another party, the creditor. A third party, the surety, by contract assumes a secondary obligation to perform that is determined by reference to the primary obligor’s duty to perform. The creditor, meanwhile, is entitled to only one performance. The Restatement of Suretyship scope provision, Section I, subsection (1), casts the definition in different but perhaps essentially similar terms:

(1) [W]henever:
(a) one person (the “principal obligor”) owes performance of a duty (the “underlying obligation”) to another party (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 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

114. Id. at 243.
(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.\(^{115}\)

The secondary obligor has suretyship status if the criteria in subsection (1) are satisfied. The Restatement's definition is more detailed, reading more like a statute, than did Section 82 of the prior Restatement of Security.\(^{116}\)

The new Restatement definition also makes clear that suretyship is something that arises from the parties' relationship; it need not be created by express contract among them.\(^{117}\) The commentary to Section 1 emphasizes further that it is the existence of interdependence that earmarks suretyship: "substance, rather than form determines whether suretyship status rights attach."\(^{118}\) This also confirms that the suretyship concept is inextricably intertwined with conceptions of suretyship rights. The value of suretyship status is that it gives rise to suretyship rights, unless the surety has by contract or otherwise relinquished such rights. To similar effect: "[b]oth sureties and guarantors that fulfill the criteria of § 1 [interdependence] have suretyship status."\(^{119}\) When three (or more) parties' undertakings are interdependent, there is suretyship, and, most significantly, suretyship status will be apposite. The secondary obligor's performance responsibility will be determined by reference to the rights of the principal obligor and obligee pursuant to the underlying transaction.

The conclusion that a transaction formulates sufficient interdependence, that one party has the suretyship rights and, concomitantly, the suretyship defenses, is often a post hoc judgment. When one of the three parties asserts a suretyship right or takes advantage of a suretyship de-

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\(^{115}\) Restatement of Suretyship, supra note 4, § 1(1).

\(^{116}\) Note the relative brevity of the Restatement of Security's definition of suretyship: "Suretyship is the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform." Restatement of Security § 82 (1941).

\(^{117}\) See Restatement of Suretyship, supra note 4, § 1, cmt. a. "As the term 'suretyship status' suggests, the secondary obligor obtains these rights as a matter of status in the transaction rather than by express agreement."

\(^{118}\) Id. at cmt. b; see also id. at cmt. g, entitled "Substance of contract governs; essential purpose": "The determination that a contract establishing the secondary obligation gives rise to suretyship status is based on substance, not form."

\(^{119}\) Id. at cmt. c. Note that the observation is offered in the context of discussing suretyship vis-a-vis guaranty, a distinction that maintains no currency in the Restatement. See id. at cmt. d: Sometimes the term "suretyship" is used narrowly to refer only to transactions in which one party is jointly and severally liable with another on an obligation and the term "guaranty" is used to refer to transactions in which one party is liable only after the default of the other. At other times, however, the term "suretyship" refers generically to both types of transactions. To avoid confusion . . . this Restatement avoids use of the terms "guaranty" and "surety."

For further treatment of the issue, see id. at Reporter's Note to cmt. c and the sources cited therein.
The party resisting that action will insist that there was not sufficient interdependence to give rise to such rights or that the rights and defenses that flow therefrom were circumvented by the terms of the contract between the putative surety and the creditor. While there are at least as many potential contexts in which these crucial scope issues arise as there are “suretyship” contracts, the important distinctions are captured in the persistent commercial law debate regarding the operation of the independence principle in standby letters of credit, ostensibly a two-party relationship giving rise to the primary rather than secondary liability of the issuer. 120

The suretyship restatement explicitly excludes letters of credit from its scope: “The Restatement of this subject does not apply to obligations governed by the law of letters of credit.” 121 The pertinent comment explains the bases of the exclusion, but in terms that are ultimately unconvincing:

First, the law governing letters of credit is quite well developed, is generally understood to govern all letters of credit, both traditional and standby, and has regulated standby credits effectively and efficiently. No good purpose would be served by disturbing that state of affairs. Second, while a standby letter of credit serves an economic function similar to that of suretyship devices governed by this Restatement, it does not satisfy all of the criteria of § 1. Under the independence principle governing letters of credit, performance or other discharge of the underlying obligation does not discharge the issuer of the standby letter of credit. Rather, the issuer has contracted to pay upon presentation by the obligee/beneficiary of a certificate attesting to the default of the principal obligor; the issuer’s obligation to pay is independent of whether the principal obligor has actually fulfilled the underlying obligation. Thus, the criterion of suretyship status set forth in § 1(1)(c) is not satisfied and, therefore, the rules in this Restatement do not apply to letters of credit. 122

The Restatement excludes letters of credit because the representatives of issuer interests do not want letters of credit to be within the scope of the Restatement, not because of any fundamental difference between standby credits and suretyship. If standby credits are deemed interdependent, and subject to suretyship principles, the issuer that pays notwithstanding the account party’s fraud defense will not be able to obtain or retain reimbursement from the account party and will be left with only a cause of

120. The law of commercial paper also draws a distinction between the primary liability of makers and acceptors and the secondary liability of indorsers and accommodation parties. See U.C.C. §§ 3-413 (“Contract of Maker, Drawer and Acceptor”), 3-414 (“Contract of Indorser; Order of Liability”) & 3-415 (“Contract of Accommodation Party”) (1989); and U.C.C. §§ 3-412 (“Obligation of Issuer of Note or Cashier’s Check”), 3-413 (“Obligation of Acceptor”) & 3-415 (“Obligation of Indorser”) (revised 1990).

121. RESTATEMENT OF SURETYSHIP, supra note 4, § 3(2).

122. Id. § 3 cmt. b; see id. § 1(1)(c) ("A ‘secondary obligor’ has suretyship status whenever . . . to the extent that the underlying obligation or the secondary obligation is performed the obligee is not entitled to performance of the other").
action against the fraud-feasor beneficiary. This is precisely the circumstance issuers want to avoid by excluding standby credits from the scope of suretyship.

The "exclusion" of credits in § 1(1)(c) is conclusory rather than explanatory: if the courts or the governing law in fact deemed the issuer's undertaking in standby credit transactions to be independent of the account party's duty to perform, then it would be correct to conclude that the two-party nature of credits is distinguishable and distinct from the three-party basis of suretyship. But cases construing the parties' undertaking in standby credit transactions when the account party alleges fraud confirm that credits are, in practice, three-party devices, albeit a unique form of three-party arrangements. As review of the extant credit enhancement devices reveals, however, each is unique in an important way. This, however, should not and does not obscure their fundamental affinity. Recall also that the parties are free to adjust the terms of their agreement to effect a two-party-like result, without such contractual adjustments' removing the device from the scope of the suretyship restatement. Indeed, the Restatement acknowledges that freedom of contract:

[T]he secondary obligor has suretyship status:
(a) regardless of the form of the transaction fulfilling the criteria [of § 1(1)];
(b) regardless of any term used by the parties to describe the secondary obligor or the secondary obligation;
(c) whether the secondary obligation is conditional or unconditional;
(d) whether or not the secondary obligation is known to the principal obligor; and
(e) whether or not the obligee has notice that the secondary obligor has suretyship status.123

If typical commercial guaranty agreements, absolute in their terms and containing comprehensive waivers of any rights that the guarantor interposes, may be within the scope of the Restatement notwithstanding their two-party-like nature, it is difficult to discern a reasoned basis for excluding letters of credit if, in fact, the independence of the issuer's undertaking is more aspiration than actuality.

It is appropriate here to conjecture about commercial interests that issue letters of credit to benefit from keeping standby credits outside the scope of the Restatement. Keep in mind that the issuer of a credit is akin to the secondary obligor, bound to perform on the beneficiary/obligee's demand, subject, perhaps, to the account party's interposition of a defense good against the beneficiary, namely fraud. Those same institutions

123. Id. § 1(2); see id. § 12(c), which states:
[I]f the parties to a contract identify one party as a "surety," or the contract as a "suretyship" contract, the party so identified is a secondary obligor who is subject to a secondary obligation pursuant to which the secondary obligor is jointly and severally liable with the principal obligor to perform the obligation set forth in that contract.
that issue standby credits, multinational banks, often take guaranty agreements as collateral security supporting loans that those same banks have made to borrowers/principal obligors. With regard to those financial institutions' rights as obligees in the commercial guaranty agreement context, their interests are best served by a body of legal principles favoring obligees over secondary obligors. But insofar as those same institutions are issuers of standby credits, akin to secondary obligors, they would prefer that a body of law proceeding from the opposite predisposition, favoring issuers/secondary obligors, provide the rules of decision.

Article 5 of the U.C.C. can serve the interests of large institutional creditors as issuers and the Restatement of Suretyship can serve the interests of those same institutions as obligees; but having one comprehensive body of law serving those institutions' interests in both roles at the same time would be difficult. It is much easier to divide and conquer. And that is true whether or not the division is effected with the intent to conquer. Intentional or not, principle is manipulated.

In the recent revision of Uniform Commercial Code Article 3, "Commercial Paper,"124 the suretyship rules implicated in transactions involving negotiable instruments were changed dramatically from their original form. Original Article 3125 generally followed existing suretyship rules regarding the undertaking of an accommodation party.126 Revised Section 3-605, however, departs from the common law of suretyship in order to better serve the interests of holders of accommodated paper, generally sophisticated financial institutions.127 While the wisdom of those adjustments may be controversial, for present purposes it suffices to note that the scope of the suretyship restatement includes negotiable instruments.128 The Restatement provides that Article 3 governs when the Restatement and that statute collide, certainly a gratuitous provision, insofar as statutes always govern the common law.129 Nonetheless, the Restatement accommodates the statutory commercial paper law without pretending that accommodation of a negotiable instrument is not an instance of suretyship. Why should letters of credit be treated any differently?

If the undertaking of an accommodation party on a negotiable instrument is suretyship, yet excepted from the Restatement rules, then it

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128. The Permanent Editorial Board for the Uniform Commercial Code has circulated for comment a proposed "PEB Commentary on the Uniform Commercial Code Concerning Suretyship Issues Under Sections 3-116, 3-305, 3-415, 3-419, and 3-605" (Proposed Final Draft, May 20, 1993).
129. Restatement of Suretyship, supra note 4, § 3(1): "When a transaction resulting in a person having suretyship status is governed by the law of negotiable instruments (Article 3 of the Uniform Commercial Code), that law takes precedence over otherwise applicable rules in this Restatement."
would seem that the Restatement rules would be apposite, if the paper accommodated is determined by a court not to be negotiable.\textsuperscript{130} This is true even though the instrument may be deemed not negotiable for reasons wholly unrelated to suretyship principles.\textsuperscript{131}

The same result would not prevail with regard to a letter of credit once the court decides that the independence of the credit is undermined. Then, notwithstanding the type of interdependent arrangement that is the hallmark of suretyship, the Restatement would be inapposite, at least to the extent displaced by Article 5. This is particularly curious considering that the circumstance that will result in the destruction of independence, fraud, is the very circumstance that provides the basis for the application of suretyship rights and defenses. This anomaly is the product of the Restatement's unprincipled separation of letters of credit from the scope of suretyship.

V. CONCLUSION

In determining the nature of three-party rights, commercial contracts law distinguishes two-party from three-party arrangements. The suretyship restatement, concerning ostensibly three-party obligations, expressly excepts from its scope certain contracts—letters of credit which assume the incidents of a two-party undertaking. But it is clear from a survey of the commercial credit enhancement devices that many commercial agreements that are within the scope of the Restatement may nonetheless bear the indicia of a two-party transaction that the parties to standby credits intend for their relationship. Furthermore, review of the letter of credit cases reveals that many standbys, either by their own terms or the reviewing courts' insinuation of fraud principles, are, essentially, three-party, interdependent relationships. Therefore, not only does the two-party/three-party dichotomy obscure commercial realities, it distorts principle.

While it would be overrefined to mourn the sacrifice of principle merely as some type of affront to jurisprudential symmetry, there is more at stake in the \textit{Restatement of Suretyship} and the revision of Article 5 of the \textit{Uniform Commercial Code}. Perhaps (and probably) unwittingly, the two- vs. three-party fiction vindicates the interests of those commercial

\textsuperscript{130} The elements of negotiability are formulated in original and revised U.C.C. § 3-104. Professor Cohen has also opined that the Restatement would apply to supplement Article 3 of the U.C.C. in cases in which the Code does not dispositively provide a governing rule. See Cohen, supra note 126, at 619:

With the exception of revised section 3-605(f), the U.C.C. does not provide rules governing suretyship defenses of parties who are sureties but not accommodation parties [i.e., true co-makers]. A strong case can therefore be made that such parties are protected by the common law of suretyship. The common law, of course, can be imported by application of U.C.C. section 1-103.

\textsuperscript{131} For example, an instrument will not be negotiable if it lacks the "words of negotiability," viz. "payable to order or bearer." See U.C.C. § 3-104(1)(d) (1989) & U.C.C. § 3-104(a)(1) (revised 1990).
transactors who are sometimes suretyship obligees and, at other times, standby credit issuers. Normative balance and transactional integrity only can be maintained in the commercial law if restatements of the law and uniform commercial law are formulated along lines dictated by principle: if the authors of such initiatives are not attentive to principle, they compromise immanent justice.

In the case of the suretyship restatement, the consequences of inattention to principle loom large on the horizon. It is quite possible that the Restatement project will be followed by a new Article 3A of the Uniform Commercial Code, concerning commercial suretyship. If the Restatement excludes from its scope, on the basis of some asserted but insubstantial rationale, letters of credit, then the fit between an Article 3A and a revised Article 5 will be uneasy, perhaps untenable. And if the new Article 3A is inconsistent with the Restatement, then that dissonance will undermine the efficacy of both.

The definition of suretyship offered in this article is sufficiently comprehensive to include both standby credits and the other common credit enhancement devices; any coherent definition of suretyship must. The graphic demonstration of the interrelated considerations in fixing the terms of the two-party/three-party standby credit dynamic complements the proposed definition. Furthermore, there is no chance that the definition's breadth will impair the rights of the parties to three-party relationships to fix their rights inter se by contract, subject, of course, to the irresistible power of fraud to "unravel[ ] everything." 

132. See Letter from Donald J. Rapson, General Counsel, CIT Corporation, and member of the Permanent Editorial Board of the Uniform Commercial Code as well as Adviser to the Restatement of Suretyship to Geoffrey C. Hazard, Jr., Professor, Yale Law School, and Director of the American Law Institute (May 30, 1986) in Appendix A to Donald J. Rapson, History and Background of the Restatement of Suretyship, 34 WM. & MARY L. REV. 989, 1013 (1993) ("recommending an [American Law Institute] 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").

133. See supra notes 107-10 and accompanying text.

134. JOHN M. FINNIS, NATURAL LAW AND NATURAL RIGHTS 288 (1980).