

# Notes

## Discharge of Certain Parties to Negotiable Instruments Upon a Holder's Impairment of Collateral

### I. THRESHOLD ISSUES

Section 3-606(1)(b)<sup>1</sup> of the Uniform Commercial Code (UCC) discharges certain parties to a negotiable instrument when a holder "unjustifiably impairs" collateral given for the instrument. This Note discusses which parties can take advantage of this right to discharge, against which holders the right can be asserted, and what acts constitute such unjustifiable impairment of collateral. The questions of which parties come within section 3-606(1)(b) and against which holders the section is available are known as threshold issues. The considerations applicable to these threshold issues are the same as for the threshold issues involved in the other special suretyship defenses, which are found in section 3-606(1)(a).

Section 3-606 as a whole is an expansion and clarification of section 120<sup>2</sup> of the Negotiable Instruments Law (NIL). The NIL

---

<sup>1</sup>UNIFORM COMMERCIAL CODE [hereinafter cited as UCC] § 3-606(1) provides in full:

(1) The holder discharges any party to the instrument to the extent that without such party's consent the holder

(a) without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person, except that failure or delay in effecting any required presentment, protest or notice of dishonor with respect to any such person does not discharge any party as to whom presentment, protest or notice of dishonor is effective or unnecessary; or

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

<sup>2</sup>UNIFORM NEGOTIABLE INSTRUMENTS LAW [hereinafter cited as NIL] § 120 provides in relevant part:

A person secondarily liable on the instrument is discharged:

....

distinguished between parties primarily and secondarily liable. The latter category included drawers and indorsers. Since these parties generally stood on the instrument as sureties for primary parties (makers and acceptors), the drafters of the NIL gave secondary parties the right to discharge on the instrument upon certain misdeeds of the creditor-holder which under the general law of suretyship discharged a surety.<sup>3</sup> No specific provision of the NIL extended this right to primary parties. With the exception of the defense of extension of time for payment, however, a number of courts allowed makers and acceptors who signed the instrument as sureties to seek discharge under general suretyship principles.<sup>4</sup>

The distinction between primary and secondary parties was not retained under the UCC. Comment 1 to section 3-606<sup>5</sup> states that the provisions of the section "are not limited to parties who

---

5. By a release of the principal debtor, unless the holder's right of recourse against the party secondarily liable is expressly reserved.

6. By any agreement binding upon the holder to extend the time of payment, or to postpone the holder's right to enforce the instrument, unless made with the assent of the party secondarily liable, or unless the right of recourse against such party is expressly reserved.

<sup>3</sup>W. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES §§ 291-93 (2d ed. 1961) [hereinafter cited as BRITTON]. Impairment of collateral was not mentioned in the NIL as a cause for discharge even of secondary parties. Professor Britton argues, however, that the drafters of the NIL obviously intended to include all of the special suretyship defenses and that the courts dealing with the NIL read section 120 to include the defense of impairment of collateral. These defenses, Professor Britton continues, applied only to secondary parties qua secondary parties, that is, to regular indorsers and drawers. An accommodation drawer or indorser (a party signing specifically as a surety) should technically have sought discharge under the general law of suretyship, incorporated into the NIL by section 196. BRITTON § 293, at 686.

<sup>4</sup>There is some dispute as to the availability to primary parties under the NIL of these special suretyship defenses. Compare BRITTON § 301, at 705, with 4 S. WILLISTON, THE LAW OF CONTRACTS § 1260 (rev. ed. 1936) [hereinafter cited as WILLISTON].

On suretyship under the NIL, see generally BRITTON §§ 290, 291; J. BRANNAN, BRANNAN NEGOTIABLE INSTRUMENT LAW 1114-40, 1148-66 (7th ed. F. Beutel 1948); WILLISTON § 1260; Annot., 74 A.L.R. 129 (1931); Annot., 2 A.L.R.2d 260 (1948); 43 YALE L.J. 1015 (1934).

<sup>5</sup>UCC § 3-606, Comment 1 explains the statutory language concerning which parties are covered by the section:

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

are 'secondarily liable.'"<sup>6</sup> Nor does section 3-606 cover only accommodation parties;<sup>7</sup> rather its coverage extends to "any party who is in the position of a surety."<sup>8</sup> A party "in the position of a surety" is classified as any party having a right of recourse either on the instrument or de hors it.<sup>9</sup> Rights of recourse on the instrument arise from any other provision of Article 3 of the UCC. Rights of recourse de hors the instrument flow from other sources of law, especially the general law of suretyship.<sup>10</sup> In either case,

---

<sup>6</sup>*Id.* For a case under the NIL making the distinction between primary and secondary parties but realizing that the UCC establishes a different test in section 3-606, see *Rose v. Homsey*, 347 Mass. 259, 197 N.E.2d 603 (1964). Some courts under the UCC still distinguish between secondary parties and non-accommodation primary parties. *Commerce Union Bank v. May*, 503 S.W.2d 112 (Tenn. 1973); *Peoples Bank v. Pied Piper Retreat, Inc.*, 207 S.E.2d 184 (W. Va. 1974).

<sup>7</sup>With the possible exception of *Brunner v. Smith*, 467 S.W.2d 565 (Tex. Civ. App. 1971), no case has been found under the UCC denying that accommodation parties are covered by section 3-606.

Arguing a construction of a UCC section from the Comments is somewhat risky. Many courts rely on the Comments, and a clever lawyer always cites them when they support his case, but the Comments are not legislatively enacted. One policy and two textual arguments can be made to support the position of the Comments to section 3-606 and of this Note that section 3-606 includes non-accommodation, non-indorser persons. If section 3-606 applied only to suretyship created on the instrument, the name of the individual accommodated would by definition be required to be on the instrument. In the terms of Article 3, he would need to be a "party." Section 3-606 clearly states, however, that the rights of recourse are against a "person." Also, the rights of recourse of an accommodation party are, again by definition, on the instrument. UCC § 3-415(5). The drafters showed that they distinguished between "right of recourse" and "right of recourse on the instrument" by using the latter phrase in section 3-415(5). In section 3-606(1), the right of recourse is not so qualified.

The policy argument centers on the Code's overall purpose "to simplify, clarify, and modernize the law governing commercial transactions." UCC § 1-102(2)(a). Although a majority of courts under the NIL disallowed suretyship de hors the instrument, scholarly opinion was in favor of allowing recourse de hors the instrument for purposes of establishing discharge under the special suretyship defenses. See note 76 *infra*. A broad reading of the scope of section 3-606(1) thus favors what scholars in the field have long considered the better view.

<sup>8</sup>UCC § 3-606, Comment 1.

<sup>9</sup>*Id.*

<sup>10</sup>Accommodation parties have rights of recourse on the instrument as provided in UCC § 3-415(5): "An accommodation party is not liable to the party accommodated, and if he pays the instrument has a right of recourse on the instrument against such party." For a discussion of section 3-415(5), see J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 13-16 (1972) [hereinafter cited as WHITE & SUMMERS].

Non-accommodation indorsers also have rights of recourse on the instrument established by their contracts as indorsers. UCC § 3-414. Non-accommodation makers, drawers, acceptors, and payees may have rights of

before a holder is liable under section 3-606(1) (a), he must have knowledge of the right of recourse.<sup>11</sup> Knowledge is defined by the UCC as actual knowledge.<sup>12</sup>

---

recourse dehors the instrument. These rights could arise by suretyship agreement or by operation of law and, in both cases, are created by the general law of suretyship. These rights supplement section 3-606, as provided by section 1-103. See note 17 *infra*.

Rights dehors the instrument may be against parties to the instrument or parties off the instrument. In most of the former cases, an accommodation contract would seemingly have been made. *But see* Oregon Bank v. Beardson, 256 Ore. 454, 473 P.2d 1015 (1970), in which case the court would not allow one co-maker to claim impairment of collateral when he had made an agreement dehors the instrument with the other co-maker that he would be primarily liable on the instrument.

The status of non-accommodation co-makers under section 3-606(1) (b) is more complicated. As parties to the instrument, one or more of them may have established rights of recourse dehors the instrument against a party who gave collateral for the instrument. One or more co-makers may also have made an accommodation contract on the instrument on behalf of another party to it. Arguably, however, a co-maker always has a right of recourse on the instrument against other co-makers for contribution if he pays more than his proportionate share. This right would arise on equitable grounds through section 1-103. WHITE & SUMMERS § 13-14, at 434 n.121. Case law on this point is unsettled. MacArthur v. Cannon, 4 Conn. Cir. Ct. 208, 229 A.2d 372 (1967) (co-maker liable for contribution); Hallowell v. Turner, 95 Idaho 392, 509 P.2d 1313 (1973) (reservation of rights by one co-maker precluded issue of co-maker's proportionate liability); Blakely v. Schultz, 480 P.2d 428 (Ore. 1971) (issue of co-maker's liability not decided because defendant did not plead it).

Professors White and Summers state that the right of recourse on the instrument arises only after the surety party has paid the instrument. WHITE & SUMMERS § 13-16, at 438 n.136. As a matter of recovery from the principal, this is undeniably correct. This reasoning should not, however, deny a surety party recourse to section 3-606 if he has no right of recourse dehors the instrument and the instrument is not yet due or is due and the surety has not yet paid it. Under general suretyship law the surety obtains certain rights as soon as he becomes bound, which rights are the equivalent of rights of recourse. L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 47, at 212-24 (1950) [hereinafter cited as SIMPSON]; *id* § 48, at 235-37.

<sup>11</sup>UCC § 3-606(1) (a).

<sup>12</sup>UCC § 1-201(25). This test is equivalent to one of subjective knowledge. What an individual knows in fact, rather than what he should know from the information given him, is determinative. Since actual knowledge is established generally by showing what one could know from the objective circumstances, that is, from notice, the practical differences between the actual knowledge and notice tests are probably less than the theoretical differences. Unfortunately, section 3-606, Comment 3, in applying the actual knowledge test in the context of that section, seems to make a greater distinction between notice and lack of notice than between knowledge and notice. This seeming disparity between text and comment must be resolved in favor of the clear wording of the text. The ambiguity in section 3-606, Comment 3, may have led one court to suggest that section 3-606 embodies a notice standard. Hallowell v. Turner, 95 Idaho 392, 509 P.2d 1313 (1973).

The defense of impairment of collateral found in section 3-606(1)(b) is available to a party with recourse against one who has caused collateral to be given for the instrument. Additionally, this defense is available to a party without recourse, provided that collateral has been given for the instrument by or on behalf of that party.<sup>13</sup> Although section 3-606(1)(b) has no explicit knowledge requirement, the word "unjustifiably" was probably intended to incorporate the section 3-606(1)(a) standard of the holder's subjective knowledge.<sup>14</sup> Before the special suretyship defense of impairment of collateral can be asserted under general suretyship law, the creditor must know of the suretyship relation.<sup>15</sup> There is no reason to believe the drafters of the UCC intended to establish a lower standard for impairment of collateral cases under the Code. There is also no reason for establishing a lower standard for the impairment of collateral defense vis-à-vis the other special suretyship defenses.

The standard of actual knowledge required in section 3-606 makes unclear the relationship of this section with section 3-415, which contains the basic suretyship provisions of Article 3. Subsection 3-415(3) is central:

As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharge dependent on his character as such. In other cases the accommodation character may be shown by oral proof.

The subsection can be read in two ways. Considered as a rule of substantive law, it reduces for accommodation parties the element of the holder's subjective knowledge required for asserting discharge under section 3-606 to an element of notice as to holders

---

<sup>13</sup>UCC § 3-606(1)(b). See *Peoples Bank v. Pied Piper Retreat, Inc.*, 207 S.E.2d 184 (W.Va. 1974), discussed at note 43 *infra*.

<sup>14</sup>Section 3-606, Comment 3, gives no indication other than establishing for section 3-606(1)(b) the same standard of knowledge as for section 3-606(1)(a), although the Comment may erroneously suggest that a notice standard applies to section 3-606.

<sup>15</sup>WILLISTON § 1220, at 3510. Professor Simpson states that the creditor's knowledge of the suretyship relationship is necessary before the impairment of collateral defense of release of the security can be asserted. SIMPSON § 74, at 373. It follows that the more burdensome creditor duties which could be considered impairment of collateral under section 3-606(1)(b) would also require the holder-creditor's actual knowledge of the suretyship relationship. *But see* A. STEARNS, *THE LAW OF SURETYSHIP* § 6.46, at 184 (5th ed. J. Elder 1951) [hereinafter cited as STEARNS]. Although it is stated that the creditor's knowledge of the suretyship relationship is not required for the creditor to impair the collateral, the authority cited for this rule consists of more cases that hold against the stated rule than hold for it. *Id.* at 184 n.71.

in due course and, by negative implication, completely abolishes this element as to non-holders in due course. Considered as a rule of procedure, the section merely states against whom an accommodation party may assert defenses leading to discharge. A party would first be required to establish his accommodation status under the section 3-415(3) rules for introducing proof of accommodation status.<sup>16</sup> The party would then have to prove against any holder, whether or not a holder in due course, the elements of any special suretyship defense.<sup>17</sup>

Interpreting section 3-415(3) as a rule of procedure avoids the inequitable result of allowing an accommodation party to seek discharge upon the holder's notice of the accommodation, while requiring a non-accommodation party in the position of a surety to establish the holder's actual knowledge of the suretyship status. Otherwise, since notice can be established in more ways than can actual knowledge, accommodation parties would theoretically at least obtain discharges under the special suretyship defenses more easily than non-accommodation surety parties.

If section 3-415(3) were read as a rule of substantive law, accommodation parties would sue under section 3-415 rather than under section 3-606, because, as discussed above, discharge would be more readily available under the former section. This would make section 3-606 superfluous for accommodation parties, who comprise a large number of the prospective litigants ostensibly

---

<sup>16</sup>Section 3-606 and section 3-415(3) considered as a rule of procedure will still not interrelate without contradiction if section 3-415(3) is read to require that a holder in due course have notice of a party's accommodation status before he takes the instrument. However, such a qualification does not appear in the text of section 3-415(3). Evidently, when this restriction on the liability of a holder in due course was intended by the drafters of the UCC, they explicitly stated it in the section. See UCC §§ 3-602, 3-119(1). Policy considerations support the absence of this limitation in section 3-415(3). Having a surety for the debt embodied by the instrument can only benefit the holder. A holder will discharge a surety only when the holder's conduct is inequitable towards the surety and, before this inequitable conduct can occur, the holder must have knowledge of the suretyship relationship. See note 76 *infra*.

<sup>17</sup>For further analysis of the relationships between sections 3-415(3) and 3-606, see Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833, 868-76 (1968).

Any suretyship defenses found allowable in a direct suit under section 3-415(3) would be asserted via section 1-103 from the general law of suretyship. Section 1-103 incorporates into the UCC the great body of commercial common law. Outside law "supplements" the UCC provisions unless "displaced" by the particular provision in question. For a discussion of the defenses other than the special suretyship defenses that a surety-party could assert under section 3-415, see WHITE & SUMMERS § 13-17.

brought within the provisions of the section.<sup>18</sup> Furthermore, the text and comments to section 3-606 specifically extend the section to apply to accommodation parties.<sup>19</sup> The fact that accommodation parties are specifically covered by the provisions of section 3-606 limits these parties to that section as a source of substantive law for the defenses it contains. Otherwise, contradictory results could be obtained on the same facts by applying different sections of Article 3.

Even if section 3-415(3) is construed as a rule of procedure, conflicts could arise between that section and section 3-606. A party could sue under section 3-415(3) by incorporating into the section via section 1-103 one of the special suretyship defenses available under the general law of suretyship. If the elements of the defense at common law are more lenient than those established under section 3-606, similar problems would arise as if section 3-415(3) were considered a rule of substantive law. The same arguments given above against such a construction of section 3-415(3) should prevail against a party who seeks to circumvent the section 3-606 standards by suing under sections 3-415 and 1-103.

Many courts have had difficulties analyzing and applying these threshold issues. In *Brunner v. Smith*,<sup>20</sup> for example, Brunner became an accommodation co-maker for Steele when the bank showed Brunner \$30,000 worth of stock pledged to the bank by Smith on behalf of Steele. The bank sold the note before maturity to Smith, who had judgment against both makers for \$11,238.44, the full amount of the note.

Brunner appealed, seeking not discharge but a setoff of the collateral. The Texas Court of Civil Appeals may have reached a correct decision but incorrectly analyzed the issues and misapplied the relevant Code provisions. The court found that Brunner was a maker because there was "nothing on the face of the note to the contrary."<sup>21</sup> Sections 3-415(1), (2), and (5) were cited, evidently to support the proposition that a maker is liable to a holder regardless of the maker's accommodation status.<sup>22</sup> As a maker, Brunner was himself "accommodated" by the pledge and thus had no rights to it.<sup>23</sup> Neither section 3-606(1)(b) nor impairment of collateral were mentioned by the *Brunner* court. Nor was there

---

<sup>18</sup>UCC § 3-606, Comments 1, 3. The use of "right of recourse" in the text of both section 3-415(5) and section 3-606(1) links the two sections.

<sup>19</sup>Although section 3-606 should not be limited to accommodation parties, in many cases arising under section 3-606 the parties seeking discharge will be accommodation parties.

<sup>20</sup>467 S.W.2d 565 (Tex. Civ. App. 1971).

<sup>21</sup>*Id.* at 567.

<sup>22</sup>*Id.*

<sup>23</sup>*Id.*

any discussion of whether Smith knew of the accommodation of Steele by Brunner.

The issue of subjective knowledge or notice as the standard for asserting the special suretyship defenses pervades the opinion; yet this issue is never spelled out because the context in which it would be relevant is never clarified. The court further erred in not distinguishing between initial and ultimate liability. It correctly stated that, like any other party to a negotiable instrument, an accommodation party is liable in the capacity in which he signs the instrument.<sup>24</sup> The court failed to continue, however, and to state further that from this position an accommodation party can raise defenses under section 3-415 or section 3-606, provided that he can meet the tests established by these sections for inclusion in the class covered.

From the facts given, the court should have found that Brunner was an accommodation party under section 3-415(1). This would have given Brunner recourse on the instrument. Brunner could then have attempted to establish against Smith his discharge by the bank under section 3-606(1)(b). In addition to proving the bank's actual knowledge of his right of recourse against Steele and to showing an act of impairment by the bank, Brunner would have been required to prove either Smith's notice of Brunner's discharge or Smith's lack of holder in due course status.<sup>25</sup> Alternatively, Brunner could have tried to prove that Smith was himself the impairing holder. Section 3-415(3) would not have been a bar. In establishing impairment of collateral by Smith, Brunner would have had to show Smith's actual knowledge of Brunner's

---

<sup>24</sup>UCC § 3-415, Comment 1.

<sup>25</sup>UCC § 3-602 establishes when a party can assert against the present holder his discharge by a previous holder: "No discharge of any party provided by this article is effective against a subsequent holder in due course unless he has notice thereof when he takes the instrument." Notice on the instrument of the suretyship relationship and notice of the facts giving rise to the discharge should be sufficient to bind the present holder. Under a notice standard, a party is conclusively presumed to know the legal effects of the circumstances of which he is notified. Of course, notice on the instrument should not be required if the present holder had actual knowledge of the suretyship relationship, arising either on the instrument or *dehors* it, and had actual knowledge of the discharge, since notice includes actual knowledge. UCC § 1-201(25)(a).

In *Rushton v. U.M. & M. Credit Corp.*, 245 Ark. 703, 434 S.W.2d 81 (1968), an accommodation party was denied discharge from the previous holder's failure to perfect a security given for the note because the subsequent holder was a holder in due course who had no notice that the security interest had not been perfected. Sections 3-606(1)(b) and 9-207(1) were mentioned but were not controlling. Section 3-602 was not mentioned. The opinion gave an alternate reason for the holding. See note 43 *infra*.

right of recourse. Since knowledge constitutes notice,<sup>26</sup> Brunner, at the same time, would have been establishing his right to assert any defense against Smith under a reading of section 3-415(3) as a rule of procedure.

## II. PROBLEMS ARISING SPECIFICALLY UNDER SECTION 3-606(1) (B) : FLESHING OUT THE CODE

### A. General Considerations

Unlike the special suretyship defenses listed in section 3-606 (1) (a), which exist as separate and distinct rights in suretyship law, the term "unjustifiably impairs collateral" refers to no specific act. Although there is substantial agreement among the jurisdictions, each jurisdiction has its own collection of creditor misdeeds which can reasonably be considered included within section 3-606(1) (b). Commentators<sup>27</sup> arrange these individual defenses into three general categories, which are, in order from most likely available to least available: (1) affirmative acts relating to the collateral such as release of the pledge or other security, (2) negligent dealings with the collateral such as failure to take slight affirmative action to preserve or protect it, and (3) failure to take relatively burdensome steps to preserve or protect the collateral.

The word "impairs" seems itself sufficiently pejorative to encompass acts included in any of these categories. The "unjustifiably" modifying "impairs" must therefore limit rather than expand the scope of section 3-606(1) (b). "Unjustifiably" certainly includes some kind of knowledge requirement.<sup>28</sup> It also was probably meant to incorporate the common law rule that a creditor does not discharge a surety by impairing collateral when sufficient collateral remains to pay the debt.<sup>29</sup> Furthermore, the word points to the need for a standard. A creditor-holder will not himself become a surety or insurer; there is some lower level of duty for which he will be held accountable.

When faced with fleshing out the meaning of the undefined term "unjustifiably impairs collateral" of section 3-606(1) (b), courts essentially have three approaches. First, they can incorporate into the section the specific acts available as a defense in their jurisdiction under any of three categories listed above. Secondly,

<sup>26</sup>UCC § 1-201(25) (a).

<sup>27</sup>See generally 74 AM. JUR. 2d *Suretyship* §§ 87, 89, 92, 93 (1974); BRITTON § 292; 72 C.J.S. *Principal and Surety* §§ 197, 200, 203 (1957); SIMPSON §§ 74, 75; WILLISTON §§ 1232, 1233.

<sup>28</sup>See text accompanying notes 11-16 *supra*.

<sup>29</sup>SIMPSON § 74, at 372.

they can determine a standard of creditor's care drawn from the cases and establish it as the Code standard. Thirdly, they can create a body of decisions about section 3-606(1)(b) by testing any act alleged to be "unjustifiable" against an applicable Code standard.

In adopting the third approach, courts have been faced with a problem in semantics and statutory construction which is best illustrated by the case of *Shaffer v. Davidson*.<sup>30</sup> Mrs. Davidson accommodated Nank as a co-maker on a \$200 note to Shaffer given in return for a loan from Shaffer to Nank. Davidson and Nank also signed, as security for the note, a "chattel mortgage" on an automobile bought with the loaned money by Nank from a third party. Nank received the certificate of title to the car from the previous owner and sent it to Shaffer. Before Shaffer filed the "chattel mortgage" or properly certified the title, Nank sold the car to another party and disappeared. Presumably the last party took without knowledge of the security interest and thus bought free of it under section 9-307(2).<sup>31</sup> When sued by Shaffer, Mrs. Davidson asserted section 3-606(1)(b) as a defense. Shaffer countered with the argument that by Comment 5 to section 3-606,<sup>32</sup> by section 9-207(1)<sup>33</sup> referred to in Comment 5, and by the Article 9 definition of collateral,<sup>34</sup> acts of impairment under section 3-606(1)(b) can involve only the property covered by a mortgage, not the mortgage itself.

The court held for Mrs. Davidson on two theories. First, the court read section 9-207(1) as requiring reasonable care in filing the "chattel mortgage." Secondly, the court held that since the definition of collateral given in section 9-105(1)(c) is limited by its terms to Article 9, for purposes of Article 3, "the plain, ordinary, and usual meaning of that word is to be accepted."<sup>35</sup> After sur-

---

<sup>30</sup> 445 P.2d 13 (Wyo. 1968).

<sup>31</sup> UCC § 9-307(2) provides that a bona fide purchaser of consumer goods takes free of an unperfected security interest in the goods if they are bought from a consumer for personal, family, or household use.

<sup>32</sup> UCC § 3-606, Comment 5 provides in relevant part: "As to when a holder's actions in dealing with collateral may be 'unjustifiable,' the section on rights and duties with respect to collateral in the possession of a secured party (Section 9-207) should be consulted."

<sup>33</sup> UCC § 9-207(1) provides in full:

A secured party must use reasonable care in the custody and preservation of collateral in his possession. In the case of an instrument or chattel paper reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed.

<sup>34</sup> Collateral is defined in UCC § 9-105(1)(c) as follows: "'Collateral' means the property subject to a security interest and includes accounts, contract rights and chattel paper which have been sold."

<sup>35</sup> 445 P.2d at 16.

veying definitions from several sources, the court concluded that the definition of the word includes security other than pledges. By not filing the "chattel mortgage," Shaffer thus "failed or neglected to do that which the code required him to do."<sup>36</sup> Therefore, Mrs. Davidson was discharged.

The court evidently found section 9-207(1) applicable because a "chattel mortgage" was involved and because section 9-207(1) specifically mentions "chattel paper."<sup>37</sup> Such a holding is without merit. The security impaired in the *Shaffer* case is known as an "Article 9 security interest." The official definition of "chattel paper"<sup>38</sup> cannot reasonably be read to include "security interest."<sup>39</sup> "Chattel paper," as used in *Shaffer*, possibly could refer only to the papers representing the security interest.<sup>40</sup> Furthermore, section 9-207(1) deals with the proper care of pledges. Pledged chattel paper requires the same care as pledged tangible property; but, in any case, the *Shaffer* court was not involved with a pledge of chattel paper or with a pledge of any other type of property.

The court in *Shaffer* found on an alternate theory without reference to section 9-207(1) that a security interest itself can be impaired. The court's tortured utilization of section 9-207(1), however, leaves open the question of the proper effect of section 9-207(1) upon section 3-606(1)(b). At least five answers are possible: (1) Collateral, for purposes of section 3-606(1)(b), includes only those property interests covered by section 9-207(1);<sup>41</sup> (2) the standard of reasonable care found in section 9-207(1) applies to section 3-606(1)(b) only when the collateral covered by section 3-606(1)(b) includes property interests covered by section 9-207(1); (3) the section 9-207(1) standard of reasonable care applies generally to section 3-606(1)(b);<sup>42</sup> (4) application of the section

<sup>36</sup>*Id.* at 17.

<sup>37</sup>The court emphasized the word "chattel" and italicized it in quoting section 9-207(1). *Id.* at 15.

<sup>38</sup>Chattel paper is defined in UCC § 9-105(1)(b) as follows:

"Chattel paper" means a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper.

<sup>39</sup>UCC § 1-201(37) defines "security interest" as an "interest in personal property or fixtures which secures payment or performance of an obligation."

<sup>40</sup>For instances of when "chattel paper" can serve as collateral, see UCC § 9-105, Comment 3.

<sup>41</sup>*Pancoast v. Century Homes, Inc.*, 8 U.C.C. REP. SERV. 1289 (Okla. Ct. App. 1971); *Commerce Union Bank v. May*, 503 S.W.2d 112 (Tenn. 1973).

<sup>42</sup>*First Bank & Trust Co. v. Post*, 10 Ill. App. 3d 127, 293 N.E.2d 907 (1973); *White v. Household Finance Corp.*, 302 N.E.2d 828 (Ind. Ct. App. 1973); *Peoples Bank v. Pied Piper Retreat, Inc.*, 207 S.E.2d 184 (W. Va. 1974).

9-207(1) standard is optional with the court; or (5) section 9-207(1) can have no effect upon section 3-606(1)(b).<sup>43</sup>

The only reference to a possible effect of section 9-207(1) upon section 3-606(1)(b) is that made in Comment 5 to section 3-606, and the terms of the Comment may establish the limitations on such an effect. The key word in the Comment is "unjustifiably," not "collateral." This suggests that a standard of care is sought by the reference to section 9-207(1), rather than a definition of that interest to which a standard would apply. Moreover, the last phrase of the Comment refers to section 9-207(1) as dealing with security "in the possession of the secured party," that is, with pledges. This negatively implies that section 3-606(1)(b) deals with other, or at least additional, security.

The position can still be taken that regardless of any effect of section 9-207(1) upon section 3-606(1)(b), the Article 9 definition of collateral should control what constitutes collateral for purposes of section 3-606(1)(b). One can argue that by restricting the definition of collateral for section 3-606(1)(b) to exclude any type of security interest, the drafters of Article 3 made a policy decision that principals and sureties are responsible for perfecting or otherwise protecting any security interest they give to a creditor-holder.<sup>44</sup> The holding of the court in *Shaffer* that

---

<sup>43</sup>Both alternatives four and five are based on the argument that the Comments cannot control the text of a UCC section. The alternatives are distinguished by the position taken toward inter-article effectiveness. If the separate articles of the UCC are held to be separate and distinct, alternative five must be upheld. The better view is that as much as possible the UCC should be read as a unit. Even though section 9-207(1) is held to be in no way controlling for section 3-606, the reasonable care standard of section 9-207(1) can be taken as an appropriate standard for section 3-606, which use would promote uniformity among the jurisdictions in determining what constitutes unjustifiable impairment of collateral. The section 9-207(1) standard can be thought of as the opinion of the majority of the drafters of the entire UCC as to what constitutes an appropriate standard of care when property interests of one person are placed in the care of another.

<sup>44</sup>Compare the holding in *Rushton v. U.M. & M. Credit Corp.*, 245 Ark. 703, 434 S.W.2d 81 (1968), with the dissenting opinion in *Peoples Bank v. Pied Piper Retreat, Inc.*, 207 S.E.2d 184 (W. Va. 1974). In *Rushton* the co-maker of a note with a corporate buyer signed as "trustee" of the corporation. The note was given to a seller who sold equipment to the corporation. The seller transferred the note to his financing institution. The "trustee" co-maker claimed discharge when the seller failed to perfect a security interest given on the note before the corporation filed a bankruptcy petition. Evidently the seller regularly discounted his sales contracts with the financing institution. The court not only found the financier a holder in due course but also refused to find the seller to be an agent of the financier, so that acts of impairment by the seller could not be imputed to the financier. The court held that, given the relationship between the co-maker and the corporate buyer, the co-maker could also have perfected the security interest. Seemingly the co-maker's

Article 3 calls for a separate definition of collateral comprises one possible response. The more basic argument is that both the history of section 3-606(1) (b) in NIL sections 119 and 120 and its roots in general suretyship law make it highly dubious that the Code drafters intended to make such a restriction and to do so without explicitly stating the limitation. In numerous cases under the NIL<sup>45</sup> and in general suretyship law,<sup>46</sup> the creditor has been held to have discharged the surety by failing to file or to protect a security interest given for the debt.

*B. Specific Findings of Impairment of Collateral: Code Standards and Common Law Standards*

Courts that find the standard of reasonable care under section 9-207(1), whether or not limited to pledges, statutorily mandated for section 3-606(1) (b), must still look to suretyship law, not as a source of stare decisis, but for some idea of what "reasonable care" involves. Although by its terms this reasonable care test seems to fall somewhere between the second and third categories of creditor acts of impairment listed above, that line is as difficult to draw under the UCC as it is at common law to determine into which of the categories a particular acts falls.

In *First National Bank v. Helwig*,<sup>47</sup> for example, the bank did not foreclose a mortgage after it came due and the property

---

status as principal or surety was not relevant to the court's holdings.

In *Pied Piper* the sole stockholders of a corporation signing as co-makers with the corporation on a note to the bank were not allowed even prorata discharge when the bank failed to perfect a security interest given on the note and thus lost priority to a third party lien. The court held that only accommodation parties were covered by section 3-606. The question should have been whether the collateral had been given for the benefit of the stockholder co-makers. The dissent argued, however, that even a non-accommodation party is discharged by a bank's impairment of collateral given on his behalf because the maker then has less funds with which to pay the note and because banks are the specialists in financial matters and thus should have the burden of perfecting security interests they take.

The provisions of Article 9 regarding perfection give some credence to an argument that overall Code policy places a heavier burden on secured parties. A buyer for consumer purposes takes free of an unfiled security interest of which he did not have knowledge. UCC § 9-207(2). When non-consumer goods are involved, however, a subsequent secured party takes priority over a previous secured party who does not first perfect even though the subsequent party has knowledge of the previous security interest. UCC § 9-312(5). One rationale for the different provisions is that financial institutions and businesses, which will take most of the security interests under Article 9, should have the burden of following the reasonable commercial practice of perfecting their interests.

<sup>45</sup>BRITTON §§ 292, 301.

<sup>46</sup>SIMPSON § 75; STEARNS § 6.46; WILLISTON § 1233.

<sup>47</sup>464 S.W. 2d 953 (Tex. Civ. App. 1971).

serving as collateral for the mortgage burned. The mortgage itself served as collateral for a note. The court found the holder bank in technical possession of the property when it burned and held the dispositive issues in the case to be whether the bank had been negligent in dealing with the property. The court obviously benefited the defendant, who made the note as surety for the principal company, by concentrating on the burning of the property rather than the bank's failure to foreclose the mortgage as constituting the impairing act. Creditor negligence towards pledged property is a special suretyship defense much more readily available under general suretyship law than is a creditor's failure to foreclose.<sup>48</sup> Thus, such defense is more likely to be required under a section 9-207(1) standard.

The exact standard used by the *Helwig* court is unclear. The court discussed the distinction in the Texas law of suretyship between active and passive negligence and, finding the categories indistinct, evolved a new rule that a creditor in possession of property securing a debt owes a duty of ordinary care to preserve and protect that property.<sup>49</sup> Immediately after announcing this rule, however, the court cited sections 3-606(1)(b) and 9-207(1) with the caveat "if applicable."<sup>50</sup> The UCC was promulgated in Texas in the interval between the signing of the note and a renewal of the note involved in *Helwig*. The court found no conflict between its enunciated common law rule and the duty of reasonable care found in section 9-207(1). By using "security" rather than "collateral" in paraphrasing section 3-606(1)(b), the court suggested that under the Code this standard applies to security other than property in the holder's personal possession.<sup>51</sup>

It is well settled that a creditor discharges a surety when he releases collateral given on the debt.<sup>52</sup> This defense under section 3-606(1)(b) was involved with many complications in *White v. Household Finance Corp.*<sup>53</sup> The Whites were accommodation co-makers on a note for \$2,095.25 given to Household Finance Corporation (Household) by their minor nephew, Ricky Butzin, to finance the purchase of a 1960 Dodge Charger. The same parties signed a security agreement covering the car. The security agreement served as collateral on the note. Butzin obtained insurance

---

<sup>48</sup>SIMPSON § 75.

<sup>49</sup>464 S.W.2d at 955.

<sup>50</sup>*Id.*

<sup>51</sup>*Id.*

<sup>52</sup>SIMPSON § 74.

<sup>53</sup>302 N.E.2d 828 (Ind. Ct. App. 1973). For a discussion of *White*, see Bepko, *Contracts, 1974 Survey of Indiana Law*, 8 IND. L. REV. 116, 127-29 (1974); Townsend, *Secured Transactions and Creditors' Rights, 1974 Survey of Indiana Law*, 8 IND. L. REV. 234, 239-43 (1974).

on the car with Household as the beneficiary, even though he was evidently not required to do so under the terms of the security agreement.

The nephew then had an accident which resulted in a total loss of the vehicle. Household received a check for \$1,850 from the insurance company and indorsed it to a car dealer to be used by Butzin for purchasing a 1969 Plymouth. The Whites believed that the insurance proceeds had been applied to paying off the note. Title to both the Charger and the Plymouth was in the names of Butzin and the Whites, with Household listed as a lienholder.

The Indiana Court of Appeals ruled that "the indorsement of the insurance check by Household Finance Corporation and the purchase of a second automobile was not a substitution of collateral but constituted an impairment of the collateral."<sup>54</sup> Releasing the insurance proceeds constituted impairment under the Indiana common law rule that "[w]hen a creditor releases or negligently fails to protect security put in his possession by the principal debtor, the surety is released to the extent of the value of the security impaired."<sup>55</sup> The court firmly grounded its finding of impairment upon the principle of general suretyship law that a surety is "entitled to a right of subrogation to any rights in the collateral that the creditor obtains from the principal debtor."<sup>56</sup>

The insurance proceeds were collateral even though the insurance was obtained after the note was signed and was additional collateral for the note. Household did not impair the Whites' recourse against the Dodge, the initial collateral for the note. The original security agreement remained intact. Had there been no insurance, the Whites would have been responsible as sureties for the full amount of the note. Because of the fortuitous destruction of the Dodge, however, by releasing the insurance proceeds, Household failed to preserve for the Whites sufficient subrogation rights to protect them from loss.

Substitution of collateral in this case could have occurred in two ways. If the insurance proceeds were proceeds under the Article 9 security agreement, a security interest would have attached to the Plymouth.<sup>57</sup> Since the Plymouth would have replaced

---

<sup>54</sup>302 N.E.2d at 830.

<sup>55</sup>*Id.* at 832.

<sup>56</sup>*Id.* at 834.

<sup>57</sup>The court held that the insurance proceeds did not constitute proceeds under the security agreement because the latter did not include a loss payable clause. *Id.* at 836. The discussion of whether insurance proceeds constitute proceeds under an Article 9 security agreement is currently a debated issue. The debate centers around the construction of section 9-306(2). Revised Article 9 provides that insurance proceeds constitute proceeds under the security agreement. UCC § 9-306(1) and Comment 1 (1972 version). A

the Dodge as the secured property, a substitution of collateral under the security agreement would have been made. Substitution of collateral would also have resulted if a new security agreement on the Plymouth had been obtained by Household.<sup>58</sup> The new security interest in the Plymouth would have been a substitution for the released proceeds of collateral given for the note.<sup>59</sup>

The court of appeals in *White* suggested that Household's failure to obtain a new security interest in the Plymouth, since no other security interest attached to the car, was itself an impair-

---

good analysis of the problem is found in R. HENSON, HANDBOOK ON SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE § 6-8 (1973).

<sup>58</sup>The court held that Butzin's application for a title certificate on the Plymouth did not constitute a new security agreement. The court reasoned that the certificate of title could not substitute for a security agreement because it did not contain words of grant from the debtor to the putative secured party. 302 N.E.2d at 836-37.

<sup>59</sup>One interesting problem that could arise regarding release of collateral under section 3-606(1)(b) is the status of the so called "floating lien" given as collateral under a security agreement itself given as collateral for a note. A "floating lien" arises when a secured party contracts under section 9-204 for a security agreement to attach to the debtor's after-acquired inventory. Since buyers of the inventory in ordinary course would take free of the security interest under section 9-307(1), the security interest would "float" above the changing body of the debtor's inventory, attaching to the inventory while in the debtor's hand and to all proceeds from the sale of the inventory. These arrangements have been attacked by bankruptcy trustees as voidable preferences under section 60 of the Bankruptcy Act, 11 U.S.C. § 96 (1970), as to new property covered within four months of bankruptcy. Appellate courts have sustained the validity of these transfers. The most instructive of the cases in this area is *Grain Merchants of Indiana, Inc. v. Union Bank & Savings Co.*, 408 F.2d 209 (7th Cir. 1969).

The relationship of "floating liens" to section 3-606 can be investigated by a hypothetical set of facts, since no cases on this point have arisen. Assume a perfected valid "floating lien." Suppose that a holder-creditor allowed his debtor's inventory to deplete so that at the date of maturity of the note, the collateral was worth less than when the security interest was originally given, and suppose further that the present value of the collateral is insufficient to cover the note. Could a surety of the debtor who is a party to the note claim impairment? This problem has not come up under the "floating lien" cases in bankruptcy. *Grain Merchant* and similar cases may well have been decided differently if, within four months of bankruptcy, the inventory had fallen and future acquired inventory was used to increase the depreciated value of the security interest. In a case under section 3-606(1)(b), a creditor-holder could be found to have released the collateral if he failed to exercise surveillance over the inventory. Conversely, the holder's duties as to the collateral may be considered controlled by the security agreement. If the agreement allows the inventory to dip, the surety is merely suffering from the limitations on collateral given by another, as the surety is initially benefited by the giving of the collateral. That is, any loss is caused by the terms imposed by the giver of the collateral and not by the misdeeds of the holder.

ment of collateral under section 3-606(1)(b).<sup>60</sup> As stated, this is erroneous. Creating a security interest under Article 9 involves a consensual act of at least two parties.<sup>61</sup> Absent agreement otherwise, a creditor's duty cannot depend upon the free choice of another. If the court meant only that by failing to obtain a security interest in the Plymouth, Household had not substituted collateral for the note and thus had not cured any previous acts of impairment, it would only have stated the principle of suretyship law which supports the decision in the case.<sup>62</sup>

*White* can thus be cited for the general proposition that the provisions of general suretyship law should be incorporated into section 3-606(1)(b). These provisions specifically include the following: impairment of collateral discharges a surety pro tanto unless sufficient collateral remains to cover the debt;<sup>63</sup> substitution

---

<sup>60</sup>302 N.E.2d at 835.

<sup>61</sup>UCC §§ 9-204(1), 1-201(3).

<sup>62</sup>SIMPSON § 74; STEARNS § 6.46. In finding this affirmative duty, the *White* court was probably trying to answer the holding of *Hunter v. Community Loan & Inv. Corp.*, 127 Ga. App. 142, 193 S.E.2d 55 (1972). In that case a father co-signed with his daughter a note given towards the purchase of a car. The car was "pledged" as collateral for the note. When the car burned, the insurance company, with the loan company's permission, substituted a new car. The father was sued on the note. He asserted section 3-606(1)(b), but no impairment was found because his risk had not been increased by the substitution.

The court thus read into section 3-606(1)(b) a test of increased risk to the surety for determining what constitutes impairment of collateral. The facts given in *Hunter* are sketchy but, under at least one previous Georgia case, the pledged property, to become security, would not have been required to be actually deposited at the time of making the note. *Vaughn v. Farmers' & Merchants' Bank*, 146 Ga. 51, 90 S.E. 478 (1916). A substitution of pledged collateral, like that of any security, discharges a surety pro tanto. If there had been no decrease in value by substituting the second car, there could have been no discharge.

The *Hunter* decision suggests a new twist to the section 9-207(1) controversy. Instead of limiting the definition of collateral in section 3-606(1)(b) to include one type of security (pledges) available under Article 9, the court seemingly extended the definition of collateral for purposes of section 3-606(1)(b) to include security interests which cannot be created under the Code. Under section 9-203, the type of equitable pledge found in *Hunter* is not a validly created security interest. UCC § 9-203 and Comment 5. Reading into section 3-606(1)(b) a non-Code standard for "unjustifiably impairs" is arguably permissible, since the only reference in section 3-606(1)(b) to section 9-207(1) is found in the non-legislatively enacted official Comments. What constitutes security for purposes of Article 3 should not, however, conflict with permissible security interests created by Article 9. Finding non-Code security interests in transactions obviously included within the coverage of Article 9 circumvents the law.

<sup>63</sup>The pro tanto discharge comes directly from the text of section 3-606(1) and has given courts no difficulty. The same rule exists in the general law of suretyship. SIMPSON § 74; STEARNS § 6.46. The burden is on the party

of collateral for the note or for the security agreement given for the note cures previous impairment pro tanto if the substitution is made before the principal defaults on the note;<sup>64</sup> security given without the surety's knowledge and even after the note itself is given is capable of being impaired;<sup>65</sup> and the rationale for holding the creditor liable in impairment cases is always the consequent loss of a surety's subrogation rights.<sup>66</sup>

*White* leaves in doubt the method which Indiana courts will use to determine what constitutes an unjustifiable impairment of collateral under section 3-606(1)(b). The court states in a footnote<sup>67</sup> that a failure to perfect or record a security interest would be impairment. As further mentioned in the footnote, this would be a change from the Indiana general law of suretyship. Such a finding points to an independent Code standard as determinative. The court may not have meant, however, the technical definition of perfection, for the discussion to which the footnote pertains deals with the *attachment* of a security interest. In any event, discussions dealing with failure to perfect as constituting impairment would be dictum in *White*, since the case dealt with release of collateral.

The court evidently held that the section 9-207(1) standard of reasonable care is applicable to section 3-606(1)(b),<sup>68</sup> and found that the common law rule regarding release of collateral as constituting impairment is required by this standard. In a footnote to this argument, however, the court read section 1-103 as stating that the "common law is not displaced by the Uniform Commercial Code unless the Code expressly states that the common law rule is inapplicable."<sup>69</sup> This is an improper construction of section 1-103. A Code provision could cover the field with a new rule without expressly overruling inconsistent common law decisions. The status of common law rules of suretyship under section 3-606(1)(b) is thus left unresolved.

---

seeking discharge under section 3-606(1)(b) to establish the value of the collateral impaired. *Hurst v. Citizens Trust Co.*, 128 Ga. App. 224, 196 S.E.2d 394 (1973); *Christensen v. McAtee*, 473 P.2d 659 (Ore. 1970).

<sup>64</sup>SIMPSON § 74; STEARNS § 6.46.

<sup>65</sup>SIMPSON § 74; STEARNS § 6.46; WILLISTON § 1258.

<sup>66</sup>SIMPSON § 74; STEARNS § 6.46.

<sup>67</sup>302 N.E.2d at 835 n.8.

<sup>68</sup>*Id.* at 834, 835 n.8.

<sup>69</sup>*Id.* at 834 n.7.

III. MORE DIFFICULT PROBLEMS UNDER SECTION 3-606(1)(B):  
RECOURSE DEHORS THE INSTRUMENT AND MORE BURDENSOME  
AFFIRMATIVE DUTIES OF HOLDERS

A. *Duties of Holders Arising Before the Instrument Comes Due*

Problems arising under section 3-606(1)(b) not previously discussed are well surveyed in the recent Tennessee Supreme Court case of *Commerce Union Bank v. May*.<sup>70</sup> The Mays signed a note to the bank secured by a deed of trust upon land containing a hotel. The trust deed contained a provision requiring May to obtain fire insurance on the hotel with the bank as loss payee. The note had another provision absolving the bank from taking any affirmative action to preserve the collateral unless it was requested in writing to take such action and unless it was reimbursed for expenses. The Shelbys bought the property from the Mays and assumed the mortgage. A few days later the Kyles bought the property from the Shelbys, assumed the first mortgage, and gave the Shelbys a second mortgage on the same property. The bank was notified of these transactions. Kyle was later notified by the insurance company that the policy would soon lapse. There was no evidence that any other party was so informed, although the bank had in its possession a copy of the insurance policy.

Kyle failed to renew the policy on the hotel, which was destroyed by fire while not covered by insurance. Kyle later defaulted on his second mortgage, and the Shelbys repurchased the property at the foreclosure sale. The Shelbys then defaulted on the first mortgage. The bank foreclosed and sued both the Shelbys and May for a deficiency. The trial court found an affirmative duty of the bank either to have notified May of the insurance policy lapse or to have maintained the insurance at May's expense.

The Tennessee Supreme Court held that if a maker is not in the "position of a known surety" when he signs the instrument, he cannot change his status from principal to surety by transferring the property to a third party who assumes the mortgage.<sup>71</sup> The court argued that this rule was well established under the NIL and, in effect, the court placed a burden of proof on the UCC to overcome the presumptive validity of the rule. The court found that the NIL distinction between primary and secondary parties is retained in the UCC. Under the Code, as under the NIL, the maker is bound in the capacity in which he signs the instrument. Being primarily liable, a maker cannot change his status from principal to surety vis-à-vis the holder.

---

<sup>70</sup>503 S.W.2d 112 (Tenn. 1973).

<sup>71</sup>*Id.* at 116.

The argument in *May* is unpersuasive. The court stated at one point in the opinion that Article 3 represents a complete revision of the NIL.<sup>72</sup> If such is the case, using the law built up around this prior statute to construe the UCC seems a dubious procedure. The language of section 3-606(1)(b) and the Comments to it do not limit the section to accommodation parties or secondary parties.<sup>73</sup> In one sense, the court confused the actual knowledge requirement with notice on the instrument. Section 3-606 requires neither that a holder know of a party's right of recourse,<sup>74</sup> nor that such a right even exist,<sup>75</sup> before the instrument is taken. Sufficient safeguards for the holder are established by requiring him to have actual knowledge of the suretyship relationship before acting in a way that impairs collateral.<sup>76</sup>

Although the case had already been decided against *May* on the threshold issue of the applicability of section 3-606(1)(b), the court continued to find no act of impairment by the bank. Citing section 132 of the *Restatement of Security* and several recent cases in suretyship law,<sup>77</sup> it was found that on the facts of this case no affirmative duty toward the collateral had been established for the bank. Since no duty rested upon the bank, nonperformance by

---

<sup>72</sup>*Id.*

<sup>73</sup>See text associated with notes 5-10 *supra*.

<sup>74</sup>See notes 15-16 *supra*.

<sup>75</sup>This is the rule in the general law of suretyship. G. OSBORNE, *HANDBOOK ON THE LAW OF MORTGAGES* §§ 269, 270 (2d ed. 1970) [hereinafter cited as OSBORNE]; STEARNS § 2.3; WILLISTON § 1258. This was also the common law rule for negotiable instruments. WILLISTON § 1259. A probable majority of courts under the NIL did not allow a party primarily liable on an instrument to change his status vis-à-vis the holder from principal to surety. OSBORNE § 271; WILLISTON § 1259.

<sup>76</sup>In *Mortgage Guarantee Co. v. Chotiner*, 8 Cal. 2d 110, 64 P.2d 138 (1936), a case decided under the NIL, the court argued for the minority rule as follows:

Aside from the criticism that the statute itself does not compel the overruling of the existing suretyship law, the most cogent objection to the majority rule is that the rights of the surety do not depend upon the face of the paper but on outside equities, and a recognition thereof would not actually obstruct negotiability or impair circulation, since the rule only applies where the holder has knowledge of the principal and surety relation between the obligors and has acted in disregard of the equities arising from the contract of suretyship.

*Id.* at 121, 64 P.2d at 144. Authorities supporting this position are listed by the *Chotiner* court. *Id.* The same reasoning applies under section 3-606 of the UCC.

<sup>77</sup>The court cited *United States v. Fyles*, 253 F. Supp. 386 (D. Vt. 1965); *Evans v. American Bank & Trust Co.*, 116 Ga. App. 468, 157 S.E.2d 816 (1967); *Woodruff Motors, Inc. v. Commercial Credit Corp.*, 123 Vt. 404, 190 A.2d 705 (1963).

the bank of any acts that would have preserved the collateral could not constitute impairment. The standard used by the court in determining whether or not an affirmative duty rested on the holder is well stated in a comment to section 132 of the *Restatement of Security*: "The nature of the security may impose upon the creditor duties to preserve its value so long as the creditor is the only person who can conveniently take the appropriate action."<sup>78</sup> In spite of the greater business experience of the bank and the fact that it had a copy of the insurance policy, the court would not raise this standard. The bank was not notified of the imminent cancellation of the insurance, and May had equal opportunity with the bank to check up on the policy. A party with recourse also has responsibilities toward the collateral.

Exactly when these affirmative creditor duties arise cannot be determined only by a comparison of the cases dealing with the issue. Such a finding must necessarily involve the court's discretion based on the equities of a given set of facts, a process reflecting the equitable foundation of suretyship law. Section 132 of the *Restatement of Security* is no more than a guide, as are the cases under it. Incorporated into the Code, both section 132 of the *Restatement of Security* and the cases pertaining to it may be found to be an elaboration upon the section 9-207(1) test of reasonable care, or both may be considered a separate standard directly under section 3-606(1)(b). Whichever, equitable considerations will similarly remain paramount under the UCC as they are in general suretyship law when these outer limits of a holder's accountability are reached.<sup>79</sup>

Even if the court in *May* had found that the bank breached an affirmative duty toward the collateral, May would not have been discharged because he gave consent to the bank's nonperformance of managerial tasks when the bank was unsolicited to do them. Courts have read consent provisions broadly, and no serious issues concerning them have arisen to date. Section 3-606 does not require that the consent be given on the instrument. Many accommodation parties sign some type of security agreement given as collateral for the instrument. By section 3-119, they are bound as against any holder to any consent stated in such agreements.<sup>80</sup> Separate

---

<sup>78</sup>RESTATEMENT OF SECURITY § 132, Comment c (1941).

<sup>79</sup>Similar problems regarding affirmative holder's duties appear in *Liberty Nat'l Bank & Trust Co. v. Interstate Motel Developers, Inc.*, 346 F. Supp. 888 (S.D. Ga. 1972); *Pancoast v. Century Homes, Inc.*, 8 U.C.C. REP. SERV. 1289 (Okla. Ct. App. 1971).

<sup>80</sup>UCC § 3-119 provides in full:

(1) As between the obligor and his immediate obligee or any transferee the terms of an instrument may be modified or affected by any other written agreement executed as part of the same trans-

oral or written consent to a holder should also suffice to bind the party giving it.<sup>81</sup> In many cases the holder's knowledge of rights of recourse comes from information not appearing on the instrument. If rights can arise dehors the face of the instrument, they can be limited dehors the instrument.

Another possible means of establishing impairment of collateral, one not discussed in *May*, arises when a creditor specifically assumes duties regarding the collateral given for a security agreement. These duties are in a sense additional collateral. Any failure in discharging them can be viewed as an impairment of collateral. For impairment to result, the surety need not be a party to the agreement creating the duty, just as a surety need not know of or solicit collateral given on the debt.<sup>82</sup> The same reasoning applies when negotiable instruments are involved.<sup>83</sup> Section 3-119, however, controls which holders would be liable on written agreements accompanying negotiable instruments, since the creation of a duty when it would not otherwise exist seems obviously a limitation on the holder's rights.<sup>84</sup> Comment 2 to section 3-119 should not be read in this context to deny parties on the instrument in a suretyship position discharge against a nonperforming holder. These promises constitute additional security on the note and, thus, are beneficial to parties with recourse.

### *B. Duties Arising After the Instrument Comes Due*

Determining what constitutes impairment of collateral after default requires dealing with a complication in a negotiable instruments context not found in general suretyship law.<sup>85</sup> Under

---

action, except that a holder in due course is not affected by any limitation of his rights arising out of the separate written agreement if he had no notice of the limitation when he took the instrument.

(2) A separate agreement does not affect the negotiability of the instrument.

UCC § 3-119, Comment 2 provides in full:

Other parties, such as accommodation indorsers, are not affected by the separate writing unless they were also parties to it as part of the transaction by which they became bound on the instrument.

<sup>81</sup>UCC § 3-606(1) and Comment 2.

<sup>82</sup>SIMPSON §§ 74, 75; STEARNS § 6.46. When the act is optional with the holder, as in *May*, it would seem inequitable to find the holder liable for nonperformance unless the act also constituted an affirmative holder's duty independent of any agreement. If the act is optional with the holder and he begins performance, some type of estoppel argument may be appropriate, at least if the surety knew of the beginning of performance.

<sup>83</sup>UCC § 3-119 and Comment 3.

<sup>84</sup>UCC § 3-119 and Comment 4.

<sup>85</sup>Another complication with suretyship on negotiable instruments is the extent to which the time when a holder takes an instrument determines the rights of a surety-party and holder vis-à-vis each other. As to the time of

general suretyship law, after a debt comes due, a surety cannot claim impairment because of a creditor's failure to collect the proceeds of the collateral.<sup>66</sup> It is held that the surety can pay the debt and obtain subrogation rights in the collateral. Should the creditor both fail to collect on or otherwise preserve the collateral in a situation threatening release of the collateral and refuse to sue the principal or surety, the surety can tender payment and is discharged if the creditor rejects the tender.<sup>67</sup>

This relief may not be available under section 3-606(1)(b). Section 3-604(1) limits a party's remedy upon a holder's rejection of his tender after the note is due to discharge from any liability for late payment. Incorporating into section 3-606(1)(b) the general suretyship principle of discharge pro tanto upon rejection of tender thus demands a much broader reading of the section than when general suretyship law is used only to define the open-ended terms of the section. This is supplementing section 3-606(1)(b) via section 1-103 on an issue explicitly dealt with by section 3-604(1). A strong argument is thus made for the application of section 132 of the *Restatement of Security* and Comment C to section 132 in such situations.

### C. Cosuretyship Under Section 3-606(1)(b)

General suretyship law also supplements section 3-606(1)(b) when cosuretyship issues are present.<sup>68</sup> The few cases in suretyship initial creation of these rights, see Peters, *supra* note 17, at 844-48. Professor Peters bases her arguments upon section 3-415(2). As to the time limits on accrual of a cause of action, any rights of a holder against the surety-party must have accrued before maturity of the instrument. A holder taking after maturity could not be in due course under section 3-302(1)(c), and any discharge by a previous holder could thus be asserted against the present holder under section 3-602 regardless of notice or knowledge of the discharge by the present holder. See note 15 *supra*. Any post maturity discharge by the present holder would depend upon the application of section 3-606(1)(b). See *Tennessee Farmers Mut. Ins. Co. v. Scott*, 8 U.C.C. REP. SERV. 399 (Tenn. 1970).

<sup>66</sup>SIMPSON § 43; STEARNS §§ 6.35, 6.36.

<sup>67</sup>SIMPSON § 77; STEARNS § 6.35; WILLISTON §§ 1235, 1266, 1276. By statute or judicial rule a jurisdiction may apply the doctrine of *Pain v. Packard*, 13 Johns. 174 (N.Y. Sup. Ct. 1816), which releases the surety if the principal refuses the surety's request to sue the principal. Actual loss may be required before the doctrine is applied. If a statute is involved, it will often be construed narrowly. See generally SIMPSON § 42, at 178; STEARNS § 6.38; WILLISTON § 1276. If suing the principal will not secure the creditor's rights in the security and if the principal is not fully collectible, the doctrine of *Pain v. Packard*, *supra*, will not protect a surety whose creditor will not go against the collateral. WILLISTON § 1276, at 3642 n.4. The surety also has a right known as exoneration to force his principal to pay the creditor. SIMPSON § 46; STEARNS § 6.1.

<sup>68</sup>"All persons who are bound for the same debt of a principal are

law on point conflict as to whether one cosurety has an interest in collateral given by another cosurety<sup>89</sup> and, thus, by logical extension whether a creditor's impairment of the collateral given by one cosurety discharges the other cosureties. Section 135 of the *Restatement of Security* discharges the cosureties proportionately in limited situations.<sup>90</sup> This should be the result generally under the UCC. Any cosurety party to the instrument would be discharged because the collateral had been given on behalf of the principal, one against whom the party had recourse. However, by the equitable doctrine of contribution supplementing section 3-606(1)(b), the discharged party would have to share the benefits of the discharge with his fellow cosureties.<sup>91</sup>

In *Brunner v. Smith*,<sup>92</sup> interesting cosuretyship problems were present in the facts but were not discussed in the opinion and evidently were not raised by the parties. Smith and Brunner were cosureties because they were both secondarily liable on the same debt—Smith by his pledge and Brunner by his contract as accommodation maker of the note.<sup>93</sup> It makes no difference to the creation of the cosuretyship that Smith was not a party to the note. The supplemental principles of suretyship law establish the mutual rights and duties of the parties. Either Smith or Brunner could thus have claimed a contribution from the other of any benefits

---

cosureties." SIMPSON § 10. See generally SIMPSON §§ 10, 49; WILLISTON §§ 1261, 1263, 1277A, 1278-82.

This Note does not discuss subsuretyship because of the complications which could result in setting up models of successive liability, since under section 3-606 subsuretyship, as cosuretyship, could arise on or dehors the instrument. Generally, successive indorsers are subsureties. UCC § 3-414(2). Subsuretyship can be thought of as establishing a series of creditor-surety-principal obligations seriatim, with the usual rules applicable to each grouping in turn. See generally SIMPSON §§ 12, 13; WILLISTON §§ 1262, 1282.

<sup>89</sup>Compare *Marshall & Ilsley Bank v. Morrey*, 205 Mich. 513, 171 N.W. 533 (1919), with *Sanderson v. Cicero State Bank*, 125 N.J. Eq. 450, 6 A.2d 130 (1939). Professor Williston finds the rule settled that a cosurety receives the benefits of impairment of collateral only if the collateral is given by the principal. WILLISTON § 1281.

<sup>90</sup>The *Restatement* would discharge the second cosurety when the first cosurety is bound to his suretyship only by the giving of collateral. The first cosurety has made no promise of suretyship. It is reasoned that impairment of the collateral given by the first cosurety completely releases him from his obligation as surety and that such conduct by the holder is inequitable towards the second cosurety. See *RESTATEMENT OF SECURITY* § 135 and Comment c (1941).

<sup>91</sup>*RESTATEMENT OF RESTITUTION* § 81 and Comment c (1937); *RESTATEMENT OF SECURITY* § 154 (1941); SIMPSON § 49.

<sup>92</sup>467 S.W.2d 565 (Tex. Civ. App. 1971). See text accompanying notes 20-26 *supra*.

<sup>93</sup>*RESTATEMENT OF SECURITY* § 135 (1941) thus applies to the facts of *Brunner*. See note 90 *supra*.

which resulted from the holder's impairment of the pledged stock. Likewise, if one of them had paid more than half of the note, he could have demanded contribution from the other.

The application of these cosuretyship principles was complicated when Smith became a holder.<sup>94</sup> The rights of a holder against a party to the instrument are determined by the rules of Article 3. Arguably, Brunner would have been required to bring himself specifically within section 3-606(1)(b) to have obtained any relief. The only act of the bank possibly constituting impairment was its sale of the note and assignment of the collateral to Smith. If Smith's status as creditor-holder and surety then merged,<sup>95</sup> terminating the latter, Brunner lost his contribution rights in the collateral. On the one hand, had Brunner been able to establish against Smith his discharge by the bank, Smith would not have been able to seek contribution. On the other hand, had no discharge of Brunner been found or allowed, Brunner would have been the one accountable for the full amount of the note, assuming that his principal, Steele, did not pay it.

Situations such as those present but not adjudicated in *Brunner* may arise relatively frequently under the UCC because of the broadened availability of the impairment defense. One in a cosuretyship position, on or off the instrument, will pay the instrument, have it properly negotiated to him, and claim immunity from any obligation of contribution while demanding payment in full from the other sureties. In rendering a decision in such cases, courts should seek an equitable solution. This could involve a two step process of applying the Article 3 provisions as to the rights of a holder, but adjusting these rights through general suretyship law.<sup>96</sup> Since the cosuretyship relationship arises outside of Article 3, such adjustments would not involve tampering with the Code.

---

<sup>94</sup>How Brunner would have to establish impairment by either Smith or the bank after Smith became a holder was previously discussed in a context absent cosuretyship issues. See text associated with notes 24-26 *supra*.

<sup>95</sup>The Code rule may predominate for two reasons. When the same person holds both a legal and an equitable right in the same thing and the rights are coextensive, the equitable right may be considered merged into the legal right, although the rule is generally associated with the law of real property. Also, UCC Article 3 may be held controlling in all matters touching negotiable instruments.

<sup>96</sup>This does not require that the full equitable right of contribution be applied in every case. Rights of contribution may be modified by the equities of the given facts. Important considerations may be the dependence of the non-holder cosurety upon the presence of the other surety as a reason for initially making his suretyship contract, the extent to which the holder-cosurety induced this reliance, and the knowledge of the holder-cosurety of the other cosurety's suretyship status.

## IV. CONCLUSION

The difficulties some courts have had with the threshold issues of section 3-606 could have been resolved by a careful reading and analysis of the text of the section. Courts should especially avoid reading into section 3-606 the terms of the revoked NIL and cases pertaining to it. Section 3-606 contains on its face the tests for determining when it applies and which parties come within it. The actual knowledge standard of section 3-606(1) (a) should be found applicable to section 3-606(1) (b). Furthermore, the actual knowledge standard should be used whenever any party to the instrument asserts one of the special suretyship defenses. This results in evenhanded treatment for each of these defenses and for accommodation parties vis-à-vis other parties to the instrument in a suretyship position. Notice on the instrument of a party's suretyship status may be evidence of the holder's knowledge in fact of such status, but this notice remains a matter of fact, not of law, under section 3-606.

Courts should use the section 9-207(1) standard of reasonable care supplemented by the equitable principles of general suretyship law to determine what constitutes unjustifiable impairment of collateral. Establishing a Code standard for the impairment defense will build up a uniform national body of law around section 3-606(1) (b), thus furthering the Code's purpose "to make uniform the law among the various jurisdictions."<sup>97</sup> Collateral should be defined for purposes of Article 3 to include security interests as well as the collateral given for a security interest. In matters of cosuretyship, the general provisions of suretyship law should be applied if necessary to modify any inequitable results attained from an initial application of Article 3 provisions. Such results will not conflict with negotiable instrument law but, rather, will show that some parties are subject to additional limitations on their rights.

Overall, section 3-606(1) (b), indeed the entire section 3-606, does not contain difficult provisions. The section constitutes no more than a small exercise in statutory construction for the courts dealing with it. The serious problems involved in interpreting a code as relatively new as the UCC often lie not in failing to determine the exact meaning intended by the drafters, but in obscuring the issues obviously present. If a court clearly analyzes the issues involved in a given Code section, the next court can more easily correct any faulty conclusions. Reasoned debate on the meaning of that section is then possible. For similar reasons, close analysis by the legal profession of these early cases under the Code thwarts

---

<sup>97</sup>UCC § 1-102(2) (c).

the development of aberrant lines of authority before they become too well established to challenge.

NATHANIEL RUFF