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Recommended Citation

34 Wm. & Mary L. Rev. 1157 (1993)

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SURETYSHIP ON THE FRINGE: SURETYSHIP BY OPERATION OF LAW AND BY ANALOGY

D. BENJAMIN BEARD*

I. INTRODUCTION

Most practitioners, particularly those who specialize in commercial law and construction law, regularly deal with guaranty or surety bond transactions. Such practitioners likely will be aware that a special body of rules governs the rights and obligations of the parties to such transactions. In commercial lending transactions, guaranties are often required as additional security for repayment of a loan. In the construction field, the contractor and subcontractors are usually, if not always, required to obtain a bond from a corporate surety company to assure the owner, laborers, and materialmen of performance by the contractor. However, principles of suretyship can extend well beyond these traditional contexts. Even though the surety relationship is contractual in nature,¹ such relationship need not be created by express agreement. Although a surety relationship will not be created by mere implication,² suretyship "by operation of law" may arise by extension of "the privileges of suretyship to parties already bound upon some other contract."³ It is this type of transaction that will be considered in this Article.

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1. RESTATEMENT OF SECURITY, Division II, Suretyship, scope note (1941); RESTATEMENT (THIRD) OF SURETYSHIP § 1 & cmt. f (Tent. Draft No. 1, 1992); 1 GEORGE W. BRANDT, THE LAW OF SURETYSHIP AND GUARANTY § 1 (3d ed. 1905); LAURENCE P. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 18 (1950); ARTHUR A. STEARNS, THE LAW OF SURETYSHIP § 1.1 (5th ed. 1951).

2. STEARNS, *supra* note 1, § 2.2.

3. *Id.* § 2.3.

The precise scope of the various rules governing the rights and obligations of the parties to such suretyship transactions⁴ is discussed in greater detail elsewhere in this Symposium. For the purpose of this Article, it suffices to say that the obligation of the secondary obligor in such transactions, which acts as security for the underlying obligation, may be lost to the obligee if the obligee engages in certain acts that prejudicially affect the secondary obligor's right of recourse against the principal obligor upon performance of the secondary obligation.⁵ Accordingly, although the ob-

4. Each transaction giving rise to a suretyship relation involves at least the following three parties: 1) the party owed performance of the obligation (the creditor/obligee); 2) the party primarily responsible for performance of the underlying obligation (the principal debtor/principal obligor); and 3) the party secondarily liable for performance of the underlying obligation (the surety/secondary obligor). *See infra* part II.

In the *Restatement of Security*, these parties are referred to respectively as the "creditor," the "principal," and the "surety." RESTATEMENT OF SECURITY § 82 cmts. b-d. The proposed *Restatement of Suretyship* employs new, more neutral terms for the parties in an attempt to avoid the confusion that has surrounded the older terms, "surety" and "guaranty" in particular. *See* RESTATEMENT (THIRD) OF SURETYSHIP (Tent. Draft No. 1); RESTATEMENT (THIRD) OF SURETYSHIP (Tent. Draft No. 2, 1993). The proposed *Restatement* refers to the parties as the "obligee," the "principal obligor," and the "secondary obligor." RESTATEMENT (THIRD) OF SURETYSHIP § 1 & cmt. d (Tent. Draft No. 1). This Article uses the new terminology of the *Restatement of Suretyship* except when discussion of a case requires reference to the language used by the court.

5. The existence of suretyship status accords the secondary obligor, or more important for our purposes, one in the position of a secondary obligor, certain rights against the principal obligor and defenses against the obligee. The basic rights of the secondary obligor include the right of exoneration, which entitles the secondary obligor, when called upon by the obligee to perform, to require the principal obligor to perform, preventing the secondary obligor from incurring the cost of performance. RESTATEMENT OF SECURITY §§ 103, 112; RESTATEMENT (THIRD) OF SURETYSHIP §§ 14, 17 (Tent. Draft No. 1). The secondary obligor is also granted the right to recover from the principal obligor amounts paid to the obligee in satisfaction of the principal obligation. Such recovery is available by reimbursement and restitution from the principal obligor. RESTATEMENT OF SECURITY §§ 104-111; RESTATEMENT (THIRD) OF SURETYSHIP §§ 18, 22 (Tent. Draft No. 2). Finally, upon performance of the principal obligation by the secondary obligor, the secondary obligor is entitled to be subrogated to the rights of the obligee against the principal obligor. RESTATEMENT OF SECURITY § 141; RESTATEMENT (THIRD) OF SURETYSHIP §§ 23-24 (Tent. Draft No. 2).

In addition, the secondary obligor is accorded special defenses against the obligee, generally resulting from some action of the obligee that prejudices one or more of the secondary obligor's basic rights. Suretyship defenses such as discharge for release of the principal obligor, extensions of time granted the principal obligor in performing the underlying obligation, alteration of the terms of the underlying obligation, and impairment of collateral may result in discharging the secondary obligor—in whole or in part—from its obligation under the secondary obligation. RESTATEMENT OF SECURITY §§ 122, 127-129, 132; RESTATEMENT (THIRD) OF SURETYSHIP § 15 (Tent. Draft No. 1); RESTATEMENT (THIRD) OF SURETYSHIP § 33

ligee obtains additional security for the performance of the principal obligation, its rights in dealing with the principal obligor may be circumscribed in order for it to retain its full rights against the secondary obligor.⁶ Because failure to recognize those transactions that implicate suretyship principles may result in an obligee's losing the security for the principal obligation represented by a secondary obligor, it is critical for an obligee and its counsel to be able to recognize such transactions.

Part II of this Article begins by briefly reviewing the standard framework of the basic suretyship transaction. With this background, Part III considers transactions in which a third party assumes the underlying obligation and/or receives property from the original obligor securing the underlying obligation. In such transactions, the courts have granted suretyship status to the original obligor, thereby imposing on the obligee suretyship obligations toward the original obligor after the transaction. The discussion elucidates the basis for imposing a surety relationship on the parties and shows why such imposition is justified. Part IV proceeds further toward the fringe, with examples of cases that have applied suretyship principles in less obvious situations. Such cases demonstrate that, upon analysis of the totality of the substantive rights and obligations of the parties, suretyship principles properly apply to many transactions, notwithstanding the apparent lack of any surety relationship among the parties. The Article concludes with a recommendation concerning how far suretyship principles may or ought to be applied in situations that otherwise would appear to bear no relationship to suretyship.

II. THE BASIC TRANSACTION

Both Division II of the *Restatement of Security*⁷ and the unfolding *Restatement of Suretyship* address the scope of coverage

(Tent. Draft No. 2). See generally STEARNS, *supra* note 1, §§ 6.1-55 (discussing discharge of the surety).

6. A very important exception exists when the obligee has obtained waivers of suretyship defenses or consent to otherwise proscribed action from the secondary obligor. Such waivers and consents are broadly validated. See U.C.C. § 3-605 (1990); RESTATEMENT OF SECURITY §§ 122, 128 & cmt. c, 129 & cmt. b; RESTATEMENT (THIRD) OF SURETYSHIP § 42 (Tent. Draft No. 2).

7. RESTATEMENT OF SECURITY §§ 82-211.

in the law of suretyship. The basis for the existence of a surety relationship is the existence of an obligation to an obligee, performance of which is owed by two or more persons, and which, as between these obligors, should be performed by one rather than the other.⁸ The notion that one obligor rather than the other ought to perform provides the principal justification for the imposition of suretyship status, with its unique rights and defenses,⁹ in transactions that the parties might not immediately recognize as giving rise to such status.¹⁰

The fundamental structure of the suretyship transaction is triangular: on the corners one finds the creditor/obligee, the principal debtor/principal obligor, and the surety/secondary obligor.¹¹ The line running between the obligee and the principal obligor represents the underlying contract, performance of which is primarily

8. The *Restatement of Security* provides:

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 person should perform.

Id. § 82.

The *Restatement of Suretyship* clarifies this definition as follows:

Transactions Giving Rise to Suretyship Status

(1) A "secondary obligor" has suretyship status whenever:

(a) one person (the "principal obligor") owes performance of a duty (the "underlying obligation") to another person (the "obligee"); and

(b) pursuant to contract, a third person (the "secondary obligor") is subject to a "secondary obligation," whereby either:

(1) the secondary obligor also owes performance, in whole or in part, of the duty of the principal obligor to the obligee; or

(2) the obligee has recourse against the secondary obligor or its property:

(i) in the event of the failure of principal obligor to perform the underlying obligation; or

(ii) to protect the obligee against loss arising from potential non-performance by the principal obligor; and

(c) to the extent that the underlying obligation or the secondary obligation is performed the obligee is not entitled to performance of the other; and

(d) as between the principal obligor and the secondary obligor, the principal obligor has a duty to perform the underlying obligation or bear the cost of performance.

RESTATEMENT (THIRD) OF SURETYSHIP § 1(1) (Tent. Draft No. 1).

9. See *supra* note 5 and accompanying text.

10. See *infra* note 16 and accompanying text.

11. See *supra* note 4.

the responsibility of the principal obligor.¹² The lines running between the obligee and secondary obligor and the secondary obligor and the principal obligor may be less well defined. Often there is an express agreement—such as a guaranty or surety bond—between the obligee and the secondary obligor.¹³ There may be an express agreement between the principal obligor and the secondary obligor outlining the rights of the secondary obligor against the principal obligor in the event the secondary obligor is required to perform; for example, express rights of indemnification and reimbursement.¹⁴

Situations often arise, however, in which the surety relationships between the obligee and secondary obligor and the secondary obligor and the principal obligor exist not by express agreement, but by operation of law based on the contractual relations of the parties.¹⁵ Even when an express agreement exists between the obligee and the secondary obligor, often the secondary obligor and principal obligor will have no such agreement. In such cases, if the secondary obligor is called upon to perform the underlying obligation, the rights of the secondary obligor against the principal obligor result from implied contract or equitable principles of restitution and subrogation.¹⁶ More important, the obligee may obtain enforcement rights against a third party by virtue of a transfer or assignment of property by the original obligor. The obligee may obtain such enforcement rights as a third party beneficiary of the agreement between the original obligor and the third party,¹⁷ or, in

12. See, e.g., RESTATEMENT OF SECURITY § 82 cmt. c.

13. See *id.* § 83(a) & cmt. b; SIMPSON, *supra* note 1, § 18.

14. See RESTATEMENT OF SECURITY § 96 & cmt. b. Such an express agreement may be critical when the secondary obligor seeks to recover costs of defending an action by the obligee. In *Pacific Indemnity Co. v. Harper*, 94 P.2d 586 (Cal. 1939), the California Supreme Court refused to allow the surety to recover costs of successfully defending an action by the obligee, in the absence of an agreement between the principal obligor and the secondary obligor providing for indemnification of such expenses. *Id.* at 589.

15. See *supra* notes 2-3 and accompanying text.

16. See RESTATEMENT OF SECURITY § 104 & cmt. f; RESTATEMENT (THIRD) OF SURETYSHIP §§ 18 & cmt. a, 22 & cmt. a (Tent. Draft No. 2, 1993); SIMPSON, *supra* note 1, § 48 (discussing surety's right of reimbursement); see also STEARNS, *supra* note 1, §§ 11.1-17 (discussing subrogation).

17. RESTATEMENT (SECOND) OF CONTRACTS §§ 302-314 (1981); RESTATEMENT OF SECURITY § 83 & cmt. e; RESTATEMENT (THIRD) OF SURETYSHIP § 2(d)-(e) & cmts. d-e (Tent. Draft No. 1, 1992).

the context of leases, because the third party comes into privity of estate with the obligee by assignment of the original obligor's interest under the lease.¹⁸ In such cases, the obligee obtains a second obligor for performance of the underlying obligation. As between the original obligor and the third party, however, the latter ought to perform the underlying obligation because it has received the benefits of the underlying transaction and/or has agreed with the original obligor to perform the underlying transaction.¹⁹ It is in these cases, in which the secondary obligor's rights and obligations arise from changed circumstances by operation of law, that recognition of the resulting surety relationship becomes more difficult.

Both the *Restatement of Security* and the *Restatement of Suretyship* provide that the surety relationship arises when a third party assumes the obligation of the principal obligor without novation.²⁰ In such a case, the third party, by virtue of the assumption, becomes a principal obligor, and the original obligor becomes a secondary obligor with suretyship status.²¹

Such transactions comport with the basic definition of suretyship as a relationship wherein two or more obligors owe performance to the obligee and as between the two obligors, one rather than the other ought to perform or bear the cost of performance.²² In the usual mortgage assumption transaction, the mortgagor conveys the encumbered property to a third party who agrees to pay the debt secured by the property. The mortgagor has received con-

18. RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1 (1977).

19. See STEARNS, *supra* note 1, § 1.4.

20. The *Restatement of Security* provides: "The suretyship relation is created where the surety . . . having been a principal obligor, his obligation, without a novation, has been assumed by another or his property has been transferred under such circumstances as to place the property under the primary burden of the obligation." RESTATEMENT OF SECURITY § 83(c).

The *Restatement of Suretyship* provides:

The secondary obligor may become subject to the secondary obligation:

. . . .
(e) by contract between an obligor and another person pursuant to which, without a novation, the other person assumes a duty of the obligor to the obligee, with the result that the other person becomes the principal obligor and the original obligor becomes the secondary obligor.

RESTATEMENT (THIRD) OF SURETYSHIP § 2(e) (Tent. Draft No. 1).

21. RESTATEMENT OF SECURITY § 83(c); RESTATEMENT (THIRD) OF SURETYSHIP § 2(e) (Tent. Draft No. 1).

22. See RESTATEMENT OF SECURITY § 82; *supra* note 8 and accompanying text.

sideration presumably equivalent to its equity in the property. The transferee has purchased this equity and obtained the use and benefit of the property. It is only proper that, as the new owner of the property and all its benefits, the transferee should satisfy the debt secured by the property. The understanding, if not the express agreement, between transferor and transferee is that the transferee will perform the underlying obligation because it is the party receiving the benefits of ownership of the property. Similarly, when a lessee assigns a lease and the assignee agrees to perform the obligations under the prime lease, the assignee, as the new beneficiary of the prime lease, is the proper party to perform the obligations under the prime lease.

Although the relations between assignor and assignee in the foregoing situations may seem self-evident, the propriety of applying suretyship principles to these transactions may not be so apparent. After all, there is a third party—the obligee—who has a significant interest in these transactions. As between the assignor and assignee, it is certainly plausible, as an original proposition, that the law should leave them to their contract concerning their rights and obligations between themselves. Indeed, the right of reimbursement afforded the assignor as a secondary obligor is duplicative of the right of the assignor to enforce the express or implied agreement of the assignee to perform the terms of the underlying contract as part of the consideration for the assignment. Of greater significance to the assignor is the possible application of suretyship principles in restricting the rights of the obligee in its dealings with the assignee. If the assignor is imbued with suretyship status, then, under appropriate circumstances, it may have rights and defenses against the obligee that otherwise would be unavailable without the express agreement of the obligee.²³

Of critical importance to the obligee is the requirement that before the obligee is bound to recognize the suretyship status of the assignor/original obligor, the obligee must have notice of the new arrangement.²⁴ Until the obligee receives notice, it is not

23. See, e.g., *infra* notes 47-71 and accompanying text (discussing impairment of collateral); *infra* note 89 (reproducing § 33 of the *Restatement of Suretyship*, setting out suretyship defenses).

24. See *infra* notes 30-31 and accompanying text.

bound to recognize the new suretyship status of the original obligor.²⁵ Notice of the new situation allows the obligee to adjust its dealings with the parties to protect its interests. Yet even granting the propriety of such a notice requirement, the question remains whether the obligee should be bound by a unilateral act of the original obligor imposing duties not originally contemplated by the obligee.

Even though the rules of suretyship are legal rules with their basis in contract, courts and commentators have consistently recognized the equitable nature of many of the secondary obligor's rights and defenses.²⁶ This recognition of the equitable aspect of the secondary obligor's rights requires careful scrutiny of the circumstances in which suretyship status may be conferred on a party by operation of law—that is, without the express consent and agreement of all the parties—so as to ensure against injustice to any of the parties. In formulating broad rules, drafters of the *Restatement of Suretyship* not only must deal with existing authority, but also must address the underlying equity and justice of the rules adopted. Such consideration necessarily entails making assumptions about the way in which the original transactions are structured at their inception, and about how and under what circumstances assignment transactions occur. Because application of suretyship by operation of law amounts to an involuntary imposition of rights and defenses available to the original obligor against the obligee, consideration must be directed to what the obligee may have done if confronted with such a situation at the inception of the relationship with the original obligor, and how that response should be weighed against the propriety of granting these augmented rights to the original obligor.

25. RESTATEMENT OF SECURITY § 114 (1941); RESTATEMENT (THIRD) OF SURETYSHIP § 28(2)-(3) (Tent. Draft No. 2, 1993).

26. See, e.g., *American Sur. Co. v. Bethlehem Nat'l Bank*, 314 U.S. 314, 316-17 (1941) (discussing the equitable nature of the right of subrogation); RESTATEMENT (THIRD) OF SURETYSHIP §§ 18 cmt. a, 22 cmt. a (Tent. Draft No. 2) (distinguishing the secondary obligor's right of reimbursement, founded on implied contract, and right of restitution, founded on restitution and unjust enrichment principles); EDWARD W. SPENCER, *THE GENERAL LAW OF SURETYSHIP* §§ 117, 133, 149, 176 (1913) (noting the equitable origins for the secondary obligor's rights of reimbursement, subrogation, contribution, and exoneration, respectively); STEARNS, *supra* note 1, §§ 11.1-.47 (discussing equitable rights of the surety).

III. ASSIGNMENT AND ASSUMPTION CASES

A. *Debt and Mortgage Assumptions*

The assumption of an obligation by a third party, without a novation, creates a surety relationship among the original obligor, the assuming party, and the obligee.²⁷ Similarly, when an obligor/mortgagor conveys property encumbered by a mortgage to one who expressly assumes the obligation secured by the mortgage, the majority of courts have recognized that the obligee/mortgagee is bound to respect the newly acquired suretyship status of the original obligor/mortgagor.²⁸ This position is consistent with the rules outlined in both the *Restatement of Security* and the *Restatement of Suretyship*.²⁹ Furthermore, it does not prejudice the obligee, inasmuch as the obligee is bound by the original obligor's new suretyship status only from the time the obligee receives notice of the new arrangement.³⁰ As one commentator has noted, "If the arrangement

27. See *supra* note 20; see also *Westinghouse Credit Corp. v. Wolfer*, 88 Cal. Rptr. 654, 657 (Ct. App. 1970) (holding that an assumption of debt in connection with the purchase of a business created a surety relationship among the original obligor, assuming party, and obligee); *Twombly v. Wulf*, 482 P.2d 166, 168 (Or. 1971) (same); *Horman v. Gordon*, 740 P.2d 1346, 1353 (Utah Ct. App. 1987) (holding that an assumption of debt in connection with the purchase of a shopping center created a surety relationship); cf. *In re Paul R. Dean Co.*, 460 F. Supp. 452, 456-57 (W.D.N.Y. 1978) (finding that no suretyship was created when a party held retained securities as an agent and did not assume debt); *Mercantile Holdings, Inc. v. Keeshin*, 543 N.E.2d 1031, 1035 (Ill. App. Ct. 1989) (ruling that an assumption of debt in connection with an assigned interest in land trust created a surety relationship).

28. See *Moss v. McDonald*, 772 P.2d 626, 627 (Colo. Ct. App. 1988); *Ruther v. Thomas*, 604 P.2d 703, 705 (Colo. Ct. App. 1979); *Prigal v. Kearns*, 557 So. 2d 647, 648 (Fla. Dist. Ct. App. 1990); *Union Cent. Life Ins. Co. v. Alford*, 238 N.W. 646, 648 (N.D. 1931); *Sooner Fed. Sav. & Loan Ass'n v. Oklahoma Cent. Credit Union*, 790 P.2d 526, 530 (Okla. 1989); *Thompson v. Miller*, 79 S.E.2d 643, 646 (Va. 1954); *First Nat'l Bank & Trust Co. v. United States Trust Co.*, 50 P.2d 904, 907 (Wash. 1935); *Weickhardt v. Wauwatosa Sav. & Loan Ass'n*, 309 N.W.2d 865, 868 (Wis. Ct. App. 1981). *But see Yasuna v. Miller*, 399 A.2d 68, 74 (D.C. 1979) (requiring a showing of mutual agreement among the obligee, the original mortgagor, and the assuming party for the mortgagor to obtain surety status by virtue of the assumption transaction); *Shockey v. Page*, 354 S.W.2d 698, 700 (Tex. Civ. App. 1962) (holding that upon assumption of mortgage indebtedness, original obligors do not become mere sureties in the absence of an acceptance by the obligee of the assuming grantee as the principal obligor or a release of original obligors from further liability).

29. See RESTATEMENT OF SECURITY § 83 cmt. e; RESTATEMENT (THIRD) OF SURETYSHIP § 2 cmt. e, illus. 3 (Tent. Draft No. 1, 1992); RESTATEMENT (THIRD) OF SURETYSHIP § 28 (Tent. Draft No. 2).

30. RESTATEMENT OF SECURITY § 114; RESTATEMENT (THIRD) OF SURETYSHIP § 28(2)-(3) (Tent. Draft No. 2); see *infra* note 49.

is unknown to the creditor, he is in no way affected by it. However, if he knows that one party has acquired the status of a mere surety, he must recognize the equities of a surety in dealing with such party in all subsequent transactions."³¹ Thus, even though the original obligor/mortgagor may not unilaterally avoid liability to its obligee, the mortgagor can alter its status with respect to its liability on the underlying obligation by entering into a sale-and-assumption transaction and giving notice of this transaction to the obligee. However, before the original obligor/mortgagor will obtain any benefit from its newly acquired suretyship status, the obligee must take some action with respect to the assuming party/transferee that gives rise to a suretyship defense available to the original obligor.³² If the obligee does nothing to affect the rights of the secondary obligor/mortgagor, it retains full right to recover from either the transferor/mortgagor or transferee/assuming party.

In *Horman v. Gordon*,³³ the Utah Court of Appeals analyzed the relationship of parties following the sale of a shopping center.³⁴ Gordon was indebted to Horman under three separate notes aggregating \$41,500.³⁵ In connection with his purchase of a shopping center from a corporation of which Gordon was a principal shareholder, Kingston assumed the indebtedness owed to Horman.³⁶ Subsequent to this transaction, Horman released Kingston from liability on the assumed indebtedness.³⁷ The court determined that Horman was aware of the assumption of the debt by Kingston and that no novation had occurred relative to Horman's rights against Gordon.³⁸ The court held that even though Horman had not agreed to the assumption, his release of Kingston, the assuming obligor, operated to release Gordon as Kingston's surety.³⁹ Relying heavily on the *Restatement of Security*, the court held that Kingston be-

31. STEARNS, *supra* note 1, § 2.3.

32. See RESTATEMENT OF SECURITY §§ 122, 127-129, 132; RESTATEMENT (THIRD) OF SURETYSHIP § 15 (Tent. Draft No. 1); RESTATEMENT (THIRD) OF SURETYSHIP § 33 (Tent. Draft No. 2); *infra* note 89.

33. 740 P.2d 1346 (Utah Ct. App. 1987).

34. *Id.* at 1348-49.

35. *Id.* at 1349.

36. *Id.*

37. *Id.*

38. *Id.* at 1353.

39. *Id.* at 1353-54.

came the principal obligor by virtue of his assumption of the indebtedness of Gordon.⁴⁰ Accordingly, the release of Kingston, the principal obligor, by Horman, the obligee, operated as a discharge of Gordon, the secondary obligor.

Similarly, in *Prigal v. Kearn*,⁴¹ the obligee sold property to the obligor and took back a purchase-money mortgage to secure the sale price.⁴² After the sale, the original mortgagor sold the property to a party who assumed the obligation secured by the mortgage, and as a result of such assumption of personal liability by the transferee, the original mortgagor "acquired the status of a surety."⁴³ Upon default by the assuming transferee, the mortgagee accepted from the assuming transferee a deed in lieu of foreclosure and resold the land to an unrelated third party.⁴⁴ The court held that under Florida law, the receipt of the deed in lieu of foreclosure terminated any rights the mortgagee had held under the mortgage and resulted "in a discharge of the mortgage and a satisfaction of the debt."⁴⁵ Consequently, the court affirmed the discharge of the original mortgagor on the alternative grounds of discharge of the underlying obligation and impairment of collateral security for the obligation, noting that "[u]nder the facts sub judice, it would be manifestly unjust to allow the original lender to reacquire fee simple title to the land and also recover the full amount of the purchase money mortgage note given to him upon the occasion of the initial sale."⁴⁶

The result in *Prigal* is consistent with the current version of the *Restatement of Suretyship*⁴⁷ because the prejudice to the secondary obligor in that case resulted from the obligee's affirmatively accepting the deed in lieu of foreclosure and reselling the property, thereby discharging the underlying debt and impairing the original obligor's recourse to the property. However, when an impairment-of-collateral defense arises by virtue of the obligee's *failure to act*,

40. *Id.* at 1352.

41. 557 So. 2d 647 (Fla. Dist. Ct. App. 1990).

42. *Id.* at 647-48.

43. *Id.* at 648.

44. *Id.* at 647.

45. *Id.* at 648.

46. *Id.* at 649.

47. RESTATEMENT (THIRD) OF SURETYSHIP §§ 28, 38 (Tent. Draft No. 2, 1993).

the current draft of the *Restatement* provides a significant qualification. In such a case, the secondary obligor's defense based on impairment of collateral⁴⁸ arises only after the obligee has manifested assent to the obligor/transferor's change of status.⁴⁹

This qualification serves to preserve the fundamental purpose of suretyship, which is to provide "additional assurance to the one entitled to the performance of an act that the act will be per-

48. Section 38 of the *Restatement of Suretyship* provides:

(1) If the underlying obligation is secured by an interest in collateral and the obligee impairs the value of that interest, the secondary obligation is discharged to the extent that such impairment would otherwise increase the difference between the maximum amount recoverable by the secondary obligor pursuant to its subrogation rights (§§ 23-27) and the value of the collateral.

(2) Impairing the value of an interest in collateral includes:

- (a) failure to obtain or maintain perfection or recordation of the interest in collateral;
- (b) release of collateral without substitution of collateral of equal value or equivalent reduction of the underlying obligation;
- (c) failure to perform a duty to preserve the value of collateral owed to the principal obligor or the secondary obligor; and
- (d) failure to comply with applicable law in disposing of collateral.

Id. § 38.

49. Section 28 of the *Restatement of Suretyship* provides:

(1) The duties of the secondary obligor to the obligee are determined by the contract creating the secondary obligation, subject to defenses resulting from the incidents of suretyship status (§§ 33-43). The duties of the obligee to the secondary obligor are determined by the contract creating the secondary obligation and by the incidents of suretyship status (§ 33).

(2) Except as provided in subsection (3), when a person whom the obligee reasonably believes to be a principal obligor is a secondary obligor, the obligee is not affected by the incidents of the secondary obligor's suretyship status until the obligee has notice that the person is a secondary obligor.

(3) To the extent that a person originally obligated to an obligee as a principal obligor becomes a secondary obligor with respect to that obligation:

(a) the obligee is not affected by the incidents of such obligor's suretyship status until the obligee has knowledge that the original obligor has become a secondary obligor; and

(b) if (i) the original obligor furnishes collateral for its obligation before that obligor becomes a secondary obligor, and (ii) the original obligor's interest in that collateral is transferred to a person who becomes a principal obligor, then, until the obligee manifests assent to the original obligor's change of status, the obligee's failure to take any act does not discharge the secondary obligation pursuant to § 38 (impairment of collateral) except to the extent that such failure would have discharged the original obligor if the original obligor had remained a principal obligor.

Id. § 28.

formed.”⁵⁰ Although suretyship principles accord the secondary obligor unique defenses against enforcement of the secondary obligation by the obligee,⁵¹ such defenses are premised on the occurrence of some action by the obligee that prejudicially affects the secondary obligor. In a sense, actions taken by the obligee to the detriment of the secondary obligor estop the obligee from asserting all or part of its claim against the secondary obligor.⁵² In the absence of such actions, the obligee has full recourse against both the principal obligor and the secondary obligor.⁵³

When the surety relationship arises by virtue of the assumption of the original obligor's obligation, notice of the new arrangement allows the obligee to avoid taking action that would prejudice the original obligor's recourse against the assuming party.⁵⁴ Although the obligee's ability to deal solely with the principal obligor/assuming party has been circumscribed, the obligee has obtained two obligors for performance of the obligation.⁵⁵ If the obligee wishes to continue to rely solely on the original obligor, it may continue to deal with the original obligor without risk of discharging that party.⁵⁶ Only when the obligee begins dealing with the new principal obligor—for example, by extending the date for performance or otherwise altering the underlying contract—does it risk discharging the original obligor from further liability.

The *Restatement of Suretyship's* qualification to the general rule binding the obligee to the new suretyship status of the original obligor upon receipt of notice does not affect this dynamic.⁵⁷ The absence of the obligee's manifested assent to the new situation only precludes the transferor/secondary obligor from asserting discharges based on impairment of collateral resulting from the obligee's *failure to act*.⁵⁸ From the time the obligee receives notice of

50. RESTATEMENT OF SECURITY, Division II, Suretyship, scope note (1941).

51. See *supra* note 5 and accompanying text.

52. See *supra* note 5.

53. RESTATEMENT OF SECURITY § 82 & cmt. f; RESTATEMENT (THIRD) OF SURETYSHIP § 1 & cmt. b (Tent. Draft No. 1, 1992); RESTATEMENT (THIRD) OF SURETYSHIP § 33 & cmts. a-b (Tent. Draft No. 2).

54. See RESTATEMENT (THIRD) OF SURETYSHIP § 28 cmts. a-b (Tent. Draft No. 2).

55. See *id.* cmt. c.

56. *Id.*

57. See *id.* § 28.

58. See *supra* notes 48-49 and accompanying text.

the new situation, the transferor/secondary obligor retains the right to discharges based on the obligee's affirmative acts, such as releases of collateral, that impair the value of the collateral.⁵⁹

By considering the position of the obligee who takes collateral to secure the original obligation, the distinction between preserving discharges based on obligee actions taken with respect to the collateral and precluding discharges based on the obligee's inaction can be justified. When, as part of the original transaction, the obligee relies on the collateral as additional security for performance of the underlying obligation, the obligee can be expected to protect and preserve the collateral regardless of any change in the status of its original obligor. The pursuit of its own interest in preserving the collateral minimizes the likelihood that the obligee will take actions that would prejudice the rights of the secondary obligor. However, the obligee may decide to extend credit principally on the creditworthiness of the obligor, and not in reliance on the collateral. In such a case, in which the obligee takes the collateral merely as an addition to the general creditworthiness of the original obligor, the obligee "may not . . . intend[] to protect aggressively its rights with respect to the collateral."⁶⁰ In most circumstances, failure to preserve collateral would not serve to discharge the original obligor as the principal obligor. As a result, "the original obligor, by engaging in the sale and assumption transaction, would impose [costs of preserving the collateral] on the obligee that the obligee would not otherwise have any obligation to bear."⁶¹ The original obligor, by its unilateral act of entering into the sale-and-assumption transaction, should not have the ability to impose such costs on the obligee.

By requiring the obligee's assent to the changed status of the original obligor before allowing the original obligor to assert discharges based on impairment of collateral flowing from the obligee's inaction, the *Restatement* preserves the obligee's right to deal with the collateral in the manner originally contemplated at the time it extended credit to the original obligor.⁶² Because the obli-

59. See *supra* notes 48-49 and accompanying text; *infra* notes 61-62 and accompanying text.

60. RESTATEMENT (THIRD) OF SURETYSHIP § 28 cmt. d (Tent. Draft No. 2).

61. *Id.*

62. See *id.*

gee's assent may be "demonstrated by [the obligee's] dealing with the new principal obligor as a principal obligor,"⁶³ the *Restatement* preserves the right of the assignor/secondary obligor to claim discharges flowing from *actions* of the obligee that prejudice its rights.⁶⁴ The balance thus struck between the rights of the transferor/secondary obligor and the obligee assures that the obligee will receive the benefits of the new surety relationship (i.e., acquiring an additional obligor) while retaining the proper defenses of the secondary obligor that result from the actions of the obligee.

B. The "Subject to" Cases

When an obligor transfers property that serves as collateral for the obligation to a third party who takes subject to the encumbrance, but who *does not* personally assume the obligation, the application of suretyship principles becomes even more complicated. One may contend that the transferor in a "subject to" sale is in a position similar to a guarantor of a nonrecourse debt.⁶⁵ In such a case, the guarantor is the only person against whom the obligee may proceed *in personam* to collect the debt.⁶⁶ The party that has incurred the principal obligation has contractually limited any re-

63. *Id.*; see also *Prudential Sav. & Loan Ass'n v. Nadler*, 345 N.E.2d 782, 784 (Ill. App. Ct. 1976) ("[A] mortgagee, by its dealings with the grantee and mortgagor, may recognize the former as the principal debtor and the latter as a surety towards itself."); *Hazifotis v. Citizens Fed. Sav. & Loan Ass'n*, 505 N.E.2d 445, 449 (Ind. Ct. App. 1987) (finding no evidence of dealings between the mortgagee and assuming grantee to justify recognition of suretyship status of the original mortgagor).

64. See RESTATEMENT (THIRD) OF SURETYSHIP § 28 cmt. d (Tent. Draft No. 2).

65. See comment f to section 2 of the *Restatement*, which states:

Sometimes a person who owns property subject to a security interest or mortgage transfers the property to a buyer who agrees to take the property subject to the security interest or mortgage but does not assume the debt secured by the property. In such cases, it is usually an explicit or implicit term of the transaction that the buyer will either pay the debt (thereby obtaining clear title to the property) or suffer foreclosure of the property, but that the seller will not be called upon to pay the debt. The result is that the seller, who is still obligated to the creditor, becomes a secondary obligor and the buyer becomes a principal obligor whose obligation is limited to the property. Thus the seller/secondary obligor is in a position similar to that of guarantor of a non-recourse loan; i.e., one that is secured by collateral but for which the principal obligor is not personally responsible.

RESTATEMENT (THIRD) OF SURETYSHIP § 2 cmt. f (Tent. Draft No. 1, 1992).

66. See *id.*

course against itself to the collateral. The *Restatement of Suretyship*, consistent with this transaction and with the apparent understanding of all the parties, limits the guarantor's recourse for reimbursement to the collateral in order to protect the expectations of the principal obligor.⁶⁷

In the same manner, when a seller of property encumbered by a mortgage transfers the property to a buyer who takes subject to the encumbrance but does not assume the obligation secured, the transferee is in the position of a "principal obligor" who has limited the obligee's recourse for collection of the debt to an *in rem* action against the property.⁶⁸ To allow the seller the benefits of suretyship status is no different in this case than in the case in which the guarantor has agreed to be personally liable on a nonrecourse debt. Or is it?

In the guaranteed, nonrecourse debt scenario, the parties are aware of the situation at the time they enter into the deal. The obligee expects to have recourse against the land and against the guarantor. The obligee also understands that the guarantor may

67. The *Restatement of Suretyship* provides: "If satisfaction of the principal obligor's duty to the obligee pursuant to the underlying obligation is limited to a particular fund or property, satisfaction of the duty of reimbursement is limited to the same fund or property." RESTATEMENT (THIRD) OF SURETYSHIP § 19(2) (Tent. Draft No. 2).

In meetings with the Reporter for the *Restatement*, members of the American Bar Association's Task Force on Suretyship (part of the U.C.C. Committee of the ABA's Business Law Section) expressed their disagreement with this position. These members would allow the secondary obligor to have full recourse against the nonrecourse principal obligor on the ground that it is inequitable to allow the principal obligor to impose a greater obligation on the secondary obligor than it was willing to undertake itself. The response to this position focuses on the fact that all parties are aware of the liabilities assumed, and so it is not inequitable to allow the principal obligor to limit to the property its liability (to either the obligee or the secondary obligors).

In the end, the position must be determined in light of what the parties to such transactions actually understand to be the case. Do guarantors of such obligations understand that their recourse against the principal obligor will be limited to the property, and do principal obligors believe that their liability to the secondary obligors will be so limited? Given the ability to contract around the rules of the *Restatement*, the proper resolution of this issue should turn on the determination of which party, the principal obligor or the secondary obligor, is in the best position to protect its interest by appropriate contractual provisions. In the end, it may not be possible to answer this question because the parties to such transactions—on all sides—are generally sophisticated business people.

68. The *Restatement of Suretyship* actually states that "the buyer becomes a principal obligor whose obligation is limited to the property." RESTATEMENT (THIRD) OF SURETYSHIP § 2 cmt. f (Tent. Draft No. 1) (emphasis added); see *supra* note 65.

have certain suretyship defenses and rights flowing from its position as a surety. Accordingly, to give itself the greatest flexibility, the obligee is in a position to obtain from the guarantor appropriate waivers and consents to any action it may take in the future.⁶⁹

When the obligee begins with a recourse, secured obligation involving but one party, the principal obligor, its expectations are different. It generally may expect a free hand in dealing with the collateral, knowing that it has recourse personally against the principal obligor. Upon a sale to a "subject to" transferee, the creditor's position changes. At this point, if the original obligor is accorded suretyship status to the extent of the value of the collateral, the obligee's former ability to deal with the collateral is impaired. As in the case of mortgage assignments with assumption of debt,⁷⁰ the *Restatement of Suretyship* properly provides that discharges of the original obligor based on impairment of collateral resulting from the obligee's failure to act are available only upon assent by the mortgagee to treat the transferee (or the land) as the principal obligor.⁷¹

The question becomes whether the other suretyship defenses pose similar problems in the context of the "subject to" transfer. Professor George Stevens analyzed cases affording the obligor/transferor relief when the obligee extended the time for performance of the obligation by the "subject to" transferee.⁷² As Stevens aptly notes, in "subject to" transfers, no second person is liable for the obligation and, accordingly, the transferor cannot be said to be liable for the payment of a debt that ought to be paid by another.⁷³ He further points out that in order to afford the surety a defense, the extension must be given to the principal obligor.⁷⁴ Certainly, in

69. See *supra* note 6 and accompanying text.

70. See *supra* part III.A.

71. See RESTATEMENT (THIRD) OF SURETYSHIP § 28(3) (Tent. Draft No. 2); *supra* note 49. In the context of the "subject to" transfer, this limitation on the availability of the defense of impairment of collateral (resulting from failures to take action by the obligee) is particularly important. If the transferor/obligor were to be discharged because the obligee failed to act to preserve collateral, the obligee could be faced with the loss of both the collateral and the only party personally liable for the obligation.

72. See George N. Stevens, *Extension Agreements in the "Subject-To" Mortgage Situation*, 15 U. CIN. L. REV. 58 (1941).

73. See *id.* at 71.

74. *Id.* at 72.

this context the "subject to" transferee is not a principal obligor because, as just noted, it has no liability at all on the underlying transaction. Professor Stevens forcefully argues that the technical rules of suretyship should not be imported into this area of mortgage law.⁷⁵

Regardless of any technical merit these arguments may have,⁷⁶ the inquiry in these transactions must focus on the prejudice actually resulting to the obligee in its ability to deal with the debt and the collateral. Again, when the original transaction is the guaranty of a nonrecourse obligation, the creditor is in the position to obtain all necessary waivers and consents from the guarantor as part of the original deal.⁷⁷ Because most obligees in these transactions are not in the business of foreclosing on collateral, but rather in the business of lending money for interest, most obligees likely will prefer to work out a default situation rather than foreclose or enter into litigation. In the guaranteed, nonrecourse debt transaction, the obligee retains such freedom to work out defaults with the nonrecourse principal obligor because of its ability to obtain necessary waivers and consents from the guarantors as part of the original transaction.⁷⁸ By comparing the position of the obligee following a "subject to" transfer in dealing with a default scenario, the dissimilarity between these two transactions becomes apparent.

Except with respect to defenses based on impairment of collateral, the current position of the *Restatement* is that the creditor is bound to recognize the suretyship status of the original debtor once the creditor has notice of the new situation.⁷⁹ Yet from the obligee's standpoint, the party in the better position—and arguably with the greater incentive—to pay the obligation is the current owner, the "subject to" transferee. Though not personally liable on

75. *Id.* at 72-73.

76. The approach of the *Restatement of Suretyship* avoids these technical arguments by equating the "subject to" transferee with the principal obligor under a nonrecourse obligation whose liability is limited to the property. See RESTATEMENT (THIRD) OF SURETYSHIP § 2 cmt. f (Tent. Draft No. 1, 1992); *supra* notes 65, 68.

77. See *supra* note 6.

78. See *supra* notes 6, 69 and accompanying text.

79. RESTATEMENT (THIRD) OF SURETYSHIP § 28 (Tent. Draft No. 2, 1993). Even when the defense is based on impairment of collateral, the obligee is bound from the time it receives notice as to actions taken which impair collateral. See *supra* notes 57-64 and accompanying text.

the obligation, the transferee is the party using the property and exposed to loss of any equity in the property. The original obligor may well have moved from the locale where the property is located and may take the view that the transferee can be expected to act in its own self-interest to preserve the collateral by satisfying the secured obligation. One might reasonably assume that, in the event of trouble relating to the transferee's continued performance of the underlying obligation, the obligee will work with the transferee—as it likely would work with the nonrecourse principal obligor—to attempt to work out a solution rather than attempt to work with an absentee obligor. To preserve its rights against the original obligor, however, the obligee must obtain consent to any accommodation offered to the transferee.⁸⁰ Unlike in the case of an original guaranty of a nonrecourse loan, the obligee has not been able to obtain “up front” waivers and consents from the secondary obligor to deal with the nonrecourse obligor/owner in any reasonable manner. It therefore appears that the obligee's freedom of action is limited under a “subject to” transfer in a way that it is not when the original transaction is a nonrecourse, guaranteed obligation. This limitation on the obligee's freedom of action following a “subject to” transfer may be more apparent than real, at least in the case of the sophisticated or well-counseled obligee.

The obligee may be in a position to obtain consents and waivers from the original obligor as part of the original mortgage transaction. For example, in *First Federal Savings & Loan Ass'n v. Arena*,⁸¹ the original mortgagor, prior to the “subject to” transfer, executed an agreement with the obligee which provided:

“That in the event the ownership of said property or any part thereof becomes vested in a person other than Mortgagor, the Mortgagee may, without notice to the Mortgagor, deal with such successor or successors in interest with reference to this mortgage and the debt hereby secured in the same manner as with the Mortgagor, and may forbear to sue or may extend time for payment of the debt, secured hereby, without discharging or in

80. See RESTATEMENT (THIRD) OF SURETYSHIP § 42 & cmt. a (Tent. Draft No. 2).

81. 406 N.E.2d 1279 (Ind. Ct. App. 1980).

any way affecting the liability of the Mortgagor hereunder or upon the debt hereby secured."⁸²

Immediately following the "subject to" transfer, the mortgagee agreed with the transferee to extend the payment of the debt in return for an express assumption by the transferee and an increase in the rate of interest payable on the debt.⁸³ The court held that the mortgagee's extension of time to the transferee did not release the original mortgagor from liability, because the mortgagor had consented to such extensions in the original agreement between the mortgagor and the mortgagee.⁸⁴ The court held, however, that the agreement did not permit the mortgagee to increase the interest payable on the underlying debt, notwithstanding the provision in the mortgage permitting the mortgagee to "deal with such successor or successors in interest with reference to this mortgage and the debt hereby secured in the same manner as with the Mortgagor."⁸⁵ As a result, the mortgagor was released from all liability to the mortgagee.⁸⁶

Given the ability of parties to contract around the rules of the *Restatement*,⁸⁷ the effective import of the rules set forth in the *Restatement* lies in their function as default rules when the parties have not agreed otherwise. Sophisticated and well-counseled lenders may be expected to draft their agreements, whether general mortgage documents or guaranty agreements used in nonrecourse obligations, with the appropriate waivers and consents necessary to avoid the potential for unintentionally discharging the liability of a party. Accordingly, the rules imposing suretyship obligations on the obligee following a "subject to" transfer become particularly significant when the parties are unsophisticated.

Given the broad validation of waivers and consents, the imposition of suretyship obligations on a sophisticated obligee following a "subject to" transfer of property may not appear to result in any

82. *Id.* at 1283 (quoting Mortgage Agreement).

83. *Id.* at 1281-82.

84. *Id.* at 1285.

85. *Id.* (quoting Mortgage Agreement); see *supra* text accompanying note 82.

86. *First Federal*, 406 N.E.2d at 1284-85. The lesson for counsel in such cases is to draft such waivers and consents with the greatest specificity possible.

87. See RESTATEMENT (THIRD) OF SURETYSHIP § 13 (Tent. Draft No. 1, 1992); RESTATEMENT (THIRD) OF SURETYSHIP §§ 31, 42 (Tent. Draft No. 2, 1993).

greater burden than an imposition in the original guaranty of a nonrecourse debt. The problem is that few, if any, unsophisticated parties deal with nonrecourse obligations. However, it is quite realistic to believe that a seller of property who takes back a mortgage to secure the purchase price may be faced with a subsequent transfer by the mortgagor to a "subject to" transferee. In such a case, the mortgagee likely will not have protected itself with appropriate waivers and consents, and it therefore runs the real risk that if it deals with the transferee to work out some subsequent default, it may inadvertently discharge—in whole or in part—the party it (wrongly) considers to be the principal obligor.⁸⁸

As a matter of policy, it may be appropriate to impose on sophisticated parties the obligation of protecting their interests through appropriate waivers and consents; the same cannot be said, however, for the unsophisticated party unwittingly undone by some technical rule of suretyship. Fortunately, it is unnecessary to formulate rules in this context based, in some way, on the sophistication of the parties, considering the rules in the *Restatement of Suretyship* relating to the extent of discharge⁸⁹ and the burden of

88. Of course, any such discharge is only to the extent of the loss caused by the actions of the obligee. RESTATEMENT (THIRD) OF SURETYSHIP § 33 (Tent. Draft No. 2).

89. Section 33 of the *Restatement of Suretyship* provides:

(1) The duty of the secondary obligor to perform the secondary obligation is subject to the condition that the obligee refrain from impairing the recourse of the secondary obligor against the principal obligor.

(2) Acts that impair the recourse of the secondary obligor against the principal obligor include:

(a) release of the principal obligor with respect to the underlying obligation, as further described in § 35;

(b) extension of time granted to the principal obligor to perform the underlying obligation, as further described in § 36;

(c) other modification of the underlying obligation, as further described in § 37;

(d) impairment of collateral, as further described in § 38; and

(e) any other act that impairs the principal obligor's duty of performance (§ 17), the principal obligor's duty to reimburse (§§ 18-21), or the secondary obligor's right of restitution (§ 22) or subrogation (§§ 23-27), as further described in § 39.

(3) If the obligee impairs the recourse of the secondary obligor against the principal obligor, the secondary obligor is discharged from any unperformed portion of the secondary obligation to the extent set forth in §§ 35-39.

(4) If the obligee impairs the recourse of the secondary obligor against the principal obligor

persuasion in establishing the same.⁹⁰ The *Restatement* limits the discharge afforded the secondary obligor *to the extent* of loss occa-

(a) after the secondary obligor performs any portion of the secondary obligation; or

(b) before the secondary obligor performs a portion of the secondary obligation, if the secondary obligor performs:

(i) without knowledge of such act;

(ii) for the benefit of an intended beneficiary who can enforce the secondary obligation notwithstanding the impairment of recourse; or

(iii) under business compulsion; then, the secondary obligor has a claim against the obligee with respect to any portion of the secondary obligation that has been performed to the extent that such impairment would have discharged the secondary obligor with respect to that performance.

Id.

90. The *Restatement of Suretyship* provides:

Burden of Persuasion

(1) A secondary obligor claiming discharge from a secondary obligation due to the obligee's impairment of recourse (§ 33) has the burden of persuasion with respect to the occurrence of the act constituting the impairment of recourse.

(2) Except as provided in subsection (3), the burden of persuasion with respect to loss or impairment caused by the act impairing recourse is allocated as follows:

(a) the burden of persuasion is on the secondary obligor if:

(i) the secondary obligor is in the business of entering into secondary obligations, received a business benefit for entering into the secondary obligation, or otherwise was induced to enter into the secondary obligation by separate consideration that directly benefits the secondary obligor; or

(ii) the act impairing recourse is a modification of the underlying obligation and the modification is not material;

(b) otherwise, it is presumed that the act impairing recourse caused a loss or impairment equal to the secondary obligor's liability pursuant to the secondary obligation and the burden of persuasion as to the non-existence or lesser amount of such loss is on the obligee.

(3) Notwithstanding subsection (2)(a), if:

(a) the secondary obligor demonstrates prejudice caused by the impairment of recourse and

(b) the circumstances of the case indicate that the amount of loss is not reasonably susceptible of calculation or requires proof of facts that are not ascertainable,

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

Id. § 43.

sioned by the actions of the obligee.⁹¹ With respect to proof of this loss, the *Restatement* distinguishes between the so-called "gratuitous" surety and "compensated" surety.⁹² In the former case, the loss is presumed to equal the amount of the secondary obligation, unless the obligee proves a lesser loss.⁹³ In the latter case, the *Restatement* places the burden on the secondary obligor to prove the extent of its loss.⁹⁴ Because the transferor of property in a "subject to" transfer has received direct consideration for entering into the secondary obligation in the form of the price paid for its equity in the property, the transferor will have the burden of establishing the extent of the loss caused by the obligee's actions. By limiting the discharge afforded the secondary obligor to the extent of loss actually suffered, and by allocating to the secondary obligor the burden of persuasion as to the existence and extent of the loss suffered by the secondary obligor, the *Restatement* avoids, as much as possible, many of the problems that arise when unsophisticated parties are involved in transfers of property subject to existing encumbrances.

In the context of the "subject to" transfer and the applicability of suretyship status and rights, the *Restatement* provides default rules that achieve an appropriate balance between the equities of unsophisticated parties, as to both obligees and original obligors.⁹⁵ At the same time, sophisticated parties retain the power to protect their respective interests by contract and may be expected to do so.⁹⁶

C. Lease Assignments

In the context of lease assignments and assumptions, the courts are split on the question of the suretyship status of the original obligor/assignor vis-à-vis the obligee.⁹⁷ One view holds that the as-

91. See *supra* note 89.

92. RESTATEMENT (THIRD) OF SURETYSHIP § 43 cmt. b (Tent. Draft No. 2).

93. *Id.* § 43(2)(b); see *supra* note 90.

94. RESTATEMENT (THIRD) OF SURETYSHIP § 43(2)(a) (Tent. Draft No. 2); see *supra* note 90.

95. See RESTATEMENT (THIRD) OF SURETYSHIP § 33 (Tent. Draft No. 2).

96. See *id.* § 42.

97. See 3A GEORGE W. THOMPSON, COMMENTARIES OF THE MODERN LAW OF REAL PROPERTY § 1220 (5th ed. 1981).

signor/original lessee remains as a principal obligor with no suretyship status,⁹⁸ except, perhaps, in the "limited sense as between the assignee and his assignor, but as between the lessor and the lessee the latter remains a primary obligor under his express contract to pay rent."⁹⁹

Generally, decisions declining to recognize the suretyship status of the assignor/original lessee involve situations in which no special suretyship defense would have been available in any event. For example, in *De Hart v. Allen*,¹⁰⁰ the lessee rented a rooming house for a five-year term.¹⁰¹ Two years later, the lessee assigned the lease to one Gammons, who assumed the obligations under the lease; Gammons abandoned the premises after two months.¹⁰² The landlord relet the premises and subsequently sued the original lessee to recover the difference between the rent received and the rent reserved under the lease.¹⁰³ The landlord gave notice of the reletting following Gammons' abandonment to the original lessee.¹⁰⁴ The lessee claimed, inter alia, that failure to give notice of reletting to the assignee operated as a discharge of the lessee as surety.¹⁰⁵ The court concluded that no such notice was necessary to preserve the liability of the lessee.¹⁰⁶ The court's rationale for this conclusion was that the lessee was a surety only in a limited sense—that is, only as between the lessee and the assignee.¹⁰⁷ This

98. See *Meredith v. Dardarian*, 147 Cal. Rptr. 761 (Ct. App. 1978); see also *infra* notes 126-30 and accompanying text (discussing *Meredith*).

99. *De Hart v. Allen*, 161 P.2d 453, 455 (Cal. 1945) (citing *T.A.D. Jones Co. v. Winchester Repeating Arms Co.*, 55 F.2d 944 (D. Conn.), *aff'd*, 61 F.2d 774 (2d Cir. 1932), *cert. denied*, 288 U.S. 609 (1933)).

100. 161 P.2d 453.

101. *Id.* at 454.

102. *Id.*

103. *Id.*

104. *Id.* at 454-55.

105. *Id.* at 455.

106. *Id.* at 454-55.

107. *Id.* at 455; see *supra* note 99 and accompanying text. See also *Broida v. Hayashi*, 464 P.2d 285 (Haw. 1970), in which the court held that no duty is imposed on the landlord to give notice of default to a lessee/assignor. *Id.* at 289-90. In the absence of such a duty, no estoppel will be imposed on the landlord attempting to recover from the lessee/assignor. See *id.*

rationale was gratuitous dicta.¹⁰⁸ The court should have ruled that notice to Gammons was unnecessary to preserve the landlord's right to recover damages from Gammons.¹⁰⁹ Accordingly, any right of recourse of the defendant against Gammons would not have been impaired. In any event, the notice given to the defendant was sufficient under landlord-tenant law to hold the original lessee on its covenant to pay rent.¹¹⁰

In cases such as *De Hart*, the lessee/assignor essentially argues that the mere assignment of the lease with the landlord's consent operates to release the lessee from further liability;¹¹¹ however, this simply is not the law.¹¹² As explained in *T.A.D. Jones Co. v. Winchester Repeating Arms Co.*,¹¹³ the case relied upon in *De Hart* for the proposition that a lessee/assignor is not a surety except that in some "limited sense,"¹¹⁴ an assignment of lease in which the assignee assumes the covenants in the lease operates to change the legal relations of the parties to the lease.¹¹⁵ The original lessee, bound by both privity of estate and privity of contract prior to the assignment, is no longer bound by privity of estate following the assignment of the lease.¹¹⁶ However, in the absence of a novation or an express release by the landlord, the original lessee remains bound, by privity of contract, under its covenant to pay rent.¹¹⁷

108. In the subsequent case of *Peiser v. Mettler*, 328 P.2d 953 (Cal. 1958), in which the issue was the appropriate venue of an action against the lessee and its assignee, the court mischaracterized this dicta as a holding. *Id.* at 957.

109. RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 12.1(3) (1977). Section 12.1(3) is further discussed in a comment: "If the tenant has abandoned the leased property and the landlord stands by and does nothing, the lease is not terminated." *Id.* § 12.1 cmt. i.

110. *Id.* § 12.1(3)(b).

111. See *Broida*, 464 P.2d at 287; *Kintner v. Harr*, 408 P.2d 487, 496 (Mont. 1965); *De Hart*, 161 P.2d at 454.

112. See *Hamlen v. Rednalloh Co.*, 197 N.E. 149, 152 (Mass. 1935); RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1.

113. 55 F.2d 944 (D. Conn.), *aff'd*, 61 F.2d 774 (2d Cir. 1932), *cert. denied*, 288 U.S. 609 (1933).

114. See *supra* note 99 and accompanying text.

115. *T.A.D. Jones*, 55 F.2d at 947.

116. *Id.*

117. *Id.*; see *Broida v. Hayashi*, 464 P.2d 285, 287 (Haw. 1970); RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1. (1977).

Notwithstanding the continued liability of the original lessee, "[o]rdinarily, of course, upon the assignment of an estate for years, the original lessee becomes a surety for the performance by its assignee of the obligation of its covenants, including the covenant to pay rent."¹¹⁸ This clear recognition of the assignor's status as a surety contrasts sharply with the California Supreme Court's reliance on this case for the proposition that the assignor's surety status is somehow limited.¹¹⁹

More fundamental than the propriety of the court's use of this authority is the determination of what is the "limited sense" in which the lessee becomes a surety as between itself and the assignee. If the lessee/assignor remains a principal obligor vis-à-vis the landlord, then the limited surety status of the lessee vis-à-vis the assignee must relate to the lessee's rights against the assignee. In the first instance, the lessee/assignor would have a direct right of recourse against the assignee under the contract of assignment.¹²⁰ Because the assignee has assumed the assignor's obligations under the prime lease in return for the assignment, the original lessee has a direct cause of action to recover for breach of this promise.¹²¹ Accordingly, the surety's right of reimbursement is largely irrelevant, in light of the assignor's direct recourse against the assignee.

Secondly, a surety's right of exoneration is of minimal, if any, value to the assignor. Because the landlord has proceeded to collect from the original lessee/assignor under its covenant to pay rent, the assignor is not in a position to sue the assignee for exoneration before the assignor has come out of pocket. Finally, if the surety relationship is limited to the assignor and the assignee, the surety's right of subrogation is not implicated. "The doctrine of subrogation is a pure unmixed equity"¹²² and applies in *any* case "[w]here property of one person is used in discharging an obligation owed by another or a lien upon the property of another, under

118. *T.A.D. Jones*, 55 F.2d at 947; see RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1 cmt. e.

119. See *supra* notes 99-107 and accompanying text (discussing *De Hart*).

120. RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1 cmt. c.

121. *Id.*

122. *Prairie State Bank v. United States*, 164 U.S. 227, 231 (1896) (quoting *Gadsden v. Brown*, 17 S.C. Eq. (Speers Eq.) 37, 41 (1842)).

such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred."¹²³

Upon assignment of a lease, the assignee, as between the lessee and assignee, becomes obligated to perform those covenants of the lease that touch and concern the leasehold interest, as well as any other covenants the assignee expressly assumes.¹²⁴ Satisfaction of the assignee's obligation by the assignor results in unjust enrichment of the assignee (who has the benefits of the lease) and, as a matter of equity, entitles the assignor to be subrogated to the rights of the obligee/landlord, regardless of any surety relationship that may exist among the landlord, lessee, and assignee.¹²⁵

Recognition of the suretyship status of the lessee/assignor only in the "limited sense" as between the lessee and the assignee is meaningless. At best, the recourse ostensibly granted to the lessee against the assignee by such limited suretyship status replicates the rights the lessee has by the contract of assignment and subrogation, irrespective of suretyship status. The mischief wrought by the *De Hart* case, however, was brought home in *Meredith v. Dardarian*,¹²⁶ in which the court stated that the defendants, assignors of a lease, were not sureties.¹²⁷ The court stated that "[d]espite their assignment, [the original lessees] remain primary obligors under the terms of the lease."¹²⁸ The court made this assertion notwithstanding its recognition that no special suretyship defense would have existed in any event.¹²⁹ Accordingly, nothing about the lessee's suretyship status precluded its "primary" responsibility to the landlord in that case.

123. RESTATEMENT OF RESTITUTION § 162 (1937).

124. RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1(2).

125. *Id.* § 16.1 cmt. c.

126. 147 Cal. Rptr. 761 (Ct. App. 1978).

127. *Id.* at 763-64.

128. *Id.* at 763.

129. *See id.* at 764. After quoting from *De Hart*, the court stated: "It is thus apparent that defendants are not entitled to the defense of exoneration of a surety. Such being the case, even if 'unauthorized extensions of time' were given or modifications to the premises which could not be restored had occurred, such facts would not constitute a defense." *Id.* (emphasis added).

Such events certainly would constitute defenses under the *Restatement of Suretyship*. *See* RESTATEMENT (THIRD) OF SURETYSHIP § 33 (Tent. Draft No. 2, 1993); *supra* note 89.

It is the very nature of suretyship that the obligee has two sources to which it may resort for satisfaction of the underlying obligation. Because the court in *Meredith* found no facts that would warrant discharging the surety, even if the original lessee had been found to be a surety,¹³⁰ the court had no occasion to declare that, after assignment, lessees remain principal obligors in all cases.

More recently, in the context of cases discussing restrictions on a landlord's right to withhold consent to assignment of leases, the California Supreme Court recognized the assignor's surety status. In *Kendall v. Ernest Pestana, Inc.*,¹³¹ the court held that a landlord could not refuse consent to an assignment except on commercially reasonable grounds.¹³² In support of its decision, the court stated that "[t]he lessor's interests are also protected by the fact that the original lessee remains liable to the lessor as a surety even if the lessor consents to the assignment and the assignee expressly assumes the obligations of the lease."¹³³

In 1992, the California Supreme Court confirmed the lessee/assignor's status as surety. In *Carma Developers (California), Inc. v. Marathon Development California, Inc.*,¹³⁴ the court faced the issue of the validity of a recapture clause permitting the landlord to terminate the lease upon notice of the lessee's intent to sublet or assign.¹³⁵ The lease also allowed the lessee to sublet or assign the lease with the consent of the landlord; upon a proposed subletting or assignment, the landlord could either terminate the lease (and with it the lessee's liability) or consent to the sublet or assignment.¹³⁶ The court's principal concern related to the validity of the termination provision and its possible effect as a forfeiture restraint on alienation.¹³⁷ In concluding that the recapture clause in this lease was not an unreasonable restraint on alienation, the court noted:

130. *Meredith*, 147 Cal. Rptr. at 764.

131. 709 P.2d 837 (Cal. 1985) (en banc).

132. *Id.* at 842-43.

133. *Id.* at 844 (emphasis added).

134. 826 P.2d 710 (Cal. 1992) (en banc).

135. *Id.* at 712.

136. *Id.* at 713.

137. *Id.* at 714.

Forfeiture restraints are generally viewed more favorably than comparable disabling restraints The reason is obvious. A disabling restraint binds the lessee to the lease throughout its term. By contrast, a forfeiture restraint permits the lessee to extricate itself if a suitable transferee can be found. The lessor must either approve a proposed transfer, *releasing the lessee from all but surety obligations*, or terminate the lease, releasing the lessee altogether.¹³⁸

The import of *Kendall* and *Carma Developers* lies in their recognition that the assignor of a lease assumes a position of surety—not in a limited sense, as only between assignor and assignee, but in the full sense, as also applicable to the landlord's rights and recourse against the lessee/assignor.

In *Gholson v. Savin*,¹³⁹ the Ohio Supreme Court cogently analyzed the relationship of the landlord, tenant, and assignee and demonstrated the propriety of according suretyship status to the lessee/assignor.¹⁴⁰ In *Gholson*, the landlord had released the assignee upon partial satisfaction of a judgment against the assignee while continuing to assert a right to recover from the original lessee the balance of rent outstanding.¹⁴¹ The court held that in the context of a lease assignment in which the lessee is not expressly released from his obligations under such lease, the assignee assumes the position of principal obligor for the performance of the covenants of the lease, and the lessee becomes his surety for such performance.¹⁴² This surety relationship results from the character of the lessee's and assignee's obligations to the landlord/creditor.¹⁴³ The nature of their relationship is such that, upon payment of the obligation, the lessee is entitled to full reimbursement and indemnification by the assignee.¹⁴⁴

This results from two key factors. First, at a minimum, a contract of assignment and assumption between the lessee and assignee implicitly binds the assignee to the lessee to perform fully

138. *Id.* at 718 (emphasis added) (citations omitted).

139. 31 N.E.2d 858 (Ohio 1941).

140. *Id.*

141. *Id.* at 860.

142. *Id.* at 862.

143. *Id.*

144. *Id.*

the obligations of the covenants in the lease.¹⁴⁵ Second, the assignee receives the full benefit of the lease from the moment of the assignment;¹⁴⁶ accordingly, as between the lessee and the assignee, the latter ought to bear the full weight of performing the return consideration, i.e., paying the rent. As discussed earlier, these factors certainly justify the lessee's direct recourse against the assignee via the assignment or by way of subrogation to the landlord's rights, irrespective of suretyship principles.¹⁴⁷ However, when considered in the context of the total relationship among the lessor, lessee, and assignee, these factors demonstrate the propriety of granting the lessee/assignor suretyship status against both the assignee and the landlord.

Although as an original proposition the landlord/obligee has the right to proceed against either the lessee or the assignee, once the landlord deals with the assignee in such a way as to recognize the assignee as the party principally liable for performance of the lease, that action should bind the landlord in future dealings with the lessee. In *Gholson*, the landlord released the assignee from liability for unpaid rental by accepting less than the full amount owing.¹⁴⁸ Once the landlord released his rights against the assignee, the lessee also lost its right to enforce the lease against the assignee, as subrogee of the landlord.¹⁴⁹

Not only is the lessee's right of subrogation adversely affected by the release, but the assignee does not receive the benefits of the release.¹⁵⁰

[S]ince the settlement with the principal debtor [assignee] cannot affect the right of the debtor secondarily liable [the lessee] to indemnity and reimbursement from his principal, the settlement operates as a fraud against the principal debtor since he must remain liable for reimbursement to the surety or debtor secondarily liable.¹⁵¹

145. See RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1 cmt. c (1977).

146. See *id.* § 16.2(2).

147. See *supra* notes 122-25 and accompanying text.

148. *Gholson*, 31 N.E.2d at 863.

149. *Id.* at 861.

150. *Id.* at 861-62.

151. *Id.*

Though phrased in the language of suretyship, this fraud on the assignee becomes clearer upon consideration that, whatever the impact on the lessee's surety rights of reimbursement, the action of the landlord in releasing the assignee certainly can have no effect on the right of the lessee to recover from the assignee under the direct contract of assignment and assumption.¹⁵²

Upon assignment of a lease, or sublease and assumption by the sublessee, a classic suretyship triangle is created.¹⁵³ Under the lease, two parties, the assignee and the lessee, owe obligations to the landlord/obligee.¹⁵⁴ As between these two parties, the assignee—the party receiving the benefits of the lease following the assignment—ought to perform the obligations.¹⁵⁵ Notice of the assignment obligates the landlord to recognize the suretyship status of the former lessee.¹⁵⁶ This situation does not prejudice the landlord/obligee because, in addition to receiving notice of the new arrangement before being bound, the landlord must take some action prejudicial to the lessee/secondary obligor that would give rise to a suretyship defense.¹⁵⁷ If the landlord takes no such prejudicial action, the landlord will retain full recourse against the lessee/secondary obligor.¹⁵⁸

Actions by the landlord that alter or modify the terms of the lease directly impact the obligations of the original lessee/assignor under the original lease. Furthermore, the recourse of the assignor against its assignee, in the event the assignor is called upon to perform, may well have been prejudiced by such actions.¹⁵⁹ As in the case of mortgage assignment and assumption, in which the obligee takes action vis-à-vis the assignee that prejudicially affects the assignor's recourse against the assignee, suretyship principles provide the assignor with a complete or partial discharge.¹⁶⁰ The result should be no different simply because the context has changed

152. *See id.* at 861.

153. *See supra* part II.

154. *See supra* notes 112-18 and accompanying text.

155. *See supra* notes 5, 9-10 and accompanying text.

156. *See* RESTATEMENT (THIRD) OF SURETYSHIP § 28(2) & cmts. a-c (Tent. Draft No. 2, 1993).

157. *See id.*

158. *Id.*

159. *See supra* notes 5, 50-51 and accompanying text.

160. *See supra* part III.A.

from a mortgagee-assignee relationship to a landlord-assignee relationship. By taking those actions, the landlord effectively recognizes and deals with the assignee as the principal obligor. Therefore, it is the actions of the landlord, and not those of the assignor, which give rise to the suretyship defense.

Upon assignment to an acceptable assignee, the landlord obtains two obligors for the performance of the lease covenants. Had no assignment occurred, any change in the terms of the lease would require the consent of the lessee.¹⁶¹ Why should the landlord be allowed to alter the terms of the lease with the assignee without obtaining the consent of the original lessee, when such consent clearly would have been required in the absence of an assignment? Furthermore, if the landlord finds an assignee unacceptable, the landlord may obtain protection by refusing consent to the assignment on reasonable grounds.¹⁶² Even if bound to consent to an assignment, the landlord can continue to deal with, and look to, the original tenant for performance.¹⁶³ Recognizing suretyship status in the assignor in no way precludes the landlord from taking this approach. Only when the landlord by its own actions implicitly recognizes the assignee as the principal obligor does the landlord run the risk of entirely or partially discharging the original lessee from liability under the lease.

Whether a lease is treated under rules of contract or property, the suretyship status of the assignor is recognized by both the *Restatement (Second) of Contracts* and the *Restatement (Second) of Property*.¹⁶⁴ When the lessee assigns the lease to one who agrees to perform the obligations under the prime lease, the lessor is a third-party beneficiary of the assignment agreement.¹⁶⁵ Particularly when the landlord consents to the assignment, the lessee and assignee most likely intend the landlord to have enforceable rights against the assignee. As an intended beneficiary, the landlord may recover against either the lessee or the assignee,¹⁶⁶ subject to the

161. RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT §§ 2.2, 2.4 cmt. b (1977).

162. *See id.* § 15.2.

163. *See id.* § 16.1(1) & cmt. c.

164. *Id.*; RESTATEMENT (SECOND) OF CONTRACTS § 302 cmt. b (1981).

165. RESTATEMENT (SECOND) OF CONTRACTS § 302.

166. *Id.* § 310(1).

rights and defenses of the lessee as surety.¹⁶⁷ Similarly, notwithstanding the continued liability of an assigning lessee under privity of contract, the landlord is subject to property rules that may grant the lessee a discharge based upon the landlord's actions in dealing with the assignee.¹⁶⁸

Acknowledging the suretyship status of an assigning lessee is consistent with the general rules of suretyship, and the relationship is recognized as a general matter of contract law and property law.¹⁶⁹ This status is proper and results in no prejudice to the landlord.¹⁷⁰ The landlord is not bound by such status unless and until the landlord has notice of the assignment.¹⁷¹ More importantly, the landlord will not lose recourse against the original lessee unless the landlord affirmatively treats the assignee as the principal obligor under the lease in a manner that is prejudicial to the rights of the lessee/secondary obligor.¹⁷² Only by the landlord's own conduct, which demonstrates—explicitly or implicitly—that the landlord will look to the assignee for principal performance of the lease, and which prejudicially affects the rights and recourse of the original lessee, can the landlord lose its rights against the original lessee.¹⁷³

IV. THE "FRINGE" CASES

Although the application of suretyship principles by operation of law usually arises in mortgage and lease transactions, as discussed in Part III, courts have relied upon suretyship principles to resolve disputes in other circumstances. The following cases present a few examples of how suretyship principles may be applicable upon in-depth analysis of the underlying rights and obligations of the parties. The courts in these cases went beyond the facial disputes and focused on the substantive rights and obligations of the parties. That focus led to the application of suretyship principles to reach

167. *Id.* § 314.

168. RESTATEMENT (SECOND) OF PROPERTY: LANDLORD AND TENANT § 16.1 cmt. e, illus. 17 (1977).

169. *See supra* text accompanying notes 155-68.

170. *See supra* text accompanying note 157.

171. *See supra* text accompanying note 156.

172. *See supra* text accompanying notes 155-63.

173. *See supra* text accompanying notes 155-63.

results consonant with the underlying rights and equities of the parties.

In *Foremost Life Insurance Co. v. Department of Insurance*,¹⁷⁴ plaintiff insurance company asserted that it was entitled to priority in the statutory liquidation of its reinsurer.¹⁷⁵ Under a reinsurance treaty, Keystone Life Insurance Company agreed to administer and pay claims under certain life insurance policies written by Foremost.¹⁷⁶ After Keystone became unable to perform its obligations under these policies and the Indiana Department of Insurance began liquidation proceedings, Foremost stepped in and paid claims arising under the existing policies.¹⁷⁷ The court noted that, as to the consumers under these policies, both Keystone and Foremost were jointly liable.¹⁷⁸ The court then stated, "As between Keystone and Foremost, however, a quasi-suretyship arrangement was created whereby Keystone was ultimately liable to discharge the claims of policyholders and Foremost acquired the status of surety."¹⁷⁹

The court reasoned that this situation was analogous to Indiana cases holding that the assumption of mortgage indebtedness created a principal surety relation between the original mortgagor and the assuming grantee.¹⁸⁰ Accordingly, the court of appeals held that Foremost was entitled to be subrogated to the priority status of those policyholders whose claims it had paid.¹⁸¹ *Foremost* is a

174. 395 N.E.2d 418 (Ind. Ct. App. 1979), *vacated*, 409 N.E.2d 1092 (Ind. 1980). The decision of the court of appeals was vacated by the Indiana Supreme Court on grounds of statutory interpretation. The supreme court reasoned that the legislature, in adopting the priority scheme applicable upon insolvency of an insurance company, did not intend to grant priority to insurance companies, as subrogees of paid policyholders, reinsured by the insolvent company. The purpose of the priority granted to policyholders was to protect consumers unable to determine the financial strength of the insurance company. *Foremost*, 409 N.E.2d at 1096. Companies such as Foremost have the ability to protect their own interests and so were not intended beneficiaries, via subrogation, of the statutory priority scheme. *Id.* at 1096-97.

175. *Foremost*, 395 N.E.2d at 421.

176. *Id.* at 422.

177. *Id.* at 423.

178. *Id.*

179. *Id.* at 423-24.

180. *Id.* at 424.

181. *Id.* at 424-25. While consistent with suretyship principles, the court of appeals' decision was vacated on the ground of legislative intent in adopting the priority scheme for claims against insolvent insurance companies, which scheme did not include claims of so-

solid example of the application of suretyship principles. Because the original obligation of Foremost to its policyholders had been assumed by Keystone through the reinsurance treaty, both Foremost and Keystone owed a single obligation to the policyholders/obligees.¹⁸² Yet as between Keystone and Foremost, Keystone had the principal obligation to satisfy the claims of the policyholders.¹⁸³

In *Campanella v. Ranier National Bank*,¹⁸⁴ Campanella, the owner of a hotel, sold the property and took back a deed of trust to secure the purchase price.¹⁸⁵ Campanella's buyer resold the hotel to Douglas, who intended to remodel the hotel.¹⁸⁶ In order to permit Douglas to obtain financing for the remodeling, Campanella agreed to subordinate the priority of his deed of trust for a period of one year.¹⁸⁷ After a number of defaults by Douglas, the financing mortgagee commenced foreclosure proceedings under its deed of trust.¹⁸⁸ Although foreclosure proceedings were commenced within one year of the subordination, the actual sale was scheduled beyond the one-year period.¹⁸⁹ After the period of the subordination, Campanella commenced his own action to foreclose his deed of trust.¹⁹⁰ The question before the court turned on the timing of the expiration of the subordination agreement; if the agreement terminated after one year regardless of the commencement of foreclosure proceedings, Campanella's deed of trust would have priority over the financing mortgagee's deed.¹⁹¹

phisticated insurance companies as subrogees of unsophisticated policyholders. See *supra* note 174. See also *American Surety Co. v. Bethlehem National Bank*, 314 U.S. 314 (1941), in which Justice Douglas noted in dissent:

It is ordinarily true that a surety succeeds to all of the rights and remedies of the creditor, including the latter's priority. But that is no inexorable rule. . . .

While a surety was entitled to be subrogated to the rights of a State against an insolvent bank, the surety did not, in absence of statute, acquire the State's priority.

Id. at 323-24 (Douglas, J., dissenting) (citations omitted).

182. See *Foremost*, 395 N.E.2d at 423-24.

183. *Id.* at 424.

184. 612 P.2d 460 (Wash. Ct. App. 1980).

185. *Id.* at 461.

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. *Id.*

191. *Id.* at 462.

The court held that the subordination agreement expired after one year by its own terms, and accordingly, Campanella reacquired priority at that time.¹⁹² The court's decision was based upon the following rationale: "The bank's priority rights under a subordination agreement are strictly limited to the express terms and conditions of the agreement. The rationale behind the rule is that the owner is a quasi-surety who has pledged his property to the bank in order to finance a construction loan."¹⁹³

When a person pledges property to secure the debt of another, the pledgor is deemed a surety to the extent of the property pledged.¹⁹⁴ A subordination agreement can be viewed as an effective pledge of the subordinating party's priority interest in the property. In *Campanella*, the application of suretyship principles led to the court's applying a form of the doctrine of *strictissimi juris*, pursuant to which the court strictly construed the agreement in favor of the subordinating party and limited the term to one year.¹⁹⁵

Although the doctrine of *strictissimi juris* in construing suretyship contracts is out of favor,¹⁹⁶ the lesson for counsel in such cases is that suretyship principles may operate to relieve the subordinating party of obligations under the subordination agreement. In the event that the financing bank grants some accommodation to the obligor without the consent of the subordinating party, the bank may lose the priority it obtained through the subordination agreement because it may be subject to a suretyship defense available to the subordinating party. Accordingly, attorneys are well advised to draft appropriate waiver and consent clauses into such agreements.

Perhaps the most creative application of suretyship principles arose in *Eastwood Apartments, Inc. v. Anderson*.¹⁹⁷ In *Anderson*, Eastwood Apartments opposed the City of Rochester's grant of a

192. *Id.*

193. *Id.* (citations omitted).

194. RESTATEMENT OF SECURITY § 83(b) (1941); RESTATEMENT (THIRD) OF SURETYSHIP §§ 1(1)(b)(2), 2(c) (Tent. Draft No. 1, 1992).

195. See *Campanella*, 612 P.2d at 462.

196. RESTATEMENT OF SECURITY § 88 & cmt. b; RESTATEMENT (THIRD) OF SURETYSHIP § 11 & cmt. c (Tent. Draft No. 1); see also *United States Fidelity & Guar. Co. v. Borden Metal Prods. Co.*, 539 S.W.2d 170 (Tex. Civ. App. 1976) (reluctantly following *strictissimi juris* after stating a preference to adopt the majority position).

197. 266 N.Y.S.2d 197 (Sup. Ct. 1965).

variance to a building supply company.¹⁹⁸ The building supply company objected to Eastwood Apartments' status as a proper party to raise such an objection because Eastwood was not a "person aggrieved" under the applicable zoning statute.¹⁹⁹ In order to be a "person aggrieved" with standing to object to such a variance, "[t]here must be special injury or damage to one's personal or property rights as distinguished from the role of being only a champion of causes."²⁰⁰

Eastwood did not own the property that allegedly was adversely affected by the granting of the variance.²⁰¹ Rather, Eastwood had purchased the property with a loan secured by a mortgage and then immediately conveyed the property (subject to the mortgage) to its principal shareholders, who effectively had agreed to assume the mortgage.²⁰² As a result of the transfer subject to the mortgage, the court concluded that "either as surety or as one having 'the equities of a surety' by virtue of being a mortgagor, [Eastwood] has shown itself to be a person 'aggrieved' within the purview of said statute."²⁰³

Application of the mortgagor suretyship rules resulted in recognition of rights in the surety outside the normal ken of suretyship law; the result nonetheless appears appropriate. Eastwood, as surety, had recourse to the secured property in the event the bank called upon Eastwood to satisfy its secondary obligation.²⁰⁴ As a result, any factors affecting the value of the land impacted the surety's ability to recover. For that reason, a surety and an owner of property that may be adversely affected by a variance grant should be equally entitled to oppose that variance.

V. CONCLUSION

Surety relationships do not always arise through transactions denominated "guaranty" or "suretyship." When an obligee to whom another owes performance of an obligation agrees to a third-party

198. *Id.* at 198.

199. *Id.*

200. *Id.* at 199 (citations omitted).

201. *Id.* at 200.

202. *Id.* at 199-200.

203. *Id.* at 201 (quoting *Murray v. Marshall*, 94 N.Y. 611, 615 (1884)).

204. *Id.* at 200.

assumption of the existing obligor's obligation (whether that obligation is also secured by property security or not), the obligee must be aware of the possibility that subsequent actions in dealing with the new obligor may operate to release the original obligor. As the saying goes, "Forewarned is forearmed." By being aware of the potential downside to the assumption (i.e., the discharge, in whole or in part, of the original obligor), the obligee can protect itself by obtaining appropriate waivers and consents from the original obligor and/or secondary obligor—either as part of the original transaction or as a condition to consenting to the assignment.

In the absence of waiver or consent, when confronted with an obligee's demand for performance, the original obligor must also realize that it has potential rights against the assuming principal obligor, as well as defenses against the obligee. Some of the obligor's rights may be important in ways not readily apparent; for example, the obligor may have legally protected rights in property.

In short, it is essential that whenever two or more parties are obligated on a single obligation, the parties must carefully scrutinize the situation to determine whether suretyship principles may be applicable. In the case of the obligee, this analysis ideally occurs prior to the inception of a given transaction so that appropriate steps may be taken to protect the obligee's rights, regardless of future occurrences. In the case of the secondary obligor, or potential secondary obligor, such analysis will normally take place at the time that demand for performance occurs or recourse against the principal obligor is sought. In sum, the parties should be aware of the potential applicability of suretyship principles and should proceed accordingly.

Considering the myriad transactions to which principles of suretyship may apply, the scope of the proposed *Restatement (Third) of Suretyship* becomes perhaps its single most important feature. The increasing complexity and sophistication of the players in today's business world suggests that multiparty transactions involving assignments and assumptions of obligations will not diminish. Consequently, the question of whether the rules set forth in the *Restatement* will apply in the first instance takes on larger significance. In any event, the current provisions of the *Restatement of Suretyship* clearly set forth the proper scope for the applicability of suretyship principles.