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Restatement of the Law, Security
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Rules and Principles

Scope

Scope Note

Security is an interest in chattels, in land, or in the obligation of a third party. A security interest must be the result of a transaction that gives recourse against a particular chattel or land or against a third party on an obligation. The purpose of security is generally to secure the repayment of money, but it may also secure the performance of any duty. When money is advanced a personal duty to repay will be implied even if security is given, unless the parties agree that the debtor has no personal obligation except to allow security to be used to satisfy the debt and that the creditor must rely solely upon the security in the event of default.

Security, other than the obligation of a third party, may be either possessory or non-possessory. The pledge and the common law lien as distinguished from equitable security interests and some statutory liens are forms of security dependent upon possession of a chattel or land. Non-possessory security depends upon title to or charge on a chattel or land, but not upon possession. The chattel mortgage, the conditional sale and the real estate mortgage are the principal forms of non-possessory security. The tripartite trust receipt is a form of non-possessory security having enforcement features usually associated with possessory security.

The obligation of a third party who acts as a surety is classified in this Restatement within the general category of Security. This classification is also found in the German and Austrian Codes. While not found specifically in the French Code, this classification is also often adopted by French commentators on the French Code.

This Restatement of Security is divided into two parts. Division I deals with personal property as Security; Division II with Suretyship. Division I is limited to Pledges and Possessory Liens. Statutory Liens and Equitable Security Interests are not separately treated but incidental reference to Statutory Liens is made at appropriate points and various Equitable Security Interests are considered in connection with other Topics.

Chattel Mortgages, Conditional Sales, Trust Receipts and security interests in land are not included in this Restatement

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawSecured TransactionsDefaultCreditor ObligationsContracts LawSecured TransactionsThird Party RightsGeneral OverviewContracts LawSecured TransactionsTrust Receipt Transactions



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Rules and Principles

Division 1 - Personal Property as Security

Chapter 1 - Pledges

Topic 1 - Nature and Requisites of Pledges

Scope Note

The subject of pledges is restated in three topics: Topic 1 deals with the nature and requisite of pledges; Topic 2 with the rights, privileges and duties of pledgor and pledgee before default; and Topic 3 with the enforcement of pledges and their incidents after default. Under Topic 1 the pledge is defined, the methods of creating a pledge are stated, typical pledge interests are described, the effect of a contract to pledge is indicated, characteristic modern business uses of pledges are discussed and reference is made to permissible contractual modifications of the usual incidents of pledge



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Division 1 - Personal Property as Security

Chapter 1 - Pledges

Topic 1 - Nature and Requisites of Pledges

Restat 1st of Security, § 1

§ 1 Pledge Defined

A pledge is a security interest in a chattel or in an intangible represented by an indispensable instrument, the interest being created by a bailment for the purpose of securing the payment of a debt or the performance of some other duty.

Special Note: Collateral security. The term "collateral" or "collateral security" is sometimes used to describe a pledge of instruments or documents. While this usage has some popular sanction and is not without judicial and other professional support, the terms have no established meaning. Bankers often use the term "collateral security" to include chattel mortgages, conditional sales, assignments of contracts, guaranties, and other forms of security as well as pledges. The terms "collateral" and "collateral security" are not used in the Restatement of this Subject.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Nature of pledge. The pledge is one of the simplest of the security devices. The fundamental idea of the pledge is possession by the pledgee. If the creditor's security interest depends upon possession obtained and held primarily for security, he has a pledge. If his security interest depends primarily upon title or is some other form of non-possessory charge, his security interest may be valid, but it is something other than a pledge.

The pledge differs from the common law lien, which is also a form of possessory security, in that the bailment by the pledgor is for the purpose of security, while the bailment which results in the privilege of retention by the holder of the common law lien is to enable some service to be rendered to the bailor, usually in respect of the chattel upon which the lien is claimed. For the Restatement of Possessory Liens, see Chapter 2.

In the Restatement of this Subject as in the Restatement of Torts (§ 216), a person who is in possession of a chattel is one who

(a) has physical control of a chattel with the intent to exercise such control in his behalf, or otherwise than as a servant on behalf of another, or

(b) has been in physical control of a chattel with intent to exercise such control, although he is no longer in physical control, if

- (i) he has not abandoned it, and
- (ii) no other person has obtained possession as stated in Clause (a), or

(c) has the privilege as against all persons to the immediate physical control of a chattel, if no other person is in possession as stated in Clauses (a) and (b).

The noun "pledge" is used throughout the Restatement only to mean a legal interest. The parties to the pledge transaction are the pledgor and pledgee. The transaction by which the pledgee or a third person is placed in possession is a bailment. The verb "to pledge" is used to denote the making of a bailment for the purpose of a pledge or the designation of a bailment already made for the purpose of constituting a pledge. "Pledged" as an adjective is used to describe personalty in which the pledgee has a pledge interest. The subject-matter of the pledge is personal property, that is, an interest in personalty. The subject-matter of the bailment out of which a pledge arises is a chattel. As to what is included in the term "chattel," see Comment *d*. As to the meaning of the term "indispensable instrument," see Comment *e*. As to the effect of the pledge of indispensable instruments and documents of title, see § 2, including Comment *a*. For certain modifications of the requirements of possession in case of bulky goods, see § 6. On the subject of relaxation of the rules as to maintenance of possession by the pledgee when pledged chattels are returned to the pledgor for temporary and limited purposes, see § 11(2).

The early common law recognized pledge interests only in tangible chattels. Modern law allows pledge interests also to be created in intangibles. With the development of the rules as to the assignability of choses in action, whether or not represented by indispensable instruments, and the consequent availability of choses in action to secure the performance of duties, the distinction between pledges and other security devices has often been obscured. The fusion of law and equity, the abolition of forms of action and other procedural changes, frequently make the protection accorded the creditor with a security interest in personalty much the same whatever the name given the security device. On the other hand, certain incidents have always been characteristic of pledges. Some of these are also found in connection with other forms of security. Since the incidents of pledge are primarily related to the fact that possession is in the pledgee, it has been thought desirable to restrict the concept of pledge as stated in § 1. This does not mean, of course, that security interests may not be created which, although not called pledges, have certain similar features. Security assignments of contracts are often called pledges, although they constitute title, rather than possessory, security. This Restatement does not consider an assignment of a contract as a pledge unless the contract is represented by an indispensable instrument. Where a chose in action is represented by an indispensable instrument, whether negotiable or non-negotiable, the chose in action may be pledged. Where the chose in action is not represented by an indispensable instrument, the assignment of the chose in action for the purpose of security is not considered in the Restatement as a pledge.

b. Pawn. Pledge and pawn were synonymous terms in the early common law. Modern usage tends to restrict the term "pawn" to the pledge of jewels and other personal chattels to pawnbrokers as security for small loans. In many states pawnbrokers are subject to statutory regulations affecting, among other things, the permissible terms in contracts between pawnor and pawnbroker. The pawnor's right of redemption is generally protected by special statutory requirements as to notice and public sale. The contract between pawnor and pawnbroker is sometimes interpreted as implying that the pawnor assumes no personal obligation to the pawnbroker but that the pawnbroker must rely solely upon the pawned chattel in the event that his loan is not repaid. In certain other transactions not involving pawnbrokers, the parties may similarly stipulate that the party giving the security is under no personal obligation. Where there is a debt or other duty on the bailor of the chattel but this duty is limited by the value of the chattel, the transaction does not involve any modification of the purpose of pledge as stated in the definition in § 1. Where there is no personal obligation, however, the transaction represents a contractual modification of the purpose therein stated. In such a case if the pawned chattel were destroyed by an act of God, the pawnbroker would lose the amount of his loan. The same problem is presented in respect to chattel and real estate mortgages and other forms of security interests where the parties agree that the debtor is under no personal duty except that of permitting the security to be used to satisfy the

demand of the creditor. The Restatement of this Subject does not deal with pawns as distinguished from pledges. It is convenient to consider pawns as pledges and to regard their slight variations as a permissible modification by statute or special agreement of the normal incidents of pledge. See Comment *g*.

c. Interest. The term "interest" is used in the Restatement of this Subject as in the *Restatement of Property*, § 5, both generically to include varying aggregates of rights, privileges, powers and immunities and distributively to mean any one of them. An interest in the law of pledges denotes therefore a legal relation. A pledge is the legal relation resulting from a bailment for the purpose of security and is not the subject-matter of the bailment. A pledgee's interest may be affected by other interests existing with respect to a pledged chattel. The holder of a share certificate, for example, may be subject to certain liens in favor of the issuing corporation. The creation of certain pledge interests may be forbidden by law. An instance of such a prohibition is the Federal statute making illegal the pledge of a pension certificate.

d. Chattel. The term "chattel" means any physical object which is capable of manual delivery and which is not the subject-matter of real property. It includes instruments and documents.

e. Indispensable instrument. An indispensable instrument as used in the Restatement of this Subject means the formal written evidence of an interest in intangibles, so representing the intangible that the enjoyment, transfer or enforcement of the intangible depends upon possession of the instrument. If the instrument cannot be produced, the interest which it represents can be effectively asserted only by accounting for the absence of the instrument and obtaining as a substitute for it, either a duplicate or some form of court decree. Indispensable instruments include not only negotiable instruments such as promissory notes and bills of exchange, but also share certificates, bonds, interim certificates, savings bank books and insurance policies. Where the instrument is not an indispensable one, for example, a written assignment of a list of book accounts as security, the interest obtained by the assignee in the accounts is not a pledge.

f. Bailment. The term "bailment" denotes the possession of a chattel, rightful as between the parties to the bailment, by one not its owner.

g. Debts and other duties and liabilities of a pledgor. A pledge is usually security for a debt, or other duty of the pledgor to the pledgee incurred when the pledge is made. The pledge may secure not the duty of the pledgor but the duty of another person on whose behalf the pledge has been made. One who thus acts for the accommodation of another may deliver the chattel to the debtor to be pledged by the latter or the accommodation party may himself be the pledgor. A pledge may also secure antecedent indebtedness and contingent or secondary obligations. A pledge may be made to secure future advances, but the interest of the pledgee as to future advances is subject to the title of bona fide purchasers from the pledgor and to the liens of attaching and levying creditors, acquired before the future advances are made, unless the pledgee has incurred an obligation to make the advances.

As indicated in Comment *b*, relating to pawn, the parties may agree that no formal obligation is incurred to the pledgee. This is a permissible contractual modification of the usual incidents of pledge. Without such modification the pledgee has both a right against the pledgor, or against one on whose behalf the pledge has been made, on a personal obligation and also a power to enforce his security interest in the pledged chattel. The pledgor or another is subject to a personal duty to pay or perform, and a liability to have the chattel sold to satisfy the debt or other duty. Where the personal obligation is eliminated the pledgor has the privilege of paying to redeem the chattel. The chattel remains subject to the interest of the pledgee. The definition in § 1 must be read with the realization that the parties may modify the normal purpose of pledge to the extent just indicated. Unless so modified every pledge includes a bailment, a duty, and an agreement that the bailment is to secure the performance of a duty. No pledge exists in the absence of a duty which the pledge secures, except where the pledgee relieves the pledgor from personal liability beyond the amount which can be realized from the pledged chattel. In such a case, the pledgee in case of negotiable instruments has a power of sale or a power to collect, subject to the pledgor's privilege of redemption. See §§ 48, 50, and 55. Unless the parties agree to the contrary, either the debt of the pledgor or, in the absence of a debt, the power of the pledgee, is

transferable and the pledge passes as an incident to such a transfer.

h. Cross references. For a discussion of contracts to pledge, including contracts purporting to create a present pledge without delivery by the pledgor, see § 10. For Comments on Bona Fide Purchasers, Notice and Value, see § 10, *d*, *e*, and *f*, respectively.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawSecured TransactionsPerfection & PriorityPerfectionMethodsFinancing
StatementsRequirementsContracts LawTypes of ContractsBailments



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Restat 1st of Security, § 2

§ 2 Subject-Matter Of Bailments as Affecting the Creation of Pledge Interests

(1) The bailment of goods creates an interest in the goods themselves.

(2) The bailment of a negotiable document of title creates an interest not only in the document of title but in the goods represented by it.

(3) The bailment of an indispensable instrument creates an interest not only in the instrument but in the intangible represented by it.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (2):*

a. Document of title. The term "document of title" is used as defined in the Uniform Sales Act, § 76. This definition is as follows: "'Document of title to goods' includes any bill of lading, dock warrant, warehouse receipt or order for the delivery of goods, or any other document used in the ordinary course of business in the sale or transfer of goods, as proof of the possession or control of the goods, or authorizing or purporting to authorize the possessor of the document to transfer or receive, either by indorsement or by delivery, goods represented by such document." While the bailment of a document of title with the intent to create a security interest will create a pledge, if the document is to the order of the pledgor, the pledgee is also entitled to the pledgor's indorsement. Even without an indorsement, the pledgee is invested with the interest of the pledgor, subject to the latter's power to redeem. The laws relating to negotiable documents of title determine the procedure to be followed by a pledgee in realizing upon his interest in an unindorsed document of title.

Illustrations:

1. A delivers to B a negotiable warehouse receipt for 10 bales of cotton as security for a loan. B has a pledge interest in the cotton as well as in the warehouse receipt.

2. A delivers to B an order bill of lading representing a railroad shipment of 1000 bushels of wheat as security for a

loan. B has a pledge interest in the wheat as well as in the bill of lading.

Comment on Subsection (3):

b. Instruments. Where a negotiable instrument is pledged, the pledgee acquires the interest of the pledgor, subject to the latter's power to redeem. Where the instrument requires the indorsement of the pledgor, the pledgee is entitled to such indorsement. The law of negotiable instruments determines the procedure to be followed by the pledgee in realizing upon his interest.

Where the instrument is an indispensable one but not negotiable, the delivery of the instrument, if made for the purpose of creating a pledge, transfers to the pledgee the pledgor's interest in the intangible represented by the instrument, subject to the pledgor's power to redeem. Where the instrument is not an indispensable one, the delivery may be evidence of an intent to make an assignment of the intangible, but the bailment alone creates an interest in the thing delivered rather than in the intangible represented by it. In the Restatement of this Subject, if an interest is created in an intangible, not represented by an indispensable instrument, it is considered a security assignment rather than a pledge.

Illustrations:

3. A delivers to B a bearer bond as security for a loan. B has a pledge interest in the obligation of the maker of the bond as well as in the paper.

4. A delivers to B a promissory note made by C to A. B has a pledge interest in the obligation of C as well as in the paper. As in the case of the pledge of other forms of negotiable instruments and negotiable documents of title, B's pledge interest will arise even if the note is not indorsed by A, although his powers in respect of enforcement will be affected by the lack of indorsement.

5. A delivers to B a file of papers constituting a construction contract between A and C. A intends to give B a security interest in the papers but not to assign the contract. B has a pledge interest in the papers but no interest in the contract. (Had A intended to assign the contract, B would have obtained a security interest in the contract, but this would not have been a pledge of the contract because the papers are not indispensable instruments.)

6. A delivers to B a list of book accounts with a written assignment of the accounts, as security for a loan. The interest B receives is not a pledge.

7. A delivers to B his automobile license as security for a loan. B has a pledge interest in the paper but not in the automobile. The license is not a document of title. B's pledge interest in the paper is in the nature of a worrying asset.

Legal Topics:

For related research and practice materials, see the following legal topics:

Commercial Law (UCC) Documents of Title (Article 7) Negotiation & Transfer Contracts Law Sales of Goods Title, Creditors & Good Faith Purchasers General Overview Contracts Law Types of Contracts Bailments



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Restat 1st of Security, § 3

§ 3 Increase or Profits

In the absence of an agreement to the contrary or a waiver by the pledgee, a pledgee has a pledge interest in the increase or profits of a pledged chattel.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Examples of increase and profits. A calf born to a pledged cow, wool grown on pledged sheep, interest accruing on pledged bonds, dividends on pledged share certificates, are typical of increase and profits which enhance the value of the pledge.

b. Increase and profits on corporate and other securities. Most modern pledges are subject to written agreement. This is particularly true of pledges of bonds and share certificates to banks and others. Under these agreements the pledgor is sometimes permitted to receive dividends and interest prior to default or demand by the pledgee. It is occasionally stipulated that interest and dividends accruing on pledged bonds and shares are to be applied to interest on the debt. Pledged share certificates are often allowed to remain in the name of the pledgor until default. In the absence of special agreement, which may be proved by a course of conduct, the pledgee is entitled to a security interest in dividends, and hence, in order conveniently to collect them, he has the privilege of having share certificates registered in his own name. When the pledgee does not transfer share certificates to his own name, that fact is evidence that the pledgee has waived his privilege of obtaining the dividends as additional security prior to default or notice and demand, and the pledgor may retain such dividends as are paid to him. For further discussion of the incidents of a pledge prior and subsequent to default, see Topics 2 and 3.

Illustrations:

1. A pledges to B a coupon bond. In the absence of agreement to the contrary B is entitled to collect the coupons as they mature and hold the proceeds as additional security.

2. A pledges to B a coupon bond. A has made similar pledges to B in connection with which B has agreed that prior to default A is entitled to receive the coupons as they mature. If the prior transactions amount to a regular course of dealings between the parties and if the pledge in question is of the same sort, these facts, in the absence of other circumstances, will justify the inference that the parties have contracted that A has the privilege of collecting the coupons prior to default.

3. A pledges to B a share certificate assigned in blank. B may register the certificate in his own name and if he does so, is entitled to retain the dividends paid as additional security.

4. A pledges to B a share certificate assigned in blank. B does not register the certificate in his own name. A receives the dividends. B subsequently demands that A pay the dividends to him. In the absence of other circumstances, the inference is justified that B has waived the privilege of collecting the dividends which have been paid and that prior to his demand this waiver is conclusive.

5. A pledges to B a share certificate which by mistake A does not assign in blank or to B. B is entitled to receive an assignment from A. Unless B waives his interest in the dividends even if A does not make such an assignment B is entitled to the dividends and may hold A accountable for them if A does not pay them to B as received.



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Restat 1st of Security, § 4

§ 4 Methods of Creating a Pledge

A pledge is created by the methods described in §§ 5 to 8 or by any other method sufficient to create a bailment for the purpose of security.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The normal method for creating a pledge is stated in § 5. Other methods commonly employed or recognized by the courts are stated in §§ 6 to 8. Any other method sufficient to create a bailment for the purpose of security, if made, creates a pledge.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawTypes of ContractsBailments



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Restat 1st of Security, § 5

§ 5 Manual Delivery

A pledge can be created by manual delivery of a chattel to a pledgee by a pledgor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. As in the case of gifts of chattels, delivery of a locked receptacle and its contents may be accomplished by the delivery of the means of gaining possession. A common example is the delivery of the key to a trunk or box. For the delivery of the key to be sufficient, other obstacles to the gaining of possession and control of the receptacle must be so slight that they can be dismissed as negligible.

b. Cross reference. For the use of the device of field storage warehousing as a method of effecting manual delivery, see § 11, Comment *d* and Illustrations.



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Restat 1st of Security, § 7

§ 7 Chattel Already in Possession of Pledgee

Where the chattel is already in the possession of the pledgee no additional delivery is required to create a pledge.

COMMENTS & ILLUSTRATIONS: *Illustrations:*

1. A delivers to B five bonds as security for a loan. Subsequently A borrows an additional amount from B and agrees that the pledged bonds are to be security also for the new loan. B acquires an additional pledge interest in the bonds.

2. A bank holds A's securities in a custodian account. A obtains a loan from the bank and agrees that certain named securities in the custodian account are to be pledged to secure the loan. The bank obtains a pledge interest in the securities in question.

3. A stores wheat in B's elevator. B subsequently makes A an advance on the security of the wheat. B acquires a pledge interest in the wheat.



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Restat 1st of Security, § 8

§ 8 Chattel in Possession of Third Person

Where the chattel is in the possession of a third person a pledge may be created by assent of the pledgor and notification by either pledgor or pledgee, to the third person, that the chattel has been pledged to the pledgee.

Special Note: The Uniform Warehouse Receipts Act, Section 42; the Uniform Bills of Lading Act, Section 33, and the United States Bills of Lading Act, 39 Stat. 543 (1916), 49 USCA Section 112 (1926) provide that prior to the negotiation of the warehouseman or the carrier of the transfer of a non-negotiable document, the interest of the transferee may be defeated by garnishment, attachment or execution by creditors of the transferor or by notification to the warehouseman or carrier of a subsequent transfer of the goods by the transferor.

On January 1, 1941, the Uniform Warehouse Receipts Act had been adopted in the District of Columbia, Code of 1929, title 27, Sections 1-87, and the following states and territories:

Ala. Code (1923) sections 10505-10564;
Alaska Comp. Laws (1933) sections 3211-3269;
Ariz. Rev. Code (1928) sections 3226-3274;
Ark. Dig. Stat. (1921) sections 10345, 10403a;
Cal. Gen. Laws (Deering, 1931) act 9059, sections 1-61;
Colo. Comp. Laws (1921) sections 4050-4108;
Conn. Gen. Stat. (1930) sections 4510-4568;
Del. Rev. Code (1935) sections 5893-5950;
Fla. Comp. Gen. Laws (1937) sections 6970-7024;
Idaho Code (1932) sections 67-101 to 67-159;
Ill. Ann. St. (Smith-Hurd) ch. 114, sections 233-292;
Ind. Stat. (Burns', 1933) sections 67-401 to 67-460;
Iowa Code (1935) sections 9661-9718;
Kansas Gen. Stat. (1935) sections 82-101 to 82-160;
Ky. Stat. sections 4767b-1 to 61;

La. Dart's Gen. Stat. (1932) sections 9859-9918;
 Me. Rev. Stat. (1930) ch. 163;
 Md. Code (Bagby's, 1924) art. 14-A, sections 1-60;
 Mass. Gen. Laws (1932) ch. 105, sections 7-66;
 Mich. Comp. Laws (1929) sections 9564-9622;
 Minn. Stat. (Mason, 1927) sections 5110-5171;
 Miss. Code (1930) sections 3481-3539;
 Mo. St. Ann. sections 14375-14430;
 Mont. Rev. Code (1935) sections 4079-4139;
 Neb. Comp. Stat. (1929) sections 88-101 to 88-162;
 Nev. Comp. Laws (1929) sections 7820-7880;
 N. J. Stat. Ann. sections 57:1-1 to 58:1-58;
 N. Mex. Comp. Stat. (1929) sections 148-101 to 148-160;
 N. Y. Gen. Business Law, sections 90-143;
 N. C. Code (1939) sections 4036-4095;
 N. D. Supp. (1925) sections 3125a1-3125a62;
 Ohio Gen. Code (1934) sections 8457-8509;
 Okla. Stat. Code 81: sections 261 to 384;
 Ore. Code (1930) sections 71-201 to 71-260;
 Pa. Stat. (Purdon, 1936) Tit. 6, sections 131-180;
 Philippine Is. Laws (1912) No. 2137;
 Puerto Rico Laws (1918) No. 9;
 R. I. Gen. Laws (1938) Chs. 465-469;
 S. D. Code (1939) sections 60.0401 to 60.0452;
 Tenn. Code (1932) sections 7532-7595;
 Texas Ann. Civ. St. (Vernon) arts. 5612-5665;
 Utah Rev. Stat. (1933) sections 99-0-1 to 99-0-56;
 Vt. Public Laws (1933) sections 7386-7444;
 Va. Code (1936) sections 1290-1347;
 Wash. Rev. Stat. (Rem., 1932) sections 3587-3646;
 W. Va. Code (1931) sections 47-5-1 to 47-5-58;
 Wis. Stat. (1939) sections 119.01-119.63;
 Wyo. Rev. Stat. (1931) sections 121-101 to 121-504.

On January 1, 1941, the Uniform Bills of Lading Act had been adopted in the following states and territories:

Ala. Code of 1928 (1936 Supp.) sections 10061(1)-10061(43);
 Alaska Comp. Laws (1933) sections 741-794;
 Ariz. Rev. Code (1928) sections 286-338;
 Cal. Civ. Code (Deering, 1933) sections 2126-2133 c;
 Conn. Gen. Stat. (1930) sections 4569-4621;
 Del. Rev. Code (1935) sections 5840-5892;
 Idaho Code (1932) sections 60-601 to 60-654;
 Ill. Ann. St. (Smith-Hurd) ch. 27, sections 1-56;
 Iowa Code (1935) sections 8245-8299;
 La. Dart's Gen. Stat. (1932) sections 8065-8119;
 Me. Rev. Stat. (1930) ch. 162;
 Md. Code (Bagby's 1924) act 14, sections 1-55;
 Mass. Gen. Laws (1932) ch. 108, sections 1-51;
 Mich. Comp. Laws (1929) sections 11516-11571;
 Minn. Stat. (Mason's, 1927) sections 4958-5015;

Mo. St. Ann. sections 14431-14482;
 Nev. Comp. Laws (1929) sections 795-851;
 N. Hamp. Pub. Laws (1926) ch. 314, sections 1-54;
 N. J. Stat. Ann. sections 48:20-1 to 48:20-54;
 N. Y. Personal Property Law, sections 187-241;
 N. C. Code (1939) sections 280-323;
 Ohio Gen. Code (1934) sections 8993-1 to 8993-54;
 Pa. 6 P. S. sections 51-105;
 R. I. Gen. Laws (1938) ch. 472, sections 1-16;
 S. C. Code (1932) sections 6964-7017;
 Vt. Public Laws (1933) sections 7333-7385;
 Wash. Rev. Stat. (Remington, 1932) sections 3647-3701;
 Wis. Stat. (1939) sections 120.01-120.55.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Pledge of non-negotiable documents. An important modern instance of this type of pledge is the delivery by the pledgor to the pledgee of a straight bill of lading or non-negotiable warehouse receipt with notification by either party to the carrier or warehouseman of the pledgee's interest. The delivery of the non-negotiable document, aside from creating a pledge of the paper itself, is an indication of the assent of the pledgor to the creation of a pledge and an authorization to the holder to notify the carrier or warehouseman of the pledge. A pledge is not created until notification to the carrier or warehouseman. A more satisfactory way of making such a pledge in the case of non-negotiable warehouse receipts is to issue the warehouse receipt directly to the pledgee. There is often an important business advantage in the use of non-negotiable warehouse receipts as security when the goods represented by a receipt are not commonly sold in even-running lots. The pledgee can then permit withdrawals for sale by the pledgor in convenient units without the necessity of the surrender of the warehouse receipt and the issuance of a new receipt for the remainder of the pledged goods.

Prior to the enactment of the Uniform Warehouse Receipts Act and the Uniform Bills of Lading Act in various states, there was considerable authority for the proposition that a pledge of goods may be created solely by the pledge of a non-negotiable warehouse receipt or straight bill of lading. Under these two Acts the delivery of non-negotiable warehouse receipts and bills of lading does not give the holder an interest in the goods prior to notification of the warehouseman or carrier. The Restatement of this Subject does not regard a pledge interest in goods as being created prior to notification. It is recognized, however, that if the parties so intend, an equitable interest in the intended pledgee may arise without such notification. For the effect of such an equitable interest, see § 10.

While ordinarily an agency cannot be created without consent of the agent (Restatement of Agency, § 15) it is not considered desirable to require the consent of the third person as a condition precedent to the creation of the pledge. The third person's duties are not altered in any material respect by the pledge. To make the third person's consent a test of the creation of the pledge would invest him with an arbitrary power of affecting the interests of the other parties. The third person of course may surrender the possession if he does not wish to be under any duty to the pledgee.

b. Notification. Unless otherwise agreed, there is notification of the pledge to the third person in possession of the chattel intended to be pledged

- (a) when the pledgor or pledgee states the fact of the pledge to the third person orally or in writing delivered to him personally; or
- (b) when a reasonable time has elapsed after a writing stating such fact has been delivered:
 - (i) to the place of business of the third person;
 - (ii) to a place designated by the third person as a place for the receipt of business communications, or
 - (iii) to a place which, in view of business customs or the relations between the parties, is

reasonably believed to be the place for the receipt of such communication by the third person.

See Restatement of Agency, § 11.

Illustrations:

1. A agrees with B that a chattel in the possession of C is to be security for an indebtedness of A to B. Before C is notified the chattel is attached by D, another creditor of A, who has no notice of the agreement. The attaching creditor has priority because no pledge is created before notification.

2. A agrees with B that a chattel in C's possession is to be security for an indebtedness of A to B. Before C is notified of the agreement, A sells the same chattel to D, a bona fide purchaser. Before D demands the chattel, B notifies C of the pledge. No legal pledge had been created at the time of the sale to D and D's title is not subject to the pledge interest claimed by C.

3. A gives B a straight bill of lading and a non-negotiable warehouse receipt, as security for an indebtedness of A to B. Before the carrier and the warehouseman are notified, a petition in bankruptcy is filed against A. No pledge is created. The trustee in bankruptcy is entitled to the goods represented by the bill of lading and the warehouse receipt.

4. A agrees with B that a chattel in C's possession is to be security for an indebtedness of A to B. B notifies C who refuses to acknowledge that B has an interest in the chattel. D attaches the chattel in C's possession. The pledge is valid and B has a pledge interest in the chattel, which is superior to D's interest.

Legal Topics:

For related research and practice materials, see the following legal topics:

Commercial Law (UCC) Documents of Title (Article 7) Negotiation & Transfer Contracts Law Secured Transactions Default Foreclosure & Repossession Enforcement Transportation Law Carrier Duties & Liabilities Bills of Lading



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Chapter 1 - Pledges

Topic 1 - Nature and Requisites of Pledges

Restat 1st of Security, § 9

§ 9 Writing

A writing is not necessary to create a pledge.

Special Note: As of January 1, 1941, the Louisiana Civil Code provides that a pledge good against third parties may not be created without a writing as well as a delivery, unless the subject-matter of the bailment is an indispensable instrument representing a chose in action, or is a document of title. Louisiana Civil Code (Dart 1932) Arts. 3158, 3176.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawTypes of ContractsBailmentsContracts LawTypes of ContractsChoses in Action



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Topic 1 - Nature and Requisites of Pledges

Restat 1st of Security, § 10

§ 10 Contract to Pledge

(1) Subject to the conditions stated in §§ 6 to 8, a contract for the immediate creation of a pledge unaccompanied by delivery of the chattel does not create a pledge, but if an obligation exists or arises which it is the purpose of the transaction to secure, the intended pledgee acquires an equitable interest in a specific chattel enforceable against the intended pledgor, but not against a bona fide purchaser nor against attaching or levying creditors who have become creditors of the intended pledgor without notice of the equitable interest.

(2) A contract to pledge a specified chattel at a future date does not of itself create a pledge, but the prospective pledgee acquires an equitable interest in the chattel similar to that stated in Subsection (1).

(3) A contract to pledge a chattel not in existence or which the prospective pledgor does not own or have the power of pledging does not create a pledge, but if the chattel is sufficiently identified and if an obligation exists or arises which the contract was intended to secure, the prospective pledgee acquires an equitable interest, similar to that stated in Subsection (1), in the chattel when it comes into existence or when the prospective pledgor gets either the title to it or the power of pledging it.

Special Note: Comment e in respect of bankruptcy must be qualified by a consideration of Section 60 a and b of the Chandler Act (1938) which reads as follows:

"Sec. 60. Preferred Creditors. -- a. A preference is a transfer, as defined in this Act, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before filing by or against him of the petition in bankruptcy, or of the original petition under chapter X, XI, XII, or XIII of this Act, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class. For the purpose of subdivisions a and b of this section, a transfer shall be deemed to have been made at the time when it became so far perfected that no bona-fide purchaser from the debtor and no creditor could thereafter have acquired any rights in the property so transferred

superior to the rights of the transferee therein, and, if such transfer is not so perfected prior to the filing of the petition in bankruptcy or of the original petition under Chapter X, XI, XII, or XIII of this Act, it shall be deemed to have been made immediately before bankruptcy.

"b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however,* That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction."

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Meaning of contract to pledge. The term "contract to pledge," when not qualified, is used both in the sense of an agreement purporting to create a present pledge without a bailment and to mean a contract to make a future bailment for the purpose of security. An agreement purporting to create a present pledge while the chattel remains in the pledgor's possession may be considered as equivalent to a contract to pledge just as words which import a present sale of unspecified goods are interpreted as a contract to sell.

A contract to pledge when the chattel is already in the possession of the pledgee creates a pledge (§ 7). A contract to pledge bulky goods in the possession of a pledgor, accompanied by an assumption of control by the pledgee, creates a pledge, as stated in § 6. A contract to pledge chattels in the possession of a third person, with notification to the third person, creates a pledge, as stated in § 8.

b. Obligation secured by contract to pledge. In order to give rise to an equitable interest in a promisee as the result of a promise to pledge there must be not only technical consideration for the promise but also the promisee must have made a loan to or rendered a service as a result of which the promisor is under a duty or subject to a liability, or the promisor must have received an extension or some forbearance on an existing obligation.

The pledge is such a simple, informal type of security device, and is so nearly free from statutory regulation and filing requirements, that it might seem that parties selecting it should be held strictly to its few requirements, and particularly to its basic requirement that the pledgee have possession of the pledged chattel, limited only by the restricted privilege of return to the pledgor for a temporary and limited purpose. If the parties wish the intended pledgor to remain in possession while creating a security interest in the pledgee, they have available an appropriate security device in the chattel mortgage. The requirement of possession by the pledgee has the advantage of obtaining certainty in the identification of the subject matter of the bailment and assuring the requisite publicity to the transaction. A rigid adherence to pledge requirements would refuse to recognize any security interest, even between the parties, as a result of a contract to pledge.

Opposed to the strict rules of pledge, aside from some considerations of commercial convenience, is the equitable principle that where persons have contracted to create an interest in identified property, equity will recognize a property interest as being created by such a contract and will give effect to this interest, when the legal remedy is inadequate and when to do so will not be inequitable to other parties. When one person has contracted to give a security for a debt which is not due for a considerable period, the creditor has no real remedy except in equity. If the debtor is solvent, legal damages can be only nominal, although there is the possibility that before maturity insolvency may occur with

consequent serious loss to the creditor.

Specific performance of contracts to pledge is rare, but is in accord with the theory of equitable jurisdiction and is supported by the analogy of specific performance of contracts to give chattel and real estate mortgages. There are several reasons why specific performance of pledge contracts is infrequent. If the contract to pledge is collateral to a contract to borrow and lend money, and the loan has not been made, there will be no specific performance of the pledge contract because equity will not decree specific performance of a contract to lend money. Where the obligation to the creditor has been incurred, its maturity date will generally occur so promptly that an enforcement of the creditor's legal rights will protect him adequately. Furthermore, the amounts involved are often too small to justify the expense of equity proceedings.

The principal instance of the recognition of equitable interests arising from contracts to pledge is found in cases involving the question of voidable preferences in bankruptcy and other insolvency proceedings. Most of the actual cases have been decided by the bankruptcy courts, although in determining the question of the existence of equitable interests the bankruptcy courts are governed by state law. At least since the 1910 Amendment to the United States Bankruptcy Act of 1898, the trustee in bankruptcy has the status of a judgment creditor. As to chattels and real estate in the possession of the bankrupt at the date of the petition in bankruptcy the trustee has the rights and privileges of a creditor who has obtained a lien by legal or equitable proceedings. As to chattels and real estate not in the bankrupt's possession, the trustee has the rights and privileges of a judgment creditor with execution returned unsatisfied. The recognition of an equitable interest in the obligee as a result of a contract to pledge usually occurs when there has been a contract to pledge at a time or under circumstances not amounting to a voidable preference at the date of the contract. If by state law the holder of an equitable interest prevails against a judgment creditor, he will prevail against the trustee, subject to any specific provisions of the Bankruptcy Act relating to preferential transfers. The general rule is that an equitable interest, which arises from a contract to pledge, can be defeated by a judgment creditor. In the decided cases the holder of the interest often has learned of the insolvency prior to the petition and has obtained possession of the chattel before the petition, but within four months. If the security interest arises from the taking of possession, the creditor has received a voidable preference. If, on the other hand, the security interest may be dated from the contract, no preference has occurred. The Restatement of this Subject takes the position that a contract to pledge creates an equitable interest which can be defeated only by a transfer of the chattel to a bona fide purchaser or by a lien obtained by a creditor, provided the creditor has not known of the equitable interest at the time he became a creditor. A trustee in bankruptcy in his official capacity cannot know as of the date of the petition of the existence of such an equitable interest. It follows, therefore, that when possession of the chattel is in the obligee of a contract to pledge at the date of the petition in bankruptcy, and the contract to pledge itself does not constitute a voidable preference, the obligee prevails against the trustee in bankruptcy. Under the Chandler Act, effective September 22, 1938, the trustee in bankruptcy can defeat the interest of a pledgee, where the bailment of the chattel occurs within four months of the petition in bankruptcy, and the pledgee at that time is affected with notice of the debtor's insolvency, irrespective of the time or circumstances of the contract to pledge. (See Special note to Comment *e*.)

In probate proceedings the holder of an equitable interest arising out of a contract to pledge can enforce his interest against an executor or administrator. This interest can also be enforced against an assignee for the benefit of creditors when the assignee acquires only the property interests of the assignor.

c. Bona fide purchaser. A bona fide purchaser is a transferee for value without notice of the pledgee's interest. See Restatement of Trusts, § 284. A bona fide purchaser includes a bona fide mortgagee or bona fide pledgee.

d. What constitutes notice. A person has notice of a pledge or of a contract to pledge if he or his agent knows of the pledge or the contract to pledge, has reason to know of them, or has been given notification of them. See Restatement of Agency, § 9. See as to what constitutes notification, § 8, Comment *b*.

e. Value. The Restatement of this Subject accepts the rules as to what constitutes value as stated in § 173 of the *Restatement of Restitution* and Unjust Enrichment. These rules adopt the rules of the Restatement of Trusts, §§ 298 and

309, except that in case of a transfer of property other than an interest in land, a transfer in satisfaction of or as security for a pre-existing debt or other obligation is a transfer for value.

A creditor, who attaches the chattel or obtains and docketts a judgment or levies execution is not a bona fide purchaser, nor is an assignee for the benefit of creditors, a receiver, or a trustee in bankruptcy. This is true whether the chattel consists of goods, instruments or documents of title.

The Uniform Sales Act, § 24, provides that when a seller of goods has a voidable title, but his title has not been avoided at the time of the sale, the buyer acquires a good title to the goods, provided he buys them in good faith, for value and without notice of the seller's defect of title. In § 76 of the Uniform Sales Act value is defined as "any consideration sufficient to support a simple contract. An antecedent or pre-existing claim whether for money or not, constitutes value where goods or documents of title are taken in satisfaction thereof or security therefor."

In the Restatement of this Subject the position taken in the Restatement of Trusts, § 302, and in the Restatement of Restitution and Unjust Enrichment, § 173, is followed, that a transfer of property in consideration of a promise to make payment in the future, is not a transfer for value unless the transferee would be liable upon his promise even if he were compelled to surrender the property, and unless he has so changed his position that it would be inequitable to compel him to surrender the subject matter of the property. With this exception, the Restatement of this Subject is in accord with the rules as to value of the Sales Act as well as with the Restatement of Restitution and Unjust Enrichment.

The attaching or levying creditor is not generally considered as one who has given value merely because he obtains by his attachment or levy a lien as a security for his antecedent debt. Such a judgment creditor has not been given security but has taken it by legal process. Attaching or levying creditors, however, prevail against holders of equitable interests arising from a contract to pledge, where they have become creditors without knowledge of the equitable interest. As has been stated in § 1, Comment *a*, the pledge historically and in legal theory is a security interest based on possession. Equity modifies this conception to give effect to equitable interests arising from contracts to pledge, in respect to the parties and to those whose knowledge of the equitable interest entitles them to no better position. This modification is strictly limited to situations where the modification will not itself be inequitable. The attaching or levying creditor opposed to the holder of an equitable interest as here described is the first to obtain possession. The attaching or levying creditor is thus accorded a priority against such equitable interests similar to that accorded one who has given value.

Statutes exist in some of the States which permit under certain circumstances security interests which are equivalent to pledges to arise from agreements to pledge. Still other statutes are concerned with the acquisition of liens rather than the creation of pledges. The latter deal especially with the rights and privileges of factors. See Chapter 2 of the Restatement of this Subject.

Illustrations:

1. A agrees with B to pledge a chattel as security for a loan. The loan is made but the chattel is not delivered. B will lose in an action of replevin since he is not a pledgee.

2. A agrees with B that he will pledge a chattel to B as security for a loan from B to A, which is made. C, who does not know of the agreement, levies on the chattel before delivery to B. The levy is good against B. The result would be the same if C were a bona fide purchaser.

3. Same facts as (2), except that C knows of the agreement at the time he became a creditor. B's equitable interest is prior to the lien C obtained by his levy.

4. A agrees with B to pledge a chattel to B as security for a debt already owing by A to B. The chattel is not delivered to B. C, knowing of the agreement, buys the chattel from A. B's equitable interest in the chattel is superior to C's title.

5. Same facts as Illustration (1), except that A delivers the chattel to B at a subsequent date within four months of the filing of a petition in bankruptcy against A; the latter being insolvent, of which B has knowledge at the time of the delivery. The pledge was not a voidable preference prior to the Chandler Act, since an equitable interest is created at the time of the agreement. There would be a voidable preference if the law of the state of the transaction did not regard the contract as creating an equitable interest. Under the Chandler Act there is a voidable preference unless the transfer is valid against a bona fide purchaser.

6. A agrees to pledge to B a horse which he expects to buy, as security for a loan made by B. A buys the horse and receives possession. Before delivery is made to B, C knowing of the agreement, buys the horse from A. B's interest is superior to C's title because B has an equitable interest from the time A acquired the horse.

Comment on Subsection (3):

While the equitable interest in an after-acquired chattel does not arise until the chattel is acquired, for the purpose of determining priorities in insolvency proceedings other than bankruptcy the interest is dated from the contract and not from the time of acquiring the chattel. There is a security interest as a result of the contract itself which is superseded by the equitable interest in the chattel when it is acquired. In bankruptcy proceedings the position of the equitable transferee since the Chandler Act, effective September 22, 1938, is determined by the provisions of Section 60 requiring the transfer to be so far perfected as to be valid against a bona fide purchaser. See Special note to Comment *e*.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil ProcedureJurisdictionSubject Matter JurisdictionJurisdiction Over ActionsConcurrent JurisdictionContracts
LawDebtor & Creditor RelationsContracts LawTypes of ContractsBona Fide Purchasers



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Restat 1st of Security, § 11

§ 11 Return of Chattel to Pledgor

(1) A surrender of the pledged chattel to the pledgor terminates the pledge subject to the conditions stated in Subsection (2).

(2) A pledge is not terminated by delivery of the chattel to the pledgor for a temporary and limited purpose relating to the maintenance of the value of the pledgee's interest and having to do with the protection, improvement or sale of the chattel, or where the chattel is an instrument or document, its handling or collection.

Special Note: On January 1, 1941, the Uniform Trust Receipts Act had been adopted in the following states:

Cal. Civil Codes sections 3012 to 3016.16;
Conn. Gen. Stat. Supp. 1939 section 12308;
Ill. Ann. Stat. (Smith-Hurd) ch. 121 1/2, sections 166-187;
Ind. Stat. (Burns', 1933) sections 51-601 to 51-621;
Mass. Gen. Laws, ch. 255-A, Laws of 1936, ch. 264.
New Hamp. Laws (1939) ch. 196;
New Jersey Stat. Ann. 46:35-1 to 46:35-21;
N. Y. Personal Property Law (McKinney, 1934) sections 50-58;
Ore. Supp. to Code of 1930 (1935) sections 63-1401 to 63-1421.
Tenn. Code Supp. (1938) sections 7298(1) to 7298(20);

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Pledgor's receipt for chattel. Where the pledgor, who has received possession for a temporary and limited purpose, gives the pledgee a written receipt, setting forth the pledgee's continued interest and the duties of the pledgor in respect to the pledge chattel, the document executed by the pledgor is often called a trust receipt. Such a trust receipt should not be confused with the tripartite trust receipt referred to in Comment *e*.

b. Pledgor as agent of pledgee. The possession of a pledged chattel by an agent of a pledgee has, in general, the same legal consequences as possession by the pledgee personally. As stated in § 8, a pledge may be created although the chattel is in the possession of a third person. Once the pledge has been created, a pledgor in the capacity of agent of the pledgee, might hold possession for the pledgee were it not that in the dual status of owner and agent, the pledgor might find his interests in conflict with those of the pledgee, and might be put in a position where his possession is deceptive to third persons. Even in case of temporary possession by the pledgor there is some danger of loss of identity of the pledged chattels with consequent dispute and litigation. There is some danger that the pledgor may be accorded a false credit rating by his possession of the pledged chattels. Aside from the possible injury to persons who extend credit during such possession, existing creditors may be induced to neglect measures available for their protection, and judgment creditors, not having the status of purchasers for value, may be put to useless expense in the expectation of having recourse against the pledged chattels in the possession of the pledgor.

The business advantages of enhancing the value of a pledge justify some relaxation of the general rule that the pledgee must have possession. On the other hand, the dangers just mentioned require that this relaxation be limited by its purpose, viz., the enhancement of the utility of the pledge as a security device.

c. Sale by pledgor in possession. The pledgor is generally the owner of the pledged chattel. As the owner he may sell it, as stated in § 16, subject to the interest of the pledgee, even where the pledgee is in possession. If the pledgee is in possession, his possession is notice that he may have an interest in it. Where title and possession are united in the pledgor, even temporarily, one who purchases for value without notice obtains title free from the pledgee's interest. The large importance of possession as a requisite of a pledge is indicated by the unusual rule that the prior legal interest of the pledgee can be cut off as a result of a sale by the pledgor in possession. Just as the pledgor himself may not deprive the pledgee of his interest in the property, so one who acquires the pledgor's title with notice of the pledgee's interest is subject to the pledge. If, however, the possession of the pledgor continues beyond the reasonable time necessary for the fulfilment of the purpose for which the chattel was returned, the pledge is terminated. Since the pledgee no longer has a pledge interest the pledgor's agreement to redeliver the chattel becomes equivalent to an agreement to pledge. Notice to a purchaser of the pledgee's equitable interest in such a case will subject the purchaser's title obtained from the pledgor to the pledgee's prior equitable interest.

The decisive difference between the situations under § 10 and under § 11 (2) is that if a pledgor sold a chattel he had contracted to pledge, he would sell before the creation of the pledge, while if he sold while he held for a temporary and limited purpose, he would sell during the existence of the pledge.

When the pledged chattel is returned to the pledgor for the pledgor's own convenience or the pledgor is allowed to retain the chattel beyond what fairly may be called a temporary and limited purpose, the pledgee retains at most an equitable interest similar to that which he obtains as a result of a contract to pledge. If the pledgor is allowed to mingle the pledged chattel with other chattels so that its identity is lost, the pledgee loses even this equitable interest.

The litigated cases usually involve third persons and the result is generally the same under modern procedure whether the pledgee retains his legal interest or has an equitable interest in place of it. However, it may still be important to determine whether the pledge exists or has been terminated when the issue concerns the procedure which may be followed by the pledgee in protecting his interest or in enforcing it. For example, unless the pledgee retains his legal interest he may be denied the right to bring replevin against the pledgor if the pledgor refuses to return the pledged chattel. See § 10.

Illustrations:

1. A pledges a chattel to B. B returns the chattel to A to keep until B calls for it. A sells the chattel to C, who knows of the arrangement with B. While B loses his legal pledge interest because the return is not for a temporary or limited purpose, he retains an equitable interest. Since the chattel is still identified and since C is not a bona fide purchaser, C's title is subject to B's interest.

2. Same facts as (1), except that B brings an action of replevin against C, after C receives possession of the chattel. B will lose since the pledge has been terminated and B's legal interest has expired.

3. A pledges a barrel of olive oil to B. B returns the oil to A for bottling and sale. C attaches the oil in A's possession. B may replevy the oil. C's knowledge of the pledge is immaterial, since C is not a bona fide purchaser.

d. Field storage warehousing. The business advantages of a return to the pledgor for a temporary and limited purpose can sometimes be obtained by the use of an arrangement known as field storage warehousing. This arrangement also facilitates temporary returns of pledged goods to the pledgor, especially for processing or sale.

A pledge is an attractive form of security device because of the simplicity of its creation and the absence of statutory requirements of filing or recording. On the other hand, it has the disadvantage of depriving the debtor of possession of the goods, instruments or documents out of which he may expect to satisfy his debt. He may need pledged goods for processing, for exhibition to prospective purchasers, or for delivery to buyers in advance of payment. While delivery to pledgor for a special and limited purpose is permitted, the pledgee always must face the possibility that it will be contended the purpose of the pledgor's possession is so extensive as to discharge the pledge. The more serious risk to the pledgee is that the goods will be sold, pledged or mortgaged to a bona fide purchaser, pledgee or mortgagee.

The device of field storage warehousing as an arrangement for allowing the pledgor a more convenient access to the pledged goods has had a considerable use. A characteristic method for employing this device is for the owner to lease a portion of the premises to a so-called warehouseman or warehouse company. Rent is nominal. The personnel of the warehouse organization usually consists of employees of the pledgor, although they may be duly licensed as warehousemen by the proper state or federal authorities. The area called a warehouse is separated from the rest of the building, access to such area is restricted to the so-called warehouse employees, and the goods to be pledged are moved to the nominal warehouse. Warehouse receipts are issued to the owner, who delivers them to the pledgee. Withdrawals are made only by following usual warehouse procedure.

Field storage warehousing has many variants. A portion of the premises may be leased directly to the pledgee, separated carefully from the rest of the establishment and an agent employed by the pledgee to receive and hold property pledged by the pledgor.

The test to be applied in field storage warehousing cases is whether there has been a real relinquishment of possession and control by the pledgor to pledgee, with such maintenance of the pledgee's possession and control as will give effective notice of the pledgee's interest to third persons. Evidence of such possession and control includes the definite separation of the warehouse or leased area from other parts of the pledgor's premises, conspicuous signs on the warehouse area or the leased premises, and on the outside of the building, and a bona fide observance by the parties of the possession and control which the pledgee is expected to have. The mere use of certain formalities will not suffice if other evidence shows that actual control has been left with the pledgor.

The purpose of field storage warehousing is not in itself to return the goods to the pledgor for a temporary and limited purpose. Goods in the "warehouse" or on the leased premises are intended to be in the possession of the pledgee. The pledgor is generally allowed in fact to remove part of the pledged goods for temporary and limited purposes. The principal object of field storage warehousing is to protect the pledgee in the event of bankruptcy of the pledgor while at the same time allowing the pledgor such business advantages as come from convenient access to the goods.

Notwithstanding the term "field storage warehousing," the device was used until recent years almost exclusively in facilitating the pledging of manufacturers' and dealers' goods. With the accumulation of a surplus of several kinds of agricultural products in the period following the World War, the scheme was also adapted to permit a similar pledging of goods stored on farms. In some cases statutes now provide that a farmer may obtain a license permitting him to store

products on his farm after designating certain buildings as warehouses. Warehouse receipts are issued in customary form covering the stored products. Some form of inspection is provided designed to assure safe storage of the products and the regular issuance of the receipts. The receipts are documents of title which may be pledged with the usual incidents of the pledge of warehouses receipts.

e. Uniform Trust Receipts Act. The Uniform Trust Receipts Act contains several provisions relating in certain situations to the return of a pledged chattel by a pledgee for temporary and limited purposes.

f. Cross reference. Questions relating to the priority of the pledgee and creditors of the pledgor are considered in § 35 of the Restatement of this Subject. For comments on Bona Fide Purchasers, Notice, and Value, see § 10, Comments *d*, *e*, and *f*.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawSecured TransactionsTrust Receipt Transactions



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Restat 1st of Security, § 12

§ 12 Stockbroker Purchasing Securities with His Own Funds on Customer's Order

(1) When a customer of a stockbroker instructs the broker to purchase stock exchange securities in whole or in part with the broker's funds, and the broker makes the purchase and obtains possession of the securities, the customer becomes the owner and the broker a pledgee to secure the amount he has thus lent to the customer.

(2) When a broker is thus acting for a number of customers at the same time in the purchase of securities of a fungible nature, the broker is a pledgee, although the amount corresponding to each order may not be identified and segregated until delivery to the customer or other disposition at the direction of the customer.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Effect of special contracts. A pledge is created in the circumstances set out in this Section only in case the parties by their contract have not made an agreement for some different result. A customer and broker may provide, of course, that although the broker's funds are used in a purchase of securities, and although the broker obtains possession of them, he has no privilege of using the subject-matter as security for the debt of the customer. Contracts between brokers and customers may however be subject to the Securities and Exchange Act, and the regulations of the Securities and Exchange Commission and of the Federal Reserve Board.

b. Agent's liens. An agent who has made advances for the purchase of goods for a principal ordinarily has either a security title or a lien for his advances except as stated in § 12 in respect to stockbrokers. See Restatement of Agency, § 464. The matter is further discussed in Chapter 2, § 61 of the Restatement of this Subject.

c. Margin transactions in shares and bonds. Where a stockbroker purchases securities for a customer in a margin transaction, the customer becomes the owner of the securities and a pledgor. The broker holds the securities as pledgee to secure the balance of the purchase price, which he has lent to the customer. The Restatement accepts the New York rule as to the pledgor-pledgee relationship of customer and broker in margin transactions. The New York rule is followed throughout the United States, except in Massachusetts, and in result seems to accord with the intent of the

parties. In Massachusetts the broker is regarded as the owner, who is under a contractual obligation to deliver the securities upon payment of purchase price. The English rule is generally assumed to be in accord with that in Massachusetts but the mechanism of margin trading in England is unlike that in the United States.

In the usual form of margin trading in the United States, the broker receives the securities from the seller within two days of the purchase. The securities, if share certificates, are usually transferred to the broker or his nominee on the books of the corporation. Share certificates and negotiable bonds are regarded as fungible goods so that the broker is not obliged to segregate securities belonging to any particular customer. The broker, however, is obliged to keep on hand enough securities to satisfy the possible demands of all his customers. The broker, except to the extent that he obtains such permission by special contract with the customer, is not allowed to mingle the securities and repledge them for his own borrowing, except to the extent of single loans in the amount due him by a particular customer. It is customary, however, for the customer to consent to the mingling of his securities with those of other customers to allow the broker to borrow larger amounts than the indebtedness of a single customer. Broker's borrowings are limited by the rules of stock exchanges, by the Securities Exchange Act and by the regulations of the Federal Reserve Board and the Securities and Exchange Commission.

No attempt is made in the Restatement of this Subject to state all the incidents of the relation of stockbroker and customer. For certain further incidents of this relationship, see §§ 41, 42, and 44.

Illustrations:

1. A, customer of B, a stockbroker, deposits \$ 5000 with B and orders B to buy for him 100 shares of United States Steel at 80. The broker buys the stock and has a certificate for 100 shares issued in his own name. B then makes an assignment for the benefit of creditors with the shares in his possession. In the absence of other claims or equities, A may pay the assignee \$ 3000 plus interest and commission and obtain the shares.

2. A, B and C are customers of D, a stockbroker. Each deposits \$ 5000 and each orders D to buy 100 shares of United States Steel for him subject to the customary margin requirements. D purchases 300 shares of Steel and obtains three 100-share certificates which he places in a box with several other Steel certificates. D in due course makes an assignment for the benefit of creditors. It is found that in various ways, which may be authorized or unauthorized, he has disposed of all the Steel stock except 240 shares. If there are no other claimants, A, B and C by paying the assignee the amount due D, after being credited for the value of 20 shares, may each obtain 80 shares.



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Restat 1st of Security, § 13

§ 13 Instruments and Documents of Title Attached to Bills of Exchange

Where a person attaches an indispensable instrument or document of title to a bill of exchange and discounts or obtains advances against the bill of exchange, he pledges the instrument or document as security for acceptance of a time bill of exchange or the payment of a sight or demand bill.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This Section like § 12 is an example of an important business use of the pledge device and also like § 12 is an instance of the creation of a pledge rather than a lien or some form of title security, although the parties have not stipulated in words for the creation of the pledgor-pledgee relationship. A seller, upon making a shipment to a buyer, frequently takes a bill of lading to his own order, attaches a bill of exchange on the buyer for the price of the goods and discounts the bill of exchange at his bank. Less commonly the seller follows the same practice with a negotiable warehouse receipt instead of a bill of lading. The bank either directly or through a correspondent presents to the buyer the bill of exchange for acceptance if a time bill, or for payment if a sight or demand bill. The buyer accepts or pays the bill of exchange, takes the document of title and obtains the goods from carrier or warehouseman. In domestic transactions the term "draft" is generally used instead of "bill of exchange" in describing such transactions.

b. Unindorsed documents of title and non-negotiable documents of title. If a negotiable document of title is made out to the order of the pledgor who does not indorse it, the pledgee nevertheless acquires the pledgor's interest. If the document of title is not negotiable the pledge is incomplete as stated in § 8 until the holder of the goods represented by the document of title is notified of the pledgee's possession of the document. See Uniform Warehouse Receipts Act, § 42, the Uniform Bills of Lading Act, § 33 and the United States Bills of Lading Act, 59 Stat. 543 (1916), 49 USCA § 112 (1926).

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsTypesBills of Exchange



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Restat 1st of Security, § 14

§ 14 Contractual Modification of Normal Incidents of Pledge

The pledgor and pledgee may not by contract or waiver modify the requirement of a bailment to create a pledge except as stated in § 6 in respect to bulky goods, nor may the pledgor surrender possession of the pledged chattel except for a temporary and limited purpose as stated in § 11, nor, as stated in § 55 may they provide for a forfeiture, but they may by contract or waiver modify the normal incidents of a pledge relating to their respective privileges and duties and in respect to the enforcement of a pledge.

INTRODUCTORY NOTE TO TOPICS 2 AND 3

Following Topic 1, which is concerned primarily with the creation of the pledge, this Chapter is divided into two topics dealing respectively with the characteristics of the pledge relationship and with the enforcement of the pledge. In general the two topics cover the incidents of the pledge relationship before and after default. No absolute division among the three topics is possible. Certain Sections, for example, § 46 in respect to the equitable remedies available to pledgor and pledgee, are applicable to the general subject matter of the other topics as well as to that of the topic under which they are included.

Pledge transactions in modern business frequently, if not usually, involve instruments or documents in respect to which a bona fide pledgee for value is protected irrespective of the power of the pledgor to make the pledge. In most cases the position of the pledgee is the same irrespective of the nature of the negotiable chattel. In Topics 2 and 3, therefore, unless the context requires otherwise, the term "negotiable instrument" is used to include not only bills of exchange, promissory notes, corporate and other bonds, but also negotiable warehouse receipts, order bills of lading, share certificates assigned in blank or with power of attorney, and interim certificates. The term "holder in due course" is used to mean not only holders in due course of bills and notes but also bona fide transferees for value of documents of title and share and interim certificates.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. See § 1, Comment *g* as to the possibility of the elimination of a personal obligation of the pledgor to the pledgee. With the exceptions stated in § 14 the parties may modify the normal incidents of pledge. While mention of the possibility of such modification is made from time to time in succeeding Sections, the general proposition stated in § 14 is a reminder that in most respects the pledge relationship is subject to the control of the parties.

Illustrations:

1. A and B agree that a pledge shall be created in B although possession of the pledged chattel is to be retained by A until demand by B and that B is to have all the rights, privileges and powers of a pledgee irrespective of a delivery. The contract does not make B a pledgee although it does give him an equitable interest in the chattel.

2. A pledges to B a chattel which B returns to him to keep until demand and use for A's purposes but A agrees that B is to retain all the rights, privileges and powers of a pledgee. The contract will not enable B to retain his legal interest as pledgee though an equitable interest will arise.

3. A pledges to B a chattel and agrees that B may use it as he sees fit without liability for loss or damage. B loses the chattel without negligence. B is under no liability to A on account of such loss.

4. A pledges to B a chattel with a stipulation that B may not assign his pledge interest in the chattel without A's consent. B assigns A's obligation to him and at the same time assigns his pledge interest in the chattel. A may sue B as a converter.

5. A pledges to B promissory notes which, according to the usual rules of pledge, B may not sell on default. A agrees that on default B may sell the notes. B's sale under this power is valid.

6. Same facts as (5), except that A also agrees that, contrary to the usual rules of pledge, B may buy the notes himself at a public sale. A purchase by B in accordance with this permission is valid.

Legal Topics:

For related research and practice materials, see the following legal topics:

Commercial Law (UCC) Documents of Title (Article 7) Negotiation & Transfer Contracts Law Negotiable Instruments Enforcement Duties & Liabilities of Parties Types of Parties Holders in Due Course General Overview Contracts Law Types of Contracts Bailments



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Restat 1st of Security, § 15

§ 15 Breach of Contract by Pledgor

(1) Where an agreement to secure the performance of an act by a pledge is a material and indivisible part of a contract between two parties, a failure to make a pledge as agreed is a total breach of contract.

(2) Under the rule stated in Subsection (1) a total breach of contract results where the pledgor

(a) makes no pledge, or

(b) lacks either the power or the privilege to make the pledge which he purports to make, or

(c) makes a pledge which is materially different from the one which he agreed to make.

(3) Where the pledgor voluntarily and without consideration undertakes to make a pledge to secure his or another's existing obligation, the pledgee has no right of action because of a failure of the pledgor to perform his undertaking.

COMMENTS & ILLUSTRATIONS: *Comment on Subsections (1) and (2):*

a. A pledge may be created in four situations. The first and most important is to fulfil a contractual duty to secure the performance of an act, which is generally a personal obligation, usually for the payment of money by the pledgor or less frequently by a third person. The second is where the pledgor makes a pledge to obtain a modification of an existing contract between the pledgee and himself or a third person. This often occurs in consideration of an extension of an obligation by the pledgee. The third is where a pledge is made for a consideration not relating to the principal obligation. The fourth is where a pledge is made voluntarily and without consideration to secure an existing obligation. The rule stated in this Section recognizes that where a contract includes a duty to secure the performance of an act by the creation of a pledge interest, the failure either to create any pledge interest or to create a pledge interest substantially similar to that which is promised is a total breach of contract.

Circumstances may exist where the failure to make a pledge as agreed is not a total breach either because the variation between promise and performance is so slight as to be immaterial (see Restatement of Contracts, § 275) or

because the pledge agreement which is not carried out is contained in a part of the contract which is divisible (see Restatement of Contracts, § 266).

The pledgor normally is the party under a personal obligation to the pledgee but it is also possible for a pledge to be made as security for the obligation of another. The making of a pledge includes a contract that the pledgor is the owner with the privilege to pledge, or, if not the owner, that he has been authorized to create the pledge interest. Unless the contrary intention appears, the pledgee is entitled to assume that the pledgor has the power and the privilege of creating a paramount interest in the pledged chattel. If the pledgor has a life interest, is a bailee for a term, is a conditional vendee, or has previously given a chattel mortgage, the pledgor can pledge the chattel to the extent of his interest. It is the duty of the pledgor, however, to disclose his limited interest so that the pledgee may not be deceived. Circumstances, as well as words, may indicate that the pledgee has accepted a pledge interest subject to prior interests, in fulfilment of the pledgor's contractual duty. Since the pledgee is entitled otherwise to assume that the pledgor has the power and privilege to create a paramount interest, the pledgee's remedies in respect to the pledgor or other debtor will not be affected by the fact that an encumbrance on the pledged chattel is a matter of public record.

b. Remedies for breach of contract. A total breach of contract is a breach where remedial rights provided by law are substituted for all the existing contractual rights, or can be so substituted by the injured party. A partial breach of contract is a breach where remedial rights provided by law can be substituted by the injured party for only part of the existing contractual rights. Restatement of Contracts, § 313. Any breach is total if it consists of such non-performance of a promise as is material. Restatement of Contracts, §§ 317 and 275. Where there has been a total breach of contract, the injured party may by continuance or assenting to the continuance of performance, or by otherwise manifesting an intention to do so, treat the breach as partial. Restatement of Contracts, § 317.

The judicial remedies for breach of contract are judgments and decrees for

- (a) damages, meaning a sum of money awarded as compensation for injury caused by a breach of contract;
- (b) restitution, meaning either
 - (i) the restoration of a specific thing, or
 - (ii) the payment of the value in money of a performance rendered by one and received by another;
- (c) specific performance, meaning the rendering, as nearly as is practicable, of a promised performance. Restatement of contracts, § 326.

In the case of a breach of contract due to the failure of the pledgor to make a pledge as agreed, the remedy of a judgment for damages is of little importance where the pledgee has the personal obligation of the pledgor or another. The pledgee can rarely show any damages as a result of the pledgor's failure to make the pledge as agreed.

Restitution is the chief remedy of the pledgee for breach of contract to make a pledge (see Restatement of Contracts, § 347). The pledgee can offer to return whatever he has received from the pledgor and demand the restitution of whatever he has given (see Restatement of Contracts, § 349). If a chattel is pledged, which is claimed by a third person, the pledgee can take appropriate steps to have the ownership of the chattel judicially determined.

Occasions for specific performance are rare in pledge cases. Transactions involving large amounts are generally supervised by experienced counsel who define by written agreement the interest of the parties and permit no advances until the pledgee has delivered the required securities. In other cases the amounts involved are usually small and the maturities short. In respect to either large or small transactions, even where the legal remedy is inadequate a court of equity may not be able to make an effective decree. Where a long term obligation exists which constitutes a valuable investment and it is possible for the pledgor to be compelled to make the pledge agreed upon, the case is a proper one for specific performance (see Restatement of Contracts, § 358).

Illustrations:

1. B lends A \$ 1000 for 90 days on A's agreement to pledge ten corporate shares as security. A does not make the pledge. This is a breach of contract by A. B has an immediate right of action against A for the restitution of \$ 1000.

2. Same facts as Illustration 1, except that B makes the loan on A's agreement that C will pledge the shares. C's failure to make the pledge is a breach of the contract between A and B. B has an immediate right of action against A for the restitution of \$ 1000.

3. B lends A \$ 1000 for 90 days without security. At maturity A agrees to pledge 10 corporate shares if B will extend the debt for 30 days. B makes the extension but A does not make the pledge. A new contract has been made which has been broken by A. B may sue at once for the \$ 1000 with interest to date of judgment.

4. B lends A \$ 1000 for 90 days on A's agreement to pledge a certain painting. A delivers the painting but the painting is owned by A's wife, who has, however, authorized A to pledge it. The pledge is valid and A has fulfilled his contractual duty.

5. Same facts as Illustration 4 except that A's wife has given no permission to make the pledge. A is guilty of breach of contract and B can sue at once for \$ 1000.

6. Same facts as Illustration 4 except that the painting is subject to a chattel mortgage, duly filed. B can sue at once for \$ 1000.

7. B lends A \$ 1000 for 90 days on A's agreement to pledge a certain painting by Corot. The painting is delivered but it is owned by A's wife who has given no permission to A to make the pledge. A subsequently obtains the permission before B discovers his lack of power. B can treat the contract as broken or can acquiesce in A's performance.

8. B lends A \$ 100,000 for four years at seven per cent upon A's agreement to pledge \$ 150,000 in mortgage bonds owned by A and in A's possession. A does not deliver the bonds within a reasonable time. B can treat A's conduct as a total breach of contract, or he can have an action in equity against A for specific performance.

Comment on Subsection (2) (c):

c. Where the agreement to pledge requires the pledge of a particular object, for example a specific painting by a specific artist, the pledge of a different painting without the pledgee's consent will be a breach of contract. Where the agreement is in general terms to pledge securities or commodities having a stated value a material difference in nature will be a total breach of contract. On the other hand where, for example, there is an agreement to pledge a long list of securities, a slight variation between the securities listed in the agreement and the securities actually delivered, the value being substantially the same, will be a partial breach.

d. *Power and privilege.* A power is an ability on the part of a person to produce a change in a given legal relation by doing or not doing a given act (see *Restatement of Property*, § 3).

A privilege is a legal freedom on the part of one person as against another to do a given act or a legal freedom not to do a given act (see *Restatement of Property*, § 2).

The term "right" is not used in the sense of power or privilege because of the restriction of the word "right" to mean a legally enforceable claim of one person against another that the other shall do a given act or shall not do a given act. *Restatement of Property*, § 1.

Comment on Subsection 3:

e. Power without privilege. The pledgor may have the power to make a pledge although he has no privilege to do so. Thus where the pledgor is in possession of negotiable instruments, where he is a trustee or where he has obtained title to a chattel by fraud, he can create a pledge interest if the pledgee gives value in good faith. The rule stated in Subsection (3) requires the pledgor to have both the power and the privilege to make a pledge. While the pledgee does obtain a pledge interest which he can defend if he desires, the lack of privilege on the part of the pledgor can be considered a complete breach of contract at the option of the pledgee, because otherwise the pledgee would be compelled to accept the advantages of the pledgor's wrong. If, however, the pledgee, having received his pledge interest in good faith, wishes to maintain his pledge interest and is subjected to expense to protect his interest, the pledgor is responsible for this expense because the attack on the pledgee's interest is a consequence of the pledgor's breach of duty to a third person. The pledgee's successful defense is due to the strength of his own position, not to that of the pledgor. Where the pledgor has both the power and the privilege to make the pledge, he has no responsibility for expenses that may be incurred by the pledgee to defend himself from claims of third persons.

Illustrations:

9. A, in possession of negotiable bonds which he does not have the privilege to pledge, pledges them to B, a holder in due course, to secure a loan. A is guilty of a breach of contract, since he did not have the privilege to make the pledge, although he had the power to do so. If C, the owner, brings replevin, and B defends the suit successfully, A is liable in damages to B because of the partial breach of contract. If B wishes to refuse the security, he may do so and sue A at once for the amount due.

10. Same facts as Illustration 9, except that A pledges, pursuant to contract, non-negotiable chattels, to which he has obtained title by fraud. The same consequences follow as under Illustration 9.

11. Same facts as Illustration 10, except that A is a trustee of non-negotiable chattels, in which as a result of A's conduct, B obtains a valid pledge interest. The same consequences follow as under Illustration 9.

Comment on Subsection 4:

f. Where an existing contract is modified in connection with an agreement to make a pledge, a new contract arises and the rules of Subsections (1) to (3) apply. A common instance is when a pledge is made in consideration of an extension or some forbearance. To be consideration the forbearance must be bargained for (see Restatement of Contracts, § 75 and Comment *b*). Thus where a demand debt exists and a pledge is made and a forbearance results which is not a part of the bargain between pledgor and pledgee, there is no consideration.

If a pledge were made in such circumstances, although not in accordance with the pledgor's promise, the pledge would be valid since an antecedent debt is value (see § 10, Comment *f*). One must distinguish in such a case between the contractual relation arising from the contract itself and a contract of which an agreement to pledge is a part which either creates a principal obligation or modifies it.

A pledge may be made to secure an existing contract for a consideration that does not relate to the principal contract. While the pledgee in such a case is entitled to the customary remedies for breach of contract, these remedies affect only the new pledge contract and not the principal obligation of the pledgor. The rule stated in Subsection (4) deals with the situation where the pledgor, not in fulfilment of any contractual duty, undertakes to make a pledge and either makes no pledge or does not make the pledge which he undertook to make. In this case since there is no contractual duty, there is no breach of contract. The pledgee has no right of action because of the failure of the pledgor to carry out his undertaking.

Illustrations:

12. A owes B \$ 1000 without security. Before the maturity of the debt A agrees with B to pledge share certificates having a market value of \$ 1500 provided B will buy from A a motor car for \$ 750. A does not make the pledge. The

result is a breach of the second contract, but the first is not affected.

13. A owes B \$ 1000 payable in six months. B asks A for security. A promises to pledge two paintings. One painting is not pledged and although A delivers the other, he does not own it and has no permission to pledge it. No breach of contract results.

14. A owes B \$ 1000, payable on demand. B asks A to secure the debt. A promises to pledge a painting, hoping that B will forbear to demand payment. B makes no such agreement but in fact does forbear for a brief period. A refuses to deliver the painting. There is no consideration for A's promise and A is not guilty of a breach of contract.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawBreachNonperformanceContracts LawBreachTotal Breach



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Restat 1st of Security, § 16

§ 16 Transfer by Pledgor

Where the pledgor transfers a pledged chattel to a third person, the transferee acquires the pledgor's interest in the chattel but the transferee's interest is subject to the interest of the pledgee unless the transferee is a
(a) bona fide purchaser from a pledgor who is in possession with the consent of the pledgee and the purchaser has relied upon the pledgor's possession, or
(b) holder in due course of a negotiable instrument.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The pledgee's interest is primarily dependent upon possession. His paramount interest cannot be defeated by a purchaser from the pledgor, so long as the pledgee retains possession. The pledgee's possession is notice of his pledge interest. When the pledgee's claim is satisfied, the transferee of the pledgor is entitled to the full enjoyment of his ownership. As owner, the transferee has the privilege of redeeming the chattel (see § 54).

If the pledgor is in possession with the consent of the pledgee, title and possession are united in him, and he can transfer to a bona fide purchaser, title unencumbered by the pledge interest provided the purchaser relies on pledgor's possession. Bona fide purchasers include bona fide pledgees and mortgagees (see § 10, Comment *d*). Possession may be delivered to a pledgor, without terminating the pledge, only for a temporary and limited purpose relating to the maintenance of the value of the pledgee's interest and having to do with the protection, improvement or sale of the chattel, or where the chattel is an instrument or document, its handling or collection. Even in such a case, however, the bona fide purchaser from the pledgor, who has relied on the latter's possession will prevail against the pledgee (see § 11, Subsection 2, and Comment *c*).

The pledgee's possessory interest is a legal one. If the pledgor obtains possession of a non-negotiable pledged chattel without the pledgee's consent, a bona fide purchaser from the pledgor is subject to the pledgee's interest. If the possession is obtained by fraud, the pledgee's interest can be defeated by a transfer to a bona fide purchaser who relies upon the pledgor's possession. Unless the chattel is negotiable, the pledgee cannot be deprived of his interest in it by

theft or otherwise involuntarily.

Illustrations:

1. A pledges a painting to B as security for a loan. A, while B is in possession, sells the painting to C. C obtains legal title, subject to B's pledge interest.

2. A pledges a painting to B as security for a loan. B returns the painting to A for a temporary and limited purpose. A sells to C, a bona fide purchaser, who relies on A's possession. C's title is not subject to the pledge.

3. Same facts as Illustration 2, except that A pledges the painting to C as security for a new loan. C is a bona fide purchaser to the extent of his pledge interest.

4. A pledges a painting to B as security for a loan. A without B's consent obtains possession of the painting and sells it to C, a bona fide purchaser who relies on A's possession. C's title is subject to B's pledge interest.

5. Same facts as Illustration 4, except that A obtains possession by representing to B that he wishes to clean the picture. C's title is not subject to B's pledge interest.

6. A pledges a painting to B. B returns the painting to A for a temporary and limited purpose. A transfers the painting to C by deed. C neither knows of the pledge nor of A's possession. A returns the painting to B. C's title is subject to B's pledge interest.

7. Same facts as Illustration 6, but A delivers the painting to C before C learns of B's pledge interest. C's title is not subject to B's pledge interest.

b. Meaning of term "transfer." The term "transfer" when applied to interests in chattels is used throughout this Restatement to mean an extinguishment of such interests existing in one person and the creation of such interests in another person (see *Restatement of Property*, § 13).

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law
Negotiable Instruments
Enforcement
Duties & Liabilities of Parties
Types of Parties
Holders in Due
Course
General Overview
Contracts Law
Types of Contracts
Bona Fide Purchasers



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Restat 1st of Security, § 17

§ 17 Pledgee's Duty of Reasonable Care

The pledgee owes to the pledgor the duty of reasonable care of the pledged chattel except where the chattel is in the possession of a third person designated by the pledgor or is in the possession of the pledgor himself.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule of reasonable care expressed in this Section is confined to the physical care of the chattel, whether an object such as a horse or piece of jewelry, or a negotiable instrument or document of title. In the case of an instrument or document the pledgee also has other duties in certain circumstances. See as to the pledgee's duty to collect, § 18, and as to when the pledgee's duty ceases, § 32.

b. The care which the pledgee is required to exercise in connection with his possession of a pledged chattel is that which a reasonable man under like circumstances would recognize as necessary to prevent his conduct from creating an unreasonable risk of harm to the pledgor's chattel.

Where the care by the pledgee involves an unforeseen expense, the pledgee can usually satisfy his duty of due care by giving the pledgor notice of the care which the pledged chattel requires and giving the pledgor himself the opportunity to care for the chattel. Thus where an animal is pledged which becomes ill under circumstances not requiring emergency treatment and the pledgee notifies the pledgor so that the latter, if he wishes, can procure the services of the veterinary, the pledgee satisfies his duty of due care.

The pledgee in possession is a bailee and the rule stated in this Section is the rule as to a bailee's liability for lack of reasonable care (see Restatement of Torts, § 298 and Comment *a*). As to compensation and reimbursement for expenses incurred by the pledgee in performance of his duty of reasonable care, see §§ 25 and 26.

c. Negligence by the pledgee does not result in a forfeiture of his pledge interest. See § 19, Comment *b*.



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Restat 1st of Security, § 18

§ 18 Pledgee's Duty to Collect Instruments

Where instruments representing claims of the pledgor against third persons are pledged, the pledgee has the duty of using reasonable diligence to preserve and collect the claims or to enable the pledgor to undertake such preservation and collection.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The duty stated in this Section is in addition to the rule of reasonable physical care stated in § 17. A violation of this duty is also negligence. If bills and notes are pledged, the pledgee as a holder is under a duty to present the paper for payment and to take proper steps to preserve his own rights and those of the pledgor against other parties to the instruments. In the case of insolvency proceedings known to the pledgee he is responsible for filing a proof of claim within the stipulated time for asserting claims unless he enables the pledgor to file such claim. The pledgee is generally under no duty to incur any material expenses. In this connection the pledgee usually has no duty to sue but circumstances may be such that a duty to sue will be inferred. For example, if the bringing of timely suit against a solvent person will prevent the running of the statute of limitations, the pledgee should institute the suit.

If the pledgee makes it possible by notice and other action appropriate in the circumstances, for the pledgor to enforce pledged instruments, the pledgor cannot complain of the pledgee's non-action. The pledgee has no duty to make advances out of proportion to his interest in pledged instruments, even if he has the privilege of doing so. See § 25. If a second mortgage note is pledged, for example, the pledgee has no duty to make advances to prevent the foreclosure of a first mortgage. The pledgee is not liable for a decline in the value of pledged instruments, even if timely action could have prevented such decline.

Illustrations:

1. A pledges to B as security for a loan of \$ 1000 a note for \$ 1500 payable to A by C, indorsed by D and secured by a chattel mortgage given by C. The note is indorsed to B and the mortgage assigned to him. At the maturity of the

note C is insolvent. B makes no effort to present the note to C with the result that D's liability is discharged. D is solvent. The mortgaged property is sold for \$ 500 which is applied on A's debt. B is accountable to A for the difference between the value of the mortgaged property and the amount of the note, that is, \$ 1000. The net result is that B owes A \$ 500.

2. Same facts as Illustration 1, except that D as well as C is insolvent, and B fails to refile the chattel mortgage and it becomes void. B is accountable to A for the value of the mortgaged chattels.

3. Same facts as Illustration 1, except that B presents the note to C and gives proper notice to D. B takes no steps to sue either C or D, nor to enforce the mortgage. C and D become insolvent and the mortgaged chattels, although worth the amount of the debt at the maturity of the mortgage note, subsequently become worthless. B is not liable to A for the resulting loss.

4. A pledges to B by indorsement and delivery a note for \$ 1000 payable by C to A. The note is already several years past due, and B holds the note when the statute of limitations is about to run. C is solvent. B is under a duty to sue C if the note is not paid, or to make it possible for A to bring the action.



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Restat 1st of Security, § 19

§ 19 Pledgee's Duty to Refrain From Wilful Harm

The pledgee owes to the pledgor the duty to refrain from wilful harm to the pledged chattel.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The wilful harm meant by the rule stated in this Section is such harm as does not cause such a substantial alteration in the chattel as to amount to a conversion.

b. Following the usual rules of bailments in respect to negligence and trespass by bailees, neither negligence nor wilful harm by a pledgee results in a termination of a pledge unless the negligence or wilful harm causes the destruction of the pledged chattel or unless the wilful harm results in a substantial alteration of the chattel. While the actual consequences of negligence or wilful harm may be as serious as a conversion, the assumption of dominion, which is involved in conversion, has always resulted in a forfeiture of a bailee's interest and a liability for damages for the full value of the converted chattel in contrast to the rule of liability for actual harm done in case of negligence or trespass. Negligence or wilful harm, therefore, by a pledgee does not amount to a forfeiture of the pledge interest. For the remedies of a pledgor because of negligence or wilful harm by a pledgee, see § 20. For the consequences of a conversion by a pledgee, see § 24.



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Restat 1st of Security, § 20

§ 20 Pledgor's Remedies for Negligence or Wilful Harm

(1) Where the pledgee violates his duty of reasonable care or is guilty of wilful harm, the pledgor
(a) has an immediate right of action for damages against the pledgee, or
(b) can set off the amount of his damages in any action against him by the pledgee, or
(c) subsequent to tender or performance at or after maturity of the claim secured by the pledge,
can hold the pledgee on his duty to return the pledged chattel unharmed.

(2) Where the pledgee has violated his duty in respect to the collection of instruments, the pledgor has the remedies stated in Subsection (1), Clauses (a) or (b).

(3) The damages of the pledgor under the rules stated in Subsections (1) and (2) are limited to the value of the pledgor's interest in the chattel unless the pledgee has received a tender or performance of the obligation.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1), Clause (a) and on Subsection (3):*

a. Suit by pledgor prior to maturity. Neither negligence nor wilful harm, unless the wilful harm amounts to a conversion, results in a termination of the bailment upon which the pledge depends. If the negligence or wilful harm results in damage to the pledgor's interest, the cause of action in favor of the pledgor arises when the wrong is done. In most instances, because the term of obligations secured by pledges is usually short, it will be possible to settle all controversies between the parties in one action. If, however, the obligation secured by the pledge is not due, the pledgor is not obliged to postpone enforcing his right of action for the negligence or the wilful harm. If the pledgor chooses to sue at once for the wrong done, he must show damage to his interest in order to have a substantial recovery. Since in such a case, the obligation is still outstanding, the pledgor can recover only the difference between the obligation and the value of the chattel if the chattel is worth more than the amount of the obligation. In such a suit it will be necessary to determine the amount of the harm and the value of the chattel. Even if it is found that the obligation secured by the pledge is equal to or greater than the value of the pledged chattel, the net effect of the judgment will be to decrease the amount the pledgor must pay to the pledgee on the obligation.

The value of the pledgor's interest in the chattel is computed on the basis of its value immediately before the harm is done.

The pledgor's interest is ordinarily the value of the chattel less the pledgee's interest. If a third person also has an interest the pledgor may have the privilege, or be under a duty, to recover for the damage done to the interest of the third person.

Illustrations:

1. A pledges to B a motor car worth \$ 400 to secure a debt of \$ 500. B wilfully harms the car reducing its value by \$ 50. Without tendering \$ 500, A sues B for the tort. A cannot recover the amount of the damage because B's interest is worth more than the value of the car.

2. Same facts as Illustration 1, except after maturity of the debt, B sells the car for \$ 350 and sues A for \$ 150. B may set off his damage due to the tort. B's recovery will be limited to \$ 100.

3. Same facts as Illustration 1, but at the maturity of the debt A pays B \$ 500 and B returns the car. A can obtain judgment against B for \$ 50.

Comment on Subsection (1) Clause (b):

b. Where the pledgor's performance is due and the pledgee attempts to enforce the performance, it is convenient to settle mutual claims in a single action. In the early law recoupment was permitted as a defense on account of claims arising out of the same transaction, but the plea of recoupment did not entitle the person making the plea to an affirmative judgment, but only to a reduction or extinguishment of liability. Statutes of set-off and counterclaim exist generally throughout the United States and whatever their differences of detail are sufficiently broad in scope to permit either a pledgor or pledgee not only to reduce or extinguish the claim of the other by way of set-off but also in a proper case to obtain an affirmative judgment.

In the Restatement of this Topic the term set-off is used as a general term to describe the balancing of mutual liabilities in respect to the pledge relationship rather than as referring to any technical procedure of recoupment, set-off or counterclaim.

Illustrations:

4. A pledges a chattel to B, who negligently cares for the chattel. After the maturity of the debt, A sues B for the damage caused by B's negligence. B may set off the amount of the debt. Judgment will be for B in the amount of the debt less the damage to the chattel unless the damage to the chattel is greater than the debt.

5. A pledges a chattel to B. B wilfully harms the chattel. B sues A on the debt. A can set off his damage due to the harm. If the harm to the chattel has resulted in damage to A in excess of the debt, A can have judgment for this excess.

Comment on Subsection (1), Clause (c):

c. The pledgee's duty is to return the chattel unharmed when the pledgor has performed the act for which the pledge is security. The pledgee cannot set up his own tort as an excuse for non-performance of this duty. The pledgor therefore may waive the tort and hold the pledgee to his contractual obligation.

Comment on Subsection (2):

d. Cross reference. See § 18.

Legal Topics:

For related research and practice materials, see the following legal topics:
Criminal Law & Procedure
Scienter
Willfulness



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Restat 1st of Security, § 22

§ 22 Unauthorized Use by Pledgee: Conversion

(1) The pledgee without authorization has no privilege to use the pledged chattel.

(2) Unauthorized use by the pledgee is a conversion of the chattel.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. The pledgee holds possession of the pledged chattel only as security for some act to which he is entitled. While the chattel is in his possession he is not entitled to the use and enjoyment of the chattel without the pledgor's permission but only to the custody of it, except to the extent that use may be necessary for its care and preservation. If a cow were pledged, it would be the duty of the pledgee to arrange for her to be milked. If a saddle horse were pledged, it would be a reasonable inference that the pledgee might ride it as an incident of his giving it proper exercise. If income-producing property were pledged, the pledgee might be entitled, or even required, to keep it in operation. As stated in § 3, the pledgee has a pledge interest in the increase of profits of a pledged chattel. The pledgee is accountable for the gains and profits received from the use of pledged property (see § 27). On the other hand, the pledgee is entitled to a charge against the pledged chattel and in some cases to reimbursement for his expenses (see §§ 25 and 26). The contract between the parties will determine the fact and amount of any compensation that is to be allowed to the pledgor for the use of the chattel. Express words are not necessary to show that some use by the pledgee is intended. Circumstances may show that the chattel was intended to be used, especially where it is an income-producing asset.

Comment on Subsection (2):

b. Any assertion of dominion over a chattel which is a denial of the interests of the owner is a conversion. Unauthorized use is one of the ways in which a conversion may be committed (see Restatement of Torts, § 227). The ways in which a conversion may be committed are stated as follows in the Restatement of Torts, § 223:

"A conversion may be committed by

(a) intentionally dispossessing another of a chattel,

- (b) intentionally destroying or altering a chattel in the actor's possession,
- (c) using a chattel in the actor's possession without authority so to use it,
- (d) receiving a chattel pursuant to a sale, lease, pledge, gift or other transaction intending to acquire for himself or for another a proprietary interest in it,
- (e) disposing of a chattel by a sale, lease, pledge, gift or other transaction intending to transfer a proprietary interest in it,
- (f) misdelivering a chattel, or
- (g) refusing to surrender a chattel on demand."

Where a number of chattels are pledged and the pledgee converts one or more but not all of them, his conversion of some does not amount to a conversion of the others. If, however, the chattels constitute essentially a unit, as of a necklace of matched pearls, or a team of matched horses, a conversion of part is a conversion of the whole (see § 53).

The pledgee by his wrong cannot rid himself of his duty to return the pledged chattel upon performance or tender of performance by the pledgor of the act for which the pledge is security. The pledgor, if he wishes, may waive the conversion, and hold the pledgee on his duty to return the pledged chattel at the proper time. The pledgor, although he has a choice of remedies, can, of course, obtain only one satisfaction.

As to the remedies of the pledgor for an unlawful use or other conversion, see § 25.

Illustrations:

1. A pledges an automobile to B as security for a loan. B, without A's permission, rents the car to C for a trip to Albany. The car is returned to B in good condition. B is liable to A as a converter.

2. A pledges to B a saddle horse. B rides the horse to the extent necessary to keep the horse in good condition and training. Such use being necessary and reasonable, B is under no liability to A on account of the use made of the horse.

3. A pledges to B a steamboat which is the usual means of transportation to a summer resort and which is in operation at the time of the pledge. The inference is justified that B is to continue operation of the vessel and to account to A for the net profits.



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Restat 1st of Security, § 23

§ 23 Transfer of Pledged Chattels

(1) Where a pledgee assigns a non-negotiable pledged chattel to secure a larger claim than the one for which it is security, or sells it, except in the exercise of a power of sale to enforce the pledge, the assignee acquires no interest in the pledged chattel as against the original pledgor and the pledgee and the assignee are guilty of conversion.

(2) In the circumstances described in Subsection (1), the assignor becomes constructive trustee of his claim against the pledgor for the benefit of the assignee of the chattel.

(3) Where a pledgee wrongfully assigns a pledged negotiable instrument to a holder in due course, the interest of the holder is determined by the rules pertaining to negotiable instruments.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The pledge is an interest in a pledged chattel but it is an interest created by a bailment. While the pledgor-pledgee relationship gives the pledgee the privilege of possession and certain powers of enforcement in the event of default, the pledgor, except as his position may be modified by the law governing negotiable instruments remains the owner. The pledgor and pledgee are not joint owners. The pledged chattel is in the nature of a hostage for the performance of the act for which the pledge is security. In normal circumstances, the pledgor expects to perform the act in question, usually the payment of a debt, and to resume possession of the chattel.

The rule stated in this Section follows the rule in the law of bailments that a bailee for one purpose cannot use the bailed chattel for another purpose. If he does so, the bailment is terminated and the bailor can either recover the bailed chattel or hold the bailee as a converter (see the Restatement of Torts, §§ 227 and 228). The rule stated in this Section also follows the rule in the law of conversion, that one who receives from a third person possession of a chattel with intent to acquire for himself a proprietary interest which the third person had not the power to transfer is himself liable for a conversion.

The rule stated in Subsection (1) is subject to the important modification in Subsection (3) that a bona fide assignee of a negotiable instrument is protected under the laws of negotiable instruments. So far as non-negotiable chattels are concerned the rule stated in this Section is merely an application of the established principle that an assignee of a non-negotiable chattel in the absence of estoppel acquires only the interest which the transferor has the power to transfer. Even if the assignor had originally an interest, if by his conduct he has forfeited his interest, the assignee obtains nothing. The apparent harshness to the assignee of the rule stated in Subsection (1) is also mitigated by the fact that a transferee of a non-negotiable chattel from the pledgee, under the rule stated in Subsection (2), can hold the assignor as constructive trustee of the claim secured by the pledge to the extent of the interest which the assignor purports to convey to the assignee. While the pledgee may deprive the assignee of his equitable interest in the claim by a subsequent assignment of the claim to a bona fide assignee for value, in many cases the assignee of the chattel will be in a position by appropriate procedure to set off, in any action by the pledgor, the claim of the pledgee.

Comment on Subsection (1):

b. The rule stated in Subsection (1) carries with it the negative inference that the pledgee is not guilty of a conversion if he repledges a pledged chattel, provided the repledge is for a claim not larger than the claim for which it is security. Such a repledge is not an assertion of a greater interest than has been given by the pledgor. It is not likely to cause an additional risk, even of inconvenience, to the pledgor. The actual effect in most cases would be the same as if the pledgee had assigned the claim and the pledge. The result of this negative inference is that such a repledge is not regarded as a use prohibited by the pledgor-pledgee relationship.

The rule allowing a repledge for a claim no greater than the claim secured by the pledge is one which should be strictly interpreted. Which is a larger claim is a question of fact. The pledgee should not only refrain from repledging for a larger debt than the one due him, but should not repledge for a longer time nor for an obligation of such a different sort that the pledgor may be subjected to any delay or difficulty in redeeming at maturity.

Where a pledgee has made a repledge, he must refrain from any subsequent conduct in respect to the claim for which the pledge is security, which will subject the pledgor to greater risk or inconvenience. This means, among other things, that the pledgee must not thereafter assign the claim except subject to the interests created by the repledge. If, for example, the pledgee assigns the claim to a bona fide purchaser, the pledgee because he has separated the claim and the security becomes a converter of the pledged chattel. The action of the pledgee destroys the repledgee's interest and the latter is also a converter if after demand by the pledgor he does not surrender the chattel. Where after a repledge for a lesser claim than the one secured by the pledge, the pledgee assigns the non-negotiable claim to a bona fide purchaser, the pledgor may recover the chattel from the repledgee or recover the value of the chattel from the pledgee and pay the debt to the assignee, or the pledgor in an action by the assignee, may assert the defenses available against the pledgee. If the pledged chattel is worth more than the claim, the pledgor will thereafter have a cause of action against the pledgee for this excess value. The assignee will also be able to sue the pledgee for breach of warranty in connection with the assignment of the claim.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law Negotiable Instruments Enforcement Duties & Liabilities of Parties Types of Parties Holders in Due Course General Overview Contracts Law Sales of Goods Form, Formation & Readjustment Formation Assignment of Rights Estate, Gift & Trust Law Trusts Constructive Trusts



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Restat 1st of Security, § 24

§ 24 Pledgor's Remedies for Conversion

Where the pledgee converts a non-negotiable pledged chattel the pledgor

- (a) has an immediate right of action against the pledgee or the transferee or both for the value of the chattel, or**
- (b) can recover the chattel, or**
- (c) can set off the value of the chattel in any action on the claim secured by a pledge unless the claim is represented by a negotiable instrument which has been transferred to a holder in due course, or**
- (d) can waive the conversion, tender performance at or after maturity of the claim secured by the pledge and hold the pledgee to his duty to return the pledged chattel.**

COMMENTS & ILLUSTRATIONS: *Comment on Clause (a):*

a. When a tort is committed the right of action on account of the tort, whether conversion, negligence or wilful harm, arises when the wrong is done. See § 20, Comment *a*. There is nothing in the pledgor-pledgee relationship to require a variation of this rule. In ordinary circumstances since a pledge is usually security for a short-time obligation, the debt will be due by the time the pledgor can recover judgment for the conversion, so that the pledgee or the transferee, if the latter has an equitable interest in the claim secured by the pledge, can set off the amount of the pledgee's claim in any action by the pledgor.

b. Termination of pledge. Termination of the pledge means the extinguishment of the pledge interest. If the pledgee is guilty of an act of conversion, he forfeits his pledge interest and consequently his privilege of possession. Unless the pledged chattel is negotiable and has been transferred to a holder in due course, the pledgor can recover the chattel, can hold the pledgee or he can pursue other remedies as stated in the other clauses of the Section.

Comment on Clause (c):

c. Cross reference. See Comment on recoupment and set-off, § 20, Comment *b*.

Comment on Clause (d):

d. The pledgee's duty is to return the chattel unharmed when the pledgor has performed the act for which the pledge is security. The pledgee cannot set up his own tort as an excuse for non-performance of this duty. The pledgor therefore may waive the tort and hold the pledgee to his contractual obligation.

Illustrations:

1. A pledges an automobile to B. B hires the car to a friend for a week-end trip. The car is returned to B in good condition. A may sue B at once for conversion, or sue to recover the car, or set off the value of the car in an action by B on the obligation, or waive the conversion and hold B accountable for the use of the car in the settlement of the account.

2. A pledges a chattel to B. B converts the chattel. B sues A on the debt. A can set off the value of the chattel. A can have judgment for the value of the chattel in excess of the amount of the debt.

3. A pledges to B negotiable warehouse receipts for 10,000 bushels of wheat as security for a loan of \$ 5000 due in 90 days. B repledges the warehouse receipts, without A's permission, as security for a loan of \$ 6000. At the time of the repledge wheat is worth 70 cents a bushel. A knows of the repledge as soon as it is made. At the maturity of the loan wheat is worth 80 cents a bushel. A tenders B \$ 5000 and demands the return of the warehouse receipts. If B refuses, A has a cause of action against B on the contract for \$ 8000. B can set off the amount of the debt.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementClaims to InstrumentsContracts LawNegotiable InstrumentsEnforcementDuties & Liabilities of PartiesTypes of PartiesHolders in Due CourseGeneral OverviewContracts LawNegotiable InstrumentsTransfers



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Restat 1st of Security, § 25

§ 25 Pledgee's Expenses

Reasonable expenses incurred and reasonable payments made by the pledgee in caring for the pledged chattel, preserving his interest therein, satisfying charges which are primarily obligations of the pledgor and enforcing the pledge, are a prior charge on the pledged chattel.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The normal situation in a pledge transaction is that a creditor has lent the pledgor money which the pledgee is entitled to have returned to him with a profit on the investment. When chattels are pledged, the pledgee should not be put in a position where he must reduce his own assets in caring for the pledged chattel or in enforcing his pledge interest. The pledgee should get back his money with interest and the pledgor should obtain the return of his chattel. If the pledgee merely uses space which has no salable value and his own time in the care of the pledged chattel, the transaction is balanced with a payment of the debt and a return of the chattel. On the other hand, if the pledgee must pay out money, or expend other valuable assets in caring for the chattel or in protecting his interest in it, this amount should come out of the pledged chattel before the proceeds of the pledged chattel are applied on the debt.

The expenses of the pledgee may be those the pledgee must incur to satisfy his duty of due care, as when he must feed a pledged horse, may be those he has no obligation to pay but which he may feel it is desirable to pay to protect his interest, as when the pledged chattel is subject to a prior chattel mortgage, or may be those which the law compels him to pay because of his possession of the chattel, as when an assessment on corporate shares is the legal obligation of the holder of record, even if only a pledgee. Such necessary or proper payments by the pledgee are a prior charge on the pledged chattel. As to the personal liability of the pledgor to reimburse the pledgee for such expenditure, see § 26.

Expenses incident to the enforcement of a pledge are a prior charge on the proceeds even if not paid in advance by the pledgee.

Illustrations:

1. A, in a large city, pledges his automobile to B as security for a debt. B stores the car at a public garage. B is entitled to reimbursement for reasonable storage charges and may hold the car as security for any such expenses as well as security for the debt.

2. A pledges to B a real estate mortgage note payable to A by C. The note is indorsed to B. At the maturity of the note B sues C and proceeds to foreclose the mortgage, incurring reasonable expenses including an attorney's fee. B may deduct his expenses before applying the proceeds on his claim against A.

3. A pledges to B an automobile which he has purchased under a contract of conditional sale. A does not keep up the payments. B may make the payments and hold the car as security for these payments as well as for the original obligation. If B sells the car as an incident to the enforcement of his pledge interest and the proceeds are sufficient only to meet the expenses of the sale and cover the payments made by B to the conditional vendor, B need not apply any of the proceeds to A's debt.

b. Subrogation. Where the pledgee discharges obligations of the pledgor or a lien upon the pledged chattel, under such circumstances that the pledgor would be unjustly enriched by the retention of the benefit thus conferred, the pledgee is entitled to be subrogated to the position of the obligee or lienholder (see Restatement of Restitution and Unjust Enrichment, § 162).



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Restat 1st of Security, § 26

§ 26 Pledgor's Duty of Reimbursement

Where a pledgee in consequence of his possession of a pledged chattel satisfies a charge which is primarily an obligation of the pledgor, he has a right to be reimbursed by the pledgor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. An application of the rule stated in this Section occurs where share certificates are pledged which are transferred to the name of the pledgee so that he becomes liable for calls, assessments or statutory obligations of a shareholder. If under the law of the particular jurisdiction the pledgee cannot escape such liability by showing his status as pledgee, the pledgee, if he pays, can hold the pledgor personally for reimbursement. Where the pledgee has not paid but where his liability is certain, the pledgee has a right against the pledgor of exoneration. For a further consideration of exoneration, see § 112.

Illustration:

1. A pledges to B bank shares which are subject to assessment in the event of insolvency to an amount equal to their par value. B transfers the shares to his own name. In the jurisdiction the shareholder of record is liable for the assessment. The bank becomes insolvent and an assessment is levied against B. B may bring a bill against A for exoneration, or, if B pays, he has a right of action against A for reimbursement.

b. The pledgee can hold the pledgor liable for reimbursement in some cases because the relationship of the parties makes the pledgee the agent of the pledgor in respect to the pledged chattel. See Restatement of Agency, § 429. For example, where a horse is pledged, or the horse becomes ill, the pledgee as agent of the pledgor can recover reasonable expenses for veterinary services. The pledgor as principal must reimburse or exonerate the pledgee for such expenses. In addition, as stated in § 26, the pledged chattel is security for such payments as are made by the pledgee.

Illustration:

2. A pledges a horse to B. The horse becomes so ill that B reasonably calls a veterinary at once. In spite of skilful treatment the horse dies. B, in such a case, is the agent of A to obtain the veterinary services. If B pays the veterinary, he is subrogated to the latter's right of action against A for the value of his services or as agent he has a right against his principal for reimbursement.



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Restat 1st of Security, § 27

§ 27 Pledgee's Duty to Account for Increase or Profits

The pledgee has the duty to account to the pledgor for the increase or profits accruing to the pledgee as a result of the possession of the pledged chattel.

COMMENTS & ILLUSTRATIONS: *Comment:*

As has been stated in § 3, the pledgee has a pledge interest in the increase or profits of pledged chattels. He must account to the pledgor for the profits or increase. Certain gains may accrue to the pledgee as a result of the use of pledged chattels. See § 22. While the pledgor and pledgee may contract as to the disposition of gains or profits, as, for example, the application of interest or dividends to interest due, or the acceptance by the pledgee of animal products in compensation for expenses incurred for care of such animals, in the absence of any special agreement, gains or profits received by the pledgee are charged against him in the final accounting.



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Restat 1st of Security, § 28

§ 28 Liens Acquired by Creditors of Pledgor

The pledgee's interest in the pledged chattel is superior to liens subsequently obtained by creditors of the pledgor through judicial proceedings.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The pledgor's interest may be reached by judgment creditor's bill or by some statutory proceedings. Statutes in the various States provide a procedure by which the pledgor's interest may be charged for the benefit of attacking of judgment creditors. Since to the extent of their liens, creditors are transferees by operation of law of the pledged chattels, they may redeem the chattels by satisfying the claims of the pledgee.



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Restat 1st of Security, § 30

§ 30 Assignment of Separate Claims Secured by a Pledge

(1) Subject to the rules stated in § 29 and to the rule stated in Subsection (2), where several claims are secured by a pledge, the assignee of each claim is a transferee of a pro rata interest in the pledge.

(2) Where less than all of several claims secured by a pledge are assigned and the assignor guarantees the payment of the claims assigned, the assignee has a prior interest in the pledge as against the assignor and against subsequent assignees with notice of the antecedent assignment.

(3) In the circumstances described in Subsections (1) or (2) in the absence of agreement to the contrary between assignor and assignee or restrictions in the pledge agreement, the person, whether the assignor or the assignee, having the prior interest in the pledge, or if none has a prior interest, the one having the greater interest, is entitled to the possession of the pledged chattel; where the interests are equal, the one whose pledge interest was first created is entitled to possession.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. This Section deals with situations where an entire claim but not an entire pledge interest is assigned because the pledge is security for more than one claim. Since the pledge is equally the security for all the claims when held by the pledgee, it should equally be the security for all the claims when held by different persons unless the parties agree otherwise or their relations with each other otherwise allow one person a priority of interest in the pledge.

Comment on Subsection (2):

b. Assignment with indorsement or guaranty. Where a pledgee holds more than one claim and assigns one of them with a guaranty of payment, he should not be allowed to compete with the assignee in respect to the security for its payment. Since the pledgee has guaranteed the payment of the claim he cannot expect to take any action which will not facilitate its collection. In accordance with the usual rules of equity, one who subsequently acquires the assignor's

remaining claims, or part of them, with notice of the facts, is himself subject to the priority of the first assignee.

Illustrations:

1. A pledges to B warehouse receipts representing 100 bales of cotton as security for a loan of \$ 4000 represented by two promissory notes. B endorses one note without recourse to C. B and C have a pro rata interest in the cotton.
2. Same facts as in Illustration 1, except that B endorses the notes to C and D and delivers them simultaneously. C and D have equal interests in the cotton.
3. Same facts as Illustration 1, except that B endorses the first note to C. C is entitled as against B to a prior interest in the cotton.
4. Same facts as Illustration 3, except that B also endorses the second note to D who has notice of the antecedent endorsement of the first note to C. C is entitled to a prior interest in the cotton.

Comment on Subsection (3):

c. Possession of pledged chattel. Where a debt is assigned in whole or in part the assignee becomes a transferee either of all or part of the pledge interest, unless the pledge has been made with a condition against transfer. However, even if there is such a condition, the transferee is not affected by it if he reasonably relies on the terms of the pledge agreement or other manifestations by the pledgor. See § 29. If he is the transferee of the whole he is entitled to the possession of the pledged chattel in the absence of restrictions as to the possession in the original pledge agreement. Where only part of the debt has been transferred, possession of the chattel may be a valuable privilege. The practical and fair solution is to give the privilege of possession to the one who is entitled to a prior interest in the pledge, that is, to the one who is to be paid first out of the proceeds. Where there is no priority the one having the greater interest should have the possession.

d. Where none of the assignees has a prior or a greater interest in a pledge so that all are equally entitled to possession, some choice must be made. In the absence of some agreement as to the possession the one whose interest was first created should receive or keep the possession. Thus, if the original pledgee is still entitled to an equal share with no priority in any of the others, he should keep the possession. If he has assigned all his interest in equal parts, the first assignee should receive the chattel. If the pledgee after an entire assignment retains possession he does so as trustee for the assignee. In this and in other cases of competing security interests, a court of equity also has jurisdiction upon a proper showing to appoint a receiver to hold the security interests for the benefit of the parties involved.

Illustrations:

5. A gives B three notes for \$ 1000 each, secured by a warehouse receipt for 40 bales of cotton. B endorses without recourse one note to C. B is entitled to retain possession of the receipt.
6. Same facts as Illustration 5, but B endorses one note to C and one to D, both without recourse. B is still entitled to possession of the receipt.
7. Same facts as Illustration 5, but B endorses one note to C. C has a prior interest in the receipt and is entitled to possession of it.
8. Same facts as Illustration 5, but B endorses without recourse two notes to C. C is entitled to possession of the receipt.
9. Same facts as Illustration 5, but B endorses the three notes successively to C, D and E, under circumstances which give each an equal interest. C is entitled to possession of the receipt.

10. Same facts as Illustration 5, but D and E are able to show that C is an improper custodian and C is unwilling to deliver the receipt to either of them. A court of equity may appoint a receiver for the receipt.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawSales of GoodsForm, Formation & ReadjustmentFormationAssignment of RightsContracts LawSecured TransactionsThird Party RightsAssignments



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Restat 1st of Security, § 31

§ 31 Partial Assignments

(1) Where partial assignments are made of a claim secured by a pledge each assignee is an equitable transferee of a pro rata interest in the pledge subject to the rule as to priority stated in § 30, Subsection (2).

(2) In the circumstances stated in Subsection (1), the pledgee can retain possession of the pledged chattel as trustee for the assignees.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. An assignment of either a fractional part of a single and entire right or of a stated amount from such a right is operative as to that part or amount to the same extent and in the same manner as if the part had been a separate right, subject to the limitation that if the obligor has not contracted to make such a partial performance, no legal proceeding may be maintained by the assignee against him over his objection, unless all persons having collectively a right to the entire performance are joined in the proceeding (see Restatement of Contracts, § 156). Since the pledgee in the circumstances will normally be the one who will enforce the pledge, the pledgee can retain possession of the pledged chattel but the interests of the parties in the chattel or its proceeds are determined by the rules stated in § 30.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawSecured TransactionsThird Party RightsAssignments



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Restat 1st of Security, § 33

§ 33 Successive Assignments of Non-Negotiable Claims

Where the pledgee makes successive assignments of a non-negotiable claim secured by a pledge, the assignee who obtains priority as to the debt is the transferee of the pledge, unless

- (a) the pledge has been terminated, or**
- (b) the pledged chattel is negotiable and another is a holder in due course.**

COMMENTS & ILLUSTRATIONS: *Comment:*

- a.* This Section deals only with successive assignments of an entire claim. See as to partial assignments, § 30.
- b.* The priorities between successive assignments of the same right are stated in the Restatement of Contracts, § 173:

"Where the obligee or an assignee makes two or more successive assignments of the same right, each of which would have been effective if it were the only assignment, the respective rights of the several assignees are determined by the following rules:

- (a) A subsequent assignee acquires a right against the obligor to the exclusion of a prior assignee if the prior assignment is revocable or voidable by the assignor;
- (b) Any assignee who purchases his assignment for value in good faith without notice of a prior assignment, and who obtains
 - (i) payment or satisfaction of the obligor's duty, or
 - (ii) judgment against the obligor, or
 - (iii) a new contract with the obligor by means of a novation, or
 - (iv) delivery of a tangible token or writing, surrender of which is required by the obligor's contract for its enforcement,

can retain any performance so received and can enforce any judgment or novation so acquired, and, if he has obtained a

token or writing as stated in Sub-clause (iv), can enforce against the obligor the assigned right;

(c) Except as stated in Clauses (a) and (b), a prior assignee is entitled to the exclusion of a subsequent assignee to the assigned right and its proceeds."

Illustrations:

1. A pledges certain negotiable bonds to B to secure an open account. B assigns his claim in full successively to C and D. B retains the bonds. C obtains priority as to the debt and is entitled to the possession of the bonds.

2. Same facts as Illustration 1, except that after the successive assignments of the debt, B sells the bonds to E, holder in due course. E's interest is superior to C's.

3. A pledges a motor car to B, to secure a debt. B sells the motor car to C, a bona fide purchaser. B then assigns the debt successively to D and E. Since the pledge is terminated by B's improper sale, neither D nor E has a pledge interest.

c. See as to assignment of claims represented by negotiable instruments, § 34.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law
Negotiable Instruments
Enforcement
Duties & Liabilities of Parties
Types of Parties
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General Overview
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Restat 1st of Security, § 34

§ 34 Assignment of Claim Represented by Negotiable Instrument

Where a claim represented by a negotiable instrument which is secured by a pledge is assigned to a holder in due course and the assignee obtains possession of the pledged chattel, or the pledgee or a third person agrees to hold the chattel for him, the assignee is not subject to any claims or defenses of the pledgor in respect of the pledge or of anyone deriving an interest in the pledged chattel from the pledgor subsequent to the making of the pledge.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The assignee of a claim represented by a negotiable instrument secured by a pledge acquires not only such interest as would be acquired by an assignee of a negotiable instrument but in addition in the circumstances stated in this Section acquires such interest free of claims and defenses which would be available against the assignee of a non-negotiable claim. In substance this imports the qualities of negotiability to the pledged chattel in respect to the pledgor and those whose interests are derived from the pledgor after the pledge is made. Where a pledgor secures a negotiable instrument by a pledge it may be assumed that he contemplates an assignment of the claim. The value of the negotiable instrument might be seriously impaired in the hands of a holder in due course if defenses of the pledgor were available in respect to the pledge when the assignee attempted to enforce it. The rule facilitates the transfer of a commercial asset and thus confirms its value. The rule stated in this Section does not mean that such an assignment can cut off legal interests of third persons in the pledged chattel which existed prior to the making of the pledge.

The principle underlying the rule stated in this Section is applied to real estate mortgages.

Illustrations:

1. A executes his promissory note to B which is secured by the pledge of a painting. A stipulates that if B negotiates the note the painting is to be returned. B negotiates the note to C a holder in due course and delivers the painting to him. C can enforce a pledge interest in the painting.

2. Same facts as Illustration 1, except that C takes the note and the painting with notice of A's restriction. C has no pledge interest.

3. A executes to B a promissory note. B by fraud obtains from A the pledge of non-negotiable bonds as security. B negotiates the note to C, a holder in due course, and delivers the bonds to C. C obtains a pledge interest in the bonds.

4. A delivers certain non-negotiable bonds to B as security for a promissory note with a stipulation against transfer of the pledge. B negotiates the note to C without delivering the bonds and without agreeing to hold them for C. B returns the bonds to A. C has no interest in the bonds.

5. Same facts as Illustration 4, except that C discovers that B has the bonds after he has obtained the notes, and obtains the bonds from B. C has a pledge interest in the bonds.

6. Same facts as Illustration 4, except that before C obtains the bonds A notifies C of the restriction. C has no pledge interest in the bonds.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 35

§ 35 Priorities of Pledgee and Third Persons

The priorities of the pledgee and third persons having an interest in the pledged chattel are determined by the following rules:

- (a) any person having an antecedent legal interest in a non-negotiable pledged chattel, who has given the pledgor no power to pledge, has priority over the pledgee;**
- (b) a pledgee, who as pledgee is a holder in due course of negotiable instruments, has priority over the antecedent legal interests of a third party;**
- (c) subject to the rule stated in the Restatement of Trusts, § 305, a bona fide pledgee has priority over a third person who has an antecedent equitable interest in the pledged chattel;**
- (d) where a pledge is also to secure future advances, a pledgee has priority over a person
 - (i) having an antecedent equitable interest in the pledged chattel, or**
 - (ii) one acquiring a subsequent legal or equitable interest in the pledged chattel, to the extent, and only to the extent, of advances made before notice of the interests of third persons, unless the failure of the pledgee to make the advances will subject him to an action for damages or result in an unfair change in his position.****

COMMENTS & ILLUSTRATIONS: Illustration to Clause (a):1. A is a co-owner of a painting. He pledges it to B, who believes him to be the sole owner, for an amount greater than the value of his interest. B's interest is no greater than A's.

Comment on Clause (a):

a. Statutory modification. Several types of statutes modify the rule stated in Clause (a) of this Section. Recording statutes governing chattel mortgages and conditional sales make it possible for a mortgagor or conditional buyer to give a bona fide pledgee priority over the mortgagee or conditional seller if the mortgage or conditional sale is not recorded. In the absence of the filing prescribed in the Uniform Trust Receipts Act in those States which have adopted it, and also under factor's acts in several States, a dealer or consignee has the power in certain circumstances to pledge goods so as

to defeat the prior legal interests of the owner of goods intrusted to him for sale or exhibition.

b. For the priorities of one with whom has been made a contract to pledge without a bailment, see § 10.

Illustration to Clause (b):2. A is bailee of negotiable bonds negotiable by delivery. He wrongfully pledges them to B as security for a personal indebtedness. B does not know of A's improper use of the bonds. B prevails over the one who has bailed them to A.

Comment on Clause (c):

c. The Restatement of Trusts, § 305, reads as follows:

Security for Antecedent Debt as Value.

(1) Except as stated in Subsections (2) (3), if the trustee transfers trust property as security for a pre-existing debt or other obligation, the transfer is not for value.

(2) If the trustee transfers trust property as security for a pre-existing debt or other obligation, the transfer is for value, if

- (a) the trust property transferred is a negotiable instrument or money, or
- (b) the transferee held security for the debt or other obligation and surrendered the security, or
- (c) there has been such a change of circumstances that it would be inequitable to deprive the transferee of the property.

(3) If the trustee transfers trust property as security for a debt or other obligation in pursuance of a promise made at the time of the creation of the debt or obligation to transfer the property as security therefor, the transfer is for value.

Illustrations to Clause (c):3. A is trustee of tangible chattels. He pledges them to B as security for a personal loan. B has no knowledge of A's improper conduct when the pledge is made. B's interest is superior to that of the holder of the beneficial interest.

4. A is trustee of tangible chattels. He pledges them to B, who has no knowledge that A is acting improperly, as security for an antecedent personal indebtedness. B's pledge interest is subject to that of the holder of the beneficial interest.

d. *Statutory modification.* Under agricultural co-operative statutes in some States where a farmer has made a contract of sale with a co-operative association, such contract may be recorded with the effect of giving the association the power to buy or sell the farmer's crops covered by the contract, irrespective of security interests created after the making of the contract. The security interests however are usually a charge against the proceeds of the products when sold by the association, if the association has notice of the interests.

Comment on Clause (d):

e. *Future advances.* If the pledgee has agreed with the pledgor to make a future advance upon the basis of an existing pledge, and the pledgor takes or permits some action which will deprive the pledgee of security for a future advance, the pledgee is excused as to the pledgor from any obligation he has undertaken to make the advance. If, however, the pledgee is under a duty, which will not be excused by the conduct of the pledgor, as, for example, where the pledgee is under contract to make an advance to the pledgor for the benefit of a third person, the pledge is security for such obligation. In such a case the pledgee's interest in the pledged chattel in his possession is prior to any interest of a third person arising after the pledgee has assumed the obligation, provided the future advance is made by the pledgee.

Where pledge agreements contain a future advance clause the existence of a duty to a third person is an example of a case in which the pledgee may suffer loss if he does not make the future advances. It is possible, however, that the pledgee has agreed to make future advances which will be of benefit to him as well as to the pledgor because of the improvement of the security as a result of expenditures made as a result of the future advances. The security may be inadequate until the future advances are made and the pledged chattel is improved. In such a case the pledgee's interest in making the advances entitles him to priority as to the future advances even if others acquire interests of which the pledgee has notice before the future advances are made.

Illustrations:

5. A pledges to B a life insurance policy to secure a loan of \$ 1000 with an agreement by B to advance an additional \$ 1000 on the same security at A's request. A subsequently assigns his interest in the policy to C. B, knowing of the assignment to C, at A's request lends A the second \$ 1000. B's interest in the policy is prior to C's only to the extent of the first loan.

6. Same facts as Illustration 5, but B does not know of the assignment to C at the time of the second loan. B's interest is prior to C's as to both loans. B has an equitable interest in the policy as a result of his agreement to make the future advances. B's possession of the policy is notice to C of the extent of B's interest.

7. Same facts as Illustration 5, except that B agrees to make the future advance to enable A to pay a debt to D. If B makes the second loan irrespective of notice of C's interest, B's interest is prior to C's as to both loans, because B's possession of the policy is notice to C of the extent of B's interest.

8. A pledges to B an unfinished model for a bronze statue as security for a loan of \$ 1000. A agrees to finish the model and to cast it in bronze and B agrees to advance an additional \$ 1000 for this purpose. A thereafter gives C a chattel mortgage on the model. C files the chattel mortgage and gives B personal notice of it. B advances A \$ 1000 and the statue is completed and cast in bronze. B has a prior pledge interest of \$ 2000.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 36

§ 36 Owner of Pledged Chattel as Surety

(1) Where a pledge is made as security for the obligation of a third party, the pledgor is a surety to the extent of the pledged chattel.

(2) Where a third person authorizes the pledge of his chattel to secure the obligation of a pledgor and this fact is known to the pledgee, the owner of the chattel is a surety to the extent of the pledged chattel.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section deals with the situation where the pledged chattel is not owned by the pledgor and that fact is known to the pledgee. Where the pledgor is not the debtor, the pledgee always has notice of the facts from which the surety relationship arises and is affected by this relationship in his dealings with the pledged chattel. Where a third person authorizes the pledgor to pledge the former's chattel to secure the pledgor's obligation, the third person is a surety to the extent of the pledged chattel, but the pledgee is not affected by the surety relationship until he has notice of it. See § 114.

The restriction of the liability of the pledgor in Subsection (1) or the third person in Subsection (2) to whatever can be realized out of the pledged chattel does not prevent a genuine suretyship relation from arising. The accommodator, whether he is the pledgor under Subsection (1) or the third person under Subsection (2), has the defenses of a surety and is entitled to a surety's rights and privileges. One of the consequences is that the pledge is terminated if the pledgee grants an extension to or releases the debtor without the consent of the pledgor under Subsection (1) or the third person under Subsection (2). The surety because of his interest in the pledged chattel is entitled to notice of time and place of sale in case the pledgee enforces the pledge. If there are other sureties, the surety is entitled to contribution, if his chattels are used to satisfy the pledgee's claim. The surety is also entitled to exoneration or reimbursement by the debtor. For details of suretyship, see Chapters 3, 4, 5 and 6.

Illustrations:

1. A borrows \$ 1000 for six months from B which C secures by a pledge of certain bonds. B at maturity, without C's consent, extends A's loan ninety days. The pledge is terminated. Since C is a surety he is discharged by a change in the principal obligation.

2. A borrows \$ 1000 from B payable on demand. C endorses A's note and D pledges a \$ 1000 bond as security. On A's default B sells D's bond. D is entitled to reimbursement from A. Unless D has been reimbursed by A, D is also entitled to contribution from C.

3. Same facts as Illustration 2, except that D lends A the bond, which A pledges. The result is the same if C has notice of D's interest.

b. Where the pledgor gives the pledgee permission to use a pledged chattel as security for the pledgee's own obligations otherwise than in connection with an assignment of the claim for which the pledge is security, the pledgor himself is a surety for the pledgee to the extent of the repledged chattel See § 29. Whether the repledgee is affected by this surety relationship depends upon whether he has notice of it. See § 114.



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Restat 1st of Security, § 37

§ 37 Effect of Payment or Tender

(1) Performance or tender of performance to the proper person of the obligation secured by the pledge terminates the pledge and entitles the pledgor to the possession of the pledged chattel.

(2) The tender of the amount of a debt or the tender of performance of any other obligation secured by a pledge does not discharge the debt or other obligation for which the pledge is security.

(3) Refusal or failure of the pledgee to return the pledged chattel upon tender or performance is prima facie evidence of a conversion.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. It is the duty of pledgee to return the pledged chattel when the pledgor performs the act for which the chattel is security. The performance includes not only the payment of the principal obligation but of any other sums for which the pledge is security, including interest, reimbursement for necessary expenses and other proper charges against the pledgor. If the pledgor tenders performance, the pledgee should accept it and return the pledged chattel. The pledgor is entitled to terminate the pledgor-pledgee relationship by performance. If the pledgee refuses performance, he should not thereby be able to compel the pledgor to continue the security relationship. The pledge is terminated and the pledgor is entitled to immediate possession of the chattel. The pledgee cannot thereafter transfer any interest in the chattel, even to a bona fide transferee unless the pledged chattel is negotiable.

If the pledgee's words or conduct are such that it is evident a proper tender will be refused, the tender is waived and the pledge terminated. The mere assertion by the pledgee of a larger claim than the one due does not excuse the pledgor from a tender.

Where the claim is non-negotiable, performance by the pledgor to the pledgee discharges the obligation and terminates the pledge even if the claim has been assigned, provided the pledgor has no notice of the assignment. If the

pledgee has assigned the claim and refuses a tender on this ground, the refusal of the tender does not terminate the pledge.

Illustrations:

1. A borrows \$ 100 of B secured by a pledged chattel. When the debt is due A tenders the proper amount to B, who refuses to return the chattel until a contingent liability of A to B is satisfied. A thereupon retains the money. A may regain the chattel by peaceable self-help or in an action to recover it or can sue B as a converter. It is no defense to an action that the debt is still unpaid.

2. Same facts as Illustration 1, except that after the tender B sells the necklace to C, a bona fide purchaser. C gets no interest in the necklace.

b. Effect of tender on principal obligation. While a tender of payment of a debt secured by a pledge terminates the pledge, it does not discharge the debt. To make tender equivalent to payment of a debt would punish the creditor and reward the debtor out of all proportion to the inconvenience suffered by the debtor from the creditor's refusal of the tender.

Illustration:

3. A owes B \$ 1000, which is secured by a pledge of two bonds. A tenders the amount due, which B refuses. A thereupon demands his bonds and upon B's refusal sues B as a converter of the bonds. B sets off his claim. A's recovery cannot exceed the value of the bonds in excess of B's claim.

c. Since the pledgor is entitled to the possession of the chattel upon tender of performance, the withholding of the chattel by the pledgee is a conversion unless excused. The pledgee is not a converter if the chattel has been destroyed without the pledgee's fault, has been repledged with the pledgor's permission and the pledgee is unable to repossess it because of insolvency (see § 45).



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Restat 1st of Security, § 38

§ 38 Tortfeasor's Liability to Pledgor and Pledgee

(1) A third person who harms or converts a pledged chattel while it is not in possession of the pledgor is liable to the pledgor for the damage to the pledgor's interest unless the pledgee has obtained a judgment against the third person for the full damage or made a settlement with him for such damages.

(2) A third person who harms or converts the pledged chattel in the possession of the pledgee is liable to the pledgee for full damages, less the amount of any judgment already obtained or settlement made by the pledgor for harm to the pledgor's interest.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rules stated in this Section are in accordance with the usual rules as to the liability of third persons to bailors and bailees. See as to Subsection 1, Restatement of Torts, § 220, and as to Subsection (2), Restatement of Torts, § 219. By full damages are meant the total damages arising from the tort irrespective of various interests in the chattel. Under the rule stated in Subsection (1), a third person might be a repledgee to whom the pledgor had allowed the pledgee to repledge the pledged chattel and who had violated a duty in respect to it.

Illustrations:

1. A pledges an automobile to B as security for a loan. C converts the automobile. A sues C. A's judgment will be limited by the value of the automobile less B's pledge interest.

2. Same facts as Illustration 1, except that B first sues C and recovers a judgment for the full value of the car. A has no right of action against C.

3. Same facts as Illustration 2, except that B, instead of obtaining judgment, makes a settlement with C. A has no right of action against C.

4. Same facts as Illustration 2, except that B's suit is brought after A has recovered judgment. B's judgment will be for the value of the chattel less the amount of the judgment for the damages to A's interest.

Comment on Subsection (2):

b. The pledgee, in addition to the cases where the chattel is temporarily in the possession of the pledgor, may not be in possession because a third person is bailee for both pledgor and pledgee or the chattel may have been repledged with permission of the pledgor. Unless the pledgee is in possession or entitled to the immediate possession from a bailee at will, the pledgee's recovery is limited also to the value of his interest.



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Restat 1st of Security, § 39

§ 39 Pledgor's Liability to Pledgee for Harm or Dispossession

A pledgee, who is dispossessed by the pledgor, or to whom a pledgor who has received the pledged chattel for a temporary and limited purpose refuses or fails to return the chattel, has a right of action against the pledgor

- (a) for breach of contract, or**
- (b) for recovery of the chattel, or**
- (c) for conversion, but the pledgee's damages cannot exceed the value of his interest, or**
- (d) for equitable relief where the legal remedy is inadequate and a court of equity is able to grant an effective decree.**

COMMENTS & ILLUSTRATIONS: *Comment on Clause (a):*

a. Where, as a part of a contract, a pledgor has agreed to secure his obligation by a pledge, his contractual duty is not only to make the pledge as agreed but not to deprive the pledgee of his security. If the pledgee is so deprived, he can treat the contract as broken. In most instances his substantial remedy is to sue for restitution. The effect of the pledgor's conduct is thus to accelerate the pledgor's obligation. In appropriate cases, the pledgee can also obtain equitable relief. See § 15.

Where the pledge is made after the making of the principal contract, and not as a part of the consideration for it, such conduct on the part of the pledgor as is described in this Section is not a breach of the principal contract. If the pledge is made in fulfilment of a subsequent contract, not modifying the principal contract, the pledgor's conduct is a breach only of the subsequent contract. If the pledge is made voluntarily and without consideration, the pledgor's conduct is not a breach of contract.

Even if the pledge were made as security for an antecedent debt, the pledge would be validly created since an antecedent debt is value. See § 10, Comment *f*. The lack of a contractual remedy would not deprive the pledgee of the other remedies stated in the Section.

Illustrations:

1. A agrees to pledge to B and does so pledge a collection of etchings as security for a six months' loan of \$ 1000. Without B's consent, A obtains possession of the etchings. B can treat the contract as broken and sue A at once for \$ 1000.

2. Same facts as Illustration 1, except that A obtains possession of the etchings on the representation that he wishes them for a week to mount and frame them. A refuses to return the etchings. B can sue A at once for \$ 1000.

Comment on Clause (b):

b. Since a pledgee is entitled to possession of pledged chattels until his claim is satisfied, if the pledgor deprives him of possession, the pledgee can obtain court help to recover the chattels.

Comment on Clause (c):

c. The pledgee, being entitled to possession, can sue anyone who dispossesses him for conversion. Since, however, if he were allowed to recover the full value from the pledgor, there would be a possibility of a later action by the pledgor to recover the excess, to avoid this possible circuity of action, the pledgee recovers only the value of his interest. While this result is not strictly logical, it is practically desirable because in most instances, owing to the short terms of debts secured by pledges, the debt is due before judgment is recovered by the pledgee. The limitation on the recovery by the pledgee thus results in the immediate settlement of the entire transaction between the parties.

Illustration:

3. A pledges to B a collection of etchings to secure a loan of \$ 1000. A obtains possession of the etchings without B's consent. B can sue A in conversion but recovers only the amount of his claim with costs.

Comment on Clause (d).

d. A pledge may secure an obligation of the pledgor, of such a nature that damages for a breach may be uncertain but performance may be of potentially great value to the pledgee. It may be impossible to obtain the return of pledged chattels from a pledgor unlawfully in possession by a legal action for their recovery. Such a case is a proper one for equitable relief, including a decree for discovery, tracing of proceeds, or for the delivery of other chattels of equivalent value. The limit of equitable jurisdiction in such an instance is the power of the court to grant an effective decree.

Illustration:

4. X, a manager of a heavyweight boxer of great reputation, contracts with a promoter that the boxer will participate in a contest on a certain date. X pledges \$ 25,000 in bonds as security for his obligation. X later obtains the bonds for a temporary and limited purpose, refuses to return them, and removes them from the State. The promoter in any action for the recovery of the bonds or for conversion, is unable to allege and prove any certain damages, although it is evident that if the contract is broken the damages will be large. The promoter is entitled to the aid of a court of equity, either to locate and obtain the return of the bonds, or as a possible alternative to compel X to deliver other security of equivalent value.

Legal Topics:

For related research and practice materials, see the following legal topics:
TortsIntentional TortsConversionRemedies



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Restat 1st of Security, § 40

§ 40 Substitution of Pledged Chattels: Pledgee's Interest

A pledgee who obtains money or another thing as compensation or substitution for a pledged chattel has an interest in the money or other thing as security for his claim against the pledgor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Changes in the pledged chattel may result from substitutions which the pledgor is allowed to make, from changes by corporate action or operation of law, from collections for harm done to the chattel by third persons, from the payment of insurance policies, or from the enforcement of security interests, see § 18. In all such cases the proceeds or the substituted things are subject to the pledgee's security interest. Even if in the first instance the proceeds of a pledged chattel come to the pledgor, his duty is to deliver them to the pledgee under the rule that the pledgee has a security interest in the increase and profits of a pledged chattel, see § 3. The rule stated in this Section does not apply to a case where the pledgee's wrongful conduct has been responsible for the substitution or compensation. In such a case the usual rules relating to the pledgee's breach of duty are applicable, see especially §§ 20 and 24.

Illustrations:

1. A pledges to B certain bonds to secure a debt. B allows A to withdraw the bonds and substitute share certificates. B has a pledge interest in the certificates.
2. A pledges to B a motor truck to secure a debt. The government compels the sale of all such trucks to it for compensation in money. B is entitled to the money but he holds it as security for the debt.
3. A pledges to B a painting which is insured. The insurance policy is assigned to B. The picture is destroyed by an accidental fire. B holds any proceeds of the policy as security for his claim.
4. A pledges to B a motor car which B is allowed to use. C damages the car in an accident. B obtains a judgment against C, which is paid. B holds the judgment and its proceeds, if collected, as security for his claim against A.

5. A pledges to B a note executed by C secured by a chattel mortgage on cattle. B enforces the chattel mortgage and in connection therewith buys the cattle at the foreclosure sale. B has a security interest in the cattle for the amount of his claim against A, including the expenses of the foreclosure sale.



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Restat 1st of Security, § 41

§ 41 Wrongful Repledge of Negotiable Pledged Documents; Duty of Repledgee

Where a pledgee wrongfully repledges negotiable instruments to a bona fide repledgee to secure a larger claim of the repledgee than the claim secured by the pledge, it is the duty of the repledgee upon notice of the wrongful repledge to refrain from enforcing his claim against the pledgor's negotiable instruments if the repledgee has other security sufficient to satisfy his claim and not subject to similar equities.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The pledgee by repledging the pledgor's negotiable instruments for a larger claim than his own has converted the pledgor's instruments. As between himself and the pledgor the pledge is terminated. See § 24. The repledgee, as a holder in due course, is protected, but only to the extent necessary to satisfy his claims against the pledgee. If the repledgee has notice of the pledgee's wrongful conduct before the repledge is enforced, he must first satisfy his claim as far as possible out of securities properly pledged.

b. Improper repledge of share certificates. An application of the rule stated in this Section is found in a pledge by a stockbroker to a bank, where only part of the pledged securities are improperly pledged. If the bank is notified of the facts, it has the duty of limiting its realization on the securities, which the broker should not have mingled and repledged, to the deficiency remaining after realizing on securities properly pledged.

Illustration:

1. A pledges share certificates endorsed in blank and worth \$ 20,000 to B as security for a loan of \$ 10,000. B mingles them with other securities and repledges them to C for a loan of \$ 100,000. A discovers B's action and notifies C of B's wrongful conduct, with a demand that C first enforce his claim against securities not subject to similar equities, and that after C's claim is satisfied, the securities belonging to A be returned to him. C has enough securities properly repledged to satisfy B's debt to him without using A's securities. C nevertheless sells A's securities with others and returns the balance of money and securities to B. C is liable to A for any loss which he sustains by C's failure to comply

with A's demand.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementGeneral Overview



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Restat 1st of Security, § 42

§ 42 Permitted Mingling and Repledging of Pledged Negotiable Instruments

Where a pledgee with permission mingles and repledges negotiable instruments to a repledgee under circumstances which do not amount to the separate assignment of the pledgee's claims against the individual pledgors, the debt of the pledgee thus secured becomes a charge on the pledged instruments of the several pledgors and the instruments are subject to the common burden of the pledgee's debt. As among themselves, their interests in the instruments or proceeds remaining after the debt of the pledgee has been satisfied therefrom, are in the proportion which the value of the instruments of each pledgor, which are repledged to secure the particular loan, bears to the value of the repledged instruments of all of the pledgors.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Repledges of stockbrokers. The mingling of pledged chattels and their repledge with permission of the pledgors, occurs commonly in connection with margin trading in securities. It should be noted that the repledging here is not an assignment of the pledge in consequence of the assignment of the pledgee's claim against the pledgor. The pledgee is using the pledged chattel for his own purposes by virtue of the pledgor's permission, in the same manner as any person might give another the power to pledge the former's chattels to secure the other's own debt. The permission is not to use the pledgee's interest as security but to repledge the pledgor's chattel as security for obligations of the pledgee. The rule stated in this Section is an application of the equitable principle similar to that applied in enforcing contribution between co-sureties, even if they are unaware of each other's existence at the time they become sureties. It is also like the rule of general average in admiralty, by which if part of a cargo must be sacrificed to save the ship and consequently the remainder of the cargo, the whole cargo, so far as the owners of the cargo are concerned, is subject to a common burden on account of the loss.

Illustration:

1. D makes an assignment for the benefit of creditors. A, B and C are margin customers of D, a stockbroker. Each signs the usual customer's agreement allowing D to mingle and repledge his securities. D exercises this privilege and

pledges all the securities to a Trust Company. Upon D's default, the Trust Company sells A's and B's securities and delivers C's securities to D's assignee. C tenders the balance due D on C's account and demands the securities. It is ascertained that A, B and C each owned securities worth \$ 50,000, that the Trust Company's loan was \$ 100,000 and that the balance due by C on his account is \$ 10,000. C is not entitled to his securities unless he pays \$ 33,333.33. C's securities will be charged with one-third of D's debt to the Trust Company. If C's debt to D were more than \$ 33,333.33, he would be required to pay the additional amount due to D's assignee before obtaining the securities.

b. Where a trustee or other custodian has in his possession negotiable chattels of several owners, which he pledges to a bona fide pledgee, the same rule of contributiton is applied as in the case of pledged chattels mingled and repledged with permission. The possessor of negotiable chattels has the power to give to a bona fide transferee interests which the possessor himself does not have. Since the owners have placed it in his power to subject the chattels to a common risk, if he does so, the chattels must bear the common burden. This Comment has no application to non-negotiable chattels. See § 43.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsGeneral Overview



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Restat 1st of Security, § 43

§ 43 Permitted Mingling and Repledging Non-Negotiable Chattels

Where a pledgee, who has been authorized by several pledgors to repledge non-negotiable chattels to secure his own obligations mingles and repledges them in accordance with the authorization, the rule stated in § 42 is applicable.

Special Note: The references to bankruptcy in this and the following section were made in view of the Bankruptcy Act in force January 1, 1938. Since the passage of the Chandler Act, effective September 22, 1938, the estate of a bankrupt stockbroker is administered in bankruptcy under the provisions of § 60e, which reads as follows:

"§ 60e. (1) Where the bankrupt is a stockbroker, the following definitions and provisions of this subdivision shall apply: 'Property' shall include cash, securities, whether or not negotiable, and all other property of similar character; 'customers' of a stockbroker shall include persons who have claims on account of securities received, acquired, or held by the stockbroker from or for the account of such persons (a) for safekeeping, or (b) with a view to sale, or (c) to cover consummated sales, or (d) pursuant to purchases, or (e) as collateral security, or (f) by way of loans of securities by such persons to the stockbroker, and shall include persons who have claims against the stockbroker arising out of sales or conversions of such securities; 'cash customers' shall mean customers entitled to immediate possession of such securities without the payment of any sum to the stockbroker: the same person may be a cash customer with reference to certain securities and not a cash customer with reference to other securities: the 'net equity' of a customer's account shall be determined by excluding any specifically identifiable securities reclaimable by the customer and by subtracting the indebtedness of the customer to the stockbroker from the sum which would have been owing by the stockbroker to the customer had the stockbroker liquidated, by sale or purchase on the date of bankruptcy, the remaining securities or security commitments of the customer.

"(2) All property at any time received, acquired, or held by a stockbroker from or for the account of customers, except cash customers who are able to identify specifically their property in the manner

prescribed in paragraph (4) of this subdivision and the proceeds of all customers' property rightfully transferred or unlawfully converted by the stockbroker, shall constitute a single and separate fund; and all customers except such cash customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the date of bankruptcy: *Provided, however*, That such fund shall to the extent approved by the court be subject to the priority of payment of the costs and expenses enumerated in clauses (1) and (2) of subdivision a of section 64 of this Act. If such fund shall not be sufficient to pay in full the claims of such class of creditors, such creditors shall be entitled, to the extent only of their respective unpaid balances, to share in the general estate with the general creditors.

"(3) Any property remaining after the liquidation of a pledge made by a stockbroker shall be apportioned between his general estate and such single and separate fund in the proportion in which the general property of the stockbroker and the property of his customers contributed to such pledge.

"(4) No cash received by a stockbroker from or for the account of a customer for the purchase or sale of securities, and no securities or similar property received by a stockbroker from or for the account of a cash customer for sale and remittance or pursuant to purchase or as collateral security, or for safekeeping, or any substitutes therefor or the proceeds thereof, shall for the purposes of this subdivision be deemed to be specifically identified, unless such property remained in its identical form in the stockbroker's possession until the date of bankruptcy, or unless such property or any substitutes therefor or the proceeds thereof were, more than four months before bankruptcy or at a time while the stockbroker was solvent, allocated to or physically set aside for such customer, and remained so allocated or set aside at the date of bankruptcy.

"(5) Where such single and separate fund is not sufficient to pay in full the claims of such single and separate class of creditors, a transfer by a stockbroker of any property which, except for such transfer, would have been a part of such fund may be recovered by the trustee for the benefit of such fund, if such transfer is voidable or void under the provisions of this Act. For the purpose of such recovery, the property so transferred shall be deemed to have been the property of the stockbroker and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding. If any securities received or acquired by a stockbroker from a cash customer are transferred by the stockbroker, such customer shall not have any specific interest in or specific right to any securities of like kind on hand at the time of bankruptcy, but such securities of like kind or the proceeds thereof shall become part of such single and separate fund: *Provided, however*, That a customer shall have a specific title to securities (a) which have been physically set aside by a stockbroker, more than four months before his bankruptcy or while solvent, in safekeeping for such customer, and so retained until the date of bankruptcy, regardless of the name in which such securities are registered, or (b) which a stockbroker, more than four months before his bankruptcy or while solvent, caused to be registered in the name of such customer."

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Where several pledgors have given the pledgee the power to mingle and repledge the pledged chattels they have given him the power to use their interests as security for his own debts. If he takes advantage of this permission and subjects the chattels to a common burden, the resulting situation is the same as if the chattels were negotiable. A different rule, as in the case of repledged negotiable instruments, would make the ultimate burden on the various pledgors, in the event of the pledgee's insolvency, depend upon chance or upon the intention of the repledgee to favor certain pledgors. If the rule as stated were not the law, the situation would invite attempts by pledgors to obtain a favored position by a private bargain with the repledgee.

b. Where no such permission is given for the repledge of non-negotiable chattels, the pledgee can transfer no

interest in the chattels if he repledges the chattels for a claim larger than the one for which the chattels are security. Such a repledge is a conversion. See §§ 23 and 24.

Illustrations to Comment b:1. A pledges his watch to C to secure a loan of \$ 25, and B pledges his watch to C to secure a loan of \$ 50. Each watch is worth \$ 100. Each gives C the privilege of mingling and repledging his watch with other chattels to secure C's own borrowing to the extent of \$ 100. C, in accordance with this authority, repledges A's and B's watches to D to secure a loan for \$ 100. C becomes bankrupt. D, in enforcement of the pledge, sells B's watch for \$ 100 and returns A's watch to the trustee in bankruptcy. A cannot obtain his watch unless he pays \$ 50. If A pays \$ 50, he will obtain his watch and a claim for \$ 25 against C. B is entitled to the \$ 50 paid by A.

2. Same facts as Illustration 1, except that neither A nor B gives C permission to repledge his watch for a larger amount than the debt for which it is security. If D sells B's watch, B can recover his watch from D's purchaser without tendering anything, or can sue C, D or the purchaser as a converter. If C has not assigned his claim against B, D or D's purchaser can assert an equitable interest in D's debt to B.

Legal Topics:

For related research and practice materials, see the following legal topics:

Bankruptcy LawEstate PropertyGeneral OverviewBankruptcy LawLiquidationsClearing Banks, Commodity Brokers & Stockbrokers



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Restat 1st of Security, § 44

§ 44 Priorities Among Pledgors After Mingling and Repledging

Where a pledgee mingles and repledges to secure his own debt negotiable pledged instruments as to some of which he has, and as to others he has not, the privilege of mingling and repledging, the owners of the instruments wrongfully repledged have a collective priority in the instruments or proceeds remaining after the debt of the repledgee has been satisfied therefrom, to the extent that their chattels have been used to satisfy the claim of the repledgee.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The situation covered by the rule stated in this Section is most apt to occur in stockbroker insolvencies. Creditors are classified in two groups, usually designated as Class A and Class B. In Class A are placed all persons entitled to a priority as to chattels and proceeds remaining after the debt of the repledgee has been satisfied from the repledged chattels. If the pledgee has also mingled and repledged negotiable chattels in which he has no interest, the owners of such chattels are also included in Class A. The interests of members of each class as among themselves are determined by the rule stated in § 42. If the chattels wrongfully repledged are non-negotiable, the chattels are not subject to a common burden. See § 43, Comment *a*. The repledgee acquires no interest. Each pledgor is entitled to follow his chattels into the hands of any holder. See as to the rules for liquidation in stock brokerage bankruptcies, Special Note to § 43.

Illustration to Comment *a*:1. A and B are margin customers of a stockbroker. C is an owner of negotiable securities in the broker's possession. A but not B gives the broker permission to mingle and repledge his securities for the pledgee's own debt. The broker mingles and repledges the securities of A, B and C to secure a loan from a trust company which is larger than B's indebtedness. The broker makes an assignment for the benefit of creditors. The trust company liquidates its loan, and returns money and securities to the trustee. If the securities of B and C have been used to liquidate the loan they have a collective priority over A as to the money and proceeds.



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Restat 1st of Security, § 45

§ 45 Effect of Pledgee's Insolvency on Liability as Converter

Where a pledgee with the pledgor's permission has repledged the pledgor's chattels for a larger claim than the one for which they are security, the pledgee is not liable as a converter if upon payment or tender of performance by the pledgor, the pledgee is unable because of insolvency to return the pledged chattels.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This Section represents a modification of the rule stated in § 37. The usual rule is that refusal or failure to return a pledged chattel after payment or tender makes the pledgee a converter. In cases of pledges from customer to stockbroker in connection with margin trading accounts, it is the practice for the customer to give the broker permission to mingle and repledge pledged securities for loans larger than the customer's debt. If the broker becomes insolvent, he may be unable to obtain the return of the securities when the customer tenders the amount of the debt. The broker remains accountable for the securities but he is not a converter. Conversion by a pledgee essentially consists in exercising a dominion inconsistent with the powers and privileges of the pledgee. In cases covered by the rule of this Section, the pledgor has consented to a certain exercise of dominion by granting the pledgee a power greater than would be the normal incident of a pledge. He knows that if the additional power is exercised, an additional risk is involved to his securities. Inability on the part of the pledgee to return the pledged chattels by reason of insolvency is not any new assertion of dominion by the pledgee.

A permission in general terms to repledge is conditioned by the relation between the pledgor and pledgee. If the original pledge is to secure a demand loan, the pledgee should not make a repledge to secure a time loan. If the pledge is to secure a loan for a particular period, the repledge should not secure a loan for a longer period. The pledgee will be held strictly to the permission he has received to use the pledgor's chattel for his own purposes. If he goes beyond this permission, he is a converter of the chattel at the time of the repledge. His insolvency at the time of payment or tender by the pledgor will then be no excuse for a failure to return the chattel, even if the pledgor is willing to waive the original conversion.

Illustrations:

1. A margin customer has given his stockbroker the power to mingle and repledge the customer's securities for the broker's borrowings. The broker exercises this power, repledges the customer's securities with others for a demand loan larger than the customer's debt, and becomes insolvent. The customer tenders the amount of his debt to the broker and demands the delivery of the securities. The broker is unable to comply because his insolvency makes it impossible for him to redeem the customer's securities. The broker is not liable to the customer as a converter.

2. Same facts as Illustration 1. The customer's borrowings of the broker are on a demand basis. The broker, without any special permission to use the customer's securities for time loans, repledges the securities for a three months' loan. Thirty days later the customer tenders the broker the amount of his debt. The broker is unable to obtain the customer's securities because of insolvency. The customer can treat the repledge as a conversion on the date of the repledge, or he can waive this conversion and treat the refusal as a conversion. The result would be different if the permission to repledge was in terms broad enough to permit the use of the customer's securities for any loans of the broker.



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Restat 1st of Security, § 46

§ 46 Equitable Remedies of the Pledgor and Pledgee Prior to Default

Where the legal remedies of pledgor or pledgee are inadequate to protect their respective interests, either pledgor or pledgee is entitled to the aid of a court of equity where such court is able to grant an effective decree.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. In most cases involving the pledgor-pledgee relationship the legal remedies of the parties are adequate. Where because of the uniqueness of a pledged chattel, the insolvency of either party, or for other reasons, it can be shown that an equitable remedy is the only one which will give the party seeking it adequate protection, and that facts are such that a decree by a court of equity can be enforced, the aggrieved party is entitled to appropriate equitable relief according to the usual rules of equitable procedure. See § 39 (d).

Illustrations:

1. A pledges to B a painting of great value. B cares for the painting so negligently that it is threatened with irreparable harm. A court of equity upon A's petition may enjoin B's conduct or appoint a receiver to hold possession of the painting.
2. A pledges to B promissory notes which B returns to A for collection. A is insolvent, uses some of the proceeds for his own purposes, and refuses to return the notes upon B's request. B may obtain the aid of a court of equity to compel the return of the pledged notes.



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Topic 3 - Enforcement of a Pledge

Restat 1st of Security, § 47

§ 47 Statute of Limitations and Discharge in Bankruptcy

A pledge is not terminated by the running of the statute of limitations against the claim secured by the pledge, nor by the discharge of the claim in bankruptcy.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The term "statute of limitations" is used to mean a statute barring causes of action after a particular period. (See *Restatement of Property*, § 220.) The effect of a statute of limitations is to bar the remedy but not to discharge the obligation. Certain statutes, which in terms seem to extinguish the debt, have been interpreted as statutes of limitations. Even when interpreted as extinguishing the debt, the effect is not to terminate a security interest unless it is specifically provided that security interests are to end with the extinguishment of the debt. One rationalization of this result as applied to pledges is that although the original debt is extinguished, the pledgee retains against the pledgor a claim against the pledgor of the sort he would have if the parties had agreed at the outset that the pledgor assumed no personal obligation.

b. The words "discharge in bankruptcy" mean discharge under the United States Bankruptcy Act as in force on January 1, 1941. While § 17 of the Bankruptcy Act states that a discharge in bankruptcy shall release a bankrupt from all his provable debts with certain stated exceptions, the Section is interpreted merely as barring the remedy on debts. The Bankruptcy Act contemplates that security interests are not to be affected except when the act so provides, as, for example, in the case of preferences and fraudulent conveyances.

Legal Topics:

For related research and practice materials, see the following legal topics:
Governments Legislation Statutes of Limitations General Overview



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Topic 3 - Enforcement of a Pledge

Restat 1st of Security, § 48

§ 48 Methods of Enforcement

Upon default, the pledgee, in addition to his rights in respect of the enforcement of the claim secured by the pledge, can

- (a) after giving reasonable notice of the time and place of sale to the pledgor and also to the third person where the pledgor has been authorized by a third person to pledge the latter's chattels, sell the pledged chattels at a public sale where they are goods or instruments which have a market, or**
- (b) exercise any special power of sale which he has been given by the pledgor, or**
- (c) in the absence of a special power of sale, collect but not sell, bills and notes not having a market, or**
- (d) maintain an action in a court of equity for foreclosure and sale of the pledged chattels and, if the pledgor is under a personal obligation, also obtain a deficiency judgment in the event that the proceeds of sale do not satisfy the claim which is secured by the pledge.**

Special Note: In a few States statutes regulating the enforcement of pledges do not permit action on the debt to occur simultaneously with action to enforce the pledge.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Action on the debt. The giving of security, in the absence of any special agreement, does not affect the right of action of the pledgee on the debt or other obligation of the pledgor. In the case of loans by pawnbrokers circumstances may indicate an intention that the pawnor is to assume no personal obligation and that the pawnbroker must satisfy himself, if at all, out of the pawn. The parties may always contract that the pledgee assumes no personal obligation. See § 1, Comments *b* and *g*.

Illustrations:

1. A pledges furniture to B as security for a loan. Upon the maturity of the debt B sues A. A sets up in his answer

the fact that a pledge has been made and asks that the judgment be reduced by the value of the furniture. The judgment will be for the amount of the debt with legal costs.

2. Same facts as Illustration 1, except that B after judgment requests the sheriff to levy on A's automobile. The sheriff does so and sells the car. A cannot prevent the sale except by paying the judgment.

Comment on Clause (a):

b. Demand and notice. If the debt or claim secured by a pledge is payable on demand, the pledgee must first make demand on the pledgor. After the default the pledgee must give the pledgor notice of his intention to sell at public sale so that the pledgor may have an opportunity to redeem, and also must give notice of the time and place of the public sale so that the pledgor may attend and protect his interests. As to what constitutes notice, see § 10, Comment e, and Restatement of Agency, § 9a.

Where a third person has authorized the pledgor to pledge the former's chattels and this fact is known to the pledgee, it is the duty of the pledgee also to give the third person notice of the time and place of the public sale.

Pledge agreements, especially those prepared by banks and stockbrokers, commonly give the pledgee the privilege of selling without demand and without giving notice of time and place of sale. Where by a course of conduct a pledgee has continued for a long period to give notice not required in the pledge agreement, he may be found to have waived the special privileges accorded him by the pledge agreement. To avoid such a waiver pledge agreements frequently contain a special provision to the effect that a course of conduct shall not be deemed a waiver of any provision in the pledge contract.

c. Public sale. A public sale is one to which the public is invited by advertisement to appear and bid at auction for the goods to be sold. The goods must be offered and sold for cash to the highest responsible bidder. Statutes generally regulate public sales as to place, notice and conduct. It is usual to provide that if the sale is not conducted by one of the parties or by a public official such as a sheriff, it must be in charge of a licensed auctioneer. A sale of securities or commodities on a stock or commodities exchange is now generally regarded as a public sale.

d. Marketable chattels. A power of sale is a part of most pledges unless it is excluded by the pledge agreement. The power of sale, however, extends only to goods and to instruments which have a market. Since the power of sale extends to goods, it also extends to documents of title, such as warehouse receipts and bills of lading, representing goods. Instruments which have a market include corporate and government bonds, share certificates, and interim certificates and bankers' acceptances. Trade acceptances of large corporations are in the same class. In general any securities which are bought and sold in a securities' market can be sold in the enforcement of a pledge. Securities listed on an exchange have a market even if actual sales are infrequent. Where securities are not listed but where trading is permitted in an unlisted department of an exchange or where an over-the-counter market is maintained, the securities have a market. In general, the promissory notes and bills of exchange executed by individuals do not have a market.

Illustration to Clause (b):3. A pledges to B tangible chattels with an agreement that upon default B may sell the chattels at private sale. B in good faith disposes of the chattels to a second-hand dealer. The sale is valid.

Comment on Clause (b):

e. Construction of special power of sale. Pledge contracts giving the pledgee special powers of sale are generally drawn by counsel for the pledgee and imposed upon the pledgor as a condition of a loan. In case of ambiguity such contracts are construed against the pledgee. For example, the waiver of notice of sale to the pledgor does not amount to a waiver of demand for payment of a demand debt. The power of the pledgee to sell at public or private sale does not excuse the pledgee from complying with the usual formalities of public sales if he elects to sell at auction.

Comment on Clause (d):

f. Foreclosure. Equity always has jurisdiction to entertain a petition for the enforcement of a pledge by judicial order of sale. Foreclosure in equity may be essential when the pledgor cannot be found and it is impossible to make demand or notify him of the time and place of the sale of the pledged chattels. A bill in equity is appropriate when there is any dispute as to the amount of the pledgee's claim or as to the chattels pledged. A court of equity need not refuse to take jurisdiction because the pledgee has a legal power of sale. The court will not necessarily order the sale of pledged negotiable instruments and other choses in action not having a recognized market when it seems likely that the pledgee's interest will be adequately protected by collection of the instruments in due course. When the pledged instruments will not mature for a considerable time and the principal claim of the pledgee has already matured, or when other special circumstances exist making it inequitable to restrict the pledgee to the collection of the instruments as they mature, a court of equity may order their sale on whatever conditions the court may consider essential to do justice to both parties.



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Restat 1st of Security, § 49

§ 49 Pledgee's Duty of Good Faith and Accounting in the Sale of Pledged Chattel

(1) A pledgee in enforcing his power of sale has the duty to act in good faith and with diligence in protecting the interests of the pledgor.

(2) A pledgee after exercising the power of sale of pledged chattels, has the duty of paying to the pledgor any surplus remaining after his claim, including interest and proper expenses, has been satisfied.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. In the event that a third person has authorized the pledgor to pledge a chattel to secure the pledgee's obligation, the duty of the pledgee extends also to protecting the interest of the third party. The duty of good faith and diligence in making the sale is the same whether or not a third person is involved.

b. Invalid sales of pledged chattels. Numerous circumstances will result in the setting aside of a sale by the pledgee, or where the sale cannot be set aside in holding the pledgee accountable to the pledgor for the damage due to the pledgee's breach of duty. Affirmative acts by the pledgee to mislead the pledgor or prevent fair bidding, sales wilfully made in a market where fair value cannot be realized, and other schemes designed to give the pledgee or his friends the chattel at a fraction of its value are particularly likely to be condemned by the courts.

The mere failure of the pledgee to obtain an adequate price for the pledged chattels does not, in itself, furnish occasion for setting aside a sale even if the pledgee, if permitted to buy under the pledge agreement, is the purchaser. In the absence of any real competition, the pledgee is obliged to bid a fair approximation of the market value of the pledged chattels. If the pledgee buys the pledged chattels for only a nominal amount, the sale is subject to attack, or the pledgee may be held as trustee for himself and other parties in interest, including the pledgor.



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Restat 1st of Security, § 50

§ 50 Remedies of Pledgor for Breach of Duty by the Pledgee in Sale of Pledged Chattels

(1) Where the pledgee sells a pledged chattel without due notice to the pledgor, unless the pledged chattel is negotiable and is transferred to a holder in due course, the pledgor can

- (a) set aside the sale so that the pledge remains unaffected, or**
- (b) sue the pledgee and the transferee for damages as converters, or**
- (c) recover the pledged chattel from the transferee.**

(2) Where the pledgee sells a pledged chattel to a bona fide purchaser after due notice and at public sale or otherwise in accordance with the pledge agreement but nevertheless under such circumstances as amount to a breach of the duty of good faith to the pledgor, required by the rule stated in § 49, the pledgee is liable to the pledgor for damages resulting from this breach of duty.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. The pledgee's power of sale depends upon his giving the pledgor due notice and upon his making the sale in a proper manner. In other circumstances there is no power of sale and the position of the pledgee and his transferee is the same as if the pledgee had sold the pledged chattel without authority prior to the maturity of his claim. If the pledgor wishes the pledgee to liquidate his debt by a proper sale, he can have the sale set aside. He can, in the alternative, select the more drastic remedy of regarding the pledge as terminated and recover the chattel or sue for a conversion. If he chooses either of the latter remedies, he is subject to a set-off for the amount of the debt, either by the pledgee as holder of the claim or by the transferee as equitable assignee of it. See §§ 24 and 25.

Comment on Subsection (2):

b. Where the pledgee's claim is due and where he exercises his power of sale in an apparently proper manner, but where he is guilty of a breach of his fiduciary duty to the pledgor, by selling too many of divisible chattels, by selecting first for sale chattels which are not readily salable although other pledged chattels are available, or by other unequitable

conduct, the bona fide purchaser is protected. The exercise of the legal power of sale is not such an exercise of dominion as to amount to a conversion. Nevertheless the pledgee is answerable in damages for the breach of his fiduciary duty.

Illustration:

1. A pledges to B a collection of rare and valuable Grecian and Egyptian antiquities, waiving demand and notice. B on A's default complies with the technical requirements of advertisement and sale by public auction but gives A no special notice and makes no effort to insert the advertisement in any publication likely to come to the notice of collectors or museum curators. No special notice is sent to any such persons. At the sale C buys the collection in good faith for an amount much below the collection's fair value. A may hold B liable for the fair value of the collection.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law
Negotiable Instruments
Enforcement
Duties & Liabilities of Parties
Types of Parties
Holders in Due Course
General Overview



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Restat 1st of Security, § 51

§ 51 Purchase by Pledgee

(1) The pledgee, without the consent of the pledgor, does not have the privilege of purchasing the pledged chattel directly or indirectly at a public sale, except where the sale is under the control of a court of equity.

(2) Where a pledgee purchases the pledged chattel at a public sale without the consent of the pledgor, except when the sale is under the control of a court of equity, the sale is voidable by the pledgor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Pledgor's options. The pledgor has the option of affirming the sale and holding the pledgee accountable for the purchase price, or of disaffirming the sale. If he takes the latter alternative, the pledge is not terminated. The pledgor has the same option when he has consented to a purchase by the pledgee at a public sale but where the purchase may be avoided for some irregularity. Since the purported sale does not give the pledgee ownership of the pledged chattel, he may be guilty of a conversion by subsequent assertion of a proprietary interest in the chattel.



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Restat 1st of Security, § 52

§ 52 Sale at Pledgor's Request

Before the maturity of the claim secured by the pledge the pledgee has no duty to sell pledged chattels at the request of the pledgor; subsequent to maturity the pledgee has no duty to sell pledged chattels at the request of the pledgor unless the proceeds will satisfy the pledgee's claim.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The pledgor's obligation is to perform the act for which the pledge is security. If he does that, he can obtain the return of the pledged chattel. Until maturity the pledgee can maintain his position. He need not permit an acceleration of satisfaction nor any change in security at the request of the pledgor. If the claim has matured, the pledgee need not sell at the request of the pledgor unless the proceeds will be sufficient to satisfy the pledgee's claim. The pledgee, where the security is insufficient, is therefore not liable to the pledgor for any depreciation in value of the pledged chattel before the sale actually occurs. On the other hand, if after maturity, the pledgor requests a sale which will assure satisfaction of the pledgee's claim including interest, expenses, and cost of sale, the pledgee's duty of good faith towards the pledgor does not justify a refusal. For example, if a painting has been pledged to secure a \$ 1000 loan, and after maturity the pledgor notifies the pledgee that a buyer is available who will pay \$ 1500 for immediate delivery, or if share certificates are pledged to secure a loan of \$ 1000 and after maturity the pledgor requests a sale at a time when stock exchange quotations indicate a value of \$ 1500, the pledgee has a duty to comply with the pledgor's request. If the pledgee refuses and a loss ensues to the pledgor, the pledgee is liable for the loss.

Illustrations:

1. A pledges to B share certificates worth \$ 5000 to secure a six months' loan of \$ 3000. Ninety days thereafter stock exchange quotations indicate a market value of the certificates of \$ 8000. A requests B to sell them. At the maturity of the loan the certificates are worth \$ 6,000. At the maturity of the debt B sells certificates equal to the amount of the debt and pays the balance to A. A sues B for \$ 2000. A cannot recover. B is under no duty, in the absence of special agreement, to sell or permit the sale of the certificates before the maturity of the loan.

2. A pledges to B share certificates. At maturity the certificates are not worth enough to meet B's claim. A without offering to pay the debt requests B to sell the certificates. B refuses. The certificates continue to decline in value and B sells them for less than he could have obtained at the date of A's request. B sues A for the difference between the amount realized at the sale and the amount of his claim. B can recover judgment for this deficiency.

3. Same facts as Illustration 2, except that at maturity the certificates are worth considerably more than B's claim. B's duty is to comply with A's request and failure to do so will render him liable for resulting loss.

b. Pledgee as pledgor's agent. The pledgee may also be the pledgor's agent, as in the case of a factor or of a stockbroker with whom the pledgor has a margin trading account. In such a case the broker owes to the pledgor both the duty of a pledgee and of agent. The broker's duty as agent will take precedence over his privileges as pledgee. In such a case, in the absence of a contrary agreement, the pledgee must follow the pledgor's direction to sell at any time, irrespective of the sufficiency of the security.

Illustration:

4. A, a margin customer of B, a stock-broker, has bought through B share certificates. At a time when the certificates do not have a market value sufficient to cover A's debt to B, A orders their sale. B refuses. The certificates subsequently decline in value. B then sells them. B is liable to A for the resulting loss, unless the contract between A and B makes A's power to order a sale dependent upon the sufficiency of the security.



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Restat 1st of Security, § 53

§ 53 Sale of Divisible Chattels by Pledgee

(1) When the pledged chattels can be sold advantageously in parcels the pledgee has a duty to the pledgor to sell no more than is necessary to satisfy his claim.

(2) When the pledgee has the duty to sell the pledged chattels in parcels he may use his discretion as to which parcel should be sold first, subject to his duty of good faith and diligence to the pledgor.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. As stated in § 49, the pledgee has the duty of acting in good faith and with diligence in enforcing a pledge. Where the pledged chattels are divisible, the pledgee should sell only enough to cover his claim. Instances of divisibility occur, among others, when the pledged chattels consist of bonds, corporate shares, commodities, negotiable documents of title, and goods of various sorts. Where the chattels are an economic unit, such as a matched team of horses or a necklace of graduated pearls, the possibility of dividing the pledged chattels physically does not justify their sale in parcels.

Illustrations:

1. A pledges to B bonds and shares worth \$ 25,000 to secure a debt of \$ 15,000. B in enforcing the pledge has the duty to limit his sales to the amount of the securities which will cover the debt.

2. A makes to B a bulky goods pledge of a pile of coal to secure a loan of \$ 1000. The coal is worth considerably more than the debt. In enforcing the pledge, B has the duty to limit his sale of the coal to that which will cover A's obligation if purchasers are available for less than the whole amount.

Comment on Subsection (2):

b. If the pledged chattels consist of things of various sorts of which part are sufficient to protect the pledgee and for

which as to part the pledgee can certainly obtain a purchaser at a fair price and for which as to another part an advantageous price is doubtful, it is the duty of the pledgee to sell first the part for which the better market exists. When there is no apparent difference, the pledgee can use his discretion as to the order of sale.

Illustrations:

3. A pledges to B several bonds and a group of Chinese ceramics. On A's default, either the bonds or the ceramics, or part of each, will bring enough upon sale to meet B's claim. B sells all the bonds and the ceramics at a public sale in connection with which all requirements of demand and notice, advertisement and conduct of sale are met. The bonds bring their market value, but the ceramics bring much less than their fair value although sold for an amount equal to A's debt to B. A can recover judgment from B for the difference between the amount paid him by B and the value of the ceramics.

4. Same facts as Illustration 3, but B sells the ceramics instead of the bonds. If the bonds are corporate securities having a ready market, A can hold B for the loss sustained.

c. *Marshalling.* Where a debt is secured by chattels which can be conveniently sold in parcels and as to some of the chattels a third person has a junior security interest, the pledgee can be compelled by a court of equity to sell first the chattels in which he has the exclusive security interest, provided the third person can show that such sale will not be inequitable to the pledgee.

Illustration:

5. A pledges to B as security for a loan two bonds and a motor car. A subsequently gives C a chattel mortgage on the car. C is able to show that B can satisfy all but a small part of his claim out of the bonds. A court of equity can compel B first to apply the proceeds of the bonds to the satisfaction of his claim.



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Restat 1st of Security, § 54

§ 54 Pledgor's Right to Redeem

The pledgor can obtain the aid of a court of equity to redeem the pledged chattels where his legal remedy is inadequate.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The pledgee in a proper case can bring an action to enforce his security interest by sale in judicial proceedings. See § 48. The pledgor likewise can invoke the aid of equity to enforce his right to redeem the pledged chattel after a tender of performance by the pledgor has been refused. A purchaser from the pledgor, or other persons having an interest in the pledged chattel also can redeem the pledged chattel. See § 16. In accordance with the usual rules of equity procedure, a court of equity will not take jurisdiction if the pledgor's legal remedy is adequate. A proper case for the exercise of equity jurisdiction would be presented if the pledged chattel were unique or if the pledged chattels were negotiable and an insolvent pledgee were shown to be planning an illegal transfer. Another appropriate case for equitable jurisdiction would occur where the pledgor had received notice of an assignment, but was uncertain as to whom the debt should be paid.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawSecured TransactionsDefaultForeclosure & RepossessionRedemption



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Restat 1st of Security, § 55

§ 55 Contract Not to Redeem

(1) An agreement between pledgor and pledgee in connection with the creation of a pledge which purports to deprive the pledgor of his privilege to redeem is void.

(2) An agreement after the creation of a pledge by which the pledgor and pledgee agree that the pledged chattel is to be retained by the pledgee in whole or in part satisfaction of the claim of the pledgee is valid if the pledgee sustains the burden of showing that the bargain is free from fraud and oppression.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The pledge is a security for some act to be done by the pledgor or another. Pledgees and other secured creditors have always been under a fiduciary duty in respect to the security. Rules of law prescribe the methods by which security interests can be enforced. While these are subject to considerable variance by agreement between the parties, it has long been recognized that since creditors are often in the position to exact severe terms from debtors, a contract for a forfeiture of the debtor's interest in a pledged chattel, for non-payment of debt or other breach of contract, is against public policy and void. A pledgee will not be permitted, therefore, to make it a condition of a pledge agreement that in the event of a default he can keep the pledged chattel. In spite of such an agreement, the pledgor has the privilege to redeem.

If the pledgor is unable to make a payment or tender, he can require the pledgee to sell the pledged chattel if its value is sufficient to satisfy the pledgee's claim. See § 52. Otherwise, the pledgee's interest is continued as security but not as ownership.

Subsequent to the creation of a pledge the pledgee's ability to inflict an oppressive bargain upon the pledgor is greatly diminished although not wholly absent. The pledgor and pledgee should not be prevented from making a bargain by which the pledged chattel can be taken in whole or in part satisfaction of the pledgee's claim. Such a bargain will be upheld so long as the pledgee is in a position to show that the bargain is free from fraud or oppression.

Illustrations:

1. A pledges an automobile to B as security for a loan and agrees that if the loan is not paid at maturity B may take the car in payment. Upon default A demands that the car be sold at public sale. B refuses and asserts his title to the car. If A pays or tenders the amount of B's claim, B must return the car or be held as a converter. If A does not make a payment or tender B's pledge interest continues.

2. A pledges an automobile to B as security for a loan. On default A contracts with B that B can keep the car in satisfaction of the debt. A thereafter repudiates this agreement and tenders the amount of B's claim. B refuses the tender and A sues him for conversion. A alleges no unfairness in the bargain between him and B. A cannot recover judgment against B for the value of the car.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law Secured Transactions Default Foreclosure & Repossession Redemption



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Restat 1st of Security, § 56

§ 56 Apportionment of Proceeds of Sale of Pledged Chattel

In the absence of a special agreement to the contrary where a pledge secures several claims of a pledgee, the proceeds of the enforcement of a pledge are applied in accordance with the wishes of the pledgee unless equitable considerations require a different application.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Where the pledge is enforced in foreclosure proceedings, the pledgee will normally make some request for the allocation of the proceeds. In the absence of equitable considerations to the contrary, the wishes of the pledgee will be followed. Where the pledgee makes no request, or where a pro rata application will be more equitable, the proceeds will be applied pro rata to the various obligations.

Equitable considerations involving assignees or other third persons may require an application contrary to the pledgee's request and contrary to the pro rata rule. Where the pledgee has indorsed and negotiated one of two notes secured by a pledge, the proceeds, in the absence of agreement to the contrary, should be applied first to the note held by the transferee. (See § 30.) Similarly, if the pledgee has two claims secured by the same pledge, and has other security for one of the claims, and a third party has an interest in the pledged chattel, the rules of marshalling may require that the proceeds be first applied to the claim for which the pledgee has no other security, and that the other security be exhausted before the proceeds are applied to the secured claim.



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Restat 1st of Security, § 57

§ 57 Equitable Protection to Pledgor on Suit by Pledgee

Where the pledgee sues the pledgor on his obligation the pledgor can obtain such equitable aid as may be necessary to effect the return of the pledged chattel or an accounting therefor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The purpose of the rule stated in this Section is to enable the pledgor certainly to obtain the return of the pledged chattel or an accounting for it, in the event that he satisfies a judgment for the amount of the pledgee's claim. The pledgor may have reasonable grounds to believe that the chattel has been injured or destroyed, or that a conversion has been committed or threatened, without being able to allege and prove such facts. The pledgor may not be in a position to test his belief by making a tender although a judgment against him could be satisfied.

No attempt is made here to indicate the precise procedure which the pledgor can follow. In some jurisdictions the pledgor may ask that the judgment be conditional, in others he can introduce an equitable plea, while in others separate relief in equity may be appropriate.



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Restat 1st of Security, § 58

§ 58 Effect of Pledgee's Levy on Pledged Chattels

If the pledgee attaches the pledged chattel in connection with an action against the pledgor, the existence of the attachment lien does not terminate the pledge.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Circumstances may arise where the pledgee prefers to obtain judgment and have the pledged chattel sold in connection with the enforcement of a judgment. It may be possible for example to sue the pledgor on his obligation although the pledgee is uncertain that he can give the pledgee notice of the time and place of a public sale. The pledgee may wish to establish the amount of his claim in an action at law instead of by an action of foreclosure. Since the attachment involves a surrender of possession there is a technical argument that the pledge interest has been terminated by the lien of the attachment. If this is true and if the pledgor becomes a bankrupt within four months of the attachment, since the lien of the attachment has been obtained by legal proceedings within four months in bankruptcy it is voidable by the trustee in bankruptcy. Inasmuch as the pledgee's purpose is merely to enforce his security and no injury has been done to the pledgor, the rule of this Section permits the pledgee to retain his pledge interest.

Illustration:

1. A pledges an automobile to B as security for a loan. On the maturity of the loan B gets judgment against A and directs the sheriff to levy on the car. The sheriff does so but before the car is sold and within four months of the levy A files a petition in bankruptcy. The judgment lien is voidable, but A can enforce the pledge.



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Chapter 2 - Possessory Liens

Scope Note

The term "lien" is frequently used in the broad sense of a tie or hold which one person has for the purpose of security upon land, chattels or intangibles in which another has an interest. A lien in this broad sense may also be defined as a charge. Thus broadly understood "lien" may be considered as a general term embracing all sorts of security devices, legal or equitable.

The term "possessory lien" is not used in this Chapter in the broad sense just mentioned but in a narrow sense which makes it one of the most limited, if not the most limited, of security interests. The possessory lien is an interest only in chattels. It is somewhat like a pledge but the powers of the lienor are generally less than those of the pledgee. Various sections of this Chapter indicate the similarities and differences between possessory liens and pledges. Statutory developments tend to reduce the number of differences between possessory liens and pledges. Chapter 2 is concerned chiefly with common law possessory liens, although many of the rules as to such liens apply to possessory liens created by statute.

Several terms which are used throughout Chapter 2 in the same sense as in Chapter 1 should be noted. The term "interest" is used both generically to include varying aggregates of rights, privileges, powers and immunities, and distributively to mean any one of them, see § 1, Comment *c*, and Restatement of Property, § 5. The term "chattel" means any physical object which is capable of manual delivery and which is not the subject-matter of real property. It includes instruments and documents (see § 1, Comment *d*). The term "instrument" includes documents. "Negotiable instrument" unless the context requires a more restricted meaning, is used to indicate various forms of negotiable instruments and negotiable documents, see Scope Note, Chapter 1, Topic 2. The term "bailment" denotes the possession of a chattel, rightful as between the parties to the bailment, by one not its owner, see § 1, Comment *f*.

Since the interest of the lienor, as of the pledgee, is based on possession, the concept of possession is of great importance in Chapter 2. The essential element of possession is physical control of a chattel with intent to exercise such control, otherwise than as a servant on behalf of another (see § 1, Comment *a*, and Restatement of Torts, § 216).

Since enforcement of most liens by reducing the chattel to a money equivalent and applying the proceeds on the demand for which the lien is security is permitted only by statute, Chapter 2 does not treat of enforcement except in certain instances which are noted under particular sections. (See § 72.) Where enforcement is permitted by statute or otherwise, the rules pertaining to pledges are applicable if other rules are not prescribed by statute.

Several sections of Chapter 1 are repeated with appropriate modifications in Chapter 2. Certain sections, among others, § 31 dealing with partial assignments, §§ 46 and 57 dealing with equitable remedies of the pledgor, while theoretically applicable to certain possible but unlikely lien situations, are not incorporated in Chapter 2, because they are of little practical significance in respect of liens

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsGeneral OverviewContracts LawSecured TransactionsDefaultForeclosure & RepossessionEnforcementContracts LawTypes of ContractsBailments



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Chapter 2 - Possessory Liens

Restat 1st of Security, § 59

§ 59 Possessory Lien Defined

Where a bailee has the privilege of retaining a chattel, not bailed for the purpose of securing the payment of a debt or the performance of some other act by the bailor, until some demand of the bailee against the bailor has been satisfied, the interest of the bailee is a possessory lien.

Special Note: Maritime Liens. The maritime lien is a nonpossessory charge upon a vessel, arising out of contract or tort. Liens arising out of contract are awarded in furtherance of commercial policy which demands that credit be given to the ship outside of its home port for the continuance of its voyage. In general, therefore, one who pursuant to a contract furnishes necessary services, supplies or repairs, or funds for such purposes, has a lien which attaches to the whole ship. Seamen, pilots, salvors, stevedores and those who furnish supplies and repair materials, but not masters, brokers, or builders of the original vessel, are among the beneficiaries of the lien. The rules as to maritime liens in the United States have been modified by federal statute in important particulars.

Maritime liens arising out of tort are based on the principle that the ship, apart from the owner, is itself a wrongdoer liable for personal or property damage caused by it. The liability must arise out of circumstances peculiarly maritime in nature.

Neither type of maritime lien depends upon possession, nor is there any requirement of filing or recordation. The liens attach to the res itself rather than to the interest of any person therein. Detailed and not wholly consistent rules govern the priority of maritime liens. Because it follows the res, the lien can be enforced in whatever jurisdiction the ship is found and while in the possession of anyone, including a bona fide purchaser, so long as the lienor is not guilty of undue delay or laches.

Unlike the usual possessory lien, the maritime lien is enforceable by sale of the vessel. Upon the filing of a libel in a court of admiralty, a writ of attachment may issue against the ship and upon the subsequent seizure is based the in rem jurisdiction of the court. All lien claimants are given an opportunity to have their claims adjudicated in a single proceeding. A sale made pursuant to the proceeding conveys a title good against the world. Liens which have been allowed become a charge upon the proceeds of the sale.

Maritime liens are not considered further in the Restatement of this Subject.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The term "lien" without a qualifying adjective is used in the Comments and Illustrations to the Restatement of this Chapter with the restricted meaning stated in this Section unless the context indicates that a broader significance is intended. The types of liens covered by the definition include not only liens recognized at common law where not contracted for, but also liens arising by contract and those created by statute, provided they are dependent upon possession in a bailee. The privilege of retention, originally without the power of enforcement, is the chief characteristic of the common law possessory lien. (For the meaning of enforcement as applied to liens, see § 72, Comment *a.*) Modern statutes have created liens which are not dependent upon possession, and have also provided methods for enforcing most liens. The power to enforce can be created also by agreement of the parties (see § 65).

b. Lien and pledge. The bailment that creates a pledge is for the purpose of giving security for the performance of an act by the pledgor. The transaction is essentially financial. The purpose of the bailment from which a lien arises is to enable the bailee to render some service to the bailor, often in respect to the particular chattel that is bailed.

c. Equitable lien. The term "lien," in its broadest sense includes equitable liens, which do not depend upon possession. Equitable lien is defined in the *Restatement of Restitution*, § 161, as follows: "Where property of one person can by a proceeding in equity be reached by another as security for a claim on the ground that otherwise the former would be unjustly enriched, an equitable lien arises." Equitable liens are not treated separately in the Restatement of this Subject, but certain equitable security interests are noted in various Sections. See, for example, § 10, dealing with equitable interests arising as a result of a contract to pledge.

d. The phrase "demand of the bailee" denotes that there exists a duty on the part of the bailor that is related to the bailment. The duty of the bailor is primarily to pay money. This duty generally arises from contract though in some cases it may arise out of a tort liability. Further details as to the demand for which a specific lien is security are discussed under §§ 60 and 61, and as to the hotelkeeper's demand under § 63. For items which may be included in the demand for which a general lien is security, see §§ 60 and 62. See § 64 as to items of demand for services rendered after the services for which the bailment has been made have been completed.

Legal Topics:

For related research and practice materials, see the following legal topics:

Admiralty LawMaritime ContractsGeneral OverviewAdmiralty LawMaritime LiensNatureJurisdictionCivil ProcedureRemediesProvisional RemediesAttachments



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Case Citations

Rules and Principles

Division 1 - Personal Property as Security

Chapter 2 - Possessory Liens

Restat 1st of Security, § 60

§ 60 Classification of Possessory Liens

(1) Possessory liens are either specific or general.

(2) A possessory lien is specific where the bailee has the privilege of retaining a chattel as security for a demand arising out of one contract or one tort liability, or out of one contract and such tort liabilities as arise out of the relationship created by the contract.

(3) A possessory lien is general where the bailee has the privilege of retaining a chattel as security for the balance of a general account with the bailor.

Special Note: Specific liens are sometimes called particular liens. The term "specific lien" only is used in the Restatement of this Subject.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (2):*

a. The characteristic specific lien exists where a chattel has been bailed in order that the bailee may render some service in respect of the chattel, as where a motor car is bailed for repair. The chattel can be retained as security for the single repair bill, but not as security for outstanding accounts. Where more than one chattel is bailed as part of a single transaction, any chattel can be retained for the whole bill, even if the other chattels are returned to the bailor before payment (§ 80 (2)). Where the lien exists following a seizure of the chattels, as in the case of cattle damage feasant, the lien is limited to the damage due to a single occasion of trespass by the animal seized. If the damage occurs on separate occasions and no cattle are seized on one occasion, or if seized, are released, the lien on the cattle seized on the second occasion will not secure the first liability, even if the damage is caused by the same cattle. (See § 61, Comment *r.*)

In the case of the hotelkeeper, where the bailment is related to a service to the guest personally rather than in respect of the chattel, the lien is specific in the sense that any chattel brought on the premises of the hotel by or for the guest, with certain exceptions (see § 63) can be retained for a bill against the guest arising out of an uninterrupted sojourn. That bill may include many items, but if it includes those for damage done by the guest to the hotel premises or furnishings, the lien does not extend to such tort items. If the guest departs from the hotel and is allowed to remove

his chattels without payment, the lien terminates. If the guest returns to the hotel with the same chattels for a second period of entertainment, the lien for the former bill will not revive.

Specific liens, once having arisen, continue if possession is maintained by the bailee, until lost as a result of a statute of limitations relating to liens. They are not lost by a running of the statute of limitations on the claim secured by them. See Comment *b*.

Comment on Subsection (3):

b. General account. The essential characteristic of the general lien is that the items which make up the demand for the lienor may arise out of separate transactions so long as they occur in regular course of business or arise out of the professional relationship of the parties (see § 62). The factor, for example, cannot include in the demand for which his general lien is security, advances which do not arise out of his functions as an agent to sell. An attorney who has made a personal loan to a client has no lien for the loan on papers which the client has delivered to the attorney in respect of a lawsuit. The general lien exists even if the transactions out of which the demand arises are different and are separated in time. So long as any demand arising in regular course of business or out of the professional relationship is not barred by a statute of limitation applying to liens rather than to claims, it may be included in the account for which the general lien exists.



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Rules and Principles

Division 1 - Personal Property as Security

Chapter 2 - Possessory Liens

Restat 1st of Security, § 61

§ 61 Persons Entitled to Specific Possessory Liens

Specific possessory liens exist in favor of

- (a) a bailee who at the request of the bailor does work upon or adds materials to a chattel;**
- (b) a common carrier which at the request of the consignor or passenger transports a chattel, or, if a connecting carrier, which transports a chattel in good faith at the direction of the common carrier to which the consignor has delivered it or at the direction of an intermediate carrier;**
- (c) a hotelkeeper as stated in § 63;**
- (d) a warehouseman who at the request of a bailor receives a chattel for storage;**
- (e) a finder of a chattel for the return of which a specific reward is offered;**
- (f) an unpaid seller of a chattel in possession;**
- (g) an agent who has a claim against his principal for money advanced or liability incurred in respect of a chattel in his possession;**
- (h) a landlord who after the default of a tenant in the payment of rent enters and seizes chattels in the possession of the tenant;**
- (i) a possessor of land who seizes a thing doing damage on the land.**

Special Note: Lien of Agisters. The early common law did not allow a lien to one who merely fed and housed an animal. The proprietor of a pasture did not have a lien for his grazing charges. The keeper of a livery stable was likewise denied a lien for his compensation on account of food or shelter given an animal. This rule was sometimes justified on the ground that the agister, unlike the artisan, did not do work upon the animal. It is difficult to see why the alternative basis of the artisan's lien, the adding of materials, did not justify allowing a lien to an agister. It was sometimes argued that the agister did not improve the animal, although actual improvement was not necessary in the case of the artisan's lien. Moreover, a warehouseman was allowed a lien although he neither did work on the chattel nor engaged in a public calling. Perhaps a more significant reason for the inferior position of the agister or the livery stable keeper in respect of liens was that they characteristically permitted the owner to resume possession of the animal from time to time and generally at the convenience of the owner. This was thought to be a violation of the rule that possession of the lienor must not be interrupted although the hotelkeeper was allowed a lien in spite of the fact that a guest was generally permitted to move his belongings in and out of the hotel. A few American jurisdictions refused to

follow the common law rule as to agisters and livery stable keepers. Statutes now generally allow them a lien on substantially the same terms as that of the hotelkeeper.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The list stated in this Section is intended to include all categories of persons who are allowed specific liens at common law. Statutes have created other liens, especially the lien in favor of agisters (see Special Note, *infra*). The list does not mean to preclude the development by analogy of possessory liens in favor of others. The tendency is strongly against the recognition of other liens, except under statutory authority.

b. Bailment by agent. Under the general rules of form of the Restatement, the rules in the various sections include those situations where a principal is bound by the act of his agent. Where the expression "at the request of the bailor" appears, the rule also applies where the request is properly made by an agent. (See Restatement of Agency, § 12.)

Comment on Clause (a):

c. Artisan's lien. The lien of the bailee, who does work upon or adds materials to chattels is one of the earliest of common law liens. The early common law did not permit an action on a contract which was not embodied in a specific promise. Thus the demand for work done on a chattel at the request of a bailor, who did not specifically agree to pay the bailee's charges, was not an actionable debt. The possessory lien was accordingly allowed so that artisans would not be entirely without legal protection. After demands for quantum meruit on account of work done became actionable, the possessory lien was preserved. Until the nineteenth century it was generally stated, at least in England, that there was no common law possessory lien where there was a specific contract for payment. This distinction is no longer recognized and the bailee who does work upon a chattel or adds materials to it is everywhere allowed to retain the chattel until he is paid, even if there is a specific contract for payment.

Illustrations:

1. A takes his watch to a jeweler for repair. No bargain is made as to the payment. The jeweler has a lien on the watch for reasonable compensation.

2. Same facts as Illustration 1 except that A agrees to pay \$ 5 for the repairs. The jeweler has a lien on the watch for \$ 5. At the early common law, the specific bargain prevented a lien from arising.

d. Improvement of chattel. The rule stated in Clause (a) does not require that the chattel be actually improved or increased in value. The lien exists if the services are rendered or the materials are added in accordance with the bailor's request. The service necessary to create a lien is limited to work actually performed upon the chattel itself. There is no lien for intellectual labor although it may have been wholly confined to the chattel as a subject. Thus an art expert to whom a painting has been delivered for appraisal and opinion cannot retain the painting as security for his fee, in the absence of a special contract for a lien.

e. Chattels in owner's possession. Since the lien for work done or materials added depends upon possession, if the services are rendered upon chattels in an owner's possession, the artisan has no lien.

Illustration:

3. A requests an artisan to come to his home and repair a grandfather's clock. The clock is repaired on A's premises. The artisan is not a bailee and has no lien for his services.

f. Surrender of part of chattels. Where the privilege exists of retaining several chattels until a demand is paid, the surrender of part of the chattels does not reduce the privilege of holding the remaining chattels. The lien continues on such chattels until the entire demand is satisfied. See § 80 (2).

Illustrations:

4. B brings to C, a cooper, materials from which to make 100 barrels. C makes 100 barrels and allows B to take 50 of them but refuses to allow B to take the second 50 until the entire bill is paid. C's refusal is proper. He has a lien for his whole bill on any part of the barrels not surrendered.

5. B brings to a jeweler two watches and a clock for cleaning and repair. The jeweler, after his work is done, allows B to take the watches. Since the articles are all held in connection with a single contract, the jeweler can retain the clock until the whole bill is paid.

6. Same facts as Illustration 5, except that the three articles are brought to the jeweler's on separate days. The jeweler has a lien on the clock only for the amount due for the work on it.

Comment on Clause (b):

g. Common carrier's lien. The common carrier is engaged in a public calling which affects him with special liabilities but also gives him certain privileges. If he holds himself out to serve the public generally as a common carrier of goods, it becomes his duty to receive for carriage goods offered to the limit of his facilities subject to such minor qualifications as that the goods must be delivered in a condition proper for shipment. The common carrier of persons is obliged to receive persons and their baggage for carriage. Not only does the common carrier have a duty of dealing with the public generally, once he has held himself out to do so, but he has an insurer's liability for goods entrusted to him. As a compensation for his special duties and liabilities the common carrier is allowed a possessory lien for his charges. Common carriers by both land and water are allowed possessory liens. Private carriers have less onerous duties and responsibilities and have no possessory liens unless granted by contract or statute.

It is not the purpose of the Restatement of this Subject to set out in detail the rules relating to common carriers. What is intended is to show by reference to certain generally accepted rules as to common carriers, why the common carrier is allowed the possessory lien.

h. Demurrage and storage. The common carrier's lien extends to the entire demand arising out of a single transaction with the bailor who has employed him. If goods have been consigned to the carrier to be moved from X to Y, the carrier has a lien for freight. If the consignee, in violation of the contract of carriage, does not remove the goods within a stipulated time from the vessel or vehicle in which they have been transported, the carrier can make an additional charge, which is called demurrage. If it is necessary for the carrier to remove and store the goods, either as a warehouseman, or with a warehouseman, the carrier can make a reasonable charge for storage. The carrier has the privilege of retaining the goods until all these charges for freight, demurrage and storage are paid.

i. Carrier of passengers. The common carrier's charges in respect of the carriage of the passenger may cover the fare of the passenger, compensation for transporting the passenger's luggage and storage charges. Here also, as in the case of shipment of goods, the carrier has a lien on the goods in its possession for the entire charges arising out of the single transaction.

j. Connecting carrier. As stated in § 75, a possessory lien is usually subject to the interests of third persons, whose legal interests are superior to that of the bailor. In England, the common carrier's lien is not subject to the interests of third persons where the carrier has received a chattel in good faith for carriage. As stated in § 75, in the United States, the common carrier, except where it is a connecting carrier, is subject to the superior interests of third persons. Where a connecting common carrier receives a chattel in good faith from another common carrier, to whom a consignor or passenger has delivered it, or from an intermediate common carrier, the connecting carrier has a lien for the charges which constitute his demand, even if the chattels were supposed to have been delivered to another connecting carrier or even if the chattels were supposed to have been taken to a different destination. This rule is a recognition of the fact that goods frequently reach their destinations by the use of the facilities of two or more carriers and that for the expeditious handling of commerce it is necessary for the connecting carrier to rely upon directions of the carrier from

which the goods are received.

Comment on Clause (d):

k. Warehouseman's lien. The extension of the common law lien to the warehouseman, who neither works upon the chattel nor engages in a calling under which he is obliged to deal with the public generally, is an exception to the general theories under which common law liens are allowed. The lien is allowed only to one engaged in the business of warehousing, not to one who casually stores the goods of another unless the latter is given a lien by the contract of the parties.

Comment on Clause (e):

l. Finder's lien. Unless granted by statute, the finder has no lien in the absence of the offer of a specific reward. In such a case the lien is restricted to the amount of the reward. This rule prevails even where the finder has rendered services for which he is entitled to compensation. See for the rules under which a person is entitled to compensation for preserving another's things, *Restatement of Restitution, § 117*. The finder's privileges are thus restricted partly because he has become a bailee without the intention of the owner, and partly because the allowance of a lien for a claim, which is usually small compared with the value of the chattel, might enable the finder to oppress the owner.

Illustrations:

7. B finds a dog. He takes the dog to his house and cares for it several days before A claims it. B has no lien for his expense in caring for the dog nor for any reward.

8. Same facts as Illustration 7, except that A publishes a notice, which is read by B, offering a reward of \$ 10 for the return of his dog. B has a lien on the dog for the amount of the reward.

9. Same facts as Illustration 7, except that A offers a "liberal" reward. B has no lien.

Comment on Clause (f):

m. Unpaid seller's lien. The rule that the unpaid seller who has transferred title has a lien on goods so long as he retains possession is derived from the theory in the law of sales that delivery and payment are concurrent conditions in the absence of agreement to the contrary. The lien of the unpaid seller is one of the few liens that can be enforced by sale (see § 72).

n. Stoppage in transitu. Where the seller has delivered to a common carrier the goods which have been sold, the seller, in the event of the buyer's insolvency, can recover possession of the goods by notice to the carrier, despite the fact that the carrier is regarded as the agent of the buyer to receive the goods. This privilege of recovering possession of goods sold is called "stoppage in transitu." It cannot be exercised to defeat the interests of bona fide holders for value of order bills of lading. Where order bills of lading are outstanding the carrier need not deliver the goods on the seller's order unless the bills of lading are surrendered. When the seller recovers possession from the carrier his lien revives as if his possession had not been interrupted. It is beyond the scope of this Restatement to cover in detail the rules relating to stoppage in transitu, which belong to the law of sales. See Uniform Sales Act, §§ 54-59 inclusive.

Comment on Clause (g):

o. Agent's lien. Agents who are also factors, attorneys or bankers are allowed liens for their general balances (see § 62).

The Restatement of Agency, § 464, "When Agent Has Lien," is as follows:

"Unless he undertakes duties inconsistent with such a right or otherwise agrees that it is not to exist:

(a) an agent has a right to retain possession of money, goods, or documents of the principal, of which he has gained possession in the proper execution of his agency, until he is paid the amount due him from the principal as compensation for services performed or as indemnity for money advanced or liability incurred by him in connection with such things;"

(b) and (c) relate to the general liens of factors, bankers or attorneys at law.

"(d) an agent to whom goods have been consigned but not received, and who advances money in anticipation of their receipt, has a right to their possession and thereafter, under the conditions stated in Clauses (a), (b), and (c), to the rights therein stated;"

(e) relates to a charging lien of an attorney of record.

The Restatement of Agency, § 465, "When Subagent Has Lien," is as follows:

"(1) Against the agent and subject to the rights of the ultimate principal, a subagent has a lien upon things of such principal under the conditions under which other agents have liens against their principals, as stated in § 464.

(2) Unless the principal has agreed otherwise, the lien of a subagent in things of a disclosed or partially disclosed principal is limited by the rights between the principal and the agent, except where the agent has bound the principal by a transaction with the subagent in excess of the agent's authority, under the conditions stated in §§ 159-185.

(3) Against an undisclosed principal, the subagent has a lien under the same conditions as if the agent were the principal, except where the agent has acted in excess of his authority, in which the rules stated in §§ 194-211 are applicable."

Comment on Clauses (h) and (i):

p. Two forms of possessory liens arise from a seizure by the creditor. In general a debtor's chattels may be seized at the instance of a creditor only by officers of the law. The remedy of distress, that is, the taking of a chattel from a debtor or wrongdoer without legal process, as security, is allowed to a landlord for rent and to one in possession of land for damage done by things, especially animals on the land.

Comment on Clause (h):

q. Landlord's lien by distress. In the Restatement of this Subject no attempt is made to state in full the rules relating to the landlord's lien. Such detail belongs properly to the law of Landlord and Tenant rather than to the law of Security. Stated here are merely some of the more significant incidents of the landlord's lien acquired by distraint at common law. The landlord's privileges today are much modified by statute.

The landlord by the common law is allowed to enter the rented premises and seize chattels found there, as security for rent due. Distraint can be effected by entry and forbidding the tenant to remove specific chattels. Distress by the landlord is limited strictly to amounts due for rent but, with certain exceptions, can be exercised against any chattels on the leased premises even if not owned by the tenant. The lien acquired by distress gives the landlord no privilege of use nor power of sale. The landlord, therefore, is not allowed to distraint perishable chattels or other chattels which cannot be restored in the same condition as when seized. Chattels in the manual possession of the tenant are not subject to distress. When other chattels are sufficient to give the landlord adequate security, he cannot distraint chattels incident to the tenant's calling. While distress is not restricted to the tenant's chattels, goods delivered to the tenant for services to be rendered in the course of the tenant's business are exempt. Thus the landlord is not allowed to distraint the goods of an hotel keeper's guest, goods brought to an artisan for repair, nor goods in the possession of a carrier for transportation.

Distrain is only permitted in the daytime. Forcible entry to distrain is not permitted. After the seizure occurs the landlord is in the position of other persons having a common law possessory lien. The tenant likewise is in the position of a bailor in respect of whose goods a lien exists.

Comment on Clause (i):

r. Distress of things damage feasant. One in possession of land is allowed to seize things, especially animals, in the act of doing damage on the land. After the seizure the one who distrains has a possessory lien, which covers the damage done and the expense of keeping and caring for the thing seized. The lien depends upon obtaining and retaining possession, except that the lienholder may impound animals in a public pound instead of keeping them in his own possession. Unlike the landlord's lien obtained by distress, one who distrains things damage feasant is subject to the interests of third persons unless they can be affected with responsibility for the damage. The lienholder, for example, is subject to the lien of a recorded chattel mortgage. Once possession has been obtained, the position of the lienholder is substantially like that of others entitled to common law possessory liens. Since the distress is usually of cattle, the remedy is often described as if it applied only to cattle. Distress is also permitted of other domestic animals, and is even allowed in respect of inanimate objects. A locomotive, sent upon a track without the authority of the occupier of the land upon which the track is situated, may be distrained.

The lien arising from distress of things damage feasant covers harm to land, to chattels, and to the person of the occupier. Each thing distrained can be held only for the particular damage caused by it. For example, if ten head of cattle cause damage and only one is distrained, the lien extends only to the damage done by the one seized. To avoid the danger of breach of the peace, distress is not permitted if animals are in the possession or view of the owner or one acting by authority of the owner.

Statutes in the United States have generally regulated distress of things damage feasant and have provided for the enforcement of liens acquired by such distress.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law Secured Transactions Perfection & Priority Priority Liens Contracts Law Types of Contracts Agistments Real Property Law Landlord & Tenant Landlord's Remedies & Rights Power to Reenter & Terminate



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Rules and Principles

Division 1 - Personal Property as Security

Chapter 2 - Possessory Liens

Restat 1st of Security, § 62

§ 62 Persons Entitled to General Possessory Liens

General possessory liens exist in favor of

- (a) a factor, as security for the balance due on general account, upon all goods of the principal entrusted to him for sale in the regular course of business;**
- (b) an attorney at law, as security for the general balance due him for professional services and disbursements, upon the papers and other chattels of his client, which come into his possession in his professional capacity;**
- (c) a banker, as security for the general balance due him from a customer, upon commercial paper and other instruments which can be used as the basis of credit and which are deposited with him in the regular course of business.**

Special Note: Wharfinger's Lien. A wharfinger is the proprietor of a wharf. By mercantile custom, incorporated into the common law of England, the wharfinger had on goods brought to his wharf a general possessory lien for the balance of a general account. This general lien has had no widespread recognition in the United States and may now be considered as obsolete. Except for such lien as he may enforce in admiralty, the wharfinger's lien upon goods or upon a ship left at the wharf for storage is the specific possessory lien of a warehouseman. Admiralty confers upon the wharfinger a non-possessory maritime lien on vessels for services rendered to them while actively engaged in commerce and navigation. Like other maritime liens, it does not arise for services to a vessel which is being stored or is out of commission. See as to maritime liens, § 59, Special Note.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Specific and general lien contrasted. The specific lien is security for the demand arising out of a single transaction. The general lien is an enlargement of the specific lien. It secures the demand arising out of a series of transactions. The transactions must be related to the extent that they must come within the general course of business. No lien exists in respect of transactions outside the regular course of business.

b. General liens, in the absence of contract or statute, are restricted to factors, attorneys and bankers. In the case of factors and bankers the courts have recognized a custom as being a part of the relationship of factor and principal and

banker and customer. In the relationship of attorney and client, the attorney being an officer of the court, is allowed a general lien as a compensation for the high degree of fidelity and responsibility he is bound to assume towards his client.

c. In most cases involving general liens there is only one general account. It is possible, however, for a principal, client or bank customer to engage in dealings which are partly personal and partly fiduciary. For example a man may be a customer of a bank in his private capacity and also as trustee or as a partner. In such a case the banker has two general liens for two separate general accounts, the items of which must be segregated. See as to the priority of the interests of third persons over specific and general liens, § 75.

Comment on Clause (a):

d. *Factor's lien.* The essential idea of the business of a factor or commission merchant is that he is an agent who is entrusted by a principal with the possession of the latter's goods for the purpose of sale. While the business of the modern factor includes many other activities, it is in connection with his function as a selling agent that the factor has a general lien on all goods of the principal entrusted for sale, as security for the balance due on general account.

(See Restatement of Agency, § 464 (b) and Comment *h.*)

e. A lien for the balance due on general account requires as a condition of the lien, that the entire account of the parties must show a balance due the factor.

The items in the general account must arise out of the business relation of the parties as factor, that is, as selling agent, and principal. The general lien covers among other items amounts due as commissions on sale, advances for transportation, cost of exhibiting goods, and expenses of delivery to buyers. Where the factor makes a loan for the improvement of the principal's plant, for the principal's personal expenses, or to meet the principal's general overhead, these charges are not a part of the general balance, in the absence of special agreement.

Illustrations:

1. A ships grapefruit and oranges to B throughout the course of the season for sale on commission. B pays the freight charges on the various shipments and earns certain commissions. At the end of the season with one shipment in his hands there is a balance due B. B has a lien on the shipment for his general balance.

2. Same facts as Illustration 1 except that before the last shipment A is a creditor on general balance. B pays the freight on the last shipment. The freight charges are less than the general balance. B has no lien for the freight charges he has paid.

3. B, a factor, makes A a loan not connected with his business as a commission merchant. A makes certain shipments to B, as a result of which, aside from the amount due on the loans, there is a general balance due to A with certain goods remaining in B's possession. B has no lien on these goods for the amount of his loan.

f. Just as a special agreement may add to the items entering into the general account for which the factor has a lien, so a special agreement as to the disposition of the principal's goods or the allocation of their proceeds, may prevent a lien from arising. See § 65.

Illustrations:

4. B, a factor, makes A, an orange grower, a loan at the beginning of the season so that A may install heaters in his orchards. A agrees that B is to have a lien on any shipment for the amount of the loan. At the end of the season, except for the loan, there is a balance due A and B has a large shipment on his hands. Because of the agreement, B may include the loan as a part of the general account and has a lien on the goods in the final shipment.

5. A, a farmer, is indebted to B, a factor, for freight and commissions on vegetable shipments. A ships B a car of spinach, with instructions that B after reimbursing himself for the freight charges paid on the car and the commissions for its sale, is to pay the proceeds to C. In the circumstances B has no lien on the spinach for the general balance.

g. Where the factor has a lien on goods he has also a lien on instruments and documents of title received in connection with the sale, shipment or storage of the goods. Debts due from purchasers on open account can be collected by the factor and applied in the settlement of his account with the principal.

h. The modern factor engages in many activities which are in the nature of banking rather than factoring. It is common business practice for a factor to make advances to a principal upon goods still in the principal's possession upon an agreement that the factor subsequently will receive the goods for sale or will be allowed to negotiate a sale for delivery directly from the principal. Where invoices are made out to the factor, there is strong evidence that the factor is to have a lien on the goods. Such a lien is not a common law general lien but rather an equitable lien, enforceable between the parties and against purchasers with notice and creditors of the principal who become such with notice of the contract for a lien. Where the goods thereafter come into the possession of the factor, the factor has either a general lien or a pledge depending upon the understanding of the parties (see § 10 and § 65). In a few States statutes recognize such liens and provide for their recording.

Comment on Clause (b):

i. Attorney's lien. The rule stated in Clause (b) is in accordance with the Restatement of Agency § 464 (b) and Comment *h*. The lien of the attorney is limited to indebtedness for professional services. The lien does not exist where papers or other chattels are delivered to an attorney for specific purposes inconsistent with the lien. Where the lien exists, the attorney cannot be compelled to allow the inspection of papers, to give discovery or to produce them in evidence where his lien will thereby be impaired.

Illustrations:

6. A corporation employs an attorney to take the necessary steps to amend the articles of incorporation in order to issue preferred shares. The attorney arranges for the amendment and in the course of his employment obtains possession of the preferred shares book. The attorney has a lien on this book for his advances and professional fee.

7. B, an attorney, lends \$ 2000 to A. Subsequently A employs B to conduct certain litigation for him and delivers to B a deed in connection with the litigation. A pays B for his legal services. B refuses to deliver the deed until A has repaid the \$ 2000 debt. B has no lien on the deed for the debt.

8. A consults B, an attorney, in respect to the conversion of certain bonds into common shares of a corporation. B effects an arrangement by which the shares are to be delivered upon surrender of the bonds. A thereupon delivers the bonds to B so that the transaction can be completed. The circumstances are inconsistent with a lien to B on the bonds although he will have a lien on the share certificates if they come into his possession in the course of his professional services.

j. Attorney's charging lien. The charging lien is the privilege enjoyed by the attorney of charging against a judgment obtained for a client the amount of the attorney's disbursements and the value of his professional services. The attorney also can apply against his charges money received for the client in a professional capacity. Neither of these privileges is a possessory lien and neither is considered further in this Restatement.

Comment on Clause (c):

k. Banker's lien. A bank is an institution whose characteristic functions are the receipt of deposits payable on demand, the discounting of commercial paper and the making of loans. The banker's lien arises from a mercantile custom incorporated into the common law by which the banker has a general lien, as security for the balance due from a

customer, on commercial paper and other instruments which may be used as a basis of credit and which are deposited with the banker in the regular course of business. See Restatement of Agency, § 464 and Comment *h*. The banker has no lien on securities delivered for safekeeping, nor as security for a particular loan, nor for any other purpose inconsistent with a banker's lien. In fact, bankers usually require customers who secure a loan by a pledge to agree that the subject matter of the bailment may be held as security for other obligations due the banker.

l. The banker's privilege of setting off a customer's obligation against the balance of his deposit account is not a possessory lien and is not considered in the Restatement of this Topic.

Legal Topics:

For related research and practice materials, see the following legal topics:

Admiralty Law
Maritime Liens
Nature
Property Subject to Lien
Admiralty Law
Maritime Liens
Priority & Sources
Contracts
Authority
Transportation Law
Water Transportation
Licensing & Registration



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Division 1 - Personal Property as Security

Chapter 2 - Possessory Liens

Restat 1st of Security, § 63

§ 63 Hotelkeeper's Possessory Lien

(1) The hotelkeeper's possessory lien, as to the guest, extends to all chattels which are brought on the premises by or for the guest except necessary wearing apparel and except other personal effects during such time as they are on the guest's person.

(2) The hotelkeeper's possessory lien, as to persons other than the guest who have an interest superior to that of the guest in chattels brought on the premises of the hotel by or for the guest, extends to such chattels subject to the rule as to government chattels stated in § 75 (1), unless the hotelkeeper

(a) knows that the guest is wrongfully in possession of the chattels, or

(b) knows that another person has an interest in the chattels superior to the guest and circumstances do not justify the inference that the guest is permitted to bring them to or receive them at the hotel as if they were his own.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Hotelkeeper and hotel. A hotelkeeper is a keeper of a public hotel or inn. The terms "hotel" and "inn" are synonymous. While both terms are in common use and while the term "inn" is generally found in the older discussions of the topic, the term "hotel" is employed here as more in accord with modern usage.

A hotel is a house which is held out to the public as a place where transient persons who conduct themselves properly and are able and ready to pay for their entertainment will be supplied at a reasonable charge with lodging and food and such services as are necessarily incident to the use of the house as a temporary home.

A boarding house whose keeper has the privilege of selecting his guests is not a hotel.

b. Guest. A guest of a hotel is a transient. A hotel, however, may also provide accommodations for tenants and boarders. Whether a particular person is a guest, a boarder, or a tenant, is a question of fact depending upon the arrangements between the person accommodated and the hotelkeeper. Factors which the trier of facts must consider include, among others, the duration of stay, the bargain as to compensation, and the residence of the person

accommodated. The guest need not accept all of the accommodations of the hotel to retain his character of guest. The guest characteristically comes without any bargain as to length of stay or total price to be paid, goes when he pleases, and pays only for the entertainment received.

c. The hotelkeeper's lien originated because of his general obligation to receive transients. A further reason for allowing the hotelkeeper a lien is found in the liability imposed on the hotelkeeper for the guest's chattels irrespective of negligence. A boarding house keeper who has the privilege of selecting his guests has no lien except as given by statute.

d. *Possession of hotelkeeper.* The hotelkeeper's lien is based upon the idea that he is in possession of chattels brought on the hotel premises with the exception of personal effects while on the guest's person. The lien is coextensive with the hotelkeeper's possession. The guest has the privilege of taking his chattels from the hotel unless the hotelkeeper has forbidden him to do so. The guest must always be allowed necessary wearing apparel. When the guest's chattels are away from the premises or are on the guest's person, the lien is suspended. Except for necessary wearing apparel, when such chattels are returned to the possession of the hotelkeeper the lien revives.

e. While the hotelkeeper may not detain the guest nor forcibly remove chattels from the guest's person, the guest has no privilege to remove chattels from the hotel for the purpose of defeating the hotelkeeper's lien. The exception of necessary wearing apparel is generously interpreted, but the guest has no privilege of taking away, whether on or off his person, clothing patently beyond the requirements of a single complete costume. An article on the person such as a wedding ring, although not strictly wearing apparel, will not be considered as having been removed for the purpose of defeating the hotelkeeper's lien. See as to the interest of the hotelkeeper in chattels removed from the hotel for the purpose of defeating his lien, § 80 (3) and (4) and Comment d.

f. *Hotelkeeper's charges.* The hotelkeeper has a lien for charges in respect of services furnished to the guest as a part of his entertainment. See as the demand for which a lien is security, § 59, Comment d, and § 60 (2). Under modern conditions, especially as determined by the type of hotel and its customary services, these charges include many items besides those for food and lodging. The test is whether the items on the bill are for services rendered to the guest as an appropriate part of his entertainment. For example, the hotelkeeper may add to the guest's bill charges for delivering the guest's baggage to and from the hotel if those services are furnished by or paid for by the hotelkeeper, for valet service, for payments of transportation and c.o.d. charges on goods which the guest has directed to be sent to the hotel, and for money advanced for current expenses of the guest. When the hotelkeeper receives motor vehicles as an incident to a guest's entertainment the charge for this service is also one for which the hotelkeeper has a lien. The hotelkeeper does not have a lien for services rendered by independent contractors even if these persons maintain shops or offices on the premises. For example, the hotelkeeper does not have a lien on account of professional services by a doctor whose office is in the hotel or on account of goods sold to the guest by a shop which occupies part of the hotel premises. Where goods are furnished to the guest by the hotelkeeper, it is a question of fact whether the goods are sold to the guest by the hotelkeeper in the capacity of a merchant or furnished as an incident to the guest's entertainment. In the case of advances of money also, the lien would not extend to loans of a size beyond amounts which might customarily be advanced by the proprietor of a hotel of the particular type.

The keeper's lien does not extend to charges for harm which the guest may have caused to the hotel or its furnishings.

g. If the hotelkeeper has incurred any liability to the guest growing out of their relation of hotelkeeper and guest the guest can set off the amount due him in any action by the hotelkeeper, and if the balance is found by mutual agreement or is judicially determined to be in favor of the guest, the hotelkeeper's lien is terminated. See § 79.

Comment on Subsection (2):

h. *Chattels of third persons.* Since it is a part of a hotelkeeper's duty to receive transients irrespective of the time

of arrival or advance notice, and since baggage must be received with the guest, the hotelkeeper cannot be expected to make any investigation as to the guest's ownership of baggage. As a practical matter the hotelkeeper must assume ordinarily that the guest owns the baggage he brings with him. The hotelkeeper's lien extends therefore to chattels brought on the premises by or for the guest irrespective of ownership but with certain exceptions stated in the subsection. The hotelkeeper's lien is not limited to chattels which would be classed as baggage. The guest is seeking a temporary home and the hotelkeeper's business is to make the guest comfortable and satisfied. Within reasonable limits, and with due regard to his own business and the convenience of other guests, the hotelkeeper allows the guest to bring with him or to have sent to him, chattels of the guest's own selection. Where the guest expects the hotelkeeper to receive chattels as if they are a part of his luggage, neither the guest nor a third person has any cause to object to the hotelkeeper having a lien on such chattels.

i. Chattels free of hotelkeeper's lien. The hotelkeeper's lien can be defeated by third persons, either because of their privileged position or because of the knowledge of the hotelkeeper of the superior interests of the third persons at the time the chattels are received.

The first limitation on the hotelkeeper's lien is in favor of the government. See § 75, Comment *a* and Illustrations. The other limitations on the hotelkeeper's lien relate to his knowledge. If he knows that the guest is wrongfully or criminally in possession of the chattels he brings with him, the hotelkeeper need not participate in the guest's wrong or crime by receiving the goods, and if he receives them no lien exists except in respect of the guest. Where the hotelkeeper learns of the guest's wrongful possession of any goods after the guest's arrival, the hotelkeeper's lien on such goods is limited to charges arising before the hotelkeeper acquires his knowledge. The guest's ownership of goods is not necessarily the determining factor in respect of the hotelkeeper's lien because the guest's possession of the goods may be authorized by the owner. A common instance of such authorization exists where a traveling salesman who owns neither his samples nor their containers has the privilege to take them to any hotel upon his route. In such a case the guest's lack of ownership is immaterial, and likewise immaterial is the hotelkeeper's knowledge of the facts.

The knowledge of the hotelkeeper of the superior interests of third persons is important only if, added to this knowledge, there are circumstances which are inconsistent with the inference that the guest is permitted to treat the chattels as his own, at least so far as his stay in the hotel is concerned. For example, when the hotelkeeper learns that a local music dealer is placing a piano in the hotel room of a touring pianist for his use during a brief stay, the hotelkeeper knows both that the pianist does not own the piano and he also knows facts which indicate that the local dealer has no intention to permit the guest to treat the piano as his own. The same result follows where goods are sent to the hotel for inspection or approval by the guest and these facts are known to the hotelkeeper. On the contrary where all the hotelkeeper learns is that the guest has received a package from the outside, the hotelkeeper does not have such knowledge as will defeat his lien.

Statutes regulating hotelkeeper's liens have been generally enacted throughout the United States. In a number of states the common law priority of the hotelkeeper's lien over interests of third persons, which are superior to the interests of the guest, has been limited.

Legal Topics:

For related research and practice materials, see the following legal topics:
 Contracts Law Secured Transactions Perfection & Priority Priority Liens



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Restat 1st of Security, § 64

§ 64 Possessory Lien for Charges for Services Not Specially Requested

Where a lienor other than a finder has a claim for services incident to those for which the bailment was made, or which are required of him in consequence of the bailor's failure to pay the lienor's reasonable charges, the lien is security for this claim.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The possessory lien is allowed in order to give the bailee some assurance that he will be paid for services requested by the bailor. Certain services are necessarily incident to the services requested by the bailor and can be included among the charges for which a lien is allowed. For example, if a dog is delivered to be trained as a pointer, the trainer is entitled to a lien for the housing and feeding of the dog as well as for his fee as a trainer, or if the charges are not separated, the fee includes the cost of housing and feeding.

b. The services rendered by the lienor may be a continuation of the services contemplated by the bailment. For example, where goods are stored for a term with a warehouseman, and the goods are continued in storage beyond the term, the warehouseman is allowed a lien also for the additional storage charges (see § 61, Comment *k*). The carrier is allowed a lien for demurrage and storage charges after the completion of the transportation (see § 61, Comment *h*). This result is supported both because the storage may be regarded as a continuation of the service of carriage and because the relations of carrier and shipper or passenger include the authorization of storage until payment of charges as a part of the contract of bailment. A practical reason for the rule as to carrier and warehouseman is that their additional charges, because of the nature of their business, are readily computed and give them little opportunity for oppressive demands against the bailor.

c. The lienor has no duty to surrender the chattel until the contract price, or in the absence of agreement as to price, his reasonable charges, are paid. When, in consequence of the bailor's failure to pay, the lienor retains the chattel and is thereby put to additional expense, as for example, where he must continue to feed an animal upon which he has a lien, the lien extends to the additional charges. Where the additional services do not impose any expense upon the lienor, as for example, where an artisan stores a chattel in his regular place of business, the claim of the lienor cannot be increased. In order for a lienor to add storage charges to his claim, storage for compensation must be a part of his

business, or the circumstances must require that he incur expense for storage elsewhere.

d. The finder's lien arises out of the owner's offer to pay a specific reward. Since both the existence and the amount of the lien are determined by the contract for the reward (see § 61, Clause (e) and Comment *l*) and since the lien of the finder does not extend, except by statute, even to charges for services rendered in preserving the chattel, the finder cannot enlarge his lien by the rendition of services after the owner has failed or refused to pay the reward. The finder is in a relatively disadvantageous position in comparison to other lienors whose services have been contemplated and requested at the time of the bailment.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawTypes of ContractsBailments



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Restat 1st of Security, § 65

§ 65 Possessory Liens by Contract

Specific or general possessory liens can be created, modified or precluded by contract.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is applicable to situations where the possession essential for a lien exists but where unless stipulated for by special agreement a lien is not allowed, or if allowed, is allowed as a specific rather than as a general lien. For example, although the agister or private carrier does not have a specific lien, except by statute, he can acquire such a lien by contract. By contract also he can acquire a general lien. One normally allowed a specific lien, as for example, an artisan for repairs, can obtain by contract a general lien for his entire bill on any chattel in his possession, even if the chattels have been delivered in separate transactions and the chattels delivered in some of the transactions have been returned to the bailor. Without such a contract the artisan's lien for the amount of his bill under each transaction extends only to chattels delivered in respect of that transaction. On the other hand the parties may agree specifically that no lien is to exist where a lien is normally permitted, or the circumstances agreed upon by the parties may be inconsistent with the existence of a lien.

Where the parties create a security interest by contract in connection with a bailment it is often difficult to determine whether a lien or a pledge is created. The question is one of fact to be decided by a consideration of the circumstances of the transaction. The parties by the bailment can create either a lien or a pledge. So long as they conform to the possessory requirements, they can modify most of the incidents of lien and pledge (see § 14). For example, the parties can grant the power of sale in the case of a lien or withhold it in the case of a pledge. Where the parties have clearly indicated their intention to create either a lien or a pledge, that intention should be respected. Where the form of a security interest is in doubt, the name given it by the parties is evidence, but not conclusive, as to the form they intended to create. Where no particular intention is indicated, and the bailment is for the purpose of security, the security interest is a pledge. Where the bailment is to enable the bailor to receive some service, the security interest is a lien. Where both purposes are present, it is a question of which purpose is predominant in the minds of the parties.

Since statutes at the present time commonly permit the enforcement of lien by means of sale it is rarely important

whether a particular security interest is called a lien or a pledge.



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Restat 1st of Security, § 67

§ 67 Assignment of Possessory Liens

(1) Subject to the terms of the bailment where a claim, except that of an attorney, secured by a possessory lien is effectively assigned and the assignee as an incident of the assignment obtains possession of the chattel or the assignor or a third person has possession for him, the lien also is effectively assigned.

(2) The lienor, after an effective assignment of the claim secured by a lien and a proper delivery of the chattel to the assignee of the claim, is not liable to the bailor for any breach of duty by the assignee in respect of the chattel unless prior to the delivery the lienor knows that the assignee intends to violate his duty.

(3) Where the lienor makes successive assignments of a non-negotiable claim secured by a lien, which itself can be assigned with an assignment of the claim, the assignee who obtains priority as to the claim is entitled to the possession of the chattel, unless the lien has been terminated or the lien exists on a negotiable chattel and another is a holder in due course.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Historical. In the early law it was commonly stated that a possessory lien could not be assigned and that any attempt to assign it resulted in its termination. The earliest possessory liens were allowed when the lienor did not even have a cause of action on his claim. Since the lien was only the privilege of retaining a chattel to secure a claim, which itself could neither be enforced nor assigned, it follows that there could be no assignment of the lien. Even after the claim became not only enforceable but assignable either as a result of giving the assignee a power of attorney or otherwise, the English courts considered that the personal nature of the relation of bailor and lienor prevented a transfer of the lien irrespective of the assignment of the debt. In due course, however, where a debt was secured by a lien, the assignee of the debt was allowed to enjoy the advantages of the lien except in certain situations where the confidential relation of the parties or the terms of the particular bailment were inconsistent with the power to assign the lien.

Illustrations:

1. A warehouseman, engaged in the business of storing household goods, assigns to a bank as security for a loan, a

number of accounts secured by liens. It is provided that the goods are to remain in the warehouse. The bank is entitled to the benefit of the liens.

2. A farmer in a state where an agister is allowed a lien, is pasturing a herd of cattle on his farm. The farmer sells his farm and assigns the accounts of the owners of the cattle together with the liens. The purchaser is entitled to retain the cattle until the accounts are paid.

3. The A Hotel Corporation sells the A Hotel together with all outstanding accounts and the liens securing them to B Hotels, Inc. The purchaser is entitled to the benefit of any liens held by its predecessor.

b. A fundamental rule of the law of security is that an obligation and its security shall not be separated. The rule stated in this Section accepts the consequences of the assignability of debts by providing that the assignee of the debt acquires the lien of the assignor unless the debtor has made the bailment with a stipulation against assignment of the lien, or unless the nature or terms of the lien are otherwise inconsistent with an assignment of the lien. The lien cannot be effectively assigned apart from the debt and any attempt to do so will result in the termination of the lien.

c. Assignment and effective assignment. The Restatement of Contracts, § 149 (1) defines "assignment" as follows: "An 'assignment' of a right is a manifestation to another person by the owner of the right indicating his intention to transfer, without further action or manifestation of intention, the right to such other person or to a third person."

The Restatement of Contracts, § 150 (1) thus defines "effective assignment": "An 'effective assignment' is one by which the assignor's right to performance by the obligor is extinguished or the assignee acquires a right to such performance."

The terms "assignment" or "effective assignment" are used in the Restatement of this Subject in the same sense as in the Restatement of Contracts, except that they are understood to apply to the manifestation of intent to transfer or the transfer of powers or privileges as well as rights.

d. Limitations on privilege of assignment. The rule stated in this Section does not mean that a bailee, merely because he has a lien, can compel the bailor to search throughout the United States for his chattel. Even in the case of a pledge, where the bailment is primarily to secure an obligation, which in the absence of contrary stipulation is freely assignable, circumstances may be such as to limit the power of the assignment of the pledge, or at least to subject the pledgee to continued responsibility for the pledged chattel after the assignment. Where for example a painting has been pledged under specific or implied conditions as to its care and preservation, the pledgee has no privilege to assign the pledge, even with the assignment of the debt, to a person unable to provide such care. In the case of a lien, where the purpose of the bailment is to enable some service to be rendered, the bailee is under a duty to make the chattel conveniently accessible to the bailor after the service is rendered and sometimes even while the service is being rendered. This does not mean necessarily that the chattel must remain in precisely the same spot at which the bailor delivered it. If a guest leaves a hotel without payment of his bill, the hotelkeeper need not leave the guest's luggage in the room the guest has occupied. The hotelkeeper may store the luggage in another part of the hotel or even off the premises, provided the luggage is still reasonably available to the guest. On the other hand, a San Francisco hotelkeeper, irrespective of assignment of the lien, cannot store the guest's luggage in New York. The foregoing examples indicate some of the limitations upon assignment of liens. The assignee cannot acquire any larger privileges than the assignor. When a lienor sells his entire business, assigning his accounts and the liens securing them, and the assignee continues the business at the same or a near-by location, there is no reason why the assignment of the liens should not be given effect. When a specific debt secured by a lien is assigned, and the conditions of the bailment are respected, there is no injustice in allowing the assignee to obtain the benefit of the lien. When, however, the assignment of the lien cannot be given effect except by materially changing the terms of the bailment, the lien is terminated.

Because of the confidential nature of the relationship of attorney and client, the attorney does not have the privilege of delivering his client's papers to another person without the client's permission. This fact makes an effective

assignment of an attorney's lien impossible without the client's consent.

Illustrations:

4. A, a jeweler with a shop in New York and a branch in New Haven, decides to consolidate the stores in New York. In the absence of special permission from the bailors, the jeweler does not have the privilege of removing to New York watches upon which he has a lien.

5. A owns a jewelry shop in New York and B one in New Haven. The New Haven shop is bought by A together with all outstanding accounts. The rule, a fortiori, in respect to the watches bailed in New Haven, is the same.

6. Same facts as Illustration 5, except that A removes to New York all the watches, upon which B has liens. The liens are terminated.

7. C, an attorney, has a claim against D for professional services. Papers belonging to D are in C's possession. C assigns his claim to A and delivers D's papers to A. D brings replevin for the papers D can recover. While C has a lien on the papers, this lien is not assignable.

e. Assignment by operation of law. The terms "assignment" or "effective assignment" as used in the Restatement (see Restatement of Contracts, §§ 149 and 150) refer to a voluntary act on the part of one person whereby he ends his own interests in respect to something and recreates them in someone else. They do not cover the change of interests that result from intestate or testamentary succession, nor other changes of interest that result from operation of law, such as those which occur in bankruptcy or other insolvency administration and from the enforcement of creditors' rights by levy, attachment or creditors' bills. (See Restatement of Contracts, § 149, Comment *a*.) In all cases of change of interest by operation of law, a lien can be asserted by the successor of the lienor in accordance with the appropriate rules of law and subject to the terms and conditions of the bailment out of which the lien has arisen.

Illustrations:

8. X, a warehouseman, dies intestate. A is appointed administrator. A can assert any liens which could have been asserted by X.

9. Same facts as Illustration 8, except that X becomes bankrupt and A is elected trustee in bankruptcy. The result is the same.

10. X is a jeweler to whom a number of watches have been delivered for repair. C, a creditor, obtains a judgment and after execution is returned unsatisfied C brings a creditors' bill against X and thereby acquires an equitable lien on X's accounts secured by possessory liens. C is entitled, by the court process, to the benefits of the possessory liens.

f. Subrogation. Where the demand secured by a possessory lien is discharged by a person other than the one under a duty to satisfy the demand, under such circumstances that the latter is unjustly enriched by retention of the benefit thus conferred, the former is entitled to be subrogated to the position of the lienholder. (See § 25 Comment *b* and *Restatement of Restitution*, § 162 and Comments.) If the discharge of the demand is officious there is no unjust enrichment. (See *Restatement of Restitution*, § 162, Comment *b*.)

Comment on Subsection (2):

g. The rule stated in this Subsection is similar to that stated in § 32 in respect of the duty of the pledgee to the pledgor after the effective assignment of the pledge. The Comment and Illustration to § 32 have a general application to this Subsection.

Comment on Subsection (3):

h. Transactions in connection with which possessory liens exist usually involve only small amounts, and are intended to be consummated promptly. In the circumstances, assignments of liens are infrequent. The situations where there are successive assignments of a debt secured by a lien are rare. Nevertheless it is possible that claims secured by a lien, just as claims secured by a pledge, may be assigned by mistake or fraud to two or more persons. When this occurs, the person who obtains priority as to the claim should obtain priority as to the security, even if the security is only a possessory lien, provided the lien is assignable. The rule stated in this Subsection is similar to that stated in § 33 in respect to successive assignments of claims secured by a pledge. See also the Comments and Illustrations to § 33.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementDuties & Liabilities of PartiesTypes of PartiesHolders in Due CourseGeneral OverviewContracts LawSecured TransactionsThird Party RightsAssignmentsContracts LawTypes of ContractsBailments



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Chapter 2 - Possessory Liens

Restat 1st of Security, § 68

§ 68 Assignment of Chattel by Possessory Lienor

(1) Where a lienor assigns a non-negotiable chattel in violation of his duty as bailee the assignee acquires no interest in the chattel as against the bailor and the lienor and the assignee are liable to the bailor for conversion.

(2) Where the lienor assigns to a holder in due course a negotiable instrument upon which a lien exists, the interest of the holder is determined by the rules pertaining to negotiable instruments.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section deals with a situation similar to that which may arise in pledges. The pledge situation is dealt with in § 23 (1) and the Comments to that Subsection are largely applicable to this Section. See further, § 71.

Illustrations:

1. A has a lien on B's watch for repairs. A pledges B's watch to C as security for a loan A and C are liable to B for conversion. C acquires no interest in the watch.

2. Same facts as Illustration 1, except that A sells the watch to C. The result is the same.

Comment on Subsection (2):

b. "Negotiable instrument" is used here to include negotiable documents of title, share certificates and other negotiable securities. "Holder in due course" includes any bona fide purchaser for value. See Scope Notes to Chapter 1, Topics 2 and 3 and to Chapter 2.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementDuties & Liabilities of PartiesTypes of PartiesAssignees &

Assignors Contracts Law Negotiable Instruments Enforcement Duties & Liabilities of Parties Types of Parties Holders in
Due Course General Overview Torts Vicarious Liability Bailees



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Restat 1st of Security, § 69

§ 69 Possessory Lienor's Duty of Due Care and Liability for Harm

The existence of the lien does not enlarge or reduce the duty of the lienor as bailee to exercise care of the chattel, nor enlarge or reduce his liability as bailee for harm thereto.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The lienor's duty of due care of a chattel and his liability for harm thereto are determined by the fact that he is a bailee rather than by the existence of the lien. This is true even where the bailment results from a seizure, as in the case of a distress, or from a finding. The duty and liability of the bailee may be enlarged or reduced by contract. In the absence of contract, and sometimes irrespective of contract, the duties and liabilities of bailees vary by reason of the particular bailment. Carriers and hotelkeepers, for example, generally have to some extent an insurer's liability. The particular duties and liabilities of various types of bailees belong to the law of Bailments rather than to the law of Security and are not treated in the Restatement of this Subject.

b. Cross reference. As to the effect upon the lien of the lienor's failure to exercise the care required of him, see § 79.

Legal Topics:

For related research and practice materials, see the following legal topics:

TortsPremises Liability & PropertyGeneral Premises LiabilityDuties of CareDuty on PremisesReasonable CareTortsVicarious LiabilityBailees



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Restat 1st of Security, § 70

§ 70 Use by Possessory Lienor Without Consent of Bailor: Conversion

The use of the chattel by the lienor without the consent of the bailor is an act of conversion.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is substantially like that stated in § 22 in respect of use by a pledgee. The Comments and Illustrations to § 22 are relevant also to this Section.



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Restat 1st of Security, § 71

§ 71 Bailor's Remedies for Conversion

Where the lienor converts a chattel upon which a lien exists the bailor

- (a) has an immediate right of action against the lienor or the transferee or both for the value of the chattel, or**
- (b) can recover the chattel, or**
- (c) can set off the value of the chattel in any action on the claim secured by the lien unless the claim is represented by a negotiable instrument which has been transferred to a holder in due course, or**
- (d) can waive the conversion, tender performance and hold the lienor to his duty to return the chattel.**

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section deals with a situation similar to that dealt with in respect of pledges in § 24 and largely applicable to this Section.

Comment on Clause (b):

b. The clause refers to the right of action in replevin or some equivalent action where the bailor is not able to obtain the return of his chattel by peaceable self-help; or, in the case of a unique chattel, by an action in equity. It is recognized that where the chattel is not unique, the defendant in many jurisdictions can elect to pay damages rather than return the chattel.

c. Factors' Acts in some jurisdictions protect bona fide purchasers, including pledgees and chattel mortgagees, of goods held by a factor even when the factor acts contrary to the principal's directions. In such situations the factor but not the transferee may be a converter.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementClaims to InstrumentsContracts LawNegotiable
InstrumentsEnforcementDuties & Liabilities of PartiesTypes of PartiesHolders in Due CourseGeneral
OverviewContracts LawNegotiable InstrumentsTransfers



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Restat 1st of Security, § 72

§ 72 Enforcement of Possessory Liens

(1) Except as stated in Subsection (2), no possessory lienor has the power to reduce his lien to a money equivalent by sale of the chattel or by foreclosure suit.

(2) The factor and the unpaid seller in possession have the power to reduce their liens to a money equivalent by sale of the chattel or by foreclosure suit.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The general rule of the common law is that a lienor has only a privilege of retention without the power of sale and without the privilege of foreclosure which is granted to the pledgee. By enforcement of the lien is meant its reduction to a money equivalent which can be applied in satisfaction or reduction of the demand. Since the lienor at law has no power of sale equity follows the law and does not aid in the collection of the demand by a sale in foreclosure proceedings.

The privilege of retaining a chattel even without the power of sale gives the lienor an important practical advantage. The lienor can obtain a judgment on his demand and then direct the officers of the law to levy on the chattel so that it can be sold by judicial process. In the meantime the chattel cannot be levied upon by another creditor.

b. Statutes in force at the present time enable all or most of the lienors except attorneys to enforce their claims by sale of the chattel or by foreclosure. Certain statutes in general terms allow the enforcement of liens by sale, generally with provisions regulating the sales. More frequently, statutes, in providing for the regulation of one or more liens add provisions regarding their enforcement. Statutes regulating hotelkeepers' liens generally provide also for their enforcement. The net result of the statutory changes is that nearly all possessory liens can be enforced in substantially the same manner as pledges.

Comment on Subsection (2):

c. Factor. The power of sale may be granted to the lienor by the bailor (see § 65, Comment *a*). The power of the factor to enforce a lien as stated in Subsection (2), is less of an exception than an extension of the factor's general power

of sale, which he obtains in the due course of his business as a factor (see § 62 (a) and Comment *d*).

d. The unpaid seller. The power of sale of the unpaid seller is derived from the law of sales rather than from the law of liens. The unpaid seller's possession is not acquired originally by a bailment even if after transfer of title he becomes a bailee. The lien of the unpaid seller is frequently ignored in discussions of the law of liens and considered entirely as a part of the law of sales.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawSecured TransactionsDefaultForeclosure & RepossessionGeneral Overview



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Restat 1st of Security, § 73

§ 73 Interference with Possessory Lienor's Possession

(1) Where the bailor wrongfully deprives the lienor of the chattel upon which a possessory lien exists the lienor can recover the chattel from the bailor or can hold him liable as a converter; but the damages of the lienor are limited to the amount of the demand which the lien secures.

(2) A third person who harms or converts a chattel upon which a possessory lien exists is liable to the lienor for full damages less the amount of any judgment obtained or settlement made by the owner for the damage to the owner's interest.

(3) A third person who harms or converts a chattel upon which a possessory lien exists is liable to the owner for the damage to his interest unless the lienor has obtained a judgment against the third person for full damages or has made a settlement with him for such damages.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Since the lienor is entitled to possession of a chattel upon which a lien exists, the lienor can obtain court help to recover the chattel from the bailor as well as from third persons. The lienor, being entitled to possession, can sue anyone who deprives him of the chattel, for conversion. Since, if he were allowed recovery of the full value of the chattel against the bailor the latter could subsequently recover the difference between the amount of the lienor's demand and the value of the chattel, the lienor recovers only the value of his interest. The practical result of permitting the lienor to recover the value of his interest in an action for conversion is that the bailor's wrongful conduct has made it possible for the lienor to enforce his claim by suing for conversion rather than on the demand which the lien secures. See § 39.

Comment on Subsections (2) and (3):

b. The rules stated in Subsections (2) and (3) are similar to the rules stated as to the interference by third persons with pledged chattels in § 38, which in turn are in accordance with usual rules as to the liability of third persons to bailees and bailors. See as to Subsection (2), Restatement of Torts, § 220, and as to Subsection (3), Restatement of

Torts, § 219.

Legal Topics:

For related research and practice materials, see the following legal topics:

TortsVicarious LiabilityBailees



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Restat 1st of Security, § 74

§ 74 Liens Acquired by Creditors of Bailor

The possessory lienor's interest in a chattel is superior to liens subsequently obtained by creditors of the bailor through judicial proceedings or by contract with the bailor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. The rule stated in this Section is similar to that stated in § 28 in respect of pledges, and the Comment to § 28 is applicable.

Illustrations:

1. A takes his watch to a jeweler for repair. C obtains a judgment against A and by appropriate proceedings asserts a judgment creditor's lien on the watch. The jeweler's lien is prior to that of the judgment creditor.

2. A takes a motor car to a garage for repair. While the car is in the possession of the garageman and after a lien exists for the work done, A gives C a mortgage on the car. The interest of the lienor is prior to that of the mortgagee.



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Restat 1st of Security, § 75

§ 75 Bailment Without Consent of One Having Interest Superior to Bailor

(1) Where chattels, owned or in the possession of a government, and used in connection with a governmental function, are bailed under circumstances which would create a possessory lien against a private owner, no possessory lien exists unless the government has consented to the lien.

(2) Where a private person having legal title to a chattel does not make the bailment or does not consent to it, and the possession of the bailee is not in consequence of acts of such person or for which he is responsible, his interest is not subject to a possessory lien unless the person claiming such a lien is a

- (a) hotelkeeper as stated in § 63,**
- (b) connecting carrier as stated in § 61 (b), or**
- (c) landlord, as stated in § 61 (h).**

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. The fact that a lien does not exist does not mean that there is no right to compensation. The finder, for example, has the right to compensation in cases where he has no lien, see § 61, Comment *l*. (See also *Restatement of Restitution*, § 117.) An artisan who by proper authority repairs a government chattel has a claim for compensation but to allow him a lien might interfere with governmental activities. Government customarily provides a procedure for paying bills only if a stipulated procedure is followed. Persons who deal with government must take such rules into account in their dealings with government. Even if the government does not own the chattel but is merely in possession of it, the governmental immunity attaches to it.

Where governmental chattels are taken outside the jurisdiction of the government, immunity of the chattels from liens, if any, is determined by the rules of international law and comity as accepted in the jurisdiction to which the chattels are taken. See *Restatement of Conflict of Laws*, § 98, Comment *b*.

"Government" is used here to designate any national or state government and their subdivisions, including all sorts of municipal corporations. The distinction is made between governmental chattels used in a governmental and those employed in a proprietary capacity. In the latter case the chattels are subject to the usual rules prevailing in respect of

private owners unless a statute provides otherwise.

Illustrations:

1. Computing machines owned by the United States and used by the Department of Commerce are taken to a repair shop for adjustment. No lien exists for the repairs.

2. Same facts as Illustration 1 except that the machines are owned by the City of X and are taken to a repair shop in the same state. The result is the same.

3. Electrical apparatus owned by the City of X and used in connection with the city subway system is sent to the maker's factory in the same state for repair. The proprietor of the factory has a lien in the absence of statute providing otherwise. A fortiori, the result is the same if the apparatus is taken to a different state for repair.

4. Computing machines owned by the Reconstruction Finance Corporation are taken to a repair shop for repair. All the shares of the Reconstruction Finance Corporation are owned by the United States. The machines are subject to the lien of the repairman.

5. The Mayor of X in State Y takes a typewriter owned by the City of X to a hotel in State Y. The hotel has no lien on the typewriter for the Mayor's bill.

6. An agent of the United States Bureau of Investigation while at a Chicago hotel on official business borrows laboratory apparatus from a local university for use in connection with his investigation. The hotel has no lien on the apparatus for the agent's hotel bill. The knowledge of the hotel proprietor as to the ownership of the apparatus is immaterial.

Comment on Subsection (2):

b. Cross reference. See, in addition to the references in Subsection (2), § 61, Comments *i* and *j*. For an application of the rule to chattel mortgages and conditional sales, see § 76.

c. The Restatement of Trusts, § 2, Comment *d*, after stating that the term "owner" is used to indicate a person in whom one or more interests are vested for his own benefit, states that the person in whom such interests are vested has "title" to the interests whether he holds them for his own benefit or for the benefit of another. The rule stated in Subsection (2) applies not only to an "owner" as defined in the Restatement of Trusts, but also to one having a title recognized at law as distinguished from equity.

d. Since a bailment is defined as the rightful possession of a chattel by one not its owner (see § 1, Comment *f*) a bailment may arise in a number of instances where no delivery has been made by the owner although the owner is responsible for the bailee's possession. Examples of such bailments occur in the case of a finder, a landowner who has seized animals damage feasant, and a landlord who has distrained the chattels of his tenant. (See § 61.)

e. Bailment lease. Under the rule stated in Subsection (2), the lessor in a bailment lease transaction would not be subject as to his interest to the lien of a bailee from the lessee, unless the lessor had consented to subordinate his interest. If any bailment lease is held to be in reality a conditional sale, the rule stated in § 76 is applicable.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law Secured Transactions Perfection & Priority Priority Liens Contracts Law Types of Contracts Bailments



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Restat 1st of Security, § 76

§ 76 Priorities Between Possessory Lienors and Antecedent Mortgagees and Conditional Vendors

Subject to the provisions of recording statutes, where a lien exists in consequence of the bailment of a mortgaged chattel or of a chattel held under a conditional sales contract, the interest of the mortgagee or conditional vendor is prior to that of any lienor except a hotelkeeper (see § 63 (2)) a landlord (see § 61 (h)) or a connecting carrier (see § 61 (b)), unless words or circumstances justify the inference that the mortgagee or conditional vendor has consented to subordinate his interest.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The conditional vendor retains legal title to a chattel sold on conditional sale. Dependent upon the law of the particular State, the chattel mortgagee has either legal title to or a non-possessory legal lien on a mortgaged chattel. Normally the priority of legal interests is determined by the order of their creation. While subsequent legal interests sometimes prevail over prior interests because the holders of the prior interests have created or permitted situations likely to deceive holders of subsequent interests who acquire the subsequent interests in good faith and for value, the requirements of public recordation in the case of conditional sales and chattel mortgages almost universally assure that the holders of the subsequent interests can ascertain in advance the existence of the antecedent interests. That means that a lienor is affected with notice of the interests of a conditional vendor or chattel mortgagee when the conditional sale or chattel mortgage is filed or recorded. If a bailee, knowing of prior interests, renders services for which a lien may be asserted it is proper that the lien be subordinated to the prior interest unless the services can be considered as rendered also to the holder of the prior interest or unless the peculiar position of the lienor, as in the case of the hotelkeeper or landlord, entitled him to preferred treatment.

Where the conditional vendor or the chattel mortgagee will prevail against creditors without a public registration, the interest of the vendor or mortgagee is prior to that of the lienholder irrespective of recording or filing.

Illustrations:

1. A buys a motor car under a conditional sales contract. During the winter he places the car in dead storage under circumstances giving the bailee a warehouseman's lien. The interest of the conditional vendor is prior to that of the

lienor in the absence of a filing or recording statute. If such a statute exists, and the conditional vendor has not lost his priority by failure to comply with it, the result is the same.

2. Same facts as Illustration 1 except that A owns his car but gives a chattel mortgage, which is duly filed, before the car is placed in storage. The mortgagee's interest is prior to that of the lienor.

b. Cross reference. See as to the priority of the hotelkeeper's lien over the interests of third persons, § 63 and Comment *g*; as to connecting carriers, § 61 (b) and Comment *j*; and as to the landlord's lien, § 61 (h) and Comment *q*.

c. Whether in a particular case the conditional vendor or chattel mortgagee has subordinated his interest to that of the lienor is a question of fact. The mere circumstances of possession in the vendee or mortgagor does not justify the inference that the vendor or mortgagee is willing to subordinate his lien. On the other hand where the chattel is an income-producing article, the income of which is used to pay the debt, and it is the understanding of the parties that the chattel will be kept in profitable employment, it is likely that the circumstances will indicate that the lienor who repairs the chattel has a prior interest. Hence a specific provision in a sale contract or mortgage that the vendee or mortgagor must keep the chattel in repair is a factor, but not a conclusive one, that must be considered in determining the priority of the various interests.

The tendency of modern statutes has been to favor the lienor, especially the lienor who has made repairs on motor vehicles at the request of a vendee or mortgagor in possession.

Illustration:

3. B sells to A on conditional sale a motor boat to be used as a ferry between an island summer resort and the mainland. A is required to keep the boat in operation and to pay B a stipulated percentage of the net proceeds until the boat is paid for. B authorizes A to deliver the boat periodically to a boat builder for inspection and necessary repairs. It is a fair inference that B intends to subordinate his interest to that of lien for the servicing charges.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law Secured Transactions Perfection & Priority Priority Liens Contracts Law Types of Contracts Bailments Real Property Law Financing Secondary Financing Lien Priorities



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Restat 1st of Security, § 77

§ 77 Effect of Obtaining Judgment Lien on Priority of Possessory Lienor

(1) Where a lienor obtains a judgment for the amount of his demand and levy is made upon the chattel upon which the possessory lien exists, if the judgment lien is thereafter avoided, the lienor is entitled to the possession of the chattel, and the lien revives upon return of the chattel.

(2) Where a chattel in respect of which a possessory lien exists is subsequently mortgaged and the lienor then attaches or levies upon it in enforcement of a judgment, the interest of the mortgagee is prior to that of the judgment lien.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. The lienor generally, except by statute, has no power to sell the chattel upon which a lien exists, nor can he obtain its sale by judicial proceedings. His possession, however, gives him an advantage if he obtains judgment and a levy is made on the chattel. (See § 72.) Circumstances may arise which result in the avoidance of the judgment lien, for example as a result of bankruptcy or of the failure to comply with some requirement in the obtaining of the judgment lien. The rule stated in this Subsection gives the lienor the right to compel the return of the chattel in such circumstances. Upon the return of the chattel the lien revives.

Comment on Subsection (2):

b. So long as the lienor retains possession, his lien is an interest prior to that of subsequent mortgagees. Where the lienor chooses to rely upon a judgment lien rather than upon his possessory lien, his priorities are those of a judgment lienor rather than of a possessory lienor. If a chattel upon which a lien exists is subsequently mortgaged, and the recording requirements are satisfied, the mortgagee's interest is inferior to that of the possessory lienor, but is prior to that of a judgment creditor who subsequently levies. Since as a judgment creditor, the possessory lienor is subsequent to the mortgagee, the mortgagee has the prior interest. If the chattel is sold to satisfy the judgment, it must be sold subject to the chattel mortgage.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Judgment Interest General Overview Civil Procedure Remedies Judgment Liens General
Overview Real Property Law Financing Secondary Financing Lien Priorities



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Restat 1st of Security, § 78

§ 78 Payment or Tender by Bailor

(1) Where the bailor pays the demand secured by a possessory lien, or tenders payment, or tender is waived by words or conduct of the lienor, the lien is terminated.

(2) Refusal or failure of the possessory lienor to return the bailed chattel upon payment or tender is an act of conversion unless excused.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Waiver of tender. A tender is excused if the lienor by words or conduct indicates that a tender will be refused. The mere claim of a larger amount than the one due is not of itself enough to constitute a waiver of tender. The words or conduct of the lienor must indicate that a proper tender will be refused. The lienor is entitled to the sobering effect of a tender unless it is evident that a tender will be a useless formality.

Illustrations:

1. A jeweler repairs a watch for which a reasonable charge is \$ 5.00. The bailor tenders this amount. The lienor refuses to deliver the watch unless an earlier bill is also paid. The lien is terminated.

2. A jeweler repairs a watch. The bailor asks the charge and is told that there is a charge of \$ 5.00 for this watch and \$ 3.00 for a watch delivered on a different bailment and already returned to the bailor. The jeweler adds that back bills should be paid before the watch is returned. The bailor expresses disagreement, but makes no tender. The jeweler's lien for \$ 5.00 continues.

3. Same facts as Illustration 2, but the jeweler notifies the bailor that the watch will be held until both bills are paid, and tells his assistant in the presence of the bailor that no offer of anything less than both bills is to be considered. If the bailor is reasonable in assuming that a tender of \$ 5.00 will be refused, the lien is terminated.

Comment on Subsection (2):

b. When the lienor fails or refuses to return a chattel upon which a lien has existed but which is terminated, this is an assertion of unlawful dominion and hence an act of conversion unless the lienor has an excuse for his conduct. The lienor, however, is excused where his failure to return the chattel is due to its loss or destruction without his responsibility, or to his proper delivery of the chattel to an assignee of his claim (see § 37).



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Restat 1st of Security, § 79

§ 79 Set-Off In Actions Between Possessory Lienor and Bailor

(1) Where a possessory lienor is liable to the bailor for harm to or conversion of the chattel upon which a lien exists, the amount for which the lien is security is not automatically reduced except in the case of the common carrier, but the bailor can set off in an action on the debt by the lienor, any claim he may have against the lienor arising out of the lienor's conduct in respect of the chattel.

(2) Where the possessory lienor is liable to the bailor for harm to or conversion of the chattel upon which a lien exists, the lienor can set off the debt in an action by the bailor to enforce this liability.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. A possessory lien is limited to the debt which it secures. If the demand has been paid in part the lien is reduced by the amount of the payment. The lien is reduced to the extent of each payment that is made on account of the debt. Where the debt is wholly discharged, the lien is terminated. (See § 78.) The amount of the debt in most cases is determined by the services rendered to the bailor arising out of the bailment, as in the case of the bailee's lien for repairs, or in regular course of business as determined by the relationship of the parties, as in the case of factor and principal. Just as claims not arising out of the bailment or out of the course of business cannot enhance the lien, so also counterclaims unrelated to the bailment or the course of business cannot reduce the lien. The rule stated in this Section takes the position that tort claims of the bailor, except in the case of the common carrier, do not reduce the lien, even if they relate to the bailed chattels, until the amount of the claims has been judicially determined. In other words, automatic set-off is not required except in the case of the common carrier.

Set-off, in the general sense which includes recoupment and counterclaim, is a matter of law administration for the efficient settlement of the controversies of parties and the avoidance of prolonged litigation. Since it is an act of conversion for a possessory lienor to refuse to surrender a chattel when no demand exists, a rule requiring automatic set-off between lienor and bailor places upon the lienor an undue risk of loss, in consequence of what may be an honest difference of opinion as to the amount of a tort claim asserted by the bailor. When, for example, a motor car is brought to a mechanic for repair and the car is damaged owing to the negligence of the lienor, the mechanic may honestly believe that the damage equals only half of the repair bill, while the bailor may with equal honesty believe that the

damage is at least equal to what is due for repairs. If the rule of automatic set-off prevails, and the mechanic is in error as to his opinion that the amount of the lien is greater than the damage, he is liable as a converter for the full value of the car, if he refuses to return it before his bill is paid. The rule stated in this Section requires the determination by judicial process of the amount of the bailor's claim, before the lien is reduced or terminated as a result of the lienor's tort.

If the parties agree to balance all their mutual claims as a condition of the existence of a lien, the lien is terminated whenever the claim of the bailor exceeds that of the lienor.

b. Common carrier. The general rule stated in this Section does not apply to the common carrier. Where the lienor is a common carrier the interest of the lienor is automatically reduced by the amount of damage suffered by a shipper resulting from a violation of the carrier's duty in respect of the goods received for transportation. Where, for example, the carrier has a lien for freight and the shipper has a claim for damage to goods, the carrier must decide at his peril which claim is larger, if the shipper demands the goods without payment of freight. If the amount of the damage is in fact greater than the lien the shipper can recover the goods or hold the carrier as a converter upon the carrier's refusal to deliver the goods. Under modern procedure the carrier can usually set off his claim for freight whether the action is for recovery of the goods or for their value.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawSecured TransactionsDefaultForeclosure & RepossessionEnforcementContracts LawSecured TransactionsPerfection & PriorityPriorityLiensTortsVicarious LiabilityBailees



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Restat 1st of Security, § 80

§ 80 Surrender of Possession by Possessory Lienor to the Bailor

(1) Subject to the rules stated in Subsections (2) and (3), where a possessory lienor surrenders possession of a chattel to a bailor, the lien is terminated.

(2) Where a lienor surrenders part of a group of chattels upon which a specific possessory lien exists, the lien continues upon the chattels which are retained, as security for the entire demand.

(3) Where a lienor surrenders possession of a chattel to the bailor under circumstances which impose upon the bailor an obligation to return it, the lienor can recover the chattel from the bailor and others except a bona fide purchaser for value and an officer of the law who has levied on or attached the chattel at the instance of one who has become a creditor without notice of the lienor's interest.

(4) In the circumstances described in Subsection (3) where the chattel is recovered by or returned to the lienor, the lien is revived, subject to superior interests of those third persons referred to in that Subsection.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See as to the effect of an agreement to pledge, § 10 and as to the return of a pledged chattel for a temporary and limited purpose, § 11.

b. This Section is concerned only with surrender of the chattel to the bailor. The lien can also be terminated by an unconditional surrender to a third person with the consent of the bailor. When the lienor delivers the chattel contrary to the terms of the bailment or otherwise misconducts himself in respect to it, the lien may also be terminated and the lienor be subject to liability to the bailor, see §§ 68 and 71.

Comment on Subsection (1):

c. The lien is a legal interest dependent upon possession. Where the lienor voluntarily gives up the possession, his lien, at least so far as it is a legal interest, is gone. The lienor, like the pledgee, does not lose his legal interest if he is deprived without his consent of his possession either by the bailor or a third person. If the lienor's surrender of

possession is voluntary but obtained by fraud, the lienor can recover the chattel unless third persons in the meantime have acquired interests. Where possession is taken without the consent of the lienor, even a bona fide purchaser is subject to the lien, provided the chattel is non-negotiable.

Comment on Subsections (3) and (4):

d. As stated in § 11, the pledgee may return a pledged chattel for a temporary and limited purpose relating to the maintenance of the value of the pledgee's interest and having to do with the protection, improvement or sale of the chattel, or where the chattel is an instrument or document, its handling or collection. In other words, under some circumstances the pledgee can retain his legal pledge interest even when he has given up possession although this interest can be defeated by a sale to a bona fide purchaser. The reason for this relaxation of the possessory requirement of the pledge is because business convenience demands that the pledgor be thus helped to liquidate his obligation out of the pledged chattel. No such reason exists in the case of the lien. The bailor's ability to pay his obligation to the lienor does not ordinarily depend upon his possession of the chattel. There is no sufficient reason for the law to encourage lienors to surrender possession to debtors.

The foregoing considerations may seem to justify the conclusion that when the lienor has surrendered possession in any circumstances the lienor has lost all interest in the chattel, irrespective of the obligation by agreement or otherwise on the part of the bailor to return the chattel. The consequence of such a rule would be not only that the lienor would be without a remedy to enforce the agreement but that even if the chattel were returned the lien would date only from the time of the return. So far as the contract to return is concerned, this would add nothing to the lienor's right against the bailor on the debt. In this event if the chattel were returned when the bailor was insolvent, the lienor would be subject to the preference rule in bankruptcy if bankruptcy ensued within four months of the return and the lienor knew of the insolvency when he received this chattel on its return. In the case of a hotelkeeper, such a rule would be particularly harsh, since the nature of his business requires that he allow the guest freedom of use of the guest's belongings, even if this involves taking them off the hotel premises.

The ground for recognizing an equitable interest as a result of an agreement to secure an obligation by a specified thing, is the inadequacy of the legal remedy. It has no relation to the uniqueness of the chattel. The creditor's remedy is inadequate because no one can tell if the creditor will need the security at the time the debtor's obligation is enforced. The recognition of an equitable interest in a creditor does not mean that in fact a court of equity will take jurisdiction to enforce it in a particular case. The creditor may have other adequate security, the remedy of attachment may be available at a time when the debtor is solvent, the creditor may be able to sue at law for the recovery of the chattel, or the court may not believe it can grant an effective decree. The chief practical value to the lienor in recognizing the existence of an equitable interest in a chattel because of a bailor's duty to return the chattel to the lienor, is that upon the return of the chattel, the lien can revive as if there had been no interruption of possession, assuming no superior interests of third persons have intervened. Since either a legal or equitable interest has at all times continued, the lien except for such third persons, can be regarded as dating from the time when it first arose.

The equitable interest acquired by a lienor as a result of an obligation on the part of the bailor to return the chattel is defeated by sale to a bona fide purchaser and can also be defeated by an attaching or levying creditor. The Restatement both in this Chapter and in § 11 relates to pledges, states the rule that the attaching or levying creditor is subject to the equitable interest of the lienor only if the creditor knows of the facts upon which the equitable interest is based before he becomes a creditor.



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Rules and Principles

Division 1 - Personal Property as Security

Chapter 2 - Possessory Liens

Restat 1st of Security, § 81

§ 81 Statute of Limitations and Discharge in Bankruptcy

A lien is not terminated by the running of the statute of limitations against the claim secured by the lien, nor by the discharge of the claim in bankruptcy.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. The rule stated in this Section is similar to the rule stated in § 47 in respect of pledges and the Comment to that Section is also applicable to this Section.

Legal Topics:

For related research and practice materials, see the following legal topics:
GovernmentsLegislationStatutes of LimitationsGeneral Overview



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Rules and Principles

Division 2 - Suretyship

Scope Note

Suretyship is included in the general field of Security because the obligation of a surety is an additional assurance to the one entitled to the performance of an act that the act will be performed. The relation arises where two persons are bound to a third who is entitled to but one performance, and where as between the two, one rather than the other should perform. While a variety of transactions may give rise to the relation, six type examples may be noted, which, although not comprehending all possible variations, illustrate its more important and usual aspects, as follows:

1. Two persons contract with each other and with a third person so that the two are bound on personal obligations to the third, who is entitled to but one performance, and as between the first two one rather than the other should perform.
2. Two persons contract with each other and also with a third person so that one is under a personal and the principal obligation to the third, while the second agrees to devote certain property as security to the third, although he does not otherwise assume any obligation.
3. One person is or is about to be under an obligation to another. Without the consent of the debtor or prospective debtor, the creditor or prospective creditor enters into a contract with a third person who contracts to assume an obligation to the creditor conditioned on the debtor's performance. In other words, there is a contract of a surety to which the principal has given no consent, and of which he may have no knowledge.
4. One person is already under an obligation to another. A third person assumes the obligation of the first, or purchases property from the first upon which the obligation is a charge. A common instance of this situation occurs in a transfer of mortgaged land where the grantee assumes the mortgage or takes subject to it.
5. One person contracts to save another harmless from tort damage which he may sustain, that is, he insures the other against certain losses. A loss is caused by the fault of a third person. Both the insurer and the tortfeasor are liable to the insured, but as between the insurer and the tortfeasor the latter should bear the burden.
6. Two persons are liable to a third for damage to person or property. The damage is caused by one but the other, although not causing the harm, is made liable by some rule of law. For example, a servant

may commit a tort for which the master is also responsible. A consignment of goods may be damaged because of the negligence of a person other than the carrier, although the carrier is also liable even without fault. Between the master and the servant, or between the carrier and the tortfeasor, the servant and the tortfeasor should bear the ultimate burden.

Cases under the sixth example are not considered in the Restatement of this Subject, not only because they belong particularly to the field of Torts, but because, as distinguished from the other examples, they arise outside the merchandising and financial transactions in connection with which the rules of Security have been chiefly developed. While the relations of the parties under all of the examples have a certain similarity, those under the sixth example differ from the others in that the person who should be relieved of the ultimate burden has had a duty imposed upon him without his consent. The person similarly situated under the other examples has assumed an obligation voluntarily. In other words, his duty has arisen by contract.

Suretyship, as defined in this Restatement, embraces the relations where the one who, viewing the situation as a whole, should not bear the ultimate burden, has assumed a duty to a creditor by contract. Situations which, although within the general field of Suretyship, also involve Mortgages, Insurance, Partnership or other fields of law are considered only in their Suretyship aspects. The Restatement of Contracts and the Restatement of Restitution, particularly the former, contain a number of rules which have arisen out of cases involving Suretyship or have some application to it. Several of these rules are repeated in this Restatement

Legal Topics:

For related research and practice materials, see the following legal topics:

Business & Corporate Law Agency Relationships Duties & Liabilities Negligent Acts of Agents General
 Overview Contracts Law Debtor & Creditor Relations Real Property Law Financing Mortgages & Other Security
 Instruments Transfers General Overview



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Rules and Principles

Division 2 - Suretyship

Chapter 3 - Nature and Creation of Suretyship

Restat 1st of Security, § 82

§ 82 Suretyship Defined

Suretyship is the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform.

Special Note: The term "indemnity" also is often used in suretyship to mean reimbursement. As a matter of convenience it is not so employed in this Restatement. See Special Note, § 104.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This definition is broadly descriptive of the fact situation to which the rules of the Restatement of this Subject apply. The situation, considered as a whole, always involves three parties, although in any particular case the rules generally applying to the situation may not affect all of the parties. One party, for example, due to lack of knowledge on his part or to a special agreement, may not be subject to the requirements, or may not be entitled to the advantages of the rules applied to the tripartite situation. His rights may be determined, so far at least as one of the other parties is concerned, as if the situation involved two parties rather than three. The three parties in suretyship are the surety, the principal, and the creditor.

b. Surety. The surety is the person who is bound on an obligation from which another, by the discharge of a duty, should relieve him.

c. Principal. The principal is the person who, in the solution of the rights and duties of the parties, should bear the ultimate burden unless excused for some reason personal to himself.

d. Creditor. The creditor is the person to whom the surety is bound and to whom the principal is under an obligation or other duty. The term "creditor" includes one entitled to obtain satisfaction for a tort as well as the obligee of a contract.

e. Obligation. The word "obligation" is used to mean a duty arising by contract. The right of the creditor against the principal is usually based upon an obligation, but may arise also from tort.

f. When the statement is made that the principal should perform, or that the principal has the principal or primary duty and the surety an accessory or a secondary duty, it does not mean that the creditor's assertion of his right against the surety must be postponed until some action is taken against the principal. So far as the creditor is concerned, the surety may be the primary obligor. Where principal and surety are bound jointly, from the standpoint of the creditor there is no secondary liability. In the case of bills and notes the significance of the terms primary and secondary is determined by the rules pertaining to negotiable instruments. As between the parties who are bound, the primary party to a negotiable instrument may not be the one who must bear the ultimate burden.

To say that the principal in suretyship should perform does not mean that he has made any such agreement with the surety. The surety may have undertaken his obligation as a result of direct dealings with the creditor without the consent of the principal or even without his knowledge.

The one who should perform, the one who has the principal or primary obligation, in suretyship, is the one who, considering the situation as a whole, has the ultimate liability, or who would have the ultimate liability were it not for some defense, such as infancy, which is personal to himself.

Surety and principal are each bound to his own duty though the duties of both may be co-extensive. The surety's obligation may be to perform if the principal does not or it may be only to compensate the creditor for the principal's non-performance. Where the duties of surety and principal are different, as where the principal has agreed to paint a portrait and the surety has guaranteed his performance, the principal's duty to the creditor is to fulfill his promise. This is also his duty to the surety, but he also has the duty to reimburse the surety for any outlay on account of his default. See § 104.

g. *Guaranty*. The term "guaranty" is used in this Restatement as a synonym for suretyship. "Guarantor" is used as a synonym for surety. "Guarantee" is used as a verb meaning to assume a suretyship obligation. The spelling "guaranty" is not used for the verb in the Restatement of this Subject. The terms "suretyship" and "surety" appear more frequently in this Restatement than their synonyms, but the latter are employed to describe certain situations to which they are customarily applied. For example, a suretyship obligation conditioned upon the inability of the creditor to collect from the principal is usually called a guaranty of collection. A contract resulting from an offer to answer for the debt of a principal in a series of credit extensions is generally described as a continuing guaranty.

The surety's obligation assumes a variety of forms, most of which fall into a comparatively few categories. For example, a surety may be bound on the same instrument with his principal, or on a separate instrument. The surety's obligation may be coextensive with that of his principal or may be less, as where the debt is \$ 10,000 and the surety has guaranteed only \$ 5000. The surety may be bound to the creditor on the maturity of the principal's obligation, on the principal's default, or only after certain attempts have been made to obtain payment from the principal.

The possible convenience of having certain terms denote only particular types of surety obligations has resulted in some jurisdictions in the use of "suretyship" as a general term and "guaranty" as meaning some particular type of surety contract. In several states "guaranty" is used as the general term and "suretyship" with a restricted meaning. There has never been general agreement as to which term is to be the broader and which the narrower. Moreover, if both of the two terms are used with a restricted meaning, they do not suffice to cover even the main types of surety obligations.

Suretyship obligations are contractual, and the important point of inquiry should be the precise undertaking of the surety and the duty of the principal. The recognition of the existence of different forms of contractual suretyship and the emphasis upon the obligation assumed in a particular case, are of greater significance than the distribution of labels to the various types of contracts.

By statute in a number of States, "surety" or "guarantor" or both are given special restricted meanings. In such states, the determination of cases where the term used is significant may depend upon the provisions of the applicable statute.

h. The surety is usually bound to the creditor as a result of a promise. In the commonest situation this promise is made either at the principal's request, or at least with the principal's consent. The surety may also be bound not on a promise but by pledging of a chattel, mortgaging of a chattel or land, or by otherwise using his property to secure the creditor. The surety, instead of dealing directly with the creditor, may permit the principal to use the surety's property as security. In such a case the creditor is not bound by the surety relation until he has knowledge of it. (See § 114.) A person, for example, a mortgagor, may be originally bound to a primary liability but by the assumption of this liability by another, as often happens in connection with the sale of mortgaged land, may become a surety. Even where there is no assumption the land is considered as bearing the principal burden and the mortgagor is a surety to the extent of the value of the land. Here too the creditor is not affected by the surety relation until he has knowledge of it. Finally, a tripartite relationship involving a primary and secondary liability may arise in a variety of other situations in which the person, who in final analysis has a secondary liability, nevertheless has contracted for a primary liability so far as the creditor is concerned. An insurer against damage to a chattel has a primary liability to the insured, but as between himself and one who negligently causes the damage, the relation is one of surety and principal.

None of these situations belongs solely to the field of suretyship. They are properly included in such a category because of the application to them of many similar rules. The most important of these rules relate to the duty of the one having the primary liability to reimburse the one having, as between the two, the secondary liability, to the right of the one under secondary liability to be subrogated to the creditor's right, and to the limitations upon the freedom of action of the creditor in dealing with the principal whenever he has knowledge of the existence of the tripartite situation.

i. Compensated surety. The term "compensated surety" is used in the Restatement of this Subject to mean a person who engages in the business of executing surety contracts for a compensation called a premium, which is determined by a computation of risks on an actuarial basis. Compensated sureties are generally incorporated. Other sureties, whether strictly gratuitous or whether receiving some pecuniary advantage, whose surety contracts are occasional and incidental to other business, are not included among compensated sureties.

It is important to distinguish between compensated and other sureties because the rules of suretyship, notably those relating to the defenses of the surety, are not in all respects alike for the two classes. The basis for the distinction is that one engaged in the business of executing surety contracts can be expected to have contemplated and taken account of, in the premium charged, certain elements of risk which are not considered to have been assumed by other sureties. See § 129.

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

Without attempting any precise definition of "warranty" as used in respect of conveyances of real property, the sale of goods, assignment of rights, insurance, and contracts, it signifies a representation or promise as to the title, quality or quantity of a thing or of its fitness for a particular purpose, or is a stipulation that something exists or has happened. The term "implied warranty" denotes an obligation imposed by law where there is no representation or promise.

Suretyship involves three persons, warranty, two. The obligation of the surety is accessorial to the obligation of the principal. The obligation of the warrantor is independent of any obligation of another, but is part of or collateral to a contract of his own.

Illustrations:

1. S agrees with B that if he will buy certain machines from P, S will guarantee prompt delivery and satisfactory performance. S is a surety.

2. B, in connection with a sale of machines to P, contracts that the machines will automatically perform certain processes. This is a contract of warranty. It would be a contract of warranty even if B used the word "guarantee" in

expressing his agreement as to the quality of the machines.

k. Indorsement. An indorser is one who signs a negotiable promissory note or bill of exchange otherwise than as maker, drawer or acceptor. Unless the indorser is the party for whose accommodation the negotiable instrument is executed, the indorser is a surety. Any party to a negotiable instrument may be a surety if he signs for the accommodation of another party. The rules pertaining to negotiable instruments determine the rights of the parties to them so far as those rules have been codified in the Uniform Negotiable Instruments Law. In other respects the rules of suretyship apply where suretyship exists.

The term "indorsement" is also used in connection with the signature for purpose of transfer of a negotiable document of title, that is, an order bill of lading or negotiable warehouse receipt. In such a case the indorser's position is determined primarily by the rules pertaining to documents of title. If a situation arises which involves suretyship and which is not covered by the rules pertaining to documents of title, the rules of suretyship apply.

l. Indemnity. A contract of indemnity is one where the promisor agrees to save a promisee harmless from some loss, irrespective of the liability of a third person. In this sense, indemnity is synonymous with insurance.

The indemnitor, upon the happening of the stipulated contingency, is liable whether or not the indemnitee has any recourse against a third person. In suretyship the normal expectation is that the liability will be satisfied by the third person. Indemnity contemplates two parties, at least at the time of making the contract. Suretyship always involves three parties.

Indemnity in general is of two sorts. In the first, only two parties are involved at any stage of the proceedings. For example, an insurance company insures an automobile owner against any liability he may incur by reason of harm to others in the operation of his car. In the second sort, the indemnitor insures the indemnitee against loss he may incur by reason of accident or the default of another. In this type of indemnity, suretyship may ultimately be involved. For example a company may insure an automobile owner against certain types of harm to his car. If damage ensues without responsibility of a third person the contract remains only a contract of indemnity. If, however, the damage is one for which a third person who is not protected by the same policy of insurance is liable, the insurer has also become a surety, because between the insurer and the one who causes the harm, the latter should bear the ultimate loss.

The chief importance of distinguishing between suretyship and indemnity is in cases involving the Statute of Frauds, which generally does not apply to contracts of indemnity. An oral contract of indemnity may generally be enforced, but not an oral contract to answer for the debt default or miscarriage of another. (See §§ 89, 93). Under modern statutes, however, some indemnity contracts must be in writing.

Much of the confusion which exists in connection with the administration of the rules relating to indemnity and suretyship can be avoided by recognizing that a contract of indemnity may also involve suretyship as a result of subsequent events. In other words, a relationship which involves two persons at the outset may ultimately involve three. This means that where a contract may fairly be called one of indemnity or insurance, the rules pertaining to suretyship do not apply to its execution, even if upon the introduction of a third party the rules of suretyship become applicable. It should be noted, however, that where the indemnitor becomes a surety, the indemnitee becomes the creditor and not the principal.

Illustrations:

3. I contracts with D that if D incurs any liability to any person in connection with the operation of D's factory, I will assume D's liability. This is a contract of indemnity. No suretyship relation will arise.

4. I contracts with D to assume a contractual liability to which D is subject. Between I and D this is a contract of indemnity. A suretyship relation arises, however, involving D, I and the creditor. D is the surety. The creditor is affected by this relationship only if he has knowledge of it.

5. I contracts with D that if D incurs a liability by reason of his own default or that of any employee, I will assume liability. This is a contract of indemnity so far as the making of the contract is concerned. If, however, an employee harms a third person so that both D and the employee are liable to the third person, a suretyship relation arises involving the employee, I and the third person. Between the employee and I, I is a surety. The third person is affected by this relationship only if he has knowledge of it.

6. A corporation contracts with a promisee to save him harmless from loss due to defaults by his employees. This is a contract of suretyship rather than indemnity because it is essentially a tripartite situation involving a promise to answer for the default of another.

7. A corporation contracts with a merchant to save him from loss due to the inability of customers to pay their accounts. This, like the situation in Illustration 6, is a contract of suretyship rather than indemnity. The relationship is tripartite and involves a promise to answer for the default of another. In both Illustrations 6 and 7, the liability of the surety is primary between himself and the creditor, but in both cases the ultimate liability is on another.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementDuties & Liabilities of PartiesGeneral Overview



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Rules and Principles

Division 2 - Suretyship

Chapter 3 - Nature and Creation of Suretyship

Restat 1st of Security, § 83

§ 83 Creation of Suretyship

The suretyship relation is created where the surety

- (a) contracts with the creditor either by the same instrument in which the principal contracts with the creditor or by a separate instrument; or**
- (b) secures, or permits the principal to secure with the surety's property, the performance of the principal's duty to the creditor; or**
- (c) 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; or**
- (d) having been one of several principal obligors, one or more of the other co-principals contracts to assume the entire duty of performance; or**
- (e) having contracted as an indemnitor, another person should perform a duty which will relieve the surety of his obligation, and if the surety rather than the other person performs, the latter should reimburse the surety.**

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The categories in this Section are intended to cover by general description all the recognized situations which as a matter of logic and convenience are classified within the field of Suretyship. The Section does not exclude the possibility that other situations may be brought within the same field. Certain rules of suretyship are also sometimes applied by analogy to other situations, for example, one involving joint tortfeasors, (see Scope Note), although these situations are not considered in this Restatement as belonging to Suretyship.

Comment on Clause (a):

b. This clause refers to the situation where the surety intends at the time of his contract to become a surety. The chief types of a surety's contract exist where (1) the surety and the principal contract in the same instrument with a creditor; (2) the surety at the request of or with the consent of the principal contracts separately with the creditor that the principal will perform and that upon the latter's default the surety will perform or that the surety will compensate the

creditor for the principal's non-performance; (3) the surety without the consent of the principal contracts with the creditor or with a fourth party for the benefit of the creditor.

Numerous variations are found under each of the main types of obligations of a surety. For example, where he is bound on the same instrument with the principal, the surety may contract jointly, jointly and severally, or severally. Where the surety is separately bound his duty to perform may arise at the maturity of the principal's obligation, or may be only a guaranty of collection. The surety's liability may be limited only by the amount of loss sustained by the creditor or by a stipulated maximum. The surety's contract may relate to a single transaction or a series of transactions. Finally, the surety may guarantee that the principal will satisfy a contractual obligation, or that he will perform some other duty, for example, faithful conduct of his function as a public fiscal officer. These examples, which are meant to be illustrative rather than exclusive, have the common element, that in all cases the surety expects a principal to perform. Whether, as between himself and the creditor, the obligation of the surety is primary or secondary, as between himself and the principal the latter should bear the ultimate burden.

The surety's obligation is frequently expressed by signing as a party to a negotiable instrument or by signing a writing on a negotiable instrument other than as a party. (See §§ 146, 147, and 148.) So far as he is a party on such an instrument, his obligation to a holder is determined by the law of negotiable instruments. The rules of suretyship, however, are important in determining the mutual rights and duties of parties to negotiable instruments where these matters are not controlled by the law of negotiable instruments. This is particularly true of parties to negotiable instruments who are cosureties or subsureties, see (Chapter 6).

The indorser's contract is that of a surety unless he is the accommodated party. For example, where a payee writes on a negotiable instrument, "I guarantee payment," he is a surety unless he is an accommodated party, but he is also an indorser who waives presentment and notice. (See Uniform Negotiable Instruments Law, § 63.) Where a person not otherwise a party to a negotiable instrument writes thereon, "I guarantee payment," there is no question but that he is a surety. Whether or not he is also an indorser is a matter upon which jurisdictions differ because of varying interpretations of the law of negotiable instruments.

Where a person writes a guaranty on a negotiable instrument without naming or designating a particular creditor, his promise runs to any holder of the instrument. The rights of the holder and defenses available against him are determined by the law of negotiable instruments.

Comment on Clause (b):

c. Just as the surety can bind himself for an obligation which is equivalent only to a part of the loss which may be sustained by the creditor if the principal defaults, so he can limit his liability to specific property which he is willing to devote to the securing of the duty of the principal. A common example of this form of suretyship is where the surety pledges bonds or share certificates to the creditor or lends them to the principal so that he can pledge them to the creditor. (See § 36.) A suretyship relation exists in the latter case, although the creditor is not affected by the suretyship relation until he has knowledge of the surety's interest in the pledged chattels.

d. Where, for example, a corporation pledges its own bonds, as security for the performance of a principal's duty, or lends them to a principal to be used as security, the obligation of the corporation as surety comes within the category of Clause (b) although the bonds are obligations of the corporation. The expression "personal obligation as a surety" is used to indicate a distinction between the situations of Clauses (a) and (b).

Comment on Clause (c):

e. Two important situations under Clause (c) arise within the field of mortgages. Where a mortgagor transfers mortgaged land, the grantee usually assumes the mortgage or agrees to take the land subject to the mortgage. Whatever his agreement, the land remains subject to the mortgage unless some action is taken by the mortgagee which releases it. Where the grantee assumes the mortgage the grantee becomes the principal obligor and the mortgagor a surety. Where

the grantee takes subject to the mortgage, but without assuming the debt it secures, the land is regarded as bearing the principal burden of the mortgage, and the mortgagor is a surety to the extent of the value of the land. See § 114.

So far as mortgagor and grantee are concerned, their contracts usually prescribe their respective duties with such particularity that the incidents of suretyship have little significance. The mortgagee, on the other hand, once he has knowledge that the one originally under the principal obligation has become a surety, is affected as to his own powers and privileges by the suretyship relation. He must especially guard against discharging the surety by dealings with the new principal which alter the principal obligation, as by an extension of time without the surety's consent. (See §§ 122, 128, and 129).

Comment on Clause (d):

f. Two persons, after binding themselves as principals, may subsequently change their relations so that between themselves one has the entire duty of performance, that is, so far as they are concerned, they have become principal and surety. A common situation to which the rule stated in this Clause applies is where a partner retires and the old partners assume all the firm obligations. The retiring partner is a surety in respect of the others. A similar situation occurs where two persons have made on credit a joint purchase, but subsequently agree that one is to own it and pay for it. As between themselves, the one who is to own the article is the principal and the other a surety. The creditor retains the obligation of the several parties in such cases but he must take account of their new relationship from the time he has knowledge of it (§ 114).

Comment on Clause (e):

g. The discussion under § 82 (see Comment l and Illustrations) has indicated the possibility that one who contracts as an indemnitor may also become a surety as the result of subsequent events. To make the indemnitor a surety there must be ultimately one other than the indemnitor upon whom the burden can be shifted. The object of the indemnity contract may be to protect the indemnitee from loss on his contracts from liability for his torts or from liability imposed by law. In the case of an indemnity contract the indemnitor may also become a surety at the time his contract is made or he may subsequently become a surety, or he may never become a surety.

Illustrations:

1. I contract with C to save C harmless from any loss which he may sustain on sales of goods throughout 1939. C sells goods to A and B, who refuse to pay for them. I am a surety and A and B are principals in respect of these sales.

2. I contract with C to save C harmless from any loss he may sustain in consequence of his failure to complete a building contract with O. Owing to a breach of contract by L, a labor union, on a contract between C and the union, C is liable in damages to O. Assuming that the labor union is legally responsible for this loss, I am a surety and the labor union a principal.

3. I contract with C to save C harmless from loss which he may sustain as a result of delay in completing a building contract. C is unable to complete the building within the specified time and comes under a liability to O. I must compensate C for this loss but no suretyship relation arises because I under his contract cannot shift the burden to a third person.

4. I contract with C, the proprietor of a line of trucks, to save C harmless from any damage he may sustain in the operation of the trucks. Due to faulty mechanical condition of a truck for which C alone is responsible, harm is suffered by a third person to whom C is liable. I must satisfy the damage but there is no suretyship relation.

5. Same facts as Illustration 4 except that the faulty mechanism of the truck is due to the negligence of an employee. Assuming that the employee is ultimately responsible for the loss, I become a surety and the employee is a principal.

6. I contracts with C, a shareholder in a corporation, to reimburse C for any loss he may sustain because of a statutory liability imposed on shareholders for the benefit of certain creditors. If the shareholder is entitled to be reimbursed by the corporation, I is a surety and the corporation a principal, since as between C and the corporation the latter should bear the ultimate burden.

h. The fact that one who contracts as an indemnitor may also become a surety, then or subsequently, does not necessarily mean that all the rules of suretyship are applicable to the situation. The contract between indemnitor and indemnitee may be in such definite terms as to govern all the relations of these two parties irrespective of the indemnitor's position as a surety in relation to a third person. Even if an indemnitor happens also to be a surety, nevertheless he may not be entitled to such special privileges as are accorded to sureties by statute, because the statute may in terms refer only to certain sorts of sureties, or the indemnitor may be excluded from its provisions upon proper interpretation.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 84

§ 84 Capacity to Become a Surety

(1) A person who has the general capacity to contract has the power by contract to become a surety.

(2) Lack of capacity to undertake a personal obligation as a surety does not prevent a person's becoming a surety by using or permitting the use of his property as security for the performance of an act by another, or as a result of his primary obligation being assumed by another or imposed upon another's property.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Certain persons, for example, a male person or a spinster of full age and sound mind, have the general capacity to contract. This capacity includes the power to make surety contracts. Married women today usually have this general capacity. Where they do not have general capacity, in some jurisdictions their special capacity to contract does not extend to the making of surety contracts, or if it does so extend, does not permit the making of surety contracts for particular persons, for example, the husband. The powers of a corporation generally are not sufficiently extensive to permit it to execute a surety contract other than one which in the circumstances is a necessary or proper means of furthering the corporate enterprise. The officers of the corporation may, however, have the power to bind the corporation beyond its authorized powers where those who deal with them do so in good faith. Such problems are beyond the scope of this Restatement.

Comment on Subsection (2):

b. The expression "undertake a personal obligation as a surety" refers to contracts where the primary purpose is to answer for the duty of a principal. Where a person has the capacity to transfer an interest in his property as security for another, he can become a surety without having the general power to contract as a surety. Likewise, being a mortgagor without the general power to become a surety, he can become a surety as a result of the transfer of the mortgaged land and the assumption of the mortgage by the grantee or the imposition of the primary burden of the mortgage on the land.

Illustrations:

1. In a jurisdiction where a married woman cannot contract as a surety for her husband, a wife lends her husband

certain bonds which he pledges as security for a loan. The wife is a surety.

2. In a jurisdiction where a married woman cannot contract as surety for anyone, a married woman mortgages land owned by her. She subsequently transfers the land to a grantee, who takes subject to the mortgage. The married woman is a surety to the extent of the value of the land.

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Restat 1st of Security, § 85

§ 85 Who Can Accept Offer for Surety Contract

An offer to become a surety can be accepted only by or for the benefit of the person to whom the offer is made.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is derived from § 54 of the Restatement of Contracts. The offeree of a surety's promise may be named or may be designated narrowly or broadly. An important suretyship application of this rule occurs where the surety offers to guarantee an extension of credit to the principal by anyone from whom the principal can obtain accommodation. In such a case the surety is bound to the person to whom the principal communicates the offer and who accepts it by extending the credit contemplated by the offer.

Legal Topics:

For related research and practice materials, see the following legal topics:
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Restat 1st of Security, § 86

§ 86 Notice of Acceptance of Offer to Guarantee Extension of Credit; When Required

Where the surety offers to guarantee an extension of credit to the principal and the credit is extended as the sole consideration for the surety's promise, the contract is complete upon the extension of credit, but if the surety does not know of the extension of credit and has no adequate means of ascertaining with reasonable promptness and certainty that the credit has been extended and the creditor should know this, the contract of the surety is discharged unless within a reasonable time after the extension of credit the creditor exercises reasonable diligence to notify the surety thereof.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is an important suretyship application of § 56 of the Restatement of Contracts. See also Comment and Illustrations to § 56.

b. Where the surety has received other consideration for his promise, or where his promise is under seal, the surety is under an immediate obligation even if the performance by him is conditioned upon some act by the creditor. Such situations are outside the rule stated in this Section, which applies only where the contract is made by the creditor's extension of credit.

c. Among the numerous circumstances where notice of the extension of credit need not be given by the creditor to keep alive the surety's obligation, are those where surety and principal have made a joint or joint and several offer to the creditor. The creditor's acceptance of the offer by the extension of the contemplated credit is of course known to the principal. The joint relation of surety and principal justifies the creditor in assuming that notice of his acceptance will be communicated to the surety by the principal.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 87

§ 87 Revocation by Death of Offer to Become a Surety

Where an offer to be bound as a surety is revocable it is revoked by the death of the offeror.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. The rule stated in this Section is in accord with the general rule stated in § 48 of the Restatement of Contracts.

b. The rule stated in this Section applies only where a surety's offer is revocable. It does not apply where the offer is irrevocable or where the surety has become bound on a contract. The rule is applied chiefly where the surety has made an offer to guarantee successive extensions of credit to a maximum amount or has guaranteed advances to a stipulated amount outstanding at any one time. The rule also applies where there is an offer for a single extension of credit which has not been made at the time of the death of the offeror. A dead surety can make no contract nor can a dead man request a creditor to make the advances.

Some of the situations to which the rule does not apply are those where the surety's promise is under seal or where the surety has received consideration which makes his promise binding prior to his death, although something remains to be done by the creditor as a condition of the surety's duty of performance. The consideration which makes the surety's promise binding may be a promise by the creditor. In some jurisdictions where the rule stated in this Section is accepted, there has seemed to be a recent tendency, where a surety or one who has offered to become a surety has died, to favor an interpretation of the facts of cases leading to the conclusion that there was consideration for the surety's promise prior to his death, rather than that the surety had made a revocable offer.

c. Stipulation against termination of offer by death. The fact that the offer provides that death shall not terminate the offer is immaterial. To bind the estate of the surety, the contract must be made before his death.

Illustrations:

1. S makes an offer to C to guarantee a loan to P. Before the loan is made, S dies. S's executor or administrator is not liable to C even if he subsequently makes the loan in ignorance of S's death.

2. Same facts as Illustration 1 except that S in his offer stipulates that the offer will not be revoked unless C is notified to such effect. The result is the same as in Illustration 1.

3. S, a director of a bank, offers to guarantee the payment of all advances to his bank by the Reconstruction Finance Corporation, up to \$ 100,000 outstanding at any one time. He also stipulates that the offer is not to be revoked except after receipt of written registered notice by the Treasurer of the Corporation. The Corporation lends \$ 50,000 to the bank before S dies, and \$ 50,000 after his death, without knowledge of his death. No repayments have been made. S's personal representative is liable for \$ 50,000 only.

4. In a jurisdiction where a promise under seal imposes an enforceable obligation without other consideration, S promises by an instrument under seal to guarantee advances by C to P, not exceeding \$ 100,000, if made within a year. C before S's death advances \$ 50,000. After S's death and within the year, C, knowing of S's death, advances an additional \$ 50,000. S's personal representative is liable for \$ 100,000.

5. Same facts as Illustration 4, except that in consideration for S's written promise not under seal to guarantee performance of a building contract by P, C promises to employ P for the building operations. After S's death, the building operation is begun and P is duly employed. P subsequently defaults. S's personal representative is liable for this default. At the time of S's death he was under a contractual obligation rather than in the position of one who has made a revocable offer.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts Law Formation Offers Revocable Offers



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Restat 1st of Security, § 88

§ 88 Interpretation of Contract of a Surety

The contract of a surety is interpreted according to the standards that govern the interpretation of contracts in general.

Special Note: Where there is a special standard of interpretation requiring contracts to be interpreted strictly in favor of one party or the other, such rule is frequently referred to as the rule of *strictissimi juris*. *Introductory Note*, Sections 89 to 100: These sections which deal with the Statute of Frauds are repeated in substance from the Restatement of Contracts because of their peculiar applicability to suretyship. As these rules appear in the Restatement of Contracts they are largely derived from suretyship. In the Sections 90 to 100, the expression "within the Statute of Frauds" is used to indicate the requirement of a written memorandum signed by the party to be charged.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross references. The scope and meaning of contracts is treated in Chapter 9 of the Restatement of Contracts, §§ 226-249: Topic 1, §§ 226 to 236, deals with Interpretation; Topic 2, §§ 237 to 244, with the Parol Evidence Rule; and Topic 3, §§ 245 to 249, with Usage. Reference is especially made to the Restatement of Contracts, § 226, "What is Interpretation;" § 227, "What is a Standard of Interpretation;" § 235, "Rules Aiding Application of Standards of Interpretation;" and § 236, "Secondary Rules Aiding Application of Standards of Interpretation."

b. Rule of interpretation. Under the rule stated in this Section contracts of a surety are not subject to a special standard of interpretation requiring that such contracts be interpreted strictly in favor of the surety. There is no special standard of interpretation for suretyship contracts.

c. Problems of interpretation of contracts of a surety which are often of importance include those relating to the scope of the surety's promise. It is frequently of considerable difficulty to determine whether the principal's credit has been guaranteed for a particular purpose, for a particular time, for a single transaction or a series of transactions, for a particular or an indefinite amount, for a particular amount as a total credit or as a revolving credit, or for transactions having described characteristics, as for the price of goods, when accompanied by bills of lading representing certain shipments.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 89

§ 89 Statute of Frauds

An informal contract with an obligee to answer to him for the debt, default or miscarriage of another is unenforceable unless there is a written memorandum thereof signed by the party against whom enforcement is sought.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See Restatement of Contracts, § 178. The rule stated in § 84 above is that stated in reference to the contracts of Class II under § 178. This rule is stated substantially as it appears in § 4 of the English Statute of Frauds, 29 Charles II, c. 3 (1677), which has been generally reenacted in the United States. In a few states, contracts under this Section are declared void if the statutory requirements are not followed. However, as indicated in the Restatement of Contracts, § 178, Comment *a*, even where local statutes contain the word "void," literal interpretation is not usually given the word in all applications of the statute.

b. The words in the English Statute of Frauds "debt, default or miscarriage" or corresponding words found in modern statutes include all kinds of duties recognized by law which may be conditional or even voidable and unenforceable. The contract is not within the scope of the Statute unless the promisee is the person to whom the debt is owing or is entitled to damages for the default or miscarriage. See Restatement of Contracts, § 180, Comments *b* and *c*.

c. Sealed instruments. The rule stated in this Section does not apply to sealed instruments. In jurisdictions where the common law effect of the seal has been preserved and where the Statute of Frauds follows the form of the English Statute, it is possible for a surety to be bound on an instrument sealed by him but not signed. This qualification has slight importance at the present day because it is unlikely that an instrument which is sealed will not also be signed.

d. In the majority of states, as under the English Statute of Frauds, the statute does not mean that no contract exists, but that without a signed writing the creditor does not have the evidence necessary to induce a court to give judgment in his favor. In several states, statutory modification of the common form of the Statute of Frauds permits a creditor to enforce such a surety contract by other evidence. For example, the creditor may be allowed to require the surety to appear and answer under oath a question as to his making of the contract. In this connection it may be observed that at

the time the English Statute of Frauds was passed neither party to an action at law could appear as a witness.

Illustrations to § 89 (adapted from Illustrations to § 180 of the Restatement of Contracts): 1. D commits a tort against C. S promises C orally for sufficient consideration to pay C the damages which C has suffered from the tort if D fails to do so. S's promise is unenforceable because of the Statute of Frauds, since D is under a direct duty to C, and S's promise is to perform D's duty if D fails to do so.

2. S promises C orally to guarantee the performance of any duty that D may incur to C within the ensuing year. Relying on this promise, C enters into contracts with D, by which D undertakes within the year to sell materials for a house and to act as supervising architect during its construction. D, without excuse, fails to perform his contract. S's promise is unenforceable because of the Statute of Frauds.

3. S obtains goods from C on this oral promise: "Charge them to D, and if he does not pay for them, I will." S has no authority to charge the goods to D. S's promise is not subject to the Statute of Frauds, since D is under no duty.

4. In consideration of the delivery of goods by C to D, S orally promises to pay the price of them. S's promise is not subject to the Statute of Frauds, since D is under no duty, and hence is not a principal.

5. D, an infant, obtains goods on credit from C, who is induced to part with them by S's oral guaranty that D will pay the price as agreed. The goods are not necessities but D is subject to a duty, though it is voidable. S's promise is unenforceable because of the Statute of Frauds.

6. S induces C to sell goods to D and take D's note for the price by warranting orally or in an unsigned writing that D's note is not voidable on account of infancy. S's warranty is not subject to the Statute of Frauds, whether D's promise is or is not voidable, since S does not bind himself for the performance which D has undertaken. S will become liable for such damages as C may suffer if D is an infant and whether D's note is or is not voidable it will not be discharged by S's performance.

7. D contracts with S to build a house for S. C contracts with D to furnish materials for the purpose. D in violation of his contract with C fails to pay C for some of the materials furnished, and C justifiably cancels his contract with D. S orally promises C that if C will continue to furnish D with materials that C had previously agreed to furnish, S will pay the price therefor. C does so. S's promise is not subject to the Statute of Frauds because D is not bound to pay C for the materials supplied in consideration of S's promise.

8. S, for sufficient consideration, orally promises E to pay a debt of E's son D to C, if D fails to pay it at maturity. S's promise is not subject to the Statute of Frauds because it is made to E, not to the creditor C.

9. D and S severally and unconditionally in an unsigned writing promise C, for sufficient consideration inuring to the benefit of both D and S, that C shall be paid the sum of \$ 100 a month for the next six months. D has induced S to make this promise by promising to hold S harmless. If C knows or has reason to know of this contract between D and S, when S makes his promise to C, S's promise is unenforceable. Otherwise S's promise is not subject to the Statute of Frauds.

10. D induces S to purchase goods from C. Though the purchase is for D's benefit, the goods are delivered by C to S, who afterwards turns them over to D. S orally promises C to pay for them. D, as part of the transaction, guarantees C that S will pay. C neither knows nor has reason to know that S is a surety. Though S is a surety as between himself and D, his promise is not subject to the Statute of Frauds, since the duty to pay is in truth his.

Legal Topics:

For related research and practice materials, see the following legal topics:
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Restat 1st of Security, § 90

§ 90 Two Promises of Same Performance for Same Consideration; When Within the Statute of Frauds

Where promises of the same performance are made by two persons for a consideration which inures to the benefit of only one of them, the promise of the other is within the Statute of Frauds, even if the promise is not in terms conditional on default by the one to whose benefit the consideration inures, unless

(a) the promises are in terms joint and not joint and several or several; or

(b) the promisee neither knows nor has reason to know that the consideration does not inure to the benefit of both promisors.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section is in substance § 181 of the Restatement of Contracts, and the Comments and Illustrations to this section are applicable. As pointed out in § 181, Comment *a*, where the promisors bind themselves jointly, the duty of neither of them is within those duties which are unenforceable unless there has been compliance with the Statute of Frauds, although one of the parties is in fact a surety. The debt being joint, both promisors stand for the purpose of the Statute as a unit.

b. As stated in § 181 Comment *b* of the Restatement of Contracts, the Statute of Frauds applies only to informal contracts and not to contracts under seal or those contained in a negotiable instrument.

Illustrations:

1. D and S jointly and orally promise C to pay C for goods which C knows are to be delivered for the exclusive benefit of D. S's promise is not within the Statute of Frauds, and is enforceable.

2. Same facts as Illustration 1 but the promise is joint and several. The promise of S is within the Statute of Frauds and cannot be enforced against S.

3. D and S jointly and severally promise C orally to pay for goods then ordered from C. While C knows the goods are to be delivered to D he has no reason to know that the sale is not for the benefit of both parties. S's promise is not within the Statute of Frauds and is enforceable.

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Restat 1st of Security, § 91

§ 91 Promise to Carry Out a Duty Existing Apart From the Promise

A promise to perform or otherwise to satisfy all or part of a duty of another to the promisee is not within the Statute of Frauds if, by the terms of the promise when it is made, performance thereof can involve no more than
(a) the application of funds or property then or thereafter put in the hands of the promisor for the purpose, or
(b) performance of any other duty owing, irrespective of his promise, by the promisor to the promisee, or
(c) performance of a duty which is either owing, irrespective of his promise, by the promisor to the third person, or which the promisee is justified in believing to be so owing.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This Section is in substance of § 182 of the Restatement of Contracts, and the Comments and Illustrations to that Section are applicable. The Section applies to cases where the promisor, if he fulfills his promise, will be doing no more than he is bound to do by reason of some other duty than that imposed by the promise, or the promisee is justified in so believing. In cases under Clause (a) but not necessarily in those under Clauses (b) and (c) this is apparent from the terms of the promise. Under all the Clauses the duty of the promisor apart from the promise may exist when the promise is made or may arise subsequently. What is essential for the application of the rule stated in the Section is that the duty exist when performance of the promise is due.

Illustrations to Clause (a):1. D owes C \$ 100 and pays that sum to S in trust for C, upon S's oral promise to make the payment to C. C acquires an enforceable right against S.

2. D owes C \$ 150 and pays \$ 100 to S in trust for C. S orally promises to pay in full D's debt to C. C has an enforceable right against S for only \$ 100.

Illustration to Clause (b):3. S is a member of a partnership. After he retires but before the debts of the partnership are paid, S orally promises C, a partnership creditor, to pay the amount due him. C has an enforceable right against S because irrespective of the promise, S is under an obligation to make the payment.

Illustrations to Clause (c):4. S at D's request orally promises C to guarantee the payment by D to C of the price of goods to be sold by C to D to the extent of any debt of S to D at the time when C notifies S that D is in default. C sells the goods to D. S's promise is not within the Statute of Frauds.

5. S and D severally promise C to pay for goods to be delivered to D. The goods are really for S and D is the real surety, although S and D lead C to suppose that S is the surety. S's promise is not within the Statute of Frauds; neither is D's, by the rule stated in § 90 (b).

Legal Topics:

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Restat 1st of Security, § 92

§ 92 Promise in Satisfaction of the Duty of Another

A promise that is itself accepted by the promisee in satisfaction of a previously existing duty of a third person to the promisee is not within the Statute of Frauds.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This Section relates to novations and is in substance § 183 of the Restatement of Contracts and the Comment to this Section is applicable. The contract covered by the rule stated in this Section is not a contract of suretyship.

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Restat 1st of Security, § 93

§ 93 Promise, the Consideration of Which Is Desired for the Promisor's Advantage

(1) Subject to the exception stated in Subsection (2), where the consideration for a promise that all or part of a previously existing duty of a third person to the promisee shall be satisfied is in fact or apparently desired by the promisor mainly for his own pecuniary or business advantage, rather than in order to benefit the third person, the promise is not within the Statute of Frauds.

(2) The general rule stated in Subsection (1) does not apply where the consideration is merely a premium for the promisor's insurance that the duty will be performed.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section is in substance § 184 of the Restatement of Contracts.

Comment on Subsection (1):

b. Main Purpose Rule. The rule stated in Subsection (1) is frequently called the "main purpose" rule. The situation for the application of the rule arises when one person is liable on an obligation and another promises to pay the obligation and frequently to assume a new obligation, which may also become an obligation of the first obligor, under circumstances in which the second promisor becomes a principal in respect to the creditor. The main object of the second promisor is to subserve some pecuniary or proprietary interest of his own. He is participating in the principal contract and making its obligation his own debt. The fact that there is consideration for the second promisor's promise is immaterial. He is not bound at all unless there is consideration for his promise. The importance of regarding the consideration is to ascertain whether it is so beneficial to the promisor as to be evidential of the main purpose in making the contract. It is not enough to make the Statute of Frauds inapplicable that the promise may be of slight and indirect possible advantage to the promisor. The expected advantage to the promisor must be such as to justify the conclusion that his main purpose in making the promise is to advance his own interests.

It should be observed that even if as between promisor and promisee the contract is not primarily to answer for the debt, default or miscarriage of another and hence not within the Statute of Frauds, a suretyship relation may be and in

general is created by such a contract to which many of the rules of suretyship are applicable.

Illustrations (from Restatement of Contracts, § 184): 1. D contracts with S to build a house for S. C contracts with D to furnish materials for the purpose. D, in violation of his contract with C fails to pay C for some of the materials furnished. C justifiably refuses to furnish further materials. S orally promises C, that if C will continue to furnish D with materials that C had previously agreed to furnish, S will pay the price not only for the materials already furnished but also for the remaining materials if D fails to do so. S's promise is enforceable.

2. D owes C \$ 1000. C is about to levy an attachment on D's factory. S, who is also a creditor of D's, fearing that the attachment will ruin D's business and thereby destroy his own chance of collecting his claim, orally promises C that if C will forbear to take legal proceedings against D for three months, S will pay D's debt if D fails to do so. S's promise is enforceable.

3. D owes C \$ 1000. C is about to levy an attachment on D's factory. S, who is a friend of D's desiring to prevent his friend's financial ruin, orally promises C that if C will forbear to take legal proceedings against D for three months S will pay D's debt if D fails to do so. S has no purpose to benefit himself and C has no reason to suppose so. S's promise is not enforceable.

4. C, a bank, discounts negotiable promissory notes of D, a corporation. D becomes financially involved. An official bank examiner threatens to close the bank on account of the impairment of its assets because of the loans to D. S, a shareholder of the bank, in consideration of forbearance by the examiner, orally promises the bank that if D fails to pay the note, he will do so. The promise of S is enforceable.

Comment on Subsection (2):

c. Subsection (2) excludes from the general rule stated in Subsection (1) contracts of guaranty insurance, whether making such contracts is or is not the promisor's regular business. (See Restatement of Contracts, § 184, Comment a.)

Illustration:

5. In consideration of a premium of \$ 100, S guarantees C in an unsigned writing the fidelity of D, C's employee, during D's term of employment. The guaranty is not enforceable.

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Restat 1st of Security, § 94

§ 94 Promise to Sign a Written Contract of Suretyship

A promise to an obligee to sign a written contract as a surety for the performance of a duty, or to sign a negotiable instrument for the accommodation of the obligor, is within the Statute of Frauds.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This Section is in substance § 185 of the Restatement of Contracts. The Comment to that Section is applicable.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 95

§ 95 Promise Not Originally Subject to the Statute of Frauds Where a Third Person Later Assumes the Duty

A promise which is not within the Statute of Frauds when made is not brought within it by a subsequent promise of another person to assume, as principal obligor, the performance of the duty.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. An obligor originally bound as a principal debtor may by agreement with one who subsequently assumes the duty become as between the two a surety, but this will not make the original promise subject to the Statute of Frauds. (See the Restatement of Contracts, § 187 and Comment *a.*) The rule stated in this Section applies, for example, where a partner retires from a partnership and the remaining partners agree to assume all of the partnership obligations. If the obligation on which the retiring partner was originally bound was oral, it does not become unenforceable merely because as between the retiring partner and the others, the retiring partner has become a surety.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts Law Statutes of Frauds General Overview



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Restat 1st of Security, § 96

§ 96 Promise to Indemnify a Surety

A promise which is not within the terms of §§ 91, 92 or 93, made to a surety or to one about to become a surety to indemnify him against liability or loss arising from his being or becoming a surety is within the Statute of Frauds if at the time when the promise is made or becomes a contract, the principal also is under a duty to indemnify the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section is substantially § 186 of the Restatement of Contracts.

b. One of the duties of a principal is to exonerate or reimburse a surety. See §§ 104, 112. Where one promises to indemnify a surety he is promising to answer for the default of the principal in the event of his failure to perform his obligation or his failure to reimburse the surety, if the latter performs the obligation. Such a promise is therefore a promise to answer for the default of another.

c. Where the indemnitor has not only promised to indemnify the surety but also has assumed the principal obligation, or where the principal cannot be compelled to reimburse the surety because of incapacity or otherwise, the indemnitor is the one primarily liable and his promise is not within the Statute of Frauds.

Illustrations:

1. I promises S, in consideration of S's complying with D's request to guarantee an obligation of D to C, to indemnify S for any loss on his guaranty. Since D is the one who should pay, or in the event of non-payment should reimburse S, I's promise is to answer for D's default and hence is within the Statute of Frauds.

2. D promises to indemnify S if he will guarantee D's obligation to C. D's promise is not within the Statute of Frauds.

3. D promises to indemnify S if he will sign an accommodation note to C for D's benefit. D's promise is not within the Statute of Frauds.

4. I promises D to assume his liability to S, and also promises S to indemnify him against loss sustained by S's surety obligation to C. I is now the principal obligor and his promise is not within the Statute of Frauds.

5. I promises to indemnify S against loss due to his liability upon a surety contract with C guaranteeing performance by D, an infant. Since D has no primary liability, I's promise is not within the Statute of Frauds.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 97

§ 97 Promise That the Obligor of an Assigned Right Will Perform

A promise by the assignor of a right that the obligor of the assigned right will perform his duty is not within the Statute of Frauds.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is supported both because the promise is a term of the assignment, that is of a sale of a chose in action, and because the contract is entered into for a consideration which is wholly for the benefit of the assignor. (See § 31, Comment *g*, of this Restatement and § 189 of the Restatement of Contracts.)

b. The fact that the promise of the assignor of a right is not within the Statute of Frauds does not mean that no suretyship relation is created. Rules of suretyship are applicable both in respect of the relations between the assignor and principal and the assignor and assignee. The application of the rules of suretyship, however, will be subject to the rules pertaining to negotiable instruments if the assigned right is represented by a negotiable instrument.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts Law Statutes of Frauds General Overview



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Restat 1st of Security, § 98

§ 98 Factor's Guaranty of His Customer's Account

A guaranty by a factor to his principal that a purchaser of the principal's goods through the agency of the factor will pay the price of them is not within the Statute of Frauds.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section is in substance § 189 (2) of the Restatement of Contracts.

b. The factor's promise to his principal that a customer will pay for goods sold on account of the principal is a promise to answer for the debt of another but an important inducement for the promise is the desire of the factor to advance his own interest. (See § 88, Comment *b.*) The recognition of the rule stated in this Section, which avoids a strict application of the general rule of the Statute of Frauds, see § 89, and can be interpreted as an exception to it, is based on the nature of the factor's business and his relation to his principal. His assumption of the obligation of a del credere factor, that is of one who guarantees to his principal the buyer's accounts, is not likely to be an isolated transaction, but rather a part of a course of business for which evidence other than the oral promise is usually available.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law Sales of Goods Form, Formation & Readjustment Statutes of Frauds General Overview Contracts
Law Statutes of Frauds General Overview



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Restat 1st of Security, § 99

§ 99 Promise to Buy a Right From the Obligee

A promise to purchase a right which the promisee has or may acquire against a third person is not within the Statute of Frauds.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section is substantially § 190 of the Restatement of Contracts and the Comment and Illustrations to that Section are applicable.

b. Where there is a promise to buy a right conditional upon a debtor's default and the amount to be paid is the same as if the debtor's obligation had been guaranteed, the consequences of a contract to purchase a right and a contract of a surety are the same. The distinction between a contract to buy a right and a contract of a surety does not lie in the formal difference in words used but in the reality of the transaction. The test is whether, considering all the circumstances, the promisor is acquiring a right or protecting a creditor against a default.

Illustrations:

1. D owes C \$ 1000 on open account. S, who specializes in the purchase of slow accounts, orally promises to buy C's right against D for \$ 800 if assignment is made within three months. At the end of three months, C tenders S an assignment of the account. S's promise is enforceable.

2. D corporation owes C \$ 1000 which is due. S orally promises C that if C will grant D an extension of 60 days, S will purchase the debt at that time if it is not then paid. The circumstances indicate that S is really guaranteeing the account, and the promise is unenforceable.

Legal Topics:

For related research and practice materials, see the following legal topics:
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Restat 1st of Security, § 100

§ 100 Promise to Discharge a Duty Due by the Promisee to a Third Person

A promise to discharge a duty owed by the promisee to a third person is not within the Statute of Frauds.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. This Section is substantially § 191 of the Restatement of Contracts and the Comment and Illustrations are applicable.

The promise described in this Section in most jurisdictions gives the creditor as beneficiary a direct right against the promisor without destroying his right against the original debtor. The promise is not within the Statute of Frauds, however, because the Statute is designed to require written evidence only in the case where the promise is made to the creditor.

The promise with which this Section is concerned is also not within the literal words of the Statute, since the promise is not to answer for the default of another, that is of a third person, but of the promisee himself.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Procedures Contracts Law Statutes of Frauds General Overview



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Restat 1st of Security, § 101

§ 101 Effect of Principal's or Cosurety's Failure to Sign Instrument with Surety

(1) Where the surety signs an instrument by which his obligation is in terms conditional upon another's signing the same instrument as principal or as cosurety, the surety is not bound unless the other signs the instrument.

(2) Where an instrument signed by a surety shows that another is also expected to sign it as principal or cosurety, but the surety's obligation is not in terms conditional upon such signature, the surety is bound on the instrument in the absence of signature by the principal or cosurety, if the principal or cosurety is or becomes otherwise bound to the duty stipulated in the instrument.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The surety, if he wishes, can make his obligation conditional upon the principal's or a cosurety's being bound with him on the same instrument. On the other hand, the substantial consideration to the surety is generally that the principal or cosurety is bound to the same duty. A reference to the principal in the instrument, or blanks indicating that the principal or cosurety was expected to sign do not make such a signature a condition. Even if the instrument contains an incidental agreement of indemnity by the principal this does not excuse the surety, if the principal is otherwise bound to the duties that would have been assumed by him had he signed the instrument.

Illustrations:

1. S signs and delivers a surety bond in favor of C guaranteeing performance by D, a contractor. The bond is written in terms of an obligation on S conditioned on performance by D of certain duties, which are enumerated in great detail. It contains blanks for D's signature. D does not sign the instrument but signs a copy. S is bound as surety.

2. Same facts as Illustration 1, except that D signs a separate instrument which is not a copy, but which imposes upon him the same duties as those stipulated in the contract signed by S. S is bound as a surety.

3. S signs and delivers a surety bond in favor of C guaranteeing performance by D. The instrument indicates that D was expected to sign it with S. It contains stipulations regarding D's duty to exonerate and reimburse S. The duties thus assumed by D are, however, merely those which would be enforced against D in the absence of agreement. D

signs a separate instrument embodying all of the terms of the instrument signed by S except those relating to exoneration and reimbursement. S is bound on the instrument signed by him.

4. Same facts as Illustration 3, except that the instrument signed by S imposes upon D duties in respect to exoneration and reimbursement beyond those which would be enforced against D in the absence of agreement. The instrument signed by D contains none of the special agreements. S is not bound.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementJoint & Several InstrumentsContracts LawNegotiable InstrumentsNegotiationIndorsementQualified Indorsements



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Restat 1st of Security, § 102

§ 102 Effect on Surety's Obligation of Absence of Intended Cosurety's Participation in Obligation

(1) Where the contract of a surety is subject to a condition that another assume a stipulated obligation as cosurety, the surety is not liable if the cosurety assumes an obligation which differs from the one stipulated.

(2) Where the principal is under a duty to the creditor or otherwise to obtain more than one surety or to obtain sureties having certain qualifications, the failure to fulfill this duty does not prevent a surety's becoming bound on an obligation not conditional upon the principal's fulfilling such duty.

COMMENTS & ILLUSTRATIONS: *Comment to Subsection (1):*

a. The surety may agree to assume an obligation only if other sureties are bound to the same obligation, or if other sureties are obtained for a stipulated part of the obligation, or that one or more sureties having certain qualifications be obtained; or may impose other conditions to his liability. If his liability is thus made conditional, he cannot be held if the conditions are unfulfilled.

Comment to Subsection (2):

b. If the surety does not impose any conditions upon his own liability, he will not be excused because the principal has not obtained the sureties demanded by the creditor, stipulated by another surety, or required by law. For example, the principal may have agreed with the creditor to obtain a surety having a certain financial worth. He obtains one having a lesser worth. The latter is bound. The same result obtains where a public official is required by law to obtain two sureties and he obtains only one of them. Unless the surety makes the principal's compliance with his duty a condition of his surety obligations, he will be held even if no other surety is obtained.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawTypes of ContractsGuaranty Contracts



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Restat 1st of Security, § 103

§ 103 Principal's Duty to Surety: in General

Where suretyship exists, it is the duty of the principal to the surety to satisfy the surety's obligation by performing his own duty to the creditor, in the absence of a defense between himself and the surety, or of a defense between himself and the creditor, which is also available to the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The general rule stated in this Section is included to emphasize that where suretyship exists the principal has a duty to the surety as well as to the creditor. This duty of the principal to the surety is often set out completely by specific terms in a contract between them, or a contract may be implied in fact from the circumstances. Where no contract exists between surety and principal, or where such a contract does not cover the entire duty of the principal, the surety may have a remedy in quasi-contract or may be entitled to equitable relief. Further details in respect of the relations of surety and principal are treated in subsequent Sections of this Chapter. The surety, in addition to his direct rights against the principal, may also be subrogated to the rights of the creditor. (See § 141, Chapter 5.)



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Restat 1st of Security, § 104

§ 104 Reimbursement by Principal: in General

(1) Where the surety makes a payment or otherwise performs on default by the principal, or where the surety's property is used to satisfy the principal's duty, it is the duty of the principal to reimburse the surety to the extent of his reasonable outlay if

- (a) the surety's obligation has been incurred, or his property has been subjected to a charge, with the consent of the principal, or**
- (b) the principal has assumed an obligation which was once the primary obligation of the surety.**

(2) Where a surety who has undertaken his obligation without the consent of the principal makes a payment or otherwise performs on account of the principal, it is the duty of the principal to reimburse the surety to the extent that the principal has been unjustly enriched.

Special Note: The terms "indemnity" and "reimbursement" are frequently used as synonymous in describing the duty owed to a person, who has discharged a duty which is owed by him but which as between himself and another should have been discharged by the other. See Restatement of Restitution, § 76. In the Restatement of this Subject, only the term "reimbursement" is used in the discussion of such a duty. (See § 82, Comment 1.)

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The principal is not in default until the time for his own performance is due. If the principal, for example, is liable for a debt, he has no duty to reimburse the surety prior to the maturity of the principal obligation. Where the surety pays before the date when the principal should perform, he must postpone any action for reimbursement until the maturity of the principal's obligation or other duty.

b. The principal and surety frequently contract specifically regarding their respective rights and duties. Where this is done the contract is controlling.

c. The surety in most cases satisfies his obligation by the payment of money. In other cases he may transfer property to the creditor, or the creditor may reduce to a money equivalent property of the surety in which he has a

security interest or upon which he has a lien as the result of a judgment. The principal's duty to reimburse the surety arises whenever the surety's payment or the transfer of his property to the creditor has the effect of discharging or reducing the duty of the principal.

d. Reasonable outlay. The surety's reasonable outlay includes the amount he must pay on account of the principal's default on the principal obligation, with interest, and any other charges imposed upon the surety by the principal's default. If the surety reasonably defends against a suit by the creditor, by asserting defenses of the principal after giving the principal an opportunity to defend, the surety is entitled to be reimbursed for the expenses of suit. If the surety can satisfy his own obligation and obtain a discharge of the principal's duty by paying less than the amount nominally due by the principal, his reasonable outlay is limited to that amount. For a more particular application of the rule as to reasonable outlay, see § 105. Cf. § 11. (See *Restatement of Restitution*, § 80, Comment *g*.)

Illustrations:

1. S guarantees the performance by P of a building contract with C. S has the privilege of performing in the event of P's default. P defaults and S exercises his privilege of completing the building. The completion of the work results in an outlay by S of \$ 15,000. P is able to prove that S, by purchasing materials from a favored seller in excess of the market price, has made unnecessary expenditures of \$ 3000. S is entitled to be reimbursed only for \$ 12,000.

2. S is surety for P on a building contract with State C. By state law payments to the state may be made in state bonds, which will be accepted at their face value. P defaults and the state completes the work at a cost of \$ 15,000, which S is required to pay. At that time the state bonds are selling in the open market at a discount which would enable S to buy \$ 15,000 face value of bonds for \$ 12,000 and this fact is known to S. S nevertheless pays the state \$ 15,000. S is entitled to be reimbursed only for \$ 12,000.

e. Cross reference. See as to the surety's right to be subrogated to the rights of the creditor, § 141.

Comment on Subsection (1), Clause (a):

f. The surety's right of reimbursement is equitable in origin. Where the surety has become such at the request or with the consent of the principal even without a specific agreement for reimbursement, the surety can obtain reimbursement on the theory of a contract between principal and surety implied from the circumstances. In such a case the surety has an action at law on the contract. Irrespective of the proof of a contract implied in fact from the circumstances the surety may have an action for the payment of money by way of restitution. In either case the surety under the common law forms can bring an action in general assumpsit, or in a jurisdiction where the common law forms have been eliminated, an action which has taken the place of general assumpsit. See *Restatement of Restitution*, Introductory Note and § 5. The legal remedy is the customary one for the enforcement of the right of reimbursement.

It is important to notice that while the surety can have reimbursement wherever he fulfills a duty of his own that is also a duty of the principal, the amount of the surety's recovery may be greater where he has become a surety with the principal's consent than where the surety has assumed his obligation otherwise. In the former case, for example, the surety can recover necessary expenses in connection with the settlement of the claim. See Comment *h* and *Restatement of Restitution*, § 76, Comment *b*.

Comment on Subsection (1), Clause (b):

g. Where one person without a novation assumes an obligation of another, at least as between the two of them the former becomes the principal and the latter the surety. Examples already mentioned include the grantee of land who assumes a mortgage and partners who assume the obligations of retiring partners. In such a case the surety seeking reimbursement generally sues for breach of a specific contract. Whether or not the contract to assume imposes a duty to reimburse the former obligor who has become secondarily liable, such a duty exists and is properly called a duty of reimbursement.

Comment on Subsection (2):

h. The principal is enriched whenever his duty is satisfied as the result of a payment by another. He is not unjustly enriched if the payment is made by a volunteer, that is, one who makes the payment otherwise than in discharge of his own duty. A surety who contracts with a creditor without the consent of the principal is not a volunteer. The creditor is entitled to obtain the additional security afforded by a surety. The payment by the surety in satisfaction of his own obligation, which has the effect of discharging the principal, is an unjust enrichment of the principal. He must, therefore, reimburse the surety to the extent of the enrichment. See *Restatement of Restitution*, §§ 76 and 80, and Introductory Note, Title C. The chief difference in result between the rules stated in Subsection (1) and Subsection (2) is that under the former, the surety can obtain reimbursement for his reasonable outlay, while under the second his reimbursement is limited by the amount of the principal's enrichment.

Illustrations:

3. S becomes surety to C at P's request upon P's bond for \$ 5000. At the maturity of the bond P refuses to pay, honestly believing he has a defense. C thereupon sues S, who defends the suit unsuccessfully after giving P an opportunity to defend. S then pays the amount of C's judgment. S is entitled to reimbursement for the amount of the payment and the expense of defending the suit.

4. Same facts as Illustration 1, except that S becomes surety without P's knowledge. S can obtain reimbursement from P only for the amount due on the bond.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsDischarge & PaymentDischarge of Secondary Obligors



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Restat 1st of Security, § 105

§ 105 Reimbursement After Compromise Settlement

Where a surety makes a settlement with a creditor by which the creditor accepts less than his entire claim with a binding agreement to discharge the duty of the principal, the principal's duty to reimburse the surety is limited to the amount of the settlement in addition to any expenses in connection with the settlement which are properly chargeable to the principal.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section assumes that the duty to reimburse will exist after payment by the surety, and deals only with the extent of reimbursement. It should be noted, also, that the rule deals only with the situation where the principal's duty is discharged. The effect of part payment upon the right of reimbursement is treated in § 106. See as to reasonable outlay of surety, § 104, Comment *d*, and as to the surety's duty to account for profits, § 111.

Illustration:

1. P owes C \$ 1000 for which S is surety. After P's default S arranges with C a settlement by which C accepts \$ 800 in satisfaction of P's obligation. S can recover \$ 800 but not \$ 1000 from P.



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Restat 1st of Security, § 106

§ 106 Reimbursement; Part Payment by Surety

Where the surety makes a part payment to a creditor on account of a default by the principal, the latter is under an immediate duty to reimburse the surety to the extent of the payment.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Although the principal's duty to reimburse the surety arises when the surety makes the payment, the surety may not compete with the creditor in asserting such claim if the principal's assets are being administered in bankruptcy. (See § 141, Comment *d.*)



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Restat 1st of Security, § 107

§ 107 Negotiable Instrument Taken in Satisfaction; Principal's Duty of Reimbursement

Where a creditor accepts from the surety in discharge of the principal's matured duty a negotiable instrument on which the surety is liable for an amount equal to or less than the amount due from the principal, the principal is under an immediate duty to reimburse the surety to the amount of the instrument.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is explained by the statement that negotiable instruments are treated as money in the ordinary transactions of business. Where the satisfaction of the surety's obligation to the creditor is also a satisfaction of the obligation of the principal for which the surety is bound, the principal is not prejudiced by imposing upon him the duty of reimbursement. If the creditor does not take the note in satisfaction, the principal is not under a duty of reimbursement until the note is paid in whole or in part.

Where the creditor accepts a non-negotiable instrument in satisfaction, the principal is under no duty to reimburse the surety except to the extent that the surety pays the obligation. This is regarded merely as a release of the principal by the creditor at the surety's request without essentially changing the situation of the surety. The relations of the surety and the principal are consequently unaffected by the transaction.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law
Negotiable Instruments
Discharge & Payment
Payment Time for Payment
Contracts Law
Negotiable Instruments
Enforcement
Duties & Liabilities of Parties
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Contracts Law
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Restat 1st of Security, § 108

§ 108 Reimbursement as Affected by Defenses of Surety and Principal

(1) The principal is not relieved of his duty to reimburse a person who has become a surety with the consent of the principal where the surety

- (a) pays an obligation for which the principal is liable, even if the surety has a defense; or**
- (b) pays an obligation upon which the principal has a defense which is available to the surety without knowing of the defense; or**
- (c) knowing of a defense on behalf of the principal, which is available to the surety, pays a judgment obtained on a surety obligation after giving the principal notice of the action and an opportunity to defend it; or**
- (d) performs under business compulsion, irrespective of defenses of both surety and principal.**

(2) Where the principal has not consented to the surety's obligation the principal has no duty to reimburse the surety to the extent that the principal has a defense.

(3) Where the principal is not bound on the principal obligation because of want of capacity the principal has no duty to reimburse the surety.

(4) Where the principal has received a discharge in bankruptcy in respect of a claim of a creditor for which a surety is bound, the discharge in bankruptcy is a bar to the enforcement by the surety of a right of reimbursement.

(5) Where the principal has a defense which is known to and available to a surety who has become a surety with the consent of the principal, and the surety does not assert it, or asserts it in an action without giving the principal notice of the action and an opportunity to defend it, or where the surety as well as the principal has a defense, the principal has no duty to reimburse the surety unless business compulsion requires performance by the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See Restatement of Restitution, §§ 76 and 78.

Comment on Subsection (1), Clause (a):

b. Numerous circumstances may make the surety's obligation unenforceable. For example, he may have a defense arising out of the suretyship relation, such as alteration of the contract of the principal or extension of time to the principal (see §§ 126, 127), his obligation may be oral (see § 89); he may have been discharged in bankruptcy; or action on his obligation may be barred by the Statute of Limitations. Nevertheless, so long as the principal obligation exists, the principal cannot require the surety to plead the surety's defense. It is immaterial whether the surety pays to maintain his good will, because of a mistake as to the existence of his defense, or for any other reason.

Illustrations:

1. S is surety to C on an obligation of P. S, before accepting the obligation discusses the matter with C, who conceals material facts, which while not affecting P's obligation, afford S a defense against C. S nevertheless pays C at maturity. P is liable to reimburse S.

2. S is surety to C on an obligation of P. After maturity P makes a part payment. When the Statute of Limitations has run against S's obligation but not against P's, S pays C. S can have reimbursement from P.

3. S is surety to C on an obligation of P. S is discharged in bankruptcy. C receives no dividend. After his discharge S pays C the amount for which he was originally bound. S can have reimbursement from P.

Comment on Subsection (1), Clauses (b), (c) and (d):

c. Where the surety has assumed his obligation with the consent of the principal he is entitled to assume the existence and continuance of the principal's obligation unless he has notice of the contrary. If the principal has a defense he has the burden of notifying the surety. The surety, however, must not disregard knowledge of the defense obtained otherwise than by notice from the principal. The negative implication of this Clause is stated in Subsection (5).

d. These Clauses refer only to defenses of the principal available to the surety. Where the principal has a claim against the creditor by way of setoff (see § 119), which is not available to the surety, the general rule requiring reimbursement by the principal applies. Knowledge by the surety of such a defense is immaterial.

e. Where the surety knows of a defense claimed by the principal he pays the creditor at his peril unless judgment is obtained against him. He must, however, give the principal notice of the action by the creditor, unless the principal otherwise knows of it, and an opportunity to defend. If the creditor obtains judgment, the surety may pay it and obtain reimbursement from the principal. The judgment, if after notification to the principal, is conclusive of the facts as between surety and principal. Clause (c) implies the negative rule which is stated more particularly in Subsection (5). See as to business compulsion Clause d and Comment j.

f. Vouching. Giving notice to the principal by the surety of the pendency of an action on the obligation so as to make the determination of the judgment conclusive against the principal in respect of the right of reimbursement, is analogous to the common law procedure of vouching a warrantor, where one having possession of land or a chattel is sued by a third person claiming to be entitled to possession. Vouching, however, had the effect of replacing one defendant by another.

g. Impleader. The surety in some jurisdictions by statute or decision has the privilege of impleading the principal in an action by the creditor. The impleader makes the principal a party to the action. In such a case if final judgment is rendered in favor of the creditor, the judgment is conclusive in determining the surety's rights against the principal so far as the defenses of the principal against the creditor are concerned.

Comment to Subsection (2):

h. Since the principal's duty to reimburse is limited to his enrichment as a result of the surety's payment in a situation where the principal is not responsible for the surety's obligation, the principal is not liable where he has a defense. In such a case he is not enriched.

In accordance with the general rules of law, however, the principal may be estopped to set up his defense against the surety if he induces the surety to assume the obligation is valid.

Illustrations:

4. S becomes surety to C on an obligation of P as a result of ccontract between C and S, without P's consent. P has a defense of fraud which is unknown to S. S pays C. S is not entitled to reimbursement.

5. Same facts as Illustration 4, but S asks P if he has a defense and P replies in the negative. S can have reimbursement because P is estopped.

6. S becomes surety to C on an obligation of P. P does not consent to S's assuming the obligation. P has a set-off against C. This defense is not available to S. S pays C. S is not entitled to reimbursement to the extent of the set-off.

Illustration to Subsection (3):7. S becomes surety to C for P, an infant. S pays C. S cannot obtain reimbursement from P.

Comment on Subsection (4):

i. By the Bankruptcy Act of the United States, § 57 (i), as in effect January 1, 1941, the surety can file a proof of claim for the principal's obligation to the creditor in the event that such claim is not filed by the creditor. This provision of the Bankruptcy Act, as interpreted in the light of the purposes of the Act and in the absence of any provision relating to a separate proof of claim by the surety, is construed to prevent the surety's filing a claim in his own behalf where he has not paid the claim of the creditor prior to the petition in bankruptcy. Since under the Bankruptcy Act there is in this situation but one claim against the debtor, the surety's claim is regarded as being merged in that of the creditor and the discharge has the effect of barring the surety.

Comment on Subsection (5):

j. Where both surety and principal have defenses it would be contrary to the equitable basis of the rule of reimbursement if the surety by paying the creditor could compel the principal to reimburse him. The surety in such a case is in the position of a volunteer. Where, however, the surety is under business compulsion to perform he has a right to reimbursement irrespective of the principal's defenses and even if the creditor cannot enforce his claim against either principal or surety. It should be observed that generally the surety is under no business compulsion to perform where the principal has a substantial defense. The *Restatement of Restitution*, § 78, Comment *f*, discusses this point as follows:

"f. Payment under business compulsion. A person who becomes a secondary obligor with the consent or because of the fault of the primary obligor is entitled to restitution for a payment which business reasons practically required him to perform, although neither he nor the primary obligor was under a legal duty to make payment. Thus a person who, at the request of another, has orally ccontracted with a third person, and who would be excluded from his business organization or otherwise would suffer a business loss if he failed to perform the promise, is entitled to obtain indemnity from the other for a payment to a third person which he could have avoided on the ground that his promise was oral (see Illustrations 10 and 11). Normally, a payment made with knowledge that the Statute of Limitations has run would not be under sufficient coercion to entitle the payor to restitution."

Illustrations to Subsection (5):8. S is surety at P's request on a contract of P with C. S knows that C cannot enforce the contract because of failure of consideration, and S is under no business compulsion to make the payment. Nevertheless S pays C at maturity. S cannot obtain reimbursement from P.

9. Same facts as Illustration 8, except that S is sued by C and asserts the defense of failure of consideration but gives no notice to P of the action. Judgment is obtained by C, which is paid by S. S cannot obtain reimbursement.

10. S is surety to C for P. P has a defense which is not available to S but C's claim against S is unenforceable because of the Statute of Limitations. S cannot have reimbursement against P unless his payment is required by business compulsion.

11. S, a member of a trade association, guarantees in writing to C the accounts of P, a fellow member. It is provided by the rules of the association that failure of a member to carry out his business promises is a cause for expulsion irrespective of technical defenses such as the Statute of Frauds and the Statute of Limitations. Certain accounts upon which P is liable cannot be collected because P refuses to pay them and they are within the Statute of Frauds provisions of the law of sales. The Statute of Limitations has run in favor of S before C requests S to pay. If S pays he is entitled to reimbursement from P.

12. Same facts as Illustration 11, except that the Statute of Limitations is not involved, but S's guaranty is not in writing. If S pays, P must reimburse him.

Legal Topics:

For related research and practice materials, see the following legal topics:

Bankruptcy Law Case Administration Notice Civil Procedure Remedies Bonds Sureties Procedures



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Restat 1st of Security, § 109

§ 109 Reimbursement -- Statute of Limitations on Contribution or Indemnity

Where one of several sureties makes contribution to, or indemnifies, another surety who has paid the creditor, at a time when the right to contribution or indemnity is not barred by the statute of limitations, his right to reimbursement from the principal is not barred until the running of the statutory period from the date of such contribution or indemnity.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The right to reimbursement arises wherever a surety makes a payment which satisfies to that extent a performance due from the principal to the creditor or to another surety. This is true whether the right of the surety arises by contract or because of unjust enrichment of the principal. (See §§ 104 and 106.) The time when the right of the surety begins is the time that the Statute of Limitations begins to run against that right.

The surety who has performed may lose his right to reimbursement from the principal or his right to contribution from another surety by the operation of the Statute of Limitations. If another surety contributes to or indemnifies the first surety after the right of the latter against the former is barred by limitations, the payment is a voluntary one and does not give any right of reimbursement against the principal. If the second surety's payment is made when there is still an enforceable right against him for contribution or indemnity, he has a right of reimbursement from the principal from that time. Thus the second surety's right of reimbursement may not be barred for a considerable period after the Statute of Limitations in respect to reimbursement has run against the first surety.

Illustrations:

1.1> is not entitled to recover from P.

Legal Topics:

For related research and practice materials, see the following legal topics:
GovernmentsLegislationStatutes of LimitationsTime Limitations



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Restat 1st of Security, § 110

§ 110 Surety's Right of Reimbursement After Discharge of Principal Obligation

Where the principal's obligation has been discharged by payment or by release from the creditor not reserving his rights against the surety, the principal has no duty to reimburse the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The discussion under § 108 relating to defenses assumes an obligation which has not been extinguished by a discharge, even if a defense exists which renders a principal's promise unenforceable. Where the principal has performed or where he has received a release which does not reserve the creditor's rights against the surety, the obligation is extinguished (see § 111). Since in a suretyship relation the principal is the one who should pay, the surety pays at his peril unless he first ascertains whether the obligation has been discharged. The burden is on the principal to make certain that the surety has notice of defenses other than discharge. The burden is on the surety to ascertain whether a discharge has occurred. A practical reason for relieving the principal from his burden is that normally the creditor will make no effort to collect from the surety after the principal's obligation is discharged.

Where the surety pays the creditor without knowing of the principal's discharge the surety can recover from the creditor on the ground of unjust enrichment. See *Restatement of Restitution*, §§ 8, 18 and 23 (1) (a).

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil Procedure Remedies Bonds Sureties Procedures



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Restat 1st of Security, § 111

§ 111 Performance by Surety Other Than Money Payment; Right to Reimbursement and Duty to Account

Where the principal is under a duty to do an act other than the payment of money and the surety has the privilege to perform the act himself in the event of the principal's default, if the doing of the act

(a) involves a loss to the surety, the principal is under a duty to reimburse him, or

(b) results in a profit to the surety, the surety is under a duty to account to the principal for the profit.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is a particular application of the general rule stated in § 104. In connection with certain contracts, particularly involving building contractors, the surety often reserves the privilege of performing the principal's duty in the event of the principal's default. If the surety has limited his liability to a stipulated sum, that is the limit of his reasonable outlay and consequently of his right to reimbursement, unless he reasonably incurs costs and expenses in defending an action by the creditor in which case he is also entitled to reimbursement for these items. See 104, Comment *d*.

Comment on Clause (b):

b. The surety's obligation is security for the performance of the principal's duty. The surety is entitled to no profit which has not been allowed to him by contract with the principal. In most cases involving the surety's privilege of completing the contract the surety is compensated by the payment of a premium for the assuming of his obligation. If the surety suffers a loss he is entitled to reimbursement. If he makes a profit, that is, if what he receives for completing the contract exceeds his necessary outlay, this profit must be turned over to the principal.

Illustration:

1. S is surety on a building contract of P with C. S has the privilege in the event of P's default of completing the building. It is stipulated that S is entitled to all construction apparatus and materials on the premises, and to all payments due from C. S completes the building at a cost to him of \$ 90,000. He receives \$ 105,000 from C on

completion of the building. S must pay P \$ 15,000. He must also return to P the construction apparatus and any unused materials.



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Restat 1st of Security, § 112

§ 112 Exoneration

Where the surety is under an obligation to the creditor which has matured and which he has undertaken with the consent of the principal, and the surety, if he performed would be entitled to reimbursement from the principal, the surety has the right to exoneration.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The principal owes the surety a duty to perform as soon as the performance is due. It is inequitable for the surety to be compelled to suffer the inconvenience and temporary loss which a payment by him will entail if the principal can satisfy the obligation. The surety is entitled to equitable relief without alleging any particular reason for fearing that he will not be reimbursed in the event of payment. The right to such equitable relief is called the right of exoneration.

b. It is beyond the scope of the Restatement of this Subject to state in detail the procedure which will be followed in respect of exoneration. It is understood that the court must be able to grant an effective decree and that the decree will properly protect the interests of principal and creditor as well as those of the surety. Among the courses open to the court are to direct a payment by the principal to the creditor, to require that the sum due be paid into court for the creditor, or that the principal give the surety adequate security for his ultimate reimbursement.

c. An action in equity by the surety to compel exoneration by the principal does not prevent the creditor from suing the surety or principal on their obligations, unless the procedure followed by the surety brings in the creditor as a party to the action. In such a case a possible procedure is to permit the creditor to sue the principal at law for the purpose of establishing his rights.

d. Where the principal has the defense of want of capacity, which would not only be a defense against the creditor but also against the surety, or where he has a defense against the creditor which is available to the surety, the principal cannot be compelled to exonerate the surety.

e. One condition of the right of exoneration is that the surety must be under a present obligation to the creditor. If

the surety is under no enforceable obligation, even if he will be entitled to reimbursement in the event of performance (see § 108 (1) (a)), he cannot allege a sufficient basis for equitable relief since he is under no present danger of loss.

Illustration:

1. S becomes a surety to C for P at P's request. Because of a part payment by P after maturity, at the end of five years S's obligation but not P's is unenforceable because of the Statute of Limitations. S is not entitled to exoneration although if he pays he has a right to be reimbursed by P.

f. The right to exoneration depends upon the existence of a present duty from the principal to the surety. Where the surety has become such with the consent of the principal, this duty exists from the time when the surety undertakes his obligation. When the principal has not so consented, the duty exists only when the principal has been unjustly enriched by the surety. Since no enrichment occurs until payment, there is no duty from the principal to the surety upon which to found a duty of exoneration. After payment or other performance, the duty of the principal is for reimbursement, not exoneration.



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Restat 1st of Security, § 113

§ 113 Fraudulent Conveyance by Principal; When Surety Can Set Aside

Where the principal makes a fraudulent conveyance and the surety if the principal's obligation were due, would have a right of exoneration against the principal the surety can have the fraudulent conveyance set aside.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Where a fraudulent conveyance has been made by a debtor, a creditor, after obtaining judgment, can have a levy made on the property fraudulently conveyed, treating the conveyance as void, or, after failing to satisfy the judgment out of other property, the creditor can seek the aid of equity by a creditor's bill to set aside the fraudulent conveyance. A surety, whose payment of the principal obligation entitles him to reimbursement, has a right of action at law against the principal, but the basis of this right is equitable. Because of this equitable origin of his right, the surety who has paid can have equitable relief in setting aside a fraudulent conveyance without obtaining judgment. The surety, who has paid, is himself a creditor, but in respect of fraudulent conveyance he is in a position to act somewhat more expeditiously against a fraudulent transfer than other creditors.

Prior to payment, but after maturity, the surety has a right of exoneration (see § 112). The right to set aside a fraudulent conveyance is a logical incident to the right to equitable relief by way of exoneration. The surety, even before payment, and even before maturity, is a contingent creditor. The surety's right to set aside the fraudulent conveyance need not interfere with the creditor's efforts to the same end.

b. Uniform Fraudulent Conveyance Act. In jurisdictions which have adopted the Uniform Fraudulent Conveyance Act, a creditor can set aside a fraudulent conveyance without first obtaining a judgment. A contingent creditor has the same right. The surety is a contingent creditor, whose rights and privileges are established by the suretyship relation. Since the Uniform Act speaks in general terms which cover the situation of the surety, the Act confirms the rule stated in this Section.



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Restat 1st of Security, § 114

§ 114 Changes in Relation of Parties -- Undisclosed Suretyship -- Effect on Creditor

Where a person whom the creditor reasonably believes to be a principal is in fact a surety, or where a principal becomes a surety, the creditor is affected by the incidents of suretyship from the time he has knowledge of it.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section not only requires the creditor to recognize a suretyship relation to which he has not consented but its negative inference is a general qualification of rules applicable to the relations of surety and creditor.

The rule on its positive side applies to such cases as where a new obligor has assumed the duty of a principal, or where there are several principals at the outset and less than all of them as among themselves assume the entire duty. The rule does not deprive the creditor of his rights against the original principal. No person who is bound to a creditor can by any act of his own rid himself of his duty to the creditor. The creditor is not required first to have recourse against the one who is in fact the principal but can require performance from the surety as soon as performance is due. (See § 130.) On the other hand, where several persons are bound to a creditor, the creditor is not free to conduct himself in respect of one in such a way as to prejudice the mutual relations of his several obligors. Where suretyship exists, there is no serious interference with the rights of a creditor if he is required to take account of the relationship in subsequent dealings with the parties. Where the creditor deals with two persons as principals although one is from the first, or later becomes, a surety, or where a single principal becomes a surety by the substitution of a new party as principal as in the case of a mortgagor of land who transfers the land to one who assumes the mortgage debt, the creditor is not bound by the incidents of suretyship until he has knowledge that the supposed principal is or has become a surety. (See § 83.) After the creditor knows of the relation of those bound to him, he must take account of the relationship in his dealings with them. One of the important consequences of the rule stated in this Section is that the creditor cannot grant an extension of time to the principal without releasing the surety, even if the latter has contracted as principal, unless the surety has consented to the extension. (See § 129.)

b. The word "knowledge" rather than notice is used in this Section to show that the creditor is not bound by the surety relation unless he in fact knows about it. A person has notice if he knows, has reason to know, or has been given

notification. See § 10, Comment *c*, and Restatement of Agency, § 9. Under recording and filing statutes certain persons are affected with notice from a public record irrespective of their actual knowledge. The mere fact that a transfer of land by a mortgagor to an assuming grantee has been recorded, does not subject the mortgagee to the incidents of the surety relation thus created between mortgagor and transferee.

c. The negative inference of the rule of this Section is that the creditor is not bound by the incidents of suretyship unless he knows of it. The surety has the advantage of a number of equitable rules in his favor which do not operate in favor of the principal (§ 116). An extension of time to a principal by a creditor may discharge a surety but not another principal (§ 129). So long as the creditor is entitled to regard a person as a principal, the latter will not be allowed to claim as against the creditor the benefit of rules for the protection of sureties.

d. Some states by statute require a creditor in certain circumstances and at the formal demand of the surety to proceed first against the principal. The application of such statutes to sureties not known to be such at the beginning of the transaction with the creditor, or to sureties who have originally contracted as principals, is a matter to be determined by an interpretation of the particular statutes.

e. Where the transaction between a principal and another amounts to a fraudulent conveyance, the fact that the transferee assumes the principal obligation does not limit the remedies of the creditor in respect of property fraudulently transferred. Such a situation might arise where one corporation transfers its assets to another which assumes its liabilities. If the transfer is fraudulent, even if one admits that the second corporation has become the principal and the first a surety, the creditor still has recourse against the property under the rules pertaining to fraudulent conveyances.

f. The rule stated in this Section does not apply where the creditor does not know that the surety is bound in any capacity. Such a situation may arise where an obligation secured by a surety's contract which is available to an assignee is assigned without notice to the assignee of the surety's obligation. In such a case the usual rules of suretyship apply. If the assignee deals with the principal in such a way as to entitle the surety to a defense, the surety can assert this defense if the assignee subsequently discovers his obligation and seeks to enforce it. For example, if the principal's duty is modified in a material particular by the assignee, the surety is discharged. See § 128.



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Restat 1st of Security, § 115

§ 115 Performance of Principal's Duty: When Obligation of Surety Revives

(1) Where the duty of the principal to the creditor is discharged by performance by the principal or by another on his behalf, the obligation of the surety is also discharged.

(2) Where the surety is discharged in consequence of performance by or on behalf of the principal, and the creditor under a legal duty surrenders as a preference or otherwise what he has received from or on behalf of the principal, the obligation of the surety is revived.

Special Note: The Bankruptcy Act, § 60 (b), as in force from 1910 to 1938, allowed a trustee in bankruptcy to avoid a preference if the person receiving it or to be benefited thereby had reasonable cause to believe that a preference would be effected when he received property from the bankrupt. By the prevailing interpretation of § 60 (b), the following rules were established:

1. The transfer by the bankrupt of property directly to the surety in order to indemnify him, was voidable by the trustee if the elements of a preference as defined in § 60 (a) were present and if the surety had reasonable cause to believe that such a transfer would effect a preference; and the property or its value could be recovered from the surety.

2. Payments made to the creditor, but inuring to the benefit of the surety by relieving him of an obligation which he would otherwise have to pay, were recoverable from the surety if the surety had reasonable cause to believe that a preference would be effected by the payment.

This was true irrespective of whether the creditor was an innocent recipient of the payment or himself had also reasonable cause to believe that a preference would result.

3. The "reasonable cause to believe" that a preference would be effected by the payment could have been either on the part of the one actually receiving or on the part of the one to be benefited thereby, but the trustee had to prove "reasonable cause" on the part of him from whom recovery was sought. If the creditor was an innocent recipient of the preference, the trustee's only remedy was against the surety. If there was no "reasonable cause to believe" on the part of either surety or creditor, the trustee was without remedy, i. e., there was no voidable preference. If the creditor and

surety both had "reasonable cause to believe," the trustee could recover against either or both.

The Bankruptcy Act, § 60 (b), in force since September 22, 1938, reads in part as follows:

"Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value. . . ."

In the place of "person receiving it or to be benefited thereby," has been substituted "creditor receiving it or to be benefited thereby" as the one on whose part the "reasonable cause to believe" must exist. Whether, a surety is to be regarded as a creditor, so that so far as recovery of a preference from a surety is concerned, the former rules under § 60 (b) are still in effect, or whether the new statute is intended to allow recovery only from the creditor where the creditor has received the preference, must await authoritative judicial interpretation of § 60 (b).

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Discharge. The statement that the surety is discharged when used in this and other sections means that an obligation of the surety which once existed has been extinguished. (See Restatement of Contracts, § 385.) A discharge results from performance only if the performance is exactly in accord with the duty of the one performing.

b. The rules determining when the principal duty has been performed are not within the scope of the Restatement of this Subject. See Restatement of Contracts, §§ 386-394. The duty of the principal must be fully satisfied. If the principal only partially performs or merely purports to perform, the surety's obligation continues, although the amount which the creditor can recover from the surety is reduced by what he has received from the principal.

Illustrations:

1. P owes C \$ 1000 for which S is surety. At maturity P pays C \$ 1000 and interest. S is discharged.
2. Same facts as Illustration 1, except that C is paid by T, who intends thus to make a gift to P. S is discharged.
3. P contracts to build a house for C according to certain specifications. P builds a house superficially corresponding to the plans. C tentatively accepts it but discovers with reasonable promptness that P has not built it according to contract. S is not discharged.
4. P contracts to sell Blackacre to C. P delivers a deed of Blackacre to C. P in fact has no title to Blackacre. P has not performed. S is not discharged.

c. Modification of contract. Where the principal and creditor modify their contract, the surety is discharged under the rule stated in § 128. Thus if the creditor agrees to accept a new duty of the principal in lieu of the one the surety has guaranteed, the surety is discharged. The surety, however, is not discharged when the creditor is merely making a reasonable effort to obtain payment out of such assets as the principal may have. If the principal's obligation is to pay money, the creditor may accept other property as money value. The creditor may realize on security in his hands, on assets obtained by execution following a judgment, or on property transferred to him by the principal. If the creditor knows of the principal's defective title to property and accepts the property in discharge of the principal's duty, the surety is discharged. If the creditor accepts such property at a stated valuation, he is bound by his agreement. If the creditor accepts property with the understanding that he is to sell it and apply it on the debt, the surety is discharged to the extent of the amount realized. On the other hand, the creditor may accept property from the debtor with the condition, express or implied from the circumstances, that the discharge of the debtor and consequently of the surety depends upon the extent to which he can satisfy the principal's duty out of the property. If the creditor's arrangements

with the principal amount to a binding extension of time, the surety has a defense under the rule stated in § 122.

It is to the interest of the surety that the creditor be allowed to take reasonable steps to satisfy his claim against the principal without discharging the surety. Any other rule would mean that whenever the principal owed a money obligation and was unable to make an immediate cash payment, the creditor to avoid discharging the surety, would proceed immediately against the latter.

Illustrations:

5. D owes C \$ 4000 for which S is surety. On default by D, C agrees with D that if D will build him a cottage in a satisfactory manner, he will discharge C from his obligation. S is discharged because this is a modification of D's contract with C.

6. D owes C \$ 1000 for which S is surety. At maturity D cannot pay money but is willing to turn over to C certain property, which C accepts at its fair value. S is discharged only to the extent of the value of the property.

7. Same facts as Illustration 6, except that after receiving the property, C is compelled to surrender it to T, the actual owner. S is not discharged.

8. D owes C \$ 1000 for which S is surety. D is unable to pay, but C agrees to accept a quitclaim deed to a village lot in satisfaction of this claim. C is ultimately compelled to surrender the lot to T. Both D and S are discharged since C has obtained what he bargained for, even if the deed has proved to be worthless.

d. The negative inference in Subsection 1 is that the surety is not discharged if the principal has not performed. What constitutes performance is a matter to be determined by the law of contracts. (See Restatement of Contracts, §§ 386-394.) If the principal has not performed and if the principal and creditor have not modified the duty guaranteed by the surety, the surety remains liable. If what the principal has done is regarded in the jurisdiction as performance but if the creditor subsequently comes under a legal duty to surrender what he has received, the surety's obligation, although discharged by the performance, will revive in accordance with the rule stated in Subsection (2).

Comment on Subsection (2):

e. As has been indicated in Comments *c* and *d*, the surety's discharge depends upon performance by the principal. In the usual circumstances, the performance or non-performance by the principal is readily determined. In other cases the principal may apparently perform, but the performance may be rendered valueless because of the claims of a third person. If what has been done by the principal is not regarded as performance because of the defective title received by the creditor, the negative inference of Subsection (1) is applicable. If what has been done is regarded as performance but the performance is later set aside, the rule stated in Subsection (2) applies and the surety's obligation is revived. For example, the creditor may receive in satisfaction of the principal's duty real estate which the creditor supposes is owned by the principal subject to no claims by third persons though in fact the principal is a trustee. If in the jurisdiction where the transaction occurs, an antecedent debt is not value, the beneficiaries under the trust can set aside the conveyance. The beneficiaries may have other remedies so that their action in respect of the conveyance may be uncertain. If in the jurisdiction the principal is not regarded as having performed, the surety is not discharged though the creditor cannot recover from him until he is under a legal duty to surrender the land. If in the jurisdiction the principal is regarded as having performed although the performance may be avoided, the surety is discharged, but his obligation may be revived if the creditor is compelled to surrender the land. It should be noted that while the creditor may attempt to obtain payment of a money obligation by taking property of the principal either as payment or security, the creditor will discharge the surety if a new contract is substituted for an old one.

A situation which is usually regarded as a discharge of the surety, occurs where the creditor receives a preference from an insolvent debtor, which the creditor is later compelled to surrender in a bankruptcy or other insolvency proceeding. The creditor's acceptance of payment from an insolvent is a reasonable attempt to collect the obligation. If

the payment is later nullified by operation of law, this is a possibility the surety might have contemplated in assuming his obligation. If a creditor were not permitted to accept payment from an insolvent debtor, it would be advisable for a creditor to refuse payment from the principal and to enforce his claim against the surety in all cases where the creditor had reason to believe the debtor to be insolvent. To avoid subsequent controversy creditors might be inclined to proceed against sureties in most cases of default by the principal because the debtor's unwillingness to pay where no defense is asserted is generally an indication of financial embarrassment. Insolvent debtors do not always become bankrupt, and even if bankruptcy subsequently occurs it does not always occur during the four months after the preference, in which period only the preference is voidable. A rule to the effect that the surety's obligation is irrevocably discharged where a creditor has received a voidable preference would, on the whole, have the effect of increasing rather than decreasing the burden on sureties.

Illustration:

9. S is bound as surety to C on an obligation of P to pay C \$ 1000. At the maturity of P's obligation, P pays C \$ 1000. C knows at the time of the payment that P is insolvent. A petition in bankruptcy against P is filed three months after the payment. The trustee in bankruptcy compels C to surrender the amount paid. S's obligation to C is revived.

f. Where the creditor returns what he has received in discharge of the principal's duty though he is under no duty to do so, the surety is not liable to the creditor.

Illustration:

10. S is surety to C on an obligation of P to pay C \$ 1000. P, when insolvent, pays C \$ 1000, but C is not aware that P is insolvent. Subsequently P becomes bankrupt, and C pays \$ 1000 to the trustee in bankruptcy. S is not liable to C.

Legal Topics:

For related research and practice materials, see the following legal topics:

Bankruptcy Law Case Administration Examiners, Officers & Trustees Preferential Transfers Elements Debtor
Insolvency Bankruptcy Law Case Administration Examiners, Officers & Trustees Preferential Transfers Guarantors Civil
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Restat 1st of Security, § 116

§ 116 Tender of Performance by Principal or Surety

Tender of performance by either principal or surety discharges the surety unless at the time of the tender the creditor reasonably believes that the surety is a principal.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Tender. Tender means a valid and sufficient offer of performance. To be valid and sufficient it must be to the proper person at the proper time. If the tender is accepted, it ceases to be tender and becomes performance. In such a case both principal and surety are discharged. If it is not accepted, the surety is discharged and there are often important consequences upon the liability of the principal. Problems of tender in general are outside the scope of the Restatement of Suretyship. They arise chiefly in connection with money obligations, but are possible when performance other than the payment of money is due from the principal. (See §§ 37 and 78, and Restatement of Contracts, § 323.)

b. Undisclosed surety. Where the creditor is entitled to regard the surety as principal, it would be inequitable to give the tender any greater effect than it would have on the duty of such a principal. Even where the creditor has understood that he was obtaining the obligation of two principals, after knowledge of the suretyship, he must adjust his dealings with the parties with due regard to the equitable rules for the protection of sureties, or accept the consequences. (See § 114.)

Illustrations:

1. S and P jointly and severally contract to pay C \$ 1000. S in fact is a surety for P although this fact is unknown to C. At maturity of the debt, P tenders C \$ 1000, which because of a mistake by C, is refused. Neither S nor P is discharged.

2. Same facts as Illustration 1, except that after the contract is made and before P's tender, S notifies C that he is a surety. S is discharged.

c. Tender by principal. The reasonable interpretation of the surety's undertaking is that he is bound to protect the creditor against the inability or unwillingness of the principal to perform and not against the creditor's own imprudence.

Since the creditor at the time of tender by the principal can obtain payment which will discharge the surety, it is inequitable for him to hold the surety if the principal subsequently does not perform. The delay in the satisfaction of the obligation increases the risk of the surety.

d. Tender by surety. Where a tender is made by a principal, he is not discharged, although the amount of the creditor's subsequent recovery of interest and costs will be affected by refusal of a tender. Discharge of the principal's duty is regarded as too great a penalty upon the creditor for his mistake. Where a surety makes a tender, his discharge as a result of a refusal of his tender by the creditor, still leaves the creditor with the duty of the principal. If the rule as to the surety were otherwise, the refusal of the tender would affect the surety's remedies against the principal by postponing an action for reimbursement against the principal, and his subrogation to the rights of the creditor and to any security held by the creditor.

The surety's obligation is a form of security. Like other kinds of security, the creditor's interest in it is terminated by a tender. (See §§ 37 and 78, respectively, as to the termination of a pledge and of a lien by tender.)



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Restat 1st of Security, § 117

§ 117 Impossibility or Illegality of Performance by Principal

Where the principal has a defense of impossibility or illegality, this defense is available to the surety against the creditor unless the surety has otherwise contracted with the creditor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Impossibility. Impossibility is treated at length in Restatement of Contracts (§§ 454-469, Chapter 14). Impossibility means not only strict impossibility, but impracticality because of extreme and unreasonable difficulty, expense, injury, or loss involved. Impossibility in fact that is not due to the nature of the performance but wholly to the inability of the individual promisor, neither prevents the formation of a contract nor discharges a duty created by a contract. The difference is between "the thing cannot be done" and "I cannot do it." (Restatement of Contracts, § 455, Comment *a.*)

b. Illegality. Illegality is treated at length in the Restatement of Contracts, §§ 512-609 (Chapter 18). A bargain is illegal if either its formation or its performance is criminal, tortious, or otherwise opposed to public policy. (Restatement of Contracts, § 512.) In general there is no remedy on an illegal bargain. (*Ibid.*, § 398.)

c. The usual obligation of a surety is to perform if the principal does not. Positive evidence must be found of the undertaking by the surety of a greater liability. In determining the extent of the risk undertaken by the surety it is assumed that the risk of the surety implies an enforceable duty, except for lack of capacity (§ 125) unless the specific terms of the surety's undertaking, or the terms interpreted in light of the circumstances indicate that the surety has assumed a greater risk.

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

Where the indemnity promise of the surety relates only to the impossibility of performance by the principal, the surety is always bound, unless he has an independent defense of impossibility not relating to the defense of the principal. Where the surety has assumed a money obligation and has agreed to be bound irrespective of the duty of the principal, there are likely no circumstances which would give the surety the defense of impossibility.

If the surety's promise is itself illegal, it cannot be enforced against him, not because of any merit in the surety's position but because it is against public policy to give effect to the surety's promise. Where the principal's promise is itself illegal in its inception, and the performance of the surety's contract is subject to the laws of the same jurisdiction as that of the principal, it is against public policy to give legal effect to the surety's obligation. Where, however, the principal's promise is legal where made, and there is no illegality in the surety's promise, the surety's obligation may be enforced unless it has itself become illegal of performance.

e. Conflict of laws. See as to the performance of contracts other than in the place of making, Restatement of the Conflict of Laws, §§ 355-360.

f. Partial impossibility or partial illegality. Where a contract is divisible and only a part is impossible of performance, the promisor must perform that part unless such partial performance will impose a materially greater burden on the promisor. (See Restatement of Contracts, § 463.) If there is partial illegality, which is not an essential part of the bargain, and in a unilateral contract legally executed consideration can be apportioned to a corresponding promise which is legal, or in a bilateral contract corresponding legal promises exist, a contract may be enforced in part against a promisor. (See Restatement of Contracts, §§ 606 and 607.) Where the principal under these rules has a defense only going to part of his duty, the surety's defense is limited to the part of his obligation which covers the impossible or illegal parts of the principal's duty.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawTypes of ContractsGuaranty Contracts



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Restat 1st of Security, § 118

§ 118 Fraud or Duress on Principal

(1) Subject to the rule stated in Subsection (2), where the principal has been induced to assume an obligation by the fraud or duress of the creditor, the surety is not liable to the creditor.

(2) Where the surety has undertaken his obligation with knowledge of fraud or duress by the creditor, the fraud or duress on the principal is not an available defense to the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Fraud. The term "fraud" is used in the Restatement of this Subject as defined in the Restatement of Contracts, § 471, meaning misrepresentations, concealment, or non-disclosure by one expecting to induce another to enter into a transaction.

b. Duress and fraud. Duress and fraud are treated together in this Section because in general they entitle the injured parties to the same powers of avoidance and to the same defenses. (See Restatement of Contracts, § 499.)

Comment on Subsection (1):

c. Rationale. The essential feature of suretyship is that the surety's obligation is conditioned upon the non-performance of a principal. The creditor is in no position to insist upon the surety's performance where the creditor has created the situation which has given the principal a defense and has thus made the latter's performance less likely than in the normal suretyship relation. Such conduct by the creditor is in effect a fraud on the surety as well as on the principal. To permit the creditor to enforce his right against the surety, after defrauding the principal, would also be unfair to the principal in all cases where the principal wished to assert the defense. The surety could not fairly be required to perform his own obligation without allowing him a right of reimbursement against the principal. The principal would thus be deprived of his defense, except to the extent that he could use it as the basis of affirmative action against the creditor.

The theory of this Subsection is that the surety has a defense because of the unfair risk imposed upon him by the creditor. The surety's defense, therefore, does not depend upon rescission by the principal. Even if the principal is

willing to waive the fraud, and thus remove the added element of risk introduced by the fraud, the surety's defense is not lost. The creditor's conduct does not give him any standing to insist that the surety excuse the wrong which once existed.

Illustrations:

1. C induces P by fraudulent misrepresentations to buy a plot of land for which he is to pay \$ 4000. S is surety and has no knowledge of the fraud. P rescinds the contract. If C sues S, S can set up the fraud as a defense.

2. Same facts as Illustration 1, except that P does not rescind the contract. S has a defense against C.

3. Same facts as Illustration 2, except that P agrees with C to waive the fraud. S still has a defense against C.

d. The question of the surety's liability where the creditor is guilty of fraud on the principal may arise in several situations. These situations may first be considered on the assumption that when the surety undertakes his obligation he has no knowledge of the fraud. An attempt may be made by the creditor to enforce his right against the surety at a time when the principal has (a) rescinded or otherwise indicated his intention to avail himself of his defense; (b) taken no action of any sort in respect of the fraud; (c) indicated by affirmative action that he is willing to perform notwithstanding the fraud. The rule stated in the Section gives the surety a defense in all such cases. A still different situation arises where the surety knows of the fraud at the time he undertakes his obligation. See Comment e.

Comment on Subsection (2):

e. Where the surety contracts with knowledge of the fraud, he cannot complain that his risk has been unfairly increased by the creditor. The creditor can enforce the surety's obligation in such a case unless the obligation is itself illegal. The surety, however, cannot have reimbursement against the principal unless the principal has affirmed his promise or otherwise deprived himself of the defense. (See § 108 (5)). Where the principal has taken such action as to continue his liability, the usual incidents of suretyship as between principal and surety apply. Where the principal has not taken such action, the surety's position is that of an indemnitor.

Illustrations:

4. P, induced by the fraud of C, undertakes a duty. S is surety. He is familiar with the transaction and is aware of the fraud at the time he undertakes his obligation. Subsequently P affirms his promise and states that he does not intend to avail himself of his defense. S is liable to C upon P's default.

5. Same facts as Illustration 4, except that the principal does not affirm. S is liable to C but cannot have reimbursement against P.

f. See as to the effect of fraud on the surety by the principal, § 119.



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Restat 1st of Security, § 119

§ 119 Fraud or Duress on Surety by Principal

Where the surety by fraud or duress of the principal has been induced to become bound to the creditor, the fraud or duress is not a defense against the creditor, if, without knowledge of the fraud, he has extended credit to the principal on the security of the surety's promise or, relying on the promise, has changed his position in respect of the principal.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Fraud or duress by a third person in the inducement of a contract makes the contract voidable only if the defrauded party can show that the other party knowingly accepted the advantages of the fraud or has taken no action to his detriment relying on the defrauded party's promise. See Restatement of Contracts, § 477. The rule stated in this Section is an instance of the application of a rule of contracts to an important situation in suretyship.

Illustration:

1. P induced S to sign an instrument guaranteeing an extension of credit by C to P. S had an opportunity to read the instrument but did not do so and relied upon P's representation that it was a letter of recommendation. P exhibited the instrument to C, who extended the credit without knowledge of P's fraud. S is liable to C.



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Restat 1st of Security, § 120

§ 120 Tolling of Statute or Limitations as to Principal or Surety -- Effect on Obligation of Other to Creditor

Partial payments or new promises made to the creditor by either surety or principal do not toll the running of the statute in favor of the other against the creditor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The principal and the surety each has his own obligation to the creditor. When the time for performance by each has arrived, the Statute of Limitations begins to run in his favor. Acts by either party which extend the period as to him do not of themselves have that effect as to the other. It is of course possible that one of the parties may make a new promise or a payment both for himself and as agent of the other or even solely as the agent of the other.

Illustrations:

1. P owes C a debt of \$ 1000 due January 1, 1933, upon which S is surety. The period of limitation is six years. P defaults but on January 1, 1935, makes a new promise to pay the debt. On January 2, 1941, C sues S for \$ 1000. C's action is barred by the Statute of Limitations, although had he sued P, he would have been entitled to judgment.

2. Same facts as Illustration 1, except that instead of a new promise on January 1, 1935, P makes a payment of \$ 200. C's action against S is barred by the Statute of Limitations, even if in the jurisdiction the part payment extends the statutory period as to P to January 1, 1941.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Pleading & Practice Defenses, Demurrers & Objections Affirmative Defenses Tolling Payment



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§ 121 Statute of Limitations -- Effect on Surety's Liability of Principal's Concealment of Default

Where the principal's concealment of his default prevents the running of the Statute of Limitations until the discovery of the default, the statute does not begin to run in favor of the surety until the creditor may reasonably be expected to discover the default.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The purpose of the Statute of Limitations is to discourage fraud by preventing the assertion of claims after such lapse of time that it is difficult if not impossible to ascertain the truth. It is not the purpose of the statute to deprive a party of rights because of fraud. Where the principal makes a pretended performance or in a case where his fidelity has been guaranteed conceals a default, it is easy to conclude that he cannot take advantage of his wrong to obtain the benefit of the Statute of Limitations. Where the surety has participated in the fraud, the same result follows as to the running of the period of limitations as to him. Where, however, the surety is innocent, a choice must be made between two innocent persons, the creditor and the surety. The choice is made in favor of the creditor so long as he cannot reasonably be expected to discover the principal's default, because unless limited by the surety's contract, the surety's obligation is co-extensive with that of the principal. So long as the original duty of the principal continues, the liability of the surety persists. The purpose of the Statute of Limitations is to require prompt enforcement of rights. Although the surety's performance is usually due when the principal defaults, if the default is concealed from the creditor, so far as the latter's knowledge is concerned he has no enforceable right against the surety. The actual extension of the principal's duty is not due to any act of the creditor nor to any act of the principal with which the creditor knowingly concurs. It may be observed, too, that in many cases the relations of principal and surety are such that the surety is in a better position than the creditor to know the facts regarding the principal's performance of his duty.

Where the principal's concealment of a default is such that he cannot take advantage of the Statute of Limitations until the discovery of the default, but where the creditor should reasonably have discovered the default at a time before the actual discovery, the Statute of Limitations will run in favor of the innocent surety from the time when the default should reasonably have been discovered. The contracts of sureties frequently put upon the creditor the burden of discovering the default of a principal as a condition of enforcing the liability of the surety. The Statutes of Limitations, themselves, often contain provisions covering the effect of fraudulent concealment.

Illustrations:

1. P owes C a debt of \$ 1000 upon which S is surety. The statutory period of limitation on such debts is six years. At maturity P makes a purported performance in which no value is in fact given and for several years conceals his fraud from C under such circumstances as to prevent the statute running in his favor and where C could not reasonably have discovered the fraud. More than six years after maturity but less than six years after C could reasonably have been expected to discover the fraud, C, having discovered the fraud, sues S. C is entitled to recover.

2. S guarantees P's fidelity as a fiscal employee of C for a period of a year. The statutory period of action on such contracts is six years. P is guilty of a default during the year but successfully conceals that fact from C for six years, under circumstances that continue his liability to C and where C could not reasonably have been expected to discover the fraud. More than six years after the default, C sues S. C is entitled to recover.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Pleading & Practice Defenses, Demurrers & Objections Affirmative Defenses Tolling Discovery
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Restat 1st of Security, § 122

§ 122 Release of Principal

Where the creditor releases a principal, the surety is discharged, unless
(a) the surety consents to remain liable notwithstanding the release, or
(b) the creditor in the release reserves his rights against the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The words "a principal" rather than "the principal" are used to indicate that not only where there is one principal, but also where there are more than one, and the principal or one or more of several principals is released, the surety is discharged.

b. Rationale. Where the surety and principal are bound jointly, the release of one is the release of both unless the rights of the obligee are reserved against the other. See Restatement of Contracts, §§ 121, 122. Where the surety and principal are not bound jointly, but the obligation of the surety is to answer for the duty of the principal, the termination of the principal's duty is also a termination of the surety's obligation. If the principal has no longer a duty as a result of the creditor's act, the surety should not be held to an obligation to answer for a default of that duty. Furthermore, if the surety could be compelled to pay after the principal's release, he would be entitled to reimbursement if he had become a surety at the principal's request or with his consent. Such an outcome would be unfair to the principal after a release because it would afford the creditor a means of attacking the principal indirectly through the surety.

Illustrations:

1. S at P's request becomes surety to C on an obligation of P to C. Both S and P are bound jointly on the same instrument. C releases P. S is not liable to C.

2. Same facts as Illustration 1, except that S and P are not bound jointly. S is not liable to C.

c. Secured surety. Where the surety has received security from or for the benefit of the principal, the creditor has an interest in this security (see § 140). Since the creditor is entitled to an interest in such security, the release of the principal by the creditor, where the surety is secured by the principal, is presumably an indication that the creditor

intends to rely upon this security. The release of the principal has the effect therefore of releasing the surety from his personal obligation, subject to his duty to account to the creditor for the security.

Illustration:

3. S is surety for P on a debt to C. P gives a mortgage to indemnify him against possible loss on his obligation. C releases P. S is discharged from his personal obligation, but must make the mortgage available to the creditor.

Comment on Clause (b):

d. Reservation of rights by creditor. Where the creditor releases the principal but reserves his rights against the surety, this is construed as a covenant not to sue the principal. Historically, the covenant not to sue did not prevent a suit in violation of the covenant, although a liability might be incurred by such a suit. The creditor, by a release with reservation of rights against the surety, was in effect notifying the principal that, in spite of the release, the surety might pay as the result of compulsion or voluntarily and that the principal would then be liable to reimburse the surety. Since the release was regarded as only a covenant not to sue, even the surety's right of subrogation was technically preserved. The reservation of rights showed that the creditor had no intention to release the surety. The principal had no cause for complaint since, having accepted his release with the reservation, he necessarily accepted the consequence that the liability might still be enforced against him through action by the surety.

There are probably instances where the rule stated in this Section has the advantage of encouraging compositions.

Illustration:

4. S at P's request becomes surety for P on an obligation of P to C. P proposes a composition to creditors, which is accepted by the creditors, including C. C under the composition releases P but reserves his rights against S. S remains liable to C, and if he pays, S has a right of reimbursement against P.

e. Cross reference. See § 114 as to effect of a release of a principal upon the obligation of an undisclosed surety.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil Procedure Remedies Bonds Sureties Procedures



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§ 123 Release Obtained by Fraud or Duress of Principal

Where, induced by fraud or duress on the part of the principal, the creditor releases the principal but seasonably rescinds the release, the surety's obligation is discharged only to the extent that he has been prejudiced.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See as to revival of surety's obligation after discharge by the principal's performance, § 115.

b. Rationale. The rule stated in this Section is in accordance with a general principle relating to the voidability of fraudulent transactions and the position of those who deal in good faith for value with the property in connection with which fraud has occurred. A contract cannot be avoided for fraud against one who is an innocent purchaser for value or who has innocently changed his position before the power is exercised. A release obtained by fraud or duress is voidable by the creditor. Where it is avoided, the original liabilities of the parties remain except to the extent that a party can show he is prejudiced. Where a release to a principal is avoided because of fraud or duress on the part of the principal, the surety's obligation continues, except to the extent that because of the release the principal's ability to pay has been reduced, or that the surety relying on the release has changed his position so that he will suffer loss because of the release. Since the creditor rather than the surety is responsible for the release, the creditor must suffer whatever loss the surety can show is due to the release.

Illustrations:

1. S is surety for P on a debt of P to C. P obtains a release by fraud and C subsequently rescinds the release before S learns of the fraud and before P's ability to pay has been affected. S is liable to C.

2. S is surety to C for P on a matured debt of \$ 1000. P by fraud obtains a release from C. Before C discovers the fraud, P has become wholly insolvent although he was solvent at the time of the release. S is discharged.

c. Instances of prejudice to surety. Prejudice to the surety may occur where the surety induced by the release, surrenders security to the principal; where the principal's financial responsibility has been reduced following the release;

where the surety, relying on the release, has otherwise been put into a disadvantageous position in relation to the principal; or where the surety fails to take action otherwise available to him. Where the parties can be restored to their original positions, it is not inequitable to hold the surety to his obligation so long as the creditor seasonably rescinds. Where the creditor waits unreasonably long to rescind, while it is not inequitable to hold the surety to his obligation when the parties can be restored within a reasonable time to their original positions, it is unfair to the surety to be kept in uncertainty indefinitely.

Illustrations:

3. S is surety C for P on a debt of \$ 1000. P by fraud obtains a release from C. S learns of the release, and assuming he is also released, returns to P certain security in his hands. C rescinds the release but is unable to obtain the return of the security surrendered by S. S's liability is reduced by the value of the security.

4. S is surety for P on a debt of \$ 1000 to C. C has other security worth \$ 800. P obtains a release by fraud and a return of the security. C rescinds the release and P delivers the security, but in a depreciated condition so that its value is now only \$ 500. S's liability is reduced by \$ 300.

5. S is surety to C for P on a debt of \$ 1000 represented by a promissory note. P by fraud induces C to surrender the note and destroys it. C shortly discovers the fraud but takes no steps against P. Several years later C attempts to enforce his claim against S. C cannot recover from S because of his failure to rescind the transaction with P.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Procedures



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Restat 1st of Security, § 124

§ 124 Non-Disclosure By Creditor

(1) Where before the surety has undertaken his obligation the creditor knows facts unknown to the surety that materially increase the risk beyond that which the creditor has reason to believe the surety intends to assume, and the creditor also has reason to believe that these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety, failure of the creditor to notify the surety of such facts is a defense to the surety.

(2) Where, during the existence of the suretyship relation, the creditor discovers facts unknown to the surety which would give the surety the privilege of terminating his obligation to the creditor as to liability for subsequent defaults, and the creditor has reason to believe these facts are unknown to the surety and has a reasonable opportunity to communicate them to the surety without a violation of a confidential duty, the creditor has a duty to notify the surety, and breach of this duty is a defense to the surety except in respect of his liability for defaults which have occurred before such disclosure should have been made.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Non-disclosure of material facts in the circumstances of the rule stated in this Section constitutes fraud on the surety. The rule is merely a special application in suretyship of the rule of Contracts that fraud creates a defense. See Restatement of Contracts, §§ 475 and 476.

b. Although in applying the rule stated in this Section to particular situations there is often considerable difficulty in ascertaining the precise degree of knowledge of surety and creditor and even in determining the materiality of the facts alleged to be concealed, the rule itself is simple. It does not place any burden on the creditor to investigate for the surety's benefit. It does not require the creditor to take any unusual steps to assure himself that the surety is acquainted with facts which he may assume are known to both of them. Among facts that are material are the financial condition of the principal, secret agreements between the parties, or the relations of third parties to the principal. If the surety requests information, the creditor must disclose it. Where he realizes that the surety is acting or is about to act in reliance upon a mistaken belief about the principal in respect of a matter material to the surety's risk, he should afford the surety the benefit of his information if he has an opportunity to do so.

Every surety by the nature of his obligation undertakes risks which are the inevitable concomitants of the transactions involved. Circumstances of the transactions vary the risks which will be regarded as normal and contemplated by the surety. While no surety takes the risk of material concealment, what will be deemed material concealment in respect of one surety may not be regarded so in respect of another. A creditor may have a lesser burden of bringing facts to the notice of a compensated surety who is known to make careful investigations before taking any obligation than to a casual surety who relies more completely upon the appearances of a transaction. The rule stated in this Section applies an objective test of the materiality of the facts not disclosed rather than the intent of the creditor in failing to make the disclosure.

Illustrations:

1. P requests S to act as surety to C in connection with proposed purchases of merchandise. S asks C whether his earlier dealings with P have been satisfactory. C answers in the affirmative although he has had constant difficulties with P in respect of dilatory payments, unfair rejections, and the like. S, who knows little about P, accepts C's statement and becomes a surety. P subsequently defaults. C's non-disclosure and misrepresentations are a defense to S in any action against him by C.

2. P is the cashier of C to whom S is bound as surety for P's fidelity. Before S undertook his obligation, P had embezzled a sum of money from C, but C had excused this embezzlement. P subsequently embezzles other sums. S cannot be held on the fidelity bond.

Comment on Subsection (1):

c. The rule stated in Subsection (1) applies not only to cases where the surety has made an offer for a single obligation but also to offers to guarantee successive extensions of credit. The fact that the surety is already bound on one obligation does not excuse the creditor from disclosing material facts before the second obligation is incurred.

3. S is surety to C for P on a continuing guaranty which S may revoke at any time by notice to C. After C has made several extensions of credit to P he learns that P is insolvent. S does not know this and C is aware of S's ignorance. C, without disclosing the fact of C's insolvency, makes further advances to P. S's liability is limited to P's defaults in advances occurring before C could have notified S of P's insolvency.

d. *Disclosure breach of legal duty by creditor.* Where the creditor cannot without a breach of a confidential duty disclose facts about the principal which have a material bearing on the surety's risk, the creditor is not entitled to accept the obligation of the surety. The mere fact that the creditor should not disclose information should not enable him to take advantage of the information to the detriment of the surety.

Comment on Subsection (2):

e. Where the surety has offered to become bound on successive extensions of credit, each extension of credit creates a new obligation. This situation is covered by Subsection (1). Subsection (2) is meant to cover any situation where the surety has the power upon the happening of certain events to terminate his liability as to future defaults. Such a power may arise because of an express reservation, as is generally true in fidelity bonds, or may be implied from the type of surety contract. The creditor's non-disclosure must affect a fact which, if known to the surety, would entitle the surety to terminate his liability as to future defaults. Subsection (2) has its chief application in respect of fidelity bonds. The facts which the creditor must make a reasonable effort to disclose include dishonesty and other criminal conduct of an employee which affect the risk the surety has undertaken. Mere inefficiency of the employee or irregularities of conduct within or without the scope of employment need not be disclosed unless they affect the surety's risk or have been made the subject of specific reservations. There is no general rule of suretyship that the creditor must keep the surety informed of natural facts affecting the surety's risk when they do not give the surety the power to terminate his liability. If the surety wishes the creditor to accept any such duty, he must make it a part of his contract with the

creditor. Where the creditor has properly accepted the obligation of a surety but subsequently discovers material facts which he cannot disclose without a violation of a confidential relation, non-disclosure is not a defense to the surety.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties General Overview



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Division 2 - Suretyship

Chapter 5 - Surety and Creditor

Restat 1st of Security, § 125

§ 125 Effect of Principal's Lack of Capacity on Surety's Liability

(1) The principal's lack of capacity is not a defense available to the surety against the creditor.

(2) Where a principal disaffirms a promise because of lack of capacity and returns the consideration, the creditor can hold the surety to his obligation

- (a) subject to the creditor's duty to deliver the consideration to the surety upon the latter's performance, or**
- (b) reduced by the value of the consideration when returned to the creditor.**

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Rationale. Where a person is said to lack capacity to make a contract, this may mean that his contracts are void, as was true of married women, or voidable, as is true of infants, or it may mean that certain persons cannot enforce certain contracts, as is sometimes true in respect of the ultra vires undertakings of corporations. Whatever the degree of lack of capacity, it is regarded as personal to the one without the capacity and is not available to a surety. Where the surety knows of the lack of capacity of the principal at the time he becomes a surety, he may be presumed to have contracted in respect of that fact. Even where he does not know, he will be held to his obligation so far as the principal's lack of capacity is concerned, unless the creditor by failing to disclose his knowledge of this fact has given the surety a defense based not on lack of capacity of the principal but on non-disclosure of material facts. (See § 124.) Where neither the surety nor the creditor knows of the principal's lack of capacity at the time the surety's obligation is undertaken, the result is that, since both parties are innocent, the surety has no equitable defense on his obligation. He is merely held to the obligation he has undertaken.

Illustrations:

1. P, an infant, asks S, who knows his age, to become surety to C. S agrees and C, who supposes P is an adult, makes a loan to P. P is unable to pay and disaffirms the contract. S is liable to C.
2. Same facts as Illustration 1, except that S does not know P is an infant. S is liable to C.

3. S has become a surety for P on a loan from C. S does not know P is an infant, and C does know this but does not have reason to believe that S does not know. S is liable to C.

4. S, P, and C discuss a proposed loan by C to P on which S is to become surety. C knows that P is an infant and that S supposes P is an adult. C keeps this knowledge to himself, and S becomes surety. C cannot recover from S.

Comment on Subsection (2):

b. Where the principal is an infant, he can disaffirm his promise and return the consideration. While between the principal and creditor there is no enforceable duty, the duty of the surety continues. The creditor may either accept the consideration for his own account or as the security for the surety's obligation. If he accepts the consideration for his own account and its value is equal to that which he would have obtained had the principal fulfilled his promise, the surety is discharged. If the consideration has depreciated in value, the surety's obligation is reduced pro tanto. The creditor, however, may hold the consideration for the account of the surety. If the surety performs, he is subrogated to the creditor's interest in the security.

Illustrations:

5. P, an infant, receives a conveyance of land from C and promises to pay \$ 5000 for it. S guarantees payment by P. P disaffirms his promise and conveys the land back to C. C accepts the conveyance for his own account. The land is valued at \$ 5000. S is discharged.

6. P, an infant, buys a motor car for \$ 750. S guarantees payment by P. P uses the motor car for six months, reducing its value to \$ 400, then repudiates his contract and returns the motor car to C. C is willing to keep the car. S is liable to C for \$ 350.

7. Same facts as Illustration 6, except that C accepts the car only as security for S's obligation. S is liable to pay C \$ 750 but upon payment is entitled to receive the car from C.

Legal Topics:

For related research and practice materials, see the following legal topics:
Criminal Law & Procedure Defenses Insanity Insanity Defense



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Restat 1st of Security, § 126

§ 126 Failure of Consideration Between Creditor and Principal

Where there is a promise for an agreed exchange between creditor and principal and there is a material failure of performance by the creditor not justified by the conduct of the principal, the surety is not liable to the creditor unless the principal has elected to treat the failure only as a partial breach.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The rule stated in this Section is another application of the general principle that since the surety's obligation is based upon the existence of a duty of principal and creditor, the creditor cannot recover from the surety when the creditor's conduct gives the principal a defense or creates a situation which increases the risk of the principal's non-performance. A different rule would decrease the value of the principal's own defense because if the surety were liable to the creditor, he would necessarily be allowed reimbursement from the principal, at least in cases where he had become surety with the consent of the principal. The principal's only remaining recourse would be affirmative action against the creditor.

Illustrations:

1. P contracts to buy and C to sell a small country estate on which there are several elm trees of great age, which are the estate's most distinctive feature. S is surety on P's contract. Before the time for performance, C cuts down the elm trees. In the jurisdiction this is regarded as a material breach. P refuses to accept a conveyance or pay for the land. S is discharged.

2. P, with S as surety, contracts to employ C at a salary of \$ 8000 as director of demonstrations at P's exhibit at the New York World's Fair from May 1 to November 1, 1939. When the Fair opens C is ill but subsequently conducts demonstrations for a short term and again becomes ill. Competent physicians inform P that it is unlikely that C can work regularly for several months. P notifies C that the contract is terminated and employs a new demonstrator. S is discharged.

b. Failure of consideration. The Restatement of Contracts, § 274, states that in promises for an agreed exchange a

material failure of performance by one party not justified by the conduct of the other discharges the latter's duty to give the agreed exchange even though his promise is not in terms conditional. An immaterial failure does not operate as such a discharge. The reason for such a rule is failure of consideration. Consideration, as used in the phrase, failure of consideration, means merely an exchange in fact agreed upon. Failure of consideration is failure to receive such an exchange. The rules for determining the materiality of a failure to perform are stated in the Restatement of Contracts, § 275.

c. Divisible contracts. A contract is divisible when by its terms performance of each party is divided into two or more parts, the number of parts due from each party is the same and the performance of each part by one party is the agreed exchange for a corresponding part by the other party. It is a question of interpretation whether a contract is divisible. When a surety has guaranteed the performance by a principal of all parts of a divisible contract, a failure of consideration caused by the creditor as to one part, which affords the principal a defense only as to that part, will likewise discharge the obligation of the surety only as to that part. See Restatement of Contracts, § 266 (3), and Comment *e* and Illustrations.

Illustration:

3. C promises to sell and P promises to buy C's stock in trade and the good will of C's business. P promises to pay for C's stock at its inventory cost, and also promises that he will pay C a share of the profits of the business for five years and that at the end of that time C will have the privilege of repurchasing the business at a price to be fixed by appraisers. S guarantees generally P's contract. Subsequently after P acquires the stock, C makes a contract with others which so seriously affects the value of the good will as to amount to a breach of the part of the contract relating to the payment of profits and the option to repurchase. The contract is divisible. The delivery of the stock and the payment of the delivery cost are an agreed exchange for one another. If P does not pay, S is liable to C for this part of the contract. See Restatement of Contracts, § 266, Comment *e*, Illustration 3.

d. Partial breach of contract. Where there has been a failure of consideration caused by the creditor, of such a nature as to constitute a total breach of contract, the principal by continuance or by assenting to the continuance of performance, or by otherwise manifesting an intention to do so, may treat the breach as partial except in cases of anticipatory repudiation. See Restatement of Contracts, §§ 317 and 318. Since the injured party to a contract has this privilege of treating a total breach as a partial breach, the possibility that a principal may continue with a contract after a breach by the creditor, is one which should be recognized by a surety when he assumes his obligation. The result can never be to increase the surety's obligation and will generally decrease it. The surety is therefore not discharged where the principal elects to treat a breach as partial.

Illustrations:

4. To induce C to enter into a contract with D, S signs a written guaranty that D will make the payments stipulated. Thereupon C enters into the contract with D, by the terms of which C is to ship 1000 tons of coal a month to D and D is to pay an agreed price within the receipt of each shipment. C sends the first two shipments, as agreed, but sends no coal the third month. D may refuse to accept the coal if shipped the fourth month, and if he does so refuse, S has no liability to C for that coal. If, however, D accepts the coal for the fourth month and does not pay for it, S is liable to C for the price of this coal.

5. Same facts as Illustration 1, except that the contract was for a year and after the failure of C to ship during the third month, D accepted shipments for each of the remaining nine months and paid the stipulated price promptly for each but the last, which he failed to pay. S is liable to C for the last payment.

6. C, D and S have entered into a contract that C is to ship D 1000 bushels of No. 1 yellow corn for which D is to pay \$ 500, D's payment being guaranteed by S. C ships 968 bushels of No. 1 yellow corn to D. D accepts the corn and notifies C that this is quite satisfactory since he had mentioned the figure 1000 merely because he had wished

approximately that amount. He says he will send C \$ 484 in a few days since they had agreed upon the price of 50 cents a bushel. Then D becomes bankrupt before paying C. S is liable to C for \$ 484.



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§ 127 Alteration of Instrument Expressing Contract of Principal

Subject to the rules pertaining to negotiable instruments, where the principal is discharged because of an alteration by the creditor of the instrument expressing the principal's obligation, the surety is discharged.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross references. See as to when alteration of an instrument discharges an obligor, Restatement of Contracts, § 434; as to what constitutes a material alteration, *ibid.*, § 435, and as to the effect of alteration upon an innocent party, *ibid.*, § 436.

b. Alteration of instrument expressing surety's obligation. The rule stated in this Section is not concerned with the discharge of the surety by alteration of the instrument expressing the surety's obligation. The effect of such alteration is determined by the usual rules of Contracts. (See Comment *a.*)

c. Negotiable instruments. Under the Uniform Negotiable Instruments Law, § 124, a holder in due course of a negotiable instrument that has been materially altered can recover on the instrument according to its original tenor.

d. Rationale. Fraudulent alteration by the creditor, his agent, or someone whose act the creditor has adopted, of the instrument expressing the principal's duty is an attempt to impose on the principal a duty which is not the one guaranteed by the surety. The phrase "instrument expressing the principal's obligation" means a writing integrating in whole or in part the agreement of the principal, which is one of the essential items of proof in respect of the principal's duty. (See Restatement of Contracts, §§ 228 and 229.) Fraudulent alteration of an integrated instrument is regarded as such a serious offense under the Restatement of Contracts as to deprive the party responsible even of a right on the instrument in its original form. It is an attempt to create evidence of a duty which was never assumed. Since the principal has a defense on the original duty, and since the creditor is responsible for the defense, the surety is discharged. Even if the alteration is not fraudulent, if it discharges the principal, it also discharges the surety. As in other cases of a defense for which the creditor is responsible, a different rule would be unfair to the principal, since if the surety could be held, he could also hold the principal for reimbursement and the principal would be left only an affirmative action against the creditor. See § 118.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Procedures Contracts Law Debtor & Creditor Relations Contracts Law Negotiable Instruments Enforcement Joint & Several Instruments



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Restat 1st of Security, § 128

§ 128 Modification of Principal's Duty

Where, without the surety's consent, the principal and the creditor modify their contract otherwise than by extension of time of payment

- (a) the surety, other than a compensated surety, is discharged unless the modification is of a sort that can only be beneficial to the surety, and**
- (b) the compensated surety is**
 - (i) discharged if the modification materially increases his risk, and**
 - (ii) not discharged if the risk is not materially increased, but his obligation is reduced to the extent of loss due to the modification.**

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Extension of time. Modification of the principal's duty by extension of time of payment is treated separately in § 129.

b. Variation of performance. The permitted variation of performance by the principal is in reality an alteration of the contract by substituted performance, although it frequently is evidenced by the circumstances, especially by the conduct of the parties, rather than by any specific agreement.

c. Consent of the surety. The consent of the surety to alterations is binding on him whether expressed as a part of his obligation, given later but before the alteration, or subsequent to the alteration. In the first case he is bound on his contract, in the second he is estopped, and in the third case he has waived his defense. The surety's consent may be either written or oral.

Illustrations:

1. P is under contract with C to buy from C his annual requirements of coal. S is surety. It is a part of the contract that P shall accept a 90-day bill of exchange upon each shipment. P and C without S's consent agree that P may make his purchases on open account. After the change is made S orally states that he has no objection. S is not discharged.

2. Same facts as Illustration 1, except that S does not state that he has no objection. S is discharged from liability.

d. The obligation of the surety to answer for a particular duty of the principal does not mean that he is bound to the creditor for a different duty of the principal. Where, for example, the creditor and principal substitute an entirely new obligation for the original one, the surety is discharged. Where a new agreement materially changes the old one, the result is the same. The present obligation of the principal is not the one guaranteed by the surety. On the other hand, a collateral contract between principal and creditor that in no material respect alters the obligation of the principal, though it may impose on him an additional obligation, does not affect the surety's liability in respect of the obligation for which he is answerable.

Illustrations:

3. P is under contract to buy his annual requirements of coal from C, and S is surety for P's performance. P and C without S's consent agree to substitute for this contract another relating to fuel oil. S has no liability to C for P's performance of the new contract.

4. P agrees with C to buy from C his annual requirements of coal. S is surety for P's performance. Subsequently P and C agree that C must permit P's inspector to examine the coal before shipment. S's obligation is unimpaired. The supplementary contract does not affect P's original obligation.

5. P contracts to build a house for C according to certain specifications and within a certain time. S is not a compensated surety. P with C's consent alters the specifications and does not hold to the time schedule. If P eventually defaults, S is not liable to C.

Comment on Clause (a):

e. Where the nature of the alteration is such that it can only be beneficial to the surety, he is not discharged whether non-compensated or compensated. This does not mean that the creditor can hold the non-compensated surety by showing that in the particular case the change was beneficial. The rule does not permit a speculation as to whether the change may or may not have been to the non-compensated surety's advantage. It must be of the sort that by its very nature, in no circumstances, can increase the risk of such a surety. Some examples are the reduction of the total amount due, or the reduction of interest.

Illustrations:

6. P leases a store from C for five years at a monthly rent of \$ 300. S is surety for P's performance. C contracts with P to reduce the rent to \$ 250 a month. S is not discharged since this change can only be beneficial.

7. P rents a house from C for five years. S is surety for P. At the end of three years without C's fault the house is destroyed by fire at a time when there is rent due from P for six months. C makes a binding agreement with P that if P will pay the past due rent, he will be excused from liability for the two final years. S is liable for the six months' rent. This change can only be advantageous to him.

Comment on Clauses (a) and (b):

f. The rule stated in Clause (a) has a technical application in favor of the surety. Where the alteration of the contract materially increases his risk so that the degree of his loss is a matter of conjecture, the rule is not inequitable to the creditor. In many instances, however, the alteration, although material in respect of the contract, does not materially increase the surety's risk. In certain cases it can be shown that in fact the alteration is actually advantageous to the surety. The well established principal of strictissimi juris, by which the surety was discharged by any modification, however slight, in the principal's duty, as applied to suretyship in the early law, was interpreted as excusing the surety by any change, irrespective of the actual effect upon the surety. This has been relaxed so that the surety, whether

compensated or not, remains bound if the change is of a sort that can only be beneficial. In respect of the compensated surety (see § 77, Comment *h*) there is the further change stated in Clause (b). The compensated surety has sufficient experience with the sort of risk it is accepting to calculate the possibilities of certain variations and to adjust its premium accordingly. The creditor, who has permitted the change, must bear the burden of a loss due to the change, but where the change does not materially increase the risk, the surety's obligation is not discharged.

The rules stated in Clause (b) find important application in the case of building contracts. The modifications of contract between creditor and principal may be such as are contemplated by the contract in which case no surety would be discharged. They may be slight variations which by the technical rules which have prevailed in respect to non-compensated sureties would discharge them, although not in fact disadvantageous to the surety. In such a case the compensated surety would not be discharged. They may cause slight and easily measured damage to the compensated surety, so that the penalty of a total discharge of the surety would be disproportionate to the blame attaching to the creditor for the modification. In such a case the surety is discharged only to the extent of loss. The compensated surety, however, should not be held to his obligation if the creditor and principal have so modified the contract as to impose a risk of loss substantially different from the one covered by his obligation. If the change imposes a danger of loss upon the surety which cannot fairly be measured, the surety is discharged entirely.

Illustrations:

8. P contracts to erect an office building for C. It is agreed that P is to be paid in installments after the completion of each story, the payment to be 85 per cent of the amount due for the stage of the work completed. S is a compensated surety for P's performance. P has no other contracts. At P's request, and without S's knowledge, C pays the full amount due for the completion of each story. P uses the advance payments to provide materials for the construction with the exception of \$ 100 which he uses for personal expense. P, after an earnest effort to carry out his contract, defaults. It is judicially determined that the modification has damaged the surety only to the extent of the amount used for the contractor's personal expense. S remains liable to C but is entitled to a deduction for the amount of the loss caused by C's overpayments, that is, \$ 100. Had S not been a compensated surety, he would be wholly discharged.

9. Same facts as Illustration 8, except that P is engaged in many building operations. In such a case P would be likely to continue the operations on the building in connection with which he is entitled to reserved payments. He is more likely to obtain financial assistance to insure its completion. It is judicially determined that the amount of the damage caused by the owner's overpayment is uncertain. In such a case C's conduct entirely discharges S from liability for P's default even though S is a compensated surety, because C has not only materially varied his contract with P but has materially increased S's risk.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Pleading & Practice Pleadings Time Limitations Extensions Civil
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Restat 1st of Security, § 129

§ 129 Extension of Time to Principal

(1) Subject to the rule stated in Subsection (2) and to the rules in respect of negotiable instruments, where the principal and creditor, without the surety's consent, make a binding agreement to extend the time of payment by the principal, the surety is discharged unless the creditor in the extension agreement reserves his rights against the surety.

(2) Where the surety is a compensated surety he is discharged only to the extent that he is harmed by the extension.

CAVEAT: *Caveat:* The Institution takes no position as to whether, where a maker of a negotiable promissory note or an acceptor of a negotiable bill of exchange is a surety for another party to the same instrument, the maker or acceptor is discharged by a binding extension of time on the instrument made without his consent.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Rationale. A binding extension of time by the creditor to the principal is a form of modification of the principal's duty; see § 128. Its effect is stated separately because it is a form of modification under which the creditor can reserve his rights against the surety. The basic reason for the rule stated in Subsection (1) is that the surety should not be bound on a duty of the principal which he has not guaranteed. The rule can also be supported because of the possibility that the risk of the surety will be increased by the extension.

Furthermore, if the surety were not discharged, the creditor, notwithstanding the extension, might at once enforce his right against the surety, and if the surety satisfied his obligation, the latter could proceed immediately against the principal for reimbursement. Under such a rule too the surety's right to subrogation would be affected since he could not enforce the right of the creditor by subrogation until the period of the extension has expired.

b. Time of consent by surety. The surety's consent to an extension of time of payment may be given either before or after the extension is made. The surety is bound by his consent, whether it becomes part of his contract or amounts to a waiver of a defense.

c. Binding agreement for extension. The agreement between creditor and principal must be enforceable to cause the discharge of the surety. If the agreement is without consideration or can be rescinded by the creditor for fraud or some other reason, the surety is not discharged. The breach of a binding extension agreement by the principal will not revive the surety's obligation, however, even if the breach excuses the creditor from the allowance of the extension.

d. Where the creditor grants extension of time of payment to the principal he can reserve his rights against the surety by a reservation as in the case of a release. The reservation of rights must be a part of the extension agreement. Under a release with a reservation against the surety, the surety remains liable and retains his right of reimbursement. Under an extension he not only remains liable and retains his right of reimbursement but the extension is ineffective as to the surety if he wishes to perform and proceed against the principal. (See further § 122, Comment *d.*)

Illustration:

1. P is liable to C on a debt of \$ 1000 due July 1, 1939. S is surety. P and C agree that if P will execute a renewal note for the amount of the debt and accrued interest, P can have an extension of time to January 1, 1940. In the extension agreement C reserves his rights against S. S remains liable to C, but S can pay the debt at once and proceed against P immediately for reimbursement.

Comment on Subsection (2):

e. The general rule stated in this Section, as indicated, has the important qualification that the compensated surety is discharged only to the extent that he is prejudiced by the extension. The rule in respect of other sureties applies even where, in fact, it can be shown that the particular extension was beneficial to the surety. This is another instance of giving the surety other than a compensated surety the advantage of the rule of *strictissimi juris*, by which he is discharged by any variation in the performance demanded of the principal. The compensated surety, being in the business of executing surety contracts, is in a position to measure his risk, including the possibility of an extension and to charge a premium in accordance with the risk. (See § 82, Comment *f.*)

It should be observed that in certain cases especially those involving compensated sureties, an interpretation of the terms of the contract justifies the conclusion that the surety has consented to reasonable extensions or other modifications of the duty of the principal.

Illustrations:

2. P agrees to erect a building for C, to be completed by August 1, 1939. S is a compensated surety. Shortly before August 1, P and C agree that P is to have until November 1, 1940, to complete the contract. On November 1, the building is still incomplete and P defaults. There is no evidence that S has been harmed by the extension. S remains liable.

3. Same facts as Illustration 2, except that S is able to show that P was solvent on August 1, but is insolvent on November 1, and that although he could have obtained complete reimbursement for some time after August 1, he cannot obtain any reimbursement now. S is discharged.

4. P is a building contractor and S is a compensated surety for the materialmen furnishing supplies. S's contract does not contain any stipulations as to the time of performance by P and the materialmen. The materialmen grant P a ninety day credit which is subsequently extended sixty days. It is found that the total credit extended to P was reasonable in the circumstances. S remains liable because the reasonable interpretation of his obligation is that he consented to a reasonable extension of credit to P, irrespective of the original terms of the first arrangements made between P and the materialmen.

Comment on Subsection (1) and (2):

f. Secured surety. The rules stated in this Section do not recognize an exception where the surety has security from the principal. By the rule stated in § 140, the creditor often has an interest in the surety's security from the principal. The surety may not destroy this interest of the creditor. The discharge of the surety under the rules stated in this Section refer to the surety's personal liability on his obligation. The creditor's action in so discharging the surety does not mean that the creditor is releasing his interest in the surety's security. If the creditor by the rule prevailing in the jurisdiction has an interest in the surety's security, the surety, although discharged from his personal liability by an extension of time, is liable to the creditor for any action in respect of the security which affects unfavorably the creditor's interest.

Illustration:

5. P is indebted to C on a debt of \$ 5000 for which S is surety. S has received security valued at \$ 5000 from P. Without S's consent and without reserving rights against S, C grants P an extension of time. S is discharged from personal liability to C but remains accountable to C for the security.

Comment on the Caveat:

The question of the effect of an extension of time on an accommodation maker or acceptor is determined by the law of negotiable instruments. It is held in several states that the maker or acceptor is not discharged by a binding extension of time. The effect of this holding is that where a surety expresses his obligation by signing a negotiable instrument as maker or acceptor, irrespective of the fact that he is a surety or known to be such, his obligation is enforced solely as that of maker or acceptor. Since the maker or acceptor is a primary rather than a secondary party on the instrument even if he is in fact a surety he cannot take advantage of the provisions in § 120 of the Uniform Negotiable Instruments Law relating to discharge of persons secondarily liable. The Uniform Negotiable Instruments Law in the interests of uniformity determines the liability of the various parties to negotiable instruments on the basis of what is written on the paper. The obligation of all makers and acceptors is to pay the holder in due course according to the terms of the bill or note. This obligation is primary and absolute. The Act makes no provision for the proof of another and different relation than that expressly indicated and defined by the terms of the instrument signed. The Act further provides in definite terms that the instrument and hence one primarily liable is discharged in one of five different ways (Uniform Negotiable Instruments Law, § 119); that is, by payment by the principal debtor, or by the party accommodated, by cancellation, by any other act which would discharge a simple contract, and by the principal debtor's becoming the owner after maturity. There is no mention of a discharge of an accommodation maker or acceptor by extension of time although such a provision is made in § 120 of the Act in respect of a person secondarily liable.

In a lesser number of jurisdictions it is held that since the matter is not covered in unmistakable terms in the Uniform Negotiable Instruments Law and since in § 196 of that Act, it is provided that in all cases not covered by the Act the rule of the law merchant should prevail, the matter should be determined by the ordinary rules of suretyship.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Pleading & Practice Pleadings Time Limitations Extensions Civil
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§ 130 Creditor's Failure to Enforce Claim Against Principal

(1) Subject to the rule stated in Subsection (2) and to the rules pertaining to negotiable instruments, the surety is not discharged because the creditor takes no action to enforce his claim against the principal unless the creditor's failure to act is a violation of a judicial decree.

(2) The surety who has only guaranteed the collection of the principal's obligation is discharged to the extent that the failure by the creditor to take with reasonable promptness appropriate remedies against the principal is the cause of the creditor's inability to collect from the principal.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. The creditor in suretyship has two rights, one against the principal and the other against the surety. It would diminish the attractiveness and utility of the surety's obligation as security if the creditor in all cases were obliged first to enforce his right against the principal. Since the surety may pay the claim of the creditor and himself proceed against the principal for exoneration in advance of payment (§ 112), the creditor's non-action generally affords no equitable basis for a claim of discharge by the surety.

The rule stated in this Subsection is of importance in cases where the financial condition of the principal changes during the period of the creditor's non-action and where rights are lost by the creditor against the principal because of the running of the Statute of Limitations, or by a neglect of the time within which claims may be filed in insolvency proceedings or those involving decedents' estates.

Illustrations:

1. P owes C \$ 1000 with S as surety. P defaults, and S requests C to sue P. C refuses. Thereafter C sues S. C's refusal to sue P will not prevent him from obtaining and enforcing judgment against S.

2. Same facts as Illustration 1, except that C delays action of any kind until his claim against P, but not against S, is barred by the Statute of Limitations. C can recover from S.

3. P owes C \$ 1000 with S as surety. P defaults and C conducts a series of negotiations with P in respect of payment without modifying the contract between C and P. The negotiations are fruitless. During the period of the delay, P becomes wholly insolvent though he could have been compelled to pay a considerable fraction of the debt at the time of its maturity. S remains liable to C for \$ 1000.

4. Same facts as Illustration 3, except that a petition in bankruptcy is filed against P at a time when P's assets are sufficient to pay a substantial dividend on his debts. Both S and C are aware of the bankruptcy. C makes no effort to file a claim in bankruptcy and the time for filing claims expires. S remains liable to C for \$ 1000.

b. Cross references. See as to a creditor's duty in respect of security received by him from the principal, § 132, and as to creditor's duty to notify the surety of default by the principal, § 136.

c. Surety as party to negotiable instrument. Where the surety is secondarily liable on a negotiable instrument, he is entitled to have the creditor make the presentment and give the notices required by the rules pertaining to negotiable instruments. (See Uniform Negotiable Instruments Law, §§ 70-119.) If the surety has waived presentment and notice, or if those acts have been performed, the rule stated in Subsection (1) applies.

d. Statutes in a number of states enable the surety by written demand on the creditor that he sue the principal, to postpone payment to the creditor until judgment has been obtained against the principal and a levy has been unavailing. If the creditor refuses or fails to sue the principal, the surety is discharged to the extent that loss is due to the creditor's failure to proceed against the principal. This statutory privilege is usually qualified in various ways. The surety's request must be made after maturity of the principal's duty, the principal or his property must be within the jurisdiction, and the surety must offer to indemnify the creditor for the costs of his action.

e. Claims in bankruptcy. Under the federal Bankruptcy Act as in force on January 1, 1941, the surety may file the claim of the creditor against the principal if the claim is not filed by the creditor.

f. Violation of judicial decree. Special circumstances may entitle the surety to equitable relief to compel a creditor to proceed against the principal. Occasions for granting such relief to a surety may occur when the creditor has security from the principal or has a judgment against a principal who has available assets. The problem of the surety's right to compel the creditor to realize on the assets of the principal is treated in § 131.

Comment on Subsection (2):

g. A guaranty of collection is an obligation of a surety by which the surety undertakes to satisfy the principal's duty or to compensate the creditor for the principal's default if the creditor, after taking reasonable steps, is not able to enforce the duty of the principal. Such a guaranty requires a creditor first to proceed against the principal or to show that such steps would be futile. Where the surety has guaranteed the collection of the principal claim, the surety's obligation expires by its own terms if the principal's obligation is uncollectible because of the creditor's delay. It is a fair interpretation of the surety's contract that the creditor is expected to proceed against the principal with reasonable promptness.

Illustrations:

5. P owes C \$ 1000. S guarantees that C will be able to collect the debt. C cannot obtain judgment against S unless he can show that he has obtained and failed to collect judgment against P, or that P is wholly insolvent or unavailable for suit.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Liability Civil Procedure Remedies Bonds Sureties Procedures Contracts

Restatement of the Law, Security, § 130

LawNegotiable InstrumentsDischarge & PaymentDischarge of Secondary Obligors



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Restat 1st of Security, § 131

§ 131 Surety's Right to Compel Creditor to Apply Assets of Principal

(1) Subject to the rule stated in Subsection (2) a creditor who has a security interest in property of the principal may compel performance by the surety before resorting to this security interest.

- (2) The creditor has a duty first to enforce his security interest in the property of the principal, if**
(a) his failure to do so will result in unusual hardship to the surety and doing so will not prejudice the creditor, or
(b) the surety has only guaranteed the collection of the principal's obligation.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Where the surety has undertaken an obligation to the creditor and the time for performance has arrived, the mere fact that the creditor has security from the principal affords no equitable ground for relieving the surety of his duty of immediate performance. One of the reasons why a creditor requires a surety is to avoid delay in obtaining satisfaction. The surety normally may perform and be subrogated to the creditor's security. To obtain the assistance of a court of equity the surety, as indicated in Subsection (2), must show something more than the existence of security.

Illustrations:

1. S is surety to C on P's debt of \$ 1000 to C, which is secured also to C by a chattel mortgage on P's truck. P defaults, and C demands payment of S. S refuses payment, and C sues S. The fact that C has security from P will not prevent C's obtaining a judgment against S. S cannot prevent C from enforcing this judgment unless he can bring himself under the rule stated in Subsection (2).

Comment on Subsection (2):

b. While the creditor, as stated in Subsection (1), is under no duty generally to enforce his claim against the principal rather than the surety, where the principal is in default and performance is due from the surety, circumstances of peculiar hardship may give the surety the right to require the creditor to recognize that as between the principal and surety the principal is the one who should perform, and where assets of the principal are available to the creditor, to

utilize these before compelling payment by the surety. The surety must show unfairness to himself and no unfairness to the creditor if he is to be able to compel the creditor to depart from the normal procedure of demanding performance from the surety after the principal's default. Where the surety can make such showing, however, equity will recognize that as between surety and principal, the latter is the one who should satisfy the duty, and will require the creditor first to utilize available assets of the principal.

Illustrations:

2. P is indebted to C in the sum of \$ 5000 secured by a pledge of negotiable securities amounting substantially to the face of the loan. S is surety. Upon P's default C obtains judgment against P and S. S can compel C to sell the pledged securities and apply their proceeds on the debt, and also to levy on other assets of P, if such are available, before levying on assets of S.

3. P is indebted to C for \$ 5000 secured by a first mortgage on land in a jurisdiction where the enforcement of real estate security usually requires several years. S, a surety company, is surety to C for P. P defaults, and C demands payment of S. S brings a bill in equity to compel C first to foreclose the mortgage. S will be denied relief. S can show no special hardship in being required to perform, and postponement will be prejudicial to C.

4. P is indebted to C with S as surety. Upon P's default, C obtains judgment against P and S. S's chief asset is a farm which is worth more than the debt, but which will not bring its fair value at a judgment sale. P has chattels upon which C can levy, which if sold will reduce P's debt to an amount which S can pay without selling or encumbering his farm. S can compel C first to levy on P's chattels.

c. Where the surety has only guaranteed collectibility, the creditor is under a duty to take reasonable steps to obtain satisfaction from the principal. Where he holds security from the principal, he must first enforce this security before he can require payment by the surety, even if the creditor can show that further action against the principal would be futile. (See § 132.)

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts Law Secured Transactions Default Creditor Obligations Contracts Law Secured Transactions Default Foreclosure & Repossession Enforcement



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Restat 1st of Security, § 132

§ 132 Surrender or Impairment of Security by Creditor

Where the creditor has security from the principal and knows of the surety's obligation, the surety's obligation is reduced pro tanto if the creditor

- (a) surrenders or releases the security, or**
- (b) wilfully or negligently harms it, or**
- (c) fails to take reasonable action to preserve its value at a time when the surety does not have an opportunity to take such action.**

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. As to the effect on a surety's obligation of the release by a creditor of a cosurety, see § 135.

b. Where suretyship exists, the principal frequently secures the creditor by a pledge, mortgage or other form of security. Whether or not he knows of this security, the surety has an interest in it. If the surety satisfies the creditor's claim against the principal, the surety is subrogated to the creditor's interest in the security, see § 141. If the creditor surrenders the security or impairs its value, he loses or diminishes the value of an asset which might otherwise be used to satisfy his claim against the principal, and reduces the value of the security to which the surety is entitled upon his own performance. The surety is consequently entitled to a reduction in his obligation to the extent of the value of the lost security.

c. Where a surety's obligation is not conditioned upon the creditor's enforcement of other security he may have, the continuance of the creditor's right against the surety does not depend upon his using such other security as he may have to satisfy in whole or in part his claim against the principal. Equitable considerations in special circumstances may also entitle the surety to a judicial decree requiring the creditor to enforce security he has received from the principal debtor to a realization of his claim out of the assets of the surety, see § 131. In the ordinary situation the surety by performing can avail himself of any security held by the creditor from the principal, see § 141.

The nature of the security may impose upon the creditor duties to preserve its value so long as the creditor is the only person who can conveniently take the appropriate action. This is especially true prior to the maturity of the

creditor's claim. For example, he may be the pledgee and indorsee of negotiable instruments bearing several indorsements. These instruments may mature before the maturity of the principal's obligation. In such a case the creditor must present the instrument for payment, and if it is dishonored, must notify the indorsers. In other instances, as in the case of assigned contracts about to expire by limitation, or mortgage which should be recorded, the creditor may have a duty not only to the principal but to the surety. At maturity, if the time for performance of the surety's duty has arrived and if the surety by performance can obtain the security and be put in a position where he can preserve its value, the creditor's duty to the surety in this respect may be ended. Even after maturity, however, if the conduct of the creditor indicates that he intends to rely first on the security rather than on his claim against the surety, the creditor's duty to the surety in respect of the security may continue.



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Restat 1st of Security, § 133

§ 133 Surety's Set-Off

(1) Where the surety has a claim against the creditor not arising out of the suretyship relation, the surety can set off the claim against the creditor unless the creditor's estate is being administered in insolvency proceedings and the principal is solvent, or, if insolvent, has secured the surety against loss on his obligation.

(2) The surety cannot set off against the creditor the principal's claims against the creditor unless

(a) the principal has assigned his claim to or consented to its use by the surety; or

(b) the principal is made a party to the action instituted by the creditor, or

(c) the principal is insolvent.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Where the surety has a defense arising out of the suretyship relation, this is always available against the creditor. Where the creditor is solvent and the surety has a claim available by way of set-off, the ordinary rules of set-off apply unless the interests of third persons are involved. For example, if the surety has guaranteed an obligation of the principal to the extent of \$ 1000 and has a personal claim against the creditor of the same amount, the surety can set off this claim and defeat the creditor's action. The surety has a right to be reimbursed by the principal to the extent that the effect of the set-off has been to satisfy the principal's duty.

Where the creditor is insolvent and his estate is being administered in insolvency proceedings, it is inequitable to the creditor's other creditors to permit the surety to set off his claim against the creditor and thus be paid in full if he can be reimbursed by the principal. Reimbursement is possible where the principal is solvent or where, if insolvent, the surety has received adequate security from him.

The application of the rule stated in this Subsection has occurred chiefly in cases involving insolvent banks. A surety for a debtor to the bank is a depositor in the bank. The receiver for the bank seeks to compel the surety to satisfy his obligation. As a debtor to the bank, the surety may set off his deposit unless the receiver can show that the surety can be reimbursed by the principal, either because the principal is solvent, or because the surety has security. If the surety is allowed a set-off, to the extent of the set-off, his claim as a depositor is paid in full. If he is not allowed a

set-off, he receives only the dividend allowed on such claims. The result of denying the set-off is advantageous to the other creditors. Where the surety can be reimbursed by the principal, it is not inequitable to leave him in respect to his deposit in the situation of other claimants.

Comment on Subsection (2):

b. Where the principal has a claim against the creditor and the principal is not a party to the action brought by the creditor, the surety can be allowed to set off the principal's claim only at the risk of unsatisfactory adjustment of the rights of the parties. If the surety were sued by the creditor he might allege he was a surety and that the principal had a set-off. If the set-off were allowed, judgment would be given for the surety. This would not bar the alleged principal from recovering the amount of his claim against the creditor in an action in which the principal might show that he had no connection with the claim upon which the alleged surety had been sued.

Another situation where the allowance to the surety of a claim of set-off on behalf of the principal might be unfair is where the principal's claim is for an amount in excess of the creditor's claim against the surety. The surety has no incentive to obtain the allowance of a set-off in excess of the claim against himself. If the relations of the parties were established and the surety were permitted to assert the claim of the principal, the judgment would bar the principal from subsequent action against the creditor.

A further objection to allowing the surety a set-off of the principal's claim might arise if there were several sureties who were sued separately. Each might assert the same claim.

It is desirable to settle the controversies of the parties with the minimum of litigation, and where the surety is able to make the principal a party to the action the principal's set-off against the creditor can be made available to the surety either for a reduction or a discharge of his liability.

c. The equitable considerations determining the allowance or refusal to the surety of the principal's right of set-off operate in favor of the surety where the principal is insolvent. The principal is not likely to be damaged by the set-off and other creditors of the principal are in the same position as if the principal had asserted the right of set-off in an action by the creditor against him.

d. Where the creditor is responsible for the impairment of securities given to the creditor by the principal, this may entitle the principal to a set-off against the creditor. If the creditor's conduct is also a violation of a duty to the surety, the surety can obtain a reduction of his obligation to the creditor, not because he is asserting the principal's set-off but because of the harm to his own interest. (See § 132.)



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Restat 1st of Security, § 134

§ 134 Discharge of Surety by Operation of Law: Effect on Obligations of Remaining Cosureties

Where a surety is discharged in bankruptcy or the creditor's claim against him becomes otherwise unenforceable by operation of law, the cosureties remain liable to the creditor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section covers instances where as a result of insolvency proceedings a surety's obligation to the creditor is discharged, and also cases where by the running of a period of limitation, the creditor's right is either lost or rendered unenforceable. In the first category of cases, the surety will generally also be discharged from his duty to make contribution. The creditor, however, cannot prevent such a result, and should suffer no loss in consequence. While the creditor's failure to act for the period prescribed in the Statute of Limitations is the reason for the unenforceability of his own claim against a cosurety, the other cosureties cannot defend against the creditor on this ground because their right to contribution is not barred. (See § 152.)

Illustrations:

1.1> remains liable for \$ 5000.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil Procedure Remedies Bonds Sureties Procedures



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Restat 1st of Security, § 135

§ 135 Release by Creditor of One of Several Cosureties

(1) Subject to the rule stated in Subsection (2), where the creditor releases one of several cosureties, the obligations of the remaining sureties to the creditor are reduced to the extent that upon performance of their obligations the released surety could have been compelled to make contribution.

(2) Where the creditor releases one of several cosureties and as a part of the release reserves his rights against the remaining sureties, the release as such does not have the effect of discharging or reducing the obligations of the remaining sureties.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See as to right of a surety to contribution from a cosurety, § 149; as to contributive shares of cosureties, § 154; and as to the effect of a release by a cosurety of the principal or other cosureties, §§ 157 and 159.

b. Where there are cosureties whose aggregate obligations are greater than the amount due from the principal to the creditor, their obligations as among themselves, irrespective of the terms of their obligations to the creditor and in the absence of special agreements by them, are to satisfy a pro rata share of what is due on the principal's default. If the creditor releases one of the sureties, he eliminates this surety from the several sureties and so deprives the remaining sureties of the released surety's contributive share. The obligations of the remaining sureties to the creditor therefore should be reduced by the amount of the contributive share of the released surety which has been lost to them.

The release of the principal discharges the surety completely (see § 122) because the principal should relieve the surety from the latter's entire liability. The release of a surety, however, results only in a proportionate discharge because the released surety could not in any event so far as the cosureties are concerned, have been required to bear the entire burden. The release of the cosurety in its effect is like that of a release of property security by the creditor, which results in a pro tanto discharge. (See § 132.)

As among themselves, the pro rata share of each surety is determined by considering not only the aggregate of the sureties' obligations in relation to the obligation of the principal but also the amount for which each surety is bound. For

the rules for determining the pro rata shares of the sureties, see § 154.

Where the creditor can show that the released surety was wholly insolvent, the release has no effect upon the obligations of the other cosureties to the creditor. Where, on the other hand, the released cosurety is solvent, and part of the cosureties are insolvent, the effect of the release is to discharge the remaining solvent cosureties, not only to the extent of the released cosurety's original pro rata share but also to the extent of the additional amount he could have been required to pay because of the insolvency of some of the cosureties, see § 154 (2).

Illustrations:

1.1> to reimburse him to the extent of \$ 2500.

c. Where one surety has become a surety by having used or permitted the principal to use his property as security for the principal's performance, and the creditor releases this security, another surety is discharged to the extent that he could have compelled contribution from the surety whose security is released.

Illustration:

3. S is surety to C on a debt of \$ 1200 owed by P. T pledges to C securities worth \$ 400 as security for P's debt. C releases the securities to T. P makes a part payment of \$ 600 and defaults. If T had not been released, and S paid C \$ 600, S could compel T to contribute \$ 200. C can therefore recover only \$ 400 from S.

d. Between the surety and principal the latter is the one who should perform. If the surety pays, the principal is under a duty to reimburse him. The principal is therefore not harmed by a release of the surety. The release of the surety does not affect the duty of the principal debtor.

Comment on Subsection (2):

e. The rule stated in this Subsection follows the rule in respect of the effect of a reservation of rights in connection with a release of the principal, see § 122. The rule may facilitate compositions. The creditor may have an opportunity to make an advantageous settlement with a surety. He may wish to avoid the necessity of proving that he has obtained all that was possible from the released cosurety. In connection with the payment by the surety, the creditor, by reserving his right against other sureties, is in effect stating to the released surety that the release is to apply solely to the relations between the parties to the release. The creditor not only reserves his rights against other sureties, but also by implication reserves the rights of the other sureties. He has, however, done nothing that affects the rights of the other sureties against the released surety. If the other sureties ultimately pay more than their proportionate share, they are then entitled to contribution from the released surety, see § 122, Comment d.

Illustration:

4.1>.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil Procedure Remedies Bonds Sureties Procedures



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Restat 1st of Security, § 136

§ 136 Notice to Surety of Principal's Default

Subject to the rules pertaining to negotiable instruments, the surety's obligation to the creditor is not affected by the creditor's failure to notify him of the principal's default unless such notification is required by the terms of the surety's contract.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The rule stated in this Section is an application of the usual rule of contracts that an obligor is not discharged because he is not notified that the time for his performance is due, unless he has stipulated for notification. The surety, when he undertakes his obligation, must realize that there is a risk that the principal will not perform. If the surety wishes notification, he can insert a requirement for it in his contract. If he does not stipulate for notification, the surety has the burden of ascertaining when, if ever, his performance is due, and of taking whatever steps seem appropriate to him for his own protection.

b. Surety a party to negotiable instrument. Where the surety is a drawer or indorser of a negotiable instrument, he is discharged from liability on the instrument if he does not receive the notice of dishonor or notice of protest required by the law of negotiable instruments. (See Un. N. I. L., Art. VII, §§ 88-118.)

c. Cross reference. Compare, as to notice of acceptance of offer necessary to prevent discharge of a surety, § 86. See as to notice required in the case of a guaranty of collectibility, § 137.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementJoint & Several InstrumentsContracts LawTypes of
ContractsGuaranty Contracts



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Restat 1st of Security, § 137

§ 137 Guaranty of Collectibility: Notice to Surety of Creditor's Inability to Enforce Principal's Duty

Where a surety has guaranteed the collectibility of a principal's debt, the creditor has the duty of giving the surety reasonable notice of his inability to enforce performance, and if such notice is not given, the surety is discharged to the extent of resulting prejudice.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The surety's liability in the case of a guaranty of collectibility is dependent on the action of the creditor, that is upon the creditor's taking appropriate steps to enforce performance by the principal. The risk assumed by the promise of the surety is one of performance if the creditor cannot compel the principal to perform. While the creditor need not give the surety notice of the principal's default since that in the first instance is the concern of the creditor, it is inequitable to hold the surety to his obligation for an indefinite period after the creditor's efforts have failed, if in the meantime, the surety's position has been prejudiced by his failure to receive notice.

Since the surety who has guaranteed collectibility of a principal's debt, is only discharged to the extent of prejudice from a failure to receive notice of what a creditor has done to enforce the principal's duty, the surety is not discharged if he has actual knowledge of the creditor's action, even if notice has not been received from the creditor. In such a case the prejudice does not result from the failure to receive notice.

Illustrations:

1. C is a seller of merchandise to P. S guarantees the collectibility of the accounts. C takes reasonable steps to collect the accounts without success. No notice is given to S for two years, and S has no knowledge of C's action. C then demands payment from S. S is able to show that had he known within a year of C's failure to collect from P, he could have obtained one-half the amount from P or on P's behalf, but that subsequently he could have obtained nothing. S is excused from one-half his liability.

2. Same facts as Illustration 1, except that S can show no prejudice by failure to receive notice. S is liable for the full amount of his guaranty.

3. P is indebted to C on a debt whose collectibility has been guaranteed by S. P defaults, and C takes reasonable steps to collect the debt. C fails in his efforts but gives no notice to S. C, however, is able to show that S was in constant contact with P and knew all the facts about C's efforts at collection. Even if S could have collected from P at the conclusion of C's efforts at collection, and cannot do so later, this result is not attributable to C's failure to give notice. S is liable to C on his guaranty.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Liability



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Restat 1st of Security, § 138

§ 138 Notice of Enforcement of Security Where Suretyship Exists Because Principal's Duty Is Secured by Surety's Property

Where the surety has permitted the principal to use the surety's property as security to the creditor for the principal's duty and this fact is known to the creditor, it is the duty of the creditor to notify the surety of proceedings for the enforcement of the security.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Where chattels are pledged or mortgaged, choses in action are assigned, or land is mortgaged, enforcement procedure requires notice to the pledgor, mortgagor, or assignor so that he will have an opportunity to redeem and otherwise to protect his interests. Where the creditor knows of the surety's interest in the security, he must treat the security as if it had come directly from the surety. The effect of failure to give notice is determined by the law of the jurisdiction in respect to the types of security involved. Since the surety's obligation is limited to permitting the use of his property as security, he is entitled to the remedies of a pledgor, mortgagor, or assignor, as the case may be, if the creditor pursues irregular methods of enforcing the security. (See as to notice by the pledgee, § 48.)

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Liability Contracts Law Secured Transactions Default Creditor Obligations



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Restat 1st of Security, § 139

§ 139 Judgments Between Creditor and Principal: Effect as Proof of Principal's Liability in Action by Creditor Against Surety

(1) Where, in an action by a creditor against a principal, judgment is given in favor of the principal, and the creditor subsequently brings an action against the surety, proof of the judgment in favor of the principal is conclusive of the principal's non-liability.

(2) Where, in an action by a creditor against a principal, judgment is given, other than by default or confession, in favor of the creditor, and the creditor subsequently brings an action against the surety, proof of the judgment in favor of the creditor creates a rebuttable presumption of the principal's liability to the creditor.

(3) Where, in an action by a creditor against a principal, judgment is obtained by default or confession against the principal, and the creditor subsequently brings an action against the surety, proof of the judgment against the principal is evidence only of the fact of its rendition.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. If judgment is rendered for the principal in an action against him by the creditor, this judgment is conclusive as to the principal's non-liability in an action by the creditor against the surety. If judgment is rendered for the creditor only for part of his claim, the judgment is conclusive against the creditor as to the principal's non-liability for that portion by which the creditor's claim is reduced. The issue of the principal's non-liability, in whole or in part, has been judicially determined in an action to which the creditor was a party. Whether the determination of the principal's non-liability will defeat the creditor's action against the surety depends upon whether the judgment in favor of the principal is because of a defense relating to the merits of the creditor's claim, such as fraud, duress, or failure of consideration or is a personal defense, such as infancy. (See §§ 118, 126.)

Illustrations:

1. C sues P on a debt for which S is surety. P's defense is that the debt has been paid. Judgment is rendered for P. C then sues S. The judgment against C in the action by C against P is conclusive of P's non-liability. Since P's

non-liability on account of payment is a defense to S against C, C cannot recover from S.

Comment on Subsection (2):

b. Statements regarding the evidential effect on the surety of a judgment against the principal are always qualified by the general rule that the surety can avoid this effect by showing that the judgment was obtained by fraud or collusion.

Illustrations:

2. C brings an action against P on an unfounded claim and attaches P's chattels. P obtains their release by inducing S to agree to pay any judgment obtained by C in the action. As a result of a collusive bargain between C and P, C obtains judgment. S may show the fraudulent nature of the judgment in an action against him by C.

c. The rule stated in this Subsection expresses a middle ground between the possible rule that a judgment against the principal is conclusive of the principal's liability, even in an action against the surety, and that such a judgment is evidence only of the fact of its rendition. It is inequitable to bind the surety conclusively by a judgment to which he is not a party. On the other hand, it is not unfair to make a rebuttable presumption of the regularity of the judicial proceedings antecedent to the judgment and of the correctness of the judgment as evidence of the principal's liability. Under the rule stated in Subsection (2), it is open to the surety to prove if he can that judgment should have been rendered for the principal. What must be adduced by the surety to overcome the rebuttable presumption is a matter to be determined by the law of evidence.

The result of the rule stated in Subsection (2) is that in cases where the surety cannot rebut the presumption of the judgment against the principal and where the surety has no other defense, time and expense are saved to courts and litigants by the avoidance of unnecessary duplication of trials on identical issues of fact.

Comment on Subsections (2) and (3):

d. The rules stated in Subsections (2) and (3) are not concerned with a situation in which the surety by his contract has bound himself in specific terms to answer for any judgment which may be obtained by the creditor against the principal. In such a case proof of the judgment is by the terms of the surety's obligation all that the creditor needs to show as a condition of the surety's liability. (See §§ 189-191; 201).

Illustrations:

3. C, in connection with a suit against P, attaches P's chattels. S, in consideration of C's release of the chattels to P, agrees to pay any judgment obtained by C in the pending action. C obtains judgment. The judgment is conclusive evidence of P's liability.

Comment on Subsection (3):

e. The probative significance of a judgment obtained by confession or default is much less than that of a judgment after trial on the merits. Moreover, the arguments of policy and convenience against duplication of trials have little weight where there has not been a determination after consideration of evidence introduced by both sides to a litigation. Such a judgment against the principal does not create a rebuttable presumption of the principal's liability, in an action between creditor and surety.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil Procedure Pretrial Judgments Default Default Judgments



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Case Citations

Rules and Principles

Division 2 - Suretyship

Chapter 5 - Surety and Creditor

Restat 1st of Security, § 140

§ 140 Creditor's Interest in Surety's Security

(1) Where the principal gives the surety security to secure the principal's duty to the surety, it is the surety's duty to the creditor to retain the security and in the event of the principal's default to utilize the security to satisfy the principal's duty to the creditor, unless

(a) the creditor has consented to the utilization of the security exclusively for the benefit of the surety, or

(b) the surety fully satisfies his duty to the creditor otherwise than through the utilization of the security, in which event the surety may utilize the security to the extent necessary for his own reimbursement, or

(c) both the surety and the principal have defenses other than performance which discharge their duties to the creditor.

(2) Where the surety receives security from one other than the principal, the creditor has an interest in the security only if the security is given upon such terms as to create a trust for the creditor or in connection with a contract for the benefit of the creditor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is not concerned with the situation where the surety receives security from the principal with the stipulation that it is to secure the principal's duty to the creditor. In such a case, the surety is a trustee for the creditor and must administer the security primarily for the benefit of the creditor. The principal has merely chosen the surety as a proper custodian of the security. The surety, if he satisfies the principal's duty to the creditor, may be subrogated to the creditor's interest in the security in the same way as if the security were held by the creditor (see § 141).

Illustrations:

1. S is surety in the sum of \$ 4000 on a debt of \$ 5000 due by P to C. P gives S security expressly to secure his debt to C. P defaults, and S pays C \$ 4000. S is not entitled to reimburse himself out of the security until C is fully

paid.

Comment on Subsection (1):

b. Rationale. The essential purpose of suretyship is security for the creditor. Even where the principal in terms gives the security for the protection of the surety, without mention of the creditor, the creditor at once has an interest in the security. It is immaterial that the creditor has no knowledge of the existence of the security. Viewing the suretyship relation as a whole, the principal's dealings with the surety must be interpreted in the light of the fact that the basic duty of the principal is to see that the creditor is satisfied. If the principal gave security to the surety which was unavailable to the creditor, even if there were no fraudulent conveyance, this would be inconsistent with the duty of both the principal and the surety to the creditor. It would diminish the assets of the principal which might otherwise be available to enable him to satisfy his duty to the creditor, and at the same time would enable the surety to withhold the security from the creditor at a time when the principal's duty to the creditor was unsatisfied. Where the creditor has not required property security in addition to the surety's obligation, the principal remains in control of his property so long as he does not make a fraudulent conveyance. He can therefore secure his duty of exoneration or reimbursement. Where he has once allotted part of his property to the particular debt either by giving it to the surety or creditor, the principal cannot obtain a return of the property without satisfying this obligation to the creditor unless the other parties both agree to the return. One consequence of recognizing that the creditor has an interest in the security is that the creditor may obtain the assistance of a court of equity to prevent the surety from releasing the security at a time when either the surety or the principal or both may still be solvent. In such a case the basis of equity jurisdiction is inadequacy of the legal remedy. The creditor can show no present damage, and in any event, in an action at law, the creditor would have no rights substantially greater than he already has against the surety and principal.

Illustrations:

2. S is surety to C on a debt due C by P. S has received security from P for the stated purpose of securing P's duty of reimbursement. C knows nothing of the security at the time it is given. Subsequently, when S is about to release the security to P, C learns of its existence. Neither S nor P is insolvent and P's performance is not yet due. C can enjoin S from releasing the security. If S releases the security to P before C can prevent such action, C can nevertheless assert his security interest against P and others, except bona fide purchasers for value, subject to the rules in respect of negotiable instruments and recording statutes, and also subject to rules pertaining to the type of security in question.

Comment on Subsection (1), Clause (b):

c. Where the surety fully satisfies his duty to the creditor, the surety may utilize the security for his own reimbursement. By hypothesis, this is a purpose for which the security has been given to the surety. If the surety's performance also satisfies the principal's duty, the surety is subrogated to the position of the creditor, see § 141. It should be noted that the surety may be entitled to reimbursement if he completes the satisfaction of his duty after the principal himself has partially performed.

The situation occasionally arises where the surety is only obligated for part of P's duty to the creditor, or where the principal's duty is to be performed in installments and default on one installment does not accelerate the time for performance of the remaining installments. In either case the surety may fully perform his own duty although part of the principal's duty is still unperformed. The creditor's position is not so far superior to that of the surety that the surety should be denied reimbursement where the surety has satisfied his own obligation. The surety may therefore reimburse himself from security in his control whenever he has fully performed.

Illustrations:

3. S is surety for \$ 1000 to C on P's debt of \$ 1500. P pledges to S chattels worth \$ 1000. P defaults, and S pays C \$ 1000. S may reimburse himself.

4. S is surety to C on P's debt of \$ 5000 to C payable in semi-annual installments of \$ 1000 without acceleration. S has security from P, valued at \$ 3000. P defaults on the first installment and S pays this amount to C. S is entitled to be reimbursed from the security for his payment of \$ 1000.

d. Where the surety is insolvent, the creditor is in a position of one having security for the surety's obligation. The security must be used first to satisfy the surety's duty. If there is any excess, the excess belongs to the creditor where the principal's duty is greater than the surety's duty. The rule stated in this Subsection finds its chief practical importance where both surety and principal are insolvent and their estates are being administered in bankruptcy or other insolvency proceedings. If the rule were that the security was only for the surety's reimbursement and that the creditor was not regarded as secured, the creditor could file only a claim for the amount of the surety's obligation, and the surety's trustee in bankruptcy could reimburse himself for the amount of dividends paid.

Since the surety's right of reimbursement from the security for the amount of dividends would become a further asset of the estate, in which the same creditor, until he has been paid in full, would share ratably, no part of the security could be returned to the estate of the principal for distribution among the latter's general creditors until the particular creditor was paid in full.

Illustrations:

5. S is surety on a debt due by P to C. P gives S security for the stated purpose of securing his duty of reimbursement to S. S and P become bankrupt at a time when P's trustee in bankruptcy cannot avoid the security transaction as a preference. The security is available to satisfy C's claim.

e. Where the principal fully satisfies his own duty, the creditor has no further interest in security held by the surety. Since the principal's performance also discharges the surety (§ 115), the principal is entitled to the return of the security.

Comment on Subsection (1), Clause (c):

f. The theory of the rule stated in this Subsection is that the security given by the principal to the surety is security not only for the duty of the principal to the surety but also is security to the creditor for the duty of the principal and of the surety. Taking the relationship as a whole, the security is to satisfy the ultimate liability. The discharge of either the surety alone or the principal alone does not afford a basis for the surrender of the security. The creditor has an interest in the security unless both surety and principal have defenses which discharge their duties. It is not enough that a procedural bar exists to the enforcement of the duties of the surety and the principal; the defenses must be such as to discharge the duties. Since, however, the creditor's claim to an interest in the security is equitable, the creditor may be barred by laches from obtaining any advantage from the security.

Illustrations:

6. S is surety to C on a contractual obligation of P to C. S holds security from P. C's conduct towards P excuses P from performance. S is discharged as a result of P's non-liability. C has no interest in the security held by S.

7. S is surety to C on a debt of P to C. P gives S security for the latter's protection. P is discharged in bankruptcy. C's interest in the security is unaffected by the discharge of P.

8. Same facts as Illustration 7, except that S and not P is discharged in bankruptcy. C can require S's trustee in bankruptcy to apply the security to his claim.

Comment on Subsection (2):

g. Where the surety receives security from a person other than the principal, whether or not the creditor has an interest in the security depends upon the terms under which the security is given. The owner of the security, being

under no existing duty to the creditor, may if he desires, create a trust for the benefit of the creditor or make a contract for his benefit. In such a case the creditor will have the usual position of a trust beneficiary or a third party beneficiary under a contract. If the security, however, is designated as being for the benefit of the surety without reference to the creditor, the creditor can reach the security only by the judicial proceedings which would enable any creditor to reach an asset of his debtor. For example, after a judgment, with execution returned unsatisfied, the creditor might reach the asset by a creditor's bill. If the security were surrendered when the surety was insolvent, the surrender might amount to a fraudulent conveyance.

Illustrations:

9. S is surety to C for P on a debt of P to C. P's father pledges securities to S to secure S from loss on his obligation. S, while solvent, surrenders the securities to the owner. C cannot prevent this surrender.

10. Same facts as Illustration 9, except that the father also stipulates that the securities are to secure the payment of P's debt to C. C can enjoin the surrender of the securities.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawSecured TransactionsDefaultCreditor ObligationsEstate, Gift & Trust LawTrustsGeneral Overview



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Restat 1st of Security, § 141

§ 141 Subrogation

Where the duty of the principal to the creditor is fully satisfied, the surety to the extent that he has contributed to this satisfaction is subrogated

- (a) to the rights of the creditor against the principal, and**
- (b) subject to the rule stated in Clause (d), to the interests which the creditor has in security for the principal's performance and in which the creditor has no continuing interest, and**
- (c) to the rights of the creditor against persons other than the principal whose negligence or wilful conduct has made them liable to the creditor for the same default, and**
- (d) to the rights of the creditor against cosureties and to the creditor's interest in security held by them, but in such case the cosurety's personal liability is limited to the amount which will satisfy his duty to contribute his share of the principal's default.**

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Subrogation. Subrogation is a term describing the equitable remedy by which, where the property of one person is used to discharge a duty of another or a lien upon the property of another, under such circumstances that the other will be unjustly enriched by the retention of the benefit thus conferred, the former is placed in the position of the obligee or lienholder. See *Restatement of Restitution*, § 162. Subrogation is based on general principles of justice and does not spring from contract although it may be confirmed or qualified by contract. It is a mode which equity adopts to compel the discharge of a debt by the one who in good conscience ought to pay it. As applied to suretyship, subrogation denotes that the surety, upon performance, is placed in the position of the creditor both in respect of the creditor's right against the principal and of security held by the creditor. The surety also, subject to equitable limitations succeeds to the creditor's rights against others than the principal who may be liable for the principal's default. Where the surety performs so that he satisfies the duty of the principal to the creditor, or where a combination of performance by principal and surety satisfies the principal's duty, the principal's duty although discharged so far as the creditor is concerned, is kept alive against the principal or, subject to equitable limitations, against others, for the benefit of the surety. Equity, in effect, creates in the surety who has performed, rights similar to those of the creditor before the duty to him was discharged. This is sometimes called an assignment by operation of law. It does not depend upon an actual assignment, however, although where necessary to give the surety procedural or other advantages, the creditor can be

required to make an assignment.

Subrogation, as a creation of equity is subject to the limitation that it will not be allowed where it will prejudice the creditor or be inequitable to third persons. Like other forms of equitable relief it may be lost by laches.

Illustrations:

1. P owes C \$ 1000 secured by a chattel mortgage on P's motor car. S is surety to C. P defaults, and S pays C \$ 1000. S is entitled to the mortgage.

2. P owes C \$ 1000 for which S is surety. P defaults, and C obtains a judgment against him. S pays C the amount of the judgment. S is entitled to enforce the judgment against P.

3. P owes C \$ 5000. S is surety to C. P makes a fraudulent conveyance of land and defaults. C brings a creditor's bill against P. S pays C the amount of C's claim. S is entitled to proceed under the creditor's bill against P.

Comment on Clause (a):

b. The rule stated in Clause (a) refers to the principal in the suretyship relation and not to other persons who may be in the relation of principal to the creditor, even if in connection with the same obligation but whose duty is not guaranteed by the surety.

c. The surety's subrogation to the rights of the creditor entitles the surety to priorities and other advantages of the creditor. Thus a surety for government is entitled to the governmental preference; a surety for wage earners is entitled to their priority in an insolvency administration; and a surety for a trustee is entitled to any advantage belonging to a beneficiary. The surety by subrogation is also generally allowed remedial advantages connected with the creditor's right, but there are some situations particularly where a governmental unit is a creditor where the nature of these advantages is such that they belong exclusively to the creditor. For example, the immunity of government from requirements as to time of filing claims in insolvency proceedings, or the remedy of summary execution sometimes accorded the state in connection with tax claims do not pass to the surety by subrogation.

Illustrations:

4. S is surety for a building contractor to laborers employed by the contractor. The contractor becomes insolvent. The laborers by statute are preferred creditors. S pays the amount due the laborers. He is entitled to their preferences in the insolvency proceedings.

5. S is surety for a State's deposit in a bank. The bank is closed because of insolvency. In the jurisdiction the State is a preferred creditor. S pays the State the amount of its deposit. S is entitled to the State's preference in the insolvency administration.

6. S is surety for a trustee who embezzles funds belonging to the beneficiary. S pays the beneficiary the amount of the loss. Part of the embezzled funds can be traced in the estate of the trustee. S is subrogated to the beneficiary's right to trace the embezzled funds.

7. S contracts to indemnify C against loss due to the torts of third parties. C suffers loss from the negligence of P. S is subrogated to C's right against P.

8. S is surety to C on a promissory note due January 1, 1935, signed by P. In the jurisdiction, S's right of action for reimbursement is barred after three years, but action on a promissory note is not barred for six years. P defaults, and S pays C the amount of the note at maturity. Four years after payment, S can recover from P by subrogation to C's right on the note.

d. Surety's claim against bankrupt principal. Under the federal Bankruptcy Act, § 57 (i), as in force January 1, 1941, where the creditor fails to file and prove his claim against the principal, the surety may file the claim in the name of the creditor, and if the surety discharges his undertaking in whole or in part, he is subrogated to that extent to the right of the creditor.

Comment on Clauses (a) and (b):

e. The surety is not subrogated to the right of the creditor nor to the creditor's interest in security so long as the creditor still has a continuing interest in the right or in the security. The creditor may have such a continuing interest, especially in security, where the security has been given to secure another duty besides the one guaranteed by the surety, or where the surety has only guaranteed part of the principal's duty. The surety in such cases is subrogated only after every duty protected by the security has been fully satisfied. If there are two duties and the principal satisfies one, and the surety satisfies another, or if complete satisfaction occurs with a partial performance by the principal and the satisfaction of the remainder of the duty by the utilization of part of the security, the surety is subrogated.

Illustrations:

9. S is surety for P on a building contract P has made with C by which S's obligation is limited to \$ 50,000. By the terms of S's obligation he is bound not only to C but also to materialmen and laborers in connection with P's contract. P completes the work for C with an unpaid balance of \$ 25,000 due from C and with debts to materialmen of \$ 60,000. S pays \$ 50,000 to the materialmen. S is not subrogated to the amount due from C until the balance due the materialmen has been paid.

10. P owes C \$ 3000 and \$ 2000. S is surety for only the \$ 3000 obligation. P has given C a mortgage securing both debts. P defaults, and S pays C \$ 3000. S is not subrogated to the mortgage until C has realized \$ 2000 out of it.

11. P owes C \$ 5000 for which S is surety. The debt is secured by a pledge of bonds. P pays C \$ 3500, and S pays \$ 1500. S is subrogated to C's interest in the bonds.

12. P owes C \$ 5000 for which S is surety. P also owes C \$ 5000 upon which S is not surety. P pledges bonds worth \$ 6000 to C as security for both debts. P defaults, and S pays C \$ 5000. S is not subrogated to the security until the other obligation is paid.

13. Same facts as Illustration 12, except that P pays C \$ 4000 on the debt for which S is surety, and C realizes \$ 1000 by the sale of some of the bonds, which he applies on the secured obligation. S is subrogated to C's interest in the remaining bonds.

f. Where there are different sureties for different obligations of the principal to the same creditor, and the creditor also has other security for all the principal's obligations, each surety after the creditor is satisfied is subrogated to the creditor's interest in the security and also to the creditor's rights against the other sureties, but in the latter case the surety's right against the other sureties is determined by the rules of cosuretyship. The distribution of the security is governed by the amount of the principal's obligation which is guaranteed. (See § 146, Comment c; § 149, Comment d; § 154 (3).)

Illustrations:

14.1> pays C \$ 5000, S is subrogated to C's original right against S, but his remedy is limited to \$ 2500.

Comment on Clause (b):

g. The surety's right to be subrogated to the security held by the creditor from the principal is not affected by his ignorance of the existence of the security at the time he became a surety, nor by the fact that the security came to the

creditor after the surety's obligation was undertaken.

Comment on Clause (c):

h. Where others than the principal and the surety are liable to the creditor for the principal's default, and the surety has satisfied the duty of the principal, the surety is subrogated to the creditor's rights against the others, if and to the extent that such subrogation is equitable, taking into account the position of the creditor and that of the others. The circumstances where others may have a liability to a creditor for the principal's default are of infinite variety. The rule stated in Clause (c) is limited to the situation where a person by negligence or willful conduct shares responsibility for the principal's default and thus contributed to the cause of the surety's liability. The rule so stated does not carry the negative inference that there are not other cases where the surety is subrogated either to the creditor's entire right against others or to the extent that the surety can compel contribution.

Illustrations:

16. P is an employee of C for whose fidelity S is surety. T induces P to embezzle funds from C, which are lent to T. S pays C the amount of P's defalcation. S is subrogated to C's rights against T.

17. P is an employee of C, for whose fidelity S is surety. C has an account with the T bank to which he gives the names of the only employees who are authorized to make deposits and withdrawals. P is not one of such employees. P appears at the bank with a number of negotiable instruments which as known to the bank, belong to C. P states he has been authorized to collect them in cash. Although this is an unusual procedure the bank without any inquiry under circumstances clearly negligent cashes the items for P, who dissipates the proceeds. S pays C the amount of P's defalcation. S is subrogated to C's rights against the bank.

Comment on Clause (d):

i. The surety who satisfies the principal's duty may be subrogated to the creditor's rights not only against the principal but to the creditor's right against cosureties and to the creditor's interest in security held by cosureties. In the enforcement of the creditor's right the surety's recovery is limited to the cosurety's contributive share. See as to the creditor's interest in a surety's security, § 140, and as to the surety's duty of contribution, § 149.

Legal Topics:

For related research and practice materials, see the following legal topics:
Contracts LawSecured TransactionsDefaultCreditor Obligations



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Restat 1st of Security, § 142

§ 142 Application of Payments to Creditor

Where the creditor has claims against the principal other than that upon which the surety is bound, payments to the creditor are applied according to the following rules:

- (a) Subject to rules stated in Clauses (c) and (d), where the principal makes a payment from his own funds, the creditor must apply the payment in accordance with the intention manifested by the principal at or before the time of payment; or
- (b) if the principal makes no such manifestation, the payment will be applied in accordance with the intention manifested by the creditor within a reasonable time after the payment;
- (c) where the principal makes a payment with funds obtained from the surety or on the credit of the surety for the purpose of making payment on the debt for which the surety is bound, the payment, irrespective of the principal's directions, must be applied by the creditor to the satisfaction of his claim against the principal for which the surety is liable, if the creditor knows of the source of the principal's payment either at or before the time of payment, or subsequently before the creditor has changed his position;
- (d) where a principal makes a payment to a creditor with funds arising out of a contract for which the surety is bound, the rules as to the application of payments are not affected by the fact that the creditor is aware of the source of these funds, unless the principal has contracted with the surety as to the application of such funds and this fact is known to the creditor;
- (e) where neither the principal nor the creditor seasonably manifests an intention as to the application of a payment, the payment is applied in the way most favorable to the creditor, unless under the circumstances such an application would violate a right of the surety, the principal, or another to a more equitable application.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. Rules as to applications of payments to different debts are stated in the Restatement of Contracts, §§ 387 to 394.

b. Performances other than the payment of money rarely present questions as to their proper application, and are

not considered in connection with the rules stated in this Section. See Restatement of Contracts, § 387, Comment *b*.

Comment on Clause (a):

c. The rule stated in this Clause refers to funds entirely within the control of the principal and in respect of which he is under no duty as to their disposition. He may even use them to make a gift, assuming that he is not thereby making a fraudulent conveyance. The principal therefore has an uncontrolled discretion as to the application of a payment.

Comment on Clause (b):

d. The principal cannot control the application of a payment unless he manifests an intention when or before the payment is made. If he manifests no intention it is presumed he assents to such application as the creditor cares to make. The creditor may even apply the payment to a debt unenforceable because of the running of the Statute of Limitations or because of the lack of a memorandum satisfying a Statute of Frauds. The creditor, however, can apply the payment only to a matured debt. See Restatement of Contracts, § 487, Comment *g*. While the creditor has the privilege of applying a payment from the principal, in the absence of a direction from the principal, he must make some disposition of the payment within a reasonable time. If he does not do so, the rule stated in Clause (e) applies.

Comment on Clause (c):

e. The principal may obtain funds from the surety or on the surety's credit. For example, the surety may lend the principal money to pay the debt, or for the same purpose sign an accommodation note for the benefit of the principal. In such a case, the creditor, if he knows the facts, cannot apply the payment to another debt, even if the principal so directs. The situation is substantially the same as if payment had been made by the surety to the creditor. Even if at the time of payment the creditor is not aware of the source of the funds the creditor must apply the payment in accordance with the surety's intention when he learns of it, unless he has changed his position before obtaining this knowledge.

Illustrations:

1. P owes C two debts of \$ 1000 each, upon one of which S is surety. Both debts have matured. S, to the knowledge of C, gives P \$ 1000 to pay the debt upon which S is bound. P pays C \$ 1000 without any direction as to application. C must apply the payment on the debt for which S is bound.

2. Same facts as Illustration 1, except that P tells C to apply the payment on the other debt. C must apply it to the debt for which S is surety.

3. Same facts as Illustration 2, except that C does not know that P has received the money from S. Three days later, before C has changed his position, he learns the source of the funds. C must change the application of the payment to the debt for which S is surety.

4. P owes C two debts of \$ 1000 each, represented by promissory notes. On one D is an indorser; on the other S is surety. S, to enable P to raise money, indorses for P an accommodation note to a bank upon which P obtains \$ 1000. P pays \$ 1000 to C, directing him to surrender the note upon which D is indorser. The payment is made on the date of maturity. C surrenders the note to P. Several days later, S notifies C that P has obtained the money on S's credit and requests that C return the note for which S is surety. Since C has changed his position without the knowledge of the facts, the first application of the payment need not be altered.

Comment on Clause (d):

f. Where the creditor has several claims against a principal upon one of which there is a surety, the creditor occasionally knows that the payment made by the principal arises out of the contract upon which the surety is bound,

although there is no specific agreement between the principal and surety as to the application of the principal's payments. (See Clause (a).) For example, a materialman may furnish supplies to a building contractor engaged in several enterprises, on one of which he has a surety who is bound to the materialman as well as to the owner of the building. The owner of the building during the progress of the construction makes payments to the contractor. The funds thereafter belong to the contractor. He can use them for personal expenses, or otherwise as he desires. If he pays the materialman with a direction as to the application of the payment, this direction must be followed unless the materialman knows that the contractor has agreed otherwise with the surety. If he manifests no intention as to the application of the payment, the materialman may apply the payments to any matured debt in the absence of knowledge that the contractor has a duty to require some other application. The contractor may contract specifically with the surety that money paid him on one contract shall be used only for the payment of materials and labor for that operation. If such a contract is made and this fact is known to the materialman, he is bound by his knowledge of the interest of the surety in such payments. In such a case the payments received by the materialman must be applied to his account growing out of the enterprise in connection with which the surety is bound, regardless of directions by contractor to the contrary.

Illustrations:

5. P contracts with C to erect a building. S is surety under a contract by which S is bound not only to C but to materialmen who furnish supplies for the building. M, a materialman, sells cement on credit to P, by different contracts for use in several building operations. C makes a part payment by check to P. P indorses the check to M and directs that it be applied to an account for which S is not bound. M must follow P's direction although he knows the source of the payment.

6. Same facts as Illustration 5, except that P makes the payment to M unconditionally. M may apply the money to any matured debt.

7. P contracts with C to erect a building. S is surety for P on a contract binding him to C and to materialmen. P contracts with S that all payments received from C will be applied first to outstanding matured accounts for materials. A copy of this contract is given M, who supplies P with materials for various construction enterprises. C makes a payment to P by check, who turns it over to M, who knows that it is a payment by C on the contract for which S is surety. M must apply the payment to the account for materials on this building operation.

Comment on Clause (e):

g. The rule stated in this Clause is substantially that stated in the Restatement of Contracts, § 387 (c) as amplified in § 394. Where there is a controversy as to application of a payment and it is shown that the debtor has given no directions and the creditor has manifested no intention after a reasonable period, the payment will be applied as seems most equitable under the circumstances. A payment is generally applied in the way most favorable to the creditor. The most favorable application will not be made if the creditor could not himself have made such an application or if the debtor is under an immediate duty to a third person to pay one debt rather than another. The existence of security in which others are interested may also, under the rules of marshalling, affect the application of payments.

Among the applications most favorable to the creditor which will be made unless the debtor is under an unmistakable duty to pay some other debt, are applications to the earliest matured debt, to overdue interest rather than to principal, and to an unsecured and precarious debt rather than one unsecured and certain of payment. Where there is no ground for differentiating matured debts and no interests of third parties are involved, a payment not applied by either debtor or creditor is applied ratably to all matured debts. See Restatement of Contracts, § 394 and Comment *a*.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawTypes of ContractsGuaranty Contracts



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Rules and Principles

Division 2 - Suretyship

Chapter 5 - Surety and Creditor

Restat 1st of Security, § 143

§ 143 Creditor's Payment of Own Debt to Principal: Effect on Surety's Obligation

Where the creditor is indebted to a principal whose duty to the creditor is secured by the obligation of a surety, payment by the creditor of his indebtedness to the principal before or after maturity of the principal's duty does not discharge the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. A debtor, if he desires, may pay a creditor even if this creditor is also his debtor, for whom a surety is bound, unless the surety's obligation contains a stipulation that the creditor must avail himself of any right of set-off which he may have. Mutual debts do not cancel each other automatically, even if they have matured. The rules of set-off are rules of law administration by which in various proceedings, especially those connected with insolvency, parties can be permitted or required to balance mutual debts.

The rule stated in this Section has its chief practical application in the case of a bank depositor indebted to a bank on an obligation secured by a surety. While the bank may have the power to set off the debtor's deposit, it has no duty to do so. The surety is not discharged even if the depositor has funds on hand at the maturity of the obligation and is later permitted to withdraw them.

b. The rule stated in this Section does not apply where the principal has directed the creditor to apply funds in the creditor's control to the principal's indebtedness. The making of a negotiable instrument payable at a bank is regarded as a direction to the bank to pay the note out of the debtor's deposit. Where an instrument upon which a principal is bound is payable at a bank, and the depositor has funds sufficient to meet the note at maturity, the surety is discharged. Where a depositor after making an instrument payable at a bank has on deposit funds sufficient to pay the note, this is equivalent to tender. (See as to the effect of tender on a surety's obligation, § 116. See also Uniform Negotiable Instruments Law, § 70.)



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Division 2 - Suretyship

Chapter 6 - Cosuretyship and Subsuretyship

Restat 1st of Security, § 144

§ 144 Cosuretyship Defined

Cosuretyship is the relation between two or more sureties who are bound to answer for the same duty of the principal, and who as between themselves should share the loss caused by the default of the principal.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rules of cosuretyship, like those of other phases of suretyship, are chiefly rules which are, or at least originated, as rules of equity, and which determine the rights and duties between two or more sureties where these rights and duties have not been settled by contract between the sureties. For the relation to be one of cosuretyship, aside from a contract to such effect, one must find a duty of a principal for which two or more sureties are bound in circumstances that it is equitable for the several sureties to share the burden rather than for the whole burden to be imposed on less than all of them. Cosureties are often bound jointly, jointly and severally, or severally on the same instrument, but sureties may also be cosureties where they are bound on different instruments and where their obligations arise at different times. They may not know of each other's existence at the time of undertaking their obligations. They may even be bound originally for different principals, if in the final analysis the relation of the principals is such that both sureties are bound for the same duty, see § 147. Cosureties are usually bound for the same amount, but they may still be cosureties where bound for different amounts if the final solution is a sharing of the burden.

Contrasted with cosuretyship is subsuretyship, in which ultimately at least one surety is entitled to have the other sureties bear the entire burden. See §§ 145, 146, 147.

Illustrations:

1.1> are cosureties.



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Restat 1st of Security, § 145

§ 145 Subsuretyship Defined

Subsuretyship is the relation between two or more sureties who are bound to answer for the same duty of the principal where one, the principal surety, in respect of the other, the subsurety, has the whole duty of performance.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Incidents of subsuretyship. Suretyship in its simplest form is a tripartite relationship involving a principal, a creditor, and a surety, see § 82. Where there are two sureties, the usual relation is cosuretyship, but by agreement between them or because of the equities of the situation, one of them as between themselves, may be liable for the entire loss caused by the default of the principal and hence not a cosurety. Where this is true, there are two interlocking tripartite relationships. The creditor has two sureties for his principal, but between the sureties one of them is a principal and the other a surety, that is, the former rather than the latter should perform. The former is a surety as to the principal debtor but is a principal as to the other surety. In view of the dual position of the former, he is called the principal surety. The surety to whom the principal surety is in the relation of principal is the subsurety.

The rules governing the relation of principal and surety as stated in Chapter 4, are applicable to the relation of principal surety and subsurety. The most important incident of the relation is that if the subsurety performs he is entitled to reimbursement from the principal surety. If the principal surety performs, he is not entitled to contribution from the subsurety.

b. Subsuretyship may involve not only two but also any larger number of sureties. There may be one principal surety and two or more subsureties, or two or more principal sureties and one subsurety, or two or more of each. If, for example, there are two of each, one group is collectively principal surety, and the other subsurety. In such cases the sureties in each group in respect of each other will generally be cosureties although it is also possible to have a subsurety relation within a group which as to another group is either principal surety or subsurety.

c. The creditor may assume that all sureties are cosureties unless he has knowledge to the contrary. Just as in the case of apparent coprincipals, one of whom is in fact a surety, where the creditor is not affected by incidents of

suretyship unless and until he has knowledge of it (§ 114), so in the case of subsuretyship, the creditor cannot equitably be required to take account of the relationship until he knows of it. Where he does have such knowledge, the creditor's dealings with the principal surety will affect the subsurety's liability in the same way as his dealings with a principal will affect the surety in a single tripartite relationship. For example, if a creditor refuses a tender from a principal surety, extends time to him, or releases him, the subsurety will be discharged, as will be true where a creditor refuses a tender from a principal, gives him an extension of time, or releases him. (See §§ 116, 122, 129.) Where the sureties are cosureties, the creditor's dealings with one do not affect the liability of the other so long as these dealings do not concern more than the contributive share of the surety with whom the creditor is dealing, see § 135.

Illustrations:

1.1> is discharged.



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Restat 1st of Security, § 146

§ 146 Determination of the Relation Between Sureties

Where there are two or more sureties for the same duty of the principal, the following rules are applicable to the determination of the relation between themselves:

- (a) The sureties may conclusively determine their relation by agreement.**
- (b) The sureties are cosureties in the absence of agreement or stipulation of either to the contrary or of duties or equities imposing the principal liability on one of them.**
- (c) A surety is a subsurety if he has so stipulated and is not under a duty to assume a greater liability, except to the extent that his stipulation will inequitably increase the obligation of another surety.**

COMMENTS & ILLUSTRATIONS: *Comment on Clause (a):*

a. Agreement between two sureties will control their relation so far as their mutual rights and duties are concerned. While circumstances in the absence of agreement will determine relational rights and duties, there is no policy of the law which prevents their making a conclusive determination as to whether they are cosureties, or one a principal surety and the other a subsurety. They may agree although cosureties to share the possible burden on some other basis than that of strict proportionate contribution.

The agreement controlling the relation of sureties may be written or oral. The Statute of Frauds is not applicable as it is in many cases to the promise of a surety to the creditor (§§ 89-100). The oral promise of a surety to another concerns a relation arising by operation of law. The parol evidence rule also is not violated since it affects not the integrated obligation to the creditor but only the relation of the sureties. The question of the parol evidence rule would arise only if the sureties had executed a written agreement integrating their understanding as to their relationship.

Comment on Clause (b):

b. Rationale. Where two persons are bound to a common duty and there is nothing in an agreement, stipulation, or the nature of the transaction from which to determine their mutual liability, the equitable conclusion is that they share the burden. Between themselves they are liable equally if they are bound in the same amount; liable in a proportion

mathematically computed if they are bound in different amounts. Applying this principle to the relation of two or more sureties, they are assumed to be cosureties unless there is some positive reason for making one a principal and the other a subsurety. Aside from agreement and stipulation, the relations of the several sureties to the transaction may be such as to require that one surety be a principal surety and another a subsurety. One surety may have such a business interest in the transaction that he will be the principal surety to another surety. See Comments *f* and *g*. Typical instances where circumstances make the relationship of several sureties subsuretyship rather than cosuretyship are stated in § 147.

Illustrations:

1.1> is a subsurety and S a principal surety.

c. Where a principal has separate duties to the creditor, with separate sureties, the sureties are neither cosureties nor related as principal surety and subsurety. They may, however, have a common interest in security, subject to the interests of the creditor, if the principal has secured his several duties with the same security, see § 141 (b) and § 149, Comment c. Where, however, the principal's several obligations are to secure another duty so that in fact the sureties are bound for the same duty of the principal, there may be either cosuretyship or subsuretyship taking into account the circumstances. The legal effect is the same as if there had been one undertaking by which all the sureties joined with limitation on the liability of each surety. This is true whether the separate undertakings are for the same or different amounts.

A typical situation of cosuretyship, although there are separate undertakings of a principal with different sureties, arises where a public or corporate officer is required to furnish a fidelity bond in a certain amount, with two sureties, and instead he furnishes two bonds aggregating the total amount with a different surety on each bond. If there is a default and one surety pays, the other is entitled to contribution. See as to computation of contribution, § 154.

The equities of the sureties are not equal and their relation is subsuretyship rather than cosuretyship where one surety has undertaken a general obligation against defaults of the principal while the other surety has undertaken an obligation in respect of specific defaults, and the specific default occurs. (See § 176.) In such a case, the surety against the specific default is the principal surety and the general surety the subsurety. The relationship is likewise subsuretyship where the sureties are bound in respect of defaults in two funds both under control of the principal, and the principal is guilty of two defalcations, the second of which is to cover the first by the transfer of assets from one fund to another. In such a case the surety for the first fund is the principal surety and the second surety a subsurety. See §§ 178, 179.

Illustrations:

2.1> is principal surety and S subsurety.

Comment on Clause (c):

d. Where there is no agreement between sureties and no controlling equity from the nature of the transaction or the relation of the sureties, an important method of creating subsuretyship is by a stipulation of a surety. This stipulation is not a condition of the surety's contract with the creditor and has no effect on his obligation to the creditor except that to the extent that the creditor knows of the relationship between the sureties, he must take account of it in his dealings with them (§ 114). The stipulation of a surety, like an agreement between sureties, may be written or oral. If one who is asked to sign as surety is under no duty to do so and there are no circumstances requiring him to be cosurety or principal surety if he undertakes an obligation, he may determine his relation to another surety according to his own desire. Hence he may assume the position of subsurety rather than cosurety by any appropriate manifestation of intent to bind himself in this capacity.

Where one surety has already signed, knowledge on the part of the subsequent surety that the former has signed as surety does not prevent the latter from stipulating that he is to be surety for the former surety. The addition of the word

"surety" after a signature may be considered with other evidence to establish subsuretyship. The mere addition of the word "surety" after the signature of one surety will not make him a subsurety to another surety on the same instrument if the one adding the designation knew the other was a surety. A phrase such as "surety for the above names," however, indicates an intent not to be a cosurety with anyone who has signed above the signature of the one so signing.

Illustrations:

4.1> is subsurety if there are no contrary circumstances affecting the relation.

e. Antecedent agreement. A stipulation by a surety may be a nullity because of a prior agreement between the sureties. For example, if one person agrees in advance with another to be a cosurety if the former undertakes a certain obligation, the latter upon signing his own obligation cannot assume the position of subsurety by making a stipulation to this effect. The equities of the parties make them cosureties.

f. Nature of the transaction. The nature of the transaction may manifest an intent by the subsequent surety to be bound as a subsurety and have the same effect as a stipulation to that effect. One who executes a guaranty of collection of a note signed by a principal and surety, clearly manifests an intent to be a subsurety to the first surety and will hold this position in the absence of other circumstances which affect the relation. The same is true of a guaranty of payment of such a note, the manifestation in such a case being clear although not so explicit as in the guaranty of collection.

Illustrations:

6.1> is a subsurety.

g. The effect of stipulations or the form of the transaction upon the relations of sureties must be considered in connection with the question as to whether one surety is already bound to the creditor at the time the second assumed his obligation, or whether the first surety has merely signed an instrument the binding effect of which depends upon the second surety's signature. The knowledge of the subsequent surety as to the intention of the first surety is also significant. The fact that the first surety has stipulated that the second is to be cosurety with him, or has signed upon the principal's assurance that this will be so, will not prevent the second surety from becoming subsurety to the first if the latter does not know of the former's stipulation, even if the principal by fraud or negligence has failed to communicate the stipulation to the second. The second surety, however, is unable to take the position of subsurety to the first if he signs with knowledge of such a stipulation, assuming that the signature of the second makes that of the first a binding obligation. The second may refuse to be bound at all, but if he signs in the circumstances he becomes a cosurety. It is inequitable to allow the second surety to impose on the first a liability greater than the latter intended to assume.

If the first surety is already bound to the creditor and the second surety has no existing duty to the first surety in respect of their relations, the subsequent surety can conclusively stipulate as to the relationship.

If a second surety cannot make himself asubsurety by stipulation, he cannot do so by the mere form of the undertaking. For example, in such a case he cannot successfully maintain that the position of the signature makes him a subsurety.

Illustrations:

8.1> is principal surety because of the unequal equities involved.



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Chapter 6 - Cosuretyship and Subsuretyship

Restat 1st of Security, § 147

§ 147 Typical Instances of Subsuretyship

(1) Where a surety at the time of undertaking his obligation reasonably believes that another surety is a principal, the former is a subsurety.

(2) Where a surety assumes his obligation at the request of another surety who is already bound, the former is a subsurety.

(3) Where there are two principals with different sureties, and there is a default of one principal for which liability is also imposed on the other, the surety for the latter is a subsurety.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Rationale. The risk of a surety for more than one principal is less than that of a surety who is bound with another surety for a single principal. In one case if he performs, he is entitled to reimbursement from two persons. In the other case he is entitled to reimbursement from one but only contribution from the other. If a surety is responsible for another surety's having the reasonable belief that the former is a principal it is inequitable to make the relationship of the two sureties other than subsuretyship.

Where the subsequent surety knows that of two parties one is principal and the other surety, but reasonably believes that the surety is the principal and the principal the surety, it will vary the risk the second surety intended to assume to require him to be cosurety with the other who is in fact the surety. He may be willing to be cosurety with the one who is in fact the principal because he relies on the financial responsibility of the one whom he believes to be a principal. In such a case he may be indifferent to the responsibility of the supposed cosurety. On the other hand he may not be willing to assume even a partial responsibility for the person he believes to be a surety.

The creditor is not affected by the surety's belief as to the identity of the principal unless he is responsible for inducing the belief.

Illustrations:

1.1> is a subsurety and is entitled to reimbursement from S.

Comment on Subsection (2):

b. The Section covers the situation where the principal and surety are already under a binding obligation to the creditor before the obligation of the subsequent surety arises, as distinguished from the case where principal and surety have merely signed an instrument which is later to become binding on them. Where one person requests another to join him as surety, without any promise to save him from loss, or where the nature of the transaction does not require such duty on the surety making the request, the resulting relation between the sureties is cosuretyship. The bare request is nothing more than an invitation to join as cosurety. Where the first surety is already bound at the time of the request, he derives a special benefit from the other's promise and therefore is a principal surety unless the subsequent surety agrees himself to be bound as a cosurety or principal surety.

Illustrations:

4.1> a subsurety.

Comment on Subsection (3):

c. If either of two persons may be compelled to pay for what is actually the fault of one of them, the loss as between themselves should fall upon the one at fault. If each is a principal and the sureties are different the relation between the sureties is controlled by the relation between the principals. Hence the surety for the defaulting principal is the principal surety and the surety for the other principal is subsurety. (See § 174.)

Illustrations:

6.1>, surety on the deputy's bond.



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Restat 1st of Security, § 148

§ 148 Relation of Sureties as Affected by Position on Negotiable Instruments

Subject to the rules stated in §§ 146 and 147 in respect of stipulations and equities from the nature of the transaction, and in the absence of contrary agreement, the liability of accommodation parties on a negotiable instrument among themselves is the same as if they were not accommodation parties.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Any party to a negotiable instrument may be an accommodation party. Accommodation parties on negotiable instruments normally have the liability which is determined by their position on the instrument or in the case of successive indorsers by the order of time of indorsement. Thus comakers, coacceptors, codrawers, joint payees, and joint indorsees who indorse are presumably cosureties. An accommodation maker, accommodation acceptor, or accommodation drawer is presumably a principal surety to an accommodation indorser. Successive accommodation indorsers are presumably liable in the order of indorsement, the first in time being principal surety, and the one subsequent in time to him being subsurety.

b. While the Uniform Negotiable Instruments Law defines an accommodation party in § 29 and refers to him also in §§ 119 and 121, the relations among accommodation parties are not determined by the Negotiable Instruments Law but by the law of suretyship. Parol evidence is admissible to show not only the existence of accommodation parties but their mutual relations. (See § 146, Comment *a.*) Were such evidence not admissible, it would be impossible in most instances to prove even the fact of accommodation. That sureties have bound themselves on a negotiable instrument does not interfere with their privilege of showing their true relations among themselves. It is only in the absence of proof to the contrary that the law fixes their respective liabilities in accordance with their signatures on the instrument.

A surety who assumes an obligation on a negotiable instrument in a form that would otherwise result in cosuretyship with another, may by an appropriate stipulation written on the instrument or made orally to the creditor and the principal, or to either of them, and without agreement with the other surety, become a subsurety for him, in the absence of special circumstances requiring a different result, as stated in §§ 146 and 147. The qualifications mentioned in that section have the same force in limiting the effect of such stipulations in negotiable instruments cases as in other cases. Hence a second surety on a negotiable instrument cannot make himself subsurety by stipulation if he has agreed

with the other to be cosurety, or if he knows of a stipulation or understanding by the other that they are to be cosureties.

The equities between accommodation parties to a negotiable instrument may be so unequal that one will be principal surety and the other subsurety although there has been no agreement or stipulation to this effect and the position of the signatures tends to indicate cosuretyship, in accordance with the general statement of § 146.

The rule as to mistake stated in § 147 (1) applies to negotiable instrument cases as well as to other cases, and one may be a subsurety to another because he reasonably believes the other was a principal. That one surety signs a negotiable instrument at the request of another surety is insufficient to establish subsuretyship. (See § 147, Comment *b*.)

The mere fact that a subsequent accommodation party to a negotiable instrument knows that a prior party also signed for accommodation does not prevent him from relying upon the normal order of liability upon such instruments.

The problem of agreement between sureties has one peculiarity in the negotiable instruments cases. If the form of the signatures indicates cosuretyship the sureties may agree to a relation of subsuretyship. If the form of the signature indicates subsuretyship the parties may agree to a relation of cosuretyship. Hence by agreement the parties to a negotiable instrument may be cosureties although they are

1. Maker of a note and indorser;
2. Acceptor of a bill and drawer;
3. Acceptor of a bill and indorser;
4. Drawer of a bill and indorser;
5. Successive indorsers of either a note or a bill, including the case of an irregular indorser and a payee-indorser in spite of the provision in § 64 of the Negotiable Instruments Law that one not otherwise a party to the instrument who indorses a blank before delivery "is liable to the payee and to all subsequent parties."

c. An agreement to become accommodation parties to a negotiable instrument is in the absence of a contrary understanding an agreement to become cosureties. Hence if accommodation indorsers agree in advance to sign in this capacity, with no agreement as to the order of signing, they are cosureties.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsEnforcementDuties & Liabilities of PartiesTypes of PartiesAccommodated & Accommodation PartiesContracts LawNegotiable InstrumentsEnforcementJoint & Several InstrumentsContracts LawNegotiable InstrumentsNegotiationIndorsementAccommodation Indorsements



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Restat 1st of Security, § 149

§ 149 Contribution: General Rule

A surety who in the performance of his own obligation discharges more than his proportionate share of the principal's duty is entitled to contribution from a cosurety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Since the right to contribution results from the benefit which one cosurety has received as the result of another cosurety's performance, the right to contribution depends upon performance by one of more than his proportionate share. He cannot obtain contribution in advance of his own performance, nor when he has performed no more than his proportionate share. The amount of performance, if any, by the principal, is important in determining what is the proportionate share of cosureties. (See, as to what constitutes the proportionate share of a cosurety, § 154, and as to exoneration between cosureties, § 158. See also *Restatement of Restitution*, § 81, Comment *d.*)

b. The rule stated in this Section may be modified by the terms of a specific contract between the cosureties.

c. Compensated surety. The duty of contribution is not affected by the fact that one or more of the cosureties is a compensated surety.

d. Where the principal is under separate duties to the creditor and there are different sureties for the various duties, these sureties are not cosureties. The right of contribution is based upon the benefit which the performance by one surety affords to other sureties who are liable in connection with the same transaction or series of transactions. It should be noted, however, that when the principal has given the creditor security for several duties on each of which there is a surety, and if one surety satisfies the principal's duty as to one item so that the security is available to the creditor to reduce the amount the other sureties would otherwise have been compelled to pay, the surety who has paid is entitled to contribution from the other sureties to the extent of the benefit they have derived from his payment. (See *Restatement of Restitution*, § 81, Comment *c* and Illustrations.)

Illustrations:

1.1>.

e. A cosurety who has paid more than his proportionate share is also subrogated to the creditor's rights against the cosureties, provided the principal's duty has been satisfied, see § 141. The cosurety's right of recovery is, however, limited to the amount to which he is entitled as contribution.



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Restat 1st of Security, § 150

§ 150 Time When Right to Contribution Arises

The right of a surety to contribution from a cosurety does not arise until

- (a) the time for the surety's performance has arrived, and**
- (b) he has performed more than his proportionate share, and**
- (c) performance by the cosurety also is due**

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The time when the right to contribution arises is important not only in determining whether an action has been brought prematurely but also in fixing the time from which the Statute of Limitations begins to run. (See *Restatement of Restitution*, § 82.)

Comment on Clause (b):

b. What is the proportionate share of a cosurety is affected by the amount of performance of the principal. If, for example, there are two cosureties and after the principal's default, one pays his share of the total liability, he has no right of contribution so long as the principal makes no performance. If the principal then pays the balance due, the paying surety is entitled to recover half his payment from the cosurety.

Illustrations:

1.1> for § 250.



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Restat 1st of Security, § 151

§ 151 Contribution -- Statute of Limitations

The Statute of Limitations begins to run against a cosurety on his right of contribution in respect of any payment made by him, from the time at or after maturity when the payment is or becomes more than his proportionate share.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The right to contribution depends upon a cosurety's having paid more than his proportionate share in respect of other sureties, see § 149. The right may arise either because a surety has paid more than his proportionate amount due at the time of payment or because the amount paid is more than his share, taking into account subsequent payments by the principal, see § 150. At whatever time the right to contribution arises, the Statute of Limitations begins to run.

Illustrations:

1.1> for \$ 500. S can recover. His right of contribution arose on January 1, 1935, when his payment became more than his contributive share.

c. Where a surety has paid more than his contributive share in installments over a considerable period, the amount he can recover from a cosurety may be affected by the running of the statutory period of limitation of actions in respect of part or all of his payment.

Illustration:

3.1>.

Legal Topics:

For related research and practice materials, see the following legal topics:
GovernmentsLegislationStatutes of LimitationsTime Limitations



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Restat 1st of Security, § 152

§ 152 Contribution: Where Cosurety Has a Defense

Where a surety makes a payment to a creditor and a cosurety has a defense against the creditor, the surety making the payment

- (a) is not entitled to contribution if he has become surety without the consent of the cosurety;**
- (b) is entitled to contribution if he has become surety with the consent of the cosurety, and if he made the payment**
 - (i) in the discharge of his own duty to the creditor, or**
 - (ii) without knowledge of a defense in the justifiable belief that such a duty existed,**
 - or**
 - (iii) in response to a judgment after making a reasonable defense, and if the defense was also available to cosureties, where prior to the judgment he has notified such cosureties and given them an opportunity to assist in defending the action.**

CAVEAT: *Caveat:* The Institute takes no position as to whether, if the surety became subject to the obligation with the consent of a cosurety, he may not be able to obtain contribution from the cosurety in cases not covered by Clause (b).
Comment to the Caveat:

One case which may arise under the Caveat is where the payment is made under a business compulsion notwithstanding a defense. Under § 108 (1) (d) the surety who pays under business compulsion is allowed reimbursement from a principal who has a defense, even if the surety also has a defense. This is also the position taken in § 78 (b) (iv) of the *Restatement of Restitution*. The *Restatement of Restitution* (§ 83) does not mention payment by business compulsion as one of the grounds for enforcing contribution between two persons, neither of whom has a prior duty and both of whom have defenses. While no cases have been found on the point, the situation might arise where two sureties each have defenses, perhaps technical defenses like the Statute of Frauds or the Statute of Limitations, and one surety feels that he is under a business compulsion to pay notwithstanding the defenses.

Assuming that a surety who pays under business compulsion is entitled to contribution from a cosurety with a defense, it is not clear as to what form of business compulsion will be sufficient. It has been suggested that business compulsion should be recognized wherever the paying surety is maintaining his good will or preventing business

reprisals, as well as more extreme cases where assertion of certain defenses, such as the lack of a writing, might subject a surety asserting such defense to suspension or expulsion from some exchange or association.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This Section is an application of the rules stated in the *Restatement of Restitution*, § 83, which is applicable to cases in which a coobligor, whether cosurety or not, has a defense. Clauses (a) and (b) are identical in language with § 83 of the *Restatement of Restitution* except that they are restricted to suretyship and except that Clause (b) Subclause (iii) of the *Restatement of Restitution* includes a situation here omitted.

Comment on Clause (a):

b. Where one surety has become such with the consent of the other, the right of contribution can be based upon contract. Where there is no consent, the right of contribution depends upon the unjust enrichment. In the latter situation, if the cosurety has a defense against the creditor, he is not liable to the creditor and hence he is not relieved from any liability by a cosurety's payment. Consequently there can be no recovery based upon unjust enrichment of the cosurety. (See for the application of a similar rule in respect of reimbursement of the surety by the principal, § 104 (2).)

Illustration:

1.1> is not entitled to contribution from S.

Comment on Clause (b) (i):

c. The rule stated in this Subclause assumes an obligation of the surety to which there is no defense.

While the rule would apply if this duty were confirmed by judgment, it does not apply to a case where it can be shown that the duty arises only as a result of the judgment.

Illustration:

2.1>.

Comment on Clause (b) (ii):

d. The rule stated in this Subclause applies whether or not the paying surety knows of the defense available to the cosurety. The test is whether he is justified in believing and does believe that he himself has no defense. Knowledge by a surety of a defense available to a cosurety may be a factor to be considered in determining whether the surety was justified in believing that he himself had no defense.

Comment on Clause (b) (iii):

e. Where the surety knows that he has a defense which is available to the other cosureties, he should notify the other cosureties of any suit against him and give them an opportunity to assist in the defense. If he does so and judgment is obtained against him, he is entitled to contribution if he satisfies the judgment. If he does not, the other cosureties are not bound by the judgment, and it is open to them to show in an action for contribution that the surety was not obliged to pay.

Illustration:

3.1>.



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Restat 1st of Security, § 153

§ 153 Payment by Cosurety with Defense

Where a surety who has a defense against the claim of a creditor pays the creditor at a time when the cosurety is liable to the creditor, the paying surety is entitled to contribution from the cosurety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The fact that the surety who pays is in form obligated as a party to the transaction in which the principal's duty and the cosuretyship arise prevents him from being an officious intermeddler or volunteer, even if he has a defense at the time the payment is made. Since the rule as stated assumes that the cosurety is still liable to the creditor, the right to contribution exists whether or not the cosurety has consented to the other surety's becoming bound. Instances where such a payment might be made include cases where the surety who pays has the defense of the Statute of Frauds, the Statute of Limitations, a discharge in bankruptcy, or where the creditor has released the principal and has not reserved his rights against the surety who ultimately pays.

Illustration:

1.1>.



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Restat 1st of Security, § 154

§ 154 Computation of Contribution

(1) A surety who has discharged more than his proportionate share of the principal's duty is entitled to contribution from a cosurety

(a) who has consented to the surety's becoming bound, in the proportionate amount of the net outlay properly expended,

(b) who has not consented to the surety's becoming bound in the proportionate amount by which the cosurety has benefited by the performance.

(2) Where a surety is entitled to contribution, and contribution cannot be had from one or more of the cosureties because of insolvency, non-residence, or other circumstances, each of the remaining cosureties must contribute a proportionate amount of the loss so caused.

(3) Where a surety is secured by an interest in the principal's property, the existence of the security does not affect the duty of contribution of cosureties, but in the settlement of their liability to each other, each cosurety is entitled to an interest in the security proportionate to his liability for the principal's default.

(4) Where a surety has received contribution from a cosurety and subsequently is reimbursed in whole or in part by the principal, he is under no duty to share this payment with the cosurety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See Restatement of Restitution, § 85.

Comment on Subsection (1):

b. Consent of cosurety as affecting contribution. The surety seeking contribution from cosureties is entitled to an amount which will equalize the loss among those equally bound. Under the rule stated in Subsection (1) the amount of contribution may depend upon whether the cosurety against whom contribution is sought has consented to the other's becoming bound. Where a surety has simply discharged the debt and interest, and other sureties are similarly bound, it is immaterial whether the cosureties have or have not consented to the undertaking of the paying surety. Where

additional expenses have been incurred, such as the necessary costs of making a reasonable but unsuccessful defense, the purpose of which is to protect the cosurety also, the paying surety is entitled to contribution from cosureties who have consented to his becoming bound since this is in effect their contract with the paying surety. Where they have not so consented, the duty of contribution is based upon their unjust enrichment. They are not enriched by the expenditure of sums beyond those for which they are liable. The cosurety in such a case is under a duty to contribute only the proportionate amount by which he has been benefited.

Illustrations:

1.1> must also contribute one-half of S's costs and expenses of S's defense.

c. The duty of contribution by a cosurety arises as soon as another surety's payment exceeds the latter's proportionate share even if the surety's obligation is not fully satisfied. For example, if two sureties are equally bound on a debt of \$ 1000 and one pays \$ 600, he is entitled at once to receive \$ 100 by way of contribution from the cosurety. If there are five solvent sureties upon a debt of \$ 1000 and one pays \$ 600, he has paid \$ 400 more than his share. Since the share of each is \$ 200 he can recover \$ 200 apiece from any two of them, or \$ 100 each from all of them. (See as to the effect of insolvency of one or more cosureties, Comment h.)

d. *Effect on contribution of settlement for less than amount due.* Where a surety makes a settlement with a creditor by which the creditor accepts in full satisfaction less than the amount due from the principal and sureties, the cosureties and the principal as well as the paying surety are entitled to the advantage of this settlement. (See as to Reimbursement, § 105.) Contribution is thus computed on the amount of the settlement. The paying surety, however, cannot increase the contributive shares of the others by making an overpayment since this cannot be regarded as a reasonable expenditure. (See as to payment by a surety by the giving of a negotiable instrument, § 155.)

Where a surety settles his obligation to the creditor by transferring property which is received by the creditor in full payment, ordinarily the value placed on the property by the creditor and surety will measure the contributive right of the surety. If the property has been taken by the creditor at a fictitious valuation, so that the creditor in reality has discounted the obligation of the paying surety, the paying surety is entitled to contribution only on the basis of the value actually given.

Illustration:

3.1>.

e. *Contribution as affected by principal's payment.* The amount of the proportionate shares for which cosureties are liable among themselves is affected by the extent to which the principal himself performs. This is true whether the principal's partial performance is before or after the surety's performance.

Illustrations:

4.1>.

f. *Contribution as affected by unequal surety obligations.* Sureties may be bound to answer generally for the default of the principal, or their obligations may be restricted to specific amounts which may differ among themselves. In the absence of an agreement among them as to the distribution of their liabilities, or where their stipulated liabilities are for the same amount, one who pays the entire amount is entitled to recover from each of the others a sum equal to such amount divided by the number of persons participating. Thus, if there are three cosureties and one pays the entire debt, he is entitled to a contribution of one-third from each of the others. (See *Restatement of Restitution*, § 85, Comment c.) Where the risks assumed are unequal, the proportionate share is determined by the amount of risk assumed by each. Thus, if two persons are sureties upon a debt and one limits his liability to \$ 10,000 and the other to \$ 5000, the former should bear two-thirds of the ultimate liability. If this is \$ 7500 and it is paid by the first, he can recover \$

2500 from the second.

A possible although not frequent situation is one where among several cosureties one is liable without limit and the others have limited their obligations to stated amounts. For example, one surety may guarantee that a trustee will properly administer and account for all sums coming into his hands, while two other sureties will sign similar guaranties but with a limit of liability to \$ 10,000 and \$ 5000 respectively. In such a case, if the trustee defaults to the extent of \$ 10,000 or less, and the surety who is obligated without limit pays the entire loss, the contributive shares of the sureties will be computed on a basis which assumes that the paying surety has been obligated for \$ 10,000, or the maximum obligation of any cosurety. The shares of two of the sureties will be two-fifths each, and of the other one-fifth. If the loss is \$ 8000, the surety without limit, who has paid, will be entitled to recover \$ 3200 from one and \$ 1600 from the other. If the total default is greater than \$ 10,000, the share of the surety without limited liability will be computed as if he had guaranteed the amount of the default. For example, if the loss is \$ 15,000, the shares will be in the proportion of 15, 10 and 5. If the surety without limit pays \$ 15,000, he can recover \$ 5000 from the one whose limit is \$ 10,000 and \$ 2500 from the one whose limit is \$ 5000. (See *Restatement of Restitution*, § 85.)

g. Contributive shares of separate groups. Where there are different groups of sureties, each group is considered as a unit in determining the amount of contribution. Thus if four sureties are bound to a creditor for a principal's duty for \$ 6000, and two are bound for \$ 4000 on the same duty, the first group should bear three-fifths of the loss and the second two-fifths. Assuming that all sureties are available and solvent and that each obligation is entirely satisfied, the contributive shares of each surety in the first group is \$ 1500, and \$ 2000 in the second group. If the total loss is \$ 5000, those in the first group must pay \$ 3000, and those in the second group \$ 2000. The individual shares in the first group are \$ 750 each and \$ 1000 each in the second. (See *Restatement of Restitution*, § 85, Comment *g* and Illustrations.)

Comment on Subsection (2):

h. Contribution as affected by insolvency of a cosurety and other circumstances. The basis for computing contributive shares is changed where a cosurety's insolvency or unavailability for suit in the jurisdiction prevents obtaining contribution from him. In such a case, the solvent and available cosureties must contribute a larger share. If some part of his contributive share is obtained from an insolvent surety, this will be considered in decreasing the amount of contribution from the others. To take advantage of his right to obtain a larger amount than the original contributive share of cosureties, the paying surety must join in equity all available and solvent sureties as well as the principal. In actions at law the original proportions are the basis of liability.

Where a surety has paid more than his proportionate share, it is unfair for him to have the sole burden of pursuing sureties not available in the jurisdiction. Equity can make only a personal decree against those before the court. The amount due as contribution will be determined on the basis of those available. If, however, the property of an absent cosurety can be reached in an appropriate legal proceeding and made to bear a charge for a contributive share without unfairness to the paying surety, the existence of this property will be considered in determining the amounts due by way of contribution.

Among other circumstances besides insolvency and absence from the jurisdiction which may induce a court of equity to decree a larger payment by way of contribution than the original proportions are the necessary elimination of a surety from the computation on the ground of infancy, or because a cosurety has some other defense which does not affect the duties of the paying surety or the remainder of the cosureties.

Illustrations:

8.2>.

Comment on Subsection (3):

i. Where one of the cosureties has security which he has received from the principal, the cosurety upon payment is entitled to contribution from the other cosureties irrespective of the security. In the absence of agreement, or of an equitable action to compel the reduction of the security to a money equivalent, the cosurety having the security is under no duty to the other cosureties to enforce the security, as a condition of obtaining contribution. If he utilizes the security for his reimbursement, however, his right of contribution is affected by the rule that all the cosureties have proportionate interests in the security. The cosurety having the security must account for it to the cosureties, and if he negligently loses it, or destroys it, or surrenders it to the principal, his right to contribution is diminished by an appropriate proportion of such property. If the property has been a source of income or expense, the right to contribution will be correspondingly decreased or increased, as the case may be. If the surety has already received contribution, his surrender or loss of the security will afford the cosureties the basis for an affirmative judgment.

The rule stated in this Subsection has no application where a cosurety has received security from one other than the principal unless the security has been given for the benefit of the cosureties. (See *Restatement of Restitution*, § 85, Comment b.)

Illustrations:

10.1>.

Comment on Subsection (4):

j. The duty to give cosureties the benefit of security does not mean that a surety must share the amount he receives by way of reimbursement from a principal after there has been a settlement among cosureties. (See *Restatement of Restitution*, § 85, Comment c.)

Illustration:

14.1> is not entitled to any part of this payment.



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Restat 1st of Security, § 155

§ 155 Contribution: Payment of Creditor by Negotiable Instrument of Cosurety

Where the creditor accepts in discharge of a surety's obligation a negotiable instrument upon which the surety is primarily bound, the surety has the same right of contribution from a cosurety as if he had made a cash payment to the creditor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. This Section is consistent with the rule stated in § 107 by which a principal has an immediate duty of reimbursement where a creditor accepts as payment negotiable instruments on which a surety is bound. Where the creditor is willing to receive the negotiable instrument in full payment, it is treated as the equivalent of cash, and therefore, irrespective of payment, the benefit to the cosureties is the same as if the payment had been made in cash. If the creditor accepts in full satisfaction of the surety's obligation a negotiable instrument on which the surety is primarily bound in a lesser amount than the surety's original obligation, the amount of the instrument is the amount upon which contribution must be based, just as if the creditor had accepted a cash settlement for a lesser amount. On the other hand, the surety cannot enforce upon cosureties a duty of making a larger contribution if the surety has settled his obligation by giving a note for a larger sum than is due.

Illustrations:

1.1> is under a duty at once to contribute \$ 400 to S.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawNegotiable InstrumentsDischarge & PaymentPaymentGeneral OverviewContracts LawNegotiable InstrumentsEnforcementDuties & Liabilities of PartiesGeneral OverviewContracts LawNegotiable InstrumentsEnforcementJoint & Several Instruments



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Restat 1st of Security, § 156

§ 156 Cosurety's Right of Exoneration

Where sureties are under a duty of immediate performance to a creditor, a surety has a right of exoneration against the cosureties who have consented to his becoming a surety, to the same extent that upon performance he would be entitled to contribution.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. The rule stated in this Section is similar to that stated in § 112 in respect of the surety's right of exoneration against the principal. The Comments to § 112 are applicable in general to this Section. See also *Restatement of Restitution*, § 81.



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Restat 1st of Security, § 157

§ 157 Contribution: Effect of Release of Principal by Cosurety

Where a surety whose performance is more than his contributive share releases a principal from his duty of reimbursement he discharges the cosureties from their duty of contribution to the extent of the amount released, unless in connection with the release he reserves his rights against the cosureties.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. Where one of several sureties pays a creditor, the principal's only duty of reimbursement is to the paying surety. If the cosureties pay their contributive shares, they are each entitled to reimbursement from the principal. If the paying surety releases the principal from his duty of reimbursement to the extent only of the contributive share of the paying surety, this is of no concern to the cosureties. If the paying surety goes beyond this, as where he releases the principal entirely or to any greater extent than the surety's contributive share, he not only acts as if the principal's duty of reimbursement were solely the property of the paying surety, but he deprives the cosureties of a right against the principal by subrogation to the right acquired by the paying surety on his payment. (See *Restatement of Restitution*, § 85, Comment *d.*) If, after a paying surety had given a complete release to the principal, the surety could still hold a cosurety for contribution, the consequence would be one of two results, either of which would be inequitable. Either the cosurety who paid his contributive share would have no reimbursement, or the principal would be deprived in part of the benefit of his release. These considerations require that if the paying surety releases the principal to a greater extent than the surety's contributive share without a reservation of rights against cosureties, to the extent that the release is greater than the contributive share, the paying surety loses his right to receive contribution from the cosureties.

Illustrations:

1.2>.

b. The rule stated in this Section in respect to the reservation of rights by the cosurety is consistent with the rule stated in § 122 in respect of the release of a principal by a creditor and that stated in § 135 in respect of the release of one of several cosureties by a creditor. The reservation is a notification to the principal that he may still be called upon to reimburse the other sureties to the extent that they make payments of their proportionate shares. Like the rules stated

in §§ 122 and 135, it has the advantage that compositions may thereby be facilitated.

Illustration:

5.1> pays \$ 500, he is free to attempt to recover this amount from P.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Procedures



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Restat 1st of Security, § 158

§ 158 Contribution: Extension of Time to Principal by Cosurety

(1) Subject to the rule stated in Subsection (2), where a surety makes a binding extension of time of payment to a principal under a duty of reimbursement, he discharges a cosurety who is not a compensated surety from his duty of contribution, and he discharges a compensated surety to the extent that he is prejudiced by the extension.

(2) Where in connection with the extension by a surety of the time of payment by a principal under a duty of reimbursement, the surety reserves his rights against a cosurety, the cosurety is not discharged.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is consistent with the rule stated in § 128 in respect of the extension of time by the creditor to the principal. Where a surety purports to deal with the principal's duty of reimbursement, he affects the rights of cosureties to be subrogated to his position in the event of their payment of their contributive shares. Where, however, the surety in connection with the extension reserves his right of contribution against cosureties, he is in effect notifying the principal that the extension depends upon the continuance of the existing situation between himself and the cosureties. If he obtains contribution from them, either by compulsion or their voluntary payment, the principal will owe them an immediate duty of reimbursement.

b. Compensated surety. Under the rule stated in § 125, the compensated surety is not discharged by an extension of time to a principal by a creditor except to the extent to which he is prejudiced. The rule stated in this Section, consistent with the rule of § 129, discharges a compensated cosurety only so far as he can show that he has suffered damage by an extension granted to a principal by another surety.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil ProcedurePleading & PracticePleadingsTime LimitationsExtensionsCivil
ProcedureRemediesBondsSuretiesProcedures



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Restat 1st of Security, § 159

§ 159 Contribution: Surety's Release Of, or Extension of Time To, a Cosurety

Where a surety releases a cosurety from his duty of contribution or extends the time of the cosurety's payment of the latter's contributive share, the other cosureties remain under the duty of contribution which they had irrespective of such release or extension, taking into account the amount the released surety could have paid at the time of the release or extension and his availability for suit.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. Where a surety has paid more than his proportionate share, a determinable amount is due to him from each of the other cosureties. If he chooses to release one or to extend the time of payment by him, that is a matter wholly between the parties to the release. The obligation of the other cosureties is neither increased nor diminished by the fact that the surety entitled to contribution has agreed to forego or postpone payment by one of them. If the released cosurety is solvent, the result is the same as if he had paid his full contributive share. If he is wholly insolvent and this fact is shown, the paying surety can recover contributive shares from the other cosureties based on the elimination of the released cosurety. If the released cosurety is unable to pay his entire share, the contributive shares of the others will be based on the amount the released cosurety could have paid, whether actually received by the paying surety or not. As has been mentioned (see § 146 (2), Comment *h*) where a paying surety sues at law for contribution, his recovery is limited to the original contributive share of each surety. Where he brings an action in equity he may recover a greater amount depending upon the insolvency or unavailability of one or more of the cosureties. A release by a paying surety of a cosurety is one of the factors which will be considered by a court of equity in determining the amount due from the other cosureties.

Where a cosurety receives an extension of time and is at that time insolvent, the contributive shares of the sureties are determined with due regard to the fact of insolvency. On the other hand, if he is solvent when he receives an extension but subsequently becomes insolvent, this circumstance does not increase the share which the other cosureties must contribute to the paying surety. Their shares are the same as if there had been no extension.

Illustrations:

1.2>.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil ProcedurePleading & PracticePleadingsTime LimitationsExtensionsCivil
ProcedureRemediesBondsSuretiesProcedures



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Restat 1st of Security, § 160

§ 160 Contribution: Effect of Extension of Time to Principal with Consent of Cosurety

Where a surety consents to an extension of time of payment to the principal by the creditor and subsequently is compelled to satisfy the creditor, he is not entitled to contribution from cosureties who have been discharged by such extension, and as to those not discharged, his right to contribution is diminished to the extent to which they have been prejudiced.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. A binding extension of time to a principal by a creditor discharges a non-compensated surety who has not consented to the extension unless the creditor reserves his rights against the surety (§ 129). Such an extension discharges a compensated surety to the extent that he has been prejudiced thereby unless there is a reservation of rights by the creditor. If there is no such reservation by the creditor, and the surety consents to the extension, he is bound by the consequent discharge of non-compensated cosureties and the discharge of compensated cosureties to the extent that they can show prejudice. He cannot thereafter obtain contribution from them if he is compelled to pay more than his proportionate share.

Illustrations:

1.1>.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil ProcedurePleading & PracticePleadingsTime LimitationsExtensions



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Restat 1st of Security, § 161

§ 161 Effect of Conduct of Cosurety on Contribution

Where the conduct of a surety causes the default of the principal or cosurety or decreases the amount that would otherwise have been available from the principal or a cosurety, his right to contribution from the cosureties is proportionately diminished.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The right to contribution depends upon equitable principles. If the conduct of a cosurety is responsible for increasing the ultimate liability of another cosurety, it would be inequitable to allow him to recover as much as would otherwise have been allowed. Conduct which will reduce the amount a cosurety can recover is not necessarily fraudulent. The motives of the cosurety may be honest and yet the effect of his conduct may be to reduce the amount otherwise available to the creditor.

Illustrations:

1.1> is responsible for S's failure to meet his share of the liability.



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Restat 1st of Security, § 162

§ 162 Contribution: Cosurety's Claims in Bankruptcy Against Cosurety

Where a cosurety has satisfied a claim of a creditor against a bankrupt cosurety, he is entitled by subrogation to the benefit of the claim if it is filed, or to file the claim if unfilled, but his dividends are limited to the amount due him by way of contribution.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. One of the rights of a surety who has satisfied a creditor's claim is to be subrogated to the creditor's rights not only against the principal but against cosureties. Since the creditor, had he not been paid, could have filed or maintained a claim for the entire amount due from the cosurety, the other creditors of the bankrupt cosurety are in no worse position because this right is asserted by a cosurety. Irrespective of the amount of the claim, the cosurety is entitled only to his contributive share, and when this amount has been paid, he can receive no further dividends.

Illustrations:

1.1> files a petition in bankruptcy. C files no claim, and S does not pay C \$ 10,000. S files C's claim for him. The first dividend is 25 per cent. P then pays C \$ 3500, and S pays him \$ 4000. S is entitled to the next dividends from S's estate until he has received \$ 750.



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Restat 1st of Security, § 163

§ 163 Contribution: Effect of Cosurety's Discharge in Bankruptcy on Discharge of Duty of Contribution

Where a surety is discharged in bankruptcy from his obligation to the creditor, he is also discharged from his duty of contribution to cosureties.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. By the Bankruptcy Act as in force January 1, 1941, § 57 (i):

"Whenever a creditor whose claim against a bankrupt estate is secured by the individual undertaking of any person fails to prove and file such claim, such person may do so in the creditor's name and, if he discharge such undertaking in whole or in part, he shall be subrogated to that extent to the rights of the creditor."

This Subsection refers in terms to claims of creditors against bankrupt principals. The surety has a right of reimbursement and a right of exoneration against the principal. The surety, however, does not have a separate claim against the principal, nor does payment by the surety subsequent to bankruptcy give the surety a claim against the principal, not discharged in bankruptcy. The surety is not allowed a separate claim because of the disadvantage to other creditors if proof by the surety and the creditor were both permitted. The policy of the bankruptcy law in favoring discharge of debtors who comply with its provisions prevents the surety from subsequently asserting any claim against the principal since the surety can protect himself to some extent at least by subrogation to the creditor. So far as the principal is concerned in his relations with the creditor and surety, the bankruptcy law recognizes only one claim. (See § 108 (4) and Comment *i.*)

By analogy the same rule follows in case of a bankrupt cosurety. The other sureties may pay the creditor and be subrogated to his rights. Whatever they do, the discharge of the cosurety is a discharge of his duty of contribution as well as of his obligation to the creditor.

Illustration:

1.1> sues S for \$ 1250. S can defeat the suit by pleading his discharge in bankruptcy.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Procedures



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Rules and Principles

Division 2 - Suretyship

Chapter 6 - Cosuretyship and Subsuretyship

Restat 1st of Security, § 164

§ 164 Contribution: Necessary Parties in Actions in Equity

Where a surety seeks contribution in equity, the principal and cosureties are necessary parties if they are in the jurisdiction unless the surety can show that to join them in an action would be a useless formality.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. Payment by a surety gives rise to rights of reimbursement and contribution. In the ultimate settlement the rights of several parties must be adjudicated. If possible, in order to avoid needless litigation, these rights should be determined in one action. If the principal and cosureties are available, all should be joined in an equitable action unless it is apparent that one or some of them can do nothing towards the final settlement. Since the principal has the ultimate liability, he should be joined if there is a chance of his making any payment. Where the principal cannot pay in full, the shares of the various sureties must be ascertained, see § 154.

Where one of the otherwise necessary parties in equity is outside the jurisdiction and cannot be served and has not property in the jurisdiction which can be made available to the surety seeking contribution, the surety may proceed against those who are available. Likewise where it is impossible to join one of the other parties, for example, because his estate is being administered in bankruptcy, or where it can be shown that to join him would be a useless formality, failure to join him will be excused.

Illustrations:

1.2>. He need not join P.

5. Same facts as Illustration 4, except that P, although not discharged in bankruptcy, has no property. S need not join P.

b. The rule stated in this Section also applies under many procedural statutes to actions by a cosurety under the statutory procedure.



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Chapter 7 - Third Party Beneficiaries in Construction Contracts

Introductory Note

This Chapter is an application in the field of suretyship of the rules stated in the Restatement of Contracts Chapter 6, §§ 133-146. It is here included because of the importance of the problem of the contractual rights of those not parties to a surety contract, especially in respect to public and private construction contracts. The duties of the surety which are involved in this Chapter are owed not only to the creditor to whom his promise is made, but also to others. These additional creditors in suretyship are generally donee beneficiaries although in certain circumstances where the creditor is himself liable to the beneficiaries, they may be creditor beneficiaries.

To create a donee beneficiary, the promise must benefit a person other than the promisee and the purpose must be to make a gift to the beneficiary, or to confer a right upon him against the promisor neither due nor supposed to be due from the promisor to the beneficiary. (See Restatement of Contracts, § 133.) If there is no purpose to make a gift but the performance of the promise will satisfy a duty of the promisee to the beneficiary, or a right of the beneficiary against the promisee which has been barred by the Statute of Limitations or by a discharge in bankruptcy, or one unenforceable because of the Statute of Frauds, the beneficiary is a creditor beneficiary. In either case the promise creates duties to the beneficiary as well as to the promisee. (See Restatement of Contracts, §§ 133, 136.)

It should be noted that unless the power to do so is reserved, the duty of the promisor to the donee beneficiary cannot be released by the promisee or affected by any subsequent agreement between the promisee and promisor. (See Restatement of Contracts, § 142.)

The Restatement of Contracts recognizes, however, that in respect to a creditor beneficiary a discharge of the promisor by the promisee in a contract or a variation thereof by them is effective against a creditor beneficiary if he does not bring suit upon the promise or otherwise change his position in reliance thereon before he knows of the discharge or variation and if the promisee's action is not a fraud on creditors. (See Restatement of Contracts, § 143.)

Since the question of the rights of beneficiaries against sureties arises characteristically in respect of construction contracts, the rules of this Chapter are restricted to problems of such contracts.

The rights of third parties against sureties on construction contracts, both public and private, are frequently affected by statutes whose purpose is the protection of laborers or materialmen or both.

Some of the rules stated in this Chapter have developed as rules of the interpretation of suretyship contracts in connection with public and private construction enterprises. These rules are stated in terms of the rights of the beneficiaries because they have been established to such an extent that they can no longer be considered merely rules of interpretation. (See § 165, Comment *b*, and § 166, Comment *a*.)

This Chapter is restricted to such rules of construction contracts as are of particular significance in suretyship

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawDebtor & Creditor RelationsContracts LawThird PartiesBeneficiariesGeneral OverviewContracts LawTypes of ContractsConstruction Contracts



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Restat 1st of Security, § 165

§ 165 Guaranty of Contractor's Promise to Pay for Labor and Materials

Where a surety for a contractor on a construction contract agrees in terms with the owner that the contractor will pay for labor and materials, or guarantees to the owner the promise of the contractor to pay for labor and materials, those furnishing labor or materials have a right against the surety as third party beneficiaries of the surety's contract, unless the surety's contract in terms disclaims liability to such persons.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section applies both to governmental and private contracts. The rule refers only to cases where there is a promise for the benefit of third party beneficiaries, and is not concerned with the reason for the inclusion of such a promise. See Comment *d*.

b. Rationale. The rule stated in this Section, which is stated in terms of right, represents an evolution from rules of interpretation intended to ascertain the purpose of the surety in making certain promises to a governmental or private owner of land or other subject matter of a construction enterprise. In every construction case it must be determined if in fact the surety has made a promise for the benefit of laborers and materialmen. Where no such promise has been made, the surety has no liability to laborers and materialmen. If the surety has in terms guaranteed the payment by the contractor of laborers and materialmen, the result is a liability on the surety determined by the rules stated in Chapter 6 of the Restatement of Contracts. Where the words used by the surety are subject to different possible interpretations, it is necessary to ascertain the purpose of the surety. The position taken in this Section, is that the promise of the surety always should be interpreted as for the benefit of the laborers and materialmen where he has guaranteed the promise of the contractor to the governmental or private owner that he will pay laborers and materialmen, and that therefore the rule may be stated in terms of the right of the laborers and materialmen. See Introductory Note to this Chapter.

Where a surety's obligation in a construction contract is both for the benefit of the owner and of laborers and materialmen, two tripartite relationships are created: one including owner as creditor, contractor as principal, and the surety; the other made up of the surety, the laborers and materialmen as creditors with the contractor as principal. Where the owner is also liable to the laborers and materialmen, at least to the extent that they may impose liens on his real estate, he is a subsurety to the amount of his liability. See § 145. As to priorities of the various persons having

rights against the surety, see § 167.

Illustrations:

1. The A Construction Company contracts with the city of X for the building of a retaining wall in a park. In the construction contract the company makes no promise to the city to pay laborers and materialmen. In connection with the contract, the company furnishes the obligation of S, a surety, in the penal sum of \$ 10,000 guaranteeing that the company will satisfactorily complete the work and will pay all valid claims for labor and materials. S is liable to unpaid laborers, materialmen, and subcontractors.

2. Same facts as Illustration 1, except that the company promises the city it will pay laborers and materialmen. S guarantees that the company will perform its contract, without specially mentioning the various promises and duties of the company. S is liable to unpaid laborers, materialmen, and subcontractors.

c. The surety is not liable to laborers and materialmen, even if he guarantees to government or a private owner that the contractor will pay for labor and materials, if the surety in terms provides in his contract that his liability is only to the creditor with whom he contracts. The surety in general is bound only on the contract he makes, and if he excludes any purpose to benefit those outside the contract, there will be no third party beneficiaries, assuming that the surety's provision is valid.

d. *Statutes.* Statutes frequently require that a surety bond be obtained for the protection of those furnishing labor or materials in connection with government contracts since mechanics' liens cannot be asserted against government property. Statutes sometimes also allow mechanics' liens against improved private real estate even where the owner has satisfied the contractor. Such statutes also have the effect of inducing private owners to obtain surety protection for laborers and materialmen, since by this means in such circumstances they can protect themselves from mechanics' liens in the event of the contractor's default. If a statute requires that government obtain a surety obligation on a construction contract for the protection of itself and laborers and materialmen, and further provides that when such an obligation is offered in connection with a construction project, it should be read as if it protected laborers and materialmen irrespective of its terms, a contrary provision by the surety will be ignored. Such statutes are rare in connection with construction contracts, although similar statutes are not uncommon in respect of official bonds. (See § 169.)

e. Under the rules stated in the Restatement of Contracts, §§ 133-146, donee and creditor beneficiaries have rights against the promisor. It should be noted, however, that the effect of a statute requiring a surety obligation protecting those furnishing labor and materials in construction contracts, especially on government contracts, may be to give the laborers, materialmen, and subcontractors a right against the surety, even in a jurisdiction which in general does not allow third party beneficiaries to proceed against promisors.

f. Subcontractors, who as a result of contracts with laborers and materialmen, supply labor or materials to a construction enterprise, have the same rights against sureties as would be enjoyed by laborers and materialmen dealing directly with the contractor.

g. The Section makes no attempt to exhaust the subject. There may be cases aside from those where in terms these promises have been made where such a purpose to benefit the laborers, materialmen and subcontractors can be found by the ordinary processes of interpretation.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawThird PartiesBeneficiariesGeneral OverviewContracts LawTypes of ContractsConstruction ContractsContracts LawTypes of ContractsGuaranty Contracts



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Restat 1st of Security, § 166

§ 166 Guaranty of Contractor's Promise to Complete Construction Free of Liens

Where a surety guarantees the performance of a contract by a contractor who does not promise the owner to pay those furnishing labor or materials but agrees to complete the work free of liens or to furnish labor and materials, laborers and materialmen have no rights against the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The rule stated in this Section, like the rule of § 165, is a rule expressed in terms of right, which represents the development of a rule of interpretation. As stated in Comment *b* to § 165, the material inquiry in surety contracts in connection with construction enterprise is whether there is a purpose to benefit someone in addition to the one for whom the construction is being done. Where there is no promise by the surety to pay laborers and materialmen, and where the surety has not by his contract excluded a liability to them, certain rules of interpretation have been established as to typical provisions in such surety contracts. These rules of interpretation, being established, can be stated in terms of right, or lack of right. In contrast to the rule stated in § 165 where there was a promise to pay laborers and materialmen, if the surety has only guaranteed the contractor's promise to complete a construction project free of liens or to furnish labor and materials, there is no right in laborers or materialmen because there is no indicated purpose to benefit them. Where the surety has only guaranteed that the contractor will carry out a promise to deliver a building free of liens, neither the surety nor the contractor has necessarily promised to pay laborers or materialmen. Even if circumstances might exist in which such liens could be established against the owner, the building might be freed from liens in other ways than by payment. The promise that the contractor will furnish labor and materials does not of itself amount to a promise to pay for them. The contractor may already own the materials; he may buy them on credit to be paid for in connection with some other enterprise; he may perform all or part of the labor himself or the laborers may contract with him to participate in the enterprise upon some basis other than immediate payment. If the surety is to be made liable to third persons his obligation must contain a promise which may be reasonably interpreted as for their benefit.

Illustrations:

1. The A Construction Company contracts to build a fire station for the city of Y and to furnish at its own expense

the necessary labor and materials. S guarantees that the company will perform its contract satisfactorily. The building is constructed according to contract, but the company does not pay certain materialmen. The materialmen have no right against S.

2. The A Construction Company contracts with O to build a house and to deliver the building free of liens. S guarantees the company's contract. The house is built according to contract, and O pays the company so that in the jurisdiction no lien can be established against the house. The company fails to pay certain materialmen. The materialmen have no right against S.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 167

§ 167 Respective Rights of Owner and Beneficiaries Against Surety

Where in a construction contract a surety is liable both to an owner-promisee and to those furnishing labor and materials, and the amount for which he is liable is insufficient to satisfy all claims, the fund available shall be used to satisfy the claims of his promisee before the claims of those furnishing labor or materials, unless a statute requires otherwise or unless the claims of the latter must be satisfied first in order to avoid circuity of action.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. A governmental or private owner, in making a contract for a construction enterprise, may require a surety contract containing a promise for the benefit of laborers and materialmen for a variety of reasons. The owner may be under no compulsion to demand such a provision but may wish to protect such persons for humanitarian reasons, or because he believes he is more likely to obtain satisfaction from the contractor if he assures protection to workers and those furnishing materials. In such cases it is logical to assume that if the surety's contract is also for his benefit, he intends the laborers and materialmen to have recourse against the surety only after his own claims are settled. Where the surety's obligation is for an amount which does not cover all claims, the claims of laborers and materialmen are subordinate to those of the promisee.

b. Effect of statutes. The owner, especially if a governmental authority is involved, may be under a statutory duty to obtain protection for the laborers and materialmen in construction contracts. Whether the statute is intended to give the laborers and materialmen a subordinate or paramount claim against the surety, or a pro rata claim, must be determined by an interpretation of the statute. The rule stated in this Section recognizes that a statute may deprive the promisee of priority.

c. Circuity of action. The promisee of a surety contract in connection with a construction enterprise may also be under a liability to laborers and materialmen, not only as a result of statute, but by his own contract or because his property may be subjected to liens in favor of laborers or materialmen. In such cases, to avoid circuity of action, to the extent that the promisee or his property is liable to the claims of laborers and materialmen, they are allowed a priority against the surety.

Illustrations:

1. S is surety on a construction contract made by the A Construction Company with O, an owner. Laborers and materialmen are third party beneficiaries of S's contract. O personally guarantees that the A Company will pay for certain materials bought from B. S's obligation is not sufficient to satisfy O and B. B has a prior claim against S.

2. Same facts as Illustration 1 except that O has not guaranteed the claims of materialmen but they can establish a lien against the real estate involved in the construction enterprise. To the extent that B can establish a lien, he has, in respect of O, a prior claim against S.

d. Procedure for determining priority. The consideration of the procedural aspects of the question of determining priorities among claimants under this Section is beyond the scope of this Restatement.

Legal Topics:

For related research and practice materials, see the following legal topics:

Contracts LawThird PartiesBeneficiariesGeneral OverviewContracts LawTypes of ContractsConstruction ContractsContracts LawTypes of ContractsGuaranty Contracts



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Restat 1st of Security, § 168

§ 168 Dual Position of Surety

Where there are two or more sureties for a contractor whose obligations are also for the benefit of materialmen, and one of the sureties is himself a materialman with a claim against the contractor, the materialman's claim will be included in determining the contributive shares of the several sureties, unless the other sureties can show by the terms of the materialman's surety obligation or from the circumstances that they are subsureties in respect of the materialman rather than cosureties.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. For a definition of subsuretyship, see § 145.

b. Rationale. The situation occasionally arises in construction contracts where a materialman is in the dual position of surety and claimant against the contractor. If there are other sureties, their contracts may be in such terms that materialmen are beneficiaries of their contracts. The problem concerns the effect of the surety's dual position upon his rights. So far as the owner is concerned, it is obvious that the materialman can assert no claim which is inconsistent with his obligation as surety. For example, if the materialman has guaranteed the owner against liens, he cannot compel the owner to satisfy a lien against which he has guaranteed the owner. Such a result would cause a circuity of action since the owner could subsequently recover the amount of the lien from the surety. Where there are other sureties, however, it may be equitable to take account of the amount of the materialman's claim for the purpose of ascertaining contributive shares. If by the terms of the several surety contracts the respective sureties are cosureties as to all claims, the materialman's claim should be included. Where, however, the materialman has accepted a subordinate position in respect of his own claim, either by the terms of his contract or because of the circumstances, it is inequitable to allow him to include his own claim in determining the share of the contractor's default which should be borne by each surety. Among the circumstances which should be considered in determining the materialman's rights against the other sureties, are the knowledge of the other sureties at the time their contracts were executed that the materialman was to furnish materials, and the negotiations, if any, among the sureties before their contracts were executed.

Illustrations:

1. A, a contractor, agrees to build a house for O, and requests M, a materialman, and S, a surety company, to guarantee O that the house will be satisfactorily completed and will be delivered free of liens. M furnishes building materials for the construction. A defaults. In the jurisdiction, had it not been for the surety contract, M might have asserted a lien for the materials unpaid for. M cannot establish any lien against O's property, but he is entitled to have the amount of the lien claim included in determining A's total default, and hence in ascertaining the contributive shares of S and himself.

2. Same facts as Illustration 1, except that the surety contracts instead of including an assurance against liens, contain a clause that A will pay all persons furnishing labor and materials. M is thus a beneficiary of S's contract. M's claim for materials may be included in determining the contributive shares of S and himself.

3. A is a contractor without financial responsibility, whom M, a materialman, by promise of financial backing, induces to bid on a construction contract with O. A obtains the contract conditioned upon his furnishing satisfactory sureties. M furnishes O a surety obligation, which O accepts but demands in addition a surety company bond. M requests S, a surety company, to act as surety, and represents A to be a person of good financial standing. M also pays the premium for S's obligation and orally informs S that he, M, has guaranteed A's performance. S's contract is that A will perform his contract and pay all materialmen. In the circumstances, S is a subsurety rather than a cosurety in relation to M in respect of materials furnished by M.

Legal Topics:

For related research and practice materials, see the following legal topics:
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Division 2 - Suretyship

Chapter 8 - Official Bonds

Introductory Note

This Chapter is concerned only with rules of particular importance in respect of sureties for public officers. Unless inconsistent with the rules stated in this Chapter, the rules elsewhere stated in the Division of Suretyship are applicable to official bonds. Public officer is used in this Chapter to include public employee because so far as the problems of sureties' obligations on official bonds are concerned, there is no distinction between officers and employees.

An official bond is an instrument under seal by which a public officer undertakes to pay a sum of money if he does not faithfully discharge his office, or by which a surety undertakes that if the officer does not do so, the surety will be liable in a penal sum. A penal obligation with surety in respect of the officer's duties is customarily referred to as a bond even if the common law effect of a seal has been changed so that no seal is required or affixed or if an obligation not under seal is offered in lieu of the bond required by statute. The rules stated in this Chapter assume a bond stated in general terms of faithful performance of the duties of the office except where reference is made to special bonds referring more specifically to the duties covered. Some statutes require that the bonds cover the various duties of an officer in particular detail.

This Chapter regards only two classes of bonds as falling in the category of official bonds. The first includes bonds of elected and appointed public officers. The other includes the bonds for the faithful performance of the duties of administrators, executors, guardians, receivers and others who are directly responsible to the courts and whose bonds are required by law. Bonds required in the course of judicial proceedings are called in this Restatement, Judicial Bonds. (See Chapter 9.) While bonds of administrators, executors, guardians, and receivers may also be classified as judicial bonds, since they are required by courts, it has seemed more convenient in this Restatement to regard these bonds as official. Where, however, an administrator, executor, receiver, guardian or other court officer gives a bond as a party to a judicial proceeding, such a bond is a judicial bond, see § 186. Bonds required by statute of officers of corporations, such as banks, although occasionally somewhat similar to official bonds are not considered in the Restatement of this Chapter. Also omitted is a large category of bonds required of persons engaging in particular occupations, for example, warehousemen, pawnbrokers, and other brokers of various sorts. Except for the statutory requirement and the effect the statute may have on their interpretation, the rules regarding such bonds are those applying generally to surety obligations.

Where the duties of a public officer as prescribed by statute are to government alone, the surety on the officer's official bond is liable only to government but where the officer's duties include duties to other persons, the surety's

obligation is generally also for the benefit of such persons. Whether the officer has duties other than to government must be determined by a consideration of the nature of the office and the duties prescribed for the officer. No individual has a right against a surety on an official bond merely because as a member of the public he is harmed by the officer's misconduct. In general fiscal officers of government have no official duties to other persons. On the other hand such officers as sheriffs, marshals, constables, and court officers such as guardians, administrators and clerks holding funds of individuals, have duties to persons other than government, and an important reason for the requirement of the surety on an official bond is for the protection of private persons.

Where reference is made to statutes relating to official bonds, the term "statutes" is used to include ordinances and administrative regulations which are adopted under general statutory authority

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Receiverships Receivers Appointments Contracts Law Negotiable Instruments Enforcement Joint & Several Instruments Governments Courts Court Personnel



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Restat 1st of Security, § 169

§ 169 Statutory Requirements for Official Bond: Where a Part of Surety's Obligation

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

COMMENTS & ILLUSTRATIONS: *Comment:*

a. A statute requiring an officer to furnish an official bond with one or more sureties may prescribe that the bond cover the faithful discharge of the duties in general terms, may prescribe in detail the duties to be covered, or may go further and state that a bond offered in compliance with the statute shall be deemed to cover the conditions prescribed by law irrespective of the wording of the contract. There may also be a general statute applying to all or some official bonds which provides that conditions required by law be read into official bonds. The rule stated in this Section takes the position that only in the last named situation is the surety bound within the penal amount of the bond beyond the risks undertaken by his contract. If the surety's contract is not the same as the statute's requirements, the surety will still be bound on his promise whether narrower or broader than the statutory requirements. He should not be bound for more than he has promised unless he is warned by statute in appropriate language that terms not in his contract will nevertheless be read into it.

No attempt is made to state here how various state statutes requiring official bonds should be interpreted. What is stated is only that the requirement of a bond covering certain risks does not of itself bind the surety to liability for those risks if his obligation does not cover them. If the statute goes further and provides in definite language that any bond furnished for a certain officer shall be deemed to cover certain specified risks whether or not the obligation is so worded, the surety whose bond fails to cover these risks, or even which expressly excludes them, is nevertheless bound for the officer's duties as stated in the statute. The rule stated in this Section means that a surety is not liable beyond his undertaking unless the state has enacted what is sometimes called a remedial statute, that is, a statute which states that the statutory conditions will be deemed to be included in official bonds.

The mere fact that the remedial statute provides that certain terms will be read into official bonds whether stated or

not, does not prevent the surety's undertaking from going beyond the statutory requirements, unless the remedial statute is interpreted to mean that official bonds shall cover only statutory requirements.

Illustrations:

1. A statute requires a surety on a treasurer's bond covering among other things the safety of all public deposits made by the treasurer. A surety executes a bond with a specific exception refusing to accept any responsibility for the solvency of bank depositaries. The treasurer deposits money in good faith in a bank which fails. The surety is not liable for the deposits.

2. Same facts as Illustration 1, except the same or another statute provides that any bond offered shall be understood to cover all statutory duties irrespective of its terms. The surety signs the official bond with an exception regarding bank deposits. The surety is liable for public deposits in the event of a bank failure.

b. The amount for which the surety is bound is never greater than the penal sum expressed in the bond, except for interest and legal costs. If the surety voluntarily assumes a liability in a greater amount than that required by statute, he may be held to his undertaking. If the penal sum is less than the statute requires, he is liable only up to the penal sum in any case where the bond constitutes a valid contract. The surety cannot set up the failure to comply with the statute as a defense upon the contract he has undertaken.

Illustrations:

3. A statute requires a county treasurer to furnish a bond with surety in the sum of \$ 100,000. He furnishes a bond with surety for \$ 50,000. He defaults to the extent of \$ 25,000. In an action by the county, the surety defends on the ground that his obligation does not comply with the statute. The surety is liable for \$ 25,000.

4. Same facts as Illustration 3, except that the default is \$ 75,000. The surety is liable for \$ 50,000.

5. A statute requires a county treasurer to furnish a bond with surety in the sum of \$ 100,000. He voluntarily furnishes one with surety in the sum of \$ 150,000. The treasurer embezzles \$ 125,000. The surety is liable for \$ 125,000.

Legal Topics:

For related research and practice materials, see the following legal topics:
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Restat 1st of Security, § 170

§ 170 Voluntary Bonds

Where there is no statutory requirement of an official bond but a public officer voluntarily furnishes a bond, the surety is liable on a bond given under seal or for which there is consideration.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Where a surety gives an official bond under seal, he is liable on the promise because of the seal, unless in the jurisdiction the common law effect of the seal has been abolished or if the bond, although under seal, has been given on some special consideration which has failed. It is not essential that consideration be given for a promise under seal where the common law effect of the seal has been preserved. (Restatement of Contracts, § 110.) Where there is consideration for the surety's promise, he will also be bound on his undertaking, even in a jurisdiction where the effect of a seal has been abolished. If the common law effect of the seal has been abolished, and there is no consideration, the surety is not liable on his promise.

A governmental body, although no bond is required of an officer, may be in a position where it can obtain an indemnity bond for the office. So far as the bond is to protect government from losses for which the officer is not responsible, no suretyship relation is involved. The bond may cover defaults for which the officer is liable, so that a suretyship relation arises. In any event, the indemnitor is liable on his contract.

If an officer voluntarily obtains a surety bond protecting government or others from losses due to his defaults, and pays the surety a premium for undertaking such an obligation, government and others, if named or designated in the contract, may have a right against the surety as third party beneficiaries. Here too the surety is primarily an indemnitor, though to the extent that he is liable for defaults for which the officer can be held, he is also a surety.

Illustrations:

1. County attorneys in State X are not required to furnish official bonds. The governor sends each a circular letter suggesting to each county attorney that all county attorneys having public funds in their control furnish a bond covering such funds. A, a county attorney, voluntarily acquiesces in the governor's suggestion, furnishes a bond under seal for \$

5000, which is also signed and sealed by his brother, S, who receives no consideration. A is guilty of a defalcation in county funds. S is liable to the extent of \$ 5000.

2. Same facts as Illustration 1, except that in the jurisdiction the effect of the seal has been abolished. S has no liability.

3. Same facts as Illustration 2, except that S is given consideration for executing the bond. S is liable.

b. Voluntary furnishing of excessive bond. Where an officer and his surety voluntarily execute an official bond with a penalty in excess of the requirement, they are bound on their undertaking, see § 169. In such a case there is consideration for the bond as an entirety. To avoid liability on the bond as executed, they must have some reason for claiming that their liability varies from that which they have voluntarily assumed. If the undertaking arises from their own choice, they have no defense.



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§ 171 Disapproval or Failure to Act by Officers Having Duty of Passing Upon Official Bonds

(1) Where an official bond is rejected by an officer having authority to accept or reject such a bond, one who signs as surety has no liability.

(2) Where an official bond with surety is subject to the approval of designated officers, the delay or failure of these officers to accept a bond which is delivered does not relieve the surety from liability.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Delivery of bond. A bond has no operative effect until it is delivered. It is not enough that the bond is executed so long as it is held by the surety or by anyone else who cannot be considered as representing the governmental authority to which the bond should be furnished. What constitutes delivery in any case depends upon the circumstances. The bond may be delivered although it is not placed in the hands of the proper official or is not filed or indexed as required by law. Failure to comply with such conditions may be a ground for rejection but is not a defense to the surety if it has come into the hands of anyone who can be accepted as acting for government in the premises. If the rejecting officer has no authority to refuse the bond, the bond is of course valid.

Comment on Subsection (1):

b. Statutes frequently provide that a surety's bond be approved by certain officers. Four situations other than complete approval are possible as a result of such a requirement: the bond may be rejected; the officers who should pass upon it may fail to act; they may accept it for what it is worth but request the officer to furnish an additional bond; they may accept a substitute bond and release the original surety from liability for subsequent defaults. If an officer has authority over official bonds, he represents government in this respect. Where he rejects a bond, it is as if government were telling the surety it refuses to enter into contractual relations with him. In such a case, the surety has no liability even if a default has occurred before the rejection. To excuse the surety the bond must be positively rejected. It is not enough that the bond be found to be unsatisfactory if there is an intention to keep it for what it is worth.

Illustrations:

1. A statute requires that a county treasurer furnish a bond to be approved by the County Commissioners. A bond with surety is offered. The Commissioners by formal resolution reject the bond. The surety has no liability on it.

2. Same facts as Illustration 1, except that the Commissioners take no action on the bond, but the county clerk, who has no authority to pass upon bonds, tells the surety the bond is unsatisfactory and that it is rejected. The surety is liable on the bond.

Comment on Subsection (2):

c. The requirement that an official bond be approved is for the protection of government and not of the surety. If the officers who should pass on the bond fail to act, the surety is not excused from liability. Rejection is not implied from the failure of proper officers to approve the bond. The surety will be liable even if the approval of the bond is a condition of the qualification of the officer, assuming that he does in fact exercise the functions of the officer and is guilty of a default, unless the bond is absolutely rejected by proper authorities, see § 173.

Illustrations:

3. Same facts as Illustration 1, except that the Commissioners although finding the bond to be unsatisfactory do not reject it but require the officer to furnish a supplemental bond with a new surety. Both sureties are liable for the officer's defaults.

4. Same facts as Illustration 3, except that upon the furnishing of the supplemental bond the Commissioners release the first surety from subsequent liability. The first surety is liable only for defaults of the officer prior to his release.



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§ 172 Failure to Furnish Bond Within Stipulated Period

Where a statute provides that a person elected or appointed to office must furnish a bond with surety by a stated date or forfeit the office, and the officer does not furnish the bond within the prescribed period but ultimately furnishes a bond with surety and acts as an officer, the surety is liable for the officer's defaults from the date of the delivery of the bond unless the bond contains an agreement to be bound for a different period.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Forfeitures are not favored by the courts, and statutes, even when reciting that the office shall become vacant because of a failure to furnish a bond, are not generally construed as mandatory but rather to authorize the taking of steps to declare the office vacant. If the officer, though in default, tenders a bond which is not rejected, and the officer serves, it is no defense to the surety that the office might have been declared vacant. The provision for the forfeiture of the office is for the protection of the public, and if it is waived by the authorities representing the public, the surety cannot complain.

In the event the office is subsequently declared vacant after a period of service, the surety is liable for defaults occurring while the officer exercises the functions of the office. (See § 171 (2).)

b. The surety's obligation takes effect from the date of its delivery. It covers only subsequent defaults unless it provides a liability for a different period. For example, if an officer assumes his duties at the beginning of the term and subsequently furnishes a bond with surety for the faithful discharge of the duties of his office, the surety is liable only for defaults from the date of the delivery of the bond. If, however, the surety's obligation recited a liability for defaults at any time during the term of office, the surety can be held for defaults occurring after the date the officer takes office even though they occurred before the delivery of the bond. The extent of the surety's obligation thus depends upon the interpretation of the terms of his contract, unless, as stated in § 169, statutory provisions must be read into the contract irrespective of its terms.

Illustrations:

1. A county treasurer furnishes an official bond which is subject to the approval of the County Commissioners. They do not reject the bond but consider it insufficient and request the treasurer to furnish an additional bond, which he does after three months in office. The second surety is not liable for defaults occurring before the delivery of his bond.

2. Same facts as Illustration 1, except that the bond in terms covers defaults from the beginning of the term. The surety is liable for the officer's defaults during the term before and after the delivery of the bond.

3. Same facts as Illustration 1, except that a statute provides that bond furnished for a county treasurer shall be deemed to cover defaults occurring during the entire term irrespective of the time of furnishing the bond. The second surety is liable for defaults occurring during the term before his bond is furnished.



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§ 173 De Facto Officer and Usurper

It is not a defense to a surety in an action on an obligation furnished as an official bond that his principal does not lawfully hold the office he purports to hold.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. De facto officers and usurpers. An officer may not be entitled to an office among other reasons because he is ineligible as being under age, or a non-resident, because he has not been properly elected or appointed, has not fulfilled some condition such as furnishing a proper bond, or taking oath, or because the act under which he holds office is unconstitutional or has not been signed by the governor within the proper time. Persons occupying an office under these circumstances are frequently known as de facto officers, but the rule stated in this Section is broad enough to cover usurpers in office, who are generally regarded as outside the category of de facto officers, the latter term covering persons who believe they are entitled to the office. For the purpose of deciding questions of the acts by one purporting to be an officer, it may be held that the one assuming to act as an officer does not come within the de facto category, although his surety will be liable for his defaults.

b. Rationale. When an official bond with surety is required of an officer, and a surety executes such a bond, which is delivered to the public authority, the surety is assisting the public officer to assume the functions of the office. In many instances the surety can be held on principles of estoppel. Whether or not the grounds for an estoppel can be established, the surety is held on the familiar rule that once the surety has entered into an undertaking with a creditor, the surety is bound unless he has a defense which can be related to the creditor. In the case of the surety on an official bond, the real creditors are the public as represented by a governmental authority, or certain designated members of the public who may be harmed by the officer's acts. These parties are not responsible for the surety's execution of his bond, and his own error is not a defense to him. Even if the surety has been defrauded by the officer, this is no defense to the surety unless the fraud is by the creditor, directed either against the surety himself or the principal. (See §§ 118, 119.) The rule stated in this Section is consistent with the rule stated in § 172, by which the surety is held even where there are grounds for an officer's removal.

Illustrations:

1. A court appoints as a guardian a person who is ineligible for appointment. He furnishes a surety. The surety is liable for the guardian's defaults.

2. A state treasurer is re-elected to office but fails to file a new bond until after the maximum time allowed by law. This failure in the jurisdiction is a ground for vacating the office. The treasurer, however, continues to act as treasurer and embezzles state funds. The surety on his bond is liable.

3. N is elected a sheriff although as a non-resident he is ineligible. He furnishes an official bond with sureties. The fact of his non-residence is discovered, and he is removed after a brief period of service. His surety is liable for defaults occurring when N was acting as sheriff.

4. A state constitution forbids the legislature to pass an act unless its purpose is indicated in the title to the act. The legislature by a rider to the general appropriation law provides for a new state officer with fiscal duties. The title of the act does not refer to the rider. The officer is duly appointed and furnishes an official bond with surety. Subsequently after defaults by the officer, the statute under which he holds office is declared unconstitutional. The surety is liable for the officer's defaults.

5. A sheriff dies in office. By state law in such a case, a successor for the unexpired term may be appointed by the judge of the district court. The judge duly makes the appointment, but the appointee is not immediately available. With the connivance of the County Commissioners, a deputy sheriff furnishes an official bond as sheriff, and proceeds to exercise the duties of the office, although knowing that he has no authority to do so. His surety is liable for defaults of the usurper while acting as sheriff.



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§ 174 Defaults of Deputies and Employees

The surety on a public officer's official bond is liable for the defaults of deputies and employees for which the officer is liable.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Most public offices have employees other than the principal officer and many officers have one or more deputies. The employees are always subject to the control of the principal officer. The deputies are also subject to the general control of the principal officer although they may have certain functions which cannot be changed by the officer. A deputy may act in place of the officer in the officer's absence or incapacity. Deputies, as well as employees, are usually appointed by the officer although his choice may be restricted or even determined by laws and regulations regarding official personnel. The officer, irrespective of his appointive power, is generally responsible for the wrongful acts of deputies and employees and for their failure to act where action should be taken. Even in the case of a deputy, the act of the deputy is the act of the officer, unless otherwise provided by statute. Sureties for public officers are responsible to the extent of the liability of the officer in the conduct of his office unless a statute otherwise provides, or unless such liability is expressly excluded by the sureties in a case where sureties can validly refuse such liability. (See § 169.) It is customary for an officer to require a bond with surety from a deputy for whose defaults he is liable. If necessary, creditors of a sheriff might reach such a bond as an asset of the sheriff.

Illustration:

1. A county treasurer furnishes an official bond with surety. In accordance with statute the treasurer appoints a deputy. His office also has numerous clerks, many of whom are permanent employees, protected under the merit system. Money is embezzled by a clerk and by a deputy. The treasurer's surety is liable for both defaults.

b. The statutory requirement that a deputy or employee give to government a bond with surety does not of itself release the public officer or his surety from liability under the rule stated by this Section, unless it is in terms accompanied by a release of the officer from liability for such deputy or employee, or unless the creation of independent duties for the deputy or employee, the removal of the deputy or employee from detailed supervision by the superior, or

other similar circumstances justify the inference that the officer is not to be liable for the default of the deputy or employee.

Illustration:

2. A state bank commissioner is authorized by statute to appoint a deputy commissioner as receiver in the event of the failure of a state bank under his supervision. The statute further provides that each deputy commissioner so appointed shall furnish a bond with surety covering his duties as receiver, which although subject to general supervision by the commissioner are largely defined by statute. In the circumstances neither the commissioner nor the surety is liable for defaults of a deputy commissioner acting as bank receiver.

c. Even in cases where the officer is not generally liable for defaults of deputies or employees, the officer and his surety are liable where the deputy or employee acts improperly at the direction of the officer, or where an unfit person is knowingly or negligently appointed by the officer. In such a case the default is that of the officer and consequently the surety for the officer is liable.

Illustration:

3. A State bank commissioner, who has given an official bond with surety, is authorized to appoint receivers for closed state banks. The receivers are required to give sureties to the state for the benefit of the creditors of the closed banks. In the circumstances the commissioner and his surety are not liable for defaults of receivers who are properly appointed with due regard to their fitness. The commissioner appoints a receiver of bad reputation, and with present criminal associates, who to the commissioner's knowledge has been guilty of embezzlement while acting as a bank officer. The commissioner and his surety are liable for this receiver's defaults.



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§ 175 Change of Duties of Officer

Where the duties of a public officer are changed during his term of office, the surety on his official bond is liable for defaults in connection with the new duties, unless the new duties are materially different in kind from the original duties, or unless they impose a substantially greater risk on the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The legislature has power to change the duties of officers during their terms, and this power is considered as being in the contemplation of the officer and his sureties. A similar power may sometimes be exercised by administrative agencies. The surety assumes risks in respect of the appropriate functions of the office. On the other hand, it is unfair to ask the surety to assume the changed risks where duties of a basically different sort or carrying with them a substantially greater risk are imposed on the officer. For example, if an officer having no duties in respect of public money is given fiscal duties during the continuance of his term, the existing surety is not bound for defaults in connection with fiscal duties. A surety who has such confidence in the capacity of an officer to perform one sort of duties, that he will guarantee their proper performance, should not be held accountable for the officer's ability to perform different duties which are of a kind not customarily imposed on the office and the risks connected with which he could not have contemplated. If the new duties are of the same general kind as the original duties but substantially increase the risk, the surety likewise can be held only to the risks that can fairly be said to be within the scope of his obligation. It should be observed that what is under consideration are duties newly imposed and not increased responsibility due to changed conditions. See Comment *d* and § 128.

Illustrations:

1. During the term of a constable the territorial jurisdiction of the court served by the constable is slightly increased. The surety on his official bond is liable for defaults in connection with the new duties of this constable imposed upon him by the increased jurisdiction of this unit.

2. During the term of a sheriff the legislature adds to the county a large area from another county greatly increasing the duties of the sheriff. The additional duties are so greatly in excess of those contemplated when the sheriff's surety

executed his obligation that the surety is not liable for the sheriff's defaults attributable to his increased duties.

3. A city engineer having supervision of the city water system is during his term given control over funds collected for water rents and meter rentals. The fiscal operations are so different in kind from those existing when the surety assumed his obligation that the surety has no liability for defaults of the engineer as a fiscal officer.

4. During a county treasurer's term of office the legislature charters a drainage district as part of the county and imposes upon the county treasurer the duty of acting as treasurer of the drainage district. The assessments for drainage purposes increase by only a small fraction the funds under the control of the treasurer. The treasurer's surety is liable for defaults in connection with the drainage district.

5. During a city treasurer's term of office, the city which has previously had a municipal electric light plant for street lighting, decides to sell electricity to private users, thus greatly increasing the funds in the hands of the city treasurer. The treasurer's surety is not liable for an embezzlement from the receipts from the electric light business.

b. The rule stated in this Section deals only with the question of how far the surety's undertaking covers the duties of the officer, where these are increased by statute. The problem is one of determining the scope of the surety's promise. Neither party to a contract can modify it, even if one party is government. If for example, the surety is bound for two years, the state by statute cannot extend his liability beyond that time. If by the terms of the surety's contract he is bound only for certain duties of the officer, his liability will not be enlarged, if the state by statute particularly declares that he shall be bound for new duties. Such a statute will affect future sureties only.

c. The surety for a public officer may contract to be bound for after-imposed duties whatever their kind and amount, and if he so contracts he can be held to such an obligation. Where a statute exists which provides that official bonds shall be deemed to cover the faithful performance by the officer of any subsequently imposed duty, the surety is bound for defaults in the performance of such duties.

d. Where the increase in duties of an officer is due not to change in statute or action by an administrative agency, but to causes for which government is not responsible, the surety remains liable for defaults of the officer, even if its risk is substantially increased.

Illustration:

6. During a county treasurer's term of office, oil is discovered within the county, thus greatly increasing the county's revenues. The treasurer's surety is liable to the extent of the penal sum in his bond for the treasurer's defaults.



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§ 176 Respective Liabilities of Sureties Where Special Official Bond Is Required for Particular Duties

Where an officer has various duties and the law requires a bond covering all duties and a special bond covering particular duties, the sureties on both bonds are liable for defaults in connection with the particular duties, but as between themselves the special surety is primarily liable.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section is a rule of statutory construction applicable to a restricted group of situations. The question may arise where a legislative or administrative body assigns new duties to an officer and requires a special bond covering the new duties. If the general bond does not cover the new duties because of their difference in kind or amount, there is no problem as to an existing general bond and a special bond, since in such a case each bond covers different duties, see § 175. The question of the liabilities of the respective sureties can arise out of such a situation in case of subsequent terms if the general bond still covers all duties and the officer is also required to furnish a special bond. A different situation, which is excluded from the operation of the rule of this Section, is where the statute or regulations state or can be interpreted to mean that the special bond is to be sole protection as to special duties.

b. Rationale. Where government requires two sureties, one for part of the risks and one for all of them, the inference is that the protection to government is meant to be cumulative, unless the contrary is stated. The best cumulative protection the government can have is to retain the complete liability of the general surety so that if necessary, recourse can be had against him, but also to have the liability of a special surety as to certain risks. If the penal sum for which the special surety is bound is exhausted by defaults in respect of particular duties, government if necessary can have the protection of the full penal sum of the general bond as to the other duties. The requirement of a special surety for particular duties means that such surety in relation to the general surety is primarily liable for defaults in the particular duties. If the general surety has to pay such losses, he has a right of reimbursement against the special surety.

Illustrations:

1. A county treasurer is also ex officio treasurer of a school district. The statutes require a surety bond covering

the treasurer's duties in general and one covering only his duties as school treasurer. The treasurer is guilty of defaults in both city and school funds. The defaults in the school funds are greater than the special surety's liability. The general surety is liable for the balance.

2. Same facts as Illustration 1, except that the entire amount of the default is first collected from the general surety. He is entitled to be reimbursed by the special surety for the amount of the defaults in school funds.

3. A county treasurer is required by law to keep and pay over all money coming into his hands for state, county, school, bridge, road, and all other purposes. When the county treasurer takes office, all school funds are in the custody of special school treasurers. A change in the law makes the county treasurer custodian of all school funds and requires that he furnish a special bond with surety covering the new duty. Such a bond is duly furnished. The treasurer subsequently embezzles school funds. The surety on the general bond has a subordinate liability, that is, he is a subsurety and the surety on the special bond the principal surety.



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§ 177 Negligence or Misconduct of Supervisory Officer

The surety on a public officer's bond is not excused from liability for defaults of such officer which should have been prevented or minimized by other officers.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Public fiscal officers and court officers are frequently, if not usually, subject to detailed supervision by other officers whose supervisory duties are prescribed by statute. Such supervisory officers may be guilty of negligence or wilful misconduct. Such negligence or misconduct will not relieve the surety of an officer whose defaults should have been prevented by the supervisory officers, although the sureties of the supervisory officers may also incur a liability. Government is not affected with responsibility for the action or non-action of any of its servants to the extent of relieving sureties on official bonds from their liabilities.

Illustrations:

1.1> from liability.

b. Where the surety for a public officer makes satisfaction for the defaults of the officer, he is subrogated to government's right against the officer and against others under the rules stated in § 141. Where one officer by wilful misconduct or negligence is himself liable to government for the defaults of another officer, the surety is subrogated to government's right against the other officer. If the officer has no such liability, there is of course no right to which the surety is subrogated. Even if the other officer is technically liable to government but without negligence on his part, the surety is not subrogated. (See § 141, Comment *g.*)



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§ 178 Default in One Office Satisfied by Default in Another Office

Where a public officer, who has control of more than one fund and has executed separate official bonds with sureties in respect of the different funds, is guilty of a misappropriation of one of the funds which he subsequently restores from another fund, the surety in respect of the fund from which the first defalcation occurred must, as between himself and the surety for the second fund, bear the entire loss.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Public fiscal officers frequently act as treasurer for more than one municipal corporation. For example, a city treasurer may also be treasurer for a school district, or a county treasurer may also be entrusted with the funds of one or more irrigation districts. The treasurer may be required to furnish separate sureties for the proper performance of each of several functions. If the officer embezzles funds of the city and repays the city out of school money, the surety on his bond as city treasurer rather than the surety for him in the capacity of school treasurer is liable for the default. The accounts of the city and the school district should be adjusted to the situation before the second embezzlement. If the surety for the officer as school treasurer is compelled to pay the school district he has a right to reimbursement from the city or from the officer's surety as city treasurer. The surety in such a case is subrogated to the rights of the school district. The rule stated in this Section is a special application of a general rule of subsuretyship. (See § 141 and § 145.)

Legal Topics:

For related research and practice materials, see the following legal topics:

Criminal Law & Procedure Criminal Offenses Property Crimes Embezzlement Penalties



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§ 179 Defalcation by Officer Serving Successive Terms

Where a public officer is an incumbent of an office for two or more terms with different sureties for each term, and the officer is guilty of a defalcation in one term for which he makes restitution by a defalcation in a subsequent term, the surety for the former term must as between himself and the surety for the subsequent term bear the entire loss.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rule stated in this Section although a simple and obvious one is often difficult of application, partly because a defaulting officer often tries to conceal his defaults by manipulating accounts, which complicates the determination of the time of default, and partly because preparations for embezzlement may occur in one term although the actual use of the funds for the officer's personal advantage may occur in a subsequent term. The problem is one of ascertaining the date when the default is consummated. It is this date that determines the liability of the surety. While the rule stated in this Section is usually of importance in the case of embezzlement, it applies equally to any loss for which the officer is liable in one term, which is made good out of funds in another term.

Illustrations:

1. A tax collector withholds tax funds collected during his first term and places them in his private bank account. His accounts at the beginning of the second term show the funds on hand. During his second term the collector uses the withheld funds in speculation and loses them. The surety on the bond for the first term is liable for the default.

2. A sheriff fails to make a return of funds collected on judgment levies during his first term. He retains the funds in his official funds so that his only offense during his first term is a failure promptly to pay over the collection. During his second term he embezzles the money he collects on the levies. Since the loss to the judgment creditor was due to conduct in the second term rather than in the first, the surety for the second term is liable.

b. The fact that because of the terms of his obligation, the surety for the second term may be liable for defalcations discovered in the second term although occurring in the first, does not excuse the first surety from liability. The second

surety's obligation may be in such form that he guarantees the accuracy of the officer's accounts at the beginning of the second term. In such a case, the governmental authority may recover from the second surety. The second surety, however, has a right to be reimbursed by the first. In general, however, the fact that the officer makes false entries during his second term to conceal embezzlement of funds during his first term does not impose any liability on the surety for the second term.

Illustration:

3.1> is subrogated to the county's right against S and is entitled to recover \$ 1000.



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§ 180 Expiration of Term of Office

(1) Where a public officer, elected or appointed for a definite term, has made a proper accounting at the end of the term, and there is no legal authorization for continuing in office until a successor is qualified, the surety on the officer's official bond is not liable for defaults after the end of his term.

(2) Where a public officer is directed or permitted by law to remain in office until his successor has qualified, the surety on his official bond is liable for defaults of the officer so long as he continues in office without his qualifying or another's qualifying for a succeeding term.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Term of office. A public officer may be elected or appointed for a stated period, for an indefinite period, or for a stated period and until his successor has qualified. In the case of a fixed term the officer ceases to be an officer at the end of the term. The surety's obligation covers the officer's defaults up to that time and not thereafter, provided a proper accounting is made at the end of the term.

Illustration:

1. S is surety on the bond of T, a city treasurer, whose term is fixed by law at two years from January 1, of even numbered years. A new treasurer is duly appointed, but owing to illness does not qualify on the date of the beginning of his term. T continues to act as treasurer and causes a loss to the city during the period of his extended service. S is not liable for this loss.

b. Where the term of the officer is indefinite, he ceases to be an officer when some event occurs which ends his term, such as death, removal, or resignation. The surety's obligation, unless otherwise limited, continues until the term is ended.

Comment on Subsection (2):

c. If an officer is directed or permitted by law to hold office until his successor is qualified, his term includes the

period during which he holds over continuously without qualifying for a new term. If a surety in such a case guarantees the faithful performance by the officer of his duties during his term of office, the surety's liability continues so long as the officer's term may be regarded as continuing. The length of time the officer remains in office is immaterial in respect of the surety's liability provided the officer's service is a continuance of the term for which he was duly elected or appointed. If the surety's obligation assumes a liability only for defaults between certain dates, the surety will be liable for defaults only during such period, irrespective of the actual duration of the officer's service.

Illustrations:

2. Under applicable law a public officer's term is fixed as two years, but it is also provided that the officer shall serve until his successor has qualified by giving a surety bond and taking an oath. T holds such an office with S as surety on his official bond. T is re-elected to such office. For a week after the new term is supposed to begin, T neglects to furnish a new bond. If T defaults during this week, S is liable.

3. Same facts as Illustration 2, except that a new officer is elected but does not qualify for a week after the date for the beginning of his term. S is liable for T's defaults during that week.

4. Same facts as Illustration 3, except that the new officer does not qualify for a year, and T continues to act. During the twelfth month of T's extended term, he is guilty of an embezzlement of public funds. S is liable for this embezzlement.



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§ 181 Penalties Imposed on Officer

A surety on an official bond is not liable for penalties imposed by law on the officer for breach of duty.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Where a surety guarantees that an officer will faithfully perform the duties of his office, the surety assumes a liability for losses caused by the non-feasance or misfeasance of the officer, acting in an official capacity. There is no liability for penalties which the law may impose upon the officer in addition to his liability for the losses due to his defaults unless such liability is expressly assumed. Such penalties are punitive rather than compensatory and are applicable only to the officer.

Illustrations:

1. A statute provides that if a county clerk issues a marriage license to a minor he is subject to a penalty of \$ 500, half of which goes to the state and half to the party entitled by statute to bring suit. The clerk issues a marriage license without investigation and becomes subject to the penalty. The surety on the clerk's bond is not liable for the amount of the penalty.
2. A statute imposes a penalty on a sheriff for failure promptly to return execution. The sheriff delays a return and becomes subject to the penalty. The sheriff's surety is liable for a loss due to the sheriff's breach of duty but not for the penalty.
3. A statute provides a 12 per cent penalty for failure by a tax collector promptly to account for collections. A collector is tardy in his accounts but ultimately makes a return of all sums due from him. His surety has no liability for the penalty.



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§ 182 Public Funds; Extent of Surety's Liability for Loss

A surety for an officer entrusted with public funds is liable for any loss of such funds unless such loss is caused by an act of God, the public enemy, or by government itself.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. An officer is responsible for public funds as an insurer in the sense in which insurer is used, for example, in the law of carriers. It is not enough that the officer exercise reasonable care. There is such a strong policy in favor of protecting public funds, that the officer is not permitted to excuse himself for losses even in respect to bank accounts, unless he can show that the loss was due to a cause like an act of God, the effect of which he could not have avoided by any practicable precautions. The rule has the advantage of simplicity of administration. It avoids litigation involving such issues as those of reasonable care and contributory negligence. It may diminish the chances of the officer acting criminally in collusion with others in respect of the public funds. The surety's liability is that of the officer unless the surety has expressly limited his liability in a jurisdiction where liability of the surety on an officer's bond can validly be limited by the surety, see § 169.

An important modern application of the rule stated in this Section has occurred after failure of banks in which public money is deposited. The officer making the deposits, if he has any discretion in the matter, is liable without negligence if the bank fails and loss is sustained. Neither the officer nor his surety is liable for the consequence of a bank failure where the officer is required to make the deposit and complies with statutory condition in doing so.

Statutes in some jurisdictions relieve an officer and consequently his surety from part of the liability to which he would otherwise be subjected. These statutes frequently provide that a fiscal officer is not responsible for losses of public money due to bank failures if he has followed a prescribed procedure in making and supervising the deposits. It is common to require that public deposits be secured by a surety obligation given by the depository.

Illustrations:

1. A county treasurer keeps current money in a safe provided by the county and takes reasonable precautions to

protect the safe. Armed robbers overpower the office force, blow open the safe, and steal its contents. The treasurer's surety is liable.

2. A county treasurer is permitted but not required to deposit funds in any national or state bank in the county. The treasurer deposits money in such a bank which fails. The treasurer and his surety are liable for the loss to the county, unless the statute permitting the deposit excuses the treasurer from liability if he complies with the statute in making the deposit.

3. Same facts as Illustration 2, except that the surety has stated in his contract that he does not assume any liability for loss due to bank failures. The surety is not liable unless there is a statute which provides that any bond offered in guaranty of the treasurer's performance of his official duties shall be deemed to cover losses due to bank failures, irrespective of the terms of the obligation.

b. Public funds. The expression "public funds" is used to include not only coin and paper money, but bank deposits and instruments representing investments of public money. The practical meaning of the Section is that a fiscal officer or one having fiscal duties is responsible if money or securities entrusted to him are lost or stolen, or if there is a loss due to a bank failure irrespective of his due care. If part of the public funds are invested in securities under the control of the officer, his liability for these securities is the same as if they were bank notes. The same would be true if he holds unissued negotiable bonds of the governmental authority of which he is an officer, and these bonds are lost or stolen and come into the hands of bona fide purchasers, so that government is liable on them. The rule stated in this Section carries the negative inference that the officer is not liable without fault for loss of governmental chattels other than instruments representing public funds. No rule is stated on this point because in such a case the applicable rule would apply equally to officers and other persons.

c. Act of God. The expression "act of God" or "vis major" is used to denote an overwhelming force of nature, the consequences of which could not have been prevented by any precautions which could reasonably have been expected. Among the natural phenomena which are included as acts of God are earthquakes, tidal waves, floods, tornadoes and lightning. It should be noted, however, that a natural phenomenon, lightning, for example, may in some situations not be regarded as an act of God. If in the circumstances the natural phenomenon is regarded as foreseeable and its consequences can be avoided by reasonable precautions, its occurrence is not a defense.

Illustration:

4. Petty cash is properly kept in a safe in the courthouse. An earthquake destroys the courthouse and breaks gas mains, which causes a fire in which the contents of the safe are consumed. Neither the treasurer nor his surety is liable for this loss.

d. Public enemy. An act of a public enemy is one which is a part of an attack by a foreign power, in operations of war, or a similar attack in an organized rebellion where a state of belligerency was recognized. At the opposite pole, the acts of bandits, even if organized into a considerable force, are not acts of the public enemy. The popular expression "public enemy" as referring to a dangerous or notorious criminal, has no application to the rule stated in this Section. The expression "public enemy" may be one with an expanding meaning, affected by the possible existence of considerable groups of people engaged in planned activities for the purpose of overthrowing a government or embarrassing and hindering it in its dealings with other governments.

Illustration:

5. The treasurer of a seacoast village keeps petty cash in a safe at the town hall. During a war, an enemy plane drops an incendiary bomb on the town hall, and the town money is destroyed. Neither the treasurer nor his surety is liable for the loss.

e. Act of government. Government cannot hold an officer or a surety liable for losses which it has caused itself.

If either the governmental unit served by the officer, or if a higher governmental unit to which it is subject, directs the use of funds, even if there is a diversion from their original purpose, there is no loss of the funds. Where, however, a loss does occur as a result of the directing of government, the officer is not liable. For example, if there were a central state bank, in which the treasurer was required by law to deposit all state funds, the treasurer and his surety would have no liability for loss of public money due to the failure of the state bank. The same result would follow if the effect of the statute left the officer without any real discretion, as where a county treasurer was required to deposit surplus funds in a bank in the county which was a member of the Federal Reserve System, and only one bank was a member of such a system.



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§ 183 Interest and Profits on Public Funds; Surety's Liability

The surety for a public officer is liable to the extent of the officer's liability for interest earned or which should have been earned on public funds and the profits made by legal investments, but the surety is not liable for profits made by an officer as a result of the illegal use of public funds.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The rule stated in this Section is based on the theory that a fiscal officer is not a debtor to government in respect of public money, but is rather a fiduciary with duties of accounting similar to that of a trustee although without the ownership of a trustee. It is not enough for the officer to account and turn over to his successor all the public money coming under his control. If any interest has been earned on this money or any profits made by its investment or otherwise, the officer should account to government for the interest and profits. His compensation is fixed by law, whether from salary, or fees or both, and permitting him to retain interest or profits on public money would increase the emoluments of the office without statutory authorization and would also place the officer under a temptation to increase his returns by a speculative use of the public funds. Since the officer's duty is that of a fiduciary, he can be compelled to account to the state for profits made either from an authorized or illegal use of public money.

The surety's liability in respect to public money is not coextensive with that of the officer if the surety's obligation is limited to the customary undertaking to be bound in a penal sum conditioned upon the officer's faithful performance of the duties of his office. The surety is of course liable for the failure of the officer to account for all public money coming under his control. If the officer, for example, embezzles the money, the surety is liable within the penal sum for the amount embezzled. If deposits and investments are authorized, the surety is liable for interest and profits on deposits or investments. If a treasurer, for example, is permitted to invest a temporary surplus in government bonds, and in the liquidation of those bonds, a profit is obtained, the surety as well as the treasurer is liable for the treasurer's failure to account for interest earned on the bonds and the profits from their sale. If, however, the treasurer makes an unauthorized use of the public money, the duty of the surety is to make good the default, rather than to account for the return to the officer. The officer may possibly be held for profits, even speculative profits, if the state chooses to trace the funds, but this is the result of available remedies against the officer and not the measure of the surety's liability. The surety's contract does not include an obligation to answer for speculative profits for which the officer may be

accountable. If such a liability were imposed, it would be exceedingly difficult for a surety to estimate the risk and the premium to be charged. To mention an extreme instance, if a tax collector took \$ 100 in public money and wagered on a race horse, which came in first at odds of 30 to 1, government might require the collector to account for \$ 3000, but could not compel the surety to pay more than \$ 100. It is assumed, of course, in this discussion that the surety has not participated in the officer's defaults to make himself share otherwise than as surety responsibility for the officer's wrong.

Illustrations:

1. A state treasurer is under a general duty to account for and pay over according to law public funds. he gives bond with surety covering these duties. The funds as collected are deposited with various banks until they are needed for state purposes. Interest is paid on the excess of such deposits over \$ 100,000. The treasurer accounts for the amounts deposited but retains the interest for himself. His surety is liable for this interest.

2. A state treasurer properly invests certain state funds in government bonds. At the end of his term, he sells the bonds at a profit and makes an accounting to the state for all state funds coming into his possession but retains the interest and profits on the bonds. His surety is liable for the interest and profits.

3. A state treasurer having custody of certain state bonds pledges these bonds to a broker as security for margin transactions, as a result of which the treasurer makes a profit of \$ 50,000. The treasurer closes his account and returns the bonds to the state treasury. While the state may require the officer to account for these profits, his surety has no liability for them.



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§ 184 Acts of Officer Beyond Authority

Where a public officer acts beyond the authority of his office while purporting to act officially, and the act is not outside the general class of acts pertaining to the office, the officer's surety is liable for losses due to the officer's acts.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See § 185 as to judicial officers.

b. The surety does not guarantee that the officer will do no harm in his private capacity. The rule stated in this Section is not concerned with the liability of the officer. It is assumed that where the officer acts or fails to act in connection with his official duties, the surety is liable to the extent of the officer's liability. For official acts which the officer should perform and which he performs negligently or with wilful violation of his duty, it is not difficult to determine the liability of the officer and his surety. It is likewise easy to ascertain that the surety has no liability for what the officer does which has no relation to his office. It is, however, often difficult to decide whether the officer is acting by virtue of his office or so far beyond his actual and apparent authority that his acts cannot be related to his official duties. The rule stated in this Section includes two tests for determining the surety's liability. First, the officer must purport to act officially, that is, he must use his office in some way in connection with the act, either by statements, by the exhibition of the insignia of the office, or in some other way indicating that he assumes to act officially. In most cases he will believe he is acting officially, but his lack of belief in his own authority is not decisive if he pretends that his act is official. The second requirement is that the act be one which, objectively considered, seems to belong within the scope of the duties of the office. In most cases the person against whom the act is directed will believe the officer is acting officially, but the absence of such belief is not conclusive as a defense to the officer's surety. If the act is one, which by objective standards, is the sort that belongs to the office, and the person against whom the act is directed either has no opportunity to resist it, or cannot do so without undue danger or inconvenience, the surety is liable for the harm done as if the act were an official act. Not only the act itself but the time and place of its performance are significant. While generally if an officer acts outside his territorial jurisdiction, his acts will not impose liabilities on his surety, it should be noted that occasionally an officer does have limited authority to act outside the area in which he normally exercises his functions. For example, a sheriff or his deputy may be permitted to pursue

an offender across state lines and may be recognized in another state as an officer in connection with the receipt of a defendant in extradition proceedings, just as the sheriff's surety in such circumstances may be liable for official act improperly performed so he may be liable for acts purporting to be official which are related to the sheriff's duties.

In considering the effect of an officer's conduct on the liability of the surety, it is important to consider whether his duties are broadly or narrowly defined, whether persons dealing with the officer have an opportunity for ascertaining without undue risk, the limits of his authority, and the penalties which may attach to them if they mistakenly resist the officer's assumptions. For example, within certain general limits a sheriff has comparatively broad authority and discretion; a tax collector, on the contrary, has usually only a precisely limited authority. A person faced with a sheriff's demand must often decide promptly, and with considerable risk to himself if his opinion of the extent of the sheriff's authority is wrong, whether or not to submit to the sheriff. A tax collector, on the other hand, might fairly and without undue risk be asked to prove his authority and his demands resisted without serious consequence until the authority was satisfactorily established.

Illustrations:

1. A constable has jurisdiction to levy under a writ only where the judgment is for \$ 70 or less. The constable makes a levy on a judgment for \$ 100 and subsequently comes under a liability for the full amount. His surety is liable.
2. A sheriff having an execution against A, levies by mistake upon the chattels of B. The sheriff's surety is liable to B.
3. A sheriff compels a neighbor under threat of arrest, to allow the sheriff to pasture his cows in the neighbor's pasture. The sheriff's surety is not liable for this damage.
4. A sheriff, without a warrant or other legal justification seizes A and holds him for several hours in the county jail. The sheriff's surety is liable to A.
5. A tax collector informs a landowner that he is making a special assessment against the landowner, collects the alleged tax, and absconds. No such tax could be imposed. The surety of the collector is not liable. It is manifestly not within the scope of a collector's duty to make assessments; his duty is only to collect assessment after formal action by another body.



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§ 185 Judicial Officers

A surety for a judicial officer is liable for losses due to the officer's negligence or misfeasance in the discharge of ministerial duties and for the officer's acts in a judicial capacity so far as the officer himself is subject to civil liability therefor.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Bonds are rarely required for judicial officers except those whose duties are to a considerable extent ministerial. The rule stated in this Section has its chief application in connection with bonds required of justices of the peace. No recourse is allowed against a judge, and hence not against his surety, for the judge's errors in performing his judicial functions. Few persons would care to accept judicial office if they were personally responsible for errors of judgment. No surety can be expected to guarantee judicial perfection. The law affords other methods for relieving the litigants from the consequences of judicial error. However, where the judge is also a ministerial officer, it is appropriate that he and his surety conform to the standards and accept the responsibility which would be applied to public officers in general entrusted with such duties.

Illustrations:

1. A judge in good faith grants a petition for a receiver for a corporation although the petitioner is not a proper party to ask for such relief, and even if he were, the allegations in the petition are insufficient. Before the corporation can have the order for the receivership set aside, it suffers serious loss. The judge has committed only a judicial error, for which neither the judge nor his surety is liable in damages.
2. A justice of the peace in good faith issues an execution in a case where he has jurisdiction of the subject matter, but in the issuance of which he infringes the law and causes loss to a litigant. Neither the justice nor the surety is liable for the loss.
3. Certain promissory notes are placed in the hands of a justice of the peace for collection in a jurisdiction where a justice of the peace is officially designated as a collection agent of commercial paper. When his term expires, he

neglects to turn them over to his successor, and because of his negligence the notes are lost and damage caused the owner. The justice and his surety are liable for this loss. Proper care of the notes was a ministerial rather than a judicial duty.

b. Judicial officers are not generally liable to litigants even for the arbitrary assumption of jurisdiction or for the wilful abuse of judicial authority. If in a jurisdiction where such a rule prevails, a judicial officer having ministerial duties is required to give a bond in general terms covering the faithful performance of his duties, the inference is justified that the bond is intended to cover only ministerial duties and neither the officer nor his surety is liable for losses due to arbitrary or corrupt exercise of judicial authority. On the other hand, if such a bond is exacted in a jurisdiction where the officer is liable to litigants for arbitrary or corrupt conduct his surety on a bond in general terms is also liable. A fortiori, if the judge must furnish a bond with surety which guarantees that the judge will perform his judicial duties impartially and honestly, the surety will be liable for losses due to arbitrary assumption of jurisdiction or to other wilful abuse of the judicial function.

Illustrations:

4. In State X judges generally are neither required to give bond nor are subject to civil liability for arbitrary or corrupt conduct. A justice of the peace in accordance with statute gives a bond with surety covering the faithful performance of his duties. The justice has both judicial and ministerial duties. The justice as a result of bribery erroneously decides a case within his jurisdiction against a litigant. The justice's surety is not liable for the loss caused the litigant.

5. Same facts as Illustration 4, except that by the law of State X, judges are civilly liable to litigants for losses due to arbitrary or corrupt abuse of judicial authority. The surety is liable to the litigant.

6. In State Y judges generally are not bonded and are not subject to civil liability for arbitrary or corrupt conduct. A statute, however, requires justices of the peace to give a bond with surety reciting that the justice will faithfully perform the duties of his office and will judge impartially, honestly and without favor. Such a bond is furnished. The justice arbitrarily and with knowledge of his abuse of jurisdiction directs the attachment of A's chattels in a matter beyond the justice's jurisdiction. The surety is liable to A.



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Introductory Note

This Chapter deals with surety obligations on bonds furnished in judicial proceedings. The bonds for the faithful performance of the duties of such officers in judicial proceedings as executors, administrators, guardians, and receivers, who may be designated generally as judicial fiduciaries, fall within the classification of judicial bonds but for convenience the bonds of such persons are considered in this Restatement in the Chapter on Official Bonds rather than in this Chapter, see Introductory Note, Chapter 8. Bonds given by such officers where they are parties to judicial proceedings are classified as judicial bonds and the Rules stated in this Chapter are applicable to them.

The judicial bonds dealt with in this Chapter may be variously classified. A distinction may be made between bonds required by statute and those required by court rule, between those upon the furnishing of which the jurisdiction of a court depends and those required in the discretion of the court, between those furnished as security for a litigant in a civil action and those guaranteeing the appearance of a defendant in criminal proceedings, or finally judicial bonds may be classified on the basis of the judicial proceedings in which they are furnished. Since the rules relating to surety obligations on judicial bonds are determined chiefly by the form of the proceedings in which they are furnished and since this is a Restatement of Suretyship rather than of judicial bonds, as such, the last classification is the one employed in this Chapter.

The Chapter does not contain any special treatment of surety obligations on recognizance as distinguished from bail bonds, since the rules in respect of sureties on bail bonds and recognizance are substantially the same even in a jurisdiction in which both bail bonds and recognizance are both used.

A recognizance is an obligation in a penal sum of record, entered into before some court, conditioned upon the performance, or the refraining from performance of some particular act specified therein. A recognizance resembles a bail bond and is usually required for the same purpose, although occasionally a recognizance is required in other than criminal cases and for purposes having nothing to do with the appearance of a defendant. The recognizance is a conditional judgment. It acknowledges an existing debt and is entered on the court records, but is suspended so long as the principal does or does not do certain acts in accordance with the orders of the court. The recognizance is usually by both principal and surety. If the court finds that the condition of the recognizance is not fulfilled, since the recognizance is a judgment the property of the recognizor is subject to levy without further action. A recognizance, unlike a bail bond, which is always taken pending adjudication of a case, may be taken at any time, even after final process. Instances of recognizances, other than to secure the appearance of defendants in criminal trials, include those offered in

place of bonds to procure attachment and of bonds to keep the peace.

In some jurisdictions the distinction between recognizance and bail bonds has ceased to exist and the terms are used interchangeably

Legal Topics:

For related research and practice materials, see the following legal topics:

Criminal Law & ProcedureBailRelease on Own RecognizanceCriminal Law & ProcedureBailSuretiesCriminal Law & ProcedureTrialsJudicial Discretion



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§ 186 Judicial Bond Defined

A judicial bond is a bond furnished by or on behalf of a party to a judicial proceeding.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Purpose of judicial bonds. The principal purpose of judicial bonds in civil actions is to afford security to an adverse party in a judicial proceeding that he will not be subjected to unjust delays in the enforcement of his rights and that he will be compensated for such delays or for unjust deprivation of the use of land or chattels or other interference with his property. Another important purpose of bonds in civil proceedings is to assure the payment of court costs. In criminal proceedings the primary purpose of a judicial bond is to assure the appearance of a defendant or his compliance with some order of court.



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§ 187 Ineligibility of Surety

Where a person who is ineligible to be a surety in a judicial bond undertakes an obligation as a surety, his ineligibility is not a defense to the surety.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Persons ineligible to act as sureties on judicial bonds. Ineligibility to act as surety on a judicial bond may arise either because a person is a member of a group forbidden to act as surety on judicial bonds or because he cannot comply with requirements for acting as surety in a particular case. For example, a statute may permit the acceptance of bonds only of residents, citizens or landowners. Two groups of persons who are commonly ineligible to act as sureties are attorneys, see *Comment b*, and those who are already or may be adjudged liable as a result of existing obligations in the judicial proceedings, see *Comment c*.

Rules as to the eligibility of sureties on judicial bonds are primarily for the protection of those for whose benefit the bonds are required though they may also be to some extent established for more general reasons concerned with the administration of justice. Whatever the purpose of these rules, ineligibility of the surety is a ground for the rejection of the bond. Rejection may occur by action of the court alone or action of the court prompted by objection from the party to be benefited by the bond.

b. Attorneys. Attorneys, by statute or court rule, are generally ineligible to act as sureties in judicial proceedings, although in a few jurisdictions the rule applies only to attorneys in the particular proceedings. By attorney is meant one admitted to practice in the court in connection with whose proceedings the bond is required and not merely a member of the legal profession. To permit an attorney to have such a financial stake in the outcome of litigation as would follow from his liability as a surety on a judicial bond might interfere with the attorney's position as an officer of the court. This would be true in greater degree if he were attorney and surety for a litigant than if he were surety in a case in which another was the attorney of record, but in both cases the attorney's position as surety might make it more difficult for him to maintain the objectivity desirable in a court officer. The rule stated in this Section is useful as a protection to attorneys from possible importunities of clients.

Illustration:

1. By court rule in State X, an attorney is ineligible to act as surety on a judicial bond. Defendant, after a judgment for C, files a supersedeas bond signed by his attorney as surety. No objection is made to the bond, execution is stayed, and in due course the judgment is affirmed. The attorney defends an action on the bond on the ground that the bond is void. The attorney is liable as surety.

c. Persons already liable. Parties are ineligible to act as sureties on judicial bonds and those already bound as sureties in an earlier stage of the litigation may be also ineligible if the requirement for a further surety bond is to assure additional protection for the performance of the same duty. The object of requiring that a party furnish a judicial bond with surety is to give the adverse party security. If the surety were already bound to substantially the same duty, the surety's obligation would be slight, if any, protection to the person for whose benefit the judicial bond is exacted. If the first bond is to pay the judgment and the second is only a cost bond, the surety on the first bond may be eligible to act as surety on the second.

Illustration:

2. D in State X after an attachment by C gives a bond to dissolve the attachment. S is surety on this bond, which is conditioned on the payment of the judgment. C obtains judgment and D appeals giving a bond with S as surety by which S is again obligated to pay the judgment. By statute in State X, a surety on a bond to dissolve an attachment is ineligible to be a surety on an appeal bond. The appeal is heard however, and judgment is affirmed. S is liable on the appeal bond.

d. Defenses of ineligible surety. Where a person ineligible to act as surety nevertheless undertakes a surety obligation, he is estopped to assert his own ineligibility as a defense. The fact that his ineligibility is not a defense does not mean that he may not have some other defense. For example, the bond may be required under circumstances which prevent an obligation from arising or which release an existing obligation. There may be special consideration for the bond, which has failed, or there may be lack of capacity in the circumstances to contract as a surety.

Illustrations:

3. C in State X obtains judgment against D, who gives an appeal bond with S, an infant, as surety. An infant is ineligible to be a surety in State X. Judgment for C is affirmed. S is not liable on the bond. While he cannot defend on the ground of ineligibility, he has the defense of lack of capacity.

4. C, in State X, attaches property of D, who gives a bond to dissolve the attachment with S as surety. Judgment is for C. D files a notice of appeal and furnishes an appeal bond signed by S as surety. By statute in State X, one already bound on a bond to dissolve an attachment is ineligible to act as surety on an appeal bond. The court rejects the bond on the ground of the ineligibility of the surety, and C proceeds to enforce his judgment. S is not liable on the appeal bond, although he is liable on the bond to dissolve the attachment. His defense is not his ineligibility but the rejection of the bond.

e. Judicial fiduciaries. It should be noted that although bonds of such persons as guardians, executors, administrators and receivers are considered in the Restatement of this Topic as official bonds, the rule stated in this Section applies to their sureties. See Introductory Note to this Chapter.



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§ 188 Defective Judicial Bond

Where a surety executes a judicial bond which is defective as not complying with statutory requirements or court rules, or where although the bond itself is in proper form, the principal has not followed the proper procedure in connection with the furnishing of the bond, the surety is nevertheless liable on the bond if the party on whose behalf the bond is delivered has obtained in whole or in part the benefit sought by the delivery of the bond.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The rule stated in this Section is concerned with defects in the form of the bond itself and with procedural errors in the furnishing of the bond rather than with the eligibility of the surety, see § 186.

Statutes or court rules customarily prescribe with considerable particularity the requirements for judicial bonds, and the circumstances in which they are to be furnished. This is especially true of bonds required in appellate proceedings. If a surety attempts or purports to satisfy a statutory or court rule without complying with requirements, he should not be permitted to assert the defects of his obligation or errors in procedure as a defense. Legal insufficiency or procedural error may be a basis for rejection of the bond but does not of itself defeat an action against the surety.

The circumstances in which a judicial bond is required usually show that the special consideration for the bond is found in its effect on judicial proceedings. For example, it may be to stay execution, to assure an appeal, to dissolve an attachment, or to obtain possession of land or chattels. Where the bond is given on special consideration which fails, the surety has no liability. Such a result may follow where a bond is offered and rejected with no detriment to the obligee. Likewise a bond may be void because, although it complies with requirements imposed by a judicial officer the requirements are invalid.

Consideration may be sufficient to make a defective bond valid as a common law obligation where an appeal is in fact heard, or execution stayed or in extreme cases even where the appellee is subjected to expense to obtain the dismissal of the appeal because of the defective bond.

The situations in which defective bonds are involved present so many variations due to the differences in statutes and court rules that no attempt is made to set out except in general terms the circumstances to which this Section is applicable.

Where the common law effect of the seal has been preserved and a surety executes a judicial bond under seal, the surety is liable unless he can show that the bond has been given for a special consideration which has failed.

Illustrations:

1. A statute in State X requires that a bond to dissolve an attachment be in twice the amount claimed by the plaintiff. In an action by C against D, which is begun by attachment, D with S as surety furnishes a bond to dissolve the attachment, in an amount equal to C's claim. The attached chattels are returned to D and the action proceeds to judgment for C. S is liable on the bond.

2. Same facts as Illustration 1, except that C promptly objects that the bond is insufficient and the chattel is never returned to D. The consideration for the bond has failed and S is not liable.

3. A statute in State X prescribes the wording of an appeal bond and requires two sureties. C obtains judgment against D and D appeals giving a bond with S as surety. The appeal is heard, in spite of the absence of a second surety and judgment is affirmed. S is liable on the bond.

4. C obtains judgment for \$ 99.00 against D in State X, where judgments for \$ 100.00 and over are appealable. D files notice of appeal and furnishes a bond with S as surety. The appeal is not allowed and C proceeds immediately to levy in D's chattels. S is not liable on the bond.

5. In State X, to perfect an appeal, a bond in statutory form must be filed within 20 days. C obtains judgment against D, who files notice of appeal but only after 30 days files a bond with S as surety. C may proceed at once to execution. He does not do so however, but delays execution, litigates the appeal and judgment is affirmed. S is liable on the bond.

6. In State X, an appeal bond is subject to approval by the lower court or the appeal may be dismissed. C obtains judgment against D and D appeals, giving bond with S as surety. The bond is not approved by the lower court. The appeal is heard however, and judgment for C is affirmed. S is liable on the bond.

7. C obtains judgment against D, and D appeals giving a bond with S as surety, which does not comply with statutory requirements in several important particulars. In the upper court after hearing, C obtains a dismissal of the appeal on the ground of the insufficiency of the bond. S is liable on the bond as a common law obligation. The detriment to C in having been compelled to incur expenses and inconvenience to obtain a dismissal of the appeal is sufficient consideration to support S's promise.



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Restat 1st of Security, § 189

§ 189 Appeal Bond Defined

An appeal bond is a bond required as a condition of the prosecution of an appeal or a stay of execution pending further judicial proceedings.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. A review or retrial of a case in equity was originally by appeal while a review by a higher law court was by writ of error. In most jurisdictions at the present time any review by a higher court of the record made by a lower court is called an appeal and this usage is followed in the Restatement of this Subject. The term "appeal bond" is thus used to include a supersedeas bond offered for the security of a defendant-in-error where a writ of error has been obtained in a law action.

It should be noted that the nature of the appeal may have an important effect upon the appeal bond which is required. If an appeal is taken from a court of limited jurisdiction to a court of general jurisdiction, so that a retrial is contemplated, the undertaking of a surety is a necessary step in the perfecting of the appeal and is usually prescribed by statute or court rule with great particularity. An appeal in the nature of a writ of error does not require a surety bond as a condition of a hearing in the reviewing court, but is only to stay execution. A court has the inherent power to order a stay of its mandate, and in aid of such power may also require such a bond as will protect the interests of the parties.

b. Forms of appeal bonds. The exact terms of appeal bonds vary in different jurisdictions but in general unless they are merely for costs, which is all that is required for appeals to some courts of last resort, the obligation of the surety is that the appellant will prosecute the appeal to effect and that if the appellant is unsuccessful, the surety will pay the judgment and costs. The bond customarily is limited to a stated sum, which is often, however, in excess of, and frequently twice, the amount of the judgment.

Legal Topics:

For related research and practice materials, see the following legal topics:
Criminal Law & Procedure Bail General Overview



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§ 190 Appeal Bond: Affirmance by Consent

A surety on an appeal bond conditioned on the satisfaction of the judgment if the judgment is affirmed, is not discharged in the absence of fraud if the appeal is dismissed for any reason or the judgment is affirmed by agreement of the parties or by consent of the appellant.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. The surety on an appeal bond accepts his principal as in control of the litigation. One of the risks assumed by the surety is that the appellant will not prosecute the appeal, either because of inability to continue the litigation, or because he has been convinced that further litigation will be fruitless. The principal should be allowed to terminate the case as expeditiously as possible. If he considers it to be to his advantage to conclude the case by consent to an affirmance, either with or without an agreement with the appellee, he should be permitted to do so, provided no fraud is thus committed on the surety. The principal is likely to be guided to his decision by advice of counsel. He may have lost in a lower court and his counsel may have advised an appeal. The principal may then employ new counsel for the appellate proceedings, and the new counsel may advise that the case be dropped. If the appellee cannot consent to this without discharging the surety, the result will compel the continuance of unnecessary litigation, which is contrary to public policy in the administration of justice.

The general principle embodied in the Section is qualified, as here stated, by the rule that the surety will be discharged if the agreement between appellant and the appellee is fraudulent as to him. Thus if both parties believe the appeal will be successful but an arrangement is made for its dismissal for the purpose of binding the surety and obtaining some secret advantage for the appellant, the surety cannot be held.

In the unlikely situation of a bond, which by its terms makes an affirmance after a hearing on the merits a condition of the surety's obligation, the surety is of course not liable if there is either a dismissal of the appeal or an affirmance by consent or stipulation. The mere fact however that the surety's obligation is conditioned upon an affirmance does not amount to a condition that the appeal be heard on the merits.

While the surety will not be held beyond his obligation it should be noted that if the bond makes liability dependent

on a hearing on the merits, it may not comply with statutory requirements and thus may be insufficient to perfect the appeal.

Illustrations:

1. C obtains a money judgment against D and D appeals, giving bond with S as surety, conditioned to pay the judgment if affirmed. D fails to prosecute the appeal and the appeal is dismissed. S is liable to C.

2. C obtains a money judgment against D, and D appeals giving a bond with S as surety, conditioned to pay the judgment if affirmed.

(a) C and D without S's knowledge agree that D is to take appropriate action to have the appeal dismissed. D carries out his agreement. S is liable to C.

(b) C and D agree to a stipulation to be filed with the appellate court by which C reduces his claim slightly and D consents to an affirmance. The stipulation is filed and the judgment is affirmed. S is liable to C.

(c) C and D although realizing that there are sound grounds for the appeal make a fraudulent bargain for the purpose of imposing a liability on S, by which D agrees to abandon the appeal in return for certain secret collateral advantages. S has the defense of fraud in an action on the bond by C.

3. C obtains a judgment against D and D appeals, giving a bond with S as surety. The obligation of S is conditioned upon an affirmance of the judgment after argument and decision on the merits by the appellate court. C and D agree to a dismissal of the appeal by D's consent. D consents and the appeal is dismissed. S is not liable to C.



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§ 191 Appeal Bond: Surety's Liability After Intermediate Reversal

A surety on an appeal bond is not discharged by a reversal of the judgment if the judgment is ultimately affirmed on rehearing or on further appeal.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Rationale. Where a judgment is reversed on appeal and the court on rehearing changes its decision to an affirmance or where a subsequent appeal is taken to a higher court which reverses the intermediate court, the net effect is an affirmance of the judgment in the intermediate court. In many cases the mandate of the upper court is to the intermediate court with an instruction to enter a judgment in accordance with the mandate. Even if the mandate is directed to the court in which the action originated, the judgment of the intermediate court having been held erroneous, cannot be accepted as a judgment on the appeal. To discharge the surety on the appeal bond, the reversal by the intermediate court must be a final determination of the appeal in favor of the appellant.



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§ 192 Successive Sureties

Where two bonds with different sureties are given in the course of the same litigation and one or both are appeal bonds, and the case is finally determined against the appellant,

- (a) each surety is liable to the appellee according to the terms of his undertaking;**
- (b) as between themselves to the extent to which they secure the same duty of the appellant,**
 - (i) the second surety is the principal surety if the first surety has not concurred in the obtaining of the subsequent bond;**
 - (ii) the first surety is the principal surety if he has so concurred.**

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Cross reference. See §§ 145 and 147.

Comment on Clause (a):

b. When there are successive legal proceedings and successive bonds with different sureties, for example, a bond to dissolve an attachment and a subsequent appeal bond, the first surety has no ground for claiming a discharge by reason of the subsequent proceedings. The first surety's principal, the appellant, rather than his creditor, the appellee, is responsible for the carrying on of the litigation. Presumably the subsequent appeal or other further proceeding is contrary to the creditor's wishes and interests. First and subsequent sureties are all liable to the creditor until the principal's duty to the creditor has been satisfied or until some reason has occurred for discharge for which the creditor is responsible.

c. The statement that one surety has a primary liability in respect of another, means primary to the extent of their common liabilities. The obligations of the first and second surety may be entirely co-extensive, partly co-extensive or for different duties. For example, where there is a bond to dissolve an attachment conditioned to pay the judgment, and a subsequent appeal bond similarly conditioned, the obligations are co-extensive. Where there is an attachment and a forthcoming bond conditioned upon the return of a chattel or the payment of its value, and a judgment for the plaintiff with a subsequent appeal with a surety bond conditioned upon the payment of the judgment, the obligations of the two

sureties may not be entirely co-extensive in a case where the attached chattel is worth less than the amount of the judgment. Where one bond is to pay the judgment and the other is only a cost bond there may be no common liability.

Comment on Clause (b):

d. Rationale. Where there are several sureties to a creditor in any situation and their mutual agreements do not determine their liabilities in respect of each other, their relations are determined by equitable considerations. Their relations may be cosuretyship or subsuretyship, see §§ 144-149. If a judgment has been obtained which has been appealed with surety and the judgment is affirmed but is further appealed, a surety on the second appeal is responsible for an extension of time to the principal. If the creditor were responsible for this result the surety would be in many circumstances discharged, see §§ 129 and 145, Comment *a*. The surety is not required to show actual prejudice; it is enough that a situation is created in which he may be prejudiced. Here there is no question of discharging the surety as to the creditor but the surety responsible for continuing the former surety's liability must accept the primary liability to the extent that their respective obligations cover the same duties of the principal. This result, however, is reversed where the first surety participates in the further appeal or other continuance of the proceedings in which a new surety is required. The first surety is in effect a principal as to the subsequent surety. It is not necessary that the first surety actually request the second surety's obligation, although this fact would be decisive. What must be determined is whether from all the circumstances the appeal is taken by principal alone, or by the principal and the surety. The word "concurrent" is used to describe the situation where the first surety's association with the appeal indicates that the appeal is on behalf of both principal and surety.



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§ 193 Accrual of Interest on Appeal Bond

Where a judgment is affirmed on appeal, and the amount due from the principal has been determined as a measure of the liability of the surety on the appeal bond, the surety is liable for interest from the time when performance is due from him irrespective of the penal sum of the bond.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The surety's liability is limited to the penal sum of the bond. However, since simple interest at the statutory legal rate from the time performance is due is recoverable as damages for a breach of contract to pay a definite sum of money or a sum which can be ascertained by calculation from the terms of the contract, it is possible for the surety who delays performance to become liable for more than the penal sum because of the accrual of interest. (See Restatement of Contracts, § 337.) Thus, if the condition of the surety's bond is that he pay the judgment, if affirmed with interest and costs, the limit of the surety's liability for those items is the penal sum of the bond. Where this sum is ascertained and performance is due from the surety, interest on the amount may be allowed against the surety as damages, if he does not tender performance when it is due from him.

b. The affirmance of a judgment against the principal does not amount to a judgment against the surety unless local procedure provides a method for rendering judgment against the surety in connection with the affirmance of the judgment, and appropriate action is taken for a judgment of decree against the surety fixing his liability. Statutes permitting summary judgment against the surety are common.

Legal Topics:

For related research and practice materials, see the following legal topics:
Criminal Law & ProcedureBailGeneral Overview



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Restat 1st of Security, § 194

§ 194 Injunction Bond Defined

An injunction bond is a bond required as a condition of the issuance or continuance of an injunction.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Where a petitioner states to a court of equity a case that from the petition seems to demand some immediate restraint of the respondent, especially in respect of the latter's property, to avoid irremediable damage to the petitioner, the court must recognize that upon a full consideration of the case, the allegations in the petition may not be sustained. The customary solution is to grant a temporary injunction to the petitioner provided that he furnishes a bond to cover the costs, expenses and other damages of the respondent if the petition be found to be unwarranted, see §§ 195 and 196. Injunction bonds are generally required and regulated by statute, but in the absence of statutory direction they will usually be required by any court of equity. Injunctive relief may occasionally be granted on a bond of the petitioner alone, but since the purpose of a judicial bond is security, the execution of the bond both by the principal and a surety is the general requirement.



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§ 195 Injunction Bond: Extent of Surety's Liability

Where principal and surety give an injunction bond, and the injunction is dissolved, the surety's liability within the penal sum of the bond is limited to consequences of the injunction itself, even if the principal is liable for additional penalties or damages.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. In some cases a principal may be liable for punitive damages or penalties, for example because of malice. The amount of penalties or punitive damages is not a loss due to the injunction and is not covered by the surety's obligation to pay damages which are the consequence of the injunction.



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§ 196 Injunction Bond: Attorney's Fees

The obligation of a surety on an injunction bond extends to reasonable attorney's fees incurred by the respondent for the purpose of obtaining a dissolution of the injunction, but not to attorney's fees incurred before the execution of the bond in opposing the issuance or continuance of a preliminary injunction, nor for services rendered in connection with aspects of the case not involving injunctive relief.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Resisting petition for injunction. The condition of an injunction bond is that the plaintiff or his surety will pay damages which can properly be considered the consequence of the injunction. Counsel fees incurred in resisting application for a preliminary injunction are not damages sustained from the issuance of the injunction and thus do not come within the terms of the surety's undertaking. If the injunction were denied, so that no bond were ever required or given, the expense to the defendant would be the same.

b. Rationale. Attorney's fees are not customarily allowed as costs to a successful litigant. They are so allowed as damages in the case of injunctions because the petitioner is granted a temporary interference with the respondent's freedom of action or use of his property before the determination of the petitioner's case. His attorney's fees may be a considerable element in the damage suffered or even the entire damage. It is only fair that the one who causes this damage, or the latter's surety, should compensate the respondent.

c. Allocation of damages. Where a permanent injunction is the relief sought and the petitioner after obtaining a preliminary injunction is unsuccessful in making the injunction permanent, he should pay all reasonable fees incurred in dissolving the preliminary injunction. If the respondent does not satisfy this duty, his surety should make the payment. On the other hand, where the injunctive relief is merely ancillary to the petitioner's claim, and the respondent's defense relates in part to the injunction and in part to the main cause of action, neither the petitioner nor his surety are under a duty to reimburse the respondent for the attorney's fees which the respondent cannot show are properly to be allocated to the dissolution of the injunction. The bond of the surety is an injunction bond and not one covering all expenses of the litigation. However, since the obligation of the surety is to pay damages resulting from the injunction, the respondent should not be denied the privilege of showing the loss sustained by him in consequence of the injunction

even if most of his expense would have been incurred had no injunction been granted. If part of the sum which the respondent must reasonably pay his attorney can be attributed to procuring a dissolution of the injunction, the petitioner and his surety are liable for it.

Illustrations:

1. C brings action against D to determine title to land and asks for an injunction restraining D from cutting timber on the land pending the determination of the action. D engages an attorney, whose first efforts are in opposition to the granting of a preliminary injunction. A preliminary injunction is granted upon C's giving a bond with S as surety. Subsequently, the attorney obtains a dissolution of the injunction. S is not liable for that part of the attorney's fees which should be allocated to opposing the granting of the preliminary injunction.

2. Same facts as Illustration 1, except that after the granting of the preliminary injunction D's attorney makes two unsuccessful efforts to obtain a dissolution of the injunction. The same attorney continues to represent D and in due course the action is determined in D's favor and the injunction is dissolved. S is liable for damages sustained by D as a result of the injunction including attorney's fees normally incurred by D in attempting to dissolve the injunction, but S is not liable for the attorney's fees which should be allocated to the trial of the other issues of the case.

3. C sells land to A who makes certain covenants regarding the use of the land. Among the covenants is one that in making any improvements on the land A will purchase all of his materials from C. A sells the land to D, who contracts for certain improvements, the materials for which are to be supplied by B. C, claiming that the covenant is one running with the land, obtains from the district court a preliminary injunction restraining D from making the improvements unless D purchases the materials from C. C gives a bond with S as surety. D employs an attorney to obtain a dissolution of the injunction and ultimately judgment is in favor of D. Since the only issue in the case is whether or not the injunctive relief can be made permanent, S is liable for all of D's reasonable attorney's fees incurred subsequent to the granting of the preliminary injunction.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil Procedure Remedies Injunctions Preliminary & Temporary Injunctions



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§ 197 Attachment and Replevin Bonds Defined

(1) An attachment bond is a bond which the plaintiff must furnish as a condition of the seizure of a defendant's chattels by officers of the law or of obtaining a lien on the defendant's land or other property before judgment.

(2) A replevin bond is a bond required of a plaintiff as a condition of his obtaining from a defendant possession of a chattel.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Attachment bond. A plaintiff in some jurisdictions may obtain the seizure of a defendant's chattel at the time of beginning certain actions or may obtain a lien on real or other property provided he gives a bond with surety to answer for damages due to the seizure of the chattels or other interference with property in the event that he does not obtain a judgment against the defendant. In other jurisdictions, an attachment can be made prior to judgment only in special circumstances, such as the non-residence of the defendant, or where the plaintiff makes an affidavit that the defendant is about to remove chattels from the jurisdiction or fraudulently to conceal or transfer them.

Comment on Subsection (2):

b. In common law replevin actions or their modern statutory equivalents to obtain possession of chattels, the plaintiff, who claims to be entitled to possession, is permitted to obtain possession immediately if he gives bond with surety to return the chattel and pay damages for its detention in the event that his claim is determined to be without merit. The action of replevin originated to give a remedy where there was a claim of improper distraint of chattels but as it developed the action was frequently used to determine title or right to possession in other situations. The surety's obligation is a necessary security for the defendant to avoid injustice as a result of the somewhat unusual course of the law in giving the plaintiff at least a temporary relief merely as a result of his bringing the action. The defendant in many jurisdictions can keep possession pending the adjudication of the plaintiff's claim provided he himself gives a forthcoming bond or a bond to dissolve the attachment, see §§ 199 and 201.

Comment on Subsections (1) and (2):

c. Both the attachment and the replevin bonds are to be distinguished from forthcoming bonds and bonds to dissolve attachments which are required of defendants as a condition of continuing in possession of attached chattels. (See §§ 199-201.)

d. *Counterclaims.* Under modern counterclaim statutes, the attachment bond, or in unusual cases, the replevin bond, may be required of a party who is the defendant in the original action, if in fact he is the plaintiff in respect of the counterclaim.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Provisional Remedies Replevins Contracts Law Secured Transactions Default Foreclosure & Repossession Enforcement



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§ 198 Attachment Bond: Extent of Surety's Liability

The liability of a surety on an attachment bond extends within the penal limits of the bond to all loss sustained by the defendant in consequence of a wrongful attachment including reasonable expense incurred by the defendant in procuring a dissolution of the attachment, but does not include exemplary damages which may be recovered against the plaintiff for malicious prosecution or other reasons.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Since attachment before judgment is an extraordinary remedy, which is allowed in advance of a final determination in favor of the plaintiff, it is accompanied by safeguards for the defendant. If there is a wrongful interference with the defendant's property, the defendant should be compensated for the actual loss sustained by him. To secure to the defendant this compensation, it is customary to require a surety on the attachment bond. However, if there are circumstances which justify an attachment in advance of judgment, the remedy should be a practicable one. No responsible surety can be expected to assume an undertaking unless he can estimate his risk with some accuracy. A surety may be expected to ascertain the probable loss to the defendant of the use of chattels, and to estimate the limits of the expense to which the defendant may be put to obtain a dissolution of the attachment, if wrongful. On the other hand, the surety should not be asked to judge the plaintiff's motives or to guess the amount of damage which a jury may be allowed to award if it is found that the plaintiff acted maliciously.

Items of damage for wrongful attachment for which the surety is liable include those which will compensate the defendant for loss of use of property, depreciation of chattels and harm to them while in the hands of attaching officers, reasonable attorney's fees incurred to procure the dissolution of an attachment, and personal expenses of the defendant attributable to the attachment. They do not include punitive damages for which the plaintiff may personally be liable.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Damages Punitive Damages Criminal Law & Procedure Bail General Overview



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§ 199 Forthcoming Bond Defined

A forthcoming bond is a bond required of a defendant as a condition of regaining or retaining possession of a chattel in an attachment or replevin action, by which the surety assumes a duty to surrender the chattel and to pay its value if it is not surrendered on the determination of the action in favor of the plaintiff.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Effect of forthcoming bond. The forthcoming bond does not discharge the lien of the attachment but enables the defendant to continue in possession. Whatever lien is obtained by the plaintiff by the attachment is continued after judgment. Then if there are other judgments against the same defendant, no other plaintiff by levy can supersede the lien obtained by the attachment unless the attaching plaintiff abandons his lien or otherwise so conducts himself as to lose his priority. In most instances the surety's liability will be sufficient to cover the value of the attached property but the continuance of the lien may be of importance if both defendant and surety are insolvent.

b. The modern tendency is to require bonds to dissolve the attachment rather than forthcoming bonds as a condition of permitting the defendant to resume possession of attached chattels, see § 200.



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§ 200 Forthcoming Bond: Rules of Surety's Liability

Where a surety has given a forthcoming bond and the plaintiff prevails in his action the liability of the surety is determined by the following rules:

- (a) The surety is liable for the value of the chattel if it is not surrendered, and in addition in replevin cases for damages for its detention.**
- (b) The surety is discharged if he surrenders the chattel in the same condition as when it was returned under the bond, or pays its value and in addition in replevin cases if he pays damages for its detention.**
- (c) The surety is liable for the deterioration of a surrendered chattel unless the deterioration is due merely to the passage of time, to an act of God or of the public enemy or of the plaintiff or to the acts or negligence of officers of the law while in lawful custody of the chattel.**
- (d) The surety is not liable if the chattel has been destroyed by an act of God, the public enemy or the plaintiff, or is unavailable because of seizure by legal process or by one having a superior interest.**

COMMENTS & ILLUSTRATIONS: *Comment on Clause (b):*

a. The surrender of the chattel in attachment cases is a fulfillment of the condition of the bond and a performance of the contract provided the chattel is in the same condition when surrendered as at the time of its return to the principal. Such a performance under the usual rules of contracts discharges the surety. In the alternative the surety can obtain a discharge by paying the value of the chattel. In replevin cases, since the judgment is a determination that the plaintiff should have had possession and the interest, the surety is also liable for damages for its detention. Compensation for loss of use of the chattel would be an element of damage to an owner or a bailee for hire although not to one having a security interest with no privilege to use the chattel.

Comment on Clause (c):

b. The surety guarantees that the chattel will be surrendered if it is determined that the plaintiff is entitled to possession and this means in the condition in which it would presumably have been had the plaintiff obtained it at the

beginning of the attachment or replevin action. If the deterioration is due to use by the defendant, the latter's negligence or misfeasance, or even to acts of negligence of others while the chattel is in the defendant's possession, the surety is held for the deterioration.

Illustrations:

1. C brings a replevin action against D claiming that he is entitled to the possession of a truck in D's possession. D gives a forthcoming bond with S as surety. D uses the truck in his business. Six months later it is determined that C is entitled to the possession. The decrease in value due to D's use is \$ 500. P delivers the truck to C. S is liable for \$ 500 plus damages for detention.

2. Same facts as Illustration 1, except that while P is using the truck it is harmed by T's negligence and its value further diminished \$ 300 as a result of the accident. S is liable for \$ 300 in addition to the damages allowed in Illustration 1.

Comment on Clause (d):

c. Just as in the case of deterioration, the surety has a defense if the chattel is destroyed under circumstances similar to those for which an insurer such as a common carrier would be excused. Neither the defendant nor the surety is responsible for an act of God or of the public enemy (see § 182, Comments *c* and *d*). Likewise, where the chattel is seized by legal process or by one having a superior interest, the surety is excused. The creditor's claim is that as between himself and the defendant, he is entitled to possession. In other words he is asserting that the possession of the defendant should be his, the creditor's. The surety's contract is that if the creditor prevails, the defendant will surrender the chattel. If someone else, as a result of legal process has taken possession of the chattel it is both illegal and impossible for the surety to surrender the chattel to the creditor. Finally, in the unlikely event that the act of the creditor himself prevents the surrender, the surety is discharged, for the creditor cannot expect the surety to perform what he himself has made impossible.

Illustrations:

3. D and C dispute the ownership of a valuable vase in D's possession. C brings an action of replevin for the vase, and D retains possession by giving a forthcoming bond with S as surety. Judgment is given for C. On the day the case is heard, D's house is struck by lightning, the vase is shattered and before the pieces can be saved by any reasonable effort, the remnants are consumed by fire. S is discharged.

4. Same facts as Illustration 3, except that instead of lightning the vase is destroyed by a bomb dropped from an enemy airplane in a surprise raid on New York. S is discharged.

5. C claims to be entitled to a vase in D's possession because of an agreement by D to pledge it to him for a debt. C brings an action for possession of the vase, and D, denying the pledge agreement, gives a forthcoming bond with S as surety. While this action is pending T brings an action of replevin against D, claiming to own the vase, and before the suit by C is heard, it is determined that T is owner and that D is unauthorized to pledge the vase. S is not liable to C.

6. Same facts as Illustration 5, except that D owns the vase but prior to the agreement and pledge has given a chattel mortgage on it which is duly filed. Before C's suit is tried, M forecloses the mortgage and the vase is sold for his benefit. S is discharged.

7. D owns a small painting by Memling, which C attaches in a suit against D. D gives a forthcoming bond with S as surety. Subsequently C visits D's house and after an angry dispute with D, seizes the painting and throws it into an open fireplace where it is immediately destroyed. S is discharged.

8. Same facts as Illustration 7, except that C carries off the painting and keeps it until the successful termination of

his action against D. S is discharged.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Provisional Remedies Replevin Contracts Law Secured Transactions Default Foreclosure & Repossession General Overview



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Division 2 - Suretyship

Chapter 9 - Judicial Bonds (Bonds in Judicial Proceedings)

Restat 1st of Security, § 201

§ 201 Bond to Dissolve Attachment Defined

A bond to dissolve an attachment is a bond which discharges an attachment lien by assuming an obligation either to pay the value of the attached property or to pay the judgment if judgment is obtained by the plaintiff in the action.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The defendant in an action in connection with which his chattels have been attached may be allowed to discharge the attachment by obtaining for the creditor a surety obligation adequate to assure the creditor that if he obtains a judgment it will be paid or that the value of the property will be paid. It is customary to require a bond in a penal sum of twice the amount of the plaintiff's claim or of the estimated value of the property. The effect of such an undertaking is to substitute the bond for the attachment lien.

b. Jurisdictions differ in respect of the type of bond required of a defendant as a condition of his being allowed to resume possession of chattels after an attachment. In some states a forthcoming bond is sufficient. In others the bond must be one to dissolve the attachment. The latter is coming to be the more common requirement, and generally the obligation is to pay the judgment rather than the value of the attached property.

c. Counterclaims. Where counterclaims are permitted, it is possible that the bond to dissolve the attachment will be required of a defendant in the action, if the latter is in fact the plaintiff on the counterclaim. (See § 197, Comment *d.*)



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Restat 1st of Security, § 202

§ 202 Effect of Bankruptcy on Surety's Liability on Forthcoming Bond and Bond to Dissolve Attachment

Where an attachment is not a voidable preference, bankruptcy of the defendant has no effect on the liability of the surety who has given either a forthcoming bond or a bond to dissolve the attachment.

CAVEAT: *Caveat:* The Institute takes no position as to the liability of a surety on a forthcoming bond or on a bond to dissolve an attachment where an attachment has been made within four months of bankruptcy.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. By the United States Bankruptcy Act in force Jan. 1, 1941, a lien by legal proceedings is not a voidable preference if acquired more than four months before the petition in bankruptcy. If the debtor in the circumstances gives a forthcoming bond, the lien continues and is good against the trustee in bankruptcy. There is no reason for excusing the surety from his usual duty to make the chattel available to the creditor in the event that judgment is obtained.

b. Where in the circumstances described in this Section, the surety has given a bond to dissolve the attachment, he is liable within the penal sum of the bond for the amount of the judgment. By § 16 of the Bankruptcy Act in force Jan. 1, 1941, the discharge of a principal is not a discharge of the surety. Even if the principal receives a discharge in bankruptcy, this will not prevent a judgment against him for the purpose of fixing the liability of the surety if the judgment is accompanied by a perpetual stay of execution against the principal.

Comment on the Caveat:

The position of the surety on a forthcoming bond or a bond to dissolve an attachment where an attachment has been made within four months of bankruptcy must be determined by an interpretation of § 67a of the United States Bankruptcy Act, as in effect January 1, 1941. The provisions of this Section of the Bankruptcy Act on the subject in question have not been authoritatively interpreted since the adoption of the amendments to the Bankruptcy Act (The Chandler Act) effective September 22, 1938.



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Restat 1st of Security, § 203

§ 203 Bail Bond Defined

A bail bond is a bond to obtain the release of a person from imprisonment and to secure his appearance to answer legal process.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Bail. The term "bail" is used variously to mean (1) the process by which a person is released from custody either on the undertaking of one or more sureties or on his own recognizance, (2) the delivery of a person under arrest to a surety, or (3) the surety for the appearance of such person on a bond to obtain the release of a person and to secure his appearance to answer legal process. The person for whom bail is required is generally the defendant in a criminal action, although bond may also be required of the defendant in a civil action or to assure in a criminal action the appearance of another as a witness. In the Restatement of this Subject the word "bail" as a verb is used to mean the delivery of a defendant to his surety, and as a noun to mean the surety for a defendant. In some jurisdictions by statute the defendant or another is permitted to deposit a sum of money or give security in lieu of an undertaking as security for an appearance. Such substitute is frequently called cash bail.

b. Purpose and nature of bail bonds in civil and criminal cases. Bail bonds in civil and criminal cases have the same general purpose. In both cases the principal is released from the custody of officers of the law and is considered as being in the custody of a surety of his own selection, whose duty is to assure the principal's subsequent appearance. In civil cases, the obligation of the bail within the penal sum of the bond is to pay the judgment if his principal does not appear. Under modern conditions where arrests in civil proceedings are uncommon, bail bonds are chiefly important in connection with criminal justice.

The liability of the bail in either a civil or criminal proceeding is limited by the obligation of the principal. For example, if a civil bail bond for \$ 5000 is conditioned upon the appearance of the defendant and his payment of the amount of such judgment as may be found and the defendant is adjudged to owe \$ 1000, this is the measure of the surety's liability. In criminal cases upon the non-appearance of the defendant the surety's liability is for the entire penal sum (see § 209). One should observe also that where a surety on a bail bond in a civil case pays the judgment, the principal's debt to the creditor is satisfied and the principal has no further duty to appear. The payment by the bail of the

penal sum in a criminal case has no effect upon the defendant's duty to the state to appear although it discharges the principal and his surety from liability to the state on the bond.

c. Terms of bail bonds. The surety's obligation on a bail bond as on any other surety contract is limited to the surety's promise, reasonably interpreted, unless there is a statute providing that certain statutory conditions are deemed to be contained in the bond, whether or not expressed (see § 169). Bail bonds usually contain such guaranties as that the principal "will appear and answer to the information and not depart without leave," "will appear and abide the judgment and orders of the court," or expressed in more detail that the principal "will appear personally before the court on the first day of the next term and from day to day and from term to term, and abide the order of the court until the cause is determined and not depart without leave."

d. Jail limits bonds. In some jurisdictions a defendant in certain circumstances may be released from actual detention provided he gives a bond, usually with surety, to stay within certain prescribed bounds, for example, within a city or a part of a city or a county. These bonds are not strictly bail bonds because the defendant is not technically released from the custody of the law but is rather given additional jail liberties.

Legal Topics:

For related research and practice materials, see the following legal topics:
Criminal Law & ProcedureBailGeneral Overview



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Restat 1st of Security, § 204

§ 204 Arrest and Surrender of Principal by Surety on Bail Bond

(1) The surety on a bail bond may, at his discretion, apprehend and surrender the principal.

(2) The surrender by a surety on a bail bond of his principal to the proper officer at a proper time and place discharges the surety.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Civil and criminal bail. The rule stated in this Section applies both to civil and criminal bail.

b. Rationale. The surety's liability as bail is to procure the appearance of the defendant at the prescribed time and place. If he does not do so, the surety in a criminal case must pay the penal sum stated in the bond. Since the appearance of the defendant is the surety's responsibility, the defendant is technically in the custody of the surety. If the surety believes that there is danger of the defendant's disappearance, the surety may end his own responsibility by surrendering the defendant to the proper officers. Such an act will not be taken usually unless the surety believes that there is a danger of the principal fleeing the jurisdiction. To enforce such surrender, the surety may personally arrest the defendant within or without the state or may obtain the aid of the officers of the law to compel such surrender. Since there is a strong public policy in preventing defendants from absconding, the surety is permitted a large discretion as to the steps necessary to effect the defendant's apprehension. In general the surety may do whatever an officer might do with a warrant for the defendant's arrest, even to the extent of making forcible entry into the defendant's home. The surety will incur a liability to the principal only if he takes means unnecessary or improper to effect the arrest and surrender. It is no defense to the principal that he had no intention of absconding or that the surrender was itself unnecessary. The large authority allowed the bail in respect of a defendant is justified by the responsibility imposed upon the surety. It may be noted also that the rule developed at a time when the surety was not allowed reimbursement from the defendant.

c. Since the surety voluntarily assumes a large responsibility for the appearance of a defendant, he may terminate this responsibility at his own volition by delivering the defendant to the proper officer. Such a rule is desirable because it tends to return a defendant to official custody where the surety has reason to believe he is planning to escape. To

make the surety's privilege of surrendering the principal dependent upon a showing of a reasonable cause to believe that an escape was imminent would tend to discourage timely action by the surety even where he apprehends an escape. The surrender of the defendant by the surety will not prevent the defendant's obtaining his liberty by providing a new bail, or, if permitted by law, by giving cash bail.

Comment on Subsection (2):

d. Proper time and place. To discharge the surety, the principal must be surrendered to the proper officer and at a time and place where the officer can be expected to assume responsibility for him. In general any time and place are acceptable if the proper officer can there assume custody of the defendant. The surety cannot satisfy the condition of surrendering the defendant at a proper time if the bond has already been forfeited because of the non-appearance of the defendant. A subsequent surrender of the defendant may afford the surety a basis for seeking a remission, in whole or in part, of the forfeiture, see § 209.

Legal Topics:

For related research and practice materials, see the following legal topics:
Criminal Law & ProcedureBailGeneral Overview



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Restat 1st of Security, § 205

§ 205 Defects in Procedure Against Defendant: Effect on Surety's Liability

Where the defendant in a criminal action fails to appear at the proper time and place,

(a) it is no defense to the surety on a bail bond that

- (i) the defendant is not guilty of the offense charged,**
- (ii) the defendant was illegally arrested,**
- (iii) the indictment or information is defective, or**
- (iv) the statute under which the defendant was arrested is unconstitutional unless the unconstitutionality has already been finally established;**

(b) it is a defense to the surety if

- (i) no criminal offense is charged against the defendant, or**
- (ii) the officer requiring the bond had no authority to commit the defendant.**

COMMENTS & ILLUSTRATIONS: *Comment on Clause (a) (i), (ii), and (iii):*

a Rationale. The bail in a criminal proceeding does not guarantee that the defendant is innocent but that he will appear to answer the charge against him. The issue of the criminal case is between the government and the defendant and should be determined in an action between them and not in a collateral suit involving the civil liability of the surety. The surety, therefore, cannot maintain as a defense that the defendant is innocent. If a person charged with crime is innocent, he has the privilege of defending himself and if successful he will be freed. It is desirable for his own sake that the defendant appear and clear his name if possible.

Where a defendant is illegally arrested or the indictment or information is defective, he has certain legal remedies. As in the case of an innocent defendant, such issues should be determined directly in the criminal action and not collaterally in a suit involving only a surety. In some cases by furnishing bail both defendant and surety waive the right to set up certain technical defenses, but whether or not they are waived by the defendant, they are not defenses to the surety.

Illustrations:

1. S is surety on a bail bond for P, indicted for mayhem. P fails to appear, but is located by the officers of the law, arrested, brought to trial and acquitted. S is not discharged although he may be able in the circumstances to induce the court to exercise its discretion to relieve him of the payment of part of the penal sum.

2. Same facts as Illustration 1, except that P is charged under a defective indictment which after his subsequent arrest, is quashed. S remains liable on the bond.

Comment on Clause (a) (iv):

b. Unconstitutional statute. If the statute under which the defendant has been taken into custody is invalid, this is a matter which can be raised as a defense by the principal but it is not a defense to the surety if the principal fails to appear. The surety is not charged with crime but is under a contractual duty. It is undesirable to determine the constitutionality of a statute in a collateral action. Moreover a serious interference with the administration of justice might result if sureties could raise questions of constitutionality in respect of arrest and imprisonment. It is the duty of executive officers charged with the administration of justice to enforce all statutes. Persons violating such statutes, who wish to challenge their validity, should do so by obtaining a judicial determination which can be best accomplished by court proceedings involving the principal party in interest. If the statute, however, has already been found to be unconstitutional, the statute no longer furnishes any authority for action under it. If a defendant is subsequently arrested charged with an offense under it, both he and his surety have a defense on the ground that no offense is charged. (Clause (b) (i) and Comment c.)

Illustration:

3. P is arrested charged with violation of a warehouse statute which has been enacted in State X, which has a constitutional provision that criminal penalties are invalid unless reference is made to them in the title of the statute. No such reference is made in this statute. P gives bond for his appearance with S as surety. P does not appear, and S defends on the ground of the unconstitutionality of the statute. S is liable.

Comment on Clause (b) (i):

c. No offense charged. If a person is arrested and imprisoned, charged with an act which is no offense under the law, the arresting officers in fact have no authority over him. The principal is entitled to release, not as a matter of defense, for there is in reality no charge against which to defend, but because the action of the officers is void. He has no duty to appear, and his surety no duty to produce him. The surety has no liability on the bond because the bond never created an obligation.

Illustration:

4. S is surety for P on bail bond exacted after P has been arrested on an information charging that P is guilty of "gaming." There is no such crime in the jurisdiction. S has no liability on the bail bond.

Comment on Clause (b) (ii):

d. Where an officer has no authority to commit a person, he has no authority to require a bond for his appearance, and any bond furnished as a result of such a requirement is void. If a surety were held on such a bond, he would be under a duty to keep a control over the defendant which might interfere with the authority of another officer having authority to commit. The lack of authority to commit may be due to the fact that no offense under the laws of the jurisdiction is in fact charged.

Legal Topics:

For related research and practice materials, see the following legal topics:

Criminal Law & ProcedureCriminal OffensesMiscellaneous OffensesBail Jumping & Failure to AppearGeneral
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Restat 1st of Security, § 206

§ 206 Voluntary Surrender by Defendant: Arrest in Same State for Same or Different Offenses: Effect on Surety's Liability

(1) Where a defendant surrenders himself voluntarily to the proper officers of the law, the surety on his bail bond is discharged.

(2) Where a defendant before the time for his appearance is taken into custody by the officers of the law in the cause for which he has been bailed, the surety on his bail bond is discharged.

(3) Where a defendant, before the time for his appearance, is arrested in the same state for a different cause, the surety on his bail bond is discharged only if the defendant is in custody of officers of the law at the time for his appearance in the first action.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Voluntary surrender. The defendant, who gives bail, selects a custodian whom he prefers to the public jailer. In fact, he obtains his freedom from public detention and puts himself under the surveillance of his surety. The defendant is free to return to the custody of the public officers if he desires. Since he can choose jail instead of freedom and since the surety cannot interfere with or supervise the jailers, the voluntary surrender by the principal discharges the surety. The relationship of bail is one which any party can terminate at any time before forfeiture.

Comment on Subsection (2):

b. Just as the surety may surrender the defendant or the defendant surrender himself to terminate the bail relationship, so government can terminate the relationship by remanding the defendant to custody. If government arrests the defendant for the same offense prior to the time for his appearance it is assuming responsibility for his custody in the matters in connection with which he has been bailed and the surety is discharged.

Comment on Subsection (3):

c. Where a prisoner is admitted to bail in connection with one offense this does not mean that he is immune from

arrest for a different offense. The second arrest does not excuse the principal from his duty to appear and answer the first charge. If government keeps him in custody until the time for his appearance under the first bail bond, government is in a position to produce him. The first surety has no liability where the principal is kept in custody. The principal, however, may escape before the time for his appearance or he may be bailed for the second offense. In neither case is the first surety discharged. In the case of an escape, it is the duty of the first surety to resume custody of the principal. In the case of bail for the second offense, while the principal is technically in the custody of both sureties, the custody of one must yield to the other when the latter is under the necessity of producing the principal. If either surety finds the situation distasteful he can release himself by surrendering the principal to the officers of the law. If the principal is under a duty to appear at two places in the same state on the same date and appears at either place, the other surety has a defense because the principal is complying so far as possible with the direction of government.

The rule stated in Subsection (3) has the advantage of discouraging the commission of lesser offenses to escape from penalty for greater ones. If a defendant were arrested for robbery and were released on a bail bond by which a surety was bound for a large amount, and his subsequent arrest for a traffic violation, were to release his bail in the robbery case, the security of a bail bond would be greatly lessened and the administration of justice hampered. In such a case, if the robber escapes after his arrest for the traffic violation, or is released on bond, or is released after serving sentence, and thus is available to answer the robbery charge, his surety's duty to produce him continues. The surety has a defense in such a general situation only if the state has the defendant in custody at the time he should appear to answer the robbery charge.

d. Where a principal who is out on bail in connection with a charge by the state, is arrested in the same state by the federal authorities, the effect on the surety's liability is the same as if he had been arrested by the state authorities. If he is in custody of the federal officers at the time he should appear to answer the state charge, the surety's liability is terminated if the federal authorities refuse to release the principal or if they release him to the state authorities.

Comment on Subsections (1), (2), and (3):

e. While the Comments have discussed situations where the defendant is admitted to bail in criminal proceedings, the rules stated in the Section have a possible application to civil bail.

Legal Topics:

For related research and practice materials, see the following legal topics:

Civil Procedure Remedies Bonds Sureties Procedures Criminal Law & Procedure Bail General Overview



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Restat 1st of Security, § 207

§ 207 Imprisonment of Principal in Another State: Effect on Bail Bond

Where at the time for the principal's appearance he is in custody in another state, the surety on his bail bond is not discharged unless the principal has been delivered to the other state by action of the first state, or removed there by federal authority.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The surety, having custody of the principal, should prevent his leaving the jurisdiction. If the principal nevertheless leaves, and is arrested in another state, the surety remains liable on his bond. If, however, the principal has been surrendered to another state, either as the result of extradition or by the voluntary action of the officers of the jurisdiction in which the bond has been executed or has been removed by federal authority to another jurisdiction, the surety has a defense because the non-appearance of the defendant is due to the state itself or to another authority which the surety cannot oppose. While the rule stated in this Section has its chief application to extradition within the United States, it is broad enough to cover delivery of bailed persons to foreign countries.

Illustrations:

1. P is arrested in State X and gives a bail bond with S as surety. P goes to State Y, where he is arrested and imprisoned. S is liable for his non-appearance in State X.
2. P is arrested in State X and gives a bail bond with S as surety. P is accused of a crime in State Y. The governor of State X honors extradition papers from State Y, and P is delivered to the officers of State Y. S is discharged.
3. P is arrested in State X and gives a bail bond with S as surety. P goes to State Y. While in State Y, extradition papers from State Z are honored in State Y, and P is delivered by the officers of Y to the officers of Z. P is sentenced to a long prison term in State Z. S is liable on the bond for P's non-appearance in State X.
4. P is arrested in State X and is admitted to bail with S as surety. Subsequently he is arrested in State X by federal officers and is removed to State Y, where he is held in custody by federal officers at the time for his appearance in State X. S is not liable on his bond.

Legal Topics:

For related research and practice materials, see the following legal topics:

Criminal Law & ProcedureBailGeneral Overview



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Restat 1st of Security, § 208

§ 208 Death of Principal and Other Defenses of Surety

Where a defendant fails to appear, the surety on his bail bond has a defense if the defendant

(a) is dead;

(b) is in custody within the state because of insanity;

(c) is unable to appear because of illness;

(d) is prevented from appearing by act of God or the public enemy within the jurisdiction where the surety was lawfully keeping the principal.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. The rules enumerated in this Section in substance state that the surety on a bail bond has a defense when it is impossible or unfair to expect him to produce the principal. The situations in which the surety has such defenses are largely those where the officers of the law themselves could not produce the defendant had he not been admitted to bail. (See § 209.)

Comment on Clause (d):

b. Act of the public enemy. Where the surety has kept the principal in such a place as would have enabled the surety to carry out his obligation were it not for the acts of the public enemy, government rather than the surety is responsible for the principal's nonappearance. If for example, the defendant is admitted to bail in the city of New York and is captured by an invading army in New York State or held by the enemy under siege in Albany, the surety cannot be expected to produce him. On the other hand if the principal voluntarily goes to a foreign country, where he is captured by the enemy, the surety is held on his bond.

Legal Topics:

For related research and practice materials, see the following legal topics:

Criminal Law & Procedure Criminal Offenses Miscellaneous Offenses Bail Jumping & Failure to Appear General Overview



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Restat 1st of Security, § 209

§ 209 Forfeiture of Bail Bond

The surety on a bail bond is liable for the penal sum named in the bond if the defendant fails without legal excuse to appear at the time and place required, but the court in its discretion may set the forfeiture aside or reduce the liability of the surety to the amount of the expenses to which the state has been put by failure of the defendant to appear or to any other amount.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. If the defendant defaults by non-appearance the liability of the surety on a bail bond becomes absolute and the court may declare the penal sum forfeited. It is no defense that the principal subsequently appears, voluntarily or as a result of the efforts of the surety or the state.

b. Reduction of liabilities. Where the surety has an excuse which, though not technically a defense, is an indication that no effort has been made to avoid the jurisdiction of the court as where the non-appearance of the defendant has been due to a mistake or where the surety by his own efforts obtains the appearance of the defendant with reasonable promptness, the court on the petition of the surety will generally set aside the forfeiture or reduce the liability of the surety so that it covers only the actual additional expense to which the state has been put. Statutes in many jurisdictions state circumstances in which a remission of forfeiture of bail may be allowed.

Legal Topics:

For related research and practice materials, see the following legal topics:

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Restat 1st of Security, § 210

§ 210 Reimbursement of Surety on Bail Bond

(1) The surety on a bail bond in civil proceedings is entitled to reimbursement from his principal in accordance with the rules stated in § 104.

(2) The surety on a bail bond in criminal proceeding is entitled to reimbursement by the defendant only if government by permitting the acceptance of cash bail or otherwise indicates that there is no public policy against the defendant's reimbursing the surety.

COMMENTS & ILLUSTRATIONS: *Comment on Subsection (1):*

a. Civil bail. The purpose of requiring bail in civil cases is to increase the creditor's chances of collecting a debt. Since the debt should be paid by the principal rather than the surety, there is no reason why the ordinary rules of suretyship should not apply, by which the surety is entitled to reimbursement for any payment made on account of the principal. The general rule as to reimbursement of a surety by a principal is stated in § 104. See also §§ 105 and 111.

Comment on Subsection (2):

b. Criminal bail. The purpose of the requirement of bail in criminal cases is to substitute for the public prison the friendly custody of a jailer of the defendant's own choice. The duty of the principal to appear is not satisfied by the payment of the penal sum of the bail bond. While the relationship of defendant and bail is recognized as suretyship and the bail is allowed in general the defenses of a surety and contribution from cosureties, the important incident of reimbursement is denied the bail at common law. The principal cannot make a cash deposit in lieu of a surety obligation. If the principal could do so, there might be a danger that he would purchase his liberty for the purpose of escape. Likewise, if the surety could rely on reimbursement by the principal, the surety's vigilance might be diminished and he might even be tempted to assist the principal in fleeing the jurisdiction. Because of the public policy in placing responsibility upon the surety for the defendant's appearance, not only will no implied contract to reimburse be enforced, but even an express contract is void. If government, however, permits the acceptance of cash bail in lieu of a surety obligation, it indicates a willingness to rely upon the threat of monetary loss as sufficient coercion upon the defendant. If government is willing to accept cash bail for the defendant directly, it should not object if the defendant

gives security to the surety or makes an express contract to reimburse him. Furthermore, since the only reason why the ordinary rule of reimbursement of surety by principal has not been applied in bail cases is the supposed public policy against reimbursement, if government attitude, as indicated by the acceptance of cash bail or in any other way, is that there is no policy against reimbursement, a duty to reimburse can as in other suretyship cases be found merely from the relation of principal and surety.



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Division 2 - Suretyship

Chapter 9 - Judicial Bonds (Bonds in Judicial Proceedings)

Restat 1st of Security, § 211

§ 211 Entry of Defendant Into Military or Naval Service: Effect on Bail Bond

The surety on a bail bond is not discharged by the voluntary enlistment of the defendant in the military or naval service but is discharged if the defendant is drafted into such service or is called from reserve or other inactive service into active duty and the military or naval authorities will not permit his appearance to answer the charge against him.

COMMENTS & ILLUSTRATIONS: *Comment:*

a. Since the defendant is in the custody of the surety, the surety has the responsibility of keeping the defendant available for the legal process in connection with which the bond is required. No voluntary action on the part of his principal will excuse the surety. On the other hand, where the government exercises its paramount authority over the principal so that it is impossible for the surety to keep the principal available, the surety is thereupon discharged from his obligation. The term "military and naval service" is meant to include any branch of the armed forces of the United States. The mere fact that the principal is subject to service will not discharge the surety, if upon proper application to the proper authorities the principal will be permitted to appear and answer the charge against him.

Legal Topics:

For related research and practice materials, see the following legal topics:
Civil Procedure Remedies Bonds Sureties Procedures