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The bottom line for surety and fidelity company representatives and their counsel is that the Restatement of the Law Third, Restatement of the Law - Suretyship and Guaranty "... adopts a bifurcated approach to impairments of the surety's suretyship status," combining remedies from Article 3 of the UCC revised in 1990 and UCC Section 1-106 (1995). The key to understanding this glib precis is knowing what is meant by the term "suretyship status." This paper offers insight to understanding this Restatement concept by tracing its development and assimilation into the final product and by briefly discussing Suretyship Status as the defining concept of the obligee's rights and the surety's defenses.

I. INTRODUCTION^2

A. The Origin of the Project.

The subject "Suretyship" was covered in the Restatement of Security published by the American Law Institute (ALI) in 1941. By April 1, 1989, that Restatement was the second least cited of the ALI's Restatements. It was clear that the Suretyship section of the Restatement of Security was used very little. Many of the other security provisions of that Restatement have been superseded by provisions in the Uniform Commercial Code. Thus, the subject of Suretyship was ripe for review and reconsideration by the ALI.

The original suggestion to the ALI for a study of the law of suretyship was made by Donald J. Rapson, Esq.^4 in a letter of May 30, 1986 to Professor Geoffrey C. Hazard, Jr., Director of the ALI. Mr. Rapson has set forth the background leading up to the undertaking of the project in his article, Rapson, History and Background of the Restatement of Suretyship.^5

Upon the decision to proceed with the project, Professor Hazard appointed Professor Neil B. Cohen as Reporter and Daniel Mungall, Jr., Esq., as Associate Reporter. He also appointed a group of 16 Advisers and a Members Consultative Group (MCG) of about 25

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1Comment a., §37, Restatement.

^2Parts I. and II. of this paper are adapted from D. Mungall, Introduction and An Overview of the Restatement and Suretyship Status and Its Significance, April 18, 1996, The Implications Of The New Restatement Of The Law Suretyship And Guaranty, On Surety Bonds And Indemnity Agreements, A.B.A. Tort and Insurance Practice Section, Fidelity and Surety Law Committee, Program.

^3April 9, 1989 Annual Report.

^4Senior Vice President, Assistant General Counsel and Secretary, The CIT Group, Inc., Livingston, New Jersey.

persons, the latter two groups to act as advisers to the Reporter.⁶ The Advisers consisted of academics experienced in contract law, Uniform Commercial Code and commercial law in general; practicing lawyers experienced with commercial transactions involving credit enhancement devices; and, practicing lawyers from the Fidelity & Surety Law Committee of the American Bar Association Torts and Insurance Practice Section (FSLC).⁷

**B. The Goal and Some Initial Tensions.**

Professor Hazard described the goal of this project in these words:⁸

> The primary goal of this Restatement has been to formulate rules broad enough to govern a wide variety of transactions that are subject to very different practice conventions, yet to maintain clarity. Suretyship law applies by virtue of consensual arrangements, but is not simply a subcategory of contract law. The arrangements involve three parties, but in many situations suretyship law is best understood in terms of three separate two-party relationships. The suretyship obligation may be expressed simply or it may be embedded in a financially complex transaction. All cases, however, spring from the confluence of three factors, a primary commitment, the actual or incipient failure to fulfill that commitment, and the secondary commitment of the surety. In this context, the law must often determine which of two parties will initially bear a cost that both intended to be borne by a third party and provide mechanisms to pass that loss, when possible, to the third party.

The "wide variety of transaction"⁹ to be governed by the Restatement of Suretyship include:

1. surety bonds involving an obligee, a principal and a surety;
2. financial guarantees, ranging from the simple guaranty of a debt involving a creditor, a debtor and a guarantor, to a complex financial transaction as a part of which one party agrees to be responsible to another party if the obligations of a third party are not fully discharged; and
3. agreements of the buyers of property subject to a lien to pay the seller's obligation to a lienholder.

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⁶There were 2-day meetings of the Advisers and the MCG in June of each year beginning with 1991 through 1994, to review and discuss with the Reporter the Preliminary Drafts prepared by him.

⁷Associate Reporter: Daniel Mungall, Jr. and James A. Black, Jr., James F. Crowder, Jr., T. Scott Leo, Patrick J. O’Conner, Jr., and Hugh E. Reybolds, Jr. Samuel Arena also sat in to assist Daniel Mungall.


⁹The discussion of the project at a preliminary meeting in July of 1989, led those present to the realization that there were at least "two worlds" of suretyship, involving credit enhancement devices in commercial transactions and the bonds issued by surety companies. Rapson, History and Background of the Restatement of Suretyship, 34 William and Mary Law Review 989 at 991-993 (1993).
Each of the Adviser groups, i.e. academics, attorneys experienced with credit enhancement devices and the FSLC members, had experience in one or more of these types of transactions. These groups brought differing experiences, perceptions and concepts to the discussions. Due to these widely differing views, the goal to "formulate rules broad enough to govern" this wide variety of transactions created tension in the crafting of the rules. perceptions and concepts.

An initial tension was in the nomenclature to be used. "Obligee, principal and surety", while routine to surety practitioners is not readily adaptable to some of the other areas. Accordingly, the Restatement uses the terms "obligee", "principal obligor" and "secondary obligor" to identify the parties, and "underlying obligation" and "secondary obligation" to identify the duty of the principal obligor to the obligee and the duty of the secondary obligor to the obligee. Toward the end of the process, it was recognized that the term "suretyship" was not used in many of the transactions intended to be governed by these rules, so the name of the project was changed to include the term "Guaranty."

It was recognized very early in the deliberative process that the subject deals with rights and duties between the obligee and the surety and between the principal and surety which are implied by law because of the existence of the suretyship relationship. However, the term "suretyship" is not always used to describe the relationship in many of the areas intended to be covered by the Restatement. Accordingly, the term "Suretyship Status" is used to indicate when a secondary obligor is entitled to these implied rights.

The Restatement is not limited to matters relating solely to those implied rights and duties that arise when Suretyship Status exists. As was the case with the Suretyship section of the Restatement of Security, the Reporter gathered together numerous other rules which may act upon a transaction once Suretyship Status exists so that one may find in one place all or most of the rules that may apply to a suretyship relationship.

II. AN OVERVIEW OF SURETYSHIP STATUS AND ITS CONSEQUENCES

A. The Significance of Suretyship Status.

The principles in the Restatement which deal with pure suretyship are essentially these:

1. the criteria which must be met for Suretyship Status to exist (§1);
2. the nature of the implied rights and duties between the principal and the surety (generally in §17(1), and expanded in §§18, 20-24, 26);
3. the implied rights between the surety and the obligee, which are framed in terms of "suretyship defenses" or conditions on the contractual obligations of the surety (generally in §17(2) and expanded in §§37-49);
4. the identity of, and the rights and duties between, cosureties and principal sureties and subsureties (§§52-61).

Most of the remaining Restatement sections and a few of those noted above contain rules indicating how other principles of law, outside the scope of pure suretyship, impact on that relationship.

The Restatement provides that the implied rights and duties between the surety and the principal and between the surety and the obligee arise when "Suretyship Status" exists. By Section 1(1), the Restatement applies and a secondary obligor has Suretyship Status whenever:

1. pursuant to contract, an obligee has recourse against a person (the surety) or that person's property with respect to an obligation to the obligee of a second person (the principal);
2. the obligee is entitled to only one performance; and
3. as between the surety and the principal, the latter should perform.

Subsection (2) describes circumstances in which an obligee has recourse against a surety or its property. Thus, the criteria which give rise to Suretyship Status are:

4. the obligation of the surety is contractual; the obligation of the principal to the obligee may be greater than or different from the secondary obligation;
5. the obligee "has recourse" against the surety or its property; a surety may provide collateral without assuming any further liability to the obligee;
6. that recourse is "with respect to" the principal's obligation to the obligee;
7. the obligee is entitled to only one performance; and
8. as between the principal and the surety, the principal should perform.

Subsection (3) indicates factors that do not affect the existence of Suretyship Status. The rule is substance controls form.

This Section 1 formulation of Suretyship Status stands in stark contrast to the very simple definition developed from the Statute of Frauds that suretyship is a contract to answer for the duty of another. All of the criteria in Section 1 are necessarily encompassed in that simple definition except for the Section 1 references to the obligee's having "recourse" against the surety and that recourse being "with respect to" the principal obligor's obligation. Conceivably, this last language may include transactions that are not really suretyship.

The language, "answer for the duty of another," in the Statute of Frauds definition ties the surety's promise to that of the principal obligor. Having "recourse against" a person as a result of that person's promise does not establish any connection between the two obligations; only that the consequence of the surety's promise results in liability if the other obligation is not performed. The negligent act of a tenant causes damage to the landlord's property; the landlord "has recourse" against its property damage carrier, but that coverage is certainly not suretyship.

To avoid this unintended result, there was added to "has recourse against" the phrase "with respect to" the principal's obligation. Whether this establishes the nexus between the surety's promise and the principal obligor's obligation which must exist before a suretyship

\[\text{footnote}{10}{The \ Restatement \ applies \ the \ term \ "Suretyship \ Defenses" \ to \ what \ the \ law \ implies \ between \ the \ surety \ and \ obligee. \ See \ "III. \ D.\", \ infra.}\]
relationship exists remains to be seen. Unfortunately, that phrase does not have regular use and meaning in suretyship so its interpretation will be up to the courts.

The fact that "has recourse against" deals with the consequences of events rather than the nature of the surety's promise and that "with respect to" is a new concept in the definition of suretyship suggests that Section 1 may raise as many questions as it answers.

**C. The Implied Rights and Duties Arising From Suretyship Status.**

There is no discussion in the Comments to Section 1 as to why the law has implied rights and duties between the parties to a suretyship transaction. The reason for the implication might shed some light on when the relationship exists. There is such a discussion in Comment b to Section 11 as to why the Statute of Frauds requires a writing in case of a contract to answer for the duty of another. This justification may also be the reason why the law has implied rights in a suretyship situation.

In summary, the implied duties of the principal to the surety are:

1. to perform the underlying obligation (§21(1)(a));
2. to refrain from conduct impairing its own ability to perform (§21(1)(b));
3. to reimburse the surety to the extent the surety performs the secondary obligation (§22(1)).

**D. The Contract Creating a Secondary Obligation and the Applicability of Other Law**

It is clear that the secondary obligation arises by contract and Section 2 identifies six different contractual formats by which such an obligation may be created. Since the implied rules resulting from Suretyship Status are contractual in nature, they are subject to whatever agreement the parties make with respect thereto; §6 and §48.

For the most part, provisions dealing with the formation of a secondary obligation, §7, the requirement of notice of acceptance, §8, consideration, §9, and capacity, §10, set forth general rules from contracts, as well as other areas of the law. The interpretation of a secondary obligation is governed by the standards that apply to contracts generally, §14.11

There is a rule governing the assignability of a secondary obligation by the obligee set out in Section 13. Assignments may be made which are not against public policy and which are not prohibited by contract provided the surety's duty, burden or risk is not materially changed or increased.

Unless inconsistent with the Restatement, all other principles of law and equity, including things like the law of contracts, apply to transactions involving Suretyship Status, §5. Moreover, the law of negotiable instruments and secured transactions, when applicable, takes precedence over the rules in the Restatement, §4(1).

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11This is consistent with the Florida Supreme Court's ruling in American Home Assurance v. Larkin General Hospital, 593 So.2d 195 at 197 (Fla. 1992). See also L & A Contracting Company v. Southern Concrete Services, Inc., 17 F.3d 106 at 109 (5th Cir. 1994).
III. **OBLIGEE'S RIGHTS AND DUTIES**

### A. Overview

Title "B" in Topic 3 of Chapter 3 of the Restatement encompasses Sections 37 through 49. This Title seeks to bring consensus to an area of suretyship law where there has been none, through a series of rules flowing from the common concept of protecting the rights of the surety implied from suretyship status.

Section 17(2) provides that the duties of a surety to the obligee and the obligee to the surety are those existing pursuant to the secondary obligation "subject to the secondary obligor's defenses." Section 19(c) indicates that a surety has certain "suretyship defenses" and a general statement of the obligee's duties is found in §32(1). Section 37 outlines the consequences of the obligee's improper conduct resulting in discharge of the surety in some circumstances and providing the surety with a claim against the obligee, in others.

Sections 13, 15, 16, 33-36, 38-49, 50, 51 and 70 also describe the rights and duties of obligees under the Restatement. There are some completely new Sections in Topic 3 which did not appear in the Restatement of Security. These are §§38, 45, 49 and 39(a).

### B. Philosophy

The Restatement of Security contains no reference to obligee duties and its "Black Letter" rules do not list conduct that may give the surety a claim against the obligee. Although this Restatement similarly does not state duties of the obligee, by choosing to define the rights of one with Suretyship Status in terms of defenses against the obligee, it strengthens these duties. Although there is not a single Section of the Restatement listing the duties of the obligee to the surety they may be found in the Sections listed in "A", above and include generally (i) disclosure of material information, (ii) refraining from acts increasing the cost of performance, (iii) refraining from acts that decrease the potential ability of the primary obligor to perform, (iv) preserving collateral and "recourse" and avoiding impairments of the surety's rights.

### C. Suretyship Defenses

As pointed out above, the Restatement does not identify any implied duties of the obligee to the surety. Instead, the obligation of the surety to the obligee is "subject to" defenses arising out of "suretyship status" (§17(2)). In summary, those defenses may arise based upon the following actions by the obligee:

1. release of the principal (§39);
2. extension of time (§40);
3. modification of the underlying obligation (§41);
4. impairment of collateral (§42);
5. allowing statute of limitation to run on the underlying obligation (§44);
6. other conduct impairing the ability of the surety to recover from the principal (§45); and
7. refusing a tender of performance (§46).

In several instances, these Restatement provisions recognize a right in the surety to recover any losses from the obligee. Such provisions necessarily recognize a duty owed by the obligee to the surety; however, the Restatement does not attempt to enumerate same.

Specifically, §37 is a collection of the rules detailed in §§39 through 44. It announces the "bifurcated approach" taken by the Restatement to impairments of Suretyship Status mentioned in the Preface to this paper. The Introductory Note to "Title B. Suretyship Defenses" gives significant insight into the considerations attributed to the surety by the Restatement in assessing the risks associated with assuming Suretyship Status. Based upon these considerations, the Restatement's rules are different depending on whether the obligee's acts fundamentally alter the risks imposed on the surety, §37(2), or simply impair the surety's recovery against the principal obligor, §37(3).

Section 37(4) gives the surety rights against the obligee for acts of impairment which occur after the surety has performed the secondary obligation to the extent the impairment would have discharged the surety. Also, if the impairment occurs before performance of the secondary obligation but the surety does not know about it, rights are given by the Section against the obligee.

Section 48 sets out the rules when the surety consents to acts which would otherwise be the basis for discharge or when the surety waives discharge.

IV. CONCLUSION

Suretyship Status imbues a surety with certain implied rights which are the central focus of the Restatement. The Restatement also includes and is thus a single source of most of the rules that apply once Suretyship Status exists.

An understanding of "suretyship status" is essential to comprehending the sections of the Restatement of particular interest to surety and fidelity company representatives and their counsel, as protection of the duties flowing from the principal to the surety is the primary consideration in determining the obligee's rights and duties. In order to protect the surety's rights against action or inaction by the obligee the Restatement recognizes certain suretyship defenses which protect the surety from having the risk undertaken, changed or the right of recourse against the principal impaired. In the absence of agreement to the contrary in the form of waiver of discharge or consent to such acts of impairment, partial or even total discharge may result.

In most instances in the "suretyship business" the rights of the surety against its principal are covered by a contract of indemnity. Such contracts supersede the provisions of the Restatement. However, if there is no agreement of indemnity or if there is one which is skimpy on details (the so-called "short form") the rules of the Restatement will determine the rights of the parties.