U.C.C. Article 3 Suretyship and the Holder in Due Course: Requiem for the Good Samaritan,

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Article 3 of the Uniform Commercial Code accords valuable privileges both to the holder in due course and to the surety who signs his principal's note. When the holder in due course sues the surety on the note, however, a conflict inevitably arises between these two typically innocent parties. The conflict is most acute when the surety attempts to assert a real defense of his principal against the holder in due course. In this article, Professor Wladis explores the reasons for favoring one party or the other in the context of various real defenses. The balance of policy considerations, according to Professor Wladis, weighs in favor of the holder in due course. Thus, Professor Wladis concludes that the surety should prevail only in a few situations when he can assert his own, rather than the principal's, real defense.

This article examines two old and respected friends of the law: the surety and the holder in due course. Suretyship has existed for so long that its origins have been described as "shrouded in the mists of antiquity." The holder in due course concept has endured for at least two centuries. To each friend, the
law has accorded valuable privileges. The surety, for example, often can plead defects in or discharges of his principal’s contract with a creditor as a defense against liability to that creditor. The holder in due course, however, acquires a negotiable instrument free from many defenses that a party liable on the instrument could assert against one not a holder in due course.

By the very nature of their respective privileges, the surety and the holder in due course are destined to come to blows. Which friend shall the law favor when the surety signs a negotiable instrument that is then negotiated to a holder in due course? Shall the extra defenses of the surety be effective against the holder in due course? This dilemma becomes acute when a defect in the principal’s obligation provides him with a good defense against the holder in due course.

The following facts illustrate the problem. Assume Principal needs a loan. Creditor, however, will lend to Principal only upon the promise of another to repay the loan should Principal default. Principal secures this promise from his friend, Surety. Principal and Surety, both as makers, sign a negotiable note payable to the order of Creditor. Surety adds the term “surety” after his signature. Creditor later sells the note to Holder In Due Course. Unknown to Surety, however, Creditor charged Principal a usurious rate of interest. Under applicable law, the loan is void and neither principal nor interest can be recovered from Principal, even by a holder in due course. What should be the outcome when Principal defaults, Holder sues Surety, and Surety defends by asserting his surety status and Principal’s real defense of usury? If the law

3. See, e.g., RESTATEMENT SECURITY, supra note 1, § 101 (when principal or co-surety fails to sign instrument); id. § 117 (when impossibility or illegality prevents principal’s performance); id. § 118 (when creditor fraud or duress induces principal); id. § 122 (when creditor releases principal from obligation); id. § 126 (when creditor fails to perform); id. § 127 (when creditor’s alteration of instrument discharges principal); see also U.C.C. § 3-606 (describing some special surety defenses).

4. Compare U.C.C. § 3-305 (rights of holder in due course) with id. § 3-306 (rights of one not holder in due course).


6. Holder could still qualify as a holder in due course as long as the usurious rate of interest was neither known to him nor evident from the loan documents transferred to him. See U.C.C. §§ 3-302(1)(b) (holder must act in good faith); id. § 3-302(1)(c) (holder must be without notice); id. §§ 3-119(1) (limitation of rights not effective against holder in due course without notice).


8. Suretyship is defined as “the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance and as between the two who are bound, one rather than the other should perform.” RESTATEMENT SECURITY, supra note 1, § 82.

In our hypothetical situation, as between Principal and Surety, Principal should perform because he received the benefits of the loan. Creditor is free, however, to pursue either Principal or Surety for repayment. The last clause of section 82 implies that co-obligors who are each ultimately responsible
favors Surety, Holder In Due Course may suffer the effects of Creditor's usury. This policy would discourage the purchase and circulation of surety-backed negotiable instruments because of the increased risks to Holder and thus would directly contradict the policies underlying the concept of holder in due course. We grant favored status to holders in due course precisely to encourage circulation of credit instruments in our economy which depends heavily upon extensions of credit.

If the law favors Holder and disallows Surety's defense, then Surety, who gratuitously and altruistically backed his friend Principal, must absorb the loss, unless he can shift the loss to Principal. To allow Surety to recover from Principal, however, neutralizes Principal's real defense. The wisdom of effectively rendering the note immune to real defenses because of a surety's signature is not readily apparent.

Suppose we conclude that Principal should retain his real defense and thereby deny recovery to Surety. If we assume that both sureties and holders in due course know their rights and liabilities and are motivated by economic self-interest, a rule that favors Holder at Surety's expense probably would discourage sureties from agreeing to such arrangements. Thus, the creation and circulation of surety-backed notes would be discouraged just as a rule that favors Surety would discourage the purchase of such notes.

These assumptions about the surety rarely prevail. The typical holder in due course is in the credit business; the typical surety is not in the surety business. He is usually a relative or friend of the principal and undertakes the surety obligation gratuitously. Although the surety's motive is sometimes eco-

for only a portion of the obligation are not sureties, although they may possess rights similar to those of sureties. Cf. Restatement of Restitution § 81 (1937) (co-obligor entitled to contribution from the other).

9. Article 3 does not use the terms "real" and "personal." By traditional usage, a "real" defense is assertable against a holder in due course, and therefore includes the defenses listed in section 3-305(2). On the facts in question, Principal's defense is real. See U.C.C. § 3-305(2)(b). A "personal" defense is ineffective against a holder in due course. Britton, supra note 1, at 540, White & Summers, supra note 5, at 572-73; U.C.C. § 9-206 comment 1 (using term "real" and "personal").

10. Of course, Holder can claim against Creditor. U.C.C. § 3-417(2)(d) (person who transfers instrument for consideration warrants to transferee or holder in due course that no defense of any party valid against him); id. § 3-414 (indorser engages that he will pay holder or subsequent indorser upon dishonor; indorsers liable to one another in order of indorsement). Recourse against Creditor, however, provides small comfort to Holder if Creditor is insolvent or cannot be located.

11. See White & Summers, supra note 5, at 550-51 (concept of holder in due course facilitates many commercial transactions).

12. After the principal's default and prior to judgment against the surety, the surety may seek an equitable decree to compel the principal's payment of the loan. Simpson, supra note 1, at 198-204. The right to such relief is the surety's right of exoneraton. Restatement Security, supra note 1, §§ 103 comment a, 112; Simpson, supra, at 204. Alternatively, after payment of the loan by the surety, the surety may seek a judgment at law for the amount paid. This is called the surety's right of reimbursement. Restatement Security, supra, §§ 103, 104-11; Simpson, supra, at 224-37. Finally, the surety has a subrogation right against the principal. U.C.C. § 3-415 comment 5; Restatement Security, supra, § 141; Simpson, supra, at 205. This means that if the surety has paid the holder in due course, he acquires the rights of the holder in due course against the principal. Simpson, supra, at 205. In our hypothetical transaction, Surety's right of subrogation is meaningless because Principal has an effective defense against Holder In Due Course.

The three rights of the surety reflect the policy that the ultimate loss should fall on the principal, not the surety. Restatement Security, supra, § 104 comment f (equitable origin of surety rights); id. § 141 comment a (subrogation is a method to compel payment by one that received benefit); Simpson, supra, at 225-26, 198-99, 206-09 (subrogation, exoneraton, and reimbursement to protect surety and prevent unjust enrichment of principal).

13. Companies that engage in surety business are not like the typical surety of this article because the
onomic, in most instances it is essentially altruistic. Therefore, sureties would seem less likely to be discouraged by a rule adverse to them than would holders in due course.

Thus, if our only policy objective is to facilitate the circulation of notes, we should favor the holder in due course and disallow the surety's assertion of the principal's real defense. Note circulation, however, is not our only concern, as evidenced by the allowance of real defenses. Moreover, the resolution of competing policies may indicate that the surety should prevail even against a holder in due course.

This dilemma, whether to permit a surety to assert the principal's real defenses against a holder in due course, has received scant discussion. Justice (then Professor) Peters provided the earliest treatment of this issue in 1968. She favored the holder in due course essentially because the surety is in a better position to detect real defenses before he commits himself and thus is better equipped to avoid loss. Professors White and Summers, on the other hand, would resolve the controversy in favor of the surety, although they provide little support for their preference. Dean Hart and Professor Willier apparently would protect the holder in due course either by not allowing the surety to assert the principal's defenses or by treating all of the principal's defenses as surety discharges that the holder in due course could avoid.

Obligations of such sureties usually are embodied in performance or fidelity bonds rather than negotiable instruments.


15. Justice Peters concluded that in most cases the events which give rise to the principal's real defenses constitute, "an alteration of the surety's contemplated risk, and hence a change of conditions and a personal defense." Id. at 866. She buttressed her conclusion with three arguments. First, the conduct giving rise to the principal's defense increases the chances that the principal will default and thus materially alters the risk that the surety perceived he was undertaking. From the surety's viewpoint this conduct constitutes nonperformance of a condition precedent which is a classic personal defense. Id. at 865. Second, when the principal's signature is forged, case law allows a holder in due course to recover from the surety. These cases essentially treat the surety as having been fraudulently induced by the forgery and thus as having only a personal defense. Cases in which the principal has defenses, other than forgery, that are good against a holder in due course are also essentially cases in which the surety has been fraudulently induced. Therefore, by analogy, the surety should have only a personal defense. Id. Third, should the surety be viewed as asserting the principal's own defense, rather than the surety's own defense, Justice Peters would disallow the surety's defenses as contrary to the doctrine of jus tertii set forth in section 3-306(d). Id. at 865. For a discussion of the doctrine of jus tertii, see notes 77-90 infra and accompanying text. Justice Peters' policy basis for these arguments is as follows: "[i]n a situation between a surety centrally involved in the initial negotiations and a remote and innocent holder in due course, there can be no doubt as to which has easier access to relevant information or readier channels for self-protection." Id. at 866.

16. White & Summers, supra note 5, § 13-17 & n.154 (if defense is real under U.C.C. § 3-305, surety should be permitted to raise it against holder in due course; defense ineffective in principal's hands also ineffective in surety's hands).

17. The two cases the authors cite to support their preference discuss the surety's ability to assert his own, rather than the principal's defense of fraud in the factum. Id.; see Schaeffer v. United Bank & Trust Co., 32 Md. App. 339, 347-48, 360 A.2d 461, 466 (1976) (accommodation party can assert defense against holder in due course when principal obligor obtained his signature by fraud in the factum); Amsterdam v. DePaul, 70 N.J. Super. 196, 201, 175 A.2d 219, 222 (1961) (co-maker not bound on note to holder in due course when note void ab initio because his signature procured by fraud in the factum).


19. See Hart & Willier, supra note 18, § 13.18(1) (holder in due course could avoid principal's defenses as surety discharges under U.C.C. § 3-602). Professors Nordstrom, Clovis, and Bell also address this issue, but do little more than state the dilemma and note its difficulty. See generally R.
None of these commentators purports to address our dilemma in any detail. This article will therefore attempt to provide a more thorough treatment of the issues. First, this article will review the types of sureties arising under article 3 of the Uniform Commercial Code (U.C.C.). Then, it will present and explain the defenses available to article 3 sureties. Next it will consider whether article 3 solves the dilemma by prohibiting the surety's assertion of a principal's real defenses against a holder in due course. Finally, the article will examine the dilemma within the factual context of each type of real defense.

**Article 3 Sureties**

The article 3 surety is a surety who has signed a negotiable instrument.20 The three main article 3 sureties are the guarantor, the accommodation party, and the indorser who qualifies neither as a guarantor nor as an accommodation party (hereinafter referred to as the "ordinary indorser"). Significant legal distinctions exist between these three types of sureties, particularly as to their basic contracts and the defenses available to defeat their liability.

First, consider the basic contract of each surety. The guarantor can sign in any capacity, but his basic contract is essentially that of a maker or acceptor.21 Thus, the guarantor who indorses or draws an instrument waives the indorser's rights to presentment, notice of dishonor, and protest.22 Like the guarantor, the

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20. This article is restricted to such sureties because there can be no holder in due course of the surety's obligation unless the surety has signed a negotiable instrument. Section 3-104 of the U.C.C. provides the requisites of a negotiable instrument. See also U.C.C. §§ 3-105 to 3-114 (elaboration of requirements for negotiable instrument); id. § 3-119 (other writings that affect instrument). For a discussion of these requirements, see HART & WILLIER, supra note 18, ch. 2; W. HAWKLAND, COMMERCIAL PAPER 7-33 (2d ed. 1979).

21. Compare U.C.C. § 3-416(1)-(2) with id. § 3-413(1) (in each subsection signor engages to pay instrument according to its tenor). Note that U.C.C. § 3-104 comment 2 (obligor may be stopped from asserting defense against bona fide purchaser); id. § 9-206(1) & comments (waiver of defense clauses in security agreement valid outside consumer field, but only as to defenses that could be cut off if negotiable instrument were used). See generally Beutel, Negotiability by Contract: A Problem in Statutory Interpretation, 28 ILL. L. REV. 205, 209-20 (1933) (if parties' intent clear, negotiability, and thus protection against all but real defenses, can be achieved by contract); Comment, Extension of the Concept of Negotiability, 8 WIS. L. REV. 271, 271-75 (1932-33) (same; negotiability achievable by contract, estoppel, apparent ownership, agency, or custom). Further discussion of these methods is beyond the scope of this article.

22. U.C.C. § 3-416(5) & comment. Before enactment of the Code, authorities disagreed whether an indorser who guaranteed payment waived presentment, notice of dishonor, and protest. See generally Annot., 21 A.L.R. 1375, 1387-91 (1922) (presenting conflicts among jurisdictions). Cases that found waiver by the guarantor relied on the following reasoning: the indorser explicitly contracted to pay only upon the principal's failure to pay. That explicit contract did not contain additional conditions, such as presentment, notice of dishonor, or protest. The explicit condition adds nothing to the contract of either the guarantor or the indorser because the liability of each is conditioned on the principal's
accommodation party may sign in any capacity;\textsuperscript{23} unlike the guarantor, his 
basic contract depends upon the capacity in which he signs.\textsuperscript{24} Thus, the 
accommodation indorser’s basic contract, in contrast to the guaranteeing indorser’s 
basic contract, includes conditions of dishonor, notice of dishonor, and protest. 
This difference is important because failure or delay in presentment or notice of 
dishonor can discharge the indorser from his basic contract.\textsuperscript{25} The ordinary 
indorser’s contract is identical to that of the accommodation indorser.\textsuperscript{26}

Second, consider the extent to which each type of surety can assert special 
surety defenses.\textsuperscript{27} The official comments to the Code describe the guarantor 
and the accommodation party as sureties.\textsuperscript{28} Thus, both guarantor and accom-
modation party can assert special surety defenses.\textsuperscript{29} The ordinary indorser is 

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\textsuperscript{23} See U.C.C. § 3-415(1) (accommodation party signs in any capacity).

\textsuperscript{24} See U.C.C. § 3-414(1) (unless indorser otherwise specifies, he engages, upon dishonor and any 
necessary notice, to pay instrument).

\textsuperscript{25} See U.C.C. § 3-415(2) (list of defenses available to surety). 

\textsuperscript{26} See U.C.C. § 3-417(2) (list of defenses available to surety).

\textsuperscript{27} These defenses include defenses of the principal and special discharges based upon the creditor’s 
conduct such as impairment of collateral, release of the principal, or extension of time granted to the 
principal.

\textsuperscript{28} See U.C.C. § 1-201(40) (“surety” includes guarantor); RESTATEMENT SECURITY, supra note 1, 
§ 82 comment g (same); SIMPSON, supra note 1, at 6-8 (same). Accommodation parties also are sureties.

\textsuperscript{29} See U.C.C. § 3-415(1) (accommodation party signs in any capacity).
also a surety. In theory, he too should have recourse to the same special surety defenses as guarantors and accommodation parties. Ordinary indorsers, however, usually do not. The implied warranties incurred by the ordinary indorser who transfers an instrument for consideration practically negate his rights as a surety to assert defenses of his principal. By contrast, accommodation parties and probably guarantors incur no warranties, so their special surety defenses remain intact.

Thus, it is important to distinguish between ordinary or accommodation indorsers and guaranteeing indorsers because of the differences between their basic contracts, and between accommodation or guaranteeing indorsers and ordinary indorsers because of their differing abilities to assert defenses of the principal.

The guaranteeing indorser usually is easily distinguished from the accommodation indorser. His guaranty either will be contained in the body of the instrument or added to his indorsement. The accommodation indorser usually signals his presence by indorsing out the chain of title (the so-called anomalous or irregular indorsement). These situations cover the great majority of guaranteeing and accommodation indorsers, but not the odd case, for example, in which the word “surety,” “accommodation party,” “security” or like words are added to a regular or irregular indorsement. The incentive for a surety to add such words to his otherwise unadorned regular indorsement is manifest.

makers can assert usury defense); State Bank of Rock Island v. Bryan, 268 Ill. 151, 155, 108 N.E. 1004, 1005 (1915) (guarantor can assert creditor's negligent loss of security in suit for amount owed to creditor); First Nat'l Bank v. Drake, 185 Iowa 879, 883-84, 171 N.W. 115, 116-17 (1919) (guarantor can rely on any defenses available to principal; when principal discharged, person secondarily liable also discharged). See generally 3 J. DANIEL, A TREATISE ON THE LAW OF NEGOTIABLE INSTRUMENTS, § 1592 (7th ed. 1933) (conditions that will discharge guarantor). Article 3 does not purport to change this rule.

30. See Philadelphia Mortgage Co. v. Highland Crest Homes, Inc., 235 Pa. Super. Ct. 252, 257, 340 A.2d 476, 479 (1975) (under Code, indorser also considered surety); RESTATEMENT SECURITY, supra note 1, § 82 comment k (unless indorser is party for whose accommodation negotiable instrument is executed, indorser is surety). For a description of an indorser’s suretyship attributes, see Peters, supra note 14, at 837-38.

31. U.C.C. § 3-417(2) (listing indorser's warranties).

32. See notes 133, 152, 194, 214, 238, 251 & 270 infra (discussing when principal's defenses unavailable to ordinary indorser).

33. An accommodation party incurs no implied warranties under U.C.C. § 3-417(2) because he does not “transfer” an instrument. Implied warranty liability had been deemed to be proper only for one who sells (transfers for consideration) an instrument. See HAWKLAND, supra note 20, at 77 (section 3-417(2) (reflects view that non-sellers such as accommodation parties incur no warranties); Braucher, U.C.C. Article 3—Commercial Paper—New York Variations, 17 Rut. L. Rev. 57, 71 (1962) (same); Penny, New York Revisits the Code: Some Variations in the New York Enactment of the Uniform Commercial Code, 62 Colum. L. Rev. 992, 1000-01 (1962) (same). While not mentioned specifically in the foregoing authorities, guarantors, being non-sellers also, should be treated the same as accommodation parties and thus incur no warranty liability under section 3-417(2). Note that in New York accommodation parties do incur some warranty liability. N.Y. [U.C.C.] Law § 3-415(6) (McKinney 1964) (warranties of accommodation party).


35. See Maddox v. Duncan, 143 Mo. 613, 614, 45 S.W. 688, 689 (1898) (guarantee added to indorsement).

36. See U.C.C. § 3-415(4) (indorsement that shows it is not in chain of title is notice of its accommodation character); WHITE & SUMMERS, supra note 5, at 520 (same).

37. See U.C.C. § 3-415(3) (as against holder in due course and without notice of accommodation, oral proof of accommodation not admissible to give accommodation party benefit of discharges dependent on his character as such).
The question, however, is whether he undertakes the basic contract of an accommodation or ordinary indorser or of a guaranteeing indorser? Article 3 is silent on this question. A surety may have intended one of two possible results by adding such additional language to his indorsement. First, the indorser may have wished to notify third-party holders of his surety status and thus ensure his ability to assert any special surety defenses that might arise. Alternately, the indorsee may have induced the indorser to identify himself as a surety in order to alter his basic contract by waiving the dishonor, notice of dishonor, and protest requirements.39

It seems that an indorsement with suretyship words added should be treated as an accommodation indorsement for three reasons. First, we are probably dealing with a transaction between laymen who are unfamiliar with article 3's relevant provisions. A knowing professional would not have used such ambiguous terms. A transaction between laymen should not be interpreted according to commercial standards.40 If we assume that the parties are relatively uninformed about the intricacies of commercial law, it seems more plausible that the additional language was meant to protect the indorser rather than to alter his basic contract.

Second, the trend in commercial law has been to simplify the law applicable to a surety on an instrument. Basically, that trend has been toward application of negotiable instruments law to determine the signer's basic contract and application of suretyship law to ascertain the availability of special surety defenses. Thus, the predecessor of the Uniform Commercial Code, the Negotiable Instruments Law (N.I.L.),41 provided that the anomalous indorser's basic contract was that of the capacity in which it had been signed rather than that of the maker.42 The Code now provides that even an accommodation party who signs as maker or acceptor can assert special surety de-

38. The basic contracts of the accommodation indorser and the ordinary indorser are identical. See note 26 supra and accompanying text. Therefore it is unnecessary at this point to consider whether the signer is an accommodation indorser or an ordinary indorser.

39. Under some pre-Code cases a surety was liable as a maker regardless of the capacity in which he signed. The cases, however, were split on the issue. See Stephens v. Bowles, 202 Mo. App. 599, 600-01; 206 S.W. 589, 590 (1918) (signer of note becomes prima facie maker); Bradford v. Corey, 5 Barb. 461, 463 (N.Y. 1849) (only effect of word "surety" added to indorser's signature is to provide indorser with privileges of surety); Kamm v. Holland, 2 Or. 59, 60-61 (1863) (surety not liable as maker); Ballard v. Burton, 64 Vt. 387, 396, 24 A. 769, 772 (1892) (when word "surety" added to signature, indorser liable as maker).

40. The comment to section 3-416 specifically states that the purpose of the section is to state "the commercial understanding as to the meaning and effect of words of guaranty added to a signature." U.C.C. § 3-416 comment (emphasis added).

41. The Negotiable Instruments Law (N.I.L.) was approved as a Uniform Law in 1896. It eventually was adopted in every state. See F. Beutel, Beutel's Brannan Negotiable Instruments Law 73-79 (7th ed. 1948) [hereinafter Beutel]. The N.I.L. was superceded by the U.C.C. See U.C.C. § 10-102(1). For the text of the N.I.L., see Britton, supra note 1, at 1131-56; Beutel, supra, at 110-208.

42. N.I.L. §§ 63-64. Some pre-N.I.L. cases concluded that the anomalous indorser was liable as a maker. These courts reasoned that because a surety is primarily liable along with his principal under suretyship law, the primary liability of the maker under negotiable instruments law applied instead of the secondary liability of the indorser. Sometimes old theories die hard. See Stephens v. Bowles, 202 Mo. App. 599, 601, 206 S.W. 589, 590 (1918) (section 64 of N.I.L. not applicable to anomalous indorser who adds "surety" to his indorsement). For discussions of pre-N.I.L. law and the N.I.L.'s effect on the liability of the anomalous indorser, see E. Arnold, Outlines of Suretyship and Guaranty 24-27 (1927); Beutel, supra note 41, at 1122-24; Britton, supra note 1, at 947-52; 2 Daniel, supra note 29, §§ 798-810.
fenses. The guarantor provisions of the U.C.C. run counter to this simplification effort and therefore should be narrowly construed.

Finally, because "magic words" are not new to commercial law, it is reasonable to suppose that Article 3's drafters intended words of guaranty to be "magic." In conclusion, guaranteeing indorsers should encompass only those indorsers who employ language of guaranty in connection with their indorsements. All other visible surety indorsers who use words of suretyship would undertake the indorser's contract under section 3-415.45

Differentiating between accommodation and ordinary indorsers is relatively straightforward when, as so often is the case, the indorsement is anomalous. When an indorsement is regular and thus does not indicate the indorser's accommodation status, distinction must be made according to the purpose of the indorsement.

When the accommodation party lends his name, he also lends his credit standing to the principal, who may receive one of the following benefits: (1) credit when none or a lesser amount would have been extended; (2) credit at a lower interest rate or for a longer term; (3) extensions or renewals of time instruments; or (4) creditor forbearance from calling due an instrument payable on demand. The accommodation party's liability remains constant whether he lends his name gratuitously or for a fee, or whether his signature postdates the actual extension of credit. To recapitulate, what is essential is that the

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43. See U.C.C. § 3-415 comment 1 (accommodation party differs from other sureties only in that his liability is on the instrument and thus is determined by capacity in which he signs; surety defenses recognized); id. § 3-606 comment 1 (surety defenses not limited to parties secondarily liable, but available to any party in position of surety, including accommodation maker or acceptor); see also Lee Fed. Credit Union v. Gussie, 542 F.2d 887, 889-90 (4th Cir. 1976) (co-maker and other accommodation parties relieved of further liability through assertion of surety defense; creditor extended repayment time without notice to sureties); Rose v. Homsey, 347 Mass. 259, 263, 197 N.E.2d 603, 606-607 (1964) (dictum) (surety defenses available to any surety, even accommodation maker); Philadelphia Bond & Mortgage Co. v. Highland Crest Homes, Inc., 235 Pa. Super. Ct. 252, 258, 340 A.2d 476, 480 (1975) (dictum) (accommodation co-maker also surety under U.C.C.). For a discussion of the conflict on this point under the N.I.L., see Britton, supra note 1, at 1121-29.

44. For example, without certain magic words of negotiability, such as "pay to the order of," an instrument cannot be made negotiable under Article 3 even by explicit agreement of the parties. See U.C.C. § 3-104(1)(d) (to be negotiable instrument, writing must be payable to order or bearer); id. § 3-110 (ways that indicate instrument payable to order); id. § 3-104 comment 2 (writing cannot be made negotiable within article 3 by contract or by conduct).

45. See Peters, supra note 14, at 839-42 (fair reading of § 3-416 may limit contract of guaranty to those using magic words; this interpretation, however, may not make commercial sense).

46. See U.C.C. § 3-415(1) ("An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it").

47. See U.C.C. § 3-415 comment 2 (accommodation party surety may be gratuitous or not). That the surety may receive no consideration for his signature does not invalidate his obligation. The bargained for benefits that flow to the principal constitute consideration sufficient to support the surety's obligation. See White & Summers, supra note 5, at 523-24 (creditor-principal consideration supports surety's obligation).

Section 29 of the N.I.L. required that the accommodation party sign "without receiving value therefore." The wisdom of this requirement was a topic of the famous Ames-Brewster controversy. See generally Ames, The Negotiable Instruments Law, 14 Harv. L. Rev. 241, 248 (1900); Brewster, A Defense of the Negotiable Instruments Law, 10 Yale L.J. 84, 86-87 (1901); Ames, The Negotiable Instruments Law. A Word More, 14 Harv. L. Rev. 442, 445 (1901). For an ingenious if technical resolution of this dispute, see McKeehan, The Negotiable Instruments Law, 50 U. Pa. L. Rev. 499, 509-10 (1902). With the omission of the controversial phrase from section 3-415(1), Dean Ames has triumphed.

48. See U.C.C. § 3-415 comment 2 (consideration valid when accommodation party signs after note
accommodation party sign for the benefit of another.\textsuperscript{49} Other requirements include notice of the accommodation party’s status so that it can be proved against a holder in due course,\textsuperscript{50} and that the principal also sign the instrument.\textsuperscript{51}

In contrast to the accommodation party, the ordinary indorser signs to benefit himself. He wants to sell an instrument, and signs either because negotiation of the instrument to the purchaser requires his indorsement\textsuperscript{52} or because the purchaser demands the signature for its concomitant indorser liability.\textsuperscript{53} The essential distinction between accommodation and ordinary indorsements concerns their purpose: the former are motivated by altruism, the latter by self-interest.

**Defenses Available to Article 3 Sureties**

We have seen that the terms of the article 3 surety’s basic contract vary according to the capacity and manner in which the surety signs.\textsuperscript{54} In the absence of any defense, if the terms of the basic contract are fulfilled, the surety is liable. The surety, however, may avoid liability on the contract if a defense is available. In particular, if the plaintiff is not a holder in due course, the surety can assert any defense available to him in an action on a simple contract.\textsuperscript{55} If the plaintiff is a holder in due course and has not dealt with the surety, however, the surety may assert only the real defenses set forth in section 3-305(2) of the U.C.C.\textsuperscript{56} Thus, a surety may assert some defenses even against a holder in

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\textsuperscript{49} D.C.C. § 3-415(1); \textit{id.} comment 2 ("The essential characteristic is that the accommodation party is a surety").

\textsuperscript{50} Id. § 3-415(3) (oral proof good against all but holder in due course without notice). Notice of accommodation status does not prevent one from being a holder in due course. \textit{See U.C.C. § 3-304(4)(c) (knowledge that party has signed for accommodation does not of itself give purchaser notice of defense or claim).}

\textsuperscript{51} \textit{Id.} § 3-415(1) (accommodation party signs instrument to lend his name to another party to instrument); \textit{id.} § 3-416(4) (principal’s liability not affected when surety signs instrument). Justice Peters and Professor Martin have opined that this requirement is unnecessary and is possibly a drafting error. Martin, \textit{Some Suggestions for Nonurgent Reforms in the U.C.C.’s Treatment of Accommodation Parties}, 6 U. Mich. J. of L. Reform 596, 617-18 (1973); Peters, \textit{supra} note 14, at 838-39. Unfortunately, not everyone agrees with this view. \textit{See Federal Deposit Ins. Corp. v. First Nat'l Fin. Co., 587 F.2d 1009, 1013 (9th Cir. 1978) (party to note not surety under § 3-415(1) because alleged principal's name not on note); Annot., 90 ALR 3d 342, 350 (1979) (cases holding accommodation status not established because principal not party to instrument).}

\textsuperscript{52} Without a necessary indorsement, the purchaser cannot become a holder of the instrument. \textit{See U.C.C. § 1-201(2) (definition of holder); id. § 3-202(1) (indorsement and delivery necessary to negotiate instrument payable to order); id. § 3-201(3) (any transfer for value of instrument not payable to bearer gives transferee specifically enforceable right to have unqualified indorsement of transferor).}

\textsuperscript{53} \textit{See U.C.C. § 3-414(1) (unless otherwise specified, every indorser agrees to pay holder upon dishonor, necessary notice of dishonor, and protest).}

\textsuperscript{54} \textit{See notes 21-26 supra and accompanying text (distinguishing between types of surety basic contracts).}

\textsuperscript{55} \textit{See U.C.C. § 3-306(b) (one not holder in due course takes instrument subject to defenses available in action on simple contract).}

\textsuperscript{56} These defenses are:

(a) infancy, to the extent that it is a defense to a simple contract; and

(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and

(c) such misrepresentation as has induced the party to sign the instrument with neither knowl-
due course.

In general, the surety can assert two types of defenses. First, because liability is contractual, the surety can assert ordinary contract defenses such as fraud, regardless of his surety status. Second, the surety can assert special surety defenses arising from his status as surety. These defenses require the surety to prove both his surety status and the conduct triggering the defense. In asserting these defenses, the surety claims that some defect in, alteration of, or release of the principal’s contract provides a basis to escape liability on the surety’s contract.

Several justifications often are given to support these special defenses. First, because the surety’s obligation merely secures the principal’s obligation, the surety’s liability should be no greater than that of the principal. Authorities who rely on this rationale regard the surety as asserting the principal’s defense. Second, conduct affecting the principal’s contract equally affects the surety’s contract. For example, a surety can assert a defense of fraud or duress on the principal because concealment of the fraud or duress is a fraud on the surety. In addition, release or alteration of the principal’s contract or impairment of his collateral permits the surety to rely on special surety defenses because these acts materially increase the surety’s risk on his contract.

edge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and
(d) discharge in insolvency proceedings; and
(e) any other discharge of which the holder has notice when he takes the instrument.

U.C.C. § 3-305(2).

57. See Schaeffer v. United Bank & Trust Co., 32 Md. App. 339, 344, 360 A.2d 461, 465 (1976) (fraud in the factum defense available to surety defendant under Md. [COM. LAW] CODE ANN. § 3-305), aff’d, 280 Md. 10, 370 A.2d 1138 (1977). If a defense is of a type that a non-surety party to the instrument can assert, then the surety also may assert it. See HART & WILLIER, supra note 18, §§ 13.15 & 13.17 (discussing surety’s ordinary contract defenses). Peters and Hawkland refer to these kinds of defenses as “direct” defenses. See W. HAWKLAND, supra note 20, at 100; Peters, supra note 14, at 868.

58. Peters and Hawkland refer to these kinds of defenses as “derivative” defenses, since they derive from events affecting the principal’s contract. See W. HAWKLAND, supra note 20, at 102-03; Peters, supra note 14, at 862. Hart and Willier divide these kinds of defenses into two categories: defenses “arising from the contract of the party accommodated” and “suretyship defenses.” The former category encompasses defenses of the principal allowable to the surety; the latter includes conduct by the creditor which alters the surety’s risk. See HART AND WILLIER, supra note 18, at §§ 13.15, 13.18 & 13.19-13.27 (discussing the two categories of special surety defenses).

59. Cf. U.C.C. § 3-606 (requirements of special surety defenses).

60. Examples of special surety defenses include illegality of performance by principal, RESTATEMENT SECURITY, supra note 1, § 117; SIMPSON, supra note 1, § 58; fraud infecting the principal’s contract, RESTATEMENT SECURITY, supra, § 118; SIMPSON, supra, § 56; failure of consideration or breach of warranty with respect to the principal’s contract, RESTATEMENT SECURITY, supra, § 126; SIMPSON, supra, § 60; release of the principal, RESTATEMENT SECURITY, supra, §§ 122-123; SIMPSON, supra, §§ 64; extension of time granted to the principal, RESTATEMENT SECURITY, supra, § 129; SIMPSON, supra, § 73; and impairment of the collateral securing the principal’s obligation, RESTATEMENT SECURITY, supra, § 132; SIMPSON, supra, §§ 74-75.

61. Cf. 10 WILLISTON, supra note 1, § 1214 (surety liable only if creditor is). For a general discussion of surety liability and defenses, see Note, Defenses of a Principal Available to a Surety, 27 IOWA L. REV. 601 (1943); Note, The Availability of a Principal’s Defense to His Uncompensated Surety, 46 YALE L.J. 833 (1937).

62. See 10 WILLISTON, supra note 1, § 1214.

63. RESTATEMENT SECURITY, supra note 1, § 118 comment c (creditor’s fraudulent conduct defrauds surety as well as principal); SIMPSON, supra note 1, §§ 56-57 (same).

64. 10 WILLISTON, supra note 1, § 1220 (creditor’s release of principal discharges surety); id. § 1233 (creditor’s impairment of security); id. § 1240 (alteration of creditor’s contract with principal can increase surety’s risk).
Authorities discussing these defenses are likely to speak of the surety as asserting his own defense.\(^6^5\) Third, if the defense arises from creditor misconduct toward the principal, some authorities will permit the surety to defend in order to deny to the creditor the benefits of his wrongdoing.\(^6^6\) When a holder in due course is involved we must further classify the surety’s defenses as real and personal. Thus, four general types of article 3 surety defenses exist: real, ordinary contract;\(^6^7\) personal, ordinary contract;\(^6^8\) personal, special surety;\(^6^9\) and real, special surety.\(^7^0\)

Real or personal ordinary contract defenses present no unusual problems. As we have seen, surety status is immaterial to an ordinary contract defense—the surety stands as any other party to a negotiable instrument.\(^7^1\) Thus, as against a holder in due course, the surety can assert only real ordinary contract defenses. Nor do serious problems arise if the special surety defense is personal. Whether a surety asserts the defenses as his own or the principal’s personal defense, he cannot prevail against a holder in due course.\(^7^2\)

Difficult problems occur only with real, special surety defenses. When a surety appears to assert his principal’s real defense, we must determine whether the principal’s real defense serves as a real defense for the surety. By contrast, if the surety appears to assert his own special surety defense, it usually will be simply personal. For example, if the surety is considered to assert his own defense of real fraud on the principal, he would contend that the fraud was concealed from him and that this concealment constitutes fraudulent inducement of his own contract.\(^7^3\) This kind of fraudulent inducement, however, is not a real defense.\(^7^4\) Moreover, a surety may be discharged under article 3 when a prior holder has extended the principal’s repayment period.\(^7^5\) The surety’s discharge defense, however, is personal if the holder in due course had no notice of the discharge when he took the instrument.\(^7^6\)

\(^6^5\) Simpson, supra note 1, at 278-82.
\(^6^6\) Restatement Security, supra note 1, § 118 comment c.
\(^6^7\) U.C.C. § 3-305(2). For the text of the Code, see note 56 supra.
\(^6^8\) U.C.C. § 3-306 (one not holder in due course takes instrument subject to all defenses available on simple contract and defenses of want of consideration and non-performance of condition precedent).
\(^6^9\) Id. § 3-606(1) (listing special surety discharges).
\(^7^0\) Article 3 does not explicitly deal with these kinds of defenses. They do exist however. For example, in some states, if the maker signs a note to evidence a gambling debt or if the maker is charged a usurious rate of interest, the surety on such a note may assert these facts against a holder in due course of the note. For a discussion of gambling notes, see text accompanying notes 228-40 infra; for a discussion of usurious notes, see text accompanying notes 241-55 infra.
\(^7^1\) See Hart & Willier, supra note 18, §§ 13.17, at 13-38 (surety may assert all contractual defenses available to any other party to negotiable instrument).
\(^7^2\) See U.C.C. § 3-305 (rights of holder in due course).
\(^7^3\) See Simpson, supra note 1, at 279 (concealment of creditor’s fraud on principal is fraud on surety).
\(^7^4\) See U.C.C. § 3-305(2)(c) (real contract defense exists only when misrepresentation induced party to sign instrument without knowledge of its character or essential terms). In our example, the surety knew he had signed a surety contract.
\(^7^5\) U.C.C. § 3-606(1)(a) (special surety defenses).
\(^7^6\) U.C.C. § 3-602 (effect of discharge against holder in due course).
EFFECT OF ARTICLE 3 ON THE SURETY'S RIGHT TO ASSERT DEFENSES OF HIS PRINCIPAL

At least one commentator has suggested that allowing the surety to assert his principal's defenses contradicts the Code's doctrine of *jus tertii*.77 In pertinent part, the Code states that doctrine as follows: "[t]he claim of any third person to the instrument is not otherwise available as a defense to any party liable thereon unless the third person himself defends the action for such party."78 This language seems to suggest that the surety cannot rely on the principal's defenses unless he is able to join his principal. The quoted language, however, refers to "claims," not "defenses."79 Although claims and defenses often arise from the same facts,80 review of the pre-Code application of the *jus tertii* doctrine demonstrates the significance of this distinction. The pre-Code doctrine, in fact, did not apply to special surety defenses.

The *jus tertii* doctrine typically applied in cases like *Bowles v. Oakman*.81 In

77. See Peters, supra note 14, at 865 (viewed as principal's defense, surety's claim runs against current of modern law, which opposes assertion of *jus tertii* even against ordinary holders); see also U.C.C. § 3-306(d) (presenting doctrine of *jus tertii*); U.C.C. § 3-207 (listing third-party claims not assertable by another). The *jus tertii* doctrine restricts the extent to which a party to a negotiable instrument can assert defects in subsequent transfers of the instrument. In general, defects which have the effect of preventing title from passing to the subsequent transferee can be asserted by a prior party. Other defects, for the most part, cannot.

Under pre-Code law there was virtual agreement that if the defect, such as forgery of a necessary indorsement, prevented title from passing to the subsequent transferee, a prior party could assert the defect. See Britton, supra note 1, at 749-51; Note, *Blocking Payment on a Certified Cashier's or Bank Check*, 73 Mich. L. Rev. 424, 428, 430-31 (1974). The Code does not appear to have changed this result. Although section 3-306(d) makes no exception for a case such as the forged necessary indorsement, a prior party could prevail by arguing the plaintiff's lack of legal title on the theory that it is part of plaintiff's case to prove his title. U.C.C. § 3-307(1) & comment 1; see Palmer, *Negotiable Instruments under the Uniform Commercial Code*, 48 Mich. L. Rev. 255, 283 (1950); cf. W. Hawkland, supra note 20, at 131.

At common law, if the defect in the subsequent transfer did not prevent legal title from passing to the transferee, but merely gave rise to an "equity of ownership" or a contract defense in the transferor, the weight of authority would not allow a prior party to assert these kinds of defects. Note, supra, at 429. In this context, "equity of ownership" means an equitable claim of right to possession of the negotiable instrument. For example, if the subsequent transferee were induced by personal fraud to indorse and deliver a note to another, the transferor would have an "equity of ownership," see id. at 428, which, in many jurisdictions, a prior party could not assert in a suit on the note by the transferee. The N.I.L. seems to have muddled this aspect of the *jus tertii* doctrine. See Britton, supra, at 751-57; cf. Note, supra, at 430-31. Section 3-306(d) clarifies this aspect of the doctrine by providing that claims of third persons cannot be asserted by another (except for the two defenses specifically listed) unless the third person himself defends the action. See U.C.C. § 3-306 comment 5. In other words, under article 3, equities of ownership and contract defenses of subsequent transferees cannot be asserted by a prior party unless (1) the equity of ownership or contract defense is one specifically mentioned in section 3-306(d) or (2) the subsequent transferor becomes a party to the action and asserts the equity of ownership or defense.

78. U.C.C. § 3-306(d).
79. Id.
80. For example, a person fraudulently induced to sign a note has both a claim of rescission and restitution and a defense of fraud.
81. 246 Mich. 674, 225 N.W. 613 (1929).
Bowles, the plaintiff sued Oakman, the maker of the note. For convenience, the note was payable to Thomas rather than its true owner, Walker. Thomas indorsed the note to Bates, who was to use it for Walker's benefit. Bates violated the agreement and pledged the note to the plaintiff Bowles to secure payment for legal services Bowles had provided to him. Bowles sued the maker, Oakman, for payment when the note became due. Oakman's defense was that Bates' transfer of the note defrauded Walker. The Michigan Supreme Court held that even though Bates was not a holder in due course, Oakman could not defend on the basis of Walker's claim to the note. Thus, Bowles illustrates that the doctrine of jus tertii prevents the maker or similar party with no defense of his own from using subsequent defective transfer to avoid payment on the note. In other words, the doctrine prevents the maker from relying on a third person's claim to the instrument as a defense. That this scenario is all the drafters had contemplated is evident from their Notes and Comments, which continually refer to fact patterns similar to Bowles. They make absolutely no reference to special surety defenses. The defendant who admits his liability on the instrument and wants to quibble over the proper plaintiff differs significantly from the surety who claims he is not liable on the instrument. Properly construed, the jus tertii doctrine therefore does not bar the surety's assertion of his principal's defenses.

Nor does the manner in which the Code describes real defenses necessarily bar the surety's assertion of his principal's real defenses. For example, if we substitute the word "principal" for "party" in the relevant Code section dealing with incapacity other than infancy, duress, and illegality, it reads "to the extent that a holder is a holder in due course he takes the instrument free from . . . all defenses of any [principal] to the instrument with whom the holder has not dealt except . . . such other incapacity, or duress or illegality of the transaction, as renders the obligation of the [principal] a nullity . . . ." Consistent with this reading, the surety can assert the principal's defense of real duress because the section is silent as to who may raise the real defense. Prior drafts of this section do not indicate that the drafters intended to limit any right of a surety to assert the principal's defenses.

Section 3-415(3) of the U.C.C. undoubtedly has some effect on special surety

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82. Id. at 675, 225 N.W. at 613.
83. Id.
84. Id. at 677, 225 N.W. at 614.
85. Id. at 678, 225 N.W. at 614.
86. See id. at 677, 225 N.W. at 614 (court did not intimate that true owner, Walker, was defending case).
87. See U.C.C. § 3-306(d) (specific use of term "claim").
88. See generally COMMERCIAL CODE Notes & Comments (Tentative Draft No. 2, Article III, April 25, 1947) (comments 2, 3, 4 & 6, providing examples) (copy on file at Georgetown Law Journal).
89. Id.
90. See WHITE & SUMMERS, supra note 5, at 534-35 (U.C.C. § 3-306(d) could not be intended to reverse all well-settled doctrines that authorize surety to raise certain of principal's defenses).
91. See generally U.C.C. § 3-305(2) (real defenses).
92. U.C.C. § 3-305(2)(b).
93. See generally id. & comments.
94. A listing of the prior drafts consulted appears in M. EZER, UNIFORM COMMERCIAL CODE BIBLIOGRAPHY 1-6 (1972).
The discharges described in that section are special surety defenses. Each defense consists of two elements: the particular conduct of the discharger and the surety status of the one discharged. The Code's effect on these discharges is predictable in many cases: first, if the holder in due course has no notice of either the accommodation character or the events from which the discharge arose, the surety cannot offer oral proof of his accommodation status, and therefore cannot prove all the elements necessary for his discharge. Second, if the holder in due course has notice of the events producing the discharge, because he commits the discharge, but has no notice of the accommodation character, oral proof of such character is not admissible and the discharge defense therefore would fail. Lastly, if the holder in due course has notice of both the accommodation character and the events effecting the discharge, the surety will be discharged.

A more difficult application of section 3-415(3) arises when the holder in due course has notice of the accommodation character but not of the events leading to the discharge. Although in this instance the Code would permit oral

95. See U.C.C. § 3-415(3) (accommodation party's rights against holder in due course). Section 3-415(3) states: "As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharges dependent on his character as such. In other cases the accommodation character may be shown by oral proof." Id.

96. See id. & comments (cross reference to § 3-606 surety defenses); id. § 3-606 comment 1 (specifying suretyship defenses available to any party in position of surety). Compare id. (absent holder's reservation of rights, surety discharged when holder releases principal, suspends right of enforcement, or impairs collateral for instrument) with Restatement Security, supra note 1, § 122 (suretyship defense based on release of principal); id. § 129 (suretyship defense based on extension of term); id. § 132 (suretyship defense based on creditor's surrender or impairment of security).

97. See U.C.C. § 3-415(3) ("As against a holder in due course and without notice of the accommodation oral proof of the accommodation is not admissible to give the accommodation party the benefit of discharges dependent on his character as such"). If a prior holder causes the discharge, the holder in due course would prevail. See U.C.C. § 3-602 (effect of discharge against holder in due course); see also text accompanying note 113 infra (applicability of 3-415(3)); note 286 infra (providing example).

The Code uses the term "oral proof" only in subsection 3-415(3). The drafters apparently deemed "oral proof" synonymous with the more common term "parol evidence." See U.C.C. § 3-415 comment 1 (except as against holder in due course, parol evidence admissible to prove accommodation status). See generally Martin, supra note 51, at 618 (drafting oversight in § 3-415(3)).

98. If the discharge results from the conduct of the holder in due course, it would be unfair to allow the silent surety to assert his status after the holder in due course had acted in reliance on the absence of that status. The Code and the Restatement of Security both espouse this rule. U.C.C. § 3-606; Restatement Security, supra note 1, § 114. For a discussion of this situation when a holder, prior to the plaintiff holder in due course, caused the discharge, see notes 289-99 infra and accompanying text.

99. If a holder in due course performs the discharge-causing conduct, the surety would be discharged. U.C.C. § 3-606. Note that section 3-415(3) employs the term "notice" and section 3-606 uses the term "knowledge." Significant differences exist between the two terms. See U.C.C. § 1-201(25) (person has "knowledge" when he has knowledge, has received notice, or has reason to know; knowledge means actual knowledge). For our purposes, however, this distinction appears insignificant. The issue usually is whether the surety status is clear on the face of the instrument. If a holder in due course does not "know" of the accommodation status, he is unlikely to have notice of it. For a discussion of this discrepancy in terms, see Martin, supra note 51, at 614-16.

If a holder, prior to the plaintiff holder in due course, performs the discharge-causing conduct, the surety would have a discharge defense good against the holder in due course who takes the instrument with notice of that conduct. See U.C.C. § 3-305(2)(e) (holder in due course takes free from all defenses except any other discharge of which holder has notice when he takes instrument); see also note 285 infra (discussing application of § 3-305(2)(e)).

100. For example, suppose a principal makes a note payable to the order of the creditor. The surety indorses the note and delivers it to the creditor. The principal also pledges collateral which the creditor later returns to the principal. The creditor then negotiates the note to a holder in due course. The holder
proof of the accommodation character, its effect is unclear. If proof of the discharge-causing conduct is not also allowed, the discharge defense will fail. One possible interpretation of section 3-415(3) is that its silence regarding proof of discharge-causing conduct allows the holder in due course to take free of the discharge because of lack of notice. Alternatively, section 3-415(3) might permit proof of the discharge-causing conduct despite the holder in due course's lack of notice of the conduct. The reasoning here apparently is that because section 3-415(3) allows oral proof of the accommodation character to provide the surety the benefit of discharges dependent upon that character, and since the surety cannot receive the benefit of the discharge unless he also proves the discharge-causing conduct, he should be allowed to prove that conduct. This interpretation would elevate unknown discharges of visible sureties to real defenses.

This last interpretation presents a number of problems. First, section 3-415(3) does not clearly state such a proposition. Had the drafters intended to single out these kinds of discharge for real defense status, they might have so indicated either by clearer drafting, by express comment, or by explanation in the flood of articles that followed the drafting of the Code. Prior to Justice Peters' 1968 article no one had suggested that sureties might have real defenses unavailable to non-sureties. Second, as Justice Peters has noted, this interpretation shifts the risk of unknown surety discharges to holders in due course, which is contrary to article 3's pattern to shift unknown risks away from holders in due course. Indeed, this interpretation would treat surety discharges as real, although all other unnoticed discharges are personal.

This departure from article 3's policy might reflect the differences between sureties and ordinary parties, and the formers' deserved need for additional

in due course has notice of the accommodation character. See U.C.C. § 3-415(4) (endorsement that shows it is not in chain of title is notice of its accommodation character). If, however, the note contained no reference to collateral, the holder in due course could have no notice of the release of the collateral.

101. U.C.C. § 3-415(3).
102. See U.C.C. § 3-606 (must show specific conduct of discharger).
103. See U.C.C. § 3-502 (no discharge effective against subsequent holder in due course unless he has notice thereof when taking instrument); see also Jordan, Just Sign Here—It's Only a Formality: Parol Evidence in the Law of Commercial Paper, 13 GA. L. REV. 53, 84 (1978) (holder in due course prevails under § 3-602 if without notice of discharge). Notice of the surety status does not impose a duty upon the holder in due course to inquire about possible discharges, because surety-backed instruments are not inherently suspect. Cf. U.C.C. § 3-304(4)(c) (accommodation signature does not by itself notify purchaser of defense or claim); notes 287-88 infra and accompanying text (discussing "notice" and providing examples).
104. See HART & WILLIER, supra note 18, § 13.18(1) (logical resolution of conflict would permit discharge against holder in due course as long as he is aware of suretyship arrangement); Peters, supra note 14, at 863-65, 871, 875-76 (more obvious interpretation of § 3-415(3) would extend vulnerability to all that deal in negotiable paper bearing visible sureties).
105. See generally Peters, supra note 14, at 863-64.
106. Presumably this end would be achieved under section 3-305(2)(e).
107. See U.C.C. § 3-415(3).
108. Peters, supra note 14, at 833.
109. See id. at 864-65 (shifting unknown risks to holder in due course inconsistent with article 3 pattern).
110. See U.C.C. § 3-602 (no discharge effective against holder in due course unless he has notice upon taking instrument); id. § 3-305(2)(e) (holder in due course takes instrument free of all defenses except, inter alia, discharges of which he has notice when he takes instrument).
protection. The drafters might have deemed the protection of the surety to be as important as that of the infant and the debtor discharged in bankruptcy. This interpretation, however, does not explain why the drafters permitted these surety discharges to be waived in advance or avoided by a holder's reservation of rights. If the policy supporting them is so strong, why allow such easy circumvention? Moreover, if the surety deserves protection against the holder in due course, protection should extend not only to surety discharges, but also to all special surety defenses, such as fraud or duress on the principal. Yet section 3-415(3) covers only surety discharges.

The drafters of section 3-415(3) probably never focused on the hard case, when the holder in due course has notice of the accommodation character but not of the discharge-causing conduct. They probably only contemplated a situation in which the holder in due course engaged in the discharge-causing conduct. Under the N.I.L., authorities disagreed whether an accommodation maker or acceptor could assert the special surety defense regarding extension of time to the principal. The so-called majority rule denied the defense to the accommodation maker even when the instrument evidenced the surety status. The so-called minority view granted a surety his right to special surety defenses, even when the surety was primarily liable, as long as the holder causing the discharge had known of the surety status when he had acted. The comments to sections 3-415 and 3-606 demonstrate the drafters' intent to adopt the minority rule allowing the visible accommodation maker or acceptor to

111. See U.C.C. § 3-305(2)(a) & comment 4 (holder in due course cannot take instrument free from infancy defense); id. § 3-305(2)(d) & comment 8 (holder in due course cannot take instrument free from insolvency discharge).
112. See U.C.C. § 3-606(1) & comments 2 & 4 (holder can reserve rights against party with right of recourse, while discharging another).
113. Prior drafts of article 3 are silent as to the purpose of section 3-415(3). The subsection first appears in Uniform Commercial Code: Text Only Printing Except for the Article on Sales (Article 2) and the Article on Effective Date and Repealer (Article 11) (ALI and NCCUSL, March 1, 1950). That document contains no explanation of changes from previous drafts. For a listing of article 3's prior drafts, see M. Ezer, supra note 94.
114. The courts reasoned that because a maker is primarily liable under the N.I.L., a surety who ordinarily is secondarily liable becomes primarily liable when he signs as a maker. Although the N.I.L. discharges one secondarily liable when the term of the debt is extended without his consent, it does not discharge one primarily liable on the debt. See N.I.L. § 120(6) (secondarily liable party discharged when holder extends time of repayment without reserving rights). Thus, applying the maxim expressio unius est exclusio alterius, the accommodation maker is not discharged. Hilpert, Discharge of Latent Sureties on Negotiable Instruments Because of Release or Extension of Time, 50 Yale L.J. 387, 395 (1941). Courts applied this reasoning regardless of the surety's visibility. See Restatement Security, supra note 1, at 351 (when surety signs negotiable instrument as maker or acceptor irrespective of fact that he is surety, or known to be such, obligation enforced solely as that of maker or acceptor). See generally Britton, supra note 1, § 301 (discussing whether N.I.L. impliedly repealed surety defense regarding creditor's extension of repayment time).
115. See Restatement Security, supra note 1, § 129, at 351 (lesser number of jurisdictions hold that ordinary rules of suretyship also apply when N.I.L. does not address matter in unmistakable terms); id. § 114 & comment c (creditor affected by incidents of suretyship from time he knows thereof). None of the decided cases involved an attempt by a surety to assert a discharge caused by a prior holder against a holder in due course who had no notice of the discharge.

Eventually, a special committee of the Conference of Commissioners on Uniform State Law proposed amendments to the N.I.L., several of which embraced the so-called minority rule. Britton, Proposed Amendments to the Uniform Negotiable Instruments Law, 22 Ill. L. Rev. 815, 828-31 (1928). These proposed amendments apparently were never adopted.
assert surety discharges. Neither of those sections, however, indicates that the drafters considered discharges by prior holders. Instead, they probably sought only to resolve the pre-Code conflict. If section 3-415(3) applies only to discharge-causing activity by the holder in due course, it merely restates suretyship law. Our difficult case, when the holder in due course knows of the accommodation character but not of the discharge-causing activity, thus falls outside the purview of section 3-415(3).

If section 3-415(3) does not apply to our difficult case, then the case should be resolved under section 3-602. Under section 3-602, the holder in due course would take free of the discharge because notice of the discharge-causing conduct is absent.

Article 3 does not address whether an invisible surety may assert a defense of the principal against a holder in due course. The invisible surety, however, poses a potential problem only when the defenses are real.

If the holder in due course were to suffer a detriment because the invisible surety were permitted both to prove surety status and to assert a principal's real defense, then the surety should be estopped from proving that status. In theory, an invisible surety can be estopped from asserting the principal's real defense. Estoppel should depend upon whether the holder in due course relied to his detriment on his justifiable belief in the non-existence of a surety.

The most common invisible surety is probably the accommodation party who signs as co-maker with the principal. If it is easier for a surety to assert the principal's defenses than for a co-maker to assert another co-maker's defenses,
then the holder in due course will have relied to his detriment upon the absence of surety status. The difficulties faced by co-makers and sureties in asserting their defenses, however, do not appear greatly different.\footnote{124}{See 4 Corbin, Contracts § 937, at 775-76 (1951) (results "quite consistent with law of suretyship"). Note, however, that Corbin is discussing joint and several obligors. The outcome may differ if the liability is joint because of the unitary nature of the joint obligation. Under article 3, however, co-makers are usually jointly and severally liable. See U.C.C. § 3-118(e) (unless otherwise specified, two or more accommodation signers jointly and severally liable). Moreover, even if the liability is joint, most states have abolished the unitary nature of such obligations. See generally Restatement (Second) of Contracts ch. 13, at 402-06 (1981) (discussing statutes); 2 Williston, supra note 1, § 336-336A (same).}

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Therefore, if the holder in due course suffers no significant detriment, the surety should not be estopped.\footnote{125}{Indeed, even if the surety were unable to prove his surety status he presumably could rely on his visible co-maker status to assert the co-maker's real defense.}

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The holder in due course suffers no significant detriment, the surety should not be estopped.\footnote{126}{See U.C.C. § 3-207 (when negotiation effective or rescindable); id. § 3-306(d) (setting forth doctrine of jus tertii); notes 77-90 supra and accompanying text (discussing doctrine of jus tertii).}

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If, on the other hand, the surety can assert a defense that the co-maker cannot, the holder incurs injury and the surety should be estopped.

127. See note 90 supra (section 3-306(d) not intended to reverse doctrines that permit surety to raise certain defenses of principal).

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The accommodation maker with the principal as indorser presents another type of invisible surety. The accommodation party makes a note payable to the order of the principal and delivers it to him. The principal then indorses the note to the creditor. The holder in due course may well suffer a detriment were the invisible surety allowed to prove his status. The surety-defendant would argue that because of the principal-indorser's real defense, the indorsement was ineffective to pass title and the plaintiff therefore is not a holder. The \textit{jus tertii} doctrine explicitly defeats this argument as applied to non-surety defendants.\footnote{128}{See U.C.C. §§ 3-207 (when negotiation effective or rescindable); id. § 3-306(d) (setting forth doctrine of jus tertii); notes 77-90 supra and accompanying text (discussing doctrine of jus tertii).}

128. There is also a kind of quasi-invisible surety: the accommodation regular indorser. Here, the principal makes a note payable to the order of the accommodation party and delivers it to him. The accommodation party indorses it to the creditor. The surety is "quasi-invisible" because the accommodation nature of his indorsement is invisible. The holder thus has notice that the indorser is a surety but not that the surety is an accommodation party. This difference is significant. A holder in due course ordinarily would expect to be protected by the indorser's section 3-417(2) warranties against real defenses of the maker. The accommodation indorser, however, does not make those warranties. See note 33 supra. Thus the holder in due course could suffer a detriment if the indorser were allowed to prove his accommodation status. Consequently the accommodation regular indorser should be estopped from proving that status.

The \textbf{Principal's Real Defenses}

The foregoing discussion demonstrates that article 3 does not entirely resolve the issue of whether the surety can assert a principal's real defenses against the holder in due course. The resolution of this question depends upon a number of factors, particularly the nature of the principal's real defense. The following discussions accordingly are organized by type of real defense. This format includes a description of each real defense and its justification, followed by a discussion of the surety's ability to assert a particular real defense of the principal. In some cases this will resolve our question; in others, additional inquiry will be necessary.
INFANCY

Infancy is a real defense "to the extent that it is a defense to a simple contract." The policy supporting the defense is to protect infants against those who might take advantage of them.

A surety generally cannot assert his principal's defense of infancy. It seems fair that the surety should bear the risk of the principal's infancy because, unlike the creditor, the surety usually is a relative or close friend of the principal. If the surety cannot assert the principal's infancy against the creditor, then he should not be able to assert it against a holder in due course.

Exceptions to the general suretyship rule do exist. First, if the creditor knows of both the principal's infancy and the surety's ignorance thereof, the surety is not liable to the creditor if the creditor fails to inform the surety of the potential defense. Under these circumstances, nondisclosure of the material facts would defraud the surety. Thus, the surety asserts a defense of fraud rather than the principal's defense of infancy. This defense, however, does not constitute a real defense. Thus, even when this exception allows the

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130. U.C.C. § 3-305 comment 4.

131. The Restatement of the Law of Security explains the general rule as follows:

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 [of the Restatement of the Law of Security.]) 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.

132. Only one case seems to exist in which a surety claimed not to know of the infancy of the principal: International Textbook Co. v. Mabbott, 159 Wis. 423, 426 N.W. 429 (1915). In that case, the surety claimed ignorance despite having signed a contract that stated the principal was an infant. Few such cases arise because the surety is almost always a relative or friend of the principal and therefore knows the principal's age.

133. Cf. Lagerquist v. Banker's Bond & Guar. Co., 201 Iowa 430, 435, 205 N.W. 977, 979 (1925) (dictum) (when surety for infant would be liable to payee, surety also liable to subsequent holder in due course).

When an ordinary indorser receives consideration for the transfer of an instrument to a subsequent holder, he cannot assert the principal's infancy as a defense. U.C.C. § 3-417(2)(d) (indorser warrants that holder takes free of all defenses). Compare N.I.L. § 65(3) with N.Y. [U.C.C.] Law § 3-415(6)(c) (McKinney 1964).

134. Restatement Security, supra note 1, §§ 124(1) (duty of creditor to disclose facts unknown to surety that materially increase surety's risk); Simpson, supra note 1, at 86-93 (when creditor learns that surety ignorant of material facts, duty to disclose such facts arises).

135. See Restatement Security, supra note 1, § 124 comment a ("This rule is merely a special application in suretyship of the rule of Contracts that fraud creates a defense").

136. Cf. Simpson, supra note 1, at 89-92 (nondisclosure by creditor treated as fraud when creditor knows surety deceived).

137. Real fraud is "such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential
surety a defense against a creditor, he cannot assert the defense against a holder in due course.

Second, in some states the infant principal’s disaffirmance of his contract and return of the consideration he received discharges the surety’s liability. Failure of consideration for the surety’s promise arguably supports this exception. In addition, to permit the creditor to recover the purchase price of the thing sold after returning to him the thing sold arguably enriches him unjustly.

A number of authorities, however, have refused to adopt this exception. Critics of the exception have argued that even were the creditor to be reimbursed for depreciation of the returned consideration, he still would be deprived of the benefit of his bargain. The appeal of this exception may stem from the presence of inequitable creditor conduct such as that reflected in Baker v. Kennett, the case that initiated the exception.

In Baker, the plaintiff, Baker, sold land in excess of its fair market value to an infant. The infant, Kennett, joined by his mother and sister as sureties, signed a note for the purchase price plus interest. Kennett disaffirmed the contract after having made considerable improvements to the land. In a suit terms,” U.C.C. § 3-305(2)(c); see also U.C.C. § 3-305 comment 7 (discussing difference between real and personal fraud).


139. The surety need not receive consideration for his contract to be binding. WHITE & SUMMERS, supra note 5, at 523-24. Extension of credit to the principal supports the surety’s promise. See note 47 supra and accompanying text (benefits to principal sufficient consideration to support surety’s obligation). Indeed, the surety’s obligation is enforceable even when it postdates the extension of credit. See note 48 supra and accompanying text. When the principal returns the consideration through no fault of the surety, the consideration supporting the surety’s contract fails. See Evants v. Taylor, 18 N.M. 371, 376, 137 P. 583, 584 (1913) (surety not liable when promise based on consideration that failed through no fault of his).

140. See Lagerquist v. Banker’s Bond & Mortgage Guar. Co., 201 Iowa 430, 433, 205 N.W. 977, 978 (1925) (citing Baker v. Kennett, 54 Mo. 82, 93 (1873) (“It would be a strange doctrine which would give [the creditor] back his land, and allow him to recover from the sureties the purchase money also”).

141. See Campbell v. Fender, 218 Ark. 290, 292, 235 S.W.2d 957, 958-59 (1951) (mother’s surety obligation in automobile purchase not extinguished when son disaffirms contract and returns car; mother, however, may reclaim car upon disaffirmance). See generally SIMPSON, supra note 1, at 288-90 (surety discharged only to extent consideration failed); Note, Liability of Surety When Infant Principal Disaffirms Contract and Returns Property, 11 Iowa L. Rev. 394 (1926) (criticizing exception because creditor bargained for performance, not return to status quo). The Restatement of Security does not recognize the exception. RESTATEMENT SECURITY, supra note 1, § 125(2) (creditor can hold surety to his obligation even if principal disaffirms and returns consideration).

142. Even if the creditor resells the returned consideration at the original contract price, he still may not be made whole. Had the infant performed, the creditor could have sold additional inventory to the second purchaser. If the surety’s liability is discharged, when the returned inventory item is resold the creditor incurs lost sales volume. The infant’s rescission thus has cost the creditor one unit of profit. For discussions of a creditor’s lost profit, see WHITE & SUMMERS, supra note 5, §§ 7-8 to 7-10; and Goetz & Scott, Measuring Seller’s Damages: The Lost-Profits Puzzle, 31 Stan. L. Rev. 323, 326, 330-34 (1979).
against Kennett, his mother and sister, the trial court held for Baker. In reversing, the Missouri Supreme Court held that because Kennett had not affirmed the contract as an adult, his disaffirmance as an infant barred his liability on the contract. The court refused to apply the general rule of surety liability to Kennett's mother and sister.

Relying on what it said was the contract's failed consideration, the court instead created the exception purportedly to prevent Baker's recovery of both the land and its purchase price. A modern court probably would excuse surety liability by finding fraud or unconscionable conduct.

The Missouri court, however, constructed a theory that applied regardless of creditor misconduct. As a result, some courts have applied the Baker exception to situations in which creditor recovery of the purchase price is not clearly wrong. Although these cases may reflect an implicit preference that a surety be able to assert the principal's infancy defense, they explicitly rely on the Baker exception and its rationales.

Let us examine whether the reasons given for this exception apply to our holder in due course. Failure of consideration is a classic personal defense and thus is ineffective against a holder in due course. Fear of a creditor's double recovery is unfounded. It does not follow that a creditor recovers the purchase price from the surety after the consideration is returned. The fair solution is either to credit the surety with the value of the consideration returned, or to give him the returned consideration in exchange for the full purchase price. To say that the creditor suffers no loss because he has been

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147. Id. at 87-88.
148. Id. at 91-92.
149. Id. at 92-93.
150. Id. at 93.
151. Cf. Restatement (Second) of Contracts § 79 comment e (gross inadequacy of consideration may justify rescission or cancellation for misrepresentation); J. Calamari & J. Perillo, supra note 129, at 137, 139 (same); Restatement (Second) of Contracts § 208 comment c (inadequacy of consideration an important factor in determination that contract is unconscionable); White & Summers, supra note 5, § 4-5 (same).
152. See Baker v. Kennett, 54 Mo. 82, 93 (1873) (upon rescission of principal's contract, consideration has failed and, in addition, law does not permit creditor to retain both property and purchase price).
154. It is noteworthy that courts have applied the Baker exception primarily to consumer purchases, particularly the purchases of used cars. These cases thus may reflect a rudimentary consumer protection doctrine.
155. Compare U.C.C. § 3-306(c) (one not holder in due course specifically subject to failure of consideration defense) with U.C.C. § 3-305(2) (defenses assertable against holder in due course do not include failure of consideration).
156. See Williams v. Walker, 66 Cal. App. 672, 675, 226 P. 939, 940 (1924) (dictum) (defense of failure of consideration not assertable by accommodation indorser against holder in due course); Lagerquist v. Banker's Bond & Mortgage Guar. Co., 201 Iowa 430, 433-36, 205 N.W. 977, 978-79 (1925) (court recognizes exception based on infant's disaffirmance of contract and return of consideration, but assumes sub rosa that surety secondarily liable after creditor to holder in due course). This analysis assumes that there is in fact a failure of consideration when the principal disaffirms and returns the consideration. For arguments that there is no failure of consideration under these circumstances, see Simpson, supra note 1, at 288 (return of consideration by infant not failure of consideration for surety's promise); Note, supra note 141, at 396-97 (same).
157. This is the rule the Restatement of Security suggests. See Restatement Security, supra note 1, § 125(2) & comment b (surety's payment of obligation entitles him either to receipt of consideration returned to creditor or to reduction of obligation by value of consideration returned); Simpson, supra
returned to the status quo ante does not address why the creditor is not entitled to the profit he had anticipated from the bargain.

Consequently, creditor misconduct, rather than disaffirmance of the infant principal's contract, is a better reason for relieving the surety from liability. That misconduct usually will constitute personal fraud, duress, illegality, or unconscionability. If the creditor misconduct constitutes only a personal defense, it cannot be asserted against a holder in due course.

Let us examine whether unconscionability\(^\text{158}\) is a real or personal defense. Authority on this point is scant and conflicting.\(^\text{159}\) This uncertainty largely may be due to the courts' treatment of the unconscionability issue when confronted with holders in due course. By focusing on the business relationship between the wrongful creditor and the holder in due course, a court may, if it concludes that the connection between them is too close, deny holder in due course status on the ground that the holder was a party to the original transaction.\(^\text{160}\) Courts also may rely on this close connection to impute the wrongful
creditor's knowledge to the holder, and thus conclude that the holder did not take in good faith. Alternatively, courts might impose on the holder a duty of inquiry which, if breached, is equivalent to knowledge of creditor misconduct. Finally, courts might find that the terms the defendant sought to avoid as unconscionable are sufficient to render the instrument non-negotiable.

If a court is uncomfortable with any of these rationales, it might confront the issue directly. Unless the facts constituting the unconscionability defense fit one of the real defenses enumerated in section 3-305(2), those facts and therefore the defense of unconscionability constitute a personal defense. Unconscionability undoubtedly constitutes illegality, but it probably does not make the contract a nullity. The doctrine of unconscionability, as developed in equity, denies specific performance of a contract otherwise enforceable at law. The result is a voidable rather than a void contract. Thus, unconscionability per se does not appear to be a real defense.

If the procedural or substantive elements of the transaction are sufficiently extreme, however, a real defense may result. Defendants sometimes allege that they neither knew nor had reasonable opportunity to learn of the contract terms. If this knowledge or opportunity were lacking and there were any misrepresentation, the principal would have a defense of real fraud. Even in the absence of an active misrepresentation, a court might find that the creditor had an affirmative duty to explain the contract terms; failure to discharge


161. See U.C.C. § 3-302(1)(b) (holder in due course must take in good faith). For an illustrative application of this theory in a consumer context, see American Plan Corp. v. Woods, 16 Ohio App. 2d 1, 4-5, 240 N.E.2d 886, 888-89 (1968) (transferee not holder in due course because awareness of signer's fraud negates good faith taking).


163. To qualify as an article 3 negotiable instrument, the instrument must contain "no other promise, order, obligation or power given by the maker or drawee except as authorized by this Article." U.C.C. § 3-104(1)(b); cf. Chrysler Credit Corp. v. Friendly Ford, 535 S.W.2d 110, 114 & n.2 (Mo. 1976) (doubtful that contract containing numerous promises and broad grants of power by maker is negotiable instrument).

164. See U.C.C. § 3-119(2) (separate agreement does not affect instrument's negotiability).

165. See U.C.C. § 3-305(2) (providing inclusive list of real defenses). The inclusive wording of section 3-305(2) disposes of any argument that courts still retain power to declare new real defenses.

166. See Restatement (Second) of Contracts § 234 comment b (1981) (even though contract fully enforceable at law for damages, equity grants no specific performance if "sum total of provisions drives too hard a bargain for a court of conscience to assist").

167. See Reading Trust Co. v. Hutchison, 35 Pa. D. & C.2d 790, 795-96 (1964) (principal allegedly tricked into signing note in belief it was another document); Britton, supra note 1, § 130 (discussing pre-Code law).

168. See U.C.C. § 3-305(2)(c) (real defense when misrepresentation and neither knowledge nor reasonable opportunity to obtain knowledge).

this duty could constitute misrepresentation. In practice, however, a court rarely would find real fraud in a commercial transaction. First, it would be difficult for a businessman to prove both ignorance and no reasonable opportunity to obtain knowledge of the contract terms. Second, there is a fundamental difference between finding unconscionability to place the loss on the wrongful creditor and establishing a real defense in order to allocate the loss to an innocent holder in due course.

A term of the instrument might be so harsh that a court would hold it void as against public policy. Such a result resembles real illegality. As with real fraud in a commercial context, however, a court is highly unlikely to transform its holding that the offensive term is void as against public policy into a real illegality defense. Indeed, numerous cases state that unless a statute declares the contract void, illegality cannot constitute real illegality.

Thus, neither unconscionability nor the surety's limited ability to assert the principal's infancy defense should provide the surety with a defense against a holder in due course unless the facts constitute real fraud, real duress, or some other real defense listed in section 3-305(2).

OTHER INCAPACITY

In addition to infancy, "other incapacity . . . as renders the obligation of the party a nullity" results in a real defense. Other incapacity includes "mental incompetence, guardianship, ultra vires acts or lack of corporate capacity to do business, any remaining incapacity of married women, or any other incapacity apart from infancy." Our discussion will deal only with the most common kinds of non-infancy incapacity: mental incompetence, guardianship, and ultra vires.

Mental Incompetence and Guardianship. Authorities differ on whether the contract of a mental incompetent is void or merely voidable. Once a guardian has been appointed, however, it is clear that the incompetent's contracts are void. We need not concern ourselves with the voidness issue because surety law does not permit the surety to assert the principal's mental

173. See U.C.C. § 3-305(2)(b) (illegality that renders party's obligation a nullity).
174. See notes 220-22 infra (discussing such cases).
175. U.C.C. § 3-305(b)(2).
176. U.C.C. § 3-305 comment 5; see 2 WILLISTON, supra note 1, §§ 243-272 (treating these other forms of incapacity).
177. Most contractual disabilities of married women have been abolished. See RESTATEMENT SECURITY, supra note 1, § 125 comment a (formerly true that married women's contracts void). Under suretyship law the surety could not assert the principal's coverture. See Annot., 24 A.L.R. 841-44 (1923); SIMPSON, supra note 1, at 290-91.
178. See generally 2 WILLISTON, supra note 1, §§ 250-255 (presenting conflicting authorities on whether mental incompetents' contracts void or voidable).
179. Id. § 257, at 98.
incompetency unless the surety has been defrauded as to that fact by the creditor.\textsuperscript{180} As with infancy, this rule is essentially just.\textsuperscript{181} The surety, typically a friend or relative of the principal, probably will know better whether the principal is competent and thus is better able to determine possible risks than a non-fraudulent creditor. The surety can no more assert his principal’s incompetency against a holder in due course than he can against the non-fraudulent creditor.\textsuperscript{182}

\textbf{Ultra Vires Acts or Lack of Corporate Capacity to Do Business.} The confusion surrounding the doctrine of ultra vires is principally due to the varying definitions of the term. For our purposes, ultra vires means that the act so described exceeds the capacity of the corporation.\textsuperscript{183} Corporations have power to issue negotiable instruments,\textsuperscript{184} but lack capacity to execute notes in furtherance of business not authorized by their charters or certificates of incorporation.\textsuperscript{185} This definition specifically excludes situations in which the corporation either engages in illegal conduct or in which the agent who executes the instrument on behalf of the corporation is not properly authorized. The first instance is excluded because it involves policies different from those that prohibit ultra vires acts;\textsuperscript{186} the second, because it involves a matter of

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\item 180. \textit{See}, e.g., W.T. Rawleigh Co. v. McAteer, 203 Ark. 776, 779, 158 S.W.2d 701, 702 (1942) (principal’s lunacy defense does not relieve surety, who is “said to warrant the competency of the principal”); Caldwell v. Ruddy, 2 Idaho 1, 6-7, 1 P. 339, 342-43 (1881) (surety liable because deemed to have contracted that principal competent); Severson v. Macomber, 153 A.D. 482, 485, 138 N.Y.S. 250, 253 (1912) (surety bound on guarantee of support payments to insane principal’s family), \textit{aff’d}, 212 N.Y. 274, 106 N.E. 72 (1914); \textit{Restatement Security}, \textit{supra} note 1, § 125(1) \& comment a (surety cannot assert principal’s lack of capacity against creditor); \textit{Simpson}, \textit{supra} note 1, at 286 (same). \textit{See generally Restatement Security}, \textit{supra}, § 124 (when creditor knows facts unknown to surety that materially increase surety’s risk and creditor has reason to believe such facts are unknown to surety, creditor’s nondisclosure of facts upon reasonable opportunity to communicate them provides surety with defense).
\item 181. \textit{See} Caldwell v. Ruddy, 2 Idaho 1, 6-7, 1 P. 339, 342-43 (1881) (surety deemed to contract that principal competent; principal could not disaffirm note if he received any benefit from consideration prior to its return); Lee v. Yandell, 69 Tex. 34, 36, 6 S.W. 665, 667 (1887) (friends of principal presumed to know best his capacity).
\item 182. The ordinary indorser who receives consideration for the transfer of an instrument is precluded by implied warranties from asserting his principal’s incapacity. \textit{Cf.} U.C.C. § 417(2)(d) (upon indorsement of instrument for consideration transferor warrants to subsequent holder that no defenses effective against him).
\item 183. The Code also ascribes this meaning to the term. \textit{See} U.C.C. § 3-305 comment 5 (ultra vires acts or lack of corporate capacity to do business).
\item 184. \textit{See}, e.g., \textit{Cal. Corp. Code} § 207(g) (West 1977) (corporations have all powers of natural persons to perform business activities, assume obligations, and enter into contracts, including guaranty and suretyship); \textit{Del. Code Ann. tit. 8, § 122(13)} (1974) (corporations have power to make contracts, incur liabilities, issue notes, bonds and other obligations, and secure any of such obligations by mortgage, pledge or other encumbrance of any of its property); \textit{Ill. Rev. Stat. ch. 32, § 157.5(h)} (Smith-Hurd 1954) (same); \textit{N.Y. Bus. Corp. Law} § 202(7) (McKinney 1963) (same).
\item 185. This interpretation employs the proper definition of the term. \textit{See} \textit{R. Stevens, Handbook on the Law of Private Corporations} 254-55 (1936) (ultra vires acts beyond scope of corporate purpose and activities as agreed by shareholders).
\item 186. For the distinction between illegal and ultra vires acts, see \textit{R. Stevens, supra} note 185, § 62, at
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The doctrine of ultra vires is "the expression of a social policy that failed." Colonial society's distrust of powerful corporate entities and government's assertion of control over those entities gave credence to the theory that a corporation is a fictitious person endowed with only those powers and purposes granted to it by the state. With the advent of general incorporation laws, under which state officials rubber-stamp the corporate charter as drafted by the incorporators, the policy has lost much of its force. It reaches its nadir in those states permitting all-purpose clauses in corporate charters. In addition, both courts and legislatures have minimized the availability of the ultra vires defense, even when a transaction exceeds the express purposes or powers of the corporation.

In view of the disfavor into which the defense has fallen, it is not surprising that suretyship law does not allow the surety to assert the principal's ultra vires defense. When one considers that the surety invariably is a major stockholder, officer, or director of the principal corporation, and thus is more likely to know the limits that the charter imposes on corporate purposes or powers, the rule is inherently fair. The surety can no more assert the principal's ultra vires defense against the holder in due course than he can against the creditor.

REAL DURESS

Duress can be a real defense if it renders the instrument void, not just voidable. The test for a real duress defense focuses on the effect of the duress

254-56; *id.* § 71, at 279-82. See Mitchell v. Zurn, 221 S.W. 954, 954-55 (Tex. 1920) (sureties liable on corporation's ultra vires, but not illegal, contract).

187. See CARY & EISENBERG, CASES AND MATERIALS ON CORPORATIONS 40 (5th ed. 1980) (corporate officer's unauthorized act within scope of permissible corporate behavior is ultra vires act by officer, but not by corporation).

188. *Id.* at 38.

189. *Id.* at 38-39.

190. *Id.*

191. See DEL. CODE. ANN. tit. 8, § 102(a)(3) (1974) (permitting purposes clause of certificate of incorporation to state that corporation may engage in any lawful act for which corporations may be organized).


193. See Birken v. Tapper, 45 S.D. 600, 603-04, 189 N.W. 698, 699 (1922) (lack of capacity of corporate principal to negotiate notes unavailable to surety); Mitchell v. Zurn, 221 S.W. 954, 955 (Tex. 1920) (surety liable on contract ultra vires as to the corporate principal); Mitchell v. Hydraulic Bldg. Stone Co., 61 Tex. Civ. App. 131, 135-36, 129 S.W. 148, 150 (1910) (same); Remsen v. Graves, 41 N.Y. 471, 475-76 (1869) (same); see also RESTATEMENT SECURITY, *supra* note 1, § 125 & comment a (lack of capacity of principal such as ultra vires undertaking of corporation not available to surety). Of all the authorities only Simpson appears to express some doubt about the rule, but he cites no cases contra. His doubt may result from construing the term "ultra vires" to include illegal acts. See SIMPSON, *supra* note 1, at 284-86.

194. See note 182 *supra*.

195. U.C.C. § 3-305(2)(b) (holder in due course does not take instrument free from duress that renders obligation of party nullity). Comment 6 to section 3-305 states:

Duress is a matter of degree. An instrument signed at the point of a gun is void, even in the hands of a holder in due course. One signed under threat to prosecute the son of the maker for theft may be merely voidable, so that the defense is cut off.... If under [local] law the effect of the duress...is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise, it is cut off.
upon the coerced party's assent to the contract. If the coerced party fails to
assent, the contract is void for lack of mutual assent, and the defense is real.196

Examples of duress precluding assent occur when a person's hand is seized and
his signature forcibly written by another,197 or when threats coerce a person to
sign a contract, the nature of which he is ignorant.198 Cases that address these
kinds of conduct are very rare.199 Duress is merely voidable and provides only
a personal defense when it improperly induces the coerced party's assent.200

Authorities have split on whether the surety can assert the principal's de­

fense of duress.201 Differing factual contexts may account for some of the dis­

agreement. None of the relevant cases, however, involves a surety's assertion of

196. See Restatement (Second) of Contracts §§ 174-175 & comments (1981) (when conduct
physically compelled by duress, no assent; when conduct compelled by improper threat, conduct voida­
ble by victim); Britton, supra note 1, § 131 (if no willingness or intent to be bound, no contract); 9 J.
Wigmore, Evidence in Trials at Common Law § 2423 (Chadbourn rev. 1981) (elements that make
act void or voidable go to contracting parties' motives), 13 Williston, supra note 1, § 1624 (duress may
completely prevent mutual assent or may merely be ground for setting aside contract because mutual
assent improperly obtained); Note, Nature and Effect of Duress, 26 Harv. L. Rev. 255, 255 (1913)
(when person's hand forced to sign, writing not own act and no expression of will).

Before the distinction between void and voidable evolved, some courts ruled that any type of duress
voided the contract. See, e.g., Berry v. Berry, 57 Kan. 691, 694, 47 P. 837, 838 (1897) (instrument
absolutely void when wife cosigned instrument under threats of husband); Hatch v. Barrett, 34 Kan.
223, 236, § P. 129, 138 (1885) (note void when principal signed note under threats of imprisonment);
Barry v. Equitable Life Assurance Soc'y, 59 N.Y. 587, 591 (1874) (assignment invalid when wife signed
assignment under husband's undue influence).

197. See Atwood v. Atwood, 84 Conn. 169, 171, 79 A. 59, 60 (1911) (deed void when defendant
seized hand of principal who suffered from typhoid fever and forced her signature on deed); Restate­
ment (Second) of Contracts § 174 illustration 1 (1981) (contract void when A grasps B's hand and
forms X on paper); 13 Williston, supra note 1, § 1624, at 772 (no real expression of mutual assent
when party's hand physically forced to sign).

without knowing its nature after she was arrested falsely and defendant told her she must sign to be
exonerated); Restatement (Second) of Contracts § 163 (1981) (transaction void when compelled
party does not know or have reason to know nature of transaction); 13 Williston, supra note 1,
§ 1624, at 773 (same).

199. Only two such cases seem to exist: Atwood v. Atwood, 84 Conn. 169, 79 A. 59 (1911) and
Sheppard v. Frank & Seder, 307 Pa. 372, 161 A. 304 (1932). See Restatement (Second) of Con­
tracts § 174 comment a (1981) (such situations relatively rare). The paucity of cases involving the
real duress defense may be explained either by the infrequency of the conduct, or by the disinclination
of the coerced party to disclose the conduct for fear the wrongdoer physically will harm him, his family,
or his property.

200. See note 196 supra (discussing effect of duress).

201. See E. Arnold, supra note 42, § 30 (cases not in harmony as to whether surety may use de­

fense); A. Stearns, The Law of Suretyship § 2.11 (5th ed. 1951) (majority and better view that
duress practiced on principal discharges surety when surety has no knowledge of duress). See generally
Arnold, Availability of Duress and Fraud Upon the Principal as Defenses to the Surety and Guarantor, 77
U. Pa. L. Rev. 23, 39-50 (1928) (duress on principal by stranger has no effect on surety; in some states,
surety can use defense); Note, Duress of a Third Person as Grounds for Rescission of a Legal Transac­tion,
30 Colum. L. Rev. 714, 717 (1930) (duress in inducement should not constitute ground for avoidance
against one wholly without fault); Note, Right of Surety to Avoid Contract Because of Duress on the
Principal, 68 U. Pa. L. Rev. 383, 383 (1920) (right of surety to assert principal's duress defense much
on whether surety discharged when principal induced to sign under creditor's fraud or duress).

Some cases disallow the defense. See Plummer v. People, 16 Ill. 358, 361 (1855) (defense of duress
not available to sureties when principal unlawfully imprisoned on larceny charge until he signed instru­
ment); Robinson v. Gould, 65 Mass. (11 Cush.) 55, 58 (1853) (defense of duress not available to surety
when principal imprisoned and coerced to ask surety for guarantee). Other jurisdictions permit the
defense. See, e.g., State v. Brandley, 27 Ala. 44, 46 (1855) (defense of duress available to sureties when
principal illegally imprisoned and sureties signed note to secure principal's release); Coffelt v. Wise, 62
the principal's real duress defense against a holder in due course. This question remains to be resolved.

Examination of this issue requires identification of the competing policies involved. The holder in due course receives special protection for at least two basic reasons. First, he is innocent of any wrongdoing. Although he may aquire the instrument from a wrongdoer, he is a stranger to the misconduct. Second, he is engaging in a transaction valued by society. The holder in due course purchases credit instruments. In our economy, heavily dependent as it is upon credit, the relatively unhindered circulation of credit instruments is vital. The more we subject innocent purchasers of credit instruments to risks, the more we discourage the circulation of these instruments. If a very large number of credit transactions involved significant wrongdoing by the creditor, we probably would not tolerate the protection now given to the holder in due course. We know from experience, however, that the vast majority of credit transactions involve no wrongdoing. We are thus willing to sacrifice the infrequent victim of wrongdoing upon the altar of commerce because, presumably, in the long run society benefits more by encouraging commerce than by recompensing a relatively few victims of creditor wrongdoing. This also may reflect the notion that the defendant, though innocent, is often seeking to avoid the consequences of his own folly at the expense of an innocent purchaser.

The surety may receive special protection for a number of reasons. First, most suretyship law cases involve a wrongdoing creditor rather than a holder in due course. The surety should not be held to insure the creditor against losses caused by his own misbehavior. If the creditor has by his wrongdoing given the principal a defense, we must therefore make the defense available to the surety. Second, if we do not protect the surety, the effect may be to neutralize the principal's defense. Third, the surety's motives are altruistic rather than economic. If we value this good Samaritan conduct, we will reward it.

A few illustrations will demonstrate possible resolutions of these competing policies. Suppose Creditor, by threats or physical violence, causes Principal to

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Ind. 451, 456 (1878) (duress defense available to surety when principal threatened with improper arrest and surety signed note to prevent principal's arrest).

Still other cases allow the defense only when the surety is ignorant of the duress when he signs. See, e.g., Fountain v. Bigham, 235 Pa. 35, 47, 84 A. 131, 135 (1912) (duress defense not available to surety unless he signed without knowledge of duress); Griffith v. Sitgreaves, 90 Pa. 161, 167 (1879) (surety can assert principal's duress defense because surety did not know of duress when he signed note); Restatement Security, supra note 1, § 118 (adopting this rule).

202. Very similar policies protect the good faith purchaser of goods, see U.C.C. § 2-403, and other negotiable pieces of paper such as documents of title, see id. § 7-502, and investment securities, see id. § 8-301. The classic study of this area is G. Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057 (1954); see also Note, Adverse Claims Under the Uniform Commercial Code: A Survey and Proposals, 65 Yale L.J. 807 (1956).

203. Suppose, for example, the creditor unlawfully coerces the principal and the principal subsequently asks the surety to guarantee his obligation. The surety agrees and the principal defaults. If the surety cannot assert the principal's duress defense, the creditor can recover from the surety, and the surety in turn will obtain reimbursement from the principal. See Restatement Security, supra note 1, § 104(1) (person who becomes surety with consent of principal has right of reimbursement against principal). The Restatement does not limit that right where the facts involve a defense of real duress. Id. § 108 (right of reimbursement non-existent only if principal incapable or discharged in bankruptcy).
sign a note without knowledge either of its character or its essential terms. Now that Creditor possesses a note signed by Principal, Creditor or his agent either secures Surety’s signature, or further coerces Principal to obtain surety’s signature. After negotiation of the note to Holder In Due Course, Principal defaults and Holder In Due Course sues Surety. In this illustration, if both Surety and Holder In Due Course acted in good faith, promoting negotiability of instruments must be balanced against rewarding altruistic behavior and preserving Principal’s defense of duress.

Assume Principal requested the surety to sign. To cause Principal’s persuasion of Surety, Creditor probably will have explained to Principal the nature of the document he had signed. If Principal no longer is under duress when he requests Surety’s signature, Principal should be precluded from later asserting the real duress defense against Holder In Due Course. Procuring Surety should estop Principal’s assertion of the real defense. Therefore, there will be no real defense for the surety to assert. If the principal is still under duress, the matter is more complicated. The kind of duress that coerces the principal to persuade the surety to sign can only be personal, because the principal will be aware of what he is doing. A “but for” causation approach to this fact pattern is possible: but for the personal duress, the principal’s conduct would estop him from asserting the initial real duress. Because the later duress is only personal, it should not be effective against a holder in due course. Therefore, the principal should be estopped. On the other hand, estoppel is an equitable concept, so one might choose not to adopt the technical “but for” argument. Certainly the poor principal deserves sympathy. This might be translated into a refusal to find an estoppel. Moreover, if the surety knows of the duress on the principal when he signs, he should be estopped.

Suppose Creditor, without Principal’s consent, requests Surety’s signature. Under these circumstances a surety who undertakes an obligation without the principal’s consent will have no right of reimbursement against the principal. Thus, Principal’s defense against Holder In Due Course cannot be neu-
tralized. In this situation, promoting negotiability of instruments must be balanced only against rewarding altruistic behavior.

If an object of the law is to deter real duress, the risk of loss should fall on the person most able to discover it.\textsuperscript{208} That person is the surety because he foreseeably would discuss the transaction with the principal before he signs, whereas the holder in due course may very well not locate and question the principal before he buys the instrument. Moreover, if the principal is under duress,\textsuperscript{209} he would tend to confide more readily in the surety, who may be a friend or relative, than in a stranger.\textsuperscript{210} Thus, Holder In Due Course should prevail precisely because of Surety's altruism.\textsuperscript{211}

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\textsuperscript{208} The loss also could be allocated according to the intentions of the parties. This test, however, does not seem very useful because, in all likelihood, neither the surety nor the holder in due course considered the risk of real duress on the principal when they engaged in the transaction.

The loss also should not fall automatically on the holder in due course when the principal's obligation is void. In some jurisdictions, even when the principal's signature was forged or unauthorized, the surety remains bound although the principal's obligation was void. \textit{See, e.g.,} Chase v. Hathorn, 61 Me. 505, 509-10 (1875) (surety liable even though two signatures preceding his, upon which he was induced to sign, forged); Farmers' & Traders' Bank of Auxvasse v. Harrison, 321 Mo. 815, 824, 12 S.W.2d 755, 759 (1928) (surety liable although principal bank cannot be bound because bank's cashier signed bond without authority); Johnson County v. Chamberlain Banking House, 80 Neb. 96, 98, 113 N.W. 1055, 1056 (1907) (dictum) (sureties would not be released even if name of principal bank attached to bond by person with no authority); First Nat'l Bank of York v. Blair, 315 Pa. 463, 464, 173 A. 329, 329 (1934) (per curiam) (guarantors not relieved when names of makers on some of notes forged).

Several cases do allow the surety to assert that the principal's signature is forged or unauthorized; none, however, involve a holder in due course. \textit{See} Talbot v. Carroll, 52 Ark. 437, 439, 12 S.W. 1071, 1072 (1890) (per curiam) (neither surety nor principal liable on note when principal's signature forged because no consideration); Gordon & Dulworth v. Abbott, 258 Mass. 35, 39, 154 N.E. 523, 524-25 (1926) (surety not liable on bond because principal misrepresented identity to surety); Dole Bros. v. Cosmopolitan Preserving Co., 167 Mass 481, 482, 46 N.E. 105, 106 (1897) (sureties not liable when principal's agent not authorized to sign for corporation unless surety had knowledge or belief of lack of authority); Russell v. Annable, 109 Mass. 72, 74 (1871) (sureties for partnership not bound when principal could not bind his associates); Green v. Kindy, 43 Mich. 279, 282, 5 N.W. 297, 298 (1880) (dictum) (sureties cannot be bound unless they signed with full knowledge that principal's signature forged); La Belle Iron Works v. Quarter Savings Bank, 74 W. Va. 569, 576, 82 S.E. 614, 617 (1914) (dictum) (to be binding on surety, bond must be signed by principal, executed on his behalf, or ratified, unless surety otherwise agrees to be bound or is estopped).

If the principal is not under duress, he will be estopped from asserting his real defense. \textit{See} text accompanying note 205 \textit{supra} (when principal should be estopped from asserting own defense).

210. The surety, upon learning of the real duress, may keep silent to protect the principal. Under these circumstances the surety should take the loss rather than the holder in due course. \textit{See} note 206 \textit{supra}.

211. An additional approach to allocate the burden of principal's default is to compromise and split the loss between the surety and the holder in due course (and possibly the principal) in equal amounts, or according to notions of comparative fault. For discussions of and references to this approach in contractual contexts, see Coons, \textit{Approaches to Court Imposed Compromise—The Uses of Doubt and Reason}, 58 Nw. U. L. Rev. 750, 787-88 (1964) (discussing roots of winner-take-all philosophy prevalent in our legal system and alternative of compromise); Farnsworth, \textit{Dispute Over Omission in Contracts}, 68 Colum. L. Rev. 860, 883 (1968) (discussing West German court decision that allocated loss on contract equally between buyer and seller when Berlin Blockade made complete performance of contract impossible); Hoff, \textit{Adjustment of Conflicting Rights: A Suggested Substitute for the Method of Choice-of-Laws}, 38 Va. L. Rev. 745, 747 (1952) (proposing, when municipal rights conflict, that simultaneous consideration be given to both or all municipal laws substantially connected with controversy and application of these laws be adjusted in accordance with their relative weight and bearing on case); Northrup, \textit{The Epistemology of Legal Judgments}, 58 Nw. U. L. Rev. 732, 746 (1964) (advocating media- tion as only meaningful or warrantable method for certain kinds of conflicts); \textit{Philosophy From Law: Compromise and Decision Making in the Resolution of Controversies}, 58 Nw. U. L. Rev. 795, 795-805 (1964) (discussing Professor Coons' splitting approach); Seavy, \textit{Embezzlement by Agent of Two Principals: Contribution?}, 64 Harv. L. Rev. 431, 436 (1951) (advocating freedom for courts to do justice and
In any event, the holder in due course can protect himself by taking only instruments that contain surety warranties against real duress on the principal.\textsuperscript{212} Warranties of this type do not conflict with public policy: unlike clauses that waive fraud or duress they do not operate against the victim of the misconduct, but instead favor innocent purchasers.\textsuperscript{213} Ordinary indorsers who receive consideration impliedly warrant against all defenses.\textsuperscript{214} Under the N.I.L., accommodation indorsers also impliedly warranted against real defenses.\textsuperscript{215} The drafters omitted this provision from the Code, presumably adopting Dean Ames' view that these warranties rest upon the premises that the warrantor is a vendor of the instrument, that the accommodation indorser is not a vendor, and that such warranties impose upon the accommodation

have both principals contribute when neither at fault); Sharp, \textit{Promissory Liability (II)}, 7 U. CHI. L. REV. 250, 269 (1940) (proposing equal sharing of reliance damages by parties to transaction frustrated by impossibility); von Mehren, \textit{Special Substantive Rules for Multistate Problems: Their Role and Significance in Contemporary Choice of Law Methodology}, 88 HARV. L. REV. 347, 365-71 (1974) (recommending possible formation of special substantive rules that would adjust, on basis of equality, views of all legitimately concerned jurisdictions); Wade, \textit{Restitution of Benefits Acquired Through Illegal Transactions}, 95 U. PA. L. REV. 261, 301-05 (1947) (suggests allowing plaintiff, in cases of illegal transactions, to recover full amount of enrichment but deducting a sum set by court); Wigmore, \textit{A Summary of Quasi-Contracts}, 25 AM. L. REV. 695, 712 n.(k) (1891) (criticizes theory of \textit{in pari delicto}, which deprives plaintiff of his rights when he participates in wrongdoing, and advocates system that would allow sum due to be paid into court and which would deduct from that sum penalty for violation of law); Note, \textit{Reconsideration of Share Certificate Negotiability}, 7 U. CHI. L. REV. 497, 519 (1940) (recommending splitting loss between purchaser and owner of stock transferred outside of brokerage system when both acted with approximately equal care); Note, \textit{Apportioning Loss After Discharge of a Burdensome Contract: A Statutory Solution}, 69 YALE L.J. 1054, 1074-75 (1960) (proposes statute to govern loss-splitting, which would give judiciary broad discretion but would provide relevant considerations); Comment, \textit{Quasi-Contract—Impossibility of Performance—Restitution of Money Paid for Benefits Conferred Where Further Performance Has Been Excused}, 46 MICH. L. REV. 401, 420 (1948) (discussing recent legislation in England that authorizes courts, in determining recovery, to award each party amount of benefit conferred on other party); Comment, \textit{Loss Splitting in Contract Litigation}, 18 U. CHI. L. REV. 153, 157-63 (1950) (advocating that burden of loss due to impossibility of performance be shared by both parties, unless parties provided for allocation of loss in contract); Radin, Book Review, 21 CALIF. L. REV. 293, 295 (1933) (suggesting division of loss between two equally innocent and diligent parties).

\textsuperscript{212} The inclusion of such warranties probably would not render a note non-negotiable under section 3-104(1)(b), which forbids promises on negotiable instruments other than promises to pay unless such other promise is authorized by the article. U.C.C. § 3-104(1)(b); see U.C.C. § 3-112(1)(e) (negotiability of instrument not affected by term that purports to waive benefit of any law intended for advantage or protection of obligor). The problem can be avoided entirely if the surety signs as indorser and the warranty immediately precedes the surety's indorsement. 212 Warranties of this type do not conflict with public policy: unlike

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\textsuperscript{214} Even victims can waive real defenses against holders in due course. See note 122, supra. 214. U.C.C. § 3-417(2). Under section 3-417(2)(d) such indorsers warrant to subsequent good faith holders that "no defense of any party is good against him." \textit{Id}. This warranty covers both real and personal defenses. 2 N.Y. State Law Revision Comm'n 1955 Report 306 (1955); cf. U.C.C. § 3-417 comment 9 (section assumes that buyer does not undertake to buy instrument incapable of enforcement).

Under the N.I.L., authorities generally agreed that such transferor warranties covered real defenses. There was disagreement, however, over whether such warranties also covered personal defenses. \textit{Compare} \textit{Aigler, Cases on Bills and Notes} 338-39 (1947) (statutory language leads to conclusion that warranties not intended to cover personal defenses \textit{with Britton, supra} note 1, §§ 246-254 (vendor warrants against all personal defenses).

\textsuperscript{215} Under the N.I.L., even accommodation indorsers warranted "[t]hat the instrument is genuine and in all respects what it purports to be." N.I.L. § 66. This language was construed as a warranty against real defenses. \textit{See Britton, supra} note 1, § 247-252 (phrase creates warranties against real defenses of forgery, fraud, material alteration, non-delivery, incapacity, illegality, and other types of invalidity).
indorser "a liability which he never intended to assume, and which cannot be justified on any legal principal."216 A warranty freely and knowingly given by the surety, rather than implied by law, should be equally effective.217

REAL ILLEGALITY

A real defense exists when illegality of the transaction renders the obligation of the party a nullity.218 A wide variety of conduct that is contrary to public policy can give rise to an illegality defense.219

When a statute, expressly or by necessary implication, declares an instrument connected to a proscribed act to be void, the illegality provides a real defense in accordance with the presumed legislative intent.220 When a statute merely forbids the transaction or instrument, or makes it illegal or criminal but not void, the defense is personal.221 Illegality stemming from uncodified notions of public policy also provides only a personal defense.222 In the absence of contrary evidence, these presumptions of legislative intent are determinative. Only if evidence demonstrates that the legislature did not intend the usual inferences to be drawn from the wording of a statute will a court abandon these presumptions.223

216. Ames, The Negotiable Instruments Law, 14 HARV. L. REV. 241, 252 (1900); see also W. HAWKLAND, supra note 20, at 77 (same); Braucher, supra note 33, at 71 (U.C.C. adopts Dean Ames' view and only imposes warranties on vendors); Penney, supra note 33, at 1000-01 (same).

217. See U.C.C. § 1-102(3) (effect of Code's provisions may be varied by agreement); U.C.C. § 3-417 comment 1 (like other warranties, those in this section can be varied by agreement); BRITTON, supra note 1, § 255 (implied warranties under N.I.L. also can be varied by agreement).

218. V.C.C. § 3-305(2)(b).

219. For examples of the numerous kinds of illegal conduct, see 14-15 WILLISTON, supra note 1, §§ 1628-1792.

220. Many cases recite and apply this rule. For examples of these cases, see 11 AM. JUR. 2D Bills and Notes § 672 (1963 & Supp. 1981); 10 C.J.S. Bills and Notes § 503 (1938 & Supp. 1981); F. BEUTEL, supra note 42, at 739-53; see also 2 J. DANIEL, supra note 29, § 939 (recitation of general rule); Danforth, Illegality Under the Negotiable Instruments Law, 92 CENT. L.J. 27, 34-35 (1921) (same). For criticisms of the general rule, see note 223 infra.

221. See, e.g., City National Bank v. De Baum, 166 Ark. 18, 25-26, 265 S.W. 648, 650 (1924) (when holders in due course buy notes issued in violation of state Blue Sky laws, illegality defense not good against them because statute makes notes voidable, not void); Union Trust Co. v. Preston Nat'l Bank, 136 Mich. 460, 470, 99 N.W. 399,402 (1904) (when bank employee commits crime by certifying check although drawer's account contains no funds, contract still valid in hands of bona fide holder unless statute expressly or by implication declares the instrument void); Kraft v. Hoppe, 152 Minn. 143, 145, 188 N.W. 162, 163 (1922) (personal defense when statute only provides that foreign corporation doing business in state subject to penalty and unable to resort to courts for relief if corporation fails to comply with state requirements); Frazier v. Lafferty, 150 Tenn. 105, 107-08, 263 S.W. 978, 978 (1924) (when holders in due course buy stock issued in violation of state Blue Sky laws, they may recover because statute does not declare obligation void if issued in violation of law).

222. See, e.g., Hatch v. Burroughs, 11 F. Cas. 795, 799 (C.C.S.D. Ga. 1870) (notes issued in aid of rebellion valid in hands of bona fide holder for value because no statute made them void); Sondheim v. Gilbert, 117 Ind. 71, 81, 18 N.E. 687, 691 (1888) (contract for sale of future cotton delivery valid in hands of innocent holder because statute that voids gambling notes only discusses money won or lost in betting on game); New Jersey Mortg. & Inv. Corp. v. Berenyi, 140 N.J. Super. 406, 410, 356 A.2d 421, 423 (1976) (per curiam) (note issued in violation of injunction enforceable in hands of holder in due course because no statute makes it void and unenforceable); Glenn v. Farmer Bank, 70 N.C. 162, 175 (1874) (bills issued under illegal contract with rebel government void by common law between original parties but valid in hands of innocent holder).

Earlier cases establishing infancy, incapacity, and certain types of fraud and duress as real defenses may conflict with these cases. The later cases cited here probably reflect a desire to restrict the relatively less predictable power of judges to create ex post facto real defenses.

223. Some cases have found only personal illegality even when the statute declares the transaction or
A great advantage of these presumptions is that they minimize potential disruptions in commercial paper markets as a result of the enactment of new statutes that courts otherwise would construe on a piecemeal basis. Without the rule's guidance, courts, of necessity, would have to balance the statutory policies against those supporting the holder in due course. This piecemeal approach would produce much uncertainty and thus discourage the circulation of negotiable instruments.

Instead, these presumptions allow the risks of a real illegality defense to be predicted. The potential holder in due course can then avoid instruments encumbered with such illegality or can adjust the discount rate to cover the magnitude of the risk. Optimum functioning of credit markets affects the public welfare as much as the prohibition of illegal contracts. Statutes affecting the latter should not lightly be read to affect the former.

Authorities generally favor the surety's assertion of the principal's illegality defenses against a creditor. The surety's ability to make such defenses, however, depends upon the specific facts, the wording of applicable statutes, and the policies behind the illegality. Thus, a usurious rate of interest, for example,

instrument to be void. See, e.g., Commercial Nat'l Bank v. Jordan, 71 Fla. 566, 572-73, 71 S. 760, 762 (1916) (note issued in violation of foreign corporation registration statute, which declares corporation's contracts void, not void because clear legislative purpose was to render contract unenforceable only in hands of corporation); Sonheim v. Gilbert, 117 Ind. 71, 81, 18 N.E. 687, 691 (1888) (contract for sale of future cotton delivery valid in hands of innocent purchaser, although statute declares all gambling speculation notes void, because statute did not intend to include this type of contract); McCardell v. Davis, 49 S.D. 554, 555, 207 N.W. 662, 662 (1926) (note given to winner of poker game valid in hands of holder in due course because statute voiding gambling debts and statute protecting holders in due course must be interpreted together); Rosenblum v. Gomoll, 52 Utah 206, 209, 173 P. 243, 244 (1918) (note issued in violation of usury statute, which declares such notes void, not void in hands of innocent purchaser because another statute protects innocent purchasers).

Conversely, other cases have found real illegality when statutes do not declare the transaction or instrument to be void. See, e.g., McCormick v. Fallier, 223 Ala. 80, 85, 134 S. 471, 475 (1931) (statute which provides that usurious contract cannot be enforced in law or equity renders contract void); Pacific Nat'l Bank v. Hernreich, 240 Ark. 114, 118, 398 S.W.2d 221, 223 (1966) (foreign corporation statute that only makes contract unenforceable if corporation fails to comply renders contract void even in hands of holder in due course); Bacon v. Lee & Gray, 4 Iowa 490, 495 (1857) (statute which declares that in no case shall contract for usurious interest be enforced renders contract void in hands of innocent holder); Kendall v. Robertson, 66 Mass. (12 Cush.) 156, 159 (1853) (statute against usury applies to bona fide holder because of legislative intent).

The general rule has been criticized on the ground that legislatures often mean voidable when they say void. See, e.g., Union Trust Co. v. Presten Nat'l Bank, 136 Mich. 460, 463, 99 N.W. 339, 400 (1904) (statutes cannot express their entire meaning; they must be interpreted in view of common law); Beutel, The Interpretation of the N.I.L. and Statutes Declaring Instruments Void, 83 U. Pa. L. Rev. 744, 745, 752 (1935) (legislatures often do not use "void" accurately; thus, courts should examine legislative policy behind statute); Note, Illegality as a Real Defense Against a Holder in Due Course, 38 Ky. L.J. 492, 495 (1950) (statutes that declare illegal transactions void should be reconciled with provisions in N.I.L. to allow more harmonious and equitable results); Note, Illegal Considerations in Negotiable Instruments, 7 Miss. L.J. 282, 293 (1935) (advocating uniform rule because general rule casts suspicion on commercial paper and disturbs trade).

Lawyers, judges, and legislatures certainly know the difference in the meaning between void and voidable, now that the distinction has prevailed for almost a century. Legislatures have shown an awareness of the distinction and employ it in statutes. See Hawaii Rev. Stat. § 476-4 (1976) (if usurious rate of interest, contract shall not by reason thereof be void); Neb. Rev. Stat. § 45-105 (1978) (same); Wash. Rev. Code Ann. § 19.52.030 (1978) (same).

224. See 74 Am. Jur. 2d Suretyship § 122 (1974 & Supp. 1981) (principal's illegality defense available to surety against creditor, unless surety has otherwise contracted with creditor); G. Brandt, supra note 180, § 30 (same); 72 C.J.S. Principal and Surety § 20 (1951 & Supp. 1981) (same); Restatement Security, supra note 1, § 117 (same); Simpson, supra note 1, § 58 (same); A. Stearns, supra note 201, §§ 2.10 & 7.3 (same).
has voided the surety's obligation even as against a holder in due course.\textsuperscript{225} On the other hand, a surety on the bond of a bank designated as a depository of public funds cannot avoid liability on the grounds that the bank's appointment was illegal.\textsuperscript{226}

Reasons of space and utility militate against a comprehensive survey of all types of illegality. Let us consider the two most common types, gambling and usury.\textsuperscript{227}

\textit{Instruments Used in Connection with Gambling Transactions.} With regulation of gambling or wagering contracts essentially a matter of state law, the states have taken three basically different approaches. Approximately thirty-two states and the District of Columbia make gambling notes void by statute.\textsuperscript{228} Another sixteen states apparently have no laws that directly affect the validity of gambling notes.\textsuperscript{229} The last two states say only that the note either will support no action or that the loser may recover from the winner the amount he paid.\textsuperscript{230} Of the thirty-three jurisdictions that make gambling notes void, ten have statutory exceptions in favor of holders in due course.\textsuperscript{231} One state, by case law, renders the illegality defense personal;\textsuperscript{232} nineteen establish

\textsuperscript{225}. See, e.g., McCormick v. Fallier, 223 Ala. 80, 85, 134 S. 471, 475 (1931) (when contract charges usurious interest, defense may be asserted against holder in due course); German Bank v. DeShon, 41 Ark. 331, 340-41 (1883) (when usurious contract void by state constitution, surety not liable against holder in due course); Townsend v. Bush, 1 Conn. 260, 269 (1814) (bill of exchange given upon usurious consideration void in hands of indorsee for valuable consideration); Bridge v. Hubbard, 15 Mass. 96, 101 (1818) (when note usurious, indorsees for valuable consideration cannot recover against anyone); Wilkie v. Roosevelt, 3 Johns. Cas. 66, 206, 207 (N.Y. Sup. Ct. 1802) (note given upon usurious contract absolutely void, even in hands of innocent person); Gaillard v. Le Seigneur, 26 S.C.L. (1 McMul.) 225, 230 (1841) (note given entirely for usurious interest absolutely void).

\textsuperscript{226}. See National Surety Co. v. Le Flore County, 262 F. 325 (5th Cir. 1919) (surety cannot assert invalidity of appointment of depository and of fidelity bond), \textit{cert. denied}, 253 U.S. 490 (1920).

\textsuperscript{227}. See U.C.C. § 3-305 comment 6 (most common illegality gambling or usury).


229. These states are Alaska, Arizona, California, Colorado, Delaware, Hawaii, Idaho, Kansas, Maine, Nebraska, Nevada, North Dakota, Oklahoma, Rhode Island, Texas, and Utah.

230. See LA. CIV. CODE ANN. art. 2983 (West 1952) (law grants no action for payment); id. art. 2984 (loser who voluntarily pays may not recover); MONT. CODE ANN. § 23-5-131 (1981) (loser may sue to recover).

231. These jurisdictions are Connecticut, District of Columbia, Georgia, Massachusetts, Michigan, Minnesota, New Mexico, Oregon, Washington, and West Virginia. For statutory cites, see note 228 supra.

232. See McCardell v. Davis, 49 S.D. 554, 556, 207 N.W. 662, 663 (1926) (gambling note void by
it as real and three have not decided the question. Of the sixteen states without statutes that directly affect the validity of gambling notes, four by case law classify the illegality defense as personal. The other twelve states have no relevant case law. The states that merely disallow actions on gambling notes or allow the loser to recover what he paid also have no relevant case law. This variety of results is not atypical in connection with illegality defenses.

State law accords the surety equally diverse treatment. In those states declaring gambling notes void, it seems that the surety can assert the illegality defense against a holder in due course. Cases seldom discuss this question, apparently because the wording of most gambling note statutes voids not just the principal's obligation, but the entire note. Thus, the surety is not liable

statute valid as to holder in due course). Query whether the statute on which this case is based is still effective under South Dakota Law. See S.D. CODIFIED LAWS ANN. § 53-9-2 (1980) (gambling notes absolutely void); id. § 57A-3-305(2)(b) (illegality of transaction rendering obligation nullity is good defense against holder in due course).

233. Sixteen of these states establish the defense as real directly, and in three it would be real by analogy to other illegality situations that adopt the void-by-statute rule. See Birmingham Trust & Sav. Co. v. Curry, 160 Ala. 370, 373, 49 So. 319, 320 (1909) (gambling contracts void as to innocent purchasers for value); Hare v. General Contract Purchase Corp., 220 Ark. 601, 603, 249 S.W.2d 973, 975 (1952) (defense of bona fide holder for value without notice is without merit against plea of usury); Commercial Nat'l Bank v. Jordan, 71 Fla. 566, 572, 71 So. 760, 761-62 (1916) (dictum) (in suit on contract by unregistered foreign corporation, defense of illegality against bona fide holder valid if statute declares note void); Chapin v. Dake, 57 Ill. 295, 298-99 (1870) (bona fide holders acquire no title in gambling note); Irwin v. Marquett, 26 Ind. App. 383, 395, 59 N.E. 38, 42 (1901) (gaming paper void in hands of any holder); Plank v. Swift, 187 Iowa 293, 299, 174 N.W. 236, 238 (1919) (checks for gambling debt void even in hands of professed innocent holder); Alexander & Co. v. Hazelrigg, 123 Ky. 677, 682, 685, 97 S.W. 353, 353, 354 (1906) (negotiable gambling note can be defended successfully against innocent purchaser for value without notice); Gough v. Pratt, 9 Md. 526, 535 (1856) (bill given for gambling debt void); Lucas v. Waul, 20 Miss. (12 S. & M.) 157, 161 (1849) (when contract originally void as gaming consideration, subsequent contract cannot make it valid); Manufacturers' & Mechanics' Bank v. Twelfth St. Bank, 223 Mo. App. 191, 195, 16 S.W.2d 104, 104-05 (1929) (cashiers' checks lost in crap game void as to holder in due course); Fisher v. Brehm, 100 N.J.L. 341, 345, 126 A. 444, 445 (1924) (check for gambling debt not negotiable instrument; void ab initio); Larschen v. Lantzes, 115 Misc. 616, 617, 189 N.Y.S. 137, 137 (App. Term 1921) (gambling note void in hands of holder in due course); Wachovia Bank & Trust Co. v. Crafton, 181 N.C. 404, 405, 107 S.E. 316, 316 (1921) (gambling note void in action to enforce its obligation); Lagonda Nat'l Bank v. Portner, 46 Ohio St. 381, 385, 21 N.E. 634, 635 (1889) (no action by indorsee against drawer of gambling check); Unger v. Boas, 13 Pa. 600, 602 (1850) (gaming note void in hands of innocent indorsee); Mordecai v. Dawkins, 43 S.C.L. (9 Rich.) 262, 264 (1856) (gaming note void even in hands of innocent holder); Snoddy v. American Nat'l Bank, 88 Tenn. 573, 577, 13 S.W. 127, 128 (1889) (negotiable notes for wagering consideration void in hands of innocent holder); Samuel Streit & Co. v. Sanborn, 47 Vt. 702, 706-07 (1874) (when note voided for sale of liquor, no enforcement for benefit of bona fide holder); Glassman v. Federal Deposit Ins. Corp., 210 Va. 650, 652, 173 S.E.2d 843, 844-45 (1970) (negotiable paper for gaming consideration void in hands of bona fide holder for value).

234. These states are New Hampshire, Wisconsin, and Wyoming. See Fuller v. Hutchings, 10 Cal. 523, 526 (1858) (illegality no defense against a bona fide holder without notice); Storz Brewing Co. v. Skriving, 94 Neb. 215, 216, 142 N.W. 669, 670 (1913) (gambling note not voidable as to innocent purchaser); Huffman v. Kahn, 167 Okla. 389, 390, 29 P.2d 767, 767 (1934) (innocent purchaser for value entitled to recover on instrument given in payment of gambling debt); Atwood v. Weeden, 12 R.I. 293, 295 (1879) (dictum) (note invalid unless it passes into hands of bona fide holder for value without notice).


237. The Arkansas statute is typical:

"All judgments, conveyances, bonds, bills, notes, securities and contracts, where any consideration or any part thereof is money or property won at any game or gambling device, or any bet, or wager whatever, or for money or property lent to be bet at any gaming or gambling device, or at any sport or pastime whatever, shall be void." ARK. STAT. ANN. § 34-1604 (1979).
on the note. In states that render the defense personal, the surety would lose against a holder in due course.

Several states have not yet, by statute or case law, classified the gambling defense as either real or personal. In these states the defense should be personal. Not only is this result in accord with the rule discussed above that real illegality occurs only if a statute declares the illegal transaction void, it is supported by sound judgment. Consider three paradigms: the wastrel who gambles and drinks the night away; the unsuspecting social player fleeced by card sharks; and the cad who gambles away his family's rent and grocery money. The winner fails in a suit on the wastrel's note because the court will not assist one wrongdoer to recover from another. The fleeced gambler provides the court with an additional reason to favor the loser: the winner's cheating. The cad's note will go unenforced on the further ground of hardship to the cad's family.

Suppose, however, the winner negotiates the wastrel's note to a holder in due course. The purchase by the holder in due course significantly changes the situation. When the winner sued, he and the wastrel were in pari delicto. The holder in due course as plaintiff, however, is an innocent purchaser against a wrongdoer. In choosing which party to favor, the answer is obvious. In theory, to favor the holder in due course encourages gambling by providing winners with a market for losers' notes. Conversely, the courts' refusal to enforce these transactions would discourage gambling only to the extent that it impairs collection on the note. Gamblers, however, are subject to collection methods that are often more effective than lawsuits. The social gambler who fails to pay his losses will face ostracism. More organized gambling may confront the welsher with self-help collection involving threats to his well-being. In the end, the supposed drawbacks of encouraging gambling seem to be more than outweighed by the justice of favoring the innocent purchaser over a losing wrongdoer.

The cheated loser, in contrast, is not in pari delicto with the winner. Nonetheless, as a wrongdoer he should not prevail against the holder in due course. The fact that he has been cheated should not change the result. The conduct of a cheated loser who wittingly signs a note resembles typical personal fraud conduct, and thus deserves no protection against a holder in due course.

In the cad's situation, his family deserves sympathy, but no more than the family made destitute by personal fraud. No apparent reason exists to treat hardship induced by gambling any differently from that induced by any other conduct giving rise to personal defenses. Arguments of moral turpitude lose much of their force amid state-operated lotteries and other state-sanctioned

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238. These statutes usually give ordinary indorsers no protection if they negotiate a gambling note in a legal transaction. See Wachovia Bank & Trust Co. v. Crafton, 181 N.C. 404, 405, 107 S.E. 316, 317 (1921) (voidness does not extend to holder in due course against indorser); Irwin v. Marquett, 26 Ind. App. 383, 385, 59 N.E. 38, 38 (1901) (dictum) (indorsement is separate contract warranted by indorser); see also U.C.C. § 3-417(2)(d) (indorser for consideration warrants to any subsequent holder in good faith that no defense of any party is good against him).

239. See notes 3-9 supra (on effectiveness of personal and real defenses against holder in due course).

240. See notes 220-23 supra (discussing when transaction in violation of law creates defense of real illegality).
betting schemes. Moreover, any turpitude inherent in gambling should not affect the holder in due course, himself innocent of any wrongdoing. Even in the cad's case, the holder in due course ought to prevail.

**Instruments Given for Usurious Loans.** Usury is the practice of charging more than the legal rate of interest for a loan of money or its equivalent. Though every state has some form of usury statute, few of the statutes are alike. Most states have several legal rates of interest, each applicable to a different kind of loan. For example, one rate might exist for consumer loans and a higher or unlimited rate for commercial loans. Some states impose usury laws only on loans, although in others these statutes apply also to sales on credit and to other contracts.

Most states impose one of five sanctions for violation of the applicable usury statute: voiding of the usurious note; forfeiture of interest in excess of the legal rate; barring recovery of the entire amount of interest; statutory penalty of an amount that is usually a multiple of the excess or the entire interest; or forfeiture of some or all interest in addition to a statutory penalty. Lastly, some states impose no legal rate of interest on certain kinds of loans, usually non-consumer transactions. Of the twenty-five jurisdictions

241. See Restatement of Contracts § 526 (1932) (usury is bargain under which greater profit paid than is permitted by law); H Sigman, Usury Laws and Modern Business Transactions 25-26 (1980) (usury is charging of interest in excess of rate permitted by constitution, statute, or regulation).


247. These states are Indiana, Maine, Massachusetts, New Hampshire, and Wyoming. Some states with usury statutes deny the defense to corporate debtors. E.g., Ala. Code § 8-8-5 (1975); Del. Code
that classify usury as either a personal or a real defense, nineteen make it personal\(^{248}\) and the remaining six make it real.\(^{249}\)

Consider the surety in those six states that classify the usury defense as real. Two of these states make the usurious note void.\(^{250}\) The voidness thus extends to the surety's obligation, and offers him a real defense.\(^{251}\) Two other states provide sureties the benefit of the real defense.\(^{252}\) Likewise, in the remaining

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\(^{248}\) See Whipp v. Glueck, 58 F.2d 523, 524 (App. D.C. 1932) (no relief accorded against holder in due course of usurious note); Connor v. Goebel, 217 Cal. 399, 400, 18 P.2d 931, 931 (1933) (purchase for value before maturity renders usury plea of no avail as against purchaser); Richter v. Burdock, 257 Ill. 410, 418, 100 N.E. 1063, 1066 (1913) (maker's usury defense as to payee cut off by transfer without notice for valuable consideration); Allen v. Grenada Bank, 155 Miss. 191, 98, 124 So. 69, 71 (1929) (defense of usury not available against innocent holder); Van Etten v. Howell, 40 Neb. 850, 851, 59 N.W. 389, 390 (1894) (purchaser in good faith for value takes free of usury defense); Forbes v. Marsh, 3 N.H. 119, 120 (1824) (usury defense against bona fide indorsee); Phillips v. Roper, 171 Okla. 225, 228, 42 P.2d 871, 874-75 (1935) (purchaser without notice takes free from usury defense); Bradshaw v. Van Valkenburg, 97 Tenn. 316, 320, 37 S.W. 88, 89 (1896) (same); Rosenblum v. Gomoll, 52 Utah 210, 217 P.2d 243, 244 (1918) (same); Lynchburg Nat'l Bank v. Scott, 91 Va. 652, 654, 22 S.E. 487, 488 (1895) (bona fide purchaser for valuable consideration without notice may recover); American Sav. Bank & Trust Co. v. Helgesen, 64 Wash. 54, 61, 116 P. 837, 839 (1911) (usury defense not available against holder who acquires notes in good faith for value). See generally ALA. CODE § 8-8-12(b) (1975) (usury defense may not be pleaded against holder in due course); DEL. CODE ANN. tit. 6, § 2305 (1974) (usury laws not available against bona fide holders in usual course of business); FLA. STAT. ANN. § 687.04(1) (1966) (no penalty to bona fide holder without notice of usury); IDAHO CODE § 28-22-107 (1980) (indorsee in due course of usurious note); GA. CODE ANN. § 111.410, 418, 100 N.E. 1063, 1066 (1913) (maker's usury defense as to payee cut off by transfer without notice); MINN. STAT. ANN. § 334.03 (West 1981) (usurious note void except as to holders in due course); R.I. GEN. LAWS § 6-26-4 (1969) (usury defense not available against indorsee for value without notice);

\(^{249}\)These states are Arkansas and New York. See Wilkie v. Roosevelt, 3 Johns. Cas. 66, 69-70 (N.Y.) (usurious note void as to surety and indorser without notice); appeal after remand, 3 Johns. Cas. 206, 207 (1802) (same); German Bank v. DeShon, 41 Ark. 331, 338 (1883) (holder does not prevail against surety's usury defense).

\(^{250}\) See German Bank v. DeShon, 41 Ark. 331, 338 (1883) (holder fails to prevail against surety's usury defense). As in the case of the gambling instrument, however, the ordinary indorser who transfers a usurious note in an otherwise legal transaction has no defense. See, e.g., Maestro Music, Inc. v. Rudolph Wurlitzer Co., 88 Ariz. 222, 229, 354 P.2d 266, 271 (1960) (usury defense not available to ordinary payee and creditor); Eskridge v. Thomas, 79 W. Va. 322, 330, 91 S.E. 7, 11 (1916) (indorser may be liable to bona fide holder without notice on instrument declared void by statute); see also U.C.C. § 3-417(2)(d) (indorser for consideration warrants to any subsequent holder in good faith that no defense of any party good against him).

\(^{251}\) The Polk decision does not make clear whether the bank in that case was a holder in due course. However, this case was cited in Perry Savings Bank v. Fitzgerald, 167 Iowa 446, 449 N.W. 497 (1914), in support of the proposition that usury was a defense good against a bona fide purchaser.
two states, the most sensible course would be to give the surety a real defense. If the principal who received the benefit of the loan need not repay any or all of the interest to a holder in due course, then the surety, who did not receive any of the money, should not have to pay either. In contrast, if the state classifies the usury defense as personal, then the surety would have no defense good against the holder in due course.

There remain the twenty-six states that have not classified the usury defense as personal or real. If the void-by-statute rule applied in each state, probably only one state would classify the defense as real;253 the remaining twenty-five would likely regard it as personal. The latter is the preferred result. The purpose of usury laws is to prevent rapacious lenders from taking advantage of necessitous borrowers. Thus, the statutes both punish creditors who take unfair advantage and protect borrowers from harsh repayment terms. All this looks very much like unconscionable conduct.254 Indeed, in states with no maximum legal rate of interest, courts may refuse to enforce bargains for payment of interest so great as to be unconscionable,255 much as they refuse to enforce other unconscionable contracts.

When the note comes to a holder in due course, however, the occasion to punish the usurer has passed. Enforcement is still a harsh result to the debtor, but not uniquely so. To have the defendant pay a note grounded in personal fraud, duress, or unconscionability may be just as harsh, but pay he must to a holder in due course. Since there appears to be no good reason to single out usury for special treatment as a real defense, usurious interest, unless it is the result of real fraud or real duress, ought not to constitute a real defense.

REAL FRAUD

Real fraud is "such misrepresentation as has induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms."256 The emphasis here is on the effect of the fraud upon the deceived party's assent to the contract. If the fraud results in the deceived party's giving no assent, mutual assent is lacking and no contract is created. In other words, the contract is void.257 On the other hand, if the fraud results in the deceived party's assent, a contract is created,

253. In Nevada, any agreement for usurious interest is void "as to such excessive rate of interest." NEV. REV. STAT. § 99.050 (1973). Query whether a contract can be partially void against a holder in due course. At least one court has so held under a similar statute. See Eskridge v. Thomas, 79 W. Va. 322, 327, 91 S.E. 7, 10 (1916) (if usury proven, holder in due course can collect interest only up to legal rate).

254. See note 158 supra (discussing content of unconscionability doctrine).

255. See Houghton v. Page, 2 N.H. 42, 44 (1819) (contracts may be void at common law because unconscionable and oppressive).

256. U.C.C. § 3-305(2)(c). Other equivalent terms include essential fraud, fraud in the essence (or fraud in esse contractus), fraud in the factum, fraud in the inception, and fraud in the execution.

257. See U.C.C. § 3-305(2)(c) & comment 7 (when maker tricked into signing note in belief it is some other document, "the theory of the defense is that his signature on the instrument is ineffective because he did not intend to sign such an instrument at all"); BRITTON, supra note 1, § 130 (when signer believes he is signing writing of a different character, signature imposes no duty on him to any holder); RESTATEMENT (SECOND) OF CONTRACTS § 163 (1981) (conduct induced by misrepresentation is not effective as manifestation of assent by one without knowledge of or reasonable opportunity to know terms); 12 WILLISTON, supra note 1, § 1488 (when fraud induces assent in belief of a different act, contract void).
although the fraud provides grounds to set the contract aside. In this case the contract is merely voidable.\textsuperscript{258} Litigation that alleges real fraud is more common than that which involves real duress, and appears chiefly in connection with consumer transactions.\textsuperscript{259}

Suretyship law generally recognizes the right of the surety to defend based on fraud on his principal, provided the surety does not know of the fraud when he signs.\textsuperscript{260} If someone other than the creditor commits the fraud, however, neither the principal\textsuperscript{261} nor the surety\textsuperscript{262} can assert a personal fraud defense against the innocent creditor.\textsuperscript{263} As in the case of duress, the relevant rules of suretyship law address only cases of personal fraud. Both suretyship and negotiable instruments law are silent on the issue of real fraud.

Consider a fact pattern that would give rise to a dispute between Surety and Holder In Due Course over real fraud practiced on Principal. Creditor induces Principal to sign a negotiable note by misrepresenting it as a credit application. Principal, for some non-negligent reason, neither knows nor has reasonable opportunity to learn of the note's character or its essential terms. Creditor either has Principal obtain Surety's signature or persuades Surety to sign. Creditor then negotiates the note to Holder In Due Course. After Principal defaults, Holder In Due Course sues Surety. Surety asserts Principal's defense of real fraud.

\begin{footnotes}
\item[258] \textit{Restatement (Second) of Contracts} § 164 (1981) (assent induced by fraudulent or material misrepresentation renders contract voidable by recipient); 12 \textit{Williston}, \textit{supra} note 1, § 1488 (when fraud induces assent that would not otherwise be given, contract voidable). \textit{See generally Annot., 78 A.L.R.3d 1020 (1977) (citing cases); Annot., 160 A.L.R. 1295 (1946) (same). Of course, if the signing party, despite the misrepresentation, reasonably could have learned what he was signing, the lack of assent is caused not by the misrepresentation but by the signer's own carelessness. Consequently, he cannot rely on the absence of assent to avoid liability. \textit{See Restatement (Second) of Contracts} § 163 comment b (1981) (conduct effective as manifestation of assent if recipient had reasonable opportunity to know terms of contract). \textit{See generally} 2 R. \textit{Anderson, Anderson on the Uniform Commercial Code} § 3-305:27 (2d ed. 1971); Britton, \textit{supra} note 1, § 130; \textit{Restatement (Second) of Contracts} § 172 & comments (1981).
\item[259] In a classic example of real fraud, the defendant had just come of age. To induce him to sign a negotiable note, a respected friend represented the document as a confidential paper and had him sign through holes cut in a covering blotter. The court set aside the note for want of assent. Lewis v. Clay, [1897] 67 L.J.Q.B. (n.s.) 224.
\item[260] \textit{See Restatement Security, supra} note 1, § 118 (surety not liable if principal's obligation induced by fraud); Annot., 3 A.L.R. 868, 868 (1919) (when principal defends on ground of fraud, surety entitled to same defense); E. Arnold, \textit{supra} note 42, § 30 (perhaps majority of authorities of view that surety may assert fraud on principal); 72 C.J.S. \textit{Principal and Surety} § 19 (1951) (if principal not bound because of creditor's fraud, surety also not bound); Simpson, \textit{supra} note 1, § 56 (in most states surety not liable when principal defrauded). \textit{But cf. 74 Am. Jur. 2d Suretyship} § 112 (1974) (authorities divided on whether creditor's fraud against principal discharges surety). The major conflict in this area is whether the principal must have elected to disaffirm his contract before the surety is entitled to assert the defenses. \textit{See 72 C.J.S. \textit{Principal and Surety} § 19 (1951) (surety cannot avail himself of fraud on principal unless principal also does); Simpson, \textit{supra} note 1, § 56 (in some jurisdictions defrauded principal may avoid or affirm contract but surety may not make choice for him). Because this conflict applies only to voidable contracts, it need not concern us here.
\item[261] \textit{See Restatement (Second) of Contracts} § 164(2) & comment e (1981) (fraud by third person no defense against innocent purchaser); 12 \textit{Williston, supra} note 1, § 1518 (fraudulent misrepresentation by third person generally not ground for rescission or damages against other party to contract).
\item[262] \textit{See Restatement Security, supra} note 1, § 119 (principal's fraud or duress on surety no defense against innocent creditor); Simpson, \textit{supra} note 1, § 28 (surety induced by fraud of principal or another surety liable to innocent creditor).
\item[263] Note that the combination of these rules effectively removes from the surety any personal fraud defense against an innocent purchaser, such as a holder in due course.
\end{footnotes}
This situation closely resembles that analyzed under real duress. Some material differences appear however. The principal still might be under duress when either the surety or holder in due course asks him about the note and, for that reason, might conceal the real duress, though under usual circumstances he would be more likely to reveal it to the surety than to the holder in due course. If defrauded, however, the principal will almost certainly reveal that fraud when either the surety or the potential holder in due course confront him with the note. He has less cause to fear reprisal from a defrauder than from one who employs duress. Assuming then, that either the surety or the holder in due course can uncover the real fraud simply by questioning the principal, the surety is the better party to hold responsible for the inquiry. As friend or relative, the surety is in a better position to question the principal and is probably more inclined to do so. Moreover, in the final analysis, the potential holder in due course can probably shift all risk to the surety by purchasing only notes that contain surety warranties against real fraud on the principal. For these reasons the surety should bear the risk in the first instance and thus not be able to assert the principal's defense of real fraud against the holder in due course. Again, it is expedient to favor the innocent purchaser and the flow of commerce over the good Samaritan.

DISCHARGE IN INSOLVENCY PROCEEDINGS

The principal has a real defense if he has received a discharge in insolvency proceedings. Insolvency proceedings include any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved. This defense encompasses the bankruptcy discharge. Indeed, it would appear that a discharge in bankruptcy is the only discharge for insolvency now permitted.

Under suretyship law, the surety cannot assert the principal's bankruptcy discharge against the creditor. Moreover, the principal's discharge bars the...
surety's recovery against the principal. The net effect is to put any loss that arises from the principal's bankruptcy discharge upon the surety. This result is equitable. Creditors require sureties primarily when the principal is a potential credit risk. The creditor's intent is that the surety will pay if the principal cannot, so the surety should not escape liability to the creditor by reason of the principal's bankruptcy. The surety also should not be able to shift his loss to his principal. Any other result would fail to provide the debtor with a "clean start" free of his debts, one of the basic policies of bankruptcy. Of course, the surety still can prove his claim against the principal in bankruptcy in order to share pro rata with other general creditors in the assets of the principal's estate.

ANY OTHER DISCHARGE OF WHICH THE HOLDER HAS NOTICE WHEN HE TAKES THE INSTRUMENT

Under article 3 a holder can have notice or actual knowledge that some parties to the instrument have been discharged, yet still be a holder in due course. Notice of discharges constitutes notice of a defense only when the holder has notice that all parties have been discharged. The distinction between notice of discharge and notice of defense recognizes that a holder often has valid reasons to discharge one or more parties. Thus, notice of a discharge does not per se indicate a defect in the instrument. Defenses, on the other hand, arise from facts demonstrating that something improper has occurred. Consequently, holder in due course status is there denied. Needless to say, if the holder in due course knows or has notice of a discharge, he ought not to take free of it.

U.S.C. § 524(e) (Supp. III 1979). The legislative history makes clear that this subsection covers the liabilities of sureties such as guarantors. S. REP. No. 989, 95th Cong., 2d Sess. 81, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5867 (debtor's discharge does not affect liability of co-debtors or guarantors). This position of the 1978 Act is consistent with prior federal bankruptcy law. See Bankruptcy Act of 1898, § 16, 30 Stat. 544 (1899) ("The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankrupt"); see also SIMPSON, supra note 1, 308-11 (discussion and cases referring to 1898 Act).

271. RESTATEMENT SECURITY, supra note 1, § 108(4) & comment; see SIMPSON, supra note 1, 227-28 nn.73 & 74 (cases and articles under the 1898 Act); see also J. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY 137-40 (1956) (surety for bankrupt can prove in creditor's name if creditor does not prove). The 1978 Act produces no change in result. 11 U.S.C. §§ 502(e), 509 (Supp. III 1979). The surety, however, does not take a pro rata share with the creditor to whom he is liable as surety.

272. A holder has notice of a discharge defense only if he has notice "that all parties have been discharged." U.C.C. § 3-304(1)(b). The Code's official comments confirm the negative implication that the holder does not necessarily have notice of a defense if he has notice that fewer than all parties have been discharged. See id. § 3-304 comment 4 (notice that indorser discharged does not prevent holder from taking obligation in due course); id. § 3-305 comment 9 (notice of discharge that leaves other parties liable does not prevent purchaser from becoming holder in due course); id. § 3-602 comment (purchaser can take in due course even though one or more parties discharged, as long as any party remains undischarged). The negative implication is imperative if section 3-602 is to have any application.

273. For example, a holder might choose to release his immediate transferor from liability on his contract of indorsement by striking out his signature. U.C.C. § 3-605(1)(a). The indorsement is still effective to pass title to the holder. Id. § 3-605(2). Because the holder's action is not inherently improper, subsequent holders can be holders in due course. See note 273 supra (comments cited).

274. U.C.C. § 3-304(1)(b).

275. The Code provides this result: "the holder in due course . . . takes the instrument free from . . . (2) all defenses of any party to the instrument with whom the holder has not dealt except . . . (e) any
The surety can use the Code's provisions to his advantage against a holder in due course. Under suretyship law, certain conduct of the creditor with respect to the principal, or with respect to the collateral that secures the principal's obligation, will discharge the surety. For example, if the creditor releases the principal, grants him an extension of time, or otherwise modifies the contract of the principal, the surety may be discharged. A complete or pro tanto discharge of the surety may follow if the creditor releases or otherwise impairs collateral. The reasons often given for these results are that the creditor's conduct has increased the surety's risk or has impaired the surety's right to be subrogated to the creditor's rights.

To this point in the article, we have pursued the issue basically in terms of whether the surety can assert a real defense of his principal. The advantage to the surety in posing the question thus is at once direct and easily understood. If the principal has a real defense, it should pass to the surety unchanged so that he can assert it as a defense to his own liability. The real defense now being considered is different than other real defenses. Here the defense is real not so much because of the principal's status or the nature of the creditor's conduct toward the principal, but because the holder in due course has notice of the defense. Notice, not any inherent "realness," is the key. Under these circumstances the theory that the surety is only asserting the principal's real defense narrows rather than broadens the surety's opportunities to argue discharge against a holder in due course. Thus, for example, modification of the principal's contract results in no real defense for the principal and under the principal's real defense theory would give no real defense to the surety. On the other hand, if the holder in due course knew of the surety status and also of the modification when he took the instrument, he would have notice of the surety's discharge due to the modification. Thus the surety would have a real defense. In view of this, the discussion shall focus on the extent to which the holder in due course has notice of the surety's discharge rather than whether the principal has a real defense that the surety can assert.

other discharge of which the holder has notice when he takes the instrument." U.C.C. § 3-305. Conduct that results in discharges is catalogued in section 3-601, which lists article 3 sections on discharge and also incorporates the general contract law of discharge. See id. § 3-601; Restatement of Contracts § 385 (1932) (index of general contract law discharges).

277. U.C.C. § 3-606(1)(a); Restatement Security, supra note 1, §§ 122, 128, 129; Simpson, supra note 1, at 296-301, 329-70. Note that if the surety consents to the release, extension, or other modification, he is not discharged. The consent may even be in advance of the extension or modification. U.C.C. § 3-606(1) & comment 2; Restatement Security, supra, §§ 122, 128 & comment c, 129 & comment b; Simpson, supra, at 301, 343, 366-67. The surety also is not discharged by an unconsented-to release or extension if the creditor expressly reserves his rights against the surety. U.C.C. §§ 3-606(1)(a), 3-606(2) & comment 4; Restatement Security, supra, §§ 122(b), 129; Simpson, supra, at 302-04, 362-63; see also Restatement Security, supra, § 122 comment d (reasoning behind reserved-rights exception); Simpson, supra, at 302-04 (same).

278. U.C.C. § 3-606(1)(b); Restatement Security, supra note 1, § 132; Simpson, supra note 1, at 370-82. Note that the surety's consent to release or impairment prevents a discharge. U.C.C. § 3-606(1); Simpson, supra, § 74.

279. Restatement Security, supra note 1, § 132 comment b; Simpson, supra note 1, at 351-54. For additional reasons sometimes given, see Restatement Security, supra, § 122 comment b, § 128 comment d, § 129 comment a; Simpson, supra, at 296-301, 339-40.

280. U.C.C. § 3-305(2).

281. U.C.C. § 3-606(1)(a); see also note 99 supra (discussing situation in text).

282. Cf. U.C.C. § 3-305(2)(e) (defense available to principal, and by analogy to surety).
At the outset we should distinguish between discharges caused by the holder in due course and discharges caused by prior holders. The former need not long detain us as they are specifically dealt with in article 3. If the holder in due course knows of the suretyship relationship and engages in any of the conduct described in section 3-606 without the surety's consent or, in some cases, without an express reservation of rights against the surety, he discharges the surety.283 However, if the holder in due course does not know of the suretyship relationship his conduct does not discharge the surety.284

Henceforth, we shall deal with surety discharges effected by holders before negotiation to the holder in due course. Consider two relatively straightforward cases of surety discharge effected by a holder before negotiation to the holder in due course. First, suppose the holder in due course when he takes the instrument has notice that a certain party is a surety, that another party is the principal, and that the prior holder has engaged in conduct involving the principal that discharges the surety. The holder in due course thus has notice of both the surety status and the conduct causing the discharge, and so the surety can assert his discharge against the holder in due course.285 If, however, the holder in due course knows of neither the surety status nor the discharge-causing conduct, the surety cannot assert his discharge against the holder in due course.286 The following more difficult cases remain: (1) the holder in due course has notice of surety status but not of the discharge-causing conduct; (2) the holder in due course has notice of the discharge-causing conduct but not of surety status; (3) the holder in due course has notice of the surety status and discharge-causing conduct but does not have notice that the conduct involved the principal.

283. U.C.C. § 3-606 (conduct under § 3-606 results in discharge of party whose rights the conduct impairs); see also note 99 supra. For discussions of section 3-606, see WHITE AND SUMMERS, supra note 5, at 522-29; Clark, Suretyship in the Uniform Commercial Code, 46 Tex. L. Rev. 453, 457-65 (1968); Martin, supra note 51, at 602-16; Murray, Accommodation Parties: A Popsorri of Problems, 22 U. Miami L. Rev. 814, 824-28 (1968); Note, Discharge of Sureties—Impairment of the Right of Recourse, 9 B.C. Indus. & Com. L. Rev. 970 (1968); Note, Discharge of Guarantors under U.C.C. § 3-606—Total or Pro Rata Discharge upon Release of Another Guarantor, 9 Cap. U.L. Rev. 365 (1979); Note, Suretyship in Article 3 of the Uniform Commercial Code, 17 W. Res. L. Rev., 318, 318-25 (1965); see also Annot., 95 A.L.R.3d 962 (1979); Annot., 93 A.L.R.3d 1283 (1979). As to surety discharges not covered by section 3-606 or other sections of article 3, the rules of suretyship law probably would apply under section 1-103. See U.C.C. § 1-103 (on supplementation of Code by common law principles of law and equity when not displaced by particular code provisions). For the rules of suretyship law, see, e.g., Restatement Security supra note 1, §§ 114-143; Simpson, supra note 1, §§ 63-80.

284. See U.C.C. § 3-415(3) (as against holder in due course and without notice of accommodation, oral proof of accommodation not admissible to give accommodation party benefit of discharge dependent on his status as such); id. § 3-606 comment 3 (holder does not discharge surety when he acts in ignorance of the relation). This is also the rule in suretyship law. See, e.g., E. ARNOLD, supra note 41, § 101 (creditor, when ignorant that one of parties is surety and extends time to another, does not discharge first surety); Restatement Security, supra note 1, § 114 comment c (creditor not bound by incidents of suretyship unless he knows of it); see also notes 97-98 supra.

285. U.C.C. § 3-305(2)(e). For example, Maker draws a negotiable note to the order of Payee. Payee indorses the note to Holder. Holder releases Maker by striking out Holder's signature and initialing the strike-out. Holder in Due Course who takes the note has notice that Payee was discharged. U.C.C. § 3-305(2)(e) comment 9; see also note 99 supra.

286. U.C.C. § 3-602. For example, Surety signs a note as maker without indicating his surety status. The note is payable to the order of Principal. Principal indorses to Holder. Holder releases Principal without cancelling Principal's signature or otherwise marking the note to reflect the release. A holder in due course will have no notice that Surety was discharged.
Case 1: Holder in due course has notice when he takes the instrument that a certain party to the instrument is a surety. Unknown to the holder in due course, a prior holder has engaged in conduct toward the principal causing the surety to be discharged. The surety cannot assert his discharge against the holder in due course because the holder in due course lacked notice of all the facts necessary to constitute the discharge. Thus, Case 1 should be resolved in favor of the holder in due course.

Case 2: The holder in due course has notice of the discharge-causing conduct, but does not have notice that one of the parties to the instrument is a surety. Whether the surety can assert his discharge against the holder in due course depends on the particular facts and circumstances of each dispute. If the conduct discharges the principal as well as the surety, the surety can try to assert the principal's real discharge. The holder in due course will counter that the surety must prove his status to assert the principal's defense, and that the surety's failure to indicate his status on the instrument estops him from proving the status against a holder in due course who relied upon the absence of visible sureties. This counterargument has merit. Since the ignorant holder in due course is protected against his own discharge-causing conduct, he likewise should be protected against similar conduct by prior holders. The surety may argue, however, that notice of the discharge-causing conduct is no-
notice of his surety status. The issue, in short, is whether notice of discharge-causing conduct by prior holders puts a potential holder in due course under a duty to inquire about such conduct.

Some kinds of discharge-causing conduct do put potential holders on notice. An instrument bearing a visible material alteration constitutes notice of a defense and thus defeats holder in due course status. The alteration must be such as to make the instrument appear "irregular." But the comments clearly imply that some visible alterations, involving the striking out of indorsers' signatures, do not defeat holder in due course status. Other than these hints as to what constitutes notice and what does not, article 3 provides no additional enlightenment. Perhaps the answer lies in the "reason to know" provision. If the conduct is such that a reasonably prudent person would have inquired and if such inquiry would have revealed the existence of the surety, the holder in due course has notice of the surety status and, hence, of his discharge. On the other hand, if a reasonably prudent person would not have inquired or if such an inquiry would probably not have revealed the surety status, the holder in due course would not have notice of the discharge. Such an approach would encourage the surety to sign in a manner indicating his surety status while at the same time encouraging the holder in due course to investigate potentially troublesome matters prior to taking the instrument. Indeed, the dearth of case law on this point may indicate that such holders regularly investigate visible evidence of discharging conduct.

In some respects this approach is a return to the objective good faith standard of Gill v. Cubitt, which the drafters of article 3 explicitly rejected. In any event, potential holders in due course can avoid the whole inquiry problem by taking only instruments that include consents to the most common forms of discharging conduct. Thus, a careful holder in due course should

293. U.C.C. § 3-304(1)(a) & comment 2; see also id. § 3-407 comment 4 (purchaser who takes instrument with notice of material alteration takes with notice of claim or defense and cannot be holder in due course).

294. U.C.C. § 3-305 comment 9 (when indorsement is cancelled, holder takes subject to discharge); id. § 3-602 comment (holder with notice of discharge may be holder in due course as to liability of maker).

295. U.C.C. § 1-201(25)(c); see note 288 supra (text of the "reason to know" provision).

296. Professor Peter Coogan mentioned in conversation that:

[I]n his years of experience as a bank lawyer, he never had to concern himself with the law of negotiable instruments. He attributed this to the fact that no careful banker would rely on holder-in-due-course protection for a sizeable loan; rather, he would thoroughly investigate the transaction and all its potential pitfalls, thus trading knowledge for the privilege of claiming the 'white heart and empty head' of the holder in due course.

Jordan, supra note 103, at 63 n.55.

297. 107 Eng. Rep. 806, 808-09 (1824) (no person should take a negotiable security from another not known to him without making reasonable inquiry).

298. White & Summers, supra note 5, at 562-63. Query whether the objective standard is entirely irrelevant under article 3. See U.C.C. § 3-302(1)(c) (requirements for holder in due course status); id. § 1-201(25) (defining "notice"); id. § 3-304 (stating when purchaser has notice of defense).

299. A comment to the Code states specifically that consent may be obtained in advance. U.C.C. § 3-606 comment 2. Moreover, courts regularly uphold boilerplate consents. See, e.g., Union Planters Nat'l Bank v. Markowitz, 468 F. Supp. 529, 535 (W.D. Tenn. 1979) (when guarantors waived obligations by plaintiff to preserve collateral, plaintiff not required to exercise due care with regard to collateral); Ishak v. Elgin Nat'l Bank, 48 Ill. App. 3d 614, 617, 363 N.E.2d 159, 161-62 (1977) (dictum) (surety's waiver of rights as to collateral in guaranty agreement bars defense of discharge); Haney v.
not be troubled by surety discharges in this second case.

Case 3: The holder in due course has notice of both surety status and discharge-causing conduct, but does not have notice that the conduct involved the principal. A multi-party instrument revealing that one party is a surety and that another has been released may still not show that the release discharges the surety.\(^{300}\) The surety's argument that the holder in due course has notice under a "reason to know" standard is very strong in this situation. Moreover, the holder in due course cannot argue that the surety is estopped for failure to indicate his status. To impose a duty to inquire on the potential holder in due course probably does nothing more than mandate what a prudent purchaser would do anyway under these circumstances. Purchasers who would rather avoid the costs of an inquiry can still protect themselves by taking only instruments with the consents discussed in our second case.

Conclusion

The surety does not fare well against the holder in due course. The surety is liable to the holder in due course if the principal has a real defense of infancy or other real incapacity, real fraud or duress, or discharge in bankruptcy. The surety ought to prevail against the holder in due course, however, when his principal has a defense of illegality based on a statute that makes the entire instrument void, or when the holder in due course has notice of a special surety discharge. These results are remarkably consistent with the theory that the surety is asserting a real defense of his own. They are inconsistent with a theory that the surety merely asserts the principal's real defense. Thus, the proper analysis of our question should be whether the surety has proved facts that establish a real defense to his own obligation, not whether the principal has a real defense available to the surety. Against a holder in due course, the surety's cause must stand or fall on its own merits.

These conclusions are not unreasonable. Cases which speak of the surety as asserting the principal's defense probably draw their essential support from the fact that the plaintiff is a wrongdoing creditor. That support is absent where the plaintiff holder in due course is innocent of wrongdoing. Further, if one considers the reasons for making defenses real, it is not readily apparent why the surety ought to have the advantages of the principal's real defenses. If we set aside section 3-305(2)(e) discharges as a special and obvious case, there are essentially two reasons why defenses are real: (1) the defendant obligee never assented to the obligation as in the real defenses of fraud, duress, and perhaps insanity; and (2) the policy in support of protecting the obligee is strong enough that it prevails over the policies that support the holder in due course as in the real defenses of infancy, other incapacity, illegality, and bankruptcy.

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Deposit Guar. Nat'l Bank, 362 So. 2d 1250, 1252 (Miss. 1978) (surety's consent to holder's surrender of collateral bars surety's defense of discharge).

300. For example, Principal as maker signs a note payable to the order of Surety. Surety indorses to Holder. Holder cancels the maker's signature without indicating who cancelled it. A holder in due course who takes this instrument might assume that Surety rather than Holder cancelled the maker's signature, in which case Surety is not discharged.
discharge.\(^{301}\) If the former reason is to free the surety, it must be because he did not assent to his obligation. Whether or not the principal has a real defense is irrelevant to that question. If the latter reason is to free the surety, there must be a strong policy supporting protection of the surety which ought to prevail against the holder in due course. Such a policy does not seem to exist however. Fear of neutralizing the principal’s real defense is, in practice, not a major concern.\(^{302}\) The altruistic motives of the surety are commendable, but not at the expense of an innocent holder in due course.\(^{303}\)

Economic reasons also support the same result. Commerce in surety-backed notes and the usefulness of suretyship as a security device would be more hindered by rules favoring the surety than by rules favoring the holder in due course. Most sureties are amateurs and have primarily altruistic motives. Holders in due course are self-serving professionals. Consequently, holders in due course will likely be more risk averse than sureties. A rule favoring sureties which is perceived to increase the holder in due course’s risks will discourage holders in due course to a greater degree than sureties operating under a rule favoring holders in due course. Additionally, visibly surety-backed notes already bear the mark of Cain. The presence of the surety indicates that the

301. The “non-assent” reason actually is a specific instance of the “strong policy” reason. There is some tension between the objective manifestation of consent theory in classical contract law and the subjective manifestation of consent that underlies real defenses. Under the classical contract theory, the true reason for the “non-assent” real defenses would have to rest on the “strong policy” reason, grounded in the heinousness of the wrongdoer’s conduct. Non-assent should be retained as a separate reason because courts employ that method of analysis in deciding cases. As for its inconsistency with the classical contract theory, justice rather than consistency of theory ought to be favored where these two goals are irreconcilable.

302. When the real defense is infancy, other incapacity, discharge in bankruptcy, or some forms of illegality, the principal can assert the defense even against a surety to whom he consented. See, e.g., RESTATEMENT SECURITY, supra note 1, § 108(3)-(4) (principal’s bankruptcy and want of capacity are defenses good against surety); E. ARNOLD, supra note 2, at 246 (no recovery against principal by surety when principal is under legal disability such as idiocy or infancy); SIMPSON, supra note 1, at 227-29 (surety has no right to reimbursement when principal bankrupt or when both surety and principal have complete defense against holder); see also Harley v. Stapleton’s Adm’r, 24 Mo. 248, 249 (1857) (surety cannot recover from principal when surety knowingly entered into illegal contract); 72 C.J.S. Principal & Surety § 325(d) (1951) (surety cannot recover from principal when surety paid with knowledge that underlying contract illegal). If the real defense is fraud, duress, or illegality, the principal can assert the defense against a surety to whom he did not consent. See RESTATEMENT SECURITY, supra note 1, § 108(2) (principal with defense who has not consented to surety has no duty to reimburse surety); SIMPSON, supra note 1, at 229 (principal with defense of illegality not liable to person who becomes surety without principal’s knowledge or request; note 207 supra (discussing fraud or duress). If the principal consents to the surety, he often will have acted in obtaining the surety’s signature so as to estop himself from asserting the defense against the surety. See note 205 supra and accompanying text (when party can be estopped from asserting defense).

303. Altruism is often said to be its own reward. Hence, perhaps, the courts’ reluctance to aid the altruistic intermeddler who confers unsolicited benefits and then seeks payment. See J. DAWSON & G. PALMER, CASES ON RESTITUTION 48-53 (2d ed. 1969) (American cases tend to find volunteer to be “officious intermeddler” and deny recovery); K. YORK & J. BAUMAN, CASES AND MATERIALS ON REMEDIES 218 (3d ed. 1979) (plaintiff-volunteer can recover only if he did not confer benefit as gift and did not act officiously). See generally 2 G. PALMER, THE LAW OF RESTITUTION 357-477 (1978) (broad discussion of altruism). Note that when the altruistic intermeddler is allowed to recover, some policy other than reward of altruism usually supports the recovery. See RESTATEMENT OF RESTITUTION §§ 112-117 (1937) (no restitution to volunteer except to protect interests of others or when volunteer provides necessary, prevents serious harm or suffering, preserves public decency, health, or safety, protects goods in his lawful custody, or assists another incapable of giving consent); J. DAWSON & G. PALMER, supra, at 48-53 (recovery supported by policies related to burial, medical emergency, provision of necessities, school transportation, marine salvage, preservation of estate).
principal was a less than an optimal risk. We already have a delicate balance. Should we favor the surety at the expense of the holder in due course, the result may be to consign these notes and with them the security device of suretyship to the land of Nod. Consequently, to preserve the usefulness of suretyship, the holder in due course should prevail against the surety who is unable to establish his own real defense.