NOTES

THE WAIVER OF DEFENSES BY GUARANTORS IN GUARANTY CONTRACTS AND THE NONWAIVER PROVISIONS OF THE UNIFORM COMMERCIAL CODE

INTRODUCTION

Guaranty, or surety,[1] contracts have, since ancient times,[2] served as a means by which a creditor can obtain additional assurance that he will be paid through the promise of a guarantor to pay in the event of the debtor's default. Until the enactment of the Uniform Commercial Code in most states, the law of guaranty had traditionally been treated as a separate field of contract law. Under the Code, questions have been raised about the applicability of Code nonwaiver provisions to guaranties of secured obligations. Resolution of these questions turns on whether common law guaranty rules are regarded as having been modified by Code nonwaiver rules.

The following example shows how the conflict between the Code and the common law has arisen:

Debtor wants to purchase a new automobile. Banker, to whom

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1. Chancellor Kent defined a guaranty as a "promise" to answer for the payment of some debt, or the performance of some duty, in the case of the failure of another person, who, in the first instance, is liable." 3 J. KENT, COMMENTARIES ON AMERICAN LAW 121-22 (13th ed. 1884). The term "guaranty" is used in this note in the broad sense described by Chancellor Kent. In some jurisdictions, "guaranty" has been given a different meaning than the term "surety" to distinguish among various types of secondary liability. *See* Slovenko, *Suretyship*, 39 TUL. L. REV. 427, 429-30 (1965). Such distinctions have, as a practical matter, resulted in much confusion, *see generally*, Note, *Guaranty and Suretyship in Pennsylvania—An Attempt at Clarification*, 87 U. PA. L. REV. 465 (1939), and have been criticized on the ground that it is the intent of the parties and not the labels they attach to their agreement that should determine what type of liability has been assumed. Radin, *Guaranty and Suretyship*, 18 CAL. L. REV. 21, 29 (1929). RESTATEMENT OF SECURITY § 82, Comment g (1941), for example, attaches no significance to the use of " 'surety" as opposed to "guaranty." Likewise, U.C.C. § 1-201(40) (1978 version) states that "surety' includes guarantor."

2. For a discussion of the history of the terms "guaranty" and "surety," see Radin, *Guaranty and Suretyship*, 17 CAL. L. REV. 605 (1929).

Debtor has come for a loan to buy the car, tells Debtor that the purchase transaction will have to be structured so that Debtor gives the bank a security interest in the new car. In addition, Banker tells Debtor that his credit rating is poor and that someone with an acceptable credit rating will have to sign a form guaranty contract provided by Banker if the loan is to be approved. The contract contains provisions waiving two types of guarantor defenses—defenses based upon the fact that the principal debtor has a defense, and the defense of negligent impairment by Banker of collateral securing the loan.[3]

Debtor convinces his friend, Guarantor, to sign the guaranty agreement. Subsequently, Debtor defaults on his payments to the bank, with $3,000 still owing. Pursuant to sections 9-503 and 9-504(3) of the Code,[4] the bank repossesses and sells the car without

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3. See text accompanying notes 13-14 *infra* for a discussion of the "debtor" defense and at notes 18-22 *infra* for a discussion of the impairment-of-collateral defense.

4. U.C.C. § 9-503 (1978 version) sets forth the basic criteria for an Article Nine "self-help" repossession, by a creditor, of collateral securing the debt:

> Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action. If the security agreement so provides the secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties. Without removal a secured party may render equipment unusable, and may dispose of collateral on the debtor's premises under Section 9-504.

U.C.C. § 9-504(3) (1978 version) sets forth the manner in which repossessed collateral must be sold under Article Nine:

> Disposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor, if he has not signed after default a statement renouncing or modifying his right to notification of sale. In the case of consumer goods no other notification need be sent. In other cases notification shall be sent to any other secured party from whom the secured party has received (before sending his notification to the debtor or before the debtor's renunciation of his

giving notice of the sale to either Debtor or Guarantor. Because there is a deficiency of $500, Banker demands that Guarantor pay the deficiency.

After learning the details of the sale, Guarantor feels that, had the sale been conducted properly, there would have been no deficiency. Under the Code, Debtor can assert the defenses of lack of notice and of sale in a "commercially unreasonable" manner in an action by Banker for the deficiency, and these defenses cannot be waived in advance.[5] This puts Guarantor in a difficult position. He

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rights) written notice of a claim of an interest in the collateral. The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale.

5. Code section 9-504(3) requires that notice of the sale be given by the secured party to the debtor and that the sale be conducted in a "commercially reasonable" manner. *Id.* While Article Nine contains no all-encompassing definition of "commercial reasonableness," some guidelines are furnished in section 9-507(2):

> The fact that a better price could have been obtained by a sale at a different time or in a different method from that selected by the secured party is not of itself sufficient to establish that the sale was not made in a commercially reasonable manner. If the secured party either sells the collateral in the usual manner in any recognized market therefor or if he sells at the price current in such market at the time of his sale or if he has otherwise sold in conformity with reasonable commercial practices among dealers in the type of property sold he has sold in a commercially reasonable manner. The principles stated in the two preceding sentences with respect to sales also apply as may be appropriate to other types of disposition. A disposition which has been approved in any judicial proceeding or by any bona fide creditors' committee or representative of creditors shall conclusively be deemed to be commercially reasonable, but this sentence does not indicate that any such approval must be obtained in any case nor does it indicate that any disposition not so approved is not commercially reasonable.

Basically, the "commercially reasonable" standard imposes liability on secured creditors for conduct that might be characterized as "mere" negligence as well as for conduct that is dishonest. Negligent conduct involves an act or omission in the sale of collateral that would not be considered reasonable by commercial standards, while dishonest conduct has the added element of intentional or reckless sale of the collateral for an inadequate price. *See* United States v. Cawley, 464 F. Supp. 189 (E.D. Wash. 1979), where the court identified both types of conduct in defining "commercial unreasonableness." *See generally* R. WHITE & J. SUMMERS, THE UNIFORM COMMERCIAL CODE 987-95 (1972). This note is concerned with waiver of "mere" negligence only.

Under Code section 9-501(3), the debtor's defenses of lack of notice and "commercial unreasonableness" cannot be waived. *See* note 35 *infra*. There is a diversity of opinion as to the effect of a successful assertion of these defenses in an action by a secured creditor for a

waived his defenses when he signed the guaranty contract, while Debtor is protected by the Code nonwaiver provisions. Thus, Guarantor may not only have to pay the full deficiency, he may also be barred by the Code from seeking reimbursement from Debtor.[6] It behooves Guarantor in such circumstances to argue that the nonwaiver provisions that protect Debtor protect him as well.

This note will examine the relationship between Code nonwaiver provisions, that might be read to protect guarantors in the circumstances outlined above, and common law guaranty rules. The note will explore whether the Code should be read to require that a guarantor may not waive certain debtor defenses and the impairment defense in guaranties of secured obligations.

In analyzing this issue, two countervailing policy themes are pertinent. First, there is the policy in favor of allowing waiver provisions in guaranty contracts so that creditors can insure against their own negligence in handling collateral. By having the guarantor waive any defenses predicated on the creditor's negligence, creditors are free to repossess and sell collateral *and* to collect a deficiency, even if the sale is negligently conducted. Guarantors, on the other hand, have a very strong interest in collateral securing the debt, since the value of the collateral may be sufficient to extinguish the underlying debt and with it the guaranty obligation. If

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deficiency. In a majority of jurisdictions, a showing of lack of notice or commercial unreasonableness automatically bars a claim by the creditor for a deficiency. United States v. Cawley, 464 F. Supp. 189, 192 (E.D. Wash. 1979). The minority approach rejects the punitive aspects of the majority rule by creating a rebuttable presumption that there is no deficiency once there has been a showing of lack of notice or commercial unreasonableness. *Id.*; United States v. Whitehouse Plastics, Inc., 501 F.2d 692, 696 (5th Cir. 1974).

6. At common law, a guarantor has a right, once he has paid the debt, to seek reimbursement from the debtor. 2 BENDER'S UNIFORM COM. CODE SERVICE § 13.31 at 13-78 (F. Hart & W. Willier 1976). Several courts have indicated that nonwaivable debtor defenses operate to prevent a guarantor who is found liable for a deficiency under the guaranty agreement from exercising his right of reimbursement against the debtor. *See* Mutual Finance Co. v. Politzer, 21 Ohio St. 2d 177, 185-86, 256 N.E.2d 606, 612 (1970):

> [W]here the principal debtor has and a guarantor has or would have had a valid defense against a claim for payment by him on the guaranteed indebtedness but the voluntary conduct of such guarantor amounts to a waiver of or an estoppel against the guarantor asserting that defense, such guarantor cannot compel his principal to reimburse him for such payment.

Accord First Nat'l Park Bank v. Johnson, 553 F.2d 599, 602 (9th Cir. 1977).

a creditor does something to lower the value of the collateral, then the measure of potential guarantor liability is increased.

In Part I, a brief discussion of waiver provisions in guaranty contracts is set forth. In Part II, the issue of the applicability of Code nonwaiver provisions to waiver-of-defense clauses in guaranty contracts is discussed. Analysis in Part III of both common law waiver and Code nonwaiver rules will reveal that application of Code nonwaiver rules in all cases unnecessarily penalizes creditors, and some suggestions for an equitable resolution of the controversy will then be made.

I. Cutoff of Debtor Defenses and Waiver of Impairment-of-Collateral Defense at Common Law

In the introductory hypothetical, the banker has three basic self-help alternatives in the event of the debtor's "default."[7] First, he can repossess the collateral, sell it, and attempt to collect the deficiency from the debtor; second, he can ask the guarantor for the full $3,000 due from the debtor; or, third, he can repossess the collateral, sell it, and attempt to collect the deficiency from the guarantor.

Probably the least attractive of these options to the banker is repossession and collection of a deficiency from the debtor. Because the debtor has defaulted, it is unlikely that he will be able to pay a deficiency. If the guarantor has agreed only "conditionally" to guarantee the debt, however, the banker will have to make certain that the debtor cannot pay the deficiency before resorting to the guarantor.[8]

If the guarantor "unconditionally" guaranteed the debt, the banker can rely upon the guarantor for payment without attempt-

7. "Default" is not defined by the Code. As used in this note it simply means failure to pay when payment is due.

8. Under a "conditional" guaranty agreement, sometimes referred to as a "guaranty of collection," the guarantor agrees to pay only after the creditor has reduced his claim to judgment and execution has been returned unsatisfied, or after the debtor has become insolvent or it is otherwise apparent that it is useless to proceed against the debtor. U.C.C. § 3-416(2) (1978 version). *See also* Cumpston v. McNair, 1 Wend. 457, 460-61 (Sup. Ct. N.Y. 1828).

ing to collect the collateral, if he so desires. Under an unconditional guaranty, simple default by the debtor triggers guarantor liability.[9] If the guarantor does not contest his liability and is able to pay, the banker can collect the amount due most quickly by forgetting about the collateral and asking the guarantor to pay. After payment of the debt, the guarantor would then have a right to be reimbursed by the debtor[10] and a right to be subrogated to the banker's security interest in the collateral as a means of obtaining reimbursement.[11]

If the banker is uncertain of the ability or willingness of the guarantor to pay, repossession and sale of the collateral may be the most attractive alternative, especially if there is a good possibilty that almost all of the $3,000 can be recovered. If, on the other hand, the banker feels that repossession and sale may still leave a substantial deficiency, he can still proceed with the sale of the collateral in order to get some immediate return. The banker may then look to the guarantor for any deficiency realized after sale of the collateral.

At common law, as a general rule, guarantors may use those defenses that the debtor has on the underlying contract.[12] A primary reason for allowing guarantors to assert debtor defenses is the nature of the guaranty contract. Because a guarantor is vouching for a debtor, if the debtor is not liable for the debt, it follows that the guarantor should not be liable either.[13] An additional rea-

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9. U.C.C. § 3-416(1) (1978 version).

10. *See* note 6 *supra*.

11. Indianapolis Morris Plan Corp. v. Karlen, 28 N.Y.2d 30, 33, 268 N.E.2d 632, 634, 319 N.Y.S.2d 831 (1971).

12. 10 S. WILLISTON, CONTRACTS 714 (3d ed. 1967); A. STEARNS, THE LAW OF SURETYSHIP 178 (5th ed. 1951).

13. The exact scope of this general rule is, however, open to question. It is generally agreed that defenses "personal" to the debtor, such as infancy, incapacity, or discharge in bankruptcy are not available to the guarantor. See 2 BENDER'S UNIFORM COM. CODE SERVICE, *supra* note 6, § 13.15 at 13-34 (1976). Courts have experienced difficulty, however, in deciding exactly what defenses are "personal" to the underlying debt. The New York Court of Appeals has, for example, refused to apply the four-year statute of limitations specifically applicable to sales contracts under Code section 2-725(1) to guaranties of sales contracts, choosing instead to apply the general six-year statute of limitations to guaranties of sales contracts. American Trading Co. v. Fish, 42 N.Y.2d 20, 364 N.E.2d 1309, 396 N.Y.S.2d 617

son for allowing the guarantor to assert the debtor's defenses is to protect the guarantor from a situation in which he must pay the debt and yet finds himself precluded from exercising his right of reimbursement because the debtor has a defense to payment of the debt.[14]

If our hypothetical debtor has a Code defense to payment of a deficiency based on the banker's negligent or "commercially unreasonable" sale of the collateral, common law principles would appear to provide the guarantor with the same defense. But the guarantor has a problem. In the guaranty contract he has waived the debtor's defenses and has thereby exposed himself to greater potential liability than the debtor himself.

The guarantor's guaranty is paradoxical. While purporting to be a secondary obligation and therefore dependent upon debtor liability, it contains a waiver-of-defense clause capable of making the liability of the guarantor *exceed* the liability of the debtor.

Courts have dealt with this paradox in a variety of ways. In New York it is firmly established that while, as a general rule, the liability of the guarantor will not exceed that of the debtor, "the guarantee is a separate undertaking and may impose lesser or even greater collateral responsibilty on the guarantor."[15] In California a

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(1977). But in Stonehill v. Security Nat'l Bank, 68 F.R.D. 24 (S.D.N.Y. 1975), the district court refused to treat the liability of a guarantor as separate from the liability of a debtor, even though the guaranty was "unconditional." The court found that a clause in the Securities Exchange Act of 1934 that excused the debtor from liability also excused the guarantor. To hold otherwise, the court noted, would be to allow a creditor to defeat the intent of a regulatory enactment by the "simple expedient of obtaining a guarantor." *Id.* at 33. In a similar vein, the Arkansas Supreme Court recently found a guaranty contract to be void where the underlying contract was void because the rate of interest on the underlying contract was usurious. Even though the rate of interest charged to the guarantor did not violate the usury law, the court still found the guaranty to be void because "if the debt which the guarantor has guaranteed is declared void and a nullity, the guarantee is also void." Ryder Truck Rental, Inc. v. Kramer, 263 Ark. 169, 176, 563 S.W.2d 451, 454 (1978). Other courts have rejected this approach in usury cases, particularly where the usury statute exempts guarantors from its coverage on the theory that guarantors are not the borrowers for whom the protection of the statute was designed. *See* Universal Metals & Machinery, Inc. v. Bohart, 539 S.W.2d 874, 879 (Tex. 1976), and cases cited therein.

14. *See* note 6 *supra*.

15. American Trading Co. v. Fish, 42 N.Y.2d 20, 26, 364 N.E.2d 1309, 1312, 396

statutory requirement that the obligation of a guarantor "be neither larger in amount nor in other respects more burdensome" than the obligation of the debtor has been held to be waivable.[16] Other courts have shown a greater inclination to look at the underlying debt, rather than the guaranty contract, as a measure of the guarantor's liability.[17]

If the guarantor has waived the debtor's defenses, there still remains to be considered the impairment-of-collateral defense. This defense arises from the guarantor's equitable right to pay the debt and thereby stand in the shoes of the creditor by right of subrogation.[18] Once subrogated, the guarantor has all of the rights of the creditor in collateral securing the underlying debt.[19]

In effect, the guarantor becomes a creditor of the debtor, with all of the rights in the collateral that the original creditor had. If the original creditor chooses to take possession of the collateral

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N.Y.S.2d 617, 619 (1977). In support of the quoted language, the court cited Standard Brands, Inc. v. Straile, 23 A.D.2d 363, 260 N.Y.S.2d 913 (1965). In *Straile* the junior creditor of a subordinated debt was allowed to enforce an unconditional guaranty even though the senior creditor had not yet been paid by the common debtor. The court found that even if the subordination agreement were to prevent suit by the junior creditor against the debtor, the guaranty could still be enforced. The court found that since the guarantor knew of the subordination agreement and agreed to divorce his liability from the liability of the debtor, the guaranty agreement was enforceable.

16. CAL. CIV. CODE § 2809 (West 1974) (found to be waivable in Bloom v. Bender, 48 Cal. 2d 793, 803, 313 P.2d 568, 575 (1957)). There is an interesting caveat to the California waiver rule. California courts have distinguished between so-called "true" guarantors, who are not obligated on the underlying contract between creditor and debtor, and guarantors who are also obligors on the underlying contract. *See* Union Bank v. Gradsky, 265 Cal. App. 2d 40, 42, 71 Cal. Rptr. 64, 66 (Ct. App. 1968). Where a guarantor is not a "true" guarantor, the guaranty agreement cannot be used to cut off defenses to the underlying contract, because courts will not enforce the guaranty agreement. Instead, the court will look to the underlying contract to determine the liability of the person who signed both the guaranty contract and the underlying contract. *Id.* at n.2.

17. *See* Stonehill v. Security Nat'l Bank, 68 F.R.D. 24, 33 (S.D.N.Y. 1975), and Ryder Truck Rental, Inc. v. Kramer, 263 Ark. 169, 176, 563 S.W.2d 451, 454 (1978), discussed at note 12 *supra*. *See also* Universal Metals & Machinery, Inc. v. Bohart, 539 S.W.2d 874, 880-81 (Tex. 1976) (Steakley, J., dissenting).

18. W. DE FUNIAK, HANDBOOK OF MODERN EQUITY 239 (2d ed. 1956). The author defines "subrogation" as follows: "One who has been obliged to pay the debt of another is in equity entitled to succeed to the protection of all the securities held by the creditor for the payment of such debt."

19. *Id.*

and sell it, this right of subrogation is destroyed. To compensate the guarantor for the loss of this right, equity has traditionally placed upon the creditor a duty of care in the handling and preservation of collateral, so that the value the guarantor would have received on payment of the debt and subrogation is preserved.[20] Breach of this duty, by negligent sale or otherwise, has thus given the guarantor the defense of impairment of collateral,[21] with a reduction in the guarantor's liability in proportion to the value lost as the final result in a majority of jurisdictions.[22]

At common law this defense can also be waived,[23] and some

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20. In Phares v. Barbour, 49 Ill. 370 (1868), a creditor took possession of and sold property securing a debt without giving notice to guarantors of the debt. The creditor bought the property himself at a sale he conducted. The court found that, because of a guarantor's right of subrogation, the creditor had a duty to take reasonable steps to preserve the value of the collateral, and "any waste or misapplication of the [collateral] operates as a release to the [guarantor] to the extent of the waste or misapplication." *Id.* at 375. For a modern application of this rule, see Frederick v. United States, 386 F.2d 481, 486 (5th Cir. 1967).

21. This defense appears in the RESTATEMENT OF SECURITY § 132 (1941):

> Where the creditor has security from the principal and knows of the surety's obligation, the surety's obligation is reduced pro tanto if the creditor
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> (a) surrenders or releases the security, or
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> (b) wilfully or negligently harms it, or
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> (c) fails to take reasonable action to preserve its value at a time when the surety does not have an opportunity to take such action.

The impairment defense has been codified as it applies to guaranties of negotiable instruments in Code section 3-606(1):

> (1) The holder discharges any party to the instrument to the extent that without such party's consent the holder
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> (a) without express reservation of rights releases or agrees not to sue any person against whom the party has to the knowledge of the holder a right of recourse or agrees to suspend the right to enforce against such person the instrument or collateral or otherwise discharges such person, except that failure or delay in effecting any required presentment, protest, or notice of dishonor with respect to any such person does not discharge any party as to whom presentment, protest or notice of dishonor is effective or unnecessary; or
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> (b) unjustifiably impairs any collateral for the instrument given by or on behalf of the party or any person against whom he has a right of recourse.

22. D.W. Jaquays & Co. v. First Security Bank, 101 Ariz. 301, 305, 419 P.2d 85, 89 (1966).

23. Indianapolis Morris Plan Corp. v. Karlen, 28 N.Y.2d 30, 33, 268 N.E.2d 632, 633-34,

courts have gone so far as to hold that an unconditional guaranty is itself a waiver of the defense.[24] Some cases suggest that the waiver issue is less clear, particularly where, as in the introductory hypothetical, the impairment was caused by negligence while the collateral was in the possession of the creditor.[25] Some courts have looked with disfavor upon clauses waiving the impairment defense and have consequently required that to be effective a waiver must be stated in clear and unequivocal language.[26]

As a general rule, the ordinary rules of contract construction apply to guaranty contracts.[27] Certain types of guaranty contracts have, however, been strictly construed in favor of the guarantor.[28] Common law courts distinguish between "accommodation" guarantors and "compensated" guarantors. Accommodation guarantors are guarantors who receive no payment for assuming liability.[29] Payment of consideration to the debtor by the creditor is said to constitute consideration for the accommodation guarantor's promise.[30] Compensated guarantors—usually surety companies—receive

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319 N.Y.S.2d 831, 833 (1971).

24. *See* United States v. Klebe Tool & Die Co., 5 Wis. 2d 392, 92 N.W.2d 868 (1958); Walter E. Heller & Co. v. Cox, 343 F. Supp. 519, 526 (S.D.N.Y. 1972).

25. In Girard Trust Bank v. O'Neill, 219 Pa. Super. Ct. 363, 281 A.2d 670 (1971), the plaintiff creditor took possession of accounts receivable from the debtor's trustee in bankruptcy, wrote off a substantial portion of them as uncollectible, and went after the defendant guarantors for a still-remaining deficiency. The lower court found that the guarantors had waived their right to claim a reduction in the amount of the deficiency because of the creditor's negligence, and rendered judgment for the plaintiff creditor. On appeal, the superior court chose to ignore the waiver clause, relying upon the language in RESTATEMENT OF SECURITY § 132(c) (1941) that provides for a reduction in the deficiency where the creditor "fails to take reasonable action to preserve [the value of collateral] at a time when the surety does not have an opportunity to take such action." The superior court found that since the defendant guarantors had no way of ensuring that the accounts would be collected in a nonnegligent manner, they should be allowed to assert the impairment defense. *See also* United States v. Fyles, 253 F. Supp. 386 (D. Vt. 1965), where the court found that the creditor's failure to insure collateral that was destroyed by fire precluded the creditor from collecting on an unconditional guaranty contract under RESTATEMENT OF SECURITY § 132(c) (1941).

26. D.W. Jaquays & Co. v. First Security Bank, 101 Ariz. 301, 305, 419 P.2d 85, 89 (1966); *accord* United States v. Crain, 589 F.2d 996, 1001 (9th Cir. 1979).

27. RESTATEMENT OF SECURITY § 88 (1941).

28. *See* Arnold, *The Compensated Surety*, 26 COL. L. REV. 171, 172 (1926).

29. *Id.*

30. H. ARANT, HANDBOOK OF THE LAW OF SURETYSHIP AND GUARANTY 71 (1931).

payment for assuming the risk that the debtor will default.[31] To protect accommodation guarantors, who are regarded as "favorites of the law" by the courts because of the gratuitous nature of their liability, the accommodation contract has been strictly construed, with all ambiguities interpreted in the light most favorable to the accommodation guarantor.[32] Compensated guarantors do not receive such protection.[33] The modern approach under Article Three of the Code is not to differentiate between the two types of contracts.[34]

If the guaranty contract is well drafted by the banker, the guarantor may find himself without common law defenses to protect him from liability for the debt, despite the banker's negligence. Under these circumstances, it is no wonder that guarantors have increasingly sought the safe haven of Code nonwaiver provisions.

II. Applicability of Code Nonwaiver Provisions to Guaranty Contracts

A. *To Prevent Cutoff of Article Nine "Debtor" Defenses*

Under section 9-501(3) of the Code, a number of Article Nine "debtor" defenses are made nonwaivable, including the right to notice of sale of repossessed collateral by the secured creditor and the right to challenge the "commercial reasonableness" of such a sale.[35]

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31. Arnold, *supra* note 28.

32. *Id.*

33. *Id.*

34. U.C.C. § 3-415(1) (1978 version) makes no distinction between paid and unpaid guarantors of negotiable instruments: "An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it." Comment 2 of section 3-415 also states: "The essential characteristic is that the accommodation party is a surety, and not that he has signed it gratuitously."

35. U.C.C. § 9-501(3) (1978 version):

> To the extent that they give rights to the debtor and impose duties on the secured party, the rules stated in the subsections referred to below may not be waived or varied except as provided with respect to compulsory disposition of collateral (subsection (3) of Section 9-504 and Section 9-505) and with respect to redemption of collateral (Section 9-506) but the parties may by agreement determine the standards by which the fulfillment of these rights and duties is to be measured if such standards are not manisfestly

Guarantors who have waived defenses that are based upon negligence of the creditor in handling the collateral have, for the most part, sought to escape from such clauses by arguing that guarantors fit within the definition of "debtor" in section 9-105(1)(d) and are, therefore, entitled to the nonwaiver protection of section 9-501(3).

Most courts that have dealt with the issue have held that a guarantor is a "debtor" under section 9-105(1)(d).[36] Most of these decisions have been based upon notions of fairness coupled with a conceptual shift in the way courts perceive the guaranty contract, beginning with the decision of the Arkansas Supreme Court in *Norton v. National Commerce Bank of Pine Bluff*.[37]

In *Norton* an auto dealer assigned to a bank a promissory note and a conditional sales contract for the purchase of a car. In the instrument of assignment, the auto dealer guaranteed the perform-

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unreasonable:

(a) subsection (2) of Section 9-502 and subsection (2) of Section 9-504 insofar as they require accounting for surplus proceeds of collateral;
(b) subsection (3) of Section 9-504 and subsection (1) of Section 9-505 which deal with disposition of collateral;
(c) subsection (2) of Section 9-505 which deals with acceptance of collateral as discharge of obligation;
(d) Section 9-506 which deals with redemption of collateral; and
(e) subsection (1) of Section 9-507 which deals with the secured party's liability for failure to comply with this Part.

"Debtor" is defined in U.C.C. § 9-105(1)(d) as:

> [T]he person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral, and includes the seller of accounts or chattel paper. Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires.

36. The following courts have found that a guarantor is a "debtor" under section 9-105(1)(d): Rushton v. Shea, 423 F. Supp. 468 (D. Del. 1976); Norton v. National Bank of Commerce of Pine Bluff, 240 Ark. 131, 398 S.W.2d 538 (1966); Barnett v. Barnett Bank of Jacksonville, 345 So. 2d 804 (Fla. App. 1977); Bank of Gering v. Glover, 192 Neb. 575, 223 N.W.2d 56 (1974); T & W Ice Cream, Inc. v. Carriage Barn, Inc., 107 N.J. Super. 328, 258 A.2d 162 (1969); Chase Manhattan Bank v. Natarelli, 98 Misc. 2d 78, 401 N.Y.S.2d 404 (Sup. Ct. 1977); Zions First Nat'l Bank v. Hurst, 570 P.2d 1031 (Utah 1977).

37. 240 Ark. 143, 398 S.W.2d 538 (1966).

ance of the buyer on the conditional sales contract and the note by agreeing to repurchase the contract should the buyer default in making payment. The dealer waived, in the assignment contract, all notice to which he might otherwise have been entitled. The car buyer later defaulted, and the bank repossessed and sold the car to one of its customers without notice to either the buyer or to the dealer. The bank then demanded that the dealer, pursuant to its agreement to repurchase, pay the deficiency resulting from the sale. The dealer refused, arguing that he was entitled to notice of the sale under section 9-504(3) as a "debtor" of the bank.

The Arkansas Supreme Court held that the dealer was a "debtor" as defined in section 9-105(1)(d).[38] Because the dealer had promised to repurchase the contract, the court reasoned, he was a person who owed "other performance" under section 9-105(1)(d). He was therefore entitled to notice of the sale of the collateral under section 9-504(3). The notice, in turn, could not be waived under section 9-501(3).

Curiously, the court deleted from its quotation of section 9-105(1)(d) the segment that reads: "the term 'debtor' means the owner of the collateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation. . . ."[39] No effort was made by the court to explain why, as applied to a provision like section 9-504(3) that deals exclusively with the disposition of collateral, the term "debtor" means more than "owner of the collateral."[40]

In addition, the court cited an example in comment 4 of sec-

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38. *Id.* at 145, 398 S.W.2d at 540.

39. *Id.*

40. The court did quote the language from section 9-105(1)(d) that reads: "['debtor'] may include both [the owner of the collateral and the obligor] where the context so requires," but made no attempt to explain this language. Professor Gilmore has described the second sentence of section 9-105(1)(d) as a "painstaking effort" to clarify the artificiality of using the term "debtor" to describe both a party who owes money and a party who has supplied collateral for the party who owes money "which appears to be, on the whole, unhelpful." 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 304 (1965). Perhaps the court in *Norton* chose to ignore the second sentence of section 9-105(1)(d) because it is so problematic.

tion 9-105 as evidence of the dealer's "debtor" status.[41] In the example cited, a secured party who sells a conditional sales contract to a bank is termed a "debtor" with regard to the bank, while the conditional sales contract becomes a type of collateral called "chattel paper" and the bank is a "secured party."[42] Representatives of the Permanent Editorial Board of the Code argued as amicus curiae that the secured party in the example is a "debtor" only with respect to the bank, an obligation distinct from the obligation of the original "debtor" under the conditional sales contract. The court rejected this distinction, stating that it is not "clearly spelled out by the Code, whatever the intention of its draftsmen may have been."[43]

In *Norton* the court was more concerned with the case before it than with Code construction. Early in its opinion, the court noted that "[a]ccording to the undisputed evidence it had been the bank's uniform custom in the past to give Norton and other dealers an opportunity to repurchase such contracts. Norton had never failed to repurchase when asked to do so."[44]

After deciding that the dealer was a "debtor" entitled to notice, the court concluded that the dealer "was directly affected by the sale of the Oldsmobile; the amount obtained in that sale fixed his pecuniary liability. In simple fairness he should have had notice—a requirement entailing no real inconvenience or hardship to the bank."[45]

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41. 240 Ark. at 147, 398 S.W.2d at 540-41:
> A dealer sells a tractor to a farmer on a conditional sales contract. The conditional sales contract is a "security agreement," the farmer is the "debtor," the dealer is the "secured party" and the tractor is the type of "collateral" defined in section 9-109 as "equipment." But now the dealer transfers the contract to his bank, either by outright sale [the situation now before us] or to secure a loan. Since the conditional sales contract is a security agreement relating to specific equipment the conditional sales contract is now the type of collateral called "chattel paper." In this transaction between the dealer and his bank, the bank is the "secured party," the dealer is the "debtor," and the farmer is the "account debtor."

42. *Id.*

43. *Id.* at 148, 398 S.W.2d at 541.

44. *Id.* at 144, 398 S.W.2d at 539.

45. *Id.* at 148, 398 S.W.2d at 541.

In finding that the dealer was a "debtor" based upon a concern for "fairness," a method of Code construction that has been criticized,[46] the court in *Norton* was concerned with the fact that repossession and sale by the bank had such a significant effect in determining the extent of the dealer's liability as a guarantor.[47] Other courts and commentators have picked up on this aspect of *Norton* to articulate a reading of section 9-105(1)(d) as being broad enough to include guarantors as functional "debtors."[48] The argument for this interpretation is:

> [T]he guarantor . . . is likely to be made the real target of the secured party's anticipated collection efforts. The sale will merely fix the exact amount of its pecuniary liability. Thus, in a very real sense, when the secured party prepares to dispose of the collateral by sale, it is taking the first step toward ultimate recovery under the guarantee, and is, in effect proceeding against the guarantor rather than against the original debtor. . . . [T]he secured party, who is taking comfort in its foresight in obtaining additional security, should not be permitted to deny that the very individual to whom it looks foremost for payment . . . is, in fact, its debtor, and, as such, entitled to all of the procedural and other safeguards provided for debtors in the Code.[49]

Another reason given for including guarantors within the Article Nine definition of "debtor" has its roots in the regulatory purpose of the default provisions of Article Nine.[50] If the nonwaivable

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46. Hillman, *Construction of the Uniform Commercial Code: UCC Section 1-103 and "Code" Methodology*, 18 B.C. INDUS. & COM. L. REV. 655, 679 (1977).

47. *See* text at note 45 *supra*.

48. *See* Barnett v. Barnett Bank of Jacksonville, 345 So. 2d 804 (Fla. App. 1977); Chase Manhattan Bank v. Natarelli, 98 Misc. 2d 78, 401 N.Y.S.2d 404 (Sup. Ct. 1977); Sachs & Belgrad, *Liability of the Guarantor of Secured Indebtedness After Default and Repossession Under the Uniform Commercial Code: A Walk on the Wild Side by the Secured Party*, 5 U. BALT. L. REV. 153 (1976).

49. Sachs & Belgrad, *supra* note 50, at 163.

50. Aside from equitable considerations, it is virtually indispensable to the rational functioning of the entire regulatory scheme envisaged by Article Nine of the UCC that some mechanism be provided, whereby, without unduly burdening the secured party, those with the closest and most substantial interests in the collateral be provided with the opportunity to protect these interests.

"debtor" rights and defenses are regarded as a means of regulating the private remedy of repossession through private "policing" of repossession and sale, then this purpose may be frustrated where guarantors are found not to be debtors.[51] All a creditor who wants to avoid regulation has to do, it might be argued, is have his debtor get a friend to sign a guaranty agreement.

Finally, it has been suggested that because the definition of "debtor" under section 9-105(1)(d) applies to persons who own the collateral but who are not parties to the security agreement, it should also apply to guarantors of the underlying contract.[52]

In transactions like the introductory hypothetical, including the guarantor within the "debtor" definition often leads to fair results for a number of reasons. First, because the underlying transaction is between a bank and a consumer, the acquaintance of the consumer debtor and his guarantor with guaranty contracts is probably quite minimal. Thus, it is likely that the guarantor will be unaware of the important defenses that he has waived in the guaranty contract provided by the bank.

Second, requiring the bank to give the guarantor notice of the sale and to conduct the sale in a "commercially reasonable" manner is not unduly burdensome to the creditor when weighed against the potential loss to the guarantor that may be averted if Article Nine "policing" is allowed. Had notice been given to the guarantor, for example, he would have been able to protect the value of the collateral by purchasing it from the banker, by paying the debt and assuming the banker's interest in the collateral, or by monitoring the banker's sale of the collateral to a third party.[53]

There are, however, problems with including guarantors within the Article Nine definition of "debtor." First of all, the language of section 9-105(1)(d) does not entirely support such a construction. The first sentence of the section states that a "debtor" is

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Id. at 160.

51. *Id.*

52. *Id.* at 161.

53. Under U.C.C. § 9-507(1) (1978 version), a "debtor" may enjoin a "commercially unreasonable" sale.

someone who "owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral."[54] All guaranty agreements are conditional in one sense: the guarantor owes no payment until the principal debtor has defaulted.[55] Thus, at the time the guaranty agreement comes into existence, there is no absolute duty of payment on the part of the guarantor.[56] In *Norton,* however, the court read "or other performance" to include a conditional duty of payment within the definition of "debtor." Professor Gilmore's comment on this language, however, indicates that it was not intended to include a conditional duty of performance:

> It is clear that the Code "debtor" must owe something to someone. What he owes will be, of course, a money debt. The suggestion in the definition that he may owe "payment or other performance" is an illustration of the excessively cautious drafting which mars the Code as a whole, particularly in its definitional sections.[57]

A more plausible reading of the first sentence of section 9-105(1)(d) is that the guarantor is not a "debtor" when the guaranty agreement is entered into, but the guarantor becomes a "debtor" when the principal debtor defaults, because it is not until then that the guarantor "owes payment." This construction, however, appears to be inconsistent with the second sentence of section 9-105(1)(d), which reads as follows:

> Where the debtor and the owner of the collateral are not the same person, the term "debtor" means the owner of the col-

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54. *See* note 35 *supra.*

55. *See* note 1 *supra,* and 2 BENDER'S UNIFORM COM. CODE SERVICE, *supra* note 6, § 13.04 at 13-10, where the authors distinguish between liability in the suretyship sense, which "simply refers to the fact that the obligor rather than the surety *ought* to perform," and liability in the contractual sense, which refers to whether there are conditions attached to a guarantor's duty to perform once default has occurred.

56. In United States v. Whitehouse Plastics, Inc., 501 F.2d 692, 694 (5th Cir. 1974), the fact that guarantors were the only possible parties who could be held liable for the debt was the deciding factor in the court's determination that the guarantors were section 9-105(1)(d) "debtors." The primary debtor was a defunct business entity. Thus, the Fifth Circuit seems to be saying that a guarantor with a conditional duty of payment may not be a "debtor," but once that duty becomes absolute, then the guarantor is a "debtor."

57. 1 G. GILMORE, *supra* note 40, at 303.

> lateral in any provision of the Article dealing with the collateral, the obligor in any provision dealing with the obligation, and may include both where the context so requires.[58]

Based on this language, it has been held that, because section 9-504(3) refers to the *collateral* and not to the *obligation*, a person who guarantees payment of a secured obligation but who does not own the collateral is not a "debtor" under section 9-504(3).[59] Left entirely unexplained in the cases and commentary is the meaning of the "where the context so requires" language of section 9-105(1)(d).

Perhaps most troublesome in trying to construe section 9-105(1)(d) is its expansiveness. It includes not only the traditional money debtor, but persons who have furnished collateral for the money debtor as well. Because these persons, in effect, guarantee the principal debtor's performance by furnishing collateral, it has been argued that other types of guaranty agreements should also be included within the definition of "debtor."[60]

A close reading of the commentary to section 9-105(1)(d) reveals, however, that this analogy is faulty. Comment 2 of section 9-105 refers to section 9-112 for "special rules" applicable where collateral is owned by a person other than the money debtor.[61] Sec-

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58. *See* note 35 *supra*.

59. New Haven Water Co. Employees Credit Union v. Burroughs, 6 Conn. Cir. Ct. 709, 13 U.C.C. Rpt. Serv. 972 (1973).

60. *See* Sachs & Belgrad, *supra* note 48, at 161.

61. U.C.C. § 9-105, Comment 2 (1978 version). U.C.C. § 9-112 (1978 version) reads as follows:

> Unless otherwise agreed, when a secured party knows that collateral is owned by a person who is not the debtor, the owner of the collateral is entitled to receive from the secured party any surplus under Section 9-502(2) or under Section 9-504(1), and is not liable for the debt or for any deficiency after resale, and he has the same right as the debtor
>
> (a) to receive statements under Section 9-208;
>
> (b) to receive notice of and to object to a secured party's proposal to retain the collateral in satisfaction of the indebtedness under Section 9-505;
>
> (c) to redeem the collateral under Section 9-506;
>
> (d) to obtain injunctive or other relief under Section 9-507(1); and
>
> (e) to recover losses caused to him under Section 9-208(2).

tion 9-112 states that "unless otherwise agreed" the owner of the collateral is entitled to certain Article Nine debtor rights. This means, as explained in Code section 1-102, comment 3, that the drafters of section 9-112 chose to state that, without question, the terms of section 9-112 may be waived or varied.[62] Also, the rights granted to the owner of collateral under section 9-112 are limited in comparison to the full range of rights granted the "debtor" by the default provisions of Article Nine.[63]

On the whole, the issue of whether a guarantor is a section 9-105(1)(d) "debtor" does not appear to have been considered by the drafters of Article Nine. Perhaps for this reason the section does not lend itself well to this construction.[64]

It is also questionable whether guarantors were intended to receive the nonwaiver protection of section 9-501, because the specific grant of nonwaiver protection to "debtors" in section 9-501(3) is tied in comment 4 of section 9-501 to common law equity-of-redemption principles.[65]

The long-standing common law rule against clauses that

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62. U.C.C. § 1-102, Comment 3 (1978 version). The comment states that "words such as 'unless otherwise agreed' have been used to avoid controversy as to whether the subject matter of a particular section does or does not fall within [the Section 1-102(3) nonwaiver provision]." U.C.C. § 1-102(3) (1978 version), the general code nonwaiver provision, provides:

> The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

63. Section 9-112 does not, for example, include the right to receive notice of sale of the collateral under section 9-504(3).

64. One court avoided the construction problems of section 9-105(1)(d) by finding that the "debtor" defenses created by section 9-504(3) and made nonwaivable by section 9-501(3) were available to the guarantor as a guarantor. United States v. Willis, 593 F.2d 247, 256 (6th Cir. 1979). In effect, the court in *Willis* adopted the policy arguments of the guarantor-is-a-debtor proponents, while avoiding the construction problems that such an argument entails. Such a holding may reflect a realization on the part of the *Willis* court that the real issue is one of Code *policy*, not Code construction.

65. U.C.C. § 9-501, Comment 4 (1978 version). *See also* 2 G. GILMORE, *supra* note 40, at 1228-29.

"clog" a debtor's equity of redemption[66] is for the protection of debtors who are in no position to insist that a creditor omit such clauses from the security agreement at the time it is drafted.[67] Thus, the very essence of section 9-501(3) is a policy against allowing creditors to take unfair advantage of debtors by virtue of the unequal bargaining power almost inevitably enjoyed by creditors.

The interests of a guarantor do not share the same historic concerns that have protected debtors from creditors. A guarantor who assumes liability under a guaranty contract in an attempt to help a friend or relative secure credit, for example, is not subject to the coercive pressures of a debtor-creditor relationship. Negligent sale of collateral and its effect upon the guarantor is the real issue to be dealt with in construing waiver-of-defense clauses, not any right based upon equity of redemption principles.[68]

Aside from problems of construction, including guarantors within the Code definition of "debtor" ignores those transactions where a guarantor is more than just a conditional debtor. Often a guaranty contract serves a dual purpose—it operates as security for the underlying debt and, in addition, it allows the secured creditor to insure against his own negligence in handling collateral securing the debt.[69] The ultimate issue raised by such guaranty con-

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66. The rule against clauses that "clog" the mortgagor's equity of redemption is set forth in 3 J. POMEROY, EQUITY JURISPRUDENCE 2369-70 (3d ed. 1905):

> The debtor or mortgagor cannot, in the inception of the instrument, as part of or collateral to its execution, in any manner deprive himself of his equitable right to come in after a default in paying the money at the stipulated time, and to pay the debt and interest, and thereby to redeem the land from the lien and encumbrance of the mortgage . . . .

67. The rule "protects the debtor absolutely from the consequences of his own inferiority, and of his own acts done through infirmity of will." *Id.* at 2370 n.1.

68. In Indianapolis Morris Plan v. Karlen, 28 N.Y.2d 30, 33, 268 N.E.2d 632, 633, 319 N.Y.S.2d 831, 833 (1971), the New York Court of Appeals distinguished between the rights of a debtor predicated upon equity of redemption principles, and the rights of a guarantor in the collateral. The court said that the equity of redemption is "solely a right between creditor and debtor. . . . It is different and distinct from the right of sureties not to have collateral security discharged or released without their consent. . . ."

69. *See* National Bank of Washington v. Equity Investors, 81 Wash. 2d 886, 919, 506 P.2d 20, 40 (1973), where the court said of a waiver-of-negligence clause in a guaranty contract: "A guaranty agreement of this kind is in essence a contract of indemnity, an under-

tracts is whether they should be allowed as a matter of public policy and, if so, under what conditions. This issue is addressed in Part III.

B. *To Prevent Waiver of the Impairment-of-Collateral Defense*

If the guarantor cannot assert the Code "debtor" defenses in Article Nine, he may still be able to gain the protection of the general Code nonwaiver provision, section 1-102(3), to nullify his waiver of the impairment-of-collateral defense in the guaranty contract.[70] Under section 1-102(3), "the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement."[71]

In order to receive this protection, however, the guarantor must first be able to show a Code duty of reasonable care in the handling and sale of collateral that applies to guaranty agreements.

One possible section creating such a duty, at least where the guaranty is part of a negotiable instrument, is section 3-606(1).[72] Under section 3-606(1)(b), the holder of a negotiable instrument discharges a "party to the instrument" to the extent that the holder "unjustifiably" impairs any collateral for the instrument without the party's consent.[73] The comments to section 3-606 indicate that it is intended to be a codification of defenses available to the guarantor of a negotiable instrument.[74]

The key language of section 3-606 in terms of securing the nonwaiver protection of section 1-102(3) is the phrase "unjustifiably impairs." Comment 5 of section 3-606 points to section 9-207 for guidance as to when a holder's actions in dealing with collateral are "unjustifiable."[75] Section 9-207(1) states that "[a] secured

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taking to hold harmless made for a valuable consideration and as an inducement for entering into and performance of another contract."

70. *See* note 62 *supra* for the text of section 1-102(3).

71. U.C.C. § 1-102(3) (1978 version).

72. *See* note 21 *supra* for the text of section 3-606(1).

73. U.C.C. § 3-606(1)(b) (1978 version).

74. U.C.C. § 3-606, Comment 1 (1978 version) states that the defenses set forth in section 3-606 "are available to any party who is in the position of a surety."

75. U.C.C. § 3-606, Comment 5 (1978 version).

party must use reasonable care in the custody and preservation of collateral in his possession."[76] Under section 1-102(3), this duty of care cannot be waived. Thus, a guarantor of a negotiable instrument can argue that an "unjustifiable" impairment is really a negligent impairment and cannot be waived by the secured party.

Additional points that must be considered, however, are the narrow scope given section 3-606 by most courts and language in section 3-606 and the comments indicating that an "unjustifiable" impairment may be waived. A number of courts have held that a guaranty agreement that is separate from the negotiable instrument is not covered by section 3-606, either because the guarantor is not a "party" to the negotiable instrument,[77] or because a guaranty agreement is not itself a negotiable instrument.[78] Under either constuction, those guarantors who have actually signed the negotiable instrument can assert a section 3-606 defense.

The most difficulty, however, is posed by the "consent" language of section 3-606. The section discharges a party where the holder unjustifiably impairs the collateral without the guarantor's "consent."[79] Comment 2 of section 3-606 explains the circumstances under which "consent" may be given: "Consent may be given in advance, and is commonly incorporated in the instrument. . . . "[80] In several cases this language has been cited as evidence of an intent by the drafters of section 3-606 that the impairment defense be waivable.[81]

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76. U.C.C. § 9-207(1) (1978 version).

77. Union Planters Nat'l Bank of Memphis v. Markowitz, 468 F. Supp. 529, 535 (W.D. Tenn. 1979); National Bank of Detroit v. Alford, 65 Mich. App. 634, 637, 237 N.W.2d 592, 593 (1976).

78. Ishak v. Elgin Nat'l Bank, 48 Ill. App. 3d 614, 616-17, 363 N.E.2d 159, 161 (1977); First Nat'l Bank in Albuquerque v. Equity Energies, Inc., 91 N.M. 11, 16-17, 569 P.2d 421, 426-27 (1977). This approach has been rejected as overly formalistic by one commentator. *See* Clark, *Suretyship in the Uniform Commercial Code*, 46 TEX. L. REV. 453, 459 (1968).

79. *See* note 21 *supra*.

80. U.C.C. § 3-606, Comment 2 (1978 version).

81. American Bank of Commerce v. Covolo, 88 N.M. 405, 408, 540 P.2d 1294, 1297-98 (1975); Indianapolis Morris Plan Corp. v. Karlen, 28 N.Y.2d 30, 35-36, 268 N.E.2d 632, 633-34, 319 N.Y.S.2d 831, 833-34 (1971); Rhode Island Hosp. Trust Nat'l Bank v. National Health Foundation, _ R.I. _, 384 A.2d 301, 303 (1978).

Alternatively, a guarantor might argue that a secured party's duty of care under sections 9-207(1) or 9-504(3) is a duty that includes guarantors. This argument has surfaced recently in a number of cases where guarantors have attempted to surmount waiver clauses in guaranty contracts in order to assert the impairment defense of failure by the secured creditor to file a security interest in collateral securing the underlying obligation.[82] The response of courts to this argument has been mixed. Where section 9-207 has been found to include guarantors, a policy disfavoring waiver-of-negligence clauses has been cited.[83] Other courts have been less sympathetic to guarantors, finding instead that guaranty agreements are outside the scope of Article Nine.[84]

The foregoing discussion indicates that a guarantor may resort to any number of Code avenues in attempting to circumvent a clause in the guaranty contract waiving the impairment-of-collateral defense. As with the "debtor" defense, however, none of the Code provisions sought to be invoked are particularly well suited to this task. Of paramount importance, then, is the basic policy question at the heart of attempts to avoid these clauses—should waiver of guarantor defenses predicated on the creditor's negligence be allowed in guaranty contracts of secured obligations?

III. Nonwaiver vs. Freedom of Contract

The introductory hypothetical[85] sets a scene in which the

82. *See* cases cited in note 77 *supra*.

83. *See* National Bank of Detroit v. Alford, 65 Mich. App. 634, 638, 237 N.W.2d 592, 593 (Ct. App. 1975).

84. In Union Planters Nat'l Bank of Memphis v. Markowitz, 468 F. Supp. 529, 534 (W.D. Tenn. 1979), the court found that a guaranty agreement is not a "security interest," and is therefore outside the scope of Article Nine. *See also* EAC Credit Corp. v. King, 507 F.2d 1232, 1238 (5th Cir. 1975).

85. The facts in this hypothetical are patterned after the facts in Crompton-Richmond Co., Factors v. Briggs, 560 F.2d 1195 (5th Cir. 1977). The court enforced a waiver of negligence clause in a guaranty contract, relying primarily upon the fact that the guarantor was a "highly educated and skilled businessman," *id.* at 1200, who was aware of the terms of the guaranty contract and had used the contract to induce the creditor to finance an expansion program of the guarantor's corporation. Under these circumstances, the guarantor knew that he was agreeing to guarantee payment and to indemnify the creditor by holding the creditor harmless for negligent acts. *Id.* at 1201.

"fair" result may be nonenforcement of the waiver-of-defense clauses. Requiring an unsophisticated guarantor who has come to the aid of a friend to pay for the creditor's negligence seems unjust, particularly when the negligence may have been prevented had the guarantor been given notice of sale. But other guarantors, who arouse less sympathy, may also seek nonwaiver protection. Assume, for instance, that an officer of a large corporation that is in shaky financial condition induces a bank to make a loan to the corporation to bail it out of its troubled financial condition. Although the loan is to be secured by collateral supplied by the debtor corporation, the bank decides it wants the additional security of a guaranty by the corporate officer. In order to minimize its risk of loss while maximizing its options in the event of a default, the bank also requires the guarantor to waive all debtor and impairment-of-collateral defenses and to unconditionally guarantee the debt. The guarantor, who is fully aware of the risk he is assuming, agrees to sign the guaranty contract.

The insurance aspect of the guaranty contract can thus be seen as having some commercial usefulness. Creditors can repossess and sell collateral without the risk that a negligent sale or a failure to give proper notice will jeopardize their chances of recovering a deficiency against the guarantor. Debtors can, at the same time, expand their credit opportunities by providing a potential creditor with guaranty "insurance."[86]

Under the Code this method of allocating risks through a waiver clause is unacceptable. Both the general nonwaiver provision, section 1-102(3),[87] and the Article Nine nonwaiver provision, section 9-501(3),[88] provide parties with two basic options for dealing with Code duties of care. They can choose to let the courts decide, based upon Code language and policy, whether a sale of collateral was commercially reasonable, or they can define for themselves what is "commercially reasonable" conduct, so long as

86. *See* note 69 *supra*.
87. *See* note 62 *supra*.
88. *See* note 35 *supra*.

the definition is not "manifestly unreasonable."[89]

While a creditor may, by defining the standard of care, gain some advantages that he may not have had under a court definition of the standard,[90] the Code waiver prohibition still imposes limits on the type of risks that may be contracted away. What creditors apparently cannot do under the Code, no matter how well defined are the duties of care in the contract, is shift the risk of loss from a negligent performance of those duties to the guarantor. Suppose, for example, that a guaranty contract details a method for disposing of the collateral by sale at public auction that is not "manifestly unreasonable." In such circumstances, the guarantor cannot argue that the *method* of sale is commercially unreasonable. If, however, the creditor, in publicizing the sale, gives the wrong location of the auction place, or the wrong time for the auction, and the mistake is not discovered until after the collateral has been sold, the guarantor may be able to argue that the sale was "commercially unreasonable" and reduce or escape liability for a deficiency.[91]

Unlike debtor-creditor relationships, the relationship between guarantor and creditor is not inherently unequal.[92] Restrictions on the ability of guarantor and creditor to shift the risk of loss from the creditor's negligence to the guarantor in the form of an absolute prohibition on such activity are therefore unnecessarily severe.

At common law creditors have been allowed to shift to the guarantor the risk of their own negligence in handling collateral.[93]

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89. U.C.C. §§ 1-102(3) and 9-501(3) (1978 version).

90. The "manifestly unreasonable" test for reviewing standards of care formulated by the parties suggests that the parties may create standards favorable to one of the parties without court interference. See American Bank of Commerce v. Covolo, 88 N.M. 405, 409, 540 P.2d 1294, 1298 (1975), where the court went so far as to hold that a waiver of subrogation rights in a guaranty contract was not "inherently unreasonable" under section 1-102(3).

91. *See* California Airmotive Corp. v. Jones, 415 F.2d 554 (6th Cir. 1969), where a mistake in the notice of sale (wrong location and date) was cited as a factor in the court's decision to vacate a summary judgment affirming the reasonableness of a creditor's sale of repossessed collateral.

92. *See* text accompanying note 68 *supra*.

93. *See* National Bank of Washington v. Equity Investors, 81 Wash. 886, 918-19, 506 P.2d 20, 40 (1973).

Courts have, however, placed a number of lesser restrictions on this freedom-of-contract-based approach. Traditionally, the practice of strictly construing waiver-of-negligence clauses has been used as a means of providing some protection to persons sought to be held liable.[94] A principal defect in this approach, however, is that it often leads to strained interpretations of well-drafted contracts.[95]

In some instances strict construction may be of no help where the waiver clause is well drafted by the creditor, even though enforcement of the clause may be unjust. Recently, however, courts have begun to use new methods of construing these clauses, affording greater protection and certainty to parties against whom the waiver clauses are sought to be enforced. Such factors as the presence or absence of unequal bargaining power and the conspicuousness of the waiver clause have been considered relevant to a determination of whether the waiver-of-negligence clause should be enforced.[96]

When coupled with the strict construction device, these rules of construction provide guarantors with a measure of protection from unfairness in the enforcement of waiver-of-negligence clauses.

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94. *See* Note, *The Significance of Comparative Bargaining Power in the Law of Exculpation*, 37 COL. L. REV. 248 (1937).

95. *See* Note, *Contractual Exculpation From Tort Liability in California—The "True Rule" Steps Forward*, 52 CAL. L. REV. 350 (1964).

96. The so-called "true rule" cases are those cases where, in deciding whether or not to enforce clauses waiving liability for negligence by one of the parties to a contract, the courts have looked at such factors as relative bargaining power. *Id.* In Allright, Inc. v. Elledge, 515 S.W.2d 266 (TEX. 1974), the "true rule" was applied. The court found a waiver-of-negligence clause in a contract between a parking lot owner and a patron to be valid on the ground that there was no "disparity" in bargaining power. The court defined disparity of bargaining power as existing "when one party has no real choice in accepting an agreement limiting the liability of the other party." *Id.* at 267. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 337, comment b (Tent. Draft No. 12, 1977): "[A] party's attempt to exempt himself from liability for negligent conduct may fail as unconscionable."

A court may also require "specific and conspicuous reference to neglect under the general principle that language is interpreted against the draftsman." *Id. Cf.* Lacks v. Bottled Gas Corp., 215 Va. 94, 205 S.E.2d 671 (1974) (A plaintiff was precluded on appeal from challenging application of the Code definition of "conspicuous," U.C.C. § 1-201(10) (1978 version), to a waiver of negligence clause in a contract to install a barn. The clause was found to be inconspicuous.)

The requirement of conspicuousness insures that the waiver clause is brought to the attention of the potential guarantor so that he may decide whether or not to assume liability as an insurer. A strict construction of the waiver provisions insures that the content of the waiver clause is adequate to provide the guarantor with notice of its effect. Unconscionability principles provide protection for guarantors who are in an oppressive bargaining situation.

The "true" guarantor rule of California suggests an additional guarantor protection.[97] Where a guarantor is in reality wearing two hats—that of a "debtor" who owes payment on the underlying debt as well as that of a guarantor— the guaranty agreement should not be viewed as a "true" guaranty agreement. Thus, creditors should not be able to defeat the intent of the Code nonwaiver provisions with regard to "debtors" by having the debtor execute a guaranty agreement.

Finally, the guarantor can always argue that the creditor's conduct transgresses the bounds of ordinary negligence and is wilful or reckless. Since the common law has never sanctioned waivers of liability for this type of conduct,[98] a guarantor can avoid a clause waiving this type of conduct. Several courts have indicated a concern for preventing waiver of liability for this type of conduct in cases involving guaranty contracts.[99]

These rules provide a fair measure of protection to unsophisticated guarantors like Guarantor in the introductory hypothetical. This freedom-of-contract-based common law approach is preferable to the Code approach. The commercially useful possibilities of waiver-of-negligence clauses in guaranty contracts are preserved, while the contract formation process is closely watched.

IV. A Postscript on the Law of Guaranty

Perhaps the major significance of this note lies outside the particular subject matter with which it is concerned. The conflict

97. *See* note 18 *supra*.

98. 1 J. Dooley, Modern Tort Law 524 (1977).

99. *See* United States v. Willis, 593 F.2d 247, 253-54 (6th Cir. 1979); United States v. Cawley, 464 F. Supp. 189, 195 (D. Wash. 1979).

between waiver policy in the law of guaranty versus Code non-waiver policy illustrates two general problem areas with current guaranty rules.

First, there is the problem of coordinating guaranty law with the Code. Guaranty contracts, as this note has shown, are a peculiar blend of security and insurance, with policy concerns all their own. Aside from a few sections in Article Three on negotiable instruments, the Code does not attempt to weave the law of guaranty into its fabric.[100] What is therefore missing from the Code is a *guaranty* policy that is sorely needed if guaranty law is to efficiently mesh with the rest of the Code. The application of Code policies that were formulated with other types of transactions in mind may only serve to fragment and confuse existing guaranty policy, rather than streamline and modernize it.

This points to a second general problem. Guaranty law has remained unchanged and unanalyzed for decades. A major treatise on the law of guaranty has not been written in almost thirty years, and most guaranty rules date back even further.[101] The current tension between Code and guaranty waiver rules suggests that a comprehensive modernization of the law of guaranty may be in order. Absent statutory reformulation, a reevaluation of common law policies and rules by the courts will increasingly be needed if Code and common law are to work well together.

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100. *See* Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833, 835 (1968), where the author notes that guaranty law has so far escaped "elaborate statutory regulation," and the Article Three provisions are "remarkably skeletonic." Of the Restatement of Security guaranty provisions published in 1941, Professor Peters remarks that this particular Restatement "has not had the impact which some of the other Restatements have enjoyed." *Id.* at n.12.

101. The latest treatise on guaranty law currently available is A. STEARNS, THE LAW OF SURETYSHIP (5th ed. 1951). The rules in this and other treatises come from cases decided in the late nineteenth and early twentieth centuries. Another example of the age of guaranty law can be found in California. The California Civil Code statutes, as enacted in 1872, have remained basically unchanged to the present day. CAL. CIV. CODE §§ 2787-2854. For a discussion of the history of the California statutes, see Bloom v. Bender, 48 Cal. 2d 793, 802-03, 313 P.2d 568, 573-74 (1957).

CONCLUSION

Code instructions allowing guarantors to assert the nonwaivable Article Nine rights and defenses of a "debtor" are strained, as are constructions extending the scope of nonwaivable Code duties of creditors to cover guarantors. From a policy standpoint, it is preferable to allow guarantors to waive defenses based on the creditor's negligence in handling collateral, as opposed to an absolute ban on such clauses, so long as guarantors are adequately apprised of the existence of the waiver clause in the contract and are not unduly pressured into accepting liability.

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