Why Release of Security Discharges a Surety

H.W. Arant
WHY RELEASE OF SECURITY DISCHARGES A SURETY

By H. W. ARANT*

It is well settled that a creditor's release of security, under ordinary circumstances, discharges a surety to the extent of the value of the security released. It makes no difference that the surety was unaware, when he contracted, that the creditor had other security or that the security released was obtained by the creditor subsequent to the surety's promise. Neither does it matter that the principal debtor is financially responsible so that the surety can surely collect from him what the creditor claims of the surety. The justification for this discharge of the surety is almost invariably said to be the creditor's impairment of his right of subrogation.

*Dean of the College of Law, The Ohio State University, Columbus, Ohio.


4No case has been noted where the principal's financial responsibility was urged as a reason why a release of security should not discharge the surety but it is clear that this fact is immaterial if impairment of the right of subrogation is the reason for the surety's discharge inasmuch as the right of subrogation impaired by such a release relates solely to the creditor's security. See Glazier v. Douglass, (1865) 32 Conn. 393.

5A surety, upon paying the debt, is subrogated to the rights of the creditor in any collateral security which the creditor holds for payment of the debt. It follows that, if a creditor holding collateral security surrenders it to the principal debtor without the knowledge or consent of the surety on the debt, he thereby discharges him, to the extent of the value of the property surrendered.” Morton v. Dillon, (1894) 90 Va. 592, 595, 19 S. E. 654.
ordinary circumstances, there appears to be no reason to question, and the generally accepted impairment-of-the-right-of-subrogation theory appears quite adequate to explain the decisions where the surety is held to be discharged, if it be assumed that the proper measure of damage for the violation of the surety's right is always the value of the security released. But, where the surety is apparently properly held liable notwithstanding the creditor's release of security, this theory seems to be inadequate. For example, the creditor may require payment, notwithstanding his release of a part of his security when that which he retains is ample, when he takes other security that is the equivalent of that which is released, when his release of a part of his security improves the value of that which remains, when he surrenders a disputed claim as a reasonable compromise, or surrenders security that was of no legitimate value, as where the debtor's interest in the property mortgaged merely constituted a cloud upon title.

No case has been noted where damages have been recovered by a surety from a creditor for breach of his duty to preserve his security for the surety. If such a duty arose from an express promise, where the same measure of damages would seem to be proper, there is reason to believe that the measure of the surety's recovery would not be the value of the security. In Bosch Magneto Co. v. Rushmore, (1915) 85 N. J. Eq. 93, 95 Atl. 614, 615, where specific performance of a promise to give an indemnity bond was decreed, the court said: "In the case at bar it is obvious that no more than nominal damages could be recovered at law for the failure to furnish the bond."

"Damages are an inadequate remedy where there is no basis on which a court of law could give substantial redress, and yet the defendant's promise is of value. It is on this ground that not only a promise to give a mortgage of land, but also to give a mortgage or pledge of personal property, though of a kind not ordinarily the subject of equity jurisdiction, is enforced by equity. The probable value of the security and the probable solvency of the debtor when the debt shall mature, are factors too indeterminate to make the legal remedy satisfactory." 3 Williston, Contracts, sec. 1421. See also 3 Williston, Contracts, sec. 1411; Adderly v. Dixon, (1823) 1 Sim. & St. 607; Cutting v. Dana, (1874) 25 N. J. Eq. 265.


Young v. Cleveland, (1862) 33 Mo. 126, 82 Am. Dec. 155. See also Lafayette County v. Hixon, (1879) 69 Mo. 581; State Bank v. Smith, (1898) 155 N. Y. 185.

Neff's Appeal, (1845) 9 Watts & Serg. (Pa.) 36.


The same conclusion follows when the creditor is unaware of the relations between the surety and the principal debtor, when the surety is fully indemnified, or the creditor makes reasonable use of his security to collect from the principal debtor. In some of the foregoing situations, there is conflict of decision. Those cases holding that the surety is discharged do so on the logic of the generally accepted theory that the surety's right of subrogation attaches specifically to the creditor's security as soon as he obtains it, irrespective of when it is obtained or whether the surety knew of it, and at least two courts went so far as to say that the creditor's knowledge that the defendant was a surety was unessential to the latter's defense. Manifestly, those courts holding the surety's obligation to be unaffected by the creditor's release of security practically deny that the surety has the right of subrogation, when the release takes place, as that right is generally understood. A belief in the soundness of some of the decisions denying the surety's defense has led the writer to inquire into the nature and extent of the surety's right of subrogation with a view to answering the question whether its impairment is the real basis of the surety's defense. If it is, why, if ever, should exceptions be made in favor of the creditor; if it is not, what is the basis of the surety's discharge?

Under what circumstances does the surety have the right of subrogation and what is it when he has it? If S is surety for P's debt to C that is also secured by a mortgage on P's farms Blackacre and Whiteacre, when S pays C, it is universally

---


13No case has been noted where an indemnified surety urged the release of security as a defense. But such a surety is not discharged by a release of the principal debtor. Jones v. Ward, (1888) 71 Wis. 152, 36 N. W. 711. Nor by an extension of time. Home Nat'l Bank v. Waterman, (1890) 134 Ill. 461, 29 N. E. 503; Smith v. Steele, (1853) 25 Vt. 427, 60 Am. Dec. 276; Fay v. Tower, (1883) 58 Wis. 286, 16 N. W. 558. It is generally assumed that such a surety would not be discharged by a release of security. 21 R. C. L. 1054.


agreed that he has a right to be subrogated to C's position as mortgagee; but he does not have this right until C is fully paid. When, however, he does pay C in full, he has a right to all of C's security and it is inconceivable that C could successfully resist his claim to be subrogated to his rights as mortgagee of both farms on the ground that the mortgage on Blackacre would be ample to secure the payment of what P then owes S. If C should voluntarily assign P's debt and the mortgage securing it to S, neither law nor equity could find any dereliction on his part; if he refuses to assign, equity will compel him to do so, if he still has the security, or compensate the surety for the damage done him if he disposes of the security after payment. If these assumptions are correct, the surety's "right of subrogation" is merely a right to an assignment by the creditor when he is paid and the remedy of subrogation but another name for equity's decree vindicating that right. When the creditor still has the security, the decree is the same as it would be if C had expressly promised S that he would assign his security upon payment and had refused to assign after S paid and the circumstances under which this decree would be refused are doubtless identical in the two situations. Specific performance of C's express promise to assign would be decreed because of the inadequacy of the remedy at law, but, for obvious reasons, such a decree would be rendered only when it appeared that C


19See Hill v. King, (1891) 48 Oh. St. 75, 26 N. E. 988. No instance has been noted where a law court gave relief under such circumstances.


still had the security he promised to assign. Since S could undoubtedly recover damages at law for breach of C's express promise, it is clear that it creates in S a conditional right that becomes unconditional or instantly enforceable upon payment of the debt and is remediable both at law and in equity. No case, however, has been noted where an ordinary surety brought an action at law when a creditor refused to assign security upon payment of the debt. The apparently universal resort to equity was due either to the surety's uniform preference for the remedy of specific performance or to the nonexistence of a remedy at law.

But it is generally said that the surety's right of subrogation is equitable. What this means is not entirely clear. It may refer to the forum to which the surety usually resorted for the desired remedy and may mean no more than would be meant by saying that the right to specific performance of a promise to convey land is equitable. But such a promisee could recover damages at law and his substantive right is, with reference to the forum in which he can obtain redress, both legal and equitable. Hence, the statement that the surety's right of subrogation is equitable does not necessarily mean that the right vindicated is exclusively equitable, though the absence of legal precedent affords a slight basis for the belief that courts of law did not recognize that the surety had such a right against the creditor. The term "equitable" is doubtless often applied to the right of subrogation merely to suggest the nature of the circumstances giving rise to it.

---


23In Morton v. Dillon, (1894) 90 Va. 592, 19 S. E. 54, where a creditor surrendered his security to the principal debtor upon payment of a small balance due, the rest of the debt having been previously paid by the surety, chancery decreed that the creditor pay the surety the value of the security released, it appearing that the principal debtor was insolvent and that the value of the security released was less than the amount paid by the surety. This case is consistent with the view that there was no remedy at law against the creditor under such circumstances.

24Of course the law courts professedly recognized the surety's "right of subrogation" every time they held that the creditor's release of security privileged the surety not to pay to the extent of the value of the security released. Their refusal to recognize the surety's right against the creditor affirmatively is not surprising when it is remembered that, at one time, courts of law did not even recognize the surety's right of reimbursement from the principal whose debt he had paid, in the absence of an express promise. Ames, Cases on Suretyship 499. n. 1.
the most prominent suggestion being the absence of an express promise. But, whatever the notion intended to be conveyed by the application of the term "equitable" to the surety's right of subrogation, the fact is that, upon payment, equity recognized that the surety had a right to the security and would decree that the creditor turn it over to him or pay him for the injury caused by not doing so. No case having been found where the law courts gave the surety remedy against the creditor under such circumstances, it is at least arguable that the creditor, so far as the surety was concerned, was legally privileged to do as he pleased with the security. Positive proof that this was so, however, would require the discovery of cases in which law courts refused the surety damages when the creditor refused to turn over security in his hands after he had been paid.

In order further to test the limitations of the surety's "right of subrogation," let it be supposed that the surety pays the creditor (1) without knowledge, and (2) with knowledge, that securities have been released.

If S pays C when C has reason to believe that S thinks he still has security that has in fact been released, S may recover an amount equal to the value of the security released as money paid under mistake of fact. To the extent of the security released, he supposes that he is discharging a debt where the creditor, from the beginning, was in no danger of ultimate loss and his only function was to relieve the creditor from inconvenience and delay in collection. Contrary to his reasonable expectations, the creditor's release of security has created a risk of ultimate loss from which it could not have been contemplated that S should protect him, but S pays with the reasonable belief that he will succeed to the same risk of ultimate loss that the creditor's original transaction with the principal debtor involved. When this is so, the surety obviously pays under a mistake as to a material fact, and, since it was known to the creditor, he should recover to the extent of the value of the security released.

25 "The equitable character of the right (subrogation) is shown by the fact that it is immaterial that the securities in question were given after the contract of the surety was entered into. Or that the surety was ignorant of the existence of security at that time." 2 Williston, Contracts, sec. 1266.

If the "right of subrogation" is a right to an assignment by the creditor, as seems to be the case, and the surety has the "right of subrogation" before payment, as must be the case if the creditor's release of security impairs it, the "right" is necessarily conditional in character.\textsuperscript{27} If a surety has a conditional right to an assignment of security before payment, it would doubtless be like that of a surety to whom a creditor promises that he will assign his security upon payment of the debt. In the latter case, the creditor's release of security would render him unable to perform the condition precedent to the surety's duty to pay and the surety would not be liable.\textsuperscript{28} If the surety paid in ignorance of the fact that the creditor's release of security had entirely destroyed his duty to pay, he should recover, as money paid under mistake of fact, the entire amount paid. But he would not be limited to this remedy; he could recover damages for breach of the creditor's express promise to assign the security. Such a promise would certainly give rise to an affirmative duty.\textsuperscript{29} It should be noted, however, that recovery of the amount paid is amply justified on the ground that the payment was made under a mistake of fact, namely, that the creditor had maintained his ability to perform his promise to assign. Recovery to the same extent would be required upon the same theory if the creditor made no express promise to assign but the surety's promise to pay was upon the express condition that the creditor assign.

To what extent does the position of the ordinary surety differ from the cases supposed where there is an express agreement relative to the creditor's assignment of security? That the ordinary surety can set up the creditor's release of security as a pro tanto defense, if he knows of it, is generally agreed.\textsuperscript{30} It is likewise clear that he can recover, as money paid under mistake of fact, the value of the security released when he pays without knowledge of the release.\textsuperscript{31} His defensive power in the first case and his offensive power in the second are less than those of a surety to whom the creditor has promised an assignment of

\textsuperscript{27}See note 17, supra.
\textsuperscript{28}Griggs v. Moors, (1897) 168 Mass. 354, 47 N. E. 128.
\textsuperscript{29}In an action for damages for breach of such an express promise, it may be doubted whether the measure of recovery would be the amount paid. See n. 6, supra.
\textsuperscript{30}See Note 1, supra.
\textsuperscript{31}See Note 26, supra.
his security or who promises to pay the creditor on condition that
the security be assigned. In the former case, assignment of the
security in accordance with his promise is a condition precedent
to the creditor's right to recover anything at all from the surety.\textsuperscript{32} In the latter, if the surety paid believing that the creditor had the
security to assign in accordance with his promise, he would be
able to recover the full amount paid.\textsuperscript{33} However, instead of suing
to recover what he had paid, he undoubtedly could sue for damages
for breach of the express promise to assign the security.\textsuperscript{34} But
there is much reason to believe that an ordinary surety, who pays
without knowledge of the creditor's release of security, can not
recover, as damages, an amount equal to that recoverable by a
surety to whom the creditor had expressly promised to assign.
Courts would see no basis or necessity for the implication of an
affirmative duty and the surety would not succeed if he brought
an action upon this theory. Yet, if the surety has a right of
subrogation, whenever the creditor obtains security, conditional
upon payment, his payment should mature the creditor's duty, and
his failure to perform it by assigning the security should render
him liable for such damage as results to the surety. No case,
however, presenting this theory of recovery by the surety has
been noted.

If an ordinary surety pays, when he knows that the creditor has
released his security, what are his rights? If the creditor expressly
promised to assign his security upon payment, it is clear that the
surety could not recover a payment made with knowledge of the
release of security under the mistake of fact theory. No reason
is apparent, however, why he should not recover damages for
breach of the creditor's express promise. He should be able to
perform, if he chooses to do so, and later recover whatever
damage results from the creditor's breach of his promise\textsuperscript{35} just
as a vendee may pay for goods, knowing they are not as war-

\textsuperscript{32}Griggs v. Moors, (1897) 168 Mass. 354, 47 N. E. 128. Com-
pare Walker v. Goldsmith, (1879) 7 Or. 161; Jones v. Kerr, (1860)
30 Ga. 93; Jeffries v. Lamb, (1880) 73 Ind. 202; Fay & Co. v. James

\textsuperscript{33}The creditor's inability to perform his express promise would
empower the surety to rescind. See the reasoning in Ziehen v. Smith,
(1896) 148 N. Y. 558, 42 N. E. 1080.

\textsuperscript{34}As to the measure of damages recoverable in such an action,
see Note 6, supra.

\textsuperscript{35}See 2 Williston, Contracts, sec. 679; Anson, Contracts, Corbin's
ed., sec. 365.
ranted, and later recover the damage caused by the breach of warranty.\textsuperscript{36} An ordinary surety who paid with knowledge that the creditor had released his security, of course, could not recover under the mistake of fact theory.\textsuperscript{37} Since the surety's consent to the creditor's release of security is said to operate as a waiver of his "right of subrogation," his payment with knowledge of the release would doubtless have the same effect. If this is so, it would seem nearer correct to say that the creditor's retention of his security is, to the extent of the value of the security, ordinarily a condition precedent to the surety's duty to pay\textsuperscript{38} but the surety may waive this condition either before or after the creditor's release.\textsuperscript{39} Yet, if the surety had a right, in the ordinary sense, that the creditor assign his security, it would seem that he, too, should be able to pay the debt with knowledge that the creditor had released the security and later recover whatever damage resulted from the creditor's nonperformance of his duty. There is much reason, however, to believe an ordinary surety could not recover under such circumstances.\textsuperscript{40}

If the surety made payment without knowledge that the creditor had previously taken security from the principal and released it, he would doubtless be unable to recover anything from the creditor upon any theory.\textsuperscript{41} This conclusion would be difficult to justify if the generally accepted view that the surety's right of subrogation attaches to any security the creditor has, irrespective of when he obtains it or whether the surety knows of it, is correct. The surety obviously cannot use the creditor's release of security defensively if he doesn't know of it. He could hardly claim that he had paid under a mistake of fact, and his inability to proceed offensively would justify the statement that he had no real right against the creditor relative to the security but that his duty to

\textsuperscript{36}See 2 Williston, Contracts, secs. 702-717; Anson, Contracts, Corbin's ed., sec. 399.
\textsuperscript{38}This usage was employed in Glazier v. Douglass, (1865) 32 Conn. 393.
\textsuperscript{40}See cases cited, note 37, supra.
\textsuperscript{41}There could be no recovery on the theory of a payment under a mistake of fact, and it was concluded above, though the point does not seem to have been decided, that there could be no recovery of damages, even where the surety knew of the creditor's security but paid without knowledge of its release.
pay him was merely conditional upon his retention of such security. To say that he waives the condition when he pays without knowledge that the creditor had security is no stranger than to say that a promisee makes his election by suing an agent when ignorant of the fact that he acted for an undisclosed principal. Such a promisee has a right against a principal of which he is ignorant, and he loses it by suing the party with whom he intended to contract and whose financial responsibility he trusted. The surety's duty to pay is subject to a condition precedent of which he is ignorant and when he pays the resulting situation is what he expected it would be when he contracted, namely, that he would have an unsecured claim against the principal debtor. The general assumption that the surety's right of subrogation depends neither upon his knowledge that the creditor has security nor upon when the creditor obtains it is doubtless correct when the surety really has it. But, in the light of what the courts actually do and decline to do for the surety, it seems reasonable to assert that he has no right of subrogation until the principal's debt is fully paid. If he has a right under any other circumstances, there seems to be no evidence that courts accord to it the common and expected forms of vindication.

The pro tanto defense generally allowed the surety, when the creditor releases security, as suggested above, can be explained on the basis of an implied condition that the creditor must ordinarily retain his security. The implication of such a condition is necessary to make the scope of the surety's undertaking correspond to the scope of the risk that must have been contemplated by the parties when he contracted, namely, the protection of the creditor from such inconvenience and delay in collecting from the principal as he cannot avoid by the use of reasonable prudence. This is the only protection the creditor needs and the parties would not be assumed to contemplate more in the absence of express statement so indicating. To the extent of the value of his security the creditor is in no position ultimately to lose. The surety's protection does not require the implication of a right in his favor such as would make the creditor liable in damages if he releases the security or enable the surety to obtain an injunction to prevent its release, and the courts seem never to have accorded the surety these remedies; yet no reason is apparent why they should not do so if the surety has a "right" against the creditor in any
WHY RELEASE OF SECURITY DISCHARGES SURETY

ordinary sense. To say that the surety has a right of subrogation before payment that is invaded by the release of security, when some of the most ordinary consequences of an actual or threatened breach of duty do not follow, is not only not helpful but misleading and requires the creation of a number of exceptions not required by the theory that the surety's undertaking is merely subject to a condition precedent. Furthermore, the exceptions made necessary by the adoption of the impairment-of-the-right-of-subrogation theory and justified on the ground that the surety is not injured are at variance with the attitude of the courts toward the surety in other connections, e.g., when the creditor's extension of time discharges the surety, irrespective of whether the surety is injured, because it is said to impair his right of subrogation.42

If, then, the impairment-of-the-right-of-subrogation theory will not explain all the apparently sound decisions, where the creditor's release of security has been urged as a defense, will the theory of an implied condition precedent rationalize more of them?43

It would be too much to hope that any theory could be formulated that would rationalize all of the cases. But, where the decisions in a given fact situation are obviously in conflict, it is perhaps enough to commend a theory that it offers a rational basis of choice that is consistent with the conclusion reached in decisions in other situations, where the creditor's release of security has been urged as a defense and where there is little or no conflict. Before attempting the formulation of a theory for which so much is claimed, it is necessary to discuss in somewhat elementary fashion the function of the surety in business transactions.

That the purpose of a surety's undertaking is either to decrease the probability of ultimate loss to the obligee or to protect him from the inconvenience and delay of enforced performance or from both would be generally conceded. It would hardly be claimed that an obligee needs a surety to protect him from any of such loss as can be prevented by the use of reasonable prudence on his own part. That unnecessary protection to the obligee is


43Retention of security may be a condition precedent to the surety's duty to pay when the creditor owes no duty to retain it. An express or implied promise would be essential to the existence of a duty. See Anson, Contracts, Corbin's ed., sec. 358.
uncontemplated, in the absence of express statement to the contrary, and is, therefore, not within the scope of the surety's promise would seem to be quite incontrovertible.

For example, an employer, contemplating the hiring of an employee, realizes that his judgment that the employee is trustworthy may be wrong, however careful and thorough his investigation may have been. To remove the danger of ultimate loss from such error of judgment as far as possible, the employer requires a surety for the employee's faithful performance of his duty. In the absence of express statement, it would not be supposed ordinarily that a bond was required in order that the employer might shift to the surety the hazard resulting from a reckless employment. An employer would rarely be willing to utilize a surety to protect him from losses that he should expect when he hires an employee known to have been dishonest. If the prospective employee's previous dishonesty were made known to the surety and he were willing to guarantee his future honesty notwithstanding, an employer would rarely be willing to engage him. Dishonest employees so cleverly conceal their defalcations that the full extent of the employer's loss is often not discovered until long after a suit or settlement has finally determined the right of the employer against the surety, with the result that the subsequently discovered loss goes uncompensated as far as the surety is concerned. Hence, the only way in which an employer can fully protect himself in such a case is to decline to employ a person known to have been dishonest. Since this is the course that an employer would almost invariably follow, a surety for an employee is justified in believing that the employer is pursuing it, unless he is informed to the contrary.\(^{44}\) It may be that the surety is even justified in assuming that the employer knows, when he hires the employee, what a reasonable investigation would disclose, unless he is informed that no such investigation has been made.\(^{45}\)

Consider another illustration of a somewhat different type. C is a merchant from whom P wishes to purchase goods on credit. C may be unacquainted with P, or he may know him and suspect that he would not or could not pay, or he may be-


lieve that he will pay as quickly as he can and that he will ultimately be able to pay in full. Since the profit from doing business with him, if P pays as he promises, is as great as the profit from doing the same amount of business with any one else, C cannot be indifferent to the proposal of P to purchase his goods. In the event, however, that he considers the danger of P's nonperformance too great to permit an attempt to make the profit contemplated, he will suggest that P induce S to become his surety. But C would not be understood to require that P induce S to become his surety in order that he might entirely ignore the fact that P is his debtor or depart substantially in his dealings with him from those practices that would be pursued by ordinary business men in dealing with their debtors, though a part of C's reasonable and, therefore, contemplated purpose may be to avoid the possible inconvenience and delay incident to enforced ultimate payment from P, as well as the danger of loss due to P's inability or refusal to pay. In the event that P does not pay as he promises, it is obviously advantageous to be able to call upon a responsible surety from whom prompt payment can be expected. This advantage, for which it is quite legitimate for the creditor to stipulate, is entirely consistent, however, with the requirement that the creditor conform to ordinary business practices in his dealings with P. For this reason, a creditor who releases his debtor⁴⁰ or refuses his tender of the amount due⁴¹ cannot require payment by the surety; whatever loss results from the debtor's nonpayment in either case is caused by the creditor's un-contemplated act. Prevention of loss under such circumstances is so obviously within the creditor's power that it could not have been contemplated as within the scope of the surety's undertaking. If the creditor had been asked whether he expected the surety to pay after he had released the principal or declined to accept payment from him, the answer would undoubtedly have been in the negative. Since a creditor does not need protection from loss that follows such unusual and stupid conduct upon his own part, it cannot be assumed that


the surety's undertaking was to be operative under such circumstances.

Not infrequently an applicant for credit agrees to place his property in pledge with the creditor or execute a mortgage upon it. To the extent of the value of the property to be pledged or mortgaged, the creditor is entirely free from danger of ultimate loss; only depreciation or destruction of the property can prevent the creditor's ultimate collection to the extent of its original value. A comparison of its value with the amount of indebtedness contemplated shows the creditor approximately the maximum risk of ultimate loss involved. But the possibility of the depreciation or destruction of the security, when its value is equal to or even greater than the indebtedness contemplated, as well as a desire to avoid the possible inconvenience and delay of enforced payment, may lead a cautious creditor to require the debtor to supplement such security with the undertaking of a surety. Under such circumstances, the prospective surety considers the possibility that the debtor may not pay as he agrees but he also considers the ultimate certain payment by the debtor to the extent of the value of the property pledged or mortgaged. Since, to the extent of the value of his security, when it may be necessary to realize upon it, the creditor has no risk of ultimate loss, the surety reasonably supposes that, to this extent, the creditor requires his undertaking only for the purpose of escaping the inconvenience and delay incident to enforced payment. He would not ordinarily suspect that a creditor, having taken security, would throw away his advantage by releasing it. Such an act, under ordinary circumstances, would be a departure from ordinary business practice and the resulting risk of loss, therefore, not within the scope of the surety's undertaking. To whatever extent the creditor's security may prove to be inadequate, the surety assumes the risk of ultimate loss, but to the extent of the value of the security, he assumes no such risk but merely assumes the burden of paying the creditor money that he could not ultimately lose in order to save him the inconvenience and delay of enforced payment.

In the foregoing discussion, it has been assumed that the surety knew of the creditor's security, but it seems quite clear that such knowledge is not a prerequisite to the surety's reasonable expectation that the dealings of the creditor with the
debtor will conform to the practices of ordinary business men. The creditor, under all circumstances, is expected to recognize the fact that P is his debtor and the purpose of the surety's undertaking is understood to be to protect him from such danger of loss or inconvenience in collection as he may not evade by the use of reasonable business prudence. It seems reasonable, therefore, to say that the parties contemplate that the creditor's dealings with the debtor will always accord with the requirements of ordinary prudence and this includes the expectation that, under ordinary circumstances, the creditor will utilize in the ordinary way any security he has or may acquire from the principal. This expectation is justified by the fact that creditors ordinarily do not release security. Any release, therefore, under ordinary circumstances, is uncontemplated and this is so whether the surety knew that the creditor had security when he promised or whether the security was obtained subsequent to his promise; it is a departure from ordinary business practice that produces a danger of loss from which the creditor does not need the surety's protection and is, therefore, not within the contemplation of the parties. If the creditor were specifically asked whether he expected the surety to protect him from the danger of loss caused by his release of security that the surety did not know of or that he might subsequently acquire, it seems reasonable to believe that the answer would be in the negative. If this is so, there is the same reason for construing the surety's undertaking to be subject to the implied condition precedent that the creditor retain his security that exists where the surety knows of the security. If this approach to the defense of release of security be adopted in the various fact situations already mentioned, what conclusions will be reached as to whether the surety should be discharged?

Under ordinary circumstances, if a creditor releases security, he departs from the practice of ordinary business men. In most of the cases where the surety was discharged to the extent of the security released, there were no special circumstances tending to make the creditor's act appear to be prudent or reasonable. The mere fact that the creditor accepted the security of the surety's supplementary obligation indicates that he regarded the principal's security an insufficient. Its release, when he neither realizes anything from it nor takes other security in its place, on the face of it, seems to be unbusinesslike. The creditor doubtless acts on
the assumption that he need not bother about the prospect of collecting from the principal because he has the promise of a responsible surety. Such an attitude he may not take because it is inconsistent with what was contemplated as the surety's function in the transaction, namely, to save him from such risk of loss and inconvenience as he cannot evade by the use of ordinary business prudence. To the extent to which he releases security, he himself creates a risk of ultimate loss. Since protection from loss caused by the creditor's own act is not the function of the surety's undertaking, the general conclusion that the surety is discharged pro tanto appears to be just and is reached by regarding the creditor's retention of security, to the extent of its value, under ordinary circumstances, as a condition precedent to the surety's duty to pay.

In the few cases that are reported where a creditor released security but claimed that the surety should not be discharged because the security retained was ample, the decisions are in conflict. Whether the surety should be discharged or not should depend upon the answer to the question whether the creditor's act, under the circumstances, measured up to the requirement of ordinary business prudence to which the creditor must always conform in his dealings with the principal debtor. Do creditors who have taken a superabundance of security ordinarily release any part of it? If so, the creditor's release of some of it may possibly conform to the standard of ordinary business prudence and it may be argued that his act, under the circumstances, was within the contemplation of the parties. But, with much force, it may be contended that it is always unbusinesslike to relinquish security that one has seen fit to take; else why take it? This argument seems to represent the better view in the ordinary case. But if a creditor had originally received ample security and the debtor had reduced his indebtedness to such an extent that the creditor was extravagantly secured, it would seem that the debtor might reasonably request that the creditor relinquish a part of his security. If he might, the creditor's release of a part of his security would not be a departure from ordinary business practice. If, however, the debt had not been decreased, it would seem difficult for the creditor to justify the release of any part of his security, in view of the fact that he had once regarded

48See Note 7, supra.
it as sufficiently inadequate to justify him in requiring or accepting the supplementary security of a surety's obligation. Hence, under ordinary circumstances, it would seem that any release of security would be a departure from business practice; if so, to the extent of the value of the security released, it is a breach of the condition precedent to the surety's promise to pay, causing his discharge pro tanto.

If the creditor releases security and accepts other security in its stead, his conduct may be entirely reasonable if the substituted security appears to be the reasonable equivalent of the security released. In such a case, the creditor should be required to prove that the substituted security was equal in value to that which was released. When this is so, the danger of ultimate loss to both creditor and surety remains the same; the creditor's act causes no uncontemplated risk. Hence, it would seem reasonable to hold that the surety's obligation is unaffected, under these circumstances, but that he is discharged to any extent to which the substituted security may be less valuable than the security released. Since the surety's right of subrogation is necessarily impaired by the creditor's release of the security to which it relates, and since his right attaches to security as soon as the creditor obtains it, it is clear that the view that a surety is not discharged by the creditor's release of security, when he obtains in its place other security of equal or greater value, cannot be reached if the impairment-of-the-right-of-subrogation theory is applied. Yet, such a holding appears to be reasonable and would be justified under the theory that the creditor's dealing with his security as would a business man of ordinary prudence is a condition precedent to the surety's duty to pay.

Where the creditor's security from the debtor constitutes a mere cloud on title, its release does not affect the obligation of

49"No authority has been cited, and we have been able to find none holding that a creditor may not in good faith endeavor to better his situation by exchanging one kind of collateral for another that he regards as more valuable. If a bank holds bonds of doubtful value as security for a note made by sureties for the principal debtor, may it not exchange those bonds for others that it regards of greater value without releasing the sureties? If it cannot, the law deprives it of the right to make the best use of its collateral that it can, and compels it to refrain from trying to better its condition, lest, although acting honestly and for what it regards as for its own interest as well as the interest of the sureties, it may make a mistake to their detriment." State Bank v. Smith, (1898) 155 N. Y. 185, 199, 49 N. E. 680. See cases Note 8, supra.

50State v. Smith, (1898) 155 N. Y. 185, 49 N. E. 680.
the surety. The debtor's interest being of no value, the surety's right of subrogation is not impaired; at least, he is said to sustain no injury. This is so if the creditor's retention of the interest received from the principal would not enable him, under the circumstances, to realize anything. Even though the debtor's interest may be a mere cloud on title, the creditor might, nevertheless, exact compensation for its relinquishment. Of course, no court should encourage the creditor to do this, but he might and, if the creditor might, the surety, upon payment, might likewise do so. According to the generally accepted theory of the surety's right of subrogation, he has a right that the creditor retain whatever advantage he acquires from the principal and the surety's claim that he is damaged by the creditor's release to the extent to which the payment of money to remove the cloud on title could have been compelled seems to accord with the facts. But, under the theory that the creditor's conformity to the standard of conduct of a reasonably prudent business man is a condition precedent to the surety's duty to pay, his relinquishment of his security under such circumstances would be without effect upon the surety's obligation, because an ordinary business man would not resort to extortion to collect the principal's debt from other persons.

Where the creditor releases a part of his security for the purpose of improving the value of that which remains, it has been held that the surety is not discharged, as where a creditor releases a part of the debtor's land from the lien of a judgment in order that it may be sold, it being agreed that the proceeds from the part sold will be applied to the payment of a debt secured by a mortgage that was a superior lien on all of the debtor's land. The creditor's action, under such circumstances, accords with business prudence. It does not ignore the fact the principal is the debtor and is consistent with a purpose on the creditor's part to see that he pays. This result, however, cannot be justified under the impairment-of-the-right-of-subrogation theory. It can hardly be said that the creditor's destruction of the surety's right by his release does not impair it.

Where the validity of a claim assigned to the creditor as security is disputed, its release by the creditor in return for what would be regarded in a compromise as a reasonable sum does not affect

---

52Neff's Appeal, (1845) 9 Watts & Serg. (Pa.) 36.
WHY RELEASE OF SECURITY DISCHARGES SURETY

The creditor's act represents an attempt to collect the principal's debt from his assets, and, if the compromise is reasonable, he measures up to the standard of conduct of a prudent business man under the circumstances, fulfilling the condition precedent to the surety's duty to pay. Even this very reasonable conclusion would appear to be inconsistent with the surety's right of subrogation as it has been stated by one court. Where the surety is indemnified by the principal, neither the creditor's release of the principal nor his extension of the time of payment affects the surety's obligation. The basis of this view is the generally conceded right of the creditor to utilize for the payment of his debt any security given to the surety by the principal, and this right of the creditor doubtless exists no matter how much security he himself may have taken from the principal. By analogy, the indemnified surety would probably be held notwithstanding the creditor's release of security.

Is this conclusion defensible under any theory? In holding the surety personally liable notwithstanding the creditor's release, the courts go much further than is necessary to vindicate the creditor's right to subject the surety's security to the payment of his debt; and, in so doing, they place upon the surety the burden of paying the creditor and later realizing upon whatever he had that caused the court to say that he was "indemnified."

---

52See Note 10, supra.

54"When the creditor intends to look to the surety for payment, he is compelled to preserve, unimpaired, all his rights against the debtor. If the creditor therefore does any act without the surety's consent, which impairs his rights of subrogation or the means of enforcing his claim against the principal in case he should be called upon to pay the debt, the surety will be discharged. The sureties in the case may have desired to pay their obligation, which was for $2500 each, and take the assets of their principal to the extent and amount of securing them against loss, and administer them for their benefit. . . . The plaintiff contends that the acts of the company in taking the property of Randall, operated an advantage to the sureties, and therefore they have no cause to complain. Admitting this to be so, the surety stands upon the strict terms of his contract, and even should the act be beneficial to them, if it in any way changes the contract of suretyship, the surety will be discharged. . . . In this case it is clear that the creditor by his own act has changed the contract of the surety and placed it beyond the power of the company to subrogate the sureties to its rights against the property of Randall." McEnery, J., in New England Mutual Life Ins. Co. v. Randall, (1890) 42 La. Ann. 260, 265, 7 So. 679.


56See Note 13, supra.
So long as the surety is so “indemnified” that there is no chance that what the principal gave him may not produce as much money as he is required to pay the creditor, this burden is the only apparent objection to holding the surety liable, but, since the indemnity is usually in the form of a bond, pledge or mortgage, involving the probable inconvenience of a suit, sale or foreclosure, it is obvious that the burden is not negligible. The creditor’s release of security, when the surety is indemnified, appears to be quite as contrary to prudent business practice as does his release of a part of his security when he claims that which he retains to be ample. It was suggested above that this, under ordinary circumstances, should discharge the surety pro tanto. Moreover, it is quite obvious that the view that the creditor’s release of security does not discharge an indemnified surety pro tanto denies to such a surety the right of subrogation to the creditor’s security. It is believed that no court would deny this right where such a surety actually paid the creditor and the creditor still had his security. If this is so, an indemnified surety would seem to have as much right of subrogation to the creditor’s security before payment as any other surety, and it would be absurd to say that his right is not impaired when the creditor releases his security. If it is said that the creditor’s release does not injure an indemnified surety, it may properly be observed that courts generally make no inquiry into this matter. At any rate, the surety is deprived of an amplitude of security that he may be presumed to have relied on, particularly when he knew of the creditor’s security when he contracted. If he may be deprived of this, under these circumstances, there is no logical reason why he should not be held when the creditor releases a part of an overabundant security. If the absence of damage in the sense that the surety is sure to be able to collect from the principal is to justify holding the indemnified surety, it would seem not only logical but fair to hold all sureties in favor of creditors who release security to debtors about whose solvency and ultimate ability to pay there is no doubt. No court, however, has ever held that the debtor’s financial responsibility prevents the creditor’s release of security from discharging the surety pro tanto.

Moreover, where the surety’s security is in the form of a pledge or mortgage, there is always the danger that the property pledged or mortgaged may depreciate or be destroyed.
Under the theory that the creditor’s retention of his security is, to the extent of its value, under ordinary circumstances, an implied condition precedent to the surety’s duty to pay—because such retention is ordinary practice—the surety’s liability should be dependent upon the answer to the same inquiry suggested where the creditor releases some of his security but retains what appears to be ample, namely, did the creditor’s act accord with prudent business practice under the circumstances? It seems reasonable to contend in either case that the creditor’s act is abnormal and produces an unanticipated risk of loss. The most plausible argument that can be made in favor of not discharging the indemnified surety is that he shows that he does not rely on the creditor’s protection when he, in substance, secures payment in advance from the principal. Everything considered, however, it seems fairer to require the creditor to get his money out of the surety’s security rather than to place the burden of so doing upon the surety.

When the surety assents to the creditor’s release of security, his obligation is unaffected by the creditor’s act. If, however, he has a right in any ordinary sense to the creditor’s security, under general contract principles, there would be some difficulty to his relinquishing it after the creditor’s release without consideration. But, if the creditor’s retention of security is merely a condition precedent to the duty to pay, implied for the surety’s protection, there is no difficulty about his waiving it at any time.

Implication of duty and condition are equally easy but it is obvious that there is a good deal of difference between creating a right in the surety and implying a condition to his duty. Why should either be done? Manifestly, in order that justice may be done between the parties. But the requirements of justice can be known only at the end of an inquiry as to what risk the surety assumed when he contracted. More emphasis upon this inquiry would lead to a more rational conclusion in most of the cases dealing with defenses by the surety.