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Suretyship-Subrogation-Effect of Release of Surety After Partial Satisfaction

SURETYSHIP—SUBROGATION—EFFECT OF RELEASE OF SURETY AFTER PARTIAL SATISFACTION—Plaintiff and the Bank entered into an agreement with relation to the preferred stock of the Realty Company by which the Bank purchased the stock as trustee and the plaintiff guaranteed the payment of dividends as well as redemption of the stock as provided by the stock agreement. Later, in order to raise money for repairs, a reorganization of the Realty Company was affected. As part of the reorganization plan plaintiff was released from all further liability on his guaranty. He had already paid $15,000 to the company to be used in payment of dividends and in retirement of the stock. When the Realty Company went into the hands of a receiver, plaintiff filed a claim for the money advanced, claiming to be subrogated to the rights of the preferred stockholders whose stock had been retired with the money advanced. Held: plaintiff was not entitled to the preference which the stockholders had on dissolution.[1]

The first question arising involves the effect of the contract of guaranty in the first instance. On this point it is generally held that such contracts of guaranty are valid and can be enforced with the limitation that the guaranty must be by a third person[2] and not by the corporation itself.[3] If the guaranty is made by the corporation itself, it is denied effect; for it is contrary to public policy for a corporation to pay dividends except out of earnings, and a

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12 "The Cognovit Note Act," by G. A. Farabaugh and Walter Arnold, 5 Indiana L. Jl. 93; "The Indiana Cognovit Note Statute," by Bernard C. Gavit, 5 Indiana L. Jl. 208.

13 In Phend v. Midwest Engineering Co., the court merely said, "There is no stipulation in the conditional-sales contract that the several promissory notes were to contain the usual terms and conditions of a cognovit or judgment note."

In the principal case the court said, "There is no stipulation in the mortgage that the note given as evidence of the debt should contain the cognovit feature."

1 Ellis v. Thompson (1937), 8 N. E. (2d) 430, Indiana Appellate Court.

2 Austin v. Wright (1930), 156 Wash. 24, 286 P. 48; McCampbell v. Obear (1915), 27 Cal. App. 97, 148 P. 942; Scholbe v. Schuchardt (1920), 292 Ill. 529, 127 N. E. 169; Hornor v. McDonald (1899), 52 La. Ann. 396, 27 So. 91; Rogers v. Burr (1898), 105 Ga. 432, 31 S. E. 438.

3 In some cases a guaranty by the corporation is construed, not as being void, but merely to mean that the dividends are cumulative; Prouty v. Michigan Southern Ry. Co. (1874), 1 Hun. (N. Y.) 655; Boardman v. Lake Shore Ry. Co. (1881), 84 N. Y. 157; Lockhart v. Van Alstyne (1875), 31 Mich. 76.

guaranty of payment is held to be in conflict with the same policy[4]. Therefore, plaintiff was bound on an enforceable contract. Since, at the time of plaintiff's release, the preferred stockholders, whose shares had not been retired. were parties to the release, plaintiff's liability on the guaranty ceased.

This, then, presents the principal problem involved: that is, the right of the surety to be subrogated to the rights of the preferred stockholders whose stock was retired and cancelled with the money furnished by the plaintiff. This problem can best be set forth by indicating the effects of the ruling requested by the plaintiff. If subrogation were granted, the surety would be put in position to claim on parity with the holders of the preferred stock whose shares had not been retired. This would have a double significance; for the holders of such stock would receive less on their claims; and plaintiff would receive a percentage of the remaining assets comparable to that of the stockholders rather than sustain a complete loss, inasmuch as the assets were insufficient even to pay the stockholders alone. This result gives rise to the incidental question of whether, as a matter of policy, plaintiff should be entitled to this preferential treatment, especially in view of the fact that the policy of the law in case of business failures is to treat claimants on an equal basis. In addition, the courts have generally been very partial towards an uncompensated surety;[5] however, on the other hand, they have been strict in denying favorable treatment to a compensated surety.[6] In this case plaintiff is hardly entitled to claim a position as a "favorite of the law"[7] even though he received no premium for making the guaranty; for, since he was the owner of practically all of the common stock, the floatation of the preferred stock issue was beneficial to him inasmuch as additional capital was placed at his disposal. It follows, then, that the conventional idea of justice requires no indulgence in favor of the plaintiff.

Since the policy of the law on the subject of subrogation hardly justifies a ruling in favor of the plaintiff, it remains to be considered whether adherence to the settled rules of law would necessitate a decision for the claimant. In this respect, the court correctly states the dominant rule of law; that is, the right to subrogation does not arise until the surety has paid the debt in full, or until

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[4] In the case of Walters' Palm Toffee, Ltd. v. Walters (1933), Ch. Div. 321, where plaintiff guaranteed payment of dividends and the corporation agreed to repay him on demand, the court held the agreement to be void as contrary to the public policy mentioned. Other cases so holding are: Austin v. Wright (1930), 156 Wash. 24, 286 P. 48; Lockhart v. Van Alstyne (1875), 31 Mich. 76.

[5] State v. Medary (1848), 17 Ohio 565; Birdsall v. Hedcock (1877), 32 Ohio St. 177; Anderson v. Bellenger (1889), 87 Ala. 334, 6 So. 82; Merchants Nat. Bank v. Cole (1910), 83 Ohio 50, 93 N. E. 465. In all of these cases the contract was construed in a manner more favorable to the surety than the language justified.

[6] In the case of People of the City of Detroit v. Blue Ribbon Auto Drivers' Assn. (1931), 254 Mich. 263, 237 N. W. 261, the court makes the following statement: "Bonds of sureties for hire are more strictly construed against them than are bonds against gratuitous sureties." The following cases make similar distinctions in the treatment of the two types of sureties: Rose v. Rann (1931), 254 Mich. 259, 237 S. W. 60; Grinnell Realty Co. v. Surety Co. (1931), 253 Mich. 16, 234 N. W. 125.

[7] Kingsbury v. Westfall (1875), 61 N. Y. 356; Wright v. Johnson (1832), 8 Wend. 512, 11 N. Y. Com. Law Rep. 509.

the creditor is otherwise entirely satisfied.[8] Adherence to this rule requires full satisfaction of the claim before subrogation can be granted; though it is immaterial to what extent the surety is forced to contribute to the satisfaction.[9] In other words, subrogation will not be granted where it will prejudice the claim of the creditor who had the surety's assurance of payment.[10] It is submitted that this policy of not allowing the surety to act in a manner detrimental to the interests of the assured creditor should be the determinating factor in the present case, and that the release should not be permitted to have the effect of putting the released surety in the position to affect injuriously the releasing creditor.[11] Therefore, it appears that the court was correct in denying the right of subrogation to the released surety until the entire claim which he guaranteed was satisfied. R. E. M.