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Guaranty-Scope of the Obligation

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GUARANTY—SCOPE OF THE OBLIGATION.—Appellant brought an action for a declaratory judgment to determine her liability, if any, upon a purported guaranty of preferred stock certificates. Pursuant to a reorganization agreement, the name of a certain corporation was changed to the J. B. Hamilton Furniture Co., and \$170,000 of preferred stock was issued by it and assigned to certain of the appellees. These certificates of preferred stock provided for an *absolute* payment of the par value thereof with cumulative dividends and possible penalties in ten years from the date of issuance. Pursuant to the original contract, the appellant and one J. B. Hamilton executed the following writing upon the back of each of the certificates of preferred stock: "We, the undersigned, guarantee the payment of this certificate of stock according to its terms." The corporation became insolvent and a receiver was appointed. Held, that even though the certificates of preferred stock created no enforceable primary obligation against the corporation, nevertheless the guarantor is liable for the failure to pay the amount thereof.¹

This case raises a fundamental question in the law of Guaranty,² to wit: Is the scope of the guarantor's liability limited to situations where there is involved the debt, default, miscarriage, or other *obligation* of a principal?

518; Standard Casing Co. v. California Casing Co. (1922), 233 N. Y. 413, 135 N. E. 834, Smith v. Marano (1920), 267 Pa. 107, 110 A. 94.

¹⁵ Maffei v. Ginocchio (1921), 299 Ill. 254, 132 N. E. 518; Rosenberg v. Buffum (1922), 234 N. Y. 338, 137 N. E. 609; Smith v. Marano (1920), 267 Pa. 107, 110 A. 94.

¹⁶ Rudin v. King Richardson Co. (1924), 311 Ill. 513, 143 N. E. 119; Ogg v. Shuter (1875), L. R. 10 C. P. 159.

¹⁷ Standard Casing Co. v. California Casing Co. (1922), 233 N. Y. 413, 135 N. E. 834; Rosenberg v. Buffum (1922), 234 N. Y. 338, 137 N. E. 609; Rutojee v. Frame (1923), 205 App. Div. 354, 199 N. Y. S. 523, Robinson v. Houston Ry. Co. (1912), 105 Texas 185, 146 S. W. 537.

¹ Hamilton v. Meiks (Ind. 1936), 4 N. E. (2d) 536.

² For the purposes of this note any possible distinctions between Suretyship and Guaranty will not be considered, for it is believed that the principles discussed will apply to both concepts.

Perhaps a proper approach to this question will not be obtained unless one accepts a bit of cautioning, as put by the Indiana Supreme Court, thus: "There is considerable loose writing in the text books upon the subjects of guaranty and suretyship."³ Some definitions of a surety or guarantor's liability as submitted by eminent judges and text-writers are as follows. J. Cooley: "A surety is a person, who being liable to pay a *debt* or perform an *obligation*, is entitled, if it is enforced against him, to be indemnified by some other person, who ought himself to have made payment or performance before the surety was compelled to do so."⁴ Mr. Brandt says, "A surety or guarantor is one who becomes responsible for the *debt*, *default*, or *miscarriage* of another person."⁵ Mr. Williston says, "Whoever is liable to pay the *debt* of another is a surety."⁶

In accordance with the views of the above mentioned experts, there is much dictum and some authority for the proposition that a guaranty, "in its enlarged sense," is a promise to answer for the payment of some *debt*, or the performance of some *duty*, owed by another, who in the first instance is liable therefor.⁷ Also, it is true that the great majority of guaranty cases which arise are those in which the performance of a legal obligation is the risk assumed by the guarantor's promise. However, it does not follow that the existence of an enforceable primary obligation marks the limits of the scope of the guaranty contract. This conclusion seems to be a necessary deduction from the principal case, and in this respect it is believed to be in accord with the weight of authority in the United States.⁸

A discussion of the authorities will clearly illustrate the above conclusion. An early Indiana case held that a guaranty of a married woman's contract was enforceable against the guarantor notwithstanding that the promise of a feme covert was at that time void.⁹ In *Backus v. Feeks*,¹⁰ where a statute

³ *McMillan v. Bull's Head Bank* (1869), 32 Ind. 11, 13, 2 Am. Rep. 323.

⁴ *Smith v. Shelden* (1876), 35 Mich. 42, 47.

⁵ Brandt, *Suretyship and Guaranty* (3d Ed.), Vol. 1, Sec. 1.

⁶ Williston, *On Contracts*, Vol. 2, Sec. 1211.

⁷ *Burnham v. Gallentine* (1858), 11 Ind. 295; *Merchants Nat. Bank v. Citizens State Bank* (1895), 93 Ia. 650, 61 N. W 1065, *Bishop Press Co. v. Lowe* (1919), 201 Mo. App. 68, 209 S. W 962; *Smith v. Dickerson* (1845), 6 Humph. (Tenn.) 261, 44 Am. Dec. 306, *Kilbride v. Moss* (1896), 113 Cal. 432, 45 P 812; *First Nat. Bank v. Kinner* (1873), 1 Utah 100; *Hooker v. Russell* (1886), 67 Wis. 257, *Reissans v. White* (1907), 128 Mo. App. 135, 106 S. W 603, *Webster v. Metropolitan Washing Machine Co.* (1868), 29 Ind. 453.

⁸ *Davis v. Statts* (1873), 43 Ind. 103, 13 Am. Rep. 382; *Backus v. Feeks* (1913), 71 Wash. 508, 129 P 86, *Sedalia, W & S. R. R. Co. v. Smith* (1837), 27 Mo. App. 371, *Perkins-Goodwin Co. v. Hart* (1912), 83 N. J. 471, 83 A. 877.

⁹ *Davis v. Statts* (1873), 43 Ind. 103, 13 Am. Rep. 382. It is worthy of notice, too, that such a promise was void and not merely voidable, for at least one jurisdiction has attempted to rationalize the question of the guarantor's liability when there is no enforceable primary obligation upon the difference between a "void" and a "voidable" primary obligation. See, J. Sommerville in *Sharnagel v. Furst* (1927), 215 Ala. 528, 128 So. 102. Also, see 12 *Ruling Case Law* 1072.

¹⁰ (1913), 71 Wash. 508, 129 P 86.

made any unacknowledged lease for more than one year a mere tenancy from month to month, the court held a guarantor for the "payment" of rent on an unacknowledged lease for five years, even though the lessee was not bound to the lease and did in fact repudiate it. In *Holm v. Jamieson*,¹¹ a decree of a court of equity had declared a note of a corporation unenforceable because it was not executed by an officer with authority to do so, but nevertheless a guaranty written upon the back of the note was enforceable, and the guarantor was not a director nor in any way connected with the corporation. The cases seem quite uniform in holding a director or officer of a corporation as guarantor upon an *ultra vires* undertaking by the corporation.¹² This result is generally based upon estoppel, the courts holding that the guarantor by his promise represents that the corporation had capacity and that the transaction is a valid one. Where the payment of a note was guaranteed, the guarantor was liable even though the note was a forgery,¹³ a real or inherent defense in the original contract as distinguished from those generally known as personal defenses. So further, there are numerous cases of high authority where the issue was squarely presented, holding the guarantor liable on his contract even though there was no enforceable primary or principal obligation.¹⁴

Some leading encyclopedias of law,¹⁵ after asserting as a well recognized principle, that the guarantor's contract is accessorial and secondary to some other obligation which is the principal or primary one, begin to make exceptions to the rule by saying that where the defect in the primary obligation is "personal," the guarantor is still liable; whereas, if it is "inherent" in the contract, the guarantor is not liable. Another theory reads to the effect that where the principal obligation is "void," the guarantor is not liable; but where it is "voidable" only, the guarantor will be held. Exceptions to these exceptions then ensue. Thus they attempt to rationalize the numerous cases where there never was a primary debt, default, miscarriage, or other legal obligation. Professor Arnold, in a highly respected work upon this subject, divides all contractual obligations into independent and accessorial obligations, the guarantor's contract being of the latter type. Accessorial obligations in turn are divided into primary and secondary duties, and the latter into absolute and conditional duties.¹⁶ He then lists the above cases as excep-

¹¹ (1898), 173 Ill. 295, 50 N. E. 702.

¹² *Krekel v. Thomasma* (1931), 255 Mich. 283, 238 N. W. 255, *Holm v. Jamieson* (1898), 173 Ill. 295, 50 N. E. 702; *Gist and Scott, Adm'rs v. Drakely* (1844), 2 Gill (Mo.) 330, 41 Am. Dec. 426; *Bell v. Kirkland* (1907), 102 Minn. 213, 113 N. W. 271; *Remsen v. Graves* (1869), 41 N. Y. 471, *Bowman Cycle Co. v. Dyer* (1900), 31 Misc. 496, 64 N. Y. S. 551; *Perry v. Brown* (1899), 21 Ky. L. 344, 51 S. W. 457, *Weare v. Sawyer* (1862), 44 N. H. 198.

¹³ *First Nat. Bank v. Bair* (1934), 315 Pa. 463, 173 A. 329; *Veazie v. Willis* (1856), 6 Gray (Mass.) 90.

¹⁴ *Stearns v. Marks* (1862), 35 Barb. (N. Y.) 565; *Krekel v. Thomasma* (1931), 255 Mich. 283, 238 N. W. 255, *Chicago Title & Trust Co. v. Cohen* (Ill. App. 1936), 1 N. E. (2d) 717; *McLaughlin v. McGovern* (1861), 34 Barb. (N. Y.) 208.

¹⁵ 28 C. J. 909; 12 R. C. L. 1072.

¹⁶ Earl C. Arnold, "Primary and Secondary Obligations" (1926), 74 U. Pa. L. R. 36.

tions to the rules, which would play havoc with the concise diagrams drawn by him to illustrate his theory. It is believed that such nomenclature as "personal," "inherent," "secondary," "primary," "void," "voidable," "accessorial," "absolute," "conditional" are of no aid to the practising lawyer, who looks for a working rule of law to serve him as a basis for prediction or draftsmanship. Thus, in the case of an infant one can understand that the defect in the principal undertaking is a personal defect which may be waived by the infant. Also, one might go so far as to concede that a contract of a married woman, void at common law, was still a type of personal defect, i. e., a defect in the person rather than the nature of the contract. However, if a corporation has capacity to execute an instrument or to enter into a certain contract, but the contract nevertheless is void because executed by an officer without authority, is this a "personal" or an "inherent" defect in the contract of the corporation? Also, if a note is forged, is there any defect in any contract more inherent?¹⁷ Yet the courts continually hold a guarantor liable in these cases where to do so is consistent with the terms of the guarantor's contract. Thus it can be seen that a defect is only "personal" because a court said it was; or that a certain promise of a guarantor is "absolute" and not "conditional" only after the court so adjudicates. These words and others of like import are results, not rules of law forming a basis for reasoning upon the facts of a new case.

Perhaps it is possible to point out the reason why the aforementioned text-writers, encyclopedias, and a very few cases assert with such apparent confidence that "a guaranty being collateral to another obligation, there can be no guaranty if there is no principal obligation."¹⁸ In the opinion of the writer, the Statute of Frauds is mainly responsible for the use of such dictum. To it may be added the old, rapidly weakening rule of *strictissimi juris*, by which the device of suretyship was almost entirely obliterated in a commercially minded civilization. It will be noticed that under the Statute of Frauds only such undertakings as promise to answer for the "debt, default, or miscarriages" of another must be in writing. Does it follow that all guaranty contracts must be in writing? Hundreds of cases may be found in the digests where oral guaranty contracts are enforced. Thus, no one will question the rule that an undertaking to answer for the debt, default, or miscarriage of an infant is enforceable as a guaranty contract.¹⁹ Nevertheless, such undertaking need not be in writing, but is enforceable though made orally.²⁰ The same is true of the contracts of married women, or of the *ultra vires* undertakings of corporations.²¹ Thus, it will be seen that in any case involving the Statute of Frauds only that type of guaranty contract

¹⁷ Sec. 23, Negotiable Instrument Law, Burns' 1933, Sec. 19-123.

¹⁸ Merchants Nat. Bank v. Citizens State Bank (1895), 93 Ia. 650, 61 N. W. 1065; State Bank v. Knotts (1856), 10 Rich L. (S. C.) 543, 70 Am. Dec. 234; Smith v. Dickerson (1845), 6 Humph. (Tenn.) 261, 44 Am. Dec. 306; 12 R. C. L. 1072.

¹⁹ McKee v. Hardwood Automotive Co. (Ind. App. 1928), 162 N. E. 62.

²⁰ King v. Summitt (1881), 73 Ind. 312, 38 Am. Rep. 145.

²¹ Kilbride v. Moss (1896), 113 Cal. 432, 45 P. 812; First National Bank v. Kinner (1873), 1 Utah 100; Hooker v. Russell (1886), 67 Wis. 257; Buchanan v. Moran (1892), 62 Conn. 83.

which *necessarily* involves the requirement of an enforceable primary obligation is before the court, for the rule as to the Statute of Frauds is that where there is an enforceable primary obligation against the principal, the guarantor's promise must be in writing; whereas, if there is no enforceable obligation against the principal, the guarantor's promise may be enforced though made orally.²² However, many courts, including an Indiana decision, seeking to enforce an oral promise, have gone far to disprove a guaranty contract entirely, when the only issue involved was such a guaranty as is governed by the Statute of Frauds.²³

How, then, may one determine the limits of the guarantor's contract in any given case? The decision in the principal case answers this question in a concise manner. The court construed the appellant's contract objectively and held that it was the "payment" of the stock which was guaranteed, and not an "obligation" to pay which was guaranteed, for there was no enforceable obligation against the J. B. Hamilton Furniture Co. Thus, it was the "act" of payment and not the "duty" of payment which was guaranteed. In this respect it is consistent with the weight of authority to the effect that in every case we must look to the terms of the guaranty and the circumstances under which it was made to ascertain the character and extent of the undertaking.²⁴ So if by the terms of the contract an "obligation" is guaranteed, then there must be a valid principal obligation in order to hold the guarantor; whereas, if by the terms of the guaranty contract, the performance of an act by a third person is guaranteed, then the guarantor will be liable upon the failure thereof, regardless of whether or not there was a legal obligation to perform the act.

It is believed that the holding in the principal case is based upon a sound, workable rule of law. A different result would tend to "unsettle business transactions to the great detriment of public interests."²⁵ The decision is refreshing in that it refrains from entering upon the dilemma of "accessorial," "primary," "secondary," "absolute," or "conditional" obligations of the guarantor. Furthermore, it assures the use of the guaranty contract as a risk shifting device to gain security in personam.

H. L. T.

²² Browne, Statute of Frauds (1895, 5th ed.), Sec. 156.

²³ Anderson v. Spence (1880), 72 Ind. 315, 37 Am. Rep. 162; Kilbride v. Moss (1896), 113 Cal. 432, 45 P. 812.

²⁴ Welsh v. Ebersole (1881), 75 Va. 651; Backus v. Feeks (1913), 71 Wash. 508, 129 P. 86; Sedalia, W. & S. R. R. Co. v. Smith (1837), 27 Mo. App. 371; Perkins-Goodwin Co. v. Hart (1912), 83 N. J. L. 471, 83 A. 877; McCallister v. Nat. Bank of New Mexico (N. M. 1936), 56 P. (2d) 485; Holm v. Jamieson (1898), 173 Ill. 295, 50 N. E. 702.

²⁵ Holm v. Jamieson (1898), 173 Ill. 295, 50 N. E. 702.