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RIGHT OF A SURETY TO SUBROGATION AFTER PAYMENT ON A NEGOTIABLE INSTRUMENT

BY JOHN E. FOURT

A surety is a promisor in another's behalf. After a surety pays the amount of the obligation to the creditor, he becomes subrogated to all the remedies available to the creditor against the principal debtor. This right of subrogation should include the right to bring action against the principal debtor on any securities held by the creditor evidencing the obligation.

The law of suretyship in California, however, holds that payment by a surety who is either primarily or secondarily liable on a negotiable instrument "extinguishes" the obligation. The paying surety is relegated to his action of assumpsit against his principal debtor, based on an implied in fact promise of reimbursement. This question of remedies is material since the California Statute of Limitations on promisory notes is four years, while the assumpsit statute of limitations is two years. Further, the note may contain provisions allowing the holder to confess judgment, add costs of collections, add interest, and waive defenses.

An accommodation indorser-surety who pays the holder the face amount of the note either before or after maturity, should be able to bring action on the note against the maker-principal debtor to recover the money paid out plus any added costs provided for in the note.

California, in a long line of decisions following Yule vs. Bishop, 6 Cal. Unrep. 513, 62 Pac. 68, 133 Cal. 574, 65 Pac. 1094 (1907), has held contra. In Yule vs. Bishop, Corporation X executed a promissory note to C, on which S was an accommodation indorser. C requested S to pay the note after maturity, and S did so, taking an assignment of the note. S then recovered judgment against the bankrupt maker. The assignee of S then filed action on the note and the judgment against the shareholders to enforce a statutory liability. The California Supreme Court held that payment by S extinguished the obligation, and that the statutory liability of the shareholders could only be enforced by an action in assumpsit, based on the reimbursement rights of a surety against the principal debtor. The court based its decision on Civil Code, Section 1473.

The doctrine of subrogation developed in the English Equity courts, and was early adopted into the common law. Following the custom of London, payment by a surety did not discharge a negotiable instrument. The contrary doctrine was laid down by Lord Elden in Copis vs. Middleton, 1 Turn & R 220 and by Lord Brougham in Hodgson vs. Shaw, 3 Mylne & K 183. The California court found that civil code Section 1473, enacted in 1872, had adopted this later English rule. Parliament changed the English law on this point in the 1856 Mercantile Law Amendment and provided that payment by a surety does not discharge a negotiable instrument.

Civil Code Section 1473 still reads the same in 1949 as in 1907. "Full performance of an obligation, by the party *whose duty it is to perform it*, or by any other person on his behalf, and with his assent, if accepted by the creditor, extinguishes it." (Emphasis added.) Civil Code Section 1474, which was also enacted in 1872 provides that "Performance of an obligation, by one of several persons who are jointly liable under it, extinguishes the liability of all.".

It is suggested that when an accommodation indorser-surety pays the holder of a negotiable instrument as a party secondarily liable, after default of the maker-principal debtor, that the payment extinguishes his liability as indorser-surety, but does not extinguish the primary liability of the maker-principal debtor. The phrase *"whose duty it is to perform it"* should be construed to refer to the principal debtor as between the maker and accommodation indorser, instead of to the person secondarily liable on the note, if the common law rights of a surety as codified in Civil Code sections 2848 and 2849 are to have meaning and effect.

Civil Code Section 2848: "A surety, upon satisfying the obligation of the principal, *is entitled to enforce every remedy* which the creditor then has against the principal to the extent of reimbursing what he has expended, and also to require all his co-sureties to contribute thereto, without regard to the order of time in which they became such." (Emphasis added).

Civil Code Section 2849: "A surety is entitled to the benefit of every security for the performance of the principal obligation held by the creditor, or by a co-surety at the time of entering into the contract of suretyship, or acquired by him afterwards, whether the surety was aware of the security or not."

As a rule of construction, the general Civil Code Section 1473 on extinction of obligations should be harmonized with the more specific code sections 2848 and 2849 concerning the position of sureties.

It is obvious that if the holder-creditor may bring action on the note against the maker-principal debtor, and that the surety after payment may not do so, that the surety is not *entitled to enforce every remedy* available to the creditor as is provided in Civil Code Section 2848.

Where the majority of American jurisdictions cite N.I.L. Sections 119(1), 121, and 121(2) in support of the rule that payment by an accommodation maker or accommodation indorser does not discharge the note, California citing the same sections has held contra. For example see Marston Co. vs. Fisheries Co., 201 Cal. 715, 258 Pac. 933 (1927), where the California Supreme Court cited N.I.L. Sections 120 and 121 (Civil Code Sections 3201 and 3202) without discussion as "not changing the California rule." Texas, in Fox vs. Kroeger, 119 Texas 511, 35 S.W. 2d 679 (1931) allowed the accommodation indorser-surety to be subrogated to the rights of the holder-creditor in filing action on the note against the maker-principal debtor. This court construed the N.I.L. Sections 119(1), 121, and 121(2) as a group

N.I.L. 119(1) provides "A negotiable instrument is discharged by payment in due course by or on behalf of the principal debtor." Section 121 provides "Where the instrument is paid by a party secondarily liable thereon, it is not discharged, but the party so paying it is remitted to his former rights as regards all prior parties, and he may strike out his own and all subsequent indorsements, and again negotiate the instrument, except" N.I.L. 121(2) "where it was made or excepted for accommodation, and has been paid by the party accommodated." The Texas court found that payment by a party secondarily liable does not discharge the instrument by express provision of NII.L. Section 121. This Texas Court construed N.I.L. Section 121(2) to mean that payment by the accommodated party discharges the instrument, but that payment by the accommodating drawer or accomodating indorser does not discharge the instrument.

Another analagous line of cases in California have held that payment by an accommodation maker either before or after maturity of the note extinguishes the obligation, citing Civil Code Section 1473. The California Supreme Court squarely so decided in James vs. Yeager, 86 Cal. 186, 24 Pac. 1005 (1890). It is submitted that the weight of authority has the better view in holding contra. In Pease vs. Syler, 78 Wash. 24, 138 Pac. 310 (1914), the Washington Supreme Court held that the accommodation maker-surety could bring action on the note against his co-maker principal debtor, after paying the holder at maturity. The Washington Supreme Court distinguished the California cases as based on a peculiar statute, and cited the Negotiable Instruments Law Sections 120 and 121(2) as sustaining its position.

It is submitted that the majority rule prevailing outside California in both the American and British courts will best meet the needs of the business community. Both nations have credit economies and laws which will aid the securing of credit risks will be in social favor. Creditors often require borrowers to produce persons as indemnitors on the proposed loan. A person will more likely go surety for a needful borrower if his remedies against the borrower are the equal of the creditor.

Technical arguments buttressing this social policy include the harmonizing of the California Civil Code Sections on extinguishment of obligations with the sections concerning the rights of sureties. The construction given to sections 119(1), 121 and 121(2) by the majority of the American jurisdictions, if adopted in California, would change the present law. Britton: *Bills and Notes*, 1943, at Page 1120, cites the jurisdictions which are contra to the California rule. Bigelow: *Bills, Notes and Checks*, Section 570 and 571, and Brannon: *Negotiable Instruments Law*, Sections 119 and 120, are in accord.