

Impairment of Security by Creditor's Inaction: Effect on the Surety's Liability

DePaul College of Law

Follow this and additional works at: <https://via.library.depaul.edu/law-review>

Recommended Citation

DePaul College of Law, *Impairment of Security by Creditor's Inaction: Effect on the Surety's Liability*, 2 DePaul L. Rev. 81 (1952)
Available at: <https://via.library.depaul.edu/law-review/vol2/iss1/9>

This Comments is brought to you for free and open access by the College of Law at Via Sapientiae. It has been accepted for inclusion in DePaul Law Review by an authorized editor of Via Sapientiae. For more information, please contact wsulliv6@depaul.edu, c.mcclure@depaul.edu.

the appalling number of divorces which threaten so seriously to disrupt our American society.

IMPAIRMENT OF SECURITY BY CREDITOR'S INACTION: EFFECT ON THE SURETY'S LIABILITY

"The surety," says Chancellor Kent, "by his . . . very relation of surety, has an interest that the mortgage [security] taken from the principal debtor, should be dealt with in good faith, and held in trust, . . . as well for the secondary interest of the surety, as for the more direct and immediate benefit of the creditor. . . ."¹

Since, according to Story, a creditor's laches in regard to hypothecated property will not discharge the surety,² a problem arises in the application of the "trust theory" to those circumstances where the creditor receives collateral security and, by his passive negligence, the security is lost or its value impaired.

The early American decision of *Schroepell v. Shaw*,³ established the prevailing view that inaction or laches by a creditor in realizing on security held by him does not discharge the surety. Plaintiff, who was the surety, filed suit in a court of chancery to be relieved of a judgment entered at law in favor of defendant, the creditor. Plaintiff claimed that defendant held securities in the form of bonds and mortgages, but failed to seek foreclosure on the securities for a period of two and one-half years after the obligation matured; that when defendant did seek foreclosure, he failed to docket the decree, permitting other lienors to attach the principal obligor's property; that as a result of defendant's negligence, the securities greatly depreciated in value.

After holding that the court lacked jurisdiction because the plaintiff's claims could have been pleaded as a defense at law, the court said:

No rule is more uniformly recognized than that mere indulgence, at the will of the creditor, however long, or whatever may be the consequences, will not operate to discharge the surety.⁴

Therefore, in reality, dictum became a basis for ruling law.

In the case of *Clopton v. Spratt*,⁵ the creditor's failure to enforce collateral security resulted in such security becoming worthless. The court held that a creditor discharges his duty to the surety so long as he does not perform any affirmative act which would diminish the value of the security; an act of commission will discharge the surety, an omis-

¹ *Hayes v. Ward*, 4 Johns Ch. (N.Y.) 123, 130 (1819) (brackets added).

² 1 Story's Equity Jurisprudence § 501 (11th ed., 1873).

³ 3 N.Y. 446 (1850).

⁴ *Ibid.*, at 461.

⁵ 52 Miss. 251 (1876).

sion will not.⁶ The court reasoned as follows: the surety himself is usually guilty of laches, for he could have made a proper demand upon the creditor to proceed against the security, even to the extent of filing a bill *quia timet* when it seemed likely that the collateral would depreciate or be destroyed by the lapse of time; the surety, by paying the debt, could have taken control of the collateral.⁷ The implication is that since the surety can protect himself against any procrastination of the creditor, the former, by not acting, is as negligent as the latter.

A few cases, while following the ruling in the *Clopton* case, set forth the "possession rule" as the basis for their holdings.⁸ Under this theory, the question of releasing the surety depends on whether the creditor has possession of the pledged property. If the creditor does not have possession, his mere inaction, such as delaying a foreclosure through legal proceedings, does not release the surety. However, if the creditor does have possession, the rule is different. It would appear that, under this theory, greater weight is put on the possession of the property than on the possession of the mortgage, although the latter is the actual item to be utilized in the foreclosure process.

As was previously indicated, the creditor's failure to enforce the collateral in his possession will not discharge the surety. There are other less common situations where the surety has no defense, although the security has been lost or has depreciated in value as a result of the creditor's inaction. These are: failure to insure the mortgaged property, although so authorized;⁹ failure to revive a lien or judgment;¹⁰ failure to pay taxes;¹¹ failure to give notice to the surety of a senior mortgage, resulting in the surety's loss of the right of redemption.¹²

⁶ The following cases are substantially in accord: *First Nat. Bank of Fort Worth v. Brown*, 172 S.W. 2d 151 (Tex. Civ. App., 1943); *Thornton v. Bowie*, 123 Ark. 463, 185 S.W. 793 (1916) (creditor failed to foreclose a chattel mortgage and the property was subsequently destroyed by fire); *Grisard v. Hinson*, 50 Ark. 229, 6 S.W. 906 (1888) (creditor failed to foreclose chattel mortgage on principal's corn); *Freaner v. Yingling*, 37 Md. 491 (1872) (creditor held a mortgage on the stock of the principal's store and permitted the goods to be released from the principal's possession).

⁷ This reasoning was followed in *Yell v. Davis*, 190 Okla. 322, 123 P. 2d 681 (1942), and cases cited therein.

⁸ *Felkner v. Smith*, 77 Utah 410, 296 Pac. 776 (1931); *Dillard v. Chandler*, 157 S.W. 303 (Tex. Civ. App., 1913). However, the case of *First Nat. Bank of Fort Worth v. Brown*, 172 S.W. 2d 151 (Tex. Civ. App., 1943), did not discuss the question of possession.

⁹ *Willard v. Welch*, 94 App. Div. 179, 88 N.Y.S. 173 (S. Ct., 1904); *aff'd* 186 N.Y. 564, 79 N.E. 1118 (1906).

¹⁰ *Campbell v. Sherman. Homet's Appeal*, 151 Pa. 70, 25 Atl. 35 (1892); *Kindt's Appeal*, 102 Pa. 441 (1883).

¹¹ *Wasson v. Hodshire*, 108 Ind. 26, 8 N.E. 621 (1886) (the court said that if the surety remains passive, the creditor can also remain passive).

¹² *Vance v. English*, 78 Ind. 80 (1881).

A contrary view is expressed in the case of *First National Bank v. Kittle*,¹³ wherein it was held that a surety is discharged to the extent of the loss of the security, or pro tanto, where the creditor's inaction causes such loss. In that case, plaintiff sued defendant, who was surety on a promissory note. The principal obligor had assigned a \$200.00 contract for work he had done on a county court building as security for the debt. The plaintiff failed to give notice of such assignment and the security was lost. The court stated that the authorities cited to the effect that a creditor is not bound to active diligence in pursuing the principal debtor was inapplicable to the determination of whether the creditor has any duty in respect to collateral securities. The court said:

. . . the creditor [is] bound to use proper care and *diligence* in the management and collection of such collateral, and . . . a surety is released, to the extent of the loss, actually sustained, by the negligence of the creditor, to the same extent as if lost by the positive act of the creditors.¹⁴

In Pennsylvania, it was held that the creditor's failure to revive a lien or judgment will not discharge a surety;¹⁵ nevertheless, the creditor's failure to collect on the collateral by proceeding on a bond,¹⁶ or by seeking a share of land at a sheriff's sale was held to discharge the surety.¹⁷ The apparent inconsistency in this jurisdiction exemplifies the confusion prevalent in this phase of the law.

Despite the prevailing view that the creditor's passiveness with regard to the security will not discharge the surety, an "exception" seems to have arisen in certain situations. Where the creditor fails to perform trivial or nominal acts at a time when the surety does not have the opportunity to act, the surety will be discharged pro tanto.¹⁸ The most common example of this "exception" is where the creditor receives a mortgage as collateral security, and, in failing to perform the slight act of recording, the security is lost.

The case of *Burr v. Boyer*¹⁹ is the leading decision applicable to these circumstances. Plaintiff held, as security, a chattel mortgage on the personal property of the principal debtor. A statute required the filing of chattel mortgages when the mortgagee does not take possession of the property. The plaintiff failed to record the mortgage, and the defendant, as surety, set up as a defense the fact that, due to the plaintiff's inaction, the principal debtor squandered and disposed of the property. The lower

¹³ 69 W. Va. 171, 71 S.E. 109 (1911).

¹⁴ *Ibid.*, at 174 and 110 (italics and brackets added).

¹⁵ Authority cited supra note 10.

¹⁶ *Kemmerer v. Wilson*, 31 Pa. 110 (1857).

¹⁷ *Clow to use, etc. v. Derby Coal Co.*, 98 Pa. 432 (1881).

¹⁸ *Rest., Security* § 132(c) (1941).

¹⁹ 2 Neb. 265 (1870).

court held for the plaintiff on the pleadings, and the Supreme Court of Nebraska affirmed the decision. While the court denied relief to the defendant on grounds not relevant to this discussion, it gave a good deal of consideration to the defendant's contention, and this portion of the decision has been followed in many subsequent cases.

The court's discussion was based on the proposition that the value of this type of security depends on whether it is filed. Although the Nebraska Court was cognizant of the rule expounded in the *Schroepfel* case, it sought another principle to apply to the facts involved—one which would be fair and equitable. It was reasoned that:

. . . he [the creditor] should be held responsible for the loss of any security arising from his wrongful act, *either of omission or commission*. . . . The plaintiff, and not the sureties on the note, took the mortgage. The very taking of it carries with it the idea that it was given for a purpose. That purpose should only be effectual by the further act of filing it. Can he who has taken the security stop short, and omit to do that which makes it chiefly valuable, under the excuse that others did not urge him to file it, or furnish the pittance necessary to pay the recorder?²⁰

The court supplemented this reasoning with a quote from that portion of the *Schroepfel* case dealing with the neglect of a creditor in filing a mortgage upon personal property, after it was taken by him as security on the debt:

"In these and in similar cases, surety, whose means of indemnity had been impaired by the neglect of the creditor to do what was necessary to protect the security, might well insist upon his right to be discharged to the extent of the loss sustained by reason of such neglect."²¹

Therefore, even in the *Schroepfel* case, it is recognized that the most equitable result would be achieved if the creditor were held to the duty of filing or recording the mortgage he holds as security.

The majority rule is that the passive negligence of the creditor in failing to record a mortgage held as security on the debt discharges the surety, to the extent of his injury.²² However, this "exception" is not

²⁰ *Ibid.*, at 271 (italics added).

²¹ *Ibid.*, at 273.

²² *Lewis v. Paul Brown Realty & Investment Co.*, 354 Mo. 1025, 193 S.W. 2d 13 (1946) (while the majority rule is that if the creditor fails to record the mortgage, the surety is released to the extent of his loss, the surety is not released if he fails to prove any loss or damage resulting from the creditor's omission); *Commercial Credit Corp. v. Joseph Greco Motor Co.*, 16 So. 2d 660 (La. C.A., 1944); *Mulvihill v. First Nat. Bank*, 80 Colo. 72, 249 Pac. 504 (1926) (where the creditor failed to record stock, taken as security, on the corporation's books, it was held that the law implies an agreement by the creditor to do an act without which the pledged security is invalid); *Nunn v. Smith*, 194 S.W. 406 (Tex. Civ. App., 1917) (the court cited the Burr case as the leading case in the United States pertaining to this phase of the law); *Redlon*

universally accepted. Those cases which do not adhere to it are based on the principle that since a creditor never has to take affirmative action, his mere inaction will not discharge the surety.²³

The problem involved, with respect to the creditor's conduct regarding security, does not exist where the creditor agrees to do certain acts which would affect such security. Applying simple contract law, the creditor's failure to perform discharges the surety, if such failure results in loss of the security.²⁴

An examination of the cases discloses the existence of a "conflict" in this field of law. While there is almost complete agreement as to the effect of the more usual kinds of inaction, confusion arises because the decisions seem to offer no rationale to explain the actual conclusions. The "conflict" seems to lie in theory rather than in result.

In considering this type of a case, the courts seem to seek the most equitable result while still giving effect to principles of suretyship law. Apparently, relief will be given to a surety when immediate action is required to preserve the security, such action being of slight import or nominal expense. While courts seem reluctant to impose affirmative acts upon the creditor, the security, out of which the surety might seek reimbursement, may need protection. Therefore, the courts usually place some type of duty on the creditor—whether it be one of preserving perishable goods,²⁵ or recording a mortgage. However, the extent to which the creditor must act to fulfill this duty usually depends on the facts and circumstances of each individual case.

v. Heath, 59 Kan. 255, 52 Pac. 862 (1898) (the jury found that the creditor promised to record the mortgage at the time the defendant became surety); Sullivan v. State, 59 Ark. 47, 26 S.W. 194 (1894). There is an apparent split on this question in New York. The majority rule was followed in *Auto Brokerage Co. v. Morris & Smith Auto Co.*, 106 Misc. 147, 174 N. Y. Supp. 188 (S. Ct., 1919); a contra decision was reached in *Westchester Mortgage Co. v. T. B. M'Intire, Inc.*, 174 App. Div. 525, 161 N.Y. Supp. 384 (1916).

²³ *Osage Oil & Refining Co. v. Dickason—Goodman Lumber Co.*, 108 Okla. 14, 231 Pac. 475 (1924); *Bank of Hickory Flat v. Crawford*, 132 Miss. 350, 96 So. 100 (1923) (The law to this effect is well settled in Mississippi); *Philbrooks v. McEwen*, 29 Ind. 347 (1868); *Hampton v. Levy*, 1 McCord Eq. (S.C.) 107 (1825) (the creditor waited 17 years before suing the surety and never filed the mortgage security of the debt).

²⁴ *Hubbard v. Pace*, 34 Ark. 80 (1879) (creditor failed to retain crops on which he had a lien despite a retention clause in the note); *Walker and Hewett v. Goldsmith*, 7 Ore. 161 (1879).

²⁵ In *Grisard v. Hinson*, 50 Ark. 229, 6 S.W. 906 (1888), the court refused to discharge the surety when the creditor failed to enforce the collateral, but said, at pp. 235 and 907, "If . . . in [the] case of the security consisting of perishable property, he [the creditor] allows it to be taken out of his possession and destroyed, or if for the want of ordinary care and attention, he allows it to perish and become worthless . . . the surety should be exonerated to the extent of the injury."