

**AFTER THE GUARANTOR PAYS:  
THE UNCERTAIN EQUITABLE DOCTRINES OF  
REIMBURSEMENT, CONTRIBUTION, AND  
SUBROGATION**

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*Author's Synopsis: This Article addresses the equitable doctrines of reimbursement, contribution, and subrogation as they apply to guarantors and other secondary obligors. Specifically, it explores in detail guarantors' and other secondary obligors' rights after they make payment under the guaranty or other secondary obligation and then seek to recover some or all of the amount paid from the borrower, other guarantors, or the collateral for the primary obligation. This article discusses the inconsistencies in the case law on these subjects, which can create unpredictable results. It concludes that, when multiple parties are liable on a common debt, in whatever capacity, they should enter into appropriate reimbursement and contribution agreements at the outset of the transaction to avoid litigation and unpredictable outcomes.*

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## I. INTRODUCTION

This Article explores the somewhat complex and often surprising law that governs the rights of a guarantor after it makes payment under the guaranty and then seeks to recover some or all of the amount paid from the borrower, other guarantors, or the collateral provided by the borrower to the lender. It focuses on situations involving independent or substantially independent parties. It does not address the different concerns that arise where there is a professional surety, such as a bonding company, or where the borrower and guarantor are members of groups of wholly-owned affiliated companies.

The Restatement (Third) of Suretyship & Guaranty (Am. Law Inst. 1996)<sup>1</sup> (the Restatement) has a wealth of information about the matters

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<sup>1</sup> The Restatement is the successor to the Restatement of Security (1941), which is cited in many older cases dealing with guaranty and suretyship issues.

discussed in this Article as well as extensive citations to case authority. It is an outstanding resource and will be cited frequently in this Article.

The terminology used in this area of the law can be confusing. The Restatement uses the term “secondary obligor” as the catchall term for guarantors and other types of sureties. In this Article, the terms secondary obligor and “surety” are used interchangeably and each includes both guarantors and other types of secondary obligors.<sup>2</sup> Section 1 of the Restatement defines a secondary obligor by reference to “an obligee [that] has recourse against a person (the ‘secondary obligor’) or that person’s property with respect to the obligation (the ‘underlying obligation’) of another person (the ‘principal obligor’) to that obligee”<sup>3</sup> where certain other conditions stated in that section are met, including that “as between the principal obligor and the secondary obligor, it is the principal obligor who ought to perform the underlying obligation or bear the cost of performance.”<sup>4</sup> Where the foregoing terms defined in Restatement section 1 are used in this Article, they have the meaning given to them in that section.

Much of the discussion in this Article applies to other types of secondary obligors in addition to guarantors. For ease of reading, it often refers to “guarantor” and “borrower” although the concepts discussed apply to other types of secondary obligors as well.

This Article covers the secondary obligor’s rights *after* it pays on the secondary obligation under the following equitable doctrines:

- (1) *Reimbursement* (the right to repayment in full by the principal obligor; sometimes referred to as “*indemnification*”);
- (2) *Contribution* (the right to repayment in part by other cosureties);  
and
- (3) *Subrogation* (the right to step into the shoes of the creditor with respect to collateral and certain other rights).

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<sup>2</sup> Much of the case law discussing differences between suretyship and guaranty is confused and confusing. The Restatement concludes that: “Differences between these two mechanisms have been the subject of extended debate, not all of which is illuminating.” RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 cmt. c (AM. LAW INST. 1996) and cases cited therein. The discussion in this Article treats guaranty as a subset of suretyship.

<sup>3</sup> RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1(1)(a).

<sup>4</sup> *Id.* § 1(1)(c).

This Article does not deal with the surety's rights *before* paying on the secondary obligation such as exoneration (the right to compel the principal obligor to perform, which arises only *upon* the underlying obligation becoming due and payable)<sup>5</sup> and *quia timet* (a remedy for breach of the principal obligor's duty to refrain from conduct that impairs the surety's expectation that the borrower will perform, which arises *before* the underlying obligation becomes due and payable).<sup>6</sup> Claims of exoneration and *quia timet* are much less commonly litigated than those for reimbursement, contribution, and subrogation.

The operation of the doctrines discussed in this Article is often uncertain and unpredictable in practice, and the reported cases are highly inconsistent. However, the parties can enter into agreements that vary the common law and statutory default rules that apply in the absence of a controlling agreement,<sup>7</sup> and they should almost always do so. The cases discussed in this Article will highlight the need to enter into such agreements whenever multiple parties are liable (or provide security) for the same obligation, in whatever capacity. Those cases will also provide examples of the grief that can come to parties who do not have agreements clearly spelling out how the ultimate liability on the underlying obligation will be shared by the parties.

In some situations, sureties should even consider entering into such agreements with parties that have *no* obligation with respect to the underlying obligation. For example, suppose a bank makes a loan to a closely held corporation and requires the 60% shareholder in the borrower to guarantee the loan, but does not require a guaranty from the 40% shareholder. The 60% shareholder and its counsel should consider whether it is appropriate to ask the 40% shareholder to agree to bear 40% of any amount paid by the 60% shareholder under the guaranty. Absent such an agreement, the equitable principles discussed in this Article give the guarantor shareholder no recourse at all against the nonguarantor shareholder.

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<sup>5</sup> See *id.* § 21.

<sup>6</sup> See *id.* § 21 cmt. j. A *quia timet* claim could be made, for example, for a borrower's engaging in fraudulent transfers prior to the underlying obligation becoming due and payable. Note that these claims can be made between guarantors as well as between a guarantor and the borrower. See, e.g., *Nissenberg v. Felleman*, 162 N.E.2d 304, 306–07 (Mass. 1959); *McCarthy v. Schwalje*, 560 A.2d 1283, 1284 (N.J. Super. Ct. Ch. Div. 1988); *Gardner v. Bean*, 677 P.2d 1116, 1118 (Utah 1984).

<sup>7</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 6 ("Each rule in this Restatement stating the effect of suretyship status may be varied by contract between the parties subject to it.").

## II. PRELIMINARY ISSUE: WHO IS A SURETY?

### A. Examples of Types of Sureties

The doctrines discussed in this Article are relevant in a number of common situations that can create suretyship relationships and that range far afield from the typical borrower-guarantor situation. Secondary liability can exist in almost any situation where there are multiple parties obligated (or providing security) for the same obligation, including the following situations:

- (1) One party grants collateral to secure the underlying obligation but does not have personal liability for it.<sup>8</sup>
- (2) One party provides a letter of credit to back the underlying obligation but does not have personal liability for it.<sup>9</sup>
- (3) A party assumes liability on a loan or a lease from the original borrower or tenant, but the original borrower or tenant is not released from liability.<sup>10</sup>
- (4) One spouse in a marital dissolution takes full responsibility for a debt that was formerly the obligation of both spouses, but the non-assuming spouse is not released from liability to the creditor.<sup>11</sup>
- (5) Two or more parties become comakers of a promissory note or other obligation, and both receive some of the benefits of the underlying obligation.<sup>12</sup>
- (6) Two or more parties become comakers of a promissory note or other obligation, but only one party, the “accommodated party,” receives the benefits of the underlying obligation.<sup>13</sup>

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<sup>8</sup> See *id.* § 1 cmt. g; see also CAL. CIV. CODE § 2787 (“A surety or guarantor is one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.”) (All statutory citations in this Article refer to the current statute unless otherwise indicated.)

<sup>9</sup> See U.C.C. § 5-117 cmt. 1, 2B pt. 2 U.L.A. 383 (2002) (recognizing that suretyship status may exist in the situation described, but this code section does not grant it).

<sup>10</sup> See, e.g., *Gholson v. Savin*, 31 N.E.2d 858, 861–62 (Ohio 1941) (involving a lease); *Hemenway v. Miller*, 807 P.2d 863, 864–66 (Wash. 1991) (involving a loan).

<sup>11</sup> See *Hanson v. Hanson*, 350 P.2d 859, 860–61 (Wash. 1960) (treating post-dissolution, former spouses as co-debtors with contribution rights as to undisclosed liabilities).

<sup>12</sup> See, e.g., *Knight v. Wirotzious*, 495 F.2d 543, 544–45 (5th Cir. 1974).

- (7) As a credit enhancement device, an affiliate of the borrower of a commercial real estate loan enters into a master lease of the property under which it agrees to pay substantial rent for the entire property, even if it is unable to lease the property to subtenants.<sup>14</sup>

It is important to understand that, in a particular transaction, the same party may be both a principal obligor and a secondary obligor.<sup>15</sup> For example, if two parties both sign the same promissory note evidencing a loan and each receives a portion of the proceeds of the loan, as between themselves, each will be a principal obligor for the portion of the loan proceeds it received and a secondary obligor for the portion the other received.<sup>16</sup> This is true regardless of the fact that they may be jointly and severally liable to the payee of the note.

#### B. *Honey v. Davis*: A Case Study

The various opinions in the Washington Supreme Court case of *Honey v. Davis*<sup>17</sup> present an excellent example of the struggle courts sometimes engage in when trying to determine if a particular party is a secondary obligor entitled to reimbursement, contribution, or subrogation where there is no express agreement between the parties on these subjects. They also highlight the dangers in not having such an agreement.

The case involved a land owner who entered into a forty-year ground lease with a developer-tenant who intended to expand a shopping center located on adjacent land owned by the tenant.<sup>18</sup> The tenant obtained a

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<sup>13</sup> See U.C.C. § 3-419 (amended 2010), 2A pt. II U.L.A. 441 (2004). The other comakers to the promissory note or other obligation, who do not receive benefits under the underlying obligation, are known as “accommodation part[ies].” *Id.*

<sup>14</sup> See 2 ROGER BERNHARDT ET AL., CALIFORNIA MORTGAGES, DEEDS OF TRUST AND FORECLOSURE LITIGATION § 9.107 (4th ed. 2015); Douglas P. Snyder, *Master Leases in Financing Transactions*, REAL PROP., TR. & EST. L. EREPORT (Dec. 2006), [http://www.americanbar.org/content/newsletter/publications/rpte\\_e\\_report\\_home/SnyderMasterLeases.html](http://www.americanbar.org/content/newsletter/publications/rpte_e_report_home/SnyderMasterLeases.html).

<sup>15</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 cmt. o (AM. LAW. INST. 1996).

<sup>16</sup> See *Crimmins v. Lowry*, 691 S.W.2d 582, 585 (Tex. 1985).

<sup>17</sup> 930 P.2d 908 (Wash. 1997) (en banc), *appealed by* 937 P.2d 1052 (Wash. 1997), *rev'g* 896 P.2d 1303 (Wash. Ct. App. 1995).

<sup>18</sup> See *Honey*, 896 P.2d at 1304.

construction loan to finance the expansion onto the leased land.<sup>19</sup> As required by the terms of the lease, the landlord executed the deed of trust that secured the loan and thereby encumbered the fee interest to secure the tenant's loan.<sup>20</sup> The landlord did not take on personal liability for the loan and did not receive any of the loan proceeds.<sup>21</sup> The lease provided that the landlord would own the improvements at the end of the lease term without any payment.<sup>22</sup> The lease did not provide for how the loss would be apportioned if the lender foreclosed on the property.<sup>23</sup> When the project failed, the bank foreclosed on the interests of both the landlord and the tenant.<sup>24</sup> The landlord sued the tenant seeking reimbursement for the value of the landlord's interest in the property, which was lost in the foreclosure.<sup>25</sup> The landlord took the position that it was a surety for the loan and that the tenant was the principal obligor.<sup>26</sup> The tenant denied that the landlord was a surety.<sup>27</sup>

The trial court held that the landlord was not a surety and was, therefore, not entitled to be reimbursed by the tenant.<sup>28</sup> The trial court dismissed the landlord's complaint on a motion for summary judgment.<sup>29</sup>

The intermediate court of appeals reversed the trial court, and all three appellate judges joined in deciding that, as between the landlord and the tenant, the landlord was a surety and was entitled to reimbursement as a matter of law.<sup>30</sup> The court of appeals stated that "[i]t is clear that [the tenant], rather than [the landlord], is the principal obligor and, as such, should have been the one to perform the obligation."<sup>31</sup> It went on to state that "the fact the surety stood to benefit from the transaction does not preclude surety status[.]" that "a compensated surety may enter a suretyship contract solely because it intends to benefit from

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<sup>19</sup> See *id.* at 1305.

<sup>20</sup> See *id.*

<sup>21</sup> See *id.*

<sup>22</sup> See *id.* at 1304.

<sup>23</sup> See *id.* at 1305.

<sup>24</sup> See *id.*

<sup>25</sup> See *id.*

<sup>26</sup> See *id.*

<sup>27</sup> See *id.*

<sup>28</sup> See *id.*

<sup>29</sup> See *id.*

<sup>30</sup> See *id.* at 1307.

<sup>31</sup> *Id.* at 1305.

the agreement[.]” and that, although the landlord “may have benefited indirectly[.]” the “primary benefit of the contract” went to the tenant.<sup>32</sup>

The Washington Supreme Court reversed the appellate court’s decision, but rendered three separate opinions.<sup>33</sup> The majority (five of the nine justices) held that the landlord was not a surety and did not have a right of reimbursement.<sup>34</sup> The majority opinion pointed out that there was “no written agreement establishing a principal-surety relationship”<sup>35</sup> and that “evidence of consideration for an obligation flowing to both obligors belies a contention that either is a surety.”<sup>36</sup> The majority also emphasized the fact that the landlord stood to gain from the loan by receiving improvements to the property at the end of the lease term and increased rent during the term as a result of the improvements.<sup>37</sup> Even if the court was correct on that point,<sup>38</sup> it did not consider the possibility that the landlord and the tenant should be considered co-obligors, which would have been the better analysis.<sup>39</sup> Had the court done so, it would have had to decide whether the loss should be shared between the parties in accordance with the values of their respective interests in the property—which was the practical effect of the majority ruling—or in some other manner based on the equities of the case and the relative values of the benefits received by each party from the loan.

One justice wrote a concurring opinion concluding that the landlord was “plainly a surety”<sup>40</sup> but that it would not be equitable to require reimbursement or allow subrogation to the rights of the lender in the absence of an agreement between the parties providing such a remedy.<sup>41</sup> That opinion noted that the case involved a commercial property with a value of approximately nine million dollars.<sup>42</sup>

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<sup>32</sup> *Id.* at 1306.

<sup>33</sup> *See Honey v. Davis*, 930 P.2d 908, 913 (Wash. 1997).

<sup>34</sup> *See id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 911.

<sup>37</sup> *See id.* at 912.

<sup>38</sup> It is hard to imagine that, in a commercial context, a party would ever guarantee or become a surety for another party’s debt without receiving a substantial direct or indirect benefit for doing so.

<sup>39</sup> *See Crimmins v. Lowry*, 691 S.W.2d 582, 585 (Tex. 1985); RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 1 cmt. o (AM. LAW INST. 1996).

<sup>40</sup> *Honey*, 930 P.2d at 913 (Talmage, J., concurring).

<sup>41</sup> *See id.*

<sup>42</sup> *See id.* at 914.



The dissenting opinion, joined by three justices, argued that the landlord was a surety and entitled to reimbursement.<sup>43</sup> It stated that, where “the main consideration . . . flowed” to the tenant, and the landlord “merely benefited secondarily,” the landlord is appropriately viewed as a surety.<sup>44</sup> The dissent went on to criticize the concurrence’s view that a surety is not entitled to reimbursement without a contractual provision to that effect and stressed that reimbursement is an equitable remedy that is available without the need for a contract:

The Honeys, as sureties, are entitled as a matter of law to reimbursement precisely *because* they did not specifically assign the risk of loss in the contract. “[C]ontracting parties are generally deemed to have relied on existing state law pertaining to interpretation and enforcement.” A surety who pays the obligation of the principal is entitled to indemnification. The right to indemnification arises not out of the language of the contract, but is implied by law. The Honeys were not required to further assign the risk of contract breach because the common law of surety, derived from equitable considerations, already provides that they are entitled to reimbursement from the principal, Mid-Valley. A court does not write a new contract for the parties when it recognizes a surety’s common law right of indemnification; it merely construes the existing one according to established criteria.<sup>45</sup>

The *Honey v. Davis* case is an excellent example of the confusion, uncertainty, and unintended consequences that can result when parties liable for the same underlying obligation do not clearly allocate by contract the ultimate responsibility for the obligation among themselves.

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<sup>43</sup> *Id.* at 914–16 (Sanders, J., dissenting).

<sup>44</sup> *Id.* at 916.

<sup>45</sup> *Id.* (citations omitted).

### III. REIMBURSEMENT

The equitable doctrine of reimbursement is the right of a secondary obligor to be repaid in full by the principal obligor.<sup>46</sup> Sections 22 through 25 of the Restatement deal with the right of reimbursement.

#### A. When Does the Right to Reimbursement Arise?

The right of reimbursement arises on the later of the due date of the underlying obligation or payment by the secondary obligor.<sup>47</sup> Thus, if a secondary obligor pays before the underlying obligation is due and payable, it is not entitled to be reimbursed by the principal obligor until the due date. This could occur, for example, if a lender is concerned about a borrower's future performance and enters into a settlement with the guarantor before a default by the borrower.

The surety's right of reimbursement from the principal obligor arises even if the surety has paid only part of the underlying obligation.<sup>48</sup> It also arises in favor of a surety that has paid contribution to another surety.<sup>49</sup>

Restatement section 24 deals with cases where the right of reimbursement does not arise.<sup>50</sup> It includes situations where bankruptcy law relieves the principal obligor of the reimbursement obligation, the principal obligor lacked capacity to enter into the underlying obligation, the surety failed to assert certain defenses, and the creditor released the principal obligor from liability under certain circumstances.<sup>51</sup>

#### B. How Much is the Guarantor Entitled to be Reimbursed?

The measure of reimbursement is the reasonable cost of performance by the guarantor including incidental expenses.<sup>52</sup> The reimbursable expenses include (1) interest imposed on the guarantor due to the borrower's default, (2) expenses in determining the existence of defenses, (3) expenses asserting colorable defenses available to the borrower, and (4) attorneys' fees in performing the obligation (but not

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<sup>46</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 22 (AM. LAW INST. 1996).

<sup>47</sup> See *id.*

<sup>48</sup> See *id.* § 22 cmt. b.

<sup>49</sup> See *id.* § 58; *Randles v. Hanson*, 258 P.3d 1154, 1159 (N.M. 2011).

<sup>50</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 24.

<sup>51</sup> See *id.*

<sup>52</sup> See *id.* § 23.

including attorneys' fees to enforce the right of reimbursement against the borrower).<sup>53</sup>

The Restatement does not address the obligation of the borrower to pay interest on the amount of the reimbursement claim from the time the right of reimbursement arises until it is paid by the borrower, nor does there appear to be much recent case law on the subject.<sup>54</sup> Presumably, the guarantor's entitlement to that interest would be dependent on the law of the applicable jurisdiction concerning prejudgment interest and interest on judgments generally.<sup>55</sup> As with other aspects of the equitable doctrines discussed in this Article, this obligation should be addressed in any reimbursement agreement between the borrower and the guarantor.

### C. Effect of Release of the Borrower by the Creditor

It is not uncommon for the creditor to enter into a settlement with the borrower and to release the borrower from the debt with the expectation that the creditor will be able to pursue the guarantor for the unpaid amount.<sup>56</sup> Sections 38 and 39 of the Restatement deal with the effect on the guarantor's liability of the creditor's release of the borrower from liability on the underlying obligation.<sup>57</sup> Those sections contain what are probably the most confusing and difficult to understand provisions in the Restatement. They provide that the creditor's release of the borrower has two additional effects absent adequate contractual provisions to avoid those effects.<sup>58</sup>

First, the release of the borrower also discharges the liability of the guarantor on the guaranty unless "the terms of the release effect a preservation of the secondary obligor's recourse," pursuant to Restatement section 38, or "the language or circumstances of the release otherwise show the obligee's intent to retain its claim against the secondary obligor."<sup>59</sup> Of course, this discharge is typically waived in the guaranty document and such waivers should be enforced.<sup>60</sup>

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<sup>53</sup> See *id.* § 23 cmt. a.

<sup>54</sup> See *id.*

<sup>55</sup> See *Smith v. Johnson*, 23 Cal. 63, 64–65 (1863).

<sup>56</sup> See, e.g., *Lestorti v. Delco*, 4 A.3d 269, 273 (Conn. 2010).

<sup>57</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY §§ 38-39.

<sup>58</sup> See *id.*

<sup>59</sup> *Id.* § 39(b).

<sup>60</sup> See *id.* §§ 6, 48(1); see also *Data Sales Co. v. Diamond Z Mfg.*, 74 P.3d 268, 269 (Ariz. Ct. App. 2003); *Columbia Bank v. New Cascadia Corp.*, 682 P.2d 966, 968 (Wash. Ct. App. 1984).

Second, that release discharges the borrower from the duty to reimburse the guarantor unless the terms of the release provide otherwise.<sup>61</sup> This right of discharge is usually not waived by the borrower unless there is a reimbursement agreement containing such a waiver.<sup>62</sup> Without an express waiver by the borrower, the guarantor can be required to pay the creditor without a right of reimbursement from the borrower.<sup>63</sup>

Article 3 of the Uniform Commercial Code contains similar provisions regarding situations where multiple parties are liable on a negotiable promissory note.<sup>64</sup>

Related issues can arise where the creditor allows the statute of limitations to run as to the borrower<sup>65</sup> or takes enforcement actions against collateral that have the legal effect of releasing the borrower from liability without the creditor giving a contractual release.<sup>66</sup>

In many cases where there are multiple obligors for the same obligation, some or all of whom may have rights as sureties, the parties do not adequately address the effect of these kinds of releases in the contract, which can lead to litigation and unexpected outcomes.<sup>67</sup>

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<sup>61</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 39(a).

<sup>62</sup> See *id.*

<sup>63</sup> See *id.*

<sup>64</sup> See U.C.C. § 3-605, 2A pt. 2 U.L.A. 603 (2004) (discussed at length in 2 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §§ 17:31-71:40 (6th ed. 2013)).

<sup>65</sup> See *Regents of the Univ. of Cal. v. Hartford Accident & Indem. Co.*, 581 P.2d 197, 205 (Cal. 1978) (holding that a surety that pays an obligation that is time-barred against the primary obligor, but not against the surety, still has a right of reimbursement from the primary obligor); *cf.* RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 43 and related reporter's note (taking the opposite view, but recognizing divergent case authority on the issue).

<sup>66</sup> Compare WASH. REV. CODE § 61.24.100(11) (stating that a guarantor retains reimbursement rights against a borrower where the guarantor pays a deficiency judgment even though the borrower is relieved of direct liability for deficiency by an antideficiency statute), *with* *Union Bank v. Gradsky*, 71 Cal. Rptr. 64, 69 (1968) (holding that a guarantor has no reimbursement right in that situation). In *Western Security Bank v. Superior Court*, the California Supreme Court criticized statements in *Gradsky* that had this effect as “unnecessary” and “suggesting a much broader rule than its holding and analysis warranted.” 933 P.2d 507, 518 (Cal. 1997). The significance of that criticism is uncertain.

<sup>67</sup> See *Lowe v. Albertazzie*, 516 S.E.2d 258, 259–60 (W. Va. 1999).

#### IV. CONTRIBUTION AMONG COSURETIES

Where there are multiple guarantors or other sureties and one pays more than its properly allocable contributive share of the common debt, it can have a right of contribution against the others.<sup>68</sup> A cosurety with rights of contribution is entitled to payment by the relevant cosureties upon payment of more than its contributive share of the common obligation.<sup>69</sup>

A panoply of issues arise in determining whether a paying cosurety has contribution rights and, if so, in what amounts.

##### A. Are the Sureties Cosureties or Something Else?

When there are multiple sureties for the same underlying obligation, it is necessary to determine whether the sureties are cosureties or subsureties. If they are cosureties, they can be liable for contribution among themselves such that each is required to bear its contributive share of the aggregate amounts paid by the cosureties on the common obligation.<sup>70</sup> If, on the other hand, one surety is a subsurety and another surety is a principal surety, then between the two, the principal surety has primary liability for the common obligation and the subsurety has secondary liability for it.<sup>71</sup> In that situation, the subsurety has a right of full reimbursement from the principal surety and the principal surety has no right to any repayment from the subsurety.<sup>72</sup> As with all of the default rules described in the Restatement, the parties are free to enter into an agreement to allocate liability between themselves either as cosureties or as principal and subsurety, and that agreement “may be express or may be inferred from the circumstances.”<sup>73</sup>

Subsections (a) and (b) of Restatement section 53(4) describe certain circumstances that demonstrate a subsuretyship relationship in the absence of an agreement to the contrary.<sup>74</sup> Although the provisions of those subsections are rather lengthy and complex, they are quite vague,

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<sup>68</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY §§ 55-58.

<sup>69</sup> See *id.* § 55.

<sup>70</sup> See *id.* § 53 cmt. b.

<sup>71</sup> See *id.*

<sup>72</sup> See *id.* §§ 53, 59-60; see also *Lowe*, 516 S.E.2d at 266 (stating that between 1945 and 1999, only nine states' courts addressed the distinction between cosuretyship and subsuretyship in reported opinions).

<sup>73</sup> RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 53(2); see *id.* § 6.

<sup>74</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 53(4)(a)-(b).

involving inquiries such as whether one surety “reasonably believes” that it is a subsurety or whether, between the two sureties, “one rather than the other obligor ought to perform or bear the cost of performance.”<sup>75</sup>

Case law reveals several instances in which courts may find a subsuretyship:

- (1) Where one party guarantees a specific debt of the principal obligor and another guarantees that debt and a broader set of the principal obligor’s debts, the latter may be held to be a subsurety to the former as to the specific debt guaranteed by the former.<sup>76</sup>
- (2) Where there are serial assumptions of a secured loan (for example, by successive buyers of a mortgaged property), the earlier parties are not released from liability at the time of the assumption, and the last assuming borrower defaults.<sup>77</sup> For example, a mortgagor (Seller) may sell the mortgaged property to Buyer 1, who assumes and agrees to pay the mortgage debt and later sells the property to Buyer 2, who also assumes and agrees to pay the debt. In such a situation, as among Seller, Buyer 1, and Buyer 2, Buyer 2, being the last party to assume the debt, is the principal obligor, Buyer 1 is the principal surety, and Seller is the subsurety.
- (3) Where one guarantor has no interest, or a more remote interest than another guarantor, in the borrower.<sup>78</sup>
- (4) Where a guarantor acts inequitably toward other guarantors.<sup>79</sup> It seems that this could be a basis for finding that a guarantor who

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<sup>75</sup> *Id.* § 53(4)(b)(i)-(ii).

<sup>76</sup> *See id.* § 53(4)(c); Schinnell v. Doyle, 496 P.2d 566, 570 (Wash. Ct. App. 1972).

<sup>77</sup> *See* Swanson v. Krenik, 868 P.2d 297, 298–99 (Alaska 1994); RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 5.1 (AM. LAW INST. 1997).

<sup>78</sup> *Compare* Cook v. Crabtree, 733 S.W.2d 67, 70 (Tenn. 1987) (holding ex-spouse of shareholder in borrower as a subsurety), *with* Franco v. Peoples Nat’l Bank of Wash., 693 P.2d 200, 206 (Wash. Ct. App. 1984) (holding that guarantors who were never shareholders in borrower were not subsureties as to shareholder guarantors).

<sup>79</sup> *See* Amphibious Partners, LLC v. Redman, 534 F.3d 1357, 1361–62 (10th Cir. 2008) (requiring guarantors who excluded another guarantor from the business and retained funds earned by the business to bear full amount of guaranteed debt); Tindall v. Holder, 892 S.W.2d 314, 324 (Mo. Ct. App. 1994) (“As the right to contribution depends upon equitable principles, it is a right that may be lost by a wrongful or negligent act by a co-guarantor.”); *see also* Collins v. Throckmorton, 425 A.2d 146, 149–50 (Del. 1980) (quoting ARTHUR A. STEARNS, THE LAW OF SURETYSHIP, § 11.24 (5th ed. 1951)) (“Equity

triggers liability for itself and another guarantor under a “bad acts” guaranty of a nonrecourse loan thereby becomes a principal surety with a full reimbursement obligation to the innocent guarantor.

- (5) It has been held that a person who signs a promissory note as an accommodation party is a principal surety with respect to a guarantor, and the guarantor is a subsurety as to the accommodation maker.<sup>80</sup>

Although it did not address the question in terms of subsuretyship, the California Court of Appeals in *Morgan Creek Residential v. Kemp*<sup>81</sup> held that a party that obtained a bank letter of credit (referred to as an “applicant” in U.C.C. Article 5)<sup>82</sup> to back a development loan did not have a right of contribution from other parties that guaranteed the loan.<sup>83</sup> The court held that the letter of credit applicant was not entitled to contribution because the letter of credit created a “different level of liability” from that created by the guaranties.<sup>84</sup> The court, in a rather muddled discussion, emphasized the independence principle applicable to letters of credit and the fact that a guarantor has suretyship defenses and a letter of credit issuer does not.<sup>85</sup> However, the court did not seem to take into account the fact that the plaintiff in the case was not the issuer of the letter of credit; rather, plaintiff was the applicant that obtained the issuance of the letter of credit from the issuing bank and agreed to reimburse the bank for any draw on the letter of credit.<sup>86</sup> Further, the court did not seem to consider the fact that loan guarantors are universally required to waive all suretyship defenses in the guaranty and

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requires that ‘where one of two or more obligors in suretyship aids in the commission of a default by the principal, either by his negligence or his active misconduct, he cannot assert a claim in contribution.’”)

<sup>80</sup> Compare *Irish v. Woods*, 864 N.E.2d 1117, 1124 (Ind. Ct. App. 2007) (finding subsuretyship), with *Rodehorst v. Gartner*, 669 N.W.2d 679, 687 (Neb. 2003) (finding no subsuretyship). It is far from clear why this situation, without more, would justify a finding of a subsuretyship.

<sup>81</sup> 63 Cal. Rptr. 3d 232 (Cal. Ct. App. 2007).

<sup>82</sup> U.C.C. § 5-102(a)(2) (amended 2003), 2B pt. 2 U.L.A. 138 (2002).

<sup>83</sup> See *Morgan Creek*, 63 Cal. Rptr. 3d at 243.

<sup>84</sup> *Id.*

<sup>85</sup> See *id.* at 240–41.

<sup>86</sup> See *id.* at 235; cf. *In re B.C. Rogers Poultry, Inc.*, 2009 WL 3856428 (Bankr. S.D. Miss. 2009) (ruling that the independence principle does not preclude subrogation).

undoubtedly did so in the guaranties at issue in the case.<sup>87</sup> The court also found California Civil Code section 2787, which provides in part that a “letter of credit is not a form of suretyship obligation,” to be important.<sup>88</sup> However, that statute seems inapposite as it does not address the relationship between the letter of credit applicant and other secondary obligors of the underlying obligation backed by the letter of credit.

The *Morgan Creek* court’s ruling has been criticized by commentators,<sup>89</sup> and it raises troubling questions about the circumstances that could lead a court to conclude that one secondary obligor is a principal surety and another is a subsurety. For example, if one guarantor’s guaranty has broader waivers of suretyship defenses than another guarantor’s, would the *Morgan Creek* court hold that the former is a principal surety without contribution rights against the latter?

#### B. How is Each Cosurety’s Contributive Share Determined?

Section 57(1) of the Restatement sets out the basic rule for determining the share of the common debt each cosurety is required to contribute:

Subject to subsection (2) [which deals with guaranties of only part of the underlying debt and insolvent guarantors], and to any express or implied agreement between or among the cosureties, a cosurety’s contributive share is the aggregate liability of the cosureties to the obligee divided by the number of cosureties.<sup>90</sup>

Stated somewhat differently, each cosurety is allocated an equal share of the guaranteed debt unless the guarantors have expressly or impliedly agreed otherwise. This rule is stated in a deceptively simple fashion. It has many complexities, both in determining the amount of the aggregate

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<sup>87</sup> Apparently, the guaranties themselves were not part of the record on appeal. *See Morgan Creek*, 63 Cal. Rptr. 3d at 243.

<sup>88</sup> CAL. CIVIL CODE § 2787 (West 2012).

<sup>89</sup> *See, e.g.*, ROGER BERNHARDT, INEQUITABLE NONCONTRIBUTION (Nov. 2007), <http://rogerbernhardt.com/index.php/ceb-columns/193-ineq-noncontrib> (last visited Feb. 23, 2016); Dan Schechter, *Applicant for Letter of Credit May Not Seek Equitable Contribution from Guarantors Because Letter of Credit is Not a Guarantee*, 2007 COMM. FIN. NEWS 60 (2007).

<sup>90</sup> RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 57(1) (AM. LAW INST. 1996).



liability to be allocated and in determining the portion to be allocated to each coguarantor.

*1. How is the Aggregate Liability Determined?*

Generally, the aggregate liability is the total amount of the underlying guaranteed obligation remaining after application of (1) payments made by the borrower and (2) proceeds of collateral provided by the borrower.<sup>91</sup>

The amount of the aggregate liability to be allocated for contribution purposes does not change if one guarantor settles with the creditor for a lower amount unless that guarantor obtains a release of liability not only for itself but also for the other guarantors, even if the other guarantors ultimately pay nothing (for example, because the statute of limitations runs on the creditor's claims against them).<sup>92</sup>

The 2010 Connecticut Supreme Court case of *Lestorti v. DeLeo*<sup>93</sup> provides a good illustration of these principles. In that case, the guarantors jointly and severally guaranteed a bank loan secured by a mortgage on the borrower's real property.<sup>94</sup> The bank brought a foreclosure action.<sup>95</sup> It also made claims on the guaranties of two of the guarantors, Lestorti and DeLeo, but failed to make proper service on DeLeo.<sup>96</sup> The trial court determined that the amount owing to the bank was approximately \$2.4 million, that the mortgaged property was worth \$295,000, and that Lestorti, the guarantor whom the bank had properly served, was liable for a deficiency judgment.<sup>97</sup> DeLeo was released from liability to the bank by operation of law due to the bank's failure to properly serve him before the statute of limitations ran.<sup>98</sup> Lestorti entered into a settlement with the bank in which he paid it \$275,000 and was released from the remainder of the deficiency judgment.<sup>99</sup> He then made a claim

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<sup>91</sup> See, e.g., *Humphrey v. O'Connor*, 940 P.2d 1015 (Colo. App. 1996); *Lestorti v. DeLeo*, 4 A.3d 269 (Conn. 2010); *Thomas v. Jacobs*, 751 A.2d 732 (R.I. 2000).

<sup>92</sup> See *id.* cases cited *supra* note 91.

<sup>93</sup> 4 A.3d 269 (Conn. 2010).

<sup>94</sup> See *id.* at 272.

<sup>95</sup> See *id.* at 273.

<sup>96</sup> See *id.*

<sup>97</sup> See *id.*

<sup>98</sup> See *id.*

<sup>99</sup> See *id.*

against DeLeo seeking contribution in the amount \$137,500, or one-half the amount Lestorti paid the bank to settle his deficiency liability.<sup>100</sup>

The trial court concluded that, because only Lestorti was liable for the deficiency judgment and DeLeo was not, Lestorti had no equitable right of contribution from DeLeo.<sup>101</sup>

On appeal, the intermediate appellate court held that the bank's failure to obtain personal jurisdiction over DeLeo impaired Lestorti's right to contribution from DeLeo and, therefore, the bank would not have been entitled to a deficiency judgment against Lestorti for more than his contributive share of the aggregate liability, in this case one-half of the gross deficiency or over \$1,050,000.<sup>102</sup> It went on to hold that because the amount Lestorti paid in the settlement was less than his own contributive share of the aggregate liability, he was not entitled to contribution from DeLeo.<sup>103</sup>

On further appeal, the Connecticut Supreme Court agreed with the appellate court that Lestorti was not entitled to contribution from DeLeo unless he paid more than his properly determined contributive share of the entire obligation. The Supreme Court stated:

[A] guarantor's right of contribution from a coguarantor arises only when the guarantor "has paid in excess of *his share of the whole* [outstanding] obligation," and the amount of contribution he is entitled to collect is limited to "the amount he has paid *in excess of his share of the whole* [outstanding] obligation." (Emphasis added.) *Waters v. Waters*, supra, 110 Conn. at 345, 148 A. 326. The reason for this limitation is that, in Connecticut, "[a] guarantor, as between himself and his co-guarantors, is a principal for the portion of the debt which he ought to pay and is a surety [or secondary obligor] for the remainder . . ." *Bristol Bank & Trust Co. v. Broderick*, 122 Conn. 310, 315, 189 A. 455 (1937). Thus, when a coguarantor has made a payment to the creditor in an amount that is *less than his share of the whole outstanding obligation*, he

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<sup>100</sup> See *id.*

<sup>101</sup> See *id.*

<sup>102</sup> See *id.* at 273–74.

<sup>103</sup> See *id.*

has *no right to contribution* from the other coguarantors.  
[Footnotes omitted.]<sup>104</sup>

Two justices joined in a concurring and dissenting opinion in which they stated that they would have allowed Lestorti to recover half of the amount he paid the bank from DeLeo notwithstanding DeLeo's release by operation of law.<sup>105</sup>

The ultimate result of *Lestorti v. DeLeo* was that, after extensive litigation, one guarantor paid a substantial amount to settle his liability to the lender and another guarantor was relieved of all liability on the transaction.<sup>106</sup> A contribution agreement between the guarantors could have been drafted to avoid that result in an equitable manner.

## 2. How is Each Guarantor's Contributive Share Determined?

### a. Basic Allocation Methods: Equal Per Capita vs. Pro Rata

#### (1) Equal Per Capita Method

Once the aggregate liability is determined, the amount of the contributive share of each guarantor must be assigned. The default rule of Restatement section 57(1) is that, in the absence of an express or implied agreement to the contrary, the aggregate liability is "divided by the number of cosureties" to arrive at the contributive share of each.<sup>107</sup> Many cases have applied that "per capita" rule.<sup>108</sup> Where a married couple and another individual, whether married or not, guarantee the same obligation, a question arises as to whether the married couple should be assigned one contributive share or two under this rule. Few courts have decided that issue, but the courts that have tend to hold that the married couple is assigned two shares.<sup>109</sup>

<sup>104</sup> *Id.* at 275–76.

<sup>105</sup> *See id.* at 287.

<sup>106</sup> *See id.* at 272 n.3, 283 n.14.

<sup>107</sup> RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 57(1) (AM. LAW INST. 1996).

<sup>108</sup> *See, e.g.,* *Wetzler v. Cantor*, 202 B.R. 573, 579 (D. Md. 1996); *Curtis v. Cichon*, 462 So. 2d 104, 105–06 (Fla. Dist. Ct. App. 1985); *Slutsky v. Lefft*, 609 N.Y.S.2d 528, 530 (N.Y. Civ. Ct. 1993); *Miller v. Miles*, 400 S.W.2d 4, 7 (Tex. Civ. App. 1966); *Brill v. Swanson*, 674 P.2d 211, 213 (Wash. Ct. App. 1984).

<sup>109</sup> *See Jans v. Nelson*, 100 Cal. Rptr. 2d 106, 115 (Cal. Ct. App. 2000) (holding each spouse allocated a separate per capita share by trial court; appellate court allocated according to equity interests); *Weitz v. Marram*, 366 A.2d 86, 89–90 (Md. 1976) (holding

(2) *Pro Rata Method by Equity Interests*

Some cases have allocated contributive shares pro rata on the basis of ownership interests in the borrower rather than per capita based on the number of guarantors.<sup>110</sup> That approach is consistent with the rule established in section 401(b) of the Revised Uniform Partnership Act that “[e]ach partner . . . is chargeable with a share of the partnership losses in proportion to the partner’s share of the profits.”<sup>111</sup> Comment 3 to that section explains that this “rule, carried over from the [prior Uniform Partnership Act], is predicated on the assumption that partners would likely agree to share losses on the same basis as profits, but may fail to say so.”<sup>112</sup> One would think that would be true of guarantors of the debt of a commonly owned business as well and that, if the guarantors were to negotiate a contribution agreement, they would very often agree to allocate contribution rights on the basis of their percentage ownership interests in the business.

b. *Other Factors Affecting Allocation*

Several other factors can also affect the contributive share allocated to each guarantor, including the following:

(1) *Limited Guaranties*

Where a guaranty caps the maximum liability of one guarantor to the creditor at an amount less than that guarantor’s share of the debt had it been a guaranty of the full amount of the loan, the shares of full guarantors of the loan whose guaranties do not contain such a limitation should be recalculated by deducting the limited guarantor’s maximum

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each spouse allocated a separate per capita share); *see also In re Wetzler*, 192 B.R. 109 (Bankr. D. Md. 1996); *Mansfield v. McReary*, 497 P.2d 654, 655 (Or. 1972); RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 57 cmt. e (AM. LAW INST. 1996) (“Where there are different groups of cosureties, each group is considered as a unit in determining the amount of contribution.”).

<sup>110</sup> *See, e.g., Jans*, 100 Cal. Rptr. 2d at 113–14 (holding there can be pro rata allocation only if all equity owners are guarantors); *Steele v. Grot*, 503 S.E.2d 92, 93–94 (Ga. Ct. App. 1998); *Citizens State Bank v. Bossard*, 733 P.2d 1296, 1298 (Mont. 1987); *Betz v. Fagan*, 962 S.W.2d 432, 437 (Mo. App. 1998); *Brown v. Goldsmith*, 437 P.2d 247, 248 (Okla. 1968); *see also Green Leaves Rest. v. 617 H St. Assocs.*, 974 A.2d 222, 233 (D.C. 2009) (remanding to trial court for determination of allocation method).

<sup>111</sup> UNIF. P’SHP ACT § 401(b), 6 pt. 1 U.L.A. 85 (1997).

<sup>112</sup> UNIF. P’SHP ACT at § 401(b) cmt. 3.

liability from the amount of the aggregate liability and reallocating the resulting amount among the full guarantors.<sup>113</sup>

(2) *Insolvency, Death, or Unavailability*

The Restatement provides that

When, because of insolvency, lack of personal jurisdiction, or other reasonable circumstances, the contribution obtained from a cosurety after reasonable collection efforts is less than that cosurety's contributive share, the contributive shares of the other cosureties as among themselves are recalculated pursuant to subsection 2(a) [the rule dealing with limited guarantors discussed above] as though the secondary obligation of the former cosurety limited its liability to the contribution obtained from that cosurety.<sup>114</sup>

(3) *Effect of Waivers in Guaranties*

Waivers of contribution, subrogation, and reimbursement in guaranties may be enforced in favor of the borrower and coguarantors as well as in favor of the creditor.<sup>115</sup> In some cases, nonpaying guarantors have argued that guaranty provisions allowing the lender to release one or more guarantors without impairing its recourse against the others results in a waiver of contribution rights in favor of a paying guarantor.<sup>116</sup> Courts have reached inconsistent results on this argument.<sup>117</sup>

(4) *Purchase of the Loan by a Coguarantor*

It is not uncommon for a guarantor to purchase a loan from the creditor, take an express assignment of the loan documents, and try to enforce them against the other guarantors as if it were a third party

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<sup>113</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 57(2)(a).

<sup>114</sup> *Id.* § 57(2)(b).

<sup>115</sup> See, e.g., *In re Buckhead Oil Co., Inc.*, 454 B.R. 242 (Bankr. N.D. Ga. 2011); *Harris v. Shelton*, 837 So. 2d 283, 285 (La. 2002); *Kandlis v. Huotari*, 678 A.2d 41, 42 (Me. 1996).

<sup>116</sup> See *United States v. Immordino*, 534 F.2d 1378, 1382 (10th Cir. 1976).

<sup>117</sup> Compare *First Am. Bank of N.Y. v. Fallova Shredder Co.*, 587 N.Y.S.2d 119, 120 (N.Y. App. Div. 1992) (finding no waiver of contribution rights), with *Immordino*, 534 F.2d at 1382 (finding waiver of contribution rights) and *United States v. S. Cycle Accessories, Inc.*, 567 F.2d 296, 297 (5th Cir. 1978) (finding waiver of contribution rights).

creditor. Such an approach should, and almost always does, fail, and the purchasing guarantor should be limited to the contribution rights that would apply if no purchase had occurred or something similar to such rights.<sup>118</sup> The same result should obtain when a coguarantor uses a straw buyer to buy the loan.<sup>119</sup> The court in *Sterling Savings Bank v. Emerald Development Co.* noted a split in the cases: some courts allowed the buying guarantor to enforce the assigned loan documents, but limited the recovery against each coguarantor to its individual contributive share. Other courts held that the buying guarantor cannot enforce the assigned loan documents, but rather must sue the other guarantors on a contribution theory.<sup>120</sup>

(5) *Effect of Defenses Available to Guarantors*

Where the paying guarantor fails to assert a defense to its guaranty, should that be a defense to payment of contribution by other guarantors? Does it matter if the other guarantors have the same defense? Where one guarantor unsuccessfully asserts a defense, should the other coguarantors have to contribute to the costs incurred by the creditor or the defending guarantor in doing so? Does it matter if assertion of the defense was made in good faith or was a reasonable strategy? These are tricky issues in contribution agreements, and there is a paucity of case law dealing

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<sup>118</sup> See, e.g., *In re Basil St. Partners*, 2012 WL 6101914, \*16–18 (Bankr. M.D. Fla. Dec. 7, 2012); *Curtis v. Cichon*, 462 So. 2d 104, 105 (Fla. Dist. Ct. App. 1985); *Irish v. Woods*, 864 N.E.2d 1117, 1123 (Ind. Ct. App. 2007); *Mandolfo v. Chudy*, 573 N.W.2d 135, 137 (Neb. 1998); *Sterling Sav. Bank v. Emerald Dev. Co.*, 338 P.3d 719, 728 (Or. Ct. App. 2014); *Lavender v. Bunch*, 216 S.W.3d 548, 551 (Tex. App. 2007); *Byrd v. Nelms*, 154 S.W.3d 149, 158 (Tex. App. 2004); *Pioneer Mining & Ditch Co. v. Davidson*, 190 P. 242, 246 (Wash. 1920); see also *Koeniger v. Lentz*, 462 So. 2d 228, 228–29 (La. Ct. App. 1984) (paying guarantor who is subrogated to rights of paid off lender is limited to recovering individual contributive shares from coguarantors).

<sup>119</sup> See *Mediclaim, Inc. v. Groothuis*, 834 N.Y.S.2d 200, 201 (2007) (holding straw buyer had no claim against coguarantors; only claim was one for contribution by the coguarantor who arranged the purchase and lent funds to the straw buyer to finance it); *Sterling Sav. Bank*, 338 P.3d at 737 (holding a straw buyer controlled by a guarantor can enforce guaranties of other guarantors, but only to the extent of their individual contributive shares). But see *FDIC v. Mutual Comm'ns Assocs., Inc.*, 784 A.2d 970, 978 (Conn. App. Ct. 2001) (showing how a guarantor apparently successfully evaded this rule by having his wife and attorney buy the loan through a limited liability company for ten percent of par and sell it to a subsequent buyer); see also *Terracino v. Gordon & Hillier*, 1 A.3d 97 (Conn. App. Ct. 2010) (involving a guarantors' malpractice suit against their attorneys); *Terracino v. Fairway Asset Mgmt.*, 815 A.2d 157 (Conn. App. Ct. 2003) (*new trial denied*).

<sup>120</sup> See *Sterling Savings*, 338 P.3d at 727–28.

with them. It seems that a reasonable approach in a contribution agreement would be to provide that the guarantors are free to litigate or decline to litigate defenses as long as they do so in good faith, and if they do litigate defenses in good faith, they are entitled to add the reasonable costs of the litigation to the aggregate amount to be divided into the contributive shares of the guarantors.

### 3. *Interest and Attorneys' Fees*

Absent an agreement to the contrary, interest accrues on a contribution claim at the legal rate on judgments, not at the rate borne by the underlying guaranteed debt.<sup>121</sup> Also, without an agreement for the recovery of attorneys' fees on a successful claim for contribution, a party pursuing such a claim must bear its own fees.<sup>122</sup> However, courts have split on the issue of whether attorneys' fees and interest at the rate borne by the underlying obligation can be recovered by a coguarantor who buys the underlying obligation and is allowed to enforce it against the other coguarantors up to their individual contributive shares, rather than by pursuing an action for contribution.<sup>123</sup>

### 4. *Federal Income Tax Considerations*

For recourse liabilities in the tax sense (that is, liabilities to the extent that a partner, limited liability company member, or related person, bears the "economic risk of loss" due, for example, to guaranteeing the liability of a partnership or LLC), the amount of the debt included in each partner's basis is the amount of the debt for which that partner or related person bears the economic risk of loss. A partner bears the economic risk of loss for a partnership liability to the extent that, in a "constructive liquidation" of the partnership—a liquidation in which the partnership's assets are worthless and all of its liabilities became payable in full—the partner (or related person) would be obligated to make a payment to any person (or a contribution to the partnership) and would not be entitled to

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<sup>121</sup> See *Appleford v. Snake River Mining, Milling & Smelting Co.*, 210 P. 26, 28 (Wash. 1922); *Bushnell v. Bushnell*, 46 N.W. 442, 444 (Wis. 1890).

<sup>122</sup> See *Wetzler v. Cantor*, 192 B.R. 109, 119 (Bankr. D. Md. 1996); *Appleford*, 210 P. at 30.

<sup>123</sup> Compare *Estate of Frantz v. Page*, 426 N.W.2d 894, 901–02 (N.D. 1988) (holding that the recovery of interest at contract rate under loan documents was allowed), with *Collins v. Throckmorton*, 425 A.2d 146, 151–52 (Del. 1980) (holding that the recovery of attorneys' fees and interest pursuant to terms of loan documents was not allowed, but the recovery of interest at judgment rate was allowed).

reimbursement from another partner (or person related to another partner).<sup>124</sup> Thus, a guarantor's basis can be adversely affected if, for example, a 90% member of an LLC is allocated a 50% contributive share because a court applies the per capita default rule of Restatement section 57(1). A contribution agreement should be drafted with these tax considerations in mind.

## V. SUBROGATION

Subrogation is the equitable right to be treated as the assignee of the underlying obligation,<sup>125</sup> and a subrogated guarantor is entitled to an actual assignment of the loan documents.<sup>126</sup> As a general matter, the paying guarantor is subrogated to the creditor's rights against the borrower, other guarantors, collateral, etc.<sup>127</sup> However, some courts have called this fairly simple proposition into question. For example, in *Regents of the University of California v. Hartford Accident and Indemnity Co.*,<sup>128</sup> the California Supreme Court held that "a surety who pays the principal debt extinguishes that obligation and thus cannot sue the debtor as subrogee of the original debt."<sup>129</sup> The Restatement criticizes that result.<sup>130</sup> The right of subrogation also has a tortured history in the Texas Supreme Court.<sup>131</sup>

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<sup>124</sup> See generally Treas. Reg. § 1.752-2. If the aggregate economic risk of loss that all partners bear with respect to a liability exceeds the amount of the liability, then the economic risk of loss borne by each partner will be a proportionate amount of that aggregate economic risk of loss. See Prop. Treas. Reg. § 1.752-2, 78 Fed. Reg. 76092 (Dec. 16, 2013).

<sup>125</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY §§ 27-31 (AM. LAW INST. 1996); RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 7.6 (AM. LAW INST. 1997).

<sup>126</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 28 cmt. h; RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 7.6 cmt. a (1997); see also *Weitz Co. v. Heth*, 333 P.3d 23, 28–29 (Ariz. 2014); *Weast v. Arnold*, 474 A.2d 904, 911–12 (Md. 1984); *Reimann v. Hybertsen*, 550 P.2d 436, 437 (Or. 1976).

<sup>127</sup> See U.C.C. § 9-618 (amended 2015), 3 U.L.A. 718 (2010); RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 28.

<sup>128</sup> 581 P.2d 197 (Cal. 1978).

<sup>129</sup> *Id.* at 204.

<sup>130</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 28 cmt. b.

<sup>131</sup> See, e.g., *Fox v. Kroeger*, 35 S.W.2d 679 (Tex. 1931).



Generally, the right of subrogation arises only upon satisfaction of the *entire* underlying obligation.<sup>132</sup> If a guarantor guarantees only a part of the underlying obligation, then even if the guarantor pays the full amount guaranteed, no right of subrogation exists until the entire underlying obligation is paid, including the unguaranteed amount.<sup>133</sup> Notwithstanding the general rule, cases exist in which courts have allowed subrogation without payment of the entire underlying obligation. The Arizona Supreme Court recognized a class of cases in which subrogation was allowed after partial payment in *Weitz Co. v. Heth*.<sup>134</sup> There, a bank made a \$62 million construction loan to finance the construction of a condominium project.<sup>135</sup> The loan documents provided for the partial release of individual condominium units from the lien of the deed of trust securing the construction loan upon the closing of unit sales.<sup>136</sup> After the sale of eighty-five units, the general contractor on the project recorded a mechanic's lien against the entire project, including the sold units.<sup>137</sup> The mechanic's lien had priority over the interests of the unit buyers and their lenders, but not over the lien of the construction lender's deed of trust, from which the units were released upon sale.<sup>138</sup> The construction lender's deed of trust remained in effect as a lien on the unsold units in the project.<sup>139</sup> The unit owners and their lenders asserted a right to subrogation to the released lien of the construction loan deed of trust with respect to their individual units although the construction loan had not been repaid in full.<sup>140</sup> The court recognized the general rule that, in order for subrogation to be granted, the holder of the underlying obligation must have been paid in full; however, the court allowed the unit

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<sup>132</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27 cmt. b. *But see* ARIZ. REV. STAT. § 12-1643 (“When a person who is surety on an undertaking is compelled to pay a judgment *or part thereof*, or makes a payment upon a judgment by reason of suretyship, such judgment shall not be discharged by such payment but shall remain in force for the use of the surety and shall be considered as assigned to the surety together with all rights of the creditor thereunder to the extent of the payment made by the surety, and interest thereon.”) (emphasis added).

<sup>133</sup> See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27 cmt. b.

<sup>134</sup> 333 P.3d 23 (Ariz. 2014).

<sup>135</sup> See *id.* at 26.

<sup>136</sup> See *id.*

<sup>137</sup> See *id.*

<sup>138</sup> See *id.*

<sup>139</sup> See *id.*

<sup>140</sup> See *id.*

owners and lenders to be subrogated to the released lien of the construction deed of trust as to their individual units.<sup>141</sup> In doing so, the court stated:

We agree with the Owners and Lenders, however, that a prospective subrogee is required to discharge only the portion of an obligation that is secured by the property at issue. The complexities and equities attendant to dividing security between the original obligee and the subrogee do not exist when the original obligee has released its lien against the property.<sup>142</sup>

Interest on a subrogation claim (as opposed to a claim for contribution or reimbursement) may be at the contract rate on the underlying obligation rather than the statutory judgment rate.<sup>143</sup>

U.C.C. section 5-117 addresses the subrogation rights of an applicant that obtains the issuance of a letter of credit to back an underlying obligation. The applicant receives a right of subrogation to the rights of the beneficiary of the letter of credit upon the applicant's reimbursement of the issuer of the letter of credit:

(a) *An issuer that honors a beneficiary's presentation is subrogated to the rights of the beneficiary to the same extent as if the issuer were a secondary obligor of the underlying obligation owed to the beneficiary and of the applicant to the same extent as if the issuer were the secondary obligor of the underlying obligation owed to the applicant.*

(b) *An applicant that reimburses an issuer is subrogated to the rights of the issuer against any beneficiary, presenter, or nominated person to the same extent as if the applicant were the secondary obligor of the obligations owed to the issuer and has the rights of subrogation of the issuer to the rights of the beneficiary stated in subsection (a).*<sup>144</sup>

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<sup>141</sup> See *id.* at 29.

<sup>142</sup> *Id.*

<sup>143</sup> See *Simpson v. Gardiner*, 97 Ill. 237, 241–42 (1881).

<sup>144</sup> U.C.C. § 5-117, 2B pt. 2 U.L.A. 184 (2013) (emphasis added).

Official Comment 1 to U.C.C. section 5-117 clarifies the intent of its provisions:

By itself this section does not grant any right of subrogation. It grants only the right that would exist if the person seeking subrogation “were a secondary obligor.” . . . If the secondary obligor would not have a right to subrogation in the circumstances in which one is claimed under this section, none is granted by this section. In effect, the section does no more than to remove an impediment that some courts have found to subrogation because they conclude that the issuer’s or other claimant’s rights are “independent” of the underlying obligation.<sup>145</sup>

In *Morgan Creek Residential v. Kemp*,<sup>146</sup> the California Court of Appeals dealt with a situation in which an applicant provided a \$1.4 million letter of credit to back a portion of a \$6.5 million development loan. The loan was also guaranteed by several guarantors each of whom guaranteed a portion of the overall loan amount.<sup>147</sup> Those partial guarantees were in various amounts ranging from \$400,000 to \$1.6 million, and aggregated \$4.8 million.<sup>148</sup> After the loan went into default and the letter of credit was drawn, the applicant sued the guarantors seeking contribution and subrogation.<sup>149</sup> As discussed in Part IV.A of this Article, the court denied contribution rights to the applicant on what appears to have been an implicit subsuretyship theory, although the court did not use that terminology. The court discussed U.C.C. section 5-117, but denied subrogation rights to the applicant as against the guarantors stating that it would not allow the applicant “by subrogation, to circumvent Civil Code section 2787.”<sup>150</sup> The court stated that U.C.C. section 5-117 “might allow plaintiff to go after the debtors on the underlying obligation, but it does not allow plaintiff to go after Kemp and Haws as mere guarantors.”<sup>151</sup> The key to the court’s ruling on the subrogation claim also appears to

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<sup>145</sup> U.C.C. § 5-117 cmt. 1, 2B pt. 2 U.L.A. 383 (2002).

<sup>146</sup> 63 Cal. Rptr. 3d 232 (Cal. Ct. App. 2007).

<sup>147</sup> *See id.* at 235.

<sup>148</sup> *See id.*

<sup>149</sup> *See id.* at 236–37.

<sup>150</sup> *Id.* at 245.

<sup>151</sup> *Id.* at 247.

have been its view that the letter of credit applicant had a different (and apparently higher) “level of liability” than the guarantors and that, therefore, the applicant had no right of subrogation that would allow it to seek payment of a contributive share from the guarantors.<sup>152</sup>

The Oregon Court of Appeals dealt with a similar factual situation in *Ochoco Lumber Co. v. Fibrex & Shipping Co.*,<sup>153</sup> a case that was not cited by the *Morgan Creek* court. The *Ochoco Lumber* case involved a situation in which Fibrex was the borrower of a loan from a bank.<sup>154</sup> The bank required that the loan be guaranteed by Fibrex’s sole shareholder and his wife and that it be further supported by a letter of credit in the full principal amount of the loan.<sup>155</sup> The letter of credit was provided by Ochoco, a customer of Fibrex, in connection with its agreement to buy timber from Fibrex.<sup>156</sup> Fibrex defaulted on the loan, the bank drew against the letter of credit, and Ochoco sued Fibrex and the guarantors claiming it should be subrogated to the bank’s rights under the loan documents.<sup>157</sup> The court considered arguments similar to those made by the guarantors in *Morgan Creek*, but held, under Oregon law (including Oregon’s version of U.C.C. section 5-117),<sup>158</sup> that Ochoco was entitled to subrogation against both the principal obligor and the guarantors, and remanded the case to the trial court for further proceedings.<sup>159</sup> Unlike the court in *Morgan Creek*, the *Ochoco Lumber* court did not view the independence principle or the nature of a letter of credit transaction as a sound basis for denying the applicant status as a secondary obligor entitled to subrogation.<sup>160</sup> The reported decision dealt only with subrogation and did not address possible rights of reimbursement or contribution.

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<sup>152</sup> *Id.* at 239–40.

<sup>153</sup> 994 P.2d 793 (Or. Ct. App. 2000).

<sup>154</sup> *See id.* at 794.

<sup>155</sup> *See id.*

<sup>156</sup> *See id.*

<sup>157</sup> *See id.*

<sup>158</sup> *See id.* at 795.

<sup>159</sup> *See id.* at 797.

<sup>160</sup> *See id.* at 796–97.

## VI. BANKRUPTCY CONSIDERATIONS

### A. Allowance of Claims for Reimbursement, Contribution, and Subrogation

The Bankruptcy Code<sup>161</sup> has two provisions that relate specifically to reimbursement, contribution, and subrogation.

Bankruptcy Code section 502(e)(1) provides that:

[T]he court shall disallow any claim for reimbursement or contribution of an entity<sup>162</sup> that is liable with the debtor on or has secured the claim of a creditor, to the extent that—(A) such creditor’s claim against the estate is disallowed; (B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution; or (C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.<sup>163</sup>

Subsection 502(e)(2) goes on to provide that such a claim for reimbursement or contribution “that becomes fixed after the commencement of the [bankruptcy] case shall be determined, and shall be allowed . . . or disallowed . . . the same as if such claim had become fixed before the date of the filing of the petition [that commenced the bankruptcy case].”<sup>164</sup> Whether a claim is one for reimbursement or contribution depends on whether it is characterized as such under applicable state or federal nonbankruptcy law.<sup>165</sup>

Bankruptcy Code section 502(e)(1)(B) is intended to avoid a situation in which multiple claims are allowed against the bankruptcy estate, one in favor of the creditor on the underlying obligation, and one or more in favor of parties with rights of reimbursement or contribution, on what is essentially the same debt.<sup>166</sup>

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<sup>161</sup> 11 U.S.C. §§ 101 - 1532.

<sup>162</sup> See 11 U.S.C. § 101(15) (defining the term “entity” to include “person, estate, trust, governmental unit, and United States trustee”).

<sup>163</sup> 11 U.S.C. § 502(e)(1).

<sup>164</sup> *Id.* § 502(e)(2).

<sup>165</sup> See 4 COLLIER ON BANKRUPTCY ¶ 502.06[2][a] (Alan N. Resnick & Henry J. Summer (eds. 16th ed. 2015)).

<sup>166</sup> See *Potter v. CNA Ins. Cos. (In re Mei Diversified, Inc.)*, 106 F.3d 829, 831 (8th Cir. 1997).

Bankruptcy Code section 509, entitled “Claims of Codebtors,” provides:

(a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.

(b) Such entity is not subrogated to the rights of such creditor to the extent that—

(1) a claim of such entity for reimbursement or contribution on account of such payment of such creditor’s claim is—(A) allowed under section 502 of this title; (B) disallowed other than under section 502(e) of this title; or (C) subordinated under section 510 of this title; or

(2) as between the debtor and such entity, such entity received the consideration for the claim held by such creditor.

(c) The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement or contribution, of an entity that is liable with the debtor on, or that has secured, such creditor’s claim, until such creditor’s claim is paid in full, either through payments under this title or otherwise.<sup>167</sup>

Courts have been inconsistent in their holdings with regard to whether Bankruptcy Code section 509 establishes the exclusive standards for when subrogation is allowed in bankruptcy or whether non-bankruptcy common law criteria also apply.<sup>168</sup> Courts have also been inconsistent regarding whether a surety that pays the creditor before the bankruptcy case is filed is entitled to subrogation under section 509 or only one that pays the creditor after the filing.<sup>169</sup>

Courts that have considered the issue have generally held that, because the “independence principle” is applicable to letters of credit, the

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<sup>167</sup> 11 U.S.C. § 509.

<sup>168</sup> See 4 COLLIER ON BANKRUPTCY, at ¶ 509.02.

<sup>169</sup> See *id.* at ¶ 509.03, n.13.

issuer of a letter of credit on which the debtor is the applicant is not “liable with” the debtor within the meaning of section 509(a) and is, therefore, not entitled to be subrogated to the rights of the beneficiary of the letter of credit under that statute when the letter of credit is drawn.<sup>170</sup>

Depending on the circumstances, the type of underlying claim, and the court in which the matter comes up, the surety that obtains subrogation rights under section 509 may or may not be entitled to be subrogated to any enhanced priority of the underlying claim under Bankruptcy Code section 507 or to any right of the original creditor to have the underlying claim declared nondischargeable in bankruptcy.<sup>171</sup>

Bankruptcy Code sections 502(e)(1)(C) and 509(b)(1)(A) interact to force a codebtor with both a claim of subrogation and a claim of reimbursement or contribution related to the same underlying obligation to elect to pursue one or the other, but not both, in the bankruptcy case.<sup>172</sup> The leading treatise on bankruptcy law suggests that the decision about which remedy to elect generally depends on whether one of the alternative claims provides the codebtor with a lien (or, presumably, a better lien) on property of the bankruptcy estate.<sup>173</sup> Also, if a surety has allowed the deadline for filing a proof of claim for reimbursement or contribution in the bankruptcy to pass, it may still be able to make a claim for subrogation if the creditor has filed a timely proof of claim on the underlying obligation.<sup>174</sup> If the creditor on the underlying obligation fails to file a timely proof of claim itself, a surety for that obligation can file a proof of claim on behalf of the creditor.<sup>175</sup>

It should be noted that Bankruptcy Code section 509(c) subordinates all surety claims for subrogation, reimbursement, and contribution to the claim of the creditor for the underlying obligation even though, as discussed above, outside bankruptcy a claim for reimbursement or

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<sup>170</sup> See *Hamada v. Far E. Nat'l Bank (In re Hamada)*, 291 F.3d 645, 650 (9th Cir. 2002); *CCF, Inc. v. First Nat'l Bank & Tr. Co. of Okmulgee (In re Slamans)*, 69 F.3d 468, 475–76 (10th Cir. 1995). *But see CCF, Inc.*, 69 F.3d at 475 n.5 (citing bankruptcy court cases holding to the contrary); *In re Nat'l Serv. Lines, Inc.*, 80 B.R. 144, 145 (Bankr. E.D. Mo. 1987) (holding letter of credit issuer entitled to subrogation under § 509).

<sup>171</sup> See 4 COLLIER ON BANKRUPTCY ¶ 509.05 - .06.

<sup>172</sup> See 11 U.S.C. §§ 502(e)(1)(C), 509(b)(1)(A).

<sup>173</sup> 4 COLLIER ON BANKRUPTCY ¶ 502.06[2][e].

<sup>174</sup> See FED. R. BANKR. P. 3005.

<sup>175</sup> See *id.*

contribution can become due and payable before the creditor on the underlying obligation has been paid in full.<sup>176</sup>

#### B. Recovery of Preference Payments from Guarantor

Lenders sometimes include provisions in guaranties by which the guarantor waives rights of reimbursement against the borrower. Those often work to the disadvantage of the guarantor both in the obvious way vis-à-vis the borrower and in the more insidious way vis-à-vis other guarantors as described earlier in this Article.<sup>177</sup> They can, however, also benefit the guarantor in unexpected ways.

In *In re Adamson Apparel, Inc.*,<sup>178</sup> the Ninth Circuit Court of Appeals addressed a situation in which a guarantor, who was the president and CEO of the borrower, had waived his rights of reimbursement and subrogation against the borrower at the insistence of the lender.<sup>179</sup> After the borrower filed for bankruptcy, the bankruptcy trustee for the borrower pursued a preference action against the guarantor seeking to recover a payment made by the borrower to the lender of the guaranteed loan.<sup>180</sup> The payment was made outside the generally-applicable ninety-day preference period<sup>181</sup> but within the extended one-year preference period applicable to insiders<sup>182</sup> such as the guarantor, so the committee sought to recover the payment from the guarantor rather than from the lender.<sup>183</sup> The preference statute, Bankruptcy Code section 547, allows the bankruptcy estate to recover payments made within the applicable preference period if the tests set out in the statute are met including a requirement that the payment is made “to or for the benefit of a creditor.”<sup>184</sup> The guarantor argued that he was not a creditor of the borrower because he had waived his rights of reimbursement and subrogation and, therefore, had no claim against the borrower.<sup>185</sup>

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<sup>176</sup> See 11 U.S.C. § 509(c).

<sup>177</sup> See cases cited *supra* note 118.

<sup>178</sup> 785 F.3d 1285 (9th Cir. 2015).

<sup>179</sup> See *id.* at 1288.

<sup>180</sup> See *id.*

<sup>181</sup> See 11 U.S.C. § 547(b)(4)(A).

<sup>182</sup> See *id.* § 547(b)(4)(B).

<sup>183</sup> See *Adamson Apparel*, 785 F.3d at 1288.

<sup>184</sup> 11 U.S.C. § 547(b)(1).

<sup>185</sup> See *Adamson Apparel*, 785 F.3d at 1290.



The *Adamson Apparel* court noted that no circuit court or district court had addressed the issue, and it reviewed various bankruptcy court decisions, some of which agreed with the guarantor's position and some of which did not.<sup>186</sup> Ultimately, the court's majority ruled that

when an insider guarantor has a bona fide basis to waive his indemnification rights against the debtor in bankruptcy and takes no subsequent actions [such as buying the loan from the lender] that would negate the economic impact of that waiver, he is absolved of any preference liability to which he might otherwise have been subjected.<sup>187</sup>

## VII. CONCLUSION

Guarantors and other sureties that pay on their secondary obligations have well-recognized equitable rights of reimbursement against the principal obligor, contribution from other cosureties, and subrogation to the rights of the creditor. However, when one explores the details of the case law interpreting and applying those equitable rights, they become surprisingly uncertain. There are many cases that find that, for one reason or another, the paying surety is not deemed to be entitled to recover from the principal obligor, another surety, or the collateral for the debt. Furthermore, many of the appellate court cases are decided by split courts with the judges disagreeing as to the appropriate outcome or the reasoning by which the outcome is reached.<sup>188</sup>

The uncertainty is compounded in situations in which the multiple sureties are obligated under different types of obligations (for example, when one provides a guaranty and the other obtains a letter of credit to support the underlying obligation) or have different relationships to the principal obligor.<sup>189</sup> Even when the paying surety is determined to have a right to payment from the principal obligor or a cosurety, there can be complexities in determining the proper amount of the payment.<sup>190</sup> Further complications can arise from arcane aspects of the tax and bankruptcy laws.<sup>191</sup>

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<sup>186</sup> See *id.* at 1293.

<sup>187</sup> *Id.* at 1296.

<sup>188</sup> See *id.* at 1296; see also *Hamada v. Far E. Nat'l Bank (In re Hamada)*, 291 F.3d 645, 654 (9th Cir. 2002).

<sup>189</sup> See *Morgan Creek Residential v. Kemp*, 63 Cal. Rptr. 3d 232 (Cal. Ct. App. 2007).

<sup>190</sup> See *supra* Part III.

<sup>191</sup> See *supra* Part VI.

The unpredictable and inconsistent law in the area of these equitable rights suggests that, when multiple parties are liable on a common debt, in whatever capacities, they should enter into appropriate reimbursement and contribution agreements at the outset of the transaction.<sup>192</sup> Failure to do so greatly increases the risk of litigation and unpredictable outcomes if the principal obligor defaults on the underlying obligation.

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<sup>192</sup> *See supra* Part II.B.