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Guaranty—Partial Failure of Consideration in the Principal Contract—Pro Tanto Defense for the Guarantor.—Walcutt v. Clevite Corp.

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a return to a theory "that all transactions underlying claims in bankruptcy would, in effect, be subject to federal review in the light of overriding federal commercial law,"[21] a concept already rejected in *Erie v. Tompkins*.[22]

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Guaranty—Partial Failure of Consideration in the Principal Contract—Pro Tanto Defense for the Guarantor.—*Walcutt v. Clevite Corp.*[1]—In February of 1959, the plaintiffs sold their holdings in several corporations to the Clevite Corporation. They also agreed in separate assignable writings not to compete with Clevite for a period of ten years, during which time Clevite was to remunerate them in equal quarter-annual instalments. In September, 1960, Clevite sold both the assets of the plaintiffs' former corporations and the agreements not to compete to Walco Electronics Company. As part of the bargain, Walco promised Clevite that it would pay the plaintiffs their regular instalments; moreover, Richmond, the president and sole shareholder of Walco, guaranteed Clevite that he would pay if Walco did not. The payments not forthcoming, the plaintiffs sued Clevite directly on the noncompetition agreements. They also, as third party beneficiaries of Richmond's guaranty to Clevite, sued Richmond. Walco was not served. Richmond answered, *inter alia*, that Clevite had grossly exaggerated the value of the assets sold to Walco, that Walco's agreement to pay the plaintiffs was thus obtained by fraud, and that because of such fraud *on Walco*, he, Richmond, should be freed from his obligations as Walco's guarantor. Special Term granted summary judgment in favor of the plaintiffs against both defendants, and to Clevite on its crossclaim against Richmond. Appellate Division affirmed. Upon appeal, the Court of Appeals, in concluding that the summary judgments against Richmond must be reversed, HELD: First, that although Richmond's defense of fraud upon Walco was unavailing as a matter of law, nevertheless, sufficient facts had been pleaded to support a pro tanto defense which had not been pressed, namely partial failure of consideration in the Walco-Clevite contract; and second, that since Richmond and Walco were "truly one and the same," that Richmond should be deemed to have had the implied consent of Walco to assert against the plaintiffs Walco's claim of fraud against Clevite.

In New York, it has long been the rule that a surety[2] when sued alone cannot defend by showing that his principal was defrauded by the creditor

21 Hill, supra note 6, at 1013.

22 304 U.S. 64 (1938).

1 13 N.Y.2d 48, 191 N.E.2d 894 (1963).

2 Richmond is in fact a guarantor and not a surety as strictly defined. Accordingly, his obligation is secondary, that is, conditioned upon the default of Walco. Nevertheless, since the term surety is often broadly used to indicate any responsibility for the debt of another and since the legal consequences in the instant case are the same whether Richmond is a surety or guarantor, this writer has chosen for the sake of simplicity and clarity of expression to use the term surety even when technically incorrect.

For distinction between surety and guarantor, see Simpson, Suretyship §§ 3-6 (1950).

in entering into the principal contract.[3] The fraud is thought to give rise to a cause of action personal to the principal; and were the surety allowed to assert this personal claim without the principal's consent, then, it is reasoned, the cause of action would be merged in the judgment and the principal would be deprived of his independent right to affirm or disaffirm the contract.[4] Thus, in *Walcutt*, if Richmond were allowed to plead Clevite's fraud upon Walco as a counterclaim to the action by the plaintiffs, then Walco would later be unable either to rescind its contract with Clevite or sue Clevite for fraud.

The inability of the surety to plead the creditor's fraud upon the principal does not, of course, prevent him from pleading the creditor's fraud upon himself.[5] In this respect, it is well established that the creditor's concealment from the surety of facts materially increasing the risk of the principal's nonperformance (and of the surety's consequent liability) constitutes a fraud upon the surety.[6] Thus, it has been held that the failure of an insurance company to reveal to the bondsman on its bank deposit that the depositary bank was insolvent at the time the bond was given constitutes a fraud upon the bondsman.[7] Simpson, in this context, has suggested that the concealment by the creditor of his fraud upon the principal is the concealment of a material fact within the rule just stated, and is thus a fraud upon the surety;[8] but his contention appears never to have been accepted in New York, and has been rejected in at least one New York case, *Taylor-Fichter Steel Const. Co. v. Fidelity & Cas. Co.*[9]

Not only is the surety barred from showing the creditor's fraud upon the principal, he is in fact prohibited from interposing *any* cause of action which is personal to the principal. Further, it does not matter whether the cause of action is intimately related to the contract binding his principal to the creditor or not. Thus, he cannot defend upon the ground that the

[3] Ettlinger v. National Sur. Co., 221 N.Y. 467, 117 N.E. 945 (1917), noted, 31 Harv. L. Rev. 898 (1918), annot., 3 A.L.R. 865 (1919); Elliott v. Brady, 192 N.Y. 221, 85 N.E. 69 (1908); Grill v. Driad Constr. Co., 34 N.Y.S.2d 593 (Sup. Ct. 1943). *Cf.* Fluker v. Henry's Adm'r, 27 Ala. 403 (1855); Brown v. Wright, 23 Ky. (7 T.B. Mon.) 396 (1828); Walker v. Gilbert, 8 Miss. (7 S.&M.) 456 (1846). Contra, Coffelt v. Wise, 62 Ind. 451 (1878); Bryant v. Crosby, 36 Me. 562, (1853); Putnam v. Schuyler, 4 N.Y. (Hun) 166 (Sup. Ct. 1875); Restatement, Security § 118 (1941). See also, Simpson, Suretyship § 56 (1950). Stearns, Suretyship § 7.6 (5th ed. Elder 1951); Note, Defenses of a Principal Available to a Surety, 27 Iowa L. Rev. 601 (1942); Note, Fraud and Duress as Defenses to the Surety, 40 Colum. L. Rev. 1226 (1930); Annot. 3 A.L.R. 865 (1919).

[4] Ettlinger v. National Sur. Co., supra note 3.

[5] Elliott v. Brady, supra note 3. See also Simpson, Suretyship § 28 (1950); Stearns, Suretyship § 2.11 (1951). Richmond argued on appeal that he himself had been defrauded, but his failure to raise the issue below was held to preclude its being brought to the court's attention for the first time on appeal.

[6] First Citizens Bank & Trust Co. v. Sherman's Estate, 250 App. Div. 339, 294 N.Y. Supp. 131 (1937); Howe Mach. Co. v. Farrington, 82 N.Y. 121 (1880).

[7] Phillips v. United States Fid. & Guar. Co., 200 App. Div. 208, 193 N.Y. Supp. 467 (1922).

[8] Simpson, Suretyship § 56 (1950).

[9] 258 App. Div. 235, 16 N.Y.S.2d 218 (1939).

creditor has breached the main contract,[10] or a warranty incident to it,[11] nor can he defend with a claim completely unconnected with the suretyship relation.[12] He may, however, plead the creditor's duress upon the principal since, by so doing, he would not be defending with a cause of action personal to his principal.[13]

The more influential commentators have been uniformly unimpressed with the aforementioned view, at least to the degree that the New York courts, in asserting it, have assumed that certain acts of the creditor cannot at the same time give rise to both a cause of action in favor of the principal and a complete defense in favor of the surety. Thus Stearns, in his *Law of Suretyship*, while not denying that a claim exists on behalf of the principal in the event of the creditor's fraud, nonetheless argues that "on principle" the surety should not be liable to the creditor;[14] Arant maintains that the creditor's breach of warranty or contract produces a risk of nonperformance on the part of the principal which the surety should not be required to bear;[15] and Simpson, as noted above, asserts that "the creditor's concealment from the surety of his conduct by which he has made performance by the principal less likely . . . is undoubtedly fraud upon the surety."[16] Lesser lights, many of them nameless, have taken similar stands in comments and casenotes.[17]

In *Walcutt*, the Court of Appeals has in its own way answered the critics. It has retained, to be sure, the time-honored rule prohibiting the surety from pleading in bar a cause of action belonging to his principal; but it has considerably mitigated the oppressive effect of this rule by permitting the surety to defend pro tanto on the ground of partial failure of consideration in the main contract. In extending this defense to the surety, the court has radically departed from a line of decisions which have refused to acknowledge the existence of such a defense when the failure was allegedly based on an act of the creditor sufficiently prejudicial to the principal to give rise to a cause of action. In *Gillespie v. Torrance*,[18] for example,

[10] Standard Factors Corp. v. Kreisler, 53 N.Y.S.2d 871, aff'd, 269 App. Div. 830, 56 N.Y.S.2d 414 (1945); City of New York v. Fidelity & Deposit Co., 253 App. Div. 676, 3 N.Y.S.2d 714 (1938); New Jersey Button Works v. Silverstein, 173 Misc. 1072, 19 N.Y.S.2d 610 (Munic. Ct. New York 1940).

[11] Gillespie v. Torrance, 25 N.Y. 306 (1862); Werner v. Boochever, 162 N.Y. Supp. 297 (Sup. Ct. 1916); Veriscope Co. v. Brady, 77 N.Y. Supp. 159 (New York City Ct. 1902). See also, Arant, supra note 3; reply, Levine, The Principal's Warranty and Offset Claims Against a Creditor as Defenses to the Surety, 30 Mich. L. Rev. 197 (1931).

[12] Nye Schneider Fowler Co. v. Barnes, 179 App. Div. 239, 166 N.Y. Supp. 461 (1917); East River Bank v. Rogers, 20 N.Y. Super. Ct. (7 Bosw.) 493 (1860). Accord, Meeker v. Halsey, 87 F.2d 299 (2d Cir. 1937).

[13] Osborn v. Robbins, 36 N.Y. 365 (1867); Strong v. Grannis, 26 Barb. (N.Y.) 122 (Sup. Ct. 1857). *Cf.* Colon & Co. v. East 189th St. Bldg. & Constr. Co., 141 App. Div. 441, 126 N.Y. Supp. 226 (1910). Accord, Bank of Clinchburg v. Carter, 101 W. Va. 611, 133 S.E. 370 (1926), noted 21 Ill. L. Rev. 637 (1927).

[14] Stearns, Suretyship § 2.11 (5th ed. Elder 1951).

[15] Arant, op. cit. supra note 3.

[16] Simpson, op. cit. supra note 8.

[17] See, e.g., 13 Colum. L. Rev. 426 (1913); 27 Yale L.J. 566 (1918).

[18] Supra note 11.

the defendant was surety on a note given to the creditor in return for logs allegedly subject to an implied warranty of quality. When the creditor sued the surety on the note, the surety raised the defense of partial failure of consideration, making it clear by his allegations that he intended to prove this failure by showing that the logs were not as warranted. The Court of Appeals rejected this "ingenious" plea, and held that the *real* defense was breach of warranty, a defense personal to the principal and unavailable to the surety. Were the surety allowed to recoup on the ground of breach of warranty, it was stated, then a large claim of the principal might be barred in cancelling a small one of the creditor.[19] To the same effect is *Lasher v. Williamson*,[20] a case in which the plaintiff leased to one Gibbs certain premises upon which he (the plaintiff) agreed to store a certain quantity of goods at a fixed price. In an action for the rent, it was held that Gibbs' surety could not present evidence tending to show that the plaintiffs had only partially fulfilled his storage promise. Said the court, "The nonperformance or partial performance of Lasher's engagement to Gibbs is not to be regarded as a failure of consideration, but as an independent cause of action, which Gibbs, and he only, may assert."[21] So also in *Segar, Inc. v. 1967-1975 Ocean Ave. Realty Corp.*,[22] it was held that the creditor's "improper and unworkmanlike performance" did not, so far as the surety was concerned, give rise to the defense of partial failure of consideration.[23]

Had the court in *Walcutt* been satisfied with this earlier view it might still have reversed, but on the single ground that Richmond had Walco's implied consent to use Walco's personal claim in his own defense. This, however, it refused to do, choosing to read Richmond's answer in a liberal fashion so as to create, as it were, a defense it thought wise to sustain. While it is here submitted that the holding in the instant case is a step in the right direction, it should be noted that Arant, Simpson and others[24] would give the

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[19] Putnam v. Schuyler, supra note 3, at 170, distinguishes *Gillespie* and in a sense foreshadows the holding in the instant case. In *Putnam*, it was said:

> A guarantor cannot *set up, by way* of set-off, a claim distinct from that on which he is sued. The right of set-off (that is, as distinguished from a defense arising upon the claim itself) belongs only to the principal debtor, and can be used only at his option. Such is the doctrine of *Gillespie v. Torrance*, and this is all which that case decides on this point. By indirection, however, it implies that a defense to the claim (as distinguished from a *set-off*), is available to the guarantor.

[20] 55 N.Y. 619 (1874).

[21] Id. at 620.

[22] 127 Misc. 805, 217 N.Y. Supp. 471 (Sup. Ct. 1926), noted 26 Colum. L. Rev. 1035 (1926).

[23] A few cases in New York have taken a contrary view and, prior to the instant case, have extended a pro tanto defense to the surety on the basis of partial failure of consideration in the main contract. Unlike the instant case, however, the extent of the failure has in these cases been readily ascertainable. Thus, in Sawyer v. Chambers, 43 Barb. (N.Y.) 622 (Sup. Ct. 1864), a case remarkably similar to Lasher v. Williamson, supra note 20, the defendant surety was granted the right to present evidence tending to show that only a part of the goods for which the note was given had been delivered; and in Forsythe v. United States Fid. & Guar. Co., 130 Misc. 569, 224 N.Y. Supp. 330 (Sup. Ct. 1927), a like result was reached on similar facts.

[24] See notes 14-17 supra.

surety a *complete* defense when the creditor acts in such a way as to create an undue risk that the principal will not perform, whereas under the partial failure interpretation, the defense being pro tanto, the surety in many cases will still have to respond to the creditor when, perhaps in good sense, this should not be required.

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Insurance—Cooperation Clause—Waiver of Breach Extending to All Claims.—*Mayflower Ins. Co. v. Osborne.*[1]—This is an action for declaratory judgment by the insurer to determine its liability under an automobile insurance policy in relation to three Tennessee state court judgments rendered against it. The policy in question was issued, under the laws of Virginia, to Alice Roe Osborne as the named insured and owner of the automobile. The insured and her daughter were injured in a collision in Kentucky while passengers in the car which was being driven by the named insured's husband with her consent. The driver of the other car was also injured. By a pre-arranged agreement with attorneys representing Alice Roe Osborne and the daughter, the husband submitted himself to the jurisdiction of the courts of Tennessee. Since the accident occurred in Kentucky, and the Osbornes resided in Virginia, this was the only way jurisdiction could have been obtained in Tennessee. Immediately upon learning of this collusive service, the insurer brought the present action alleging that the submission to service of process was a breach of the policy's cooperation clause.[2] Subsequently, the insurer requested and secured the Osbornes' full cooperation in defending suits brought by the other driver in Kentucky. The insurer still claims the breach as a defense to the Tennessee judgments. HELD: The cooperation of the insured was a condition precedent to any liability on the part of the insurer, and a failure of the condition completely voided the insurance contract. However, by seeking and receiving the cooperation in the defense of the suit brought in Kentucky, the insurer waived its rights to assert the breach as a defense in *any* action resulting from the accident.

Provisions for the cooperation of the insured with the insurer in settling or litigating claims arising under the policy have universally been held effective and enforceable, and are generally considered a material part of the insurance contract.[3] The purpose of such a clause is to prevent *collusion* between the insured and the injured party to the detriment of the insurer.[4]

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[1] 216 F. Supp. 127 (W.D. Va. 1963).

[2] The policy contained a standard cooperation clause:

> The insured shall cooperate with the company and, upon the company's request, attend hearings and trials and assist in making settlements, securing and giving evidence, obtaining the attendance of witnesses and in the conduct of any legal proceeding in connection with the subject matter of this insurance.

Supra note 1, at 129, n.1.

[3] Potomac Ins. Co. v. Stanley, 281 F.2d 775 (7th Cir. 1960); Tillman v. Great Am. Indem. Co., 207 F.2d 588 (7th Cir. 1953); Horton v. Employers' Liab. Assur. Corp., 179 Tenn. 526, 164 S.W.2d 1016 (1942).

[4] E.g., American Auto. Ins. v. Fidelity & Cas. Co., 159 Md. 631, 152 Atl. 523 (1930).