

JULY 2011



California
Bar
Examination

Performance Test A

INSTRUCTIONS AND FILE

IN RE BRENT QUILLEN

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IN RE BRENT QUILLEN

INSTRUCTIONS

1. You will have three hours to complete this session of the examination. This performance test is designed to evaluate your ability to handle a select number of legal authorities in the context of a factual problem involving a client.
2. The problem is set in the fictional State of Columbia, one of the United States.
3. You will have two sets of materials with which to work: a File and a Library.
4. The File contains factual materials about your case. The first document is a memorandum containing the instructions for the tasks you are to complete.
5. The Library contains the legal authorities needed to complete the tasks. The case reports may be real, modified, or written solely for the purpose of this performance test. If the cases appear familiar to you, do not assume that they are precisely the same as you have read before. Read each thoroughly, as if it were new to you. You should assume that cases were decided in the jurisdictions and on the dates shown. In citing cases from the Library, you may use abbreviations and omit page citations.
6. You should concentrate on the materials provided, but you should also bring to bear on the problem your general knowledge of the law. What you have learned in law school and elsewhere provides the general background for analyzing the problem; the File and Library provide the specific materials with which you must work.
7. Although there are no restrictions on how you apportion your time, you should probably allocate at least 90 minutes to reading and organizing before you begin preparing your response.
8. Your response will be graded on its compliance with instructions and on its content, thoroughness, and organization.

PAVLIK, GRIEGO & ZACKLER
Attorneys-at-Law

Interoffice Memorandum

Date: July 26, 2011
To: Applicant
From: Allan Zackler
Subject: In re Brent Quillen

A few years ago, our client Brent Quillen cosigned a promissory note at the request of his brother-in-law. The note was issued by InterCon, Inc., a start-up high-tech company formed by Mr. Quillen's brother-in-law, Mark Phillips, to a venture capital firm called First Franklin Group ("First Franklin") to secure a line of credit for operating expenses.

After struggling through a few years of operation, InterCon, Inc. was overtaken by technological advances, and the market for its goods collapsed. InterCon, Inc. has filed bankruptcy proceedings, and First Franklin has made demand on Mr. Quillen to pay the balance due on the note.

After talking to Mr. Quillen and reviewing the documents he furnished, I believe he may have a defense that he can assert against First Franklin and possibly some rights against his brother-in-law. Mr. Quillen is coming in for a follow-up meeting next Monday, and I need to be prepared at that time to advise him of his rights vis-à-vis First Franklin and Mark Phillips. You will find the questions he wants answered on the last page of the transcript of my interview with him.

Please draft a memorandum analyzing the issues raised by Mr. Quillen's questions. For each question, be sure to state the likely outcome. There is no need for an introductory statement of facts in your memorandum.

1 **Transcript of Interview with Brent Quillen**

2 July 21, 2011

3 **Allan Zackler:** Mr. Quillen – Brent – thanks for coming in. I've looked at the letter from
4 First Franklin and the promissory note you sent me after our phone conversation a few
5 days ago. Let's talk about the details of what happened and where things stand. It
6 sounds like just another example of the truism that no good deed goes unpunished.

7 **Brent Quillen:** You've got that right. I cosigned a promissory note as a favor to my
8 sister and her husband, Mark Phillips, to help them get started on a business venture
9 and now it appears that the chickens have come home to roost.

10 **Zackler:** From what little you've told me so far, I don't think it looks all that bleak, but
11 let's start at the beginning – tell me the facts.

12 **Quillen:** Well, back in 2002, Mark perfected a patent on a computer device that made
13 network interconnectivity much smoother, and he wanted to manufacture and market it.
14 He pitched the idea to a number of venture capital groups and ended up getting a
15 commitment from First Franklin Group. They agreed to put up \$3,000,000 to get him
16 started.

17 **Zackler:** Did First Franklin make an outright loan to Mark Phillips, or what?

18 **Quillen:** No, they insisted that he form a corporation and give them half the stock. So,
19 Mark formed InterCon, Inc., issued stock, and assigned half of it to First Franklin.

20 **Zackler:** Who owns the other half of the stock?

21 **Quillen:** Mark and his wife, my sister Vivian, jointly own about one-quarter, and the rest
22 was issued as stock options to key employees.

23 **Zackler:** All right. Describe the loan arrangement for me.

24 **Quillen:** First Franklin deposited \$3,000,000 in an escrow fund subject to the joint
25 control of First Franklin and InterCon. In other words, subject to certain controls
26 exercised by First Franklin, InterCon, Inc. was allowed to draw down prescribed
27 amounts to be used for operating expenses. The loan was backed up by a \$3,000,000
28 promissory note.

29 **Zackler:** Was it just \$3,000,000 and no more?

30 **Quillen:** It was limited to \$3,000,000, but I suppose that if things had gone well First
31 Franklin might have advanced more.

1 **Zackler:** I see there's no due date on the note. It appears to be a "demand" note. Was
2 it an unsecured note?

3 **Quillen:** Yes, it is a demand note and no, it was secured in two ways. As part of the
4 deal, InterCon, Inc. gave First Franklin a security interest in all its equipment and
5 inventory so that if InterCon, Inc. ever couldn't pay, First Franklin could foreclose on its
6 security interest – in other words, repossess and sell the equipment and inventory.
7 Mark says First Franklin perfected its security interest by filing a Commercial Code
8 financing statement with the Secretary of State.

9 **Zackler:** OK, I'll check to see if and when it was filed. You said the note was secured
10 in *two* ways – what's the second way?

11 **Quillen:** By my cosigning the note.

12 **Zackler:** How did that come about?

13 **Quillen:** I got a call from my sister, Vivian, asking me to please help out. Apparently,
14 First Franklin told Mark it would make the loan only if he, Mark, signed it as an individual
15 and if he would get me to cosign. I've been fairly successful in business, and the
16 principals at First Franklin know me and that I have substantial assets. They suggested
17 that Mark ask me to cosign, so I agreed to do it. I figured that First Franklin wouldn't
18 have put up any money if they didn't believe Mark had a good product, so I took a
19 chance. I know how tough it is to start a business, and it was my sister, after all,
20 asking for help.

21 **Zackler:** Did you get any compensation for your agreement to cosign? I mean, what
22 did you expect to get out of it?

23 **Quillen:** Well, Mark made some vague statements about me getting some stock if, and
24 when, InterCon, Inc. went public, but I wasn't holding my breath. No, I just did it as a
25 favor to Mark and Vivian.

26 **Zackler:** I see from the copy of the note that you sent me that you signed on the back.
27 Right?

28 **Quillen:** That's right.

29 **Zackler:** I see that it's signed on the front, "InterCon, Inc., by Mark Phillips, Chief
30 Executive Officer" and then just below that, "Mark Phillips, an individual." What's your
31 understanding about why Mark signed the note as "an individual?"

1 **Quillen:** That's an interesting question. He says he signed it only as a guarantor – that
2 he would have to pay only if InterCon, Inc. couldn't pay. I think Mark has talked to a
3 lawyer because he's using language that he wouldn't normally use.

4 **Zackler:** What do you mean?

5 **Quillen:** He says he wasn't a "principal maker." He's calling himself an
6 "accommodation party" and says that he did not get any "direct benefit" from signing the
7 note. I don't know what all that means, but it sounds to me as if he's trying to avoid any
8 liability.

9 **Zackler:** Well, words like "principal maker" and "accommodation party" have important
10 meanings under the Commercial Code. For example, based on what you've told me so
11 far, InterCon, Inc. is the principal maker because the loan was made to it. You're an
12 accommodation party. All that means is that you signed the note *as a favor* to InterCon,
13 Inc. and your brother-in-law. In relation to you, InterCon, Inc. is an "accommodated
14 party." You're essentially a guarantor – by signing, you agreed to pay if InterCon, Inc.
15 didn't.

16 **Quillen:** What's Mark's status?

17 **Zackler:** Well, I'm not sure at this point. If he signed as a "maker" with the intention of
18 being principally liable just like InterCon, Inc., then that's his status. It's also possible
19 that he's just like you – that is, that he signed just as a favor to InterCon, Inc., in which
20 case he'd also be an accommodation party.

21 **Quillen:** What difference does that make as far as my liability is concerned?

22 **Zackler:** If Mark is principally liable as a maker, then you have certain rights of
23 recourse against him. If he's an accommodation party like you, then a different set of
24 rights kick in. I'll spell it out to you after I do some research.

25 **Quillen:** OK. I'll be anxious to hear what the answer is.

26 **Zackler:** Do you know whether Mark or Vivian actually received for their own account
27 any of the money from the \$3,000,000 loan?

28 **Quillen:** I don't think so. Mark was pretty honest and scrupulous about making sure
29 that all the money went toward the company's operating expenses. Maybe he got a
30 benefit indirectly by getting a salary, but I don't think he put any of the First Franklin
31 money directly in his own pocket. He did tell me – and I think it's the truth – that he

1 drew only a small salary from InterCon, Inc. during the start-up period and that he was
2 looking forward to the day when the company was successful and he could get some
3 “real money” out of it.

4 **Zackler:** The letter First Franklin sent you makes demand on you for \$2,000,000 plus
5 interest. The letter refers to a bankruptcy – that’s why they’re demanding payment,
6 right?

7 **Quillen:** Right. InterCon, Inc. exhausted the First Franklin line of credit. Then, in mid-
8 2007, it went out and borrowed another \$2,000,000 from Columbia National Bank.
9 InterCon, Inc. ran through that money pretty fast, and then two months ago filed for
10 bankruptcy. That left First Franklin holding the bag, so they called the note.

11 **Zackler:** Wait a minute, slow down. What do you mean First Franklin got left holding
12 the bag? Didn’t they have a security interest in InterCon, Inc.’s equipment and
13 inventory that they could foreclose on?

14 **Quillen:** Well, I *thought* they did, but it seems that Columbia National Bank beat them
15 to the punch somehow. Mark told me that, in order to get the loan from the bank,
16 InterCon, Inc. also had to give the bank a security interest in the equipment and
17 inventory. Anyway, the bank is the party that repossessed the equipment and whatever
18 inventory was left, sold it, and applied the proceeds toward its loan.

19 **Zackler:** That could be very important. If First Franklin somehow impaired the
20 collateral, letting Columbia National get it, it might be a partial defense for you. What
21 was the value of the equipment and inventory at that time?

22 **Quillen:** I don’t know. I think the equipment was valuable, but I have no idea about the
23 inventory. I’m sure it had *some* value, but what put InterCon, Inc. out of business was
24 the obsolescence of the product.

25 **Zackler:** All right. I’ll have my paralegal check the Commercial Code filings in the
26 Secretary of State’s Office and the bankruptcy court records to see what we can find
27 out. What was the balance due on the First Franklin note at the time InterCon, Inc. filed
28 bankruptcy?

29 **Quillen:** As far as I know, it was the full \$3,000,000.

30 **Zackler:** Then why is Franklin demanding only \$2,000,000 from you?

1 **Quillen:** That's because they settled with Mark Phillips. Mark told me they accepted
2 \$1,000,000 from him in full satisfaction of his obligation, gave him a release, and said
3 that they were coming after me for the rest.

4 **Zackler:** Can Mark afford to pay \$1,000,000?

5 **Quillen:** There are a couple of sources he can tap. My sister has a trust fund left to her
6 by my parents and his parents are fairly well off, so I'm guessing they will help. You
7 know, it seems to me that, since First Franklin released Mark, it ought to be a release
8 against me as well. Why should they be able to pick and choose who they want their
9 money from and decide to pick on me?

10 **Zackler:** It's definitely something we'll look into.

11 **Quillen:** I'll tell you this. I don't know if it's possible, but if I have to pay First Franklin, I
12 certainly want to go after Mark for reimbursement.

13 **Zackler:** I understand completely. Anything else you can think of?

14 **Quillen:** No, not at the moment.

15 **Zackler:** OK. Let me summarize. I need to get back to you on four questions: (1) Can
16 you get reimbursement from Mark? (2) For that matter, can Mark get any recovery from
17 you? (3) Does First Franklin's apparent loss of its security interest in the equipment and
18 inventory reduce any obligation you have and, if so, to what extent? And (4) Does First
19 Franklin's release of Mark act as a release of you to any extent?

20 **Quillen:** That sounds right.

21 **Zackler:** All right. Give me a few days to dig up further information and do the
22 research. Can you come in next Monday at 10 o'clock? By then, I'll have a handle on
23 what your rights and obligations are, and we can talk about them and what to do next.

24 **Quillen:** Terrific. I'll see you then. Thanks.

PAVLIK, GRIEGO & ZACKLER
Attorneys-at-Law

Interoffice Memorandum

Date: July 24, 2011
To: Allan Zackler
From: Barnett Graves, Paralegal
Subject: In re Brent Quillen

Mr. Zackler: Here's the information you asked me to research. I'm fairly confident that it's reliable.

1. Commercial Code Filings: For a security interest in a debtor's inventory and equipment to be perfected under the Commercial Code, the secured party must file a financing statement describing the collateral sufficiently to give public notice that the collateral is subject to the creditor's security interest. The filing must be made in the Secretary of State's Office. I searched that office's computerized records of Commercial Code financing statement filings and received a Secretary of State's certification of the following:

- Financing statement filed by First Franklin Group. It is dated March 1, 2002 and filed on March 4, 2002. It documents a security interest granted to First Franklin Group by InterCon, Inc. in a security agreement dated March 1, 2002 and describes the collateral as "All present and hereafter acquired equipment and inventory of InterCon, Inc."
- Financing statement filed by Columbia National Bank. It is dated June 1, 2007 and filed on June 4, 2007. It documents a security interest granted to Columbia National Bank by InterCon, Inc. in a security agreement dated June 1, 2007 and describes the collateral as "All present and hereafter acquired equipment and inventory of InterCon, Inc."

- There are no continuation statements or other filings reflecting any other security interest in property of InterCon, Inc.

2. Search of Bankruptcy Court records in InterCon, Inc. bankruptcy proceedings:

You asked me to search the records regarding claims filed by InterCon, Inc.'s creditors in the Bankruptcy Court, especially claims filed by First Franklin Group and Columbia National Bank. Here is what I discovered:

- First Franklin and Columbia National Bank both filed early claims purporting to be secured creditors, each claiming to have a priority claim to InterCon, Inc.'s equipment and inventory.
 - First Franklin's claim was in the amount of \$3,000,000, plus interest, "subject to reduction after repossession and sale of its collateral and application of the proceeds of the sale to promissory note."
 - Columbia National's claim was in the amount of \$2,000,000 plus interest, "subject to reduction after repossession and sale of its collateral and application of the proceeds of the sale to promissory note."
- In a hearing before the bankruptcy judge, it was determined that Columbia National Bank had priority and that Columbia National Bank was entitled to take possession and sell the collateral. The ground of the ruling was that First Franklin's security interest had "lapsed."
- Columbia National Bank filed an amended claim as an unsecured creditor after sale of the collateral and application of the proceeds to the amount owed it. That claim shows the following:
 - Initial balance of debt: \$2,000,000 plus interest.
 - Net proceeds of sale of equipment applied to the balance: \$800,000.
 - Net proceeds of sale of inventory applied to the balance: \$400,000.
 - Unsecured remaining balance due: \$800,000 plus interest.
- First Franklin filed an amended claim as an unsecured creditor showing the following:

- “Balance due on promissory note signed by InterCon, Inc. and Mark Phillips as principals, and indorsed by Brent Quillen in the amount of \$3,000,000, plus interest.”
- The claim recited that “First Franklin will file a further amended claim after recovery, if any, on the note from cosigner, Mark Phillips, and indorser Brent Quillen.”
- An accounting filed by the Bankruptcy Trustee states that “It is very doubtful that there will be any appreciable distribution to unsecured creditors after liquidation of the bankrupt estate and payment of costs of administration.”

3. Use of funds from First Franklin loan: You also asked me to see what I could find out about how the First Franklin funds were used and what Mark Phillips’s compensation arrangements as CEO of InterCon, Inc. were. The bankruptcy schedules and report of the Bankruptcy Trustee show the following:

- The only compensation arrangement between InterCon and Phillips was that he was to be paid a salary of \$1,500 per month and reimbursement for travel and related business expenses.
- It appears that the only other benefit Phillips received is that the company leased him a mid-sized automobile for his personal use. All cash advances from both the First Franklin and Columbia National loans were used for operating expenses, including payment of salaries and wages of employees, except that it appears that Phillips himself drew his salary only in months when there was a positive cash flow.
- Phillips has filed a claim in the bankruptcy for \$18,000 in unpaid wages.

Incidentally, I called First Franklin and spoke with Lance Templar, its managing partner. He confirms that First Franklin and Mark Phillips entered into a release and settlement agreement, but he refused to tell me the details.

Please let me know if there is anything further you want me to do.

**FIRST FRANKLIN GROUP, LLP
Venture Capital Investors
One Success Way
Mayfield, Columbia 32459**

**Telephone: (555) 444-4500
Facsimile: (555) 444-3200**

July 11, 2011

**CERTIFIED MAIL
RETURN RECEIPT REQUESTED**

Mr. Brent Quillen
1251 Bellow Lane
Mayfield, Columbia 32466

Dear Mr. Quillen:

The purpose of this letter is to make a presentment and demand upon you for payment of the balance due on the PROMISSORY NOTE (copy attached) that you signed as an indorser. As you know, InterCon, Inc. is insolvent and is currently in Chapter 7 bankruptcy proceedings. InterCon, Inc. is therefore unable to pay the note.

We call upon you in your capacity as indorser to pay forthwith the sum of \$2,000,000 plus accumulated interest, which is the balance due on the note. We will make available to you our accounting records in the event you wish to ascertain the history of advances on the note since its inception in 2002.

We look forward to receiving your remittance within the next 30 days. We will, upon receipt of payment, surrender the signed original of the note to you and assign to you all rights we may have against other parties to the note, including our claim in the bankruptcy proceedings.

Very truly yours,

Lance Templar

Lance Templar
Managing Partner

Copy of Front of Promissory Note

[FRONT]

PROMISSORY NOTE

Date: March 1, 2002
Amount: \$3,000,000.00

Maker hereby promises to pay First Franklin Group on demand or to its order the sum of \$3,000,000.00 or the balance due at the time of demand, plus accumulated interest at the rate of 10% per annum. Advances up to the face amount of this note shall be made upon request of Maker and upon approval of First Franklin Group and shall be repaid periodically from operating revenues of Maker.

This promissory note is secured by a security interest granted by Maker in its equipment and inventory.

Any failure to make a payment on time shall be deemed to be a default, and the entire remaining balance shall thereupon be immediately due and payable and shall thereafter bear interest at the rate of 10% per annum until paid.

In the event it becomes necessary for First Franklin Group or any transferee of this note to take legal action to collect on this promissory note, First Franklin or said transferee shall be entitled to recover costs incurred, including a reasonable attorney's fee.

InterCon, Inc.

By *Mark Phillips*

Mark Phillips, Chief Executive Officer

Mark Phillips

Mark Phillips, an individual

Copy of Back of Promissory Note

[BACK]

Brent Quillen

Guarantor

JULY 2011



*California
Bar
Examination*

Performance Test A

LIBRARY

IN RE BRENT QUILLEN

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Walker on Negotiable Instruments

by

Professor Ervin E. Walker, University of Columbia School of Law

This treatise is intended as an introduction to Article 3 of the Columbia Commercial Code (the Code) dealing with negotiable instruments. Its purpose is to familiarize lawyers with the basics of the Code and to help them navigate the often dense statutory language.

* * *

Promissory notes: (a) A promissory note is an instrument given for value in a commercial transaction to support an obligation to pay money, usually connected with the extension of credit by a creditor or a loan by a lender. To be negotiable, the note must be an unconditional promise to pay a fixed sum of money at a certain time or upon demand.

* * *

(c) **Definitions: Signatories – Parties to the note:** Persons or entities on whose creditworthiness a creditor will extend credit or make a loan fall into different categories and incur different rights and obligations depending on the capacity in which they sign the note.

- **Maker or Principal Obligor** – A maker or principal obligor – usually the buyer in a credit transaction or the borrower in a loan transaction – is one who signs the note on its face and is primarily liable to pay it according to its terms.
- **Indorser** – A person or entity who signs the note on the back and who undertakes to pay the note according to its terms if the maker does not.
- **Accommodation Party** – A signer of the note who does not receive a direct benefit from the extension of credit or the loan but who signs as a “favor” to the maker. The following example may help to illustrate: Suppose ABC Corp. seeks a loan from Bank to purchase equipment, supplies and inventory. Bank is willing to make the loan but is not totally confident of ABC’s creditworthiness. Bank insists that ABC find a

responsible, creditworthy “cosigner” or “guarantor” to become obligated on the note and to pay it if ABC does not. Suppose ABC induces a third party to “cosign.” That third party, who does not stand to benefit directly from the proceeds of the loan, becomes an “**accommodation party**,” i.e., he or she signed as an accommodation or as a favor to ABC to help ABC obtain the loan.

- An accommodation party can sign on the face of the note, in which case, he or she becomes an **accommodation maker**, or
- That person can sign on the back, in which case he or she becomes an **accommodation indorser**.
- The rights and obligations of an accommodation party differ according to whether he or she signed as a maker or an indorser. Those rights and obligations are spelled out in Article 3 of the Code.
- **Maker (Principal Obligor) v. Accommodation Maker:** As already noted the rights and obligations of a signer differ according to whether he or she is a principal maker or an accommodation party. It is not always easy to tell the difference. Suppose Mr. X signed on the face of a note in the space directly under the signature of the corporation to which a loan has been made. Mr. X can be either a principal obligor or an accommodation maker. The key inquiry is whether and to what extent Mr. X received a direct benefit from the proceeds of the loan. If he did receive a direct benefit, he is probably a maker primarily obligated to pay the note. If not, he is probably an accommodation maker, secondarily obligated to pay the note.
- **Accommodated Party:** An “accommodated party” is the party to whom the credit was extended or the loan was made. That party is “accommodated” in the sense that it was the recipient of the “favor” done by the third party “cosigner” or “guarantor.” In the example given above, ABC Corp. is the accommodated party.

Excerpts from Columbia Commercial Code

Section 3415. Obligation of Indorser.

(a) If an instrument is dishonored, an indorser is obliged to pay the amount due on the instrument according to the terms of the instrument at the time it was indorsed. The obligation of the indorser is owed to a person entitled to enforce the instrument or to a subsequent indorser who paid the instrument under this section.

Section 3419. Instruments Signed for Accommodation.

(a) If an instrument is issued for value given for the benefit of a party to the instrument ("accommodated party") and another party to the instrument ("accommodation party") signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument, the instrument is signed by the accommodation party "for accommodation."

(b) An accommodation party may sign the instrument as maker . . . or indorser and . . . is obliged to pay the instrument in the capacity in which the accommodation party signs. The obligation of an accommodation party may be enforced whether or not the accommodation party receives consideration for the accommodation.

(c) A person signing an instrument is presumed to be an accommodation party . . . if the signature is an anomalous indorsement or is accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument.

* * *

(e) An accommodation party who pays the instrument is entitled to reimbursement from the accommodated party and is entitled to enforce the instrument against the accommodated party. An accommodated party who pays the instrument has no right of recourse against, and is not entitled to contribution from, an accommodation party.

Section 3604. Discharge by Cancellation or Renunciation.

(a) A person entitled to enforce an instrument, with or without consideration, may discharge the obligation of a party to pay the instrument (i) by an intentional voluntary act such as surrender of the instrument to the party . . . or (ii) by agreeing not to sue or otherwise renouncing rights against the party by a signed writing.

Section 3605. Discharge of Indorsers and Accommodation Parties.

* * *

(b) Discharge, under Section 3604, of the obligation of a party to pay an instrument does not discharge the obligation of an indorser or accommodation party having a right of recourse against the discharged party.

* * *

(e) If the obligation of a party to pay an instrument is secured by an interest in collateral and a person entitled to enforce the instrument impairs the value of the interest in collateral, the obligation of an indorser or accommodation party having a right of recourse against the obligor is discharged to the extent of the impairment. The value of an interest in collateral is impaired to the extent (1) the value of the interest is reduced to an amount less than the amount of the right of recourse of the party asserting discharge, or (2) the reduction in value of the interest causes an increase in the amount by which the amount of the right of recourse exceeds the value of the interest. The burden of proving impairment is on the party asserting discharge.

* * *

(g) Under subdivision (e), impairing value of an interest in collateral includes (1) failure to obtain or maintain perfection or recordation of the interest in collateral, (2) release of collateral without substitution of collateral of equal value, (3) failure to perform a duty to preserve the value of collateral owed to a debtor or surety or other person secondarily liable, or (4) failure to comply with applicable law in disposing of collateral.

Official Comments to Section 3605

Subsection (e) deals with the discharge of sureties (such as accommodation parties) by impairment of collateral. Subsection (g) states common examples of what is meant by impairment. The surety is discharged to the extent the surety proves that impairment was caused by a person entitled to enforce the instrument. For example, suppose the payee of a secured note fails to perfect a security interest. The collateral is owned by the principal debtor who subsequently files in bankruptcy. As a result of the failure to perfect, the security interest is not enforceable in the bankruptcy. If the payee obtains payment from the surety, the surety is subrogated to the payee's security interest in the collateral. In this case, the value of the security interest is impaired completely because the security interest is unenforceable. If the value of the collateral is as much or more than the amount of the note, there is a complete discharge.

Section 9515. Duration and Effectiveness of Financing Statement; Effect of Lapsed Financing Statement.

(a) A filed financing statement is effective for a period of five years after the date of filing.

(b) The effectiveness of a filed financing statement lapses on the expiration of the period of its effectiveness unless before the lapse a continuation statement is filed. Upon lapse, a financing statement ceases to be effective and any security interest that was perfected by the financing statement becomes unperfected. If the security interest becomes unperfected upon lapse, it is deemed never to have been perfected as against a purchaser of the collateral for value.

Venaglia v. Kropinak
(Columbia Court of Appeal, 2005)

The Appellants, Frank Venaglia, Ann P. Venaglia, and Roy J. Venaglia (the Venaglias), sued Roy M. Kropinak on his guarantee of a \$68,000 promissory note issued by Downtown Business Center, Inc. (DBC) and payable to the Venaglias. Kropinak was an officer and shareholder of DBC. The trial court granted Kropinak's motion for summary judgment. The Venaglias appeal, asking that we set aside the summary judgment against them. This appeal requires us to examine the capacities in which the parties signed the promissory note and their consequential suretyship rights and obligations under the Columbia Commercial Code (the CCC).¹

I. BACKGROUND

DBC agreed to purchase a downtown commercial property from the Venaglias for \$470,000, with \$90,000 due at closing and the balance payable under a real estate contract. As part of the transaction, DBC gave the Venaglias a promissory note in the amount of \$68,000. The note was signed "Robert J. Doucette, President of DBC." Immediately beneath Doucette's signature was the inscription "GUARANTOR (individually)," under which was the signature of Kropinak. No collateral secured the note.

DBC eventually failed to make the promised payments on the balance owed, and the Venaglias terminated the contract. At the time of termination, the balance due was \$340,000. Shortly afterwards, the Venaglias and DBC entered into a settlement and mutual release agreement, under which DBC relinquished the property to the Venaglias. In addition, although acknowledging that DBC had equity in the property, DBC gave up all rights to recoup any such equity. Ron Perea, then president of DBC, signed the settlement agreement for DBC. Kropinak did not sign the settlement agreement.

¹ Unless otherwise noted, all citations in this opinion are to the Columbia Commercial Code.

Nine days later, the Venaglias sold the property to Suzanne Dutcher for \$425,000. If DBC had retained the property and sold it for that amount, it would have been more than enough to pay off all the principal and interest that DBC owed on the property, including the \$68,000 note that Kropinak had signed as guarantor.

The Venaglias brought this suit against Kropinak to recover on the \$68,000 note. Kropinak filed a motion for summary judgment. The motion for summary judgment focused on the validity of defense raised by Kropinak. The district court granted summary judgment to Kropinak, ruling that his defense was meritorious.

We disagree with that ruling. Kropinak's defenses fail as a matter of law. He asserts a defense under the Columbia Commercial Code to the effect that he is fully discharged from his guarantee because the Settlement Agreement between the Venaglias and DBC prejudiced his rights as a guarantor. The gist of his assertion of prejudice is as follows: Although the Settlement Agreement explicitly states that "DBC acknowledges that it has 'equity' in the [P]roperty," DBC relinquished to the Venaglias all its rights in the Property. This left DBC with no assets whatsoever. Thus, if Kropinak were to pay off the Promissory Note in accordance with his guaranty, he would not be able to obtain any reimbursement from DBC. The unfairness of this result is apparent from the fact that a few days after execution of the Settlement Agreement, the Venaglias entered into a contract to sell the Property for a sum that exceeded what DBC owed on the Real Estate Contract and the Promissory Note. In other words, one could say that DBC's "equity" in the Property prior to the Settlement Agreement (the value of the Property less the amount owed on the Real Estate Contract) exceeded the amount owed on the Promissory Note. Hence, if DBC had obtained full value for its interest in the Property, it could have paid off the note guaranteed by Kropinak.

Kropinak contended that, pursuant to CCC Section 3605(b), he was discharged because the Settlement Agreement destroyed his right of recourse against DBC, whose only asset was its interest in the property.

II. DISCUSSION

The principal source of law governing the rights and duties of the parties with respect to a guarantee of a promissory note is Article 3 of the Columbia Commercial Code. To begin our analysis, we observe that Kropinak is an accommodation party with respect to the Promissory Note. As stated in § 3419(a):

If an instrument is issued for value given for the benefit of a party to the instrument ("accommodated party") and another party to the instrument ("accommodation party") signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument, the instrument is signed by the accommodation party "for accommodation".

Section 3419(c) states in pertinent part:

A person signing an instrument is presumed to be an accommodation party and there is notice that the instrument is signed for accommodation if the signature . . . is accompanied by words indicating that the signer is acting as surety or guarantor with respect to the obligation of another party to the instrument.

Kropinak meets the definition of § 3419(a) because it is undisputed that Kropinak signed the Promissory Note as a guarantor, that the purpose of the note was to enable DBC (the promisor on the note) to enter into the Real Estate Contract with the Venaglias, and that Kropinak was not a "direct beneficiary" of the transaction. (See § 3419(a).) Also, the presumption of § 3419(c) applies because Kropinak's signature appears under the heading "GUARANTOR (individually)."

We now turn to Kropinak's defense that he was discharged because DBC's settlement deprived him of his right of recourse.

Kropinak Was Not Discharged Under Section 3605(b).

Section 3605 addresses the discharge of accommodation parties. Subsection (b) states:

Discharge . . . of the obligation of a party to pay an instrument does not discharge the obligation of an . . . accommodation party having a right of recourse against the discharged party.

Relying on this language, Kropinak argues essentially as follows: That he was an accommodation party and, as such, would have rights of recourse against DBC (the discharged accommodated party); but he has no effective right of recourse because DBC no longer has any assets; its sole asset was an interest in the Property, and DBC relinquished that interest to the Venaglias in the Settlement Agreement. He argues, therefore, the discharge of DBC also discharges Kropinak.

We reject this argument. The second premise in the syllogism is flawed: Kropinak *does* have a right of recourse against DBC. Kropinak fails to distinguish between (a) the right of recourse against a party and (b) the economic value of that right. One can have a right of recourse against a destitute person. The right may not be worth anything, but it exists.

Here, Kropinak has a right of recourse against DBC to the extent that he makes payment on the Promissory Note. This right of recourse is explicitly provided by § 3419(e), which states:

An accommodation party who pays the instrument is entitled to reimbursement from the accommodated party and is entitled to enforce the instrument against the accommodated party.

Although in some, perhaps most, contexts a "worthless" right should be treated as no right at all, such treatment is inappropriate when dealing with accommodation parties. After all, the *very purpose* of procuring an accommodation party is to have a source of payment if the accommodated party is unable to pay in full. When the accommodated party cannot pay in full, the promisee (here, the Venaglias) should be able to collect everything possible from the accommodated party and then proceed against the accommodation party. Collecting from the accommodated party can often be facilitated by the promisee's release of the accommodated party in return for the accommodated party's paying what it can. In general, the accommodation party should have no complaints about such a settlement agreement between the promisee and the

accommodated party because it knew that the promisee would look to it if the accommodated party encountered financial difficulty. The accommodation party should not be entitled to relief on the ground that the accommodated party has no assets from which the accommodation party can obtain recourse because it is precisely the potential of such financial straits of the accommodated party that created the utility of having the accommodation party guarantee the note. As stated in Official Comment 3 to § 3605(b):

As a practical matter, Bank [the promisee] will not gratuitously release Borrower [the accommodated party]. Discharge of Borrower normally would be part of a settlement with Borrower if Borrower is insolvent or in financial difficulty. If Borrower is unable to pay all creditors, it may be prudent for Bank to take partial payment, but Borrower will normally insist on a release of the obligation. If Bank takes \$3,000 and releases Borrower from the \$10,000 debt, Accommodation Party is not injured. To the extent of the payment Accommodation Party's obligation to Bank is reduced. The release of Borrower by Bank does not affect the right of Accommodation Party to obtain reimbursement from Borrower if Accommodation Party pays Bank. Section 3419(e). Subsection (b) is designed to allow a creditor to settle with the principal debtor without risk of losing rights against sureties. Settlement is in the interest of sureties as well as the creditor.

In short, § 3605(b) is not intended to protect an accommodation party from a settlement in which the promisee discharges the accommodated party in return for paying all that it can on the note. The accommodation party should expect to be obligated to pay to the extent that the accommodated party does not have the resources to pay.

III. CONCLUSION

We hold that the district court erred in granting Kropinak summary judgment. We reverse and remand for further proceedings consistent with this opinion.

Melandris v. Richter
(Columbia Supreme Court, 2007)

This suit for declaratory relief reaches us on the cross-appeals of parties to a promissory note. David Richter was the founder, President, and Chief Executive Officer of Pharmacopaea, Inc., a Columbia corporation (the Corporation), a wholesaler of perishable pharmacological products. The Corporation's warehouse was equipped with refrigerated facilities where drugs requiring refrigeration were stored.

In 1995, the Corporation borrowed \$500,000 from Merchants and Manufacturers Bank (the Bank). The documentation consisted of a loan agreement, a ten-year interest-only promissory note, and a security agreement granting the Bank a security interest in the Corporation's "inventory." The Bank duly filed a financing statement with the Columbia Secretary of State to perfect its security interest and later filed a valid continuation statement to preserve its interest.

The signatures on the face of the promissory note were as follows: "Pharmacopaea, Inc., By David Richter, Chief Executive Officer," and immediately below that signature, "David Richter." On the back of the note appeared the anomalous indorsement of Martina Melandris, a representative of one of the Corporation's principal suppliers².

In early 2005, as the result of a disastrous loss in a product liability suit stemming from the Corporation's supplying faulty drugs to retailers, the Corporation was rendered insolvent and filed bankruptcy. The \$500,000 balance on the promissory note became due and payable, and the Corporation's insolvency made it impossible for it to pay the

² Columbia Commercial Code § 3205(d) defines "anomalous indorsement" as "an indorsement made by a person who is not a holder of the instrument." Ordinarily, indorsement of a note accompanies *negotiation* of the note – the indorser signs on the back to pass rights in the note from himself as holder to another holder/taker for value. An *anomalous* indorsement is not made for the purpose of negotiating the note, but simply for accommodation purposes of creating "backup" liability. It is "anomalous" in the sense that it is outside the chain of negotiation.

note. The Bank immediately took possession of the Corporation's unsold inventory of drugs then valued at about \$300,000. The Bank's representatives responsible for preserving the collateral failed to provide adequate refrigerated facilities for the storage of the drugs pending their sale. As a result, the entire inventory spoiled and became valueless.

The Bank then made demand upon David Richter and Martina Melandris for payment of the note. One of the issues in that litigation, which is still pending unresolved is whether, and to what extent, Richter and Melandris are discharged from any obligation to the Bank by reason of the spoliation of the inventory of drugs. Both of them have defended that action by asserting either partial or complete discharge under Columbia Commercial Code (the code) §§ 3605(e) and (g), which provide for discharge of an indorser or accommodation party "to the extent of the impairment" when the secured creditor who is entitled to enforce the note has "[failed] to perform a duty to preserve the value of the collateral." If the Bank in fact failed to protect the repossessed inventory, then, depending on the capacities in which Richter and Melandris signed the note, there will be a discharge "to the extent of the impairment." The extent of the impairment is not before us, but what is before us is the issue of the capacity in which Richter and Melandris signed the note and the consequences that flow therefrom.

Melandris indisputably signed the note as an accommodation party. She asserts that she signed as an accommodation both to the Corporation, which was a significant customer, and Richter, its CEO. None of the proceeds of the Bank's loan inured to Melandris's direct benefit. In this case, she seeks a declaration that (i) Richter is a non-accommodation maker of the note (i.e., that he was an accommodated party) and (ii) that, if she is required to pay the Bank, she is entitled to full reimbursement from Richter. Richter's position is more complicated. He seeks a declaration (i) that he signed the note as an accommodation maker and (ii) that, in any event, irrespective of whether it is ultimately determined that he is an accommodation maker or a non-accommodation maker, he is entitled to contribution (i.e., a recovery of one-half of

whatever he pays) from Melandris for any payment he may be required to make to the Bank.

Let us first examine Melandris's contentions. In support of her position that Richter was an accommodated party and therefore principally liable on the note (i.e., that he was not a surety), she points to § 3419(c), which states that "A person signing an instrument is presumed to be an accommodation party . . . if the signature is . . . accompanied by words that the signer is acting as a surety or guarantor with respect to the obligation of another party to the instrument." By inverse reasoning she argues that, since Richter's signature on the face of this note is *unaccompanied* by such words, the presumption works the other way and that he is necessarily an accommodated party principally liable on the note and not a surety.

She then cites § 3419(e) of the Code, which provides that "An accommodation party who pays the instrument is entitled to reimbursement from the accommodated party An accommodated party who pays the instrument has no right of recourse against, and is not entitled to contribution from, an accommodation party." Thus, if Melandris's position is correct – that Richter is an accommodated party – and if she pays the note, she would be entitled to get full reimbursement from him.

However, we do not believe the solution to Richter's status is as simple as Melandris would have it. Her inverse reading of § 3419(c) (*supra*) is flawed. The presumption that Richter would be an accommodation party if he had signed as a "surety or guarantor" is not rebutted merely by showing that he did *not* so sign. He can still be an accommodation party even absent such accompanying words. Nor is it determinative of Richter's status that he signed the note on the face as a maker. (Section 3419(b) provides that "An accommodation party may sign the instrument as maker . . . or indorser")

We now turn to Richter's contentions. The initial inquiry into whether Richter is an accommodated party or an accommodation party turns on the statutory definitions.

Section 3419(a) provides as follows:

If an instrument is issued for value given for the benefit of a party to the instrument ("accommodated party") and another party to the instrument ("accommodation party") signs the instrument for the purpose of incurring liability on the instrument *without being a direct beneficiary of the value given* for the instrument, the instrument is signed by the accommodation party for accommodation.

Richter relies on the italicized language of the foregoing quotation and asserts that he is an accommodation party because he received no direct benefit from the Bank's loan. In support of that argument, he contends that as one who cosigned a note that was given for a loan to Corporation, he is an accommodation party if no part of the loan was paid to him or for his direct benefit. This, he contends, is true even though he might have received an indirect benefit from the loan because he was employed by the corporation. We do not believe the matter is so simple. Although it is a question of first impression for this court, a court in our sister state of Olympia has had an opportunity to address this point. In *First National Bank v. Rafoth*, the Olympia Supreme Court identified five factors for determining whether one who signed as a maker was or was not an accommodation party:

- (i) Corporate capacity/ownership of the signer;
- (ii) Location of the signature on the note (i.e., on the face, where a non-surety maker would ordinarily sign, or on the back, where an anomalous indorser would sign);
- (iii) The language used in conjunction with the signature;
- (iv) Whether the signer received the loan proceeds; and
- (v) Intent of the parties.

We are persuaded by the Olympia case that the inquiry goes beyond simply whether the signer directly received the loan proceeds and that the result depends on application of the facts to the enumerated factors. On the record before us, we are unable to make a determination because there is a dearth of facts. The parties relied below on purely legal arguments and did not present the surrounding facts to flesh out the arguments sufficiently. Of the five factors articulated above, the only factors that

we are able to answer based on the facts we have are (i) – that Richter was President and CEO of Pharmacopaea, Inc., (ii) – that he signed on the face of the note as a maker, and (iii) – that he signed his name unaccompanied by a modifying adjective. The remaining factors, (iv) and (v), are likely to be the more influential ones and as to those, we have no clue. Accordingly, we cannot resolve this dispute definitively without further evidentiary proceedings below. We can, however, answer to some extent the contentions of the parties as follows.

As noted, Melandris is unquestionably an accommodation party and therefore obligated to the Bank for the balance due on the note, whatever that balance might be after offset, if any, for impairment of collateral. The ultimate resolution of the dispute presented to us for declaratory relief will turn on whether Richter is an accommodated party (i.e., a non-accommodation maker principally liable on the note) or an accommodation party (i.e., a surety). If he is an accommodated party and Melandris pays any or all of the note, then Melandris as an accommodation party is entitled to full reimbursement from Richter of whatever sum she pays. Richter would not be entitled to contribution from Melandris. (See § 3419(e), *supra*.)

On the other hand, if Richter were ultimately found to be an accommodation party, he also would be independently liable to the Bank for balance due on the note. In that event, Melandris would have no right of recourse – neither reimbursement nor contribution – against Richter.

This follows from the fact that, under the Code, the liability of accommodation parties to an instrument is *separate* and several, not joint and several. The Code makes provision for contribution only among parties jointly and severally liable on an instrument, but not otherwise. Thus, if *both* Melandris and Richter are accommodation parties, they are not jointly and severally liable and therefore will not be as between themselves entitled to contribution from one another. Of course, the Bank would be entitled to recover only once but may pursue one or the other of them at its option. We remand to the trial court for further proceedings.