CO-SIGNING: LAW AND PRACTICES OF CONSUMER CASH LOANS AND CONSUMER INSTALLMENT CREDIT BY LENDING INSTITUTIONS IN HAWAII

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CO-SIGNING: LAW AND PRACTICES

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INTRODUCTION

The House of Representatives in adopting House Resolution 88 (First State Legislature, Budget Session of 1962) requested the Legislative Reference Bureau to study the practice of lending institutions in Hawaii with respect to the extension of credit on the security of co-signers. The House was interested in determining whether the practice is indiscriminate; whether before accepting such security, lending institutions check the financial ability of the co-signers to pay; and whether the practice can be reasonably tempered to curtail financial hardship and prevent any resultant recourse by co-signers to welfare funds. In addition, individual legislators have requested the Bureau to report on aspects of related problems. This study and report have been formulated in response to these inquiries.

In recent years there has been growing judicial, legislative and sociological concern with the problem of protection of the consumer who borrows cash or who buys on the installment plan. Ancillary to this concern for the consumer is a parallel concern for his "co-signer", apparently a problem of especial magnitude in the State of Hawaii. A recent circuit court case illustrates pointedly some of the elements of Hawaii co-signing law and practice.[1] The defendant was found liable in an action by a credit union to collect the principal, interest and attorney's fees on a six year old promissory note which the defendant and four others had signed. Evidence was presented to the effect that the primary borrower and the other co-signers had additional outstanding notes under which they had all acted as co-signers for each other in a round-robin fashion. Subsequently they all left Hawaii, except the defendant. This case might be considered an instance of a legal result deviating from commonly accepted ideas of justice and fair play.

It has been reported unofficially that a few individuals are forced to seek financial assistance from state and private welfare funds as a result of financial difficulties caused or aggravated by improvident co-signing. Unfortunately, it is difficult to determine whether practices relating to co-signing of notes have led to excessive reliance upon welfare funds for subsistence by many persons because the records kept by welfare agencies do not reveal the necessary data and information. Although persons receiving financial assistance are required to list their creditors, they are not asked to identify which debts have been incurred through co-signing.

This report is therefore confined to the specifics of the co-signing law and practices relative to consumer cash loans and installment credit. Related and pertinent fields of inquiry would include bankruptcy of the non-business debtor or consumer-debtor and other aspects of consumer credit protection. The various aspects of the co-signer problem, including pertinent law, a survey of certain practices by lending institutions, and potential remedial measures, both legislative and administrative, are included in this discussion.

Several persons in the state departments of welfare and regulatory agencies and in the credit business have helped in the preparation of this study by furnishing necessary information. In addition, the following persons reviewed a preliminary draft:

George Coniff, Credit Bureau of Hawaii

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Charles J. Gillespie, Deputy Bank Examiner, Department of Regulatory Agencies

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Paul Lucas, Hawaiian Lenders Exchange

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George D. Nickel, Beneficial Management Corporation, Regional Director, Public Relations

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The suggestions and comments of the reviewers were considered in the revisions for the final form of the study, but the Legislative Reference Bureau assumes sole responsibility for the contents.

Finally, appreciation is due to the fifty-nine individual lending institutions who replied to the questionnaire which provided much of the specific information that forms the basis of the study.

STATEMENT OF THE PROBLEM

There are two principal types of credit transactions involving co-signers and lending institutions to which this report is directed: cash loans and installment purchases of personal property. A cash loan made by a lending institution may be described as a direct exchange of money for credit or a sale of money. An installment purchase of personal property is commonly defined as a purchase of consumer goods on credit under a conditional sales contract that provides for regular periodic payments after an initial down payment. A usual subsequent practice is the transfer by the retail seller of any credit security device including promissory notes to a lending institution.

Such credit transactions are usually designed to achieve one or more of the following aims: (1) to raise the consumer's standard of living, (2) to take advantage of the convenience of "instant money" or (3) to meet the exigencies of emergencies. In Hawaii the financial institutions which supply most consumer cash loans and handle financing of installment purchasing, apart from those merchants who provide their own financing arrangements, are banks, industrial loan companies, small loan companies and federal credit unions.

In addition to the many benefits and needs which consumer cash loans and installment purchasing satisfy, there are obvious associated dangers, attributable in part to abuses or errors of judgment by merchants and lending institutions and in part to unwisdom and excesses by the consumer borrowers. In many cases consumer credit is advanced to borrowers on the strength of a signed promissory note, which may be accompanied by a chattel mortgage, by other security or simply by the signature of a co-signer of the note. A potential area of danger in the consumer cash loan and installment purchasing field lies in the practice of supplying security for credit through the device of co-signers.

A co-maker or accommodation maker or acceptor, in effect, loans his credit to the person borrowing money. Under the rules of the Uniform Negotiable Instruments Act (Chapter 197, Revised Laws of Hawaii 1955), a co-signer of a promissory note, whether he be technically a co-maker or an accommodation maker or acceptor is primarily and unconditionally liable on the note according to its tenor and terms, including interest provisions and other provisions for payment of costs such as costs of collection.[2]

Solicitude for the co-signer focuses on the person of limited financial resources who is cajoled, coerced or otherwise induced to lend his name or credit as additional security for a promissory note made to secure a loan or installment purchase. The typical co-signer whose interests are most in need of protection is probably either not completely informed of the significance and consequences of the act of co-signing an instrument, or he is likely to overestimate his ability to meet the financial obligation which he knowingly assumes. The day of reckoning for the co-signer arrives when the principal borrower or installment purchaser defaults and is found to be judgment proof. At this point in the credit transaction the original creditor or a subsequent holder in due course of the note is free to proceed against any co-signer on the note for the full amount of the principal plus interest and any costs of collection. The co-signer is then relegated to a position of trying to recover from the borrower or other co-signers through exercising such rights of recourse as exoneration, contribution and reimbursement.

Various approaches intended to mitigate the absolute liability of the co-signer, which under given factual circumstances seems harsh and oppressive, must be considered in the light of a well-recognized dilemma. On the one hand remedial action is certainly desirable to protect the unfortunate co-signer; on the other, the dictates of contemporary commercial life require a policy of facile negotiability of commercial paper.

Proceeding from the established rule of law that the liability of a co-signer, in the absence of such real defenses as fraud and misrepresentation, is primary and unconditional, it is necessary to identify those procedures of the cash loan and installment purchasing business which permit and are conducive to results that appear unfair though technically within the letter of the law. Any one of the following circumstances can be a contributing cause in leading the unwary co-signer into extending his liabilities beyond his financial resources:

(1) Failure to inform co-signers of their legal liability prior to acceptance of their signature;

(2) Failure to investigate thoroughly the credit of co-signers to the same extent as investigations are made of principal borrowers;

(3) Failure to establish the same credit requirements for co-signers as for principal borrowers;

(4) Failure to inform co-signers of the names of other co-signers to loans;

(5) Failure to inform co-signers of delinquency in repayment by the principal borrower before default; and

(6) Failure to inform co-signers of additional amounts added on to existing outstanding loans.

PROFILES OF CONSUMER LOAN LENDING INSTITUTIONS

In an effort to acquire specific information about actual co-signing practices and procedures of lending institutions in Hawaii, a questionnaire (see Appendix) was sent to 7 banks, 69 industrial loan companies, 11 small loan companies and 115 credit unions in the State. The questionnaire was prepared after consultation with representatives of each of the above categories of lending institutions. A total of 59 replies were received from 3 banks, 25 industrial loan companies, 7 small loan companies (some organizations completing a single questionnaire classified themselves as both an industrial loan company and a small loan company) and 30 federal credit unions.

Since the questionnaire response was from less than one-third of the lending institutions, the information received cannot be used to indicate any one prevailing practice or standard. However, to the extent that information was received, it is possible to present some of the variations in practices and standards. Profiles of the responding lending institutions are set forth below.

Banks (3 responses out of 7)

The responding banks indicated that they do not rely to any great extent on loans secured by co-signers, but that when a co-signer is necessary, he is informed of his legal liability, sometimes in writing, and he is informed in writing of delinquency on the part of the primary borrower. The banks tend either to examine thoroughly the credit of the co-signer or to limit the amount of loans which he may co-sign in relation to his financial resources.[3] Bank collections from co-signers appear to occur in an infinitesimal number of cases.

Industrial Loan Companies (25 responses out of 69)

Approximately one-fourth of the responding industrial loan companies do not issue loans secured by co-signers, while another quarter use co-signers only in a few instances. This latter group of companies generally informs co-signers of their legal liability orally though not in writing, makes a thorough investigation of the credit rating of the potential co-signers, and informs them of the names of other co-signers. They also inform co-signers both orally and in writing of delinquency on the part of the primary borrower. Each of these companies takes some special steps to insure that the co-signer's liability will not exceed his ability to meet it. This group of companies collects only a small percentage of its loans secured by co-signers from co-signers.

Ten of the responding industrial loan companies estimated that between 15 and 90 per cent of their loans are secured by co-signers. A few, but not all, of these companies inform co-signers of their legal liabilities orally; only one informs the co-signer of his assumed obligations in writing and then not all the time. The firms investigate the credit rating of a co-signer usually through reliance on a lenders' exchange or clearing house. They also place some reliance on their own credit investigations. The majority, but not all, of the companies reveal the names of other co-signers in some cases, as for instance upon the request of a co-signer. Generally, the co-signer is informed in writing of a delinquency on the part of the primary borrower, but this is not always done. Two of the companies in this group do not always execute new loans for additional amounts loaned to a primary borrower or inform his co-signers of the additional amounts loaned. Two of the companies place no limit on the number or amount of loans a co-signer may sign; limits employed by the other 8 companies vary. Loan companies in this group indicated that in a recent 12-month period the percentages of loans secured by co-signers which were collected from co-signers varied from 0 to 20 per cent.

<u>Small Loan Companies</u> (7 responses out of 11)

Of this group of companies, 1 does not issue loans secured by co-signers, while 4 companies issue only a small number of loans secured by co-signers. The practices followed by these 4 small loan companies parallel those of the industrial loan companies who issue only a small number of loans so secured. Their collections from co-signers vary from 0 to 1 per cent.

Two of the responding small loan companies rely extensively on issuing loans secured by co-signers. The practices of these 2 companies tend to vary in the same manner as those for the industrial loan companies, which rely more heavily on co-signing.

<u>Federal Credit Unions</u> (30 responses out of 115)

Four of the responding credit unions do not issue loans secured by co-signers while 1 requires that a co-signer have sufficient shares in the union to serve as collateral equal to the amount of a loan. Such shares may not be withdrawn or pledged until the loan is paid.

The practices among the 26 other responding credit unions varied widely. The percentages of their loans secured by co-signers run the gamut between 1-1/2 to 100 per cent. Most of the credit unions inform co-signers of their legal liability orally; some do so sometimes; some inform them only in writing; some both orally and in writing; and 2 of the credit unions do not inform co-signers of their liability. Most of the responding credit unions use their own investigators to investigate the credit rating of co-signers. A few indicated that they make no investigation of credit rating of co-signers.

Some of the credit unions reveal the names of other co-signers to a co-signer; some do so sometimes or only if the information is requested by a co-signer. Co-signers are almost always informed of delinquency in repayment by the primary borrowers: sometimes orally, sometimes in writing and sometimes by both methods. In almost all cases a new loan is executed when additional amounts are loaned to a primary borrower. Many of the credit unions reported that their regulations were variable depending on the amount of the loan, the dividing line varying between $450 and $1,000. Limitations on number and amounts of loans a co-signer may sign range from 0 to 5 loans and from 0 to $5,000. There is no pattern among the credit unions with respect to the number of co-signers relative to the existence of other security and the amount of a loan. These 26 credit unions indicated that in recent 12-month periods the percentages of loans secured by co-signers which were collected from co-signers varied from 0 to 65 per cent.

Implications to be Drawn from the Responses of Financial Institutions

A single significant and unarguable conclusion is readily drawn from the information reported by these organizations most likely to be involved with co-signers for consumer credit: the procedures, regulations and standards which are followed constitute a bewildering variety. A competent statistical inquiry probably would develop interesting relationships, for instance, between the thoroughness of credit investigations or the extent to which co-signers are informed of their legal liability and the proportion of co-signer notes collected from co-signers. However, such a statistically significant relationship is not necessarily a causal one.

A critical contemplation of the general nature of the rights and obligations of co-signers would seem to necessitate certain minimal safeguards in order to preserve or establish fair play to co-signers in credit transactions. As might well be expected, the credit industry including credit unions would prefer "self-policing," but if the results of such self-regulation permit continued abuses against the fair interests of co-signers, legislative or administrative remedial measures are worth serious consideration. The lending institutions which currently subscribe to sound and ethically approved practices would not be affected appreciably; those institutions which currently sanction unsound and unethical practices would be affected but would have invited externally imposed regulation.

LEGAL ASPECTS OF REGULATION OF CO-SIGNING

Officers of a nation-wide industrial loan company have indicated that they had not encountered in other states the problem of co-makers or endorsers becoming insolvent because of over endorsing. Furthermore, the literature, case law and statutes do not reveal that the "co-signer" problem has warranted particular study or extensive remedial legislation in other jurisdictions of the United States. However, a few state statutes may be considered relevant to certain facets of Hawaii's co-signer problem or could be adapted to control misuse or abuse of co-signing as a security device in the cash loan and installment purchasing business.

Statutes of Other States

Types of state statutes in other states which offer some degree of protection to co-signers, or which could be amended to cover co-signer protection, are discussed below.

New Mexico; Compulsory Lenders' Exchange. New Mexico has a novel statute aimed at protecting small loan borrowers.[4] This statute provides that small loan businesses may be required by administrative regulation to form and maintain membership in a lenders' exchange and may be limited, also by regulation, in issuing additional loans. This type of legislation could be expanded to apply to the other licensed and regulated lending institutions in addition to small loan companies and to apply specifically to co-signers as well as to principal borrowers.

Arizona; Loan Limitation. Section 6-623 of the Arizona Small Loan Act prohibiting loans over $1,200 "shall also apply to any licensee who permits any person as accommodation maker or co-maker for any borrower to owe to such licensee for one or more loans of money at any time the sum of more than twelve hundred dollars for principal."[5] This provision by spelling out the limitation as it applies to co-makers is more explicit than the prohibition in section 195-22, Revised Laws of Hawaii 1955. Such loan limitation might be expanded to cover total obligations to all licensees under bank and industrial loan acts as well as small loan act licensees, and possibly to credit unions.

Iowa; Self-disclosure. Section 536.25 of the Iowa Small Loan Act provides that "Every licensee when making a loan hereunder shall require a statement in writing from each applicant setting forth a description of all installment indebtedness of such applicant by giving the amount of each such loan and the name of the lender."[6] This requirement of written self-disclosure of other installment indebtedness could be broadened to include co-signer liability of the borrower, could be made applicable to co-signers as well as borrowers and could be required of applicants for loans from banks, industrial loan companies and possibly from credit unions.

Maine; Credit Investigation Charge. Section 205III of the Main Industrial Loan Act provides "To charge for a loan made pursuant to this section $1 for each $50 or fraction thereof loaned, for expenses, including any examination or investigation of the character and circumstances of the borrower, co-maker or surety, and the drawing and taking acknowledgment of necessary papers, or other expenses incurred in making the loan. No charge shall be collected unless a loan shall have been made as a result of such examination or investigation and no such charge shall exceed $5."[7] A provision such as this could be made applicable to small loan companies and to banks, as well as to industrial loan companies, in conjunction with a requirement that they be members of a central lenders' exchange.[8]

Some Legal Jurisdictional Problems

Certain legal problems arise when state regulations are made to apply to federally-chartered financial institutions.

Federal Credit Unions. A significant impediment to effective legislation to protect the interests of co-signers of consumer loans in Hawaii is presented by the position in the State of the 115 credit unions, representing approximately 125,000 members, all of which are federal credit unions chartered under the Federal Credit Union Act.[9] The individual federal credit union by-laws require approval by the Bureau of Federal Credit Unions. It is at least doubtful if state requirements and limitations could be made mandatory upon federally-chartered credit unions although voluntary adoption of parallel rules as specific union by-laws might very well be approved by the Director of the Bureau of Federal Credit Unions.

Although there is little case law on the nature of federal jurisdiction over federal credit unions, such unions are referred to as "creatures of federal enactment."[10]

National Banks. A jurisdictional question analogous to the problem of federal credit unions is posed by the two national banks in Hawaii. The case law in this area is to the effect that a national bank is subject to state law, unless that law interferes with the purposes of its creation or destroys its efficiency or is in conflict with some federal law.[11]

Hawaii Statutes and Co-Signers of Notes

The provisions of the Revised Laws of Hawaii 1955, as amended, which are pertinent to co-signer transactions include section 14A-14, Department of Regulatory Agencies; Chapter 171A, Collection Agencies; Chapter 178, Banks; Chapter 194, the Industrial Loan Act; Chapter 195, the Small Loan Act; and Chapter 197, Uniform Negotiable Instruments Act.

Administrative Regulation. One approach toward control of co-signing practices is administrative regulation which might be deemed to fall within the existing general and specific authority of the director of regulatory agencies or which might be especially authorized under express legislative mandate. Advocates of the administrative approach stress the inadvisability of legislating the minutiae of commercial transactions.

Section 14A-14 delineates the functions, duties and powers of the department of regulatory agencies. "The department shall protect the interests of consumers, depositors and investors throughout the State. It shall set standards and enforce all laws, rules and regulations governing the licensing and operation of and register and supervise the conduct of trades, businesses and professions including banks, insurance companies, brokerage firms and other financial institutions." In addition to these broad regulatory authorizations, the director of regulatory agencies is given specific administrative authority over collection agencies, banks, industrial loan companies, and small loan companies.

Collection Agencies. Chapter 171A provides for state regulation of collection agencies, under the administration of the director of regulatory agencies. In addition to the general pertinency of the role of a collection agency in the debtor-creditor relationship, section 171A-18.5, which authorizes collection and attorneys' fees, would have to be amended if, for instance, a co-signer's legal liability would be statutorily limited to exclude collection or attorneys' fees or to cut off the accrual of interest charges beyond the date of maturity.

Banks. Chapter 178 contains two sections of particular interest to consumer credit transactions. Sections 178-2 in defining the word "banks" states that it means "...the business of discounting and negotiating promissory notes, drafts, bills of exchange and other evidence of debt; to receive deposits of money and deal in commercial paper; to lend money upon the security of real or personal property...and to do such other business as may be usual and lawful in a banking business...." Section 178-3 contains similar language in defining the term "commercial bank". These provisions suggest a possible conclusion that a loan issued by a bank on the security only of one or more co-signatures to a promissory note is not within the powers granted to banks by the legislature. The patent answer, of course, to such a conclusion is that a signature loan is within the blanket authority of the phrase "to do such other business as may be usual or lawful in a banking business."

To the extent that banks deal in negotiable instruments and discount commercial paper issued in connection with installment purchases (as contrasted to consumer cash loans made by banks), they are interested in and are entitled to rely on ready negotiability of promissory notes which is of the essence of the Uniform Negotiable Instruments Law.

Industrial Loan Companies. Chapter 194 deals with industrial loan companies and their business of lending money. It should be noted that credit unions are specifically excluded from the provisions of this chapter. Section 194-14 authorizes industrial loan companies "(b) to lend money upon individual credit or upon the security of co-makers, personal endorsement, or the pledge or mortgage of real or personal property or choses in action, or upon any combination of such credit and security, and to contract for such interest, discount or other consideration as is permitted by this chapter; (c) to discount, purchase or otherwise acquire notes, instalment contracts, warehouse receipts, or other choses in action...."

Statutory limitations on the legal liability of co-signers or statutory regulation of the right to accept co-signers on negotiable instruments would entail amendment of this section on powers of industrial loan companies. Again, a distinction would be called for as between a loan issued directly by the loan company or a negotiable instrument acquired by the company.

Small Loan Companies. Chapter 195 deals with small loan companies and their business of lending money in the amount of $300 or less. As in the case of industrial loan companies, credit unions are specifically excluded from the provisions of this chapter. Section 195-22 pertaining to loans in excess of $300 provides that the limitation on interest rates applies "to any licensee who permits any person as borrower or as endorser, guarantor or surety for any borrower, or otherwise, to owe directly or contingently, or both, to the licensee at any time a sum of more than $300 for principal."

The language of this statute suggests another curative amendment to protect the interest of co-signers. The prohibition against owing $300 to the licensee could be expanded to cover money owed to any licensee and could be further expanded to cover not only licensees under the Small Loan Act but also banks, credit unions and licensees under the Industrial Loan Act. The effectiveness of such a prohibition would call for a requirement that all covered lending institutions be members of a lenders' exchange, similar to the New Mexico provision mentioned above, and coverage would be complete except as limited by the jurisdictional question of immunity of federal credit unions from state control.

CONCLUSION

Regulations to relieve the rigorous financial burdens resulting from unregulated use of the co-signing device are not difficult to formulate. Such regulations, in addition to self-regulation by the lending institutions, include regulation by administrative rules under the existing authority of the director of regulatory agencies and regulation by explicit statutory provisions. A state could make such rules or laws applicable to all lending institutions within its borders except probably federal credit unions and perhaps to a lesser extent, national banks.

Some potential curative rules and statutory provisions are discussed below.

Compulsory Lenders' Exchange and Loan Limitation

Legislation might require that all lending institutions belong to a lenders' exchange or similar credit clearing house agency and that such institutions be prohibited against extension of credit to a borrower or a co-signer without ascertaining that his credit meets previously established standards of acceptability. One objection to this possibility is that limitations on direct and co-signed obligations might be deemed to constitute a wrongful restraint of trade in violation of anti-trust legislation. This objection, however, would seem to merit consideration only if membership in a lenders' exchange with restrictive rules on loans is voluntary. It would seem not to be in point with respect to legislatively authorized compulsory membership in an exchange where the limitations are set pursuant to administrative rules and regulations.

A second objection questions the propriety of participation by federal credit unions in a lenders' exchange as violative of the unions' prohibition against divulging confidential information. The Federal Credit Union Act does not proscribe disclosure of information although Part 320 of Chapter III of Title 45 of the Code of Federal Regulations, relating specifically to records and information of the Bureau of Federal Credit Unions and to officers and employees of the Bureau, the Social Security Administration and the Department of Health, Education and Welfare, provides that records and information of the Bureau are declared to be confidential and may not be disclosed. It does not necessarily follow that the prohibition stated in the Rules and Regulations applicable to the Bureau of Federal Credit Unions would apply as such to the individual credit unions because of participation in a lenders' exchange. In fact, the specimen copy of by-laws under which most federal credit unions operate provides that all transactions of a credit union with its members and all information respecting their personal affairs shall be held in strictest confidence, "except to the extent deemed necessary by the board in connection with the making of loans and the collection thereof." If it is established that membership in a lenders' exchange is deemed necessary in connection with the making and collection of loans, it would appear, then, that such membership would not amount to an invasion of the guaranty of confidentiality. At present the voluntary lenders' exchange, which includes the major finance companies and all the banks, operates within strict limitations on disclosure which is authorized only to members and only for the purpose of determining the amount of obligations reported against an applicant for credit.

Finally, the most serious objection to this proposition involves the inclusion of credit union members under the same standards of credit acceptability that are established for borrowers who apply for credit from commercial financial institutions. The basic security for a credit union loan is the character of the borrower-member who enjoys a common bond of interest with his co-members. Such security follows from the fundamental philosophy and purposes of credit unions including concepts of democratic organization, self-help, and voluntary and cooperative association. These principles give rise to considerations of credit that are fundamentally different from credit considerations commonly acknowledged by commercial lending institutions.

Limitation of Co-Signer's Liability to Principal

Legislation could be enacted placing a limitation restricting the obligation of a co-signer to the amount of the principal loaned and to exclude interest fees accrued after maturity, collection fees and attorneys' fees. Under authorization of existing law, the power to collect interest fees after accrual, collection fees and attorneys' fees is considered an effective deterrent to debt delinquency. It is possible that restricting the obligation of a co-signer to the amount of the principal loaned might encourage collusion between borrowers and their co-signers to arrange for payment by co-signers any time borrowers default in order to take advantage of the limited co-signer obligation. Further, grantors of credit would probably react to such limitations by imposing more stringent credit requirements in cases of credit applicants who are without security other than co-signers.

Informing Co-Signers

The director of regulatory agencies could probably require, under his existing powers and duties, that every co-signer before signing a credit instrument be furnished with oral and written information which clearly and fully explains the extent of the co-signer obligation. This requirement might be implemented by the department by: (a) drafting a model co-signer information form; (b) requiring that all licensed lending institutions furnish the form to every co-signer and that each co-signer read and sign the form before the loan is granted; and (c) conducting periodic spot-checks on co-signers to verify if the regulation is being enforced. Legislation might further strengthen the effectiveness of this requirement by providing that lenders must keep and maintain a signed copy of each co-signer form as a condition precedent to filing an action to collect a debt from any co-signer.

Guarantor as Alternative to Co-Signer

Legislation could be devised or lending institutions could provide as an alternative to the absolute and primary liability of a co-signer, a method to limit the obligation of any one co-signer in cases of credit secured by more than one co-signer. For instance, under an agreement of absolute guaranty, the individual guarantors have only a secondary liability rather than the primary liability of co-signers. The obligation of the guarantor is that the principal debtor will pay, but if he defaults, the guarantor will pay. The guarantor's liability may be expressly limited to a specified amount in the terms of the agreement of guaranty.

Cautions

In considerating administrative or legislative curative measures, two cautions should be observed. If regulations are not properly balanced or are unduly restrictive, individuals seeking necessary credit may be forced to seek it through irregular channels. Secondly, an attempt to ameliorate certain abuses in the narrow field of co-signer liability by indiscriminate tampering with the rules of negotiable instruments such as placing limitations on co-signer liability, could have far-reaching effects within the commercial community and the economy. Particular care needs to be taken not to upset the provisions insuring uniformity of legal treatment of negotiable instruments relating to commercial transactions which are incorporated in the Uniform Negotiable Instruments Law. This law, or its more modern form in the Uniform Commercial Code, applies in every state.

Mrs. Ellen Onaga prepared the manuscript for printing.

FOOTNOTES

1. H. R. T. Employees Federal Credit Union v. Kuaana Bell and Irving Keiser, reported in the Honolulu Advertiser on October 8 and 9 and in the Honolulu Star-Bulletin on October 10, 1962.

2. Territorial Collectors v. Harrison Et Als., 43 H. 98 (1959) quoting from U. S. Court of Appeals, Ninth Circuit, Yost v. Morrow (1959): "It is also settled law that an accommodation maker is bound if consideration passes to the principal maker, and that the accommodation maker has primary, not secondary liability." The rule has also been stated as follows: "One who signs a note as accommodation maker is not a surety but the one primarily liable to a holder for value." (72 C. J. S., Principal and Surety, sec. 216)

3. The following quotation is from the First National Bank of Hawaii, Standard Practice Manual: "There may be instances where a loan application contains marginal factors which could affect the borrower's ability to service his debt. In this event, the support of a co-maker or endorser may qualify the loan. The co-maker or endorser, unless he is an established borrower, should also complete a loan application and/or financial statement. Such person must have the ability to assume the burden of servicing the borrower's debt in addition to his own obligations in the event that it becomes necessary.

   "Credit investigation of the co-maker or endorser must be made and the findings domiciled in the borrower's loan jacket. It should be remembered that a co-maker or endorser does not change a poor loan into a good loan and further that the experience of calling on co-makers for payment is not a pleasant one. For these reasons, the co-maker/endorser should be thoroughly apprised of his obligations in giving his guaranty of payment."

4. N. M. Stat. Ann. ch. 48, art. 17 (1963): "48-17-45. LENDER'S EXCHANGE. In order to preclude the burdening of a small loan borrower or borrowers with multiple loans, in any municipality in this State where more than two licenses shall at any time be in effect, the Examiner may by a proper regulation and order require that the licensees therein shall form and maintain membership in a lenders' exchange through which said licensees may be kept fully informed as to outstanding loans in force under this Act to any one borrower in other licensed offices in such municipality.

   "The Examiner's regulation and order affecting licensees in such municipality may provide that where one loan to the same borrower or borrowers is in effect in one licensed office, a second loan shall not intentionally or without due care be made by a licensee in such municipality under this Act, until the outstanding loan has been paid or otherwise discharged out of the proceeds of the second loan."

5. Small Loan Act, Ariz. Rev. Stat. Ann. tit. 6, ch. 5 (1963).

6. Small Loan Act, Io. Code ch. 536 (1962).

7. Industrial or Morris Plan Banks, Me. Rev. Stat. ch. 59 (1954).

8. Edward W. Reed, Consumer Financing Costs and Practices in Hawaii (Honolulu: Economic Research Center, University of Hawaii, 1960). It has been estimated that in Hawaii the cost of a telephone credit report from the Credit Bureau is sixty-five cents, and from the Lenders' Exchange ten cents. A written report is estimated to cost one dollar and a half. Since 1960 these costs have increased somewhat.

9. 48 Stat. 1216 (1934) as amended 73 Stat. 628 (1959), 12 U.S.C.A. 1751.

10. House v. Schwartz, Supp. 1959, 188 N.Y.S.2d 308.

11. Commercial State Bank of Roseville v. Gidney, 1959, 174 F. Supp. 770, affirmed 278 F.2d871, 108 D.C. Cir. 37.

APPENDIX

QUESTIONS INCLUDED IN THE QUESTIONNAIRE

Name of Lending Organization: ______________________________

1. Nature of organization:

   _____ bank
   _____ industrial loan company
   _____ small loan company
   _____ credit union

2. Portion of total current outstanding loans secured by accommodation makers:

   a. Estimated percentage of total loans made secured by accommodation makers _____%
   b. Estimated percentage of total amount loaned secured by accommodation makers _____%
   c. Estimated percentage of total loans made secured by accommodation makers <u>only</u> _____%
   d. Estimated percentage of total amount loaned secured by accommodation makers <u>only</u> _____%

<u>Note on Questions 3 and 4</u>: If your policies and regulations relating to investigation of and informing of accommodation makers vary depending on the amount loaned, please answer question 3 for loans exceeding your limiting amount and question 4 for loans less than your limiting amount. If your policies and regulations do not vary with the amount loaned, please answer question 3 only.

	Always	Frequently	Sometimes	Never
	(please indicate your policy by placing a check in the appropriate column)			
3. Policies and regulations relating to investigation of and informing of accommodation makers on loans exceeding $_______:				
a. Do you inform accommodation makers of their legal liability prior to acceptance of their signatures:				
If yes, do you inform them orally:				
If yes, do you inform them in writing:				
b. Do you investigate credit rating of accommodation makers:				
If yes, do you use the services of a lenders' exchange or clearing house:				
If yes, do you rely on your own credit investigators:				
If yes, do you personally interview accommodation makers:				
c. Do you inform accommodation makers of the names of other accommodation makers:				
d. Do you inform accommodation makers of delinquency in repayment by the primary maker before default:				
If yes, do you inform them orally:				
If yes, do you inform them in writing:				
e. If additional amounts are loaned to the same primary maker, is a new loan executed:				
If a new loan is not executed, are accommodation makers informed of the additional amounts loaned:				
4. Policies and regulations relating to investigation of and informing of accommodation makers on loans of less than $_______:				
a. Do you inform accommodation makers of their legal liability prior to acceptance of their signatures:				
If yes, do you inform them orally:				
If yes, do you inform them in writing:				
b. Do you investigate credit rating of accommodation makers:				
If yes, do you use the services of a lenders' exchange or clearing house:				
If yes, do you rely on your own credit investigators:				
If yes, do you personally interview accommodation makers:				
c. Do you inform accommodation makers of the names of other accommodation makers:				
d. Do you inform accommodation makers of delinquency in repayment by the primary maker before default:				
If yes, do you inform them orally:				
If yes, do you inform them in writing:				
e. If additional amounts are loaned to the same primary maker, is a new loan executed:				
If a new loan is not executed, are accommodation makers informed of the additional amounts loaned:				

5. Policies and regulations relating to acceptability of accommodation makers who are already accommodation makers to existing loans:

   a. Is there a limit on the total number of loans such an accommodation maker may have co-signed: ____Yes ____No
      If yes, what is the numerical limit: ____________

   b. Is there a limit on the total amount of loans such an accommodation maker may have co-signed: ____Yes ____No
      If yes, what is the limit: $____________

6. Policies and regulations relating to number of accommodation makers on a given loan:

   a. Do you require a minimum number of accommodation makers for each loan: ____Yes ____No
      If yes, does the minimum number depend on the existence of other security: ____Yes ____No
      If yes, is the minimum number related to the amount of the loan: ____Yes ____No

7. Estimated portion of total loans for a recent 12-month period secured by accommodation makers which were collected in whole or in part from accommodation makers:

   a. Estimated percentage of total number of loans secured by accommodation makers which were collected in whole or in part from accommodation makers: ____%

   b. Estimated percentage of total amount loaned secured by accommodation makers which were collected in whole or in part from accommodation makers: ____%

   c. Inclusive dates to which above estimates are applicable: ____ to ____

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