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# MISCONCEPTIONS ABOUT ARTICLE 3 OF THE UNIFORM COMMERCIAL CODE: A SUGGESTED METHODOLOGY AND PROPOSED REVISIONS

LARY LAWRENCE†

*Article 3 of the Uniform Commercial Code governs the law of commercial paper. Courts have tried to apply Article 3 as if it were a comprehensive code. Professor Lawrence asserts that the Negotiable Instruments Law (N.I.L.), the statutory predecessor of Article 3, was not a code because it was not a comprehensive and preemptive statement of the law of negotiable instruments. Because Article 3, based on the N.I.L., is similarly not such a comprehensive and preemptive statement, it is not a true code either. He identifies three problems with applying a code methodology to Article 3: (1) Article 3 is filled with inconsistent terminology; (2) Article 3 is explicitly intended to supplement, rather than preempt, the common law; and (3) Article 3 was not intended to cover situations not envisioned by its drafters. He maintains that the provisions of Article 3 can only be interpreted properly by examining the N.I.L. provisions upon which they are based, and that Article 3 should not be forced to cover situations to which it was never meant to apply. Professor Lawrence concludes by suggesting how the drafters of the New Payments Code can amend Article 3 so that it may be treated more appropriately as a code.*

## I. INTRODUCTION

Since its promulgation, Article 3 of the Uniform Commercial Code (U.C.C.),<sup>1</sup> which covers the law of commercial paper, has perplexed judges, lawyers, scholars, and students alike. This confusion can be attributed to two causes: (1) the failure of the drafters of Article 3 to provide comprehensive rules that use consistent terminology understandable without reference to pre-U.C.C. law, or to foresee potential problems that did not exist under the prior Negotiable Instruments Law (N.I.L.); and (2) the failure of those now interpreting Article 3 to understand these shortcomings and to interpret Article 3 in light of them.

Most judges, lawyers, and scholars have attempted to apply Article 3 as though it were a comprehensive and integrated set of rules, or, in other words,

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1. All citations to the U.C.C are to the 1978 edition unless otherwise indicated; all citations to the N.I.L. are to the 1934 edition.

as a "code."<sup>2</sup> This Article demonstrates that Article 3 is not a code and examines the causes of the popular misconception that Article 3 is a code. It then suggests a more suitable methodology for interpreting Article 3. Finally, since the New Payments Code is now being drafted for the purpose of amending Articles 3 and 4 of the U.C.C.,<sup>3</sup> the Article suggests how Article 3 should be revised so it may properly be treated as a code.

## II. PURPOSES FOR DRAFTING THE UNIFORM COMMERCIAL CODE

When the effort began to draft the Uniform Commercial Code, the various state rules governing commercial transactions were often in conflict.<sup>4</sup> A lawyer would have had to spend many hours of research to safely advise his client about the legal consequences of conduct in another state. Because commercial statutes generally were outdated and only sporadically contained the applicable rules, a lawyer often would have to undertake substantial case research before he safely could give such advice even within his own state.<sup>5</sup> Due to innumerable cases that frequently conflicted, even extensive research often failed to yield a clear and certain answer.<sup>6</sup>

The drafters realized that in the field of commercial law there was a special need for a "relatively compact, relatively accessible, relatively stable body of law which will not cost a week's research for each ten-minute consultation."<sup>7</sup> Thus, in undertaking to draft the U.C.C., the drafters had formulated certain general goals: (1) to make the law uniform among the different states;<sup>8</sup> (2) to make the law more certain;<sup>9</sup> (3) to correct undesirable decisions;<sup>10</sup> (4) to

2. A "code" can be described as a preemptive, systematic and comprehensive enactment of a whole field of law. It is preemptive in that it displaces all law other than that which it excepts. It is systematic in that all parts, arranged in orderly fashion with consistent terminology, form an interlocking, integrated body, revealing its own plan and containing its own methodology. Finally, it is comprehensive in that it is inclusive and independent so as to be administered in accordance with its own basic policies. Hawkland, *Uniform Commercial "Code" Methodology*, 1962 U. ILL. L.F. 291-92 (1962). The best examples of codes in this sense of the term are the German and French Civil Codes. Patterson, *The Codification of Commercial Law in Light of Jurisprudence*, in 1 STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION FOR 1955: STUDY OF THE UNIFORM COMMERCIAL CODE 41, 67 (1955) [hereinafter cited as 1 STATE OF NEW YORK]. See generally Schlesinger, *The Uniform Commercial Code in Light of Comparative Law*, in 1 STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION FOR 1955; STUDY OF THE UNIFORM COMMERCIAL CODE 87-123 (1955); Franklin, *On the Legal Method of the Uniform Commercial Code*, 16 LAW & CONTEMP. PROBS. 330 (1951).

3. The Articles 3, 4 and 8 Committee of the Permanent Editorial Board of the Uniform Commercial Code ("Board") issued its Tentative Draft No. 3 of the New Payments Code in May, 1983. It is anticipated that the final draft will be presented to the Board's authorizing bodies, the American Law Institute and the National Conference of Commissioners on Uniform State Laws, in the summer of 1984.

4. Gilmore, *Legal Realism: Its Cause and Cure*, 70 YALE L.J. 1037, 1044 (1961); Rossman, *Uniformity of Law: An Elusive Goal*, 36 A.B.A. J. 175 (1950).

5. Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364, 379 (1952); Llewellyn, *Why We Need the Uniform Commercial Code*, 10 U. FLA. L. REV. 367, 371 (1957).

6. Gilmore, *supra* note 4, at 1041.

7. Llewellyn, *supra* note 5, at 373.

8. U.C.C. § 1-102(2)(c); Rossman, *supra* note 4.

9. Llewellyn, *supra* note 5, at 369, 370, 377.

10. Llewellyn, *supra* note 5, at 380.

eliminate the need for extensive case law research;<sup>11</sup> (5) to make the law more understandable;<sup>12</sup> and (6) to modernize the law to correspond to modern business practices.<sup>13</sup>

The drafters were familiar with the commercial codes of France and Germany.<sup>14</sup> They realized that to achieve their goals it was essential that the U.C.C. be in the nature of a civil law code.<sup>15</sup> A statute that laid down rules for specific situations to be construed narrowly by the courts would not accomplish their goals.<sup>16</sup> A statute would become so encrusted with conflicting case law that the problems that necessitated drafting the U.C.C. would haunt the U.C.C. itself. The Reporter for Article 9, the late Professor Grant Gilmore, explained the distinction between a "code" and a "statute" as follows:

A "statute," let us say, is a legislative enactment which goes as far as it goes and no further: that is to say, when a case arises which is not within the precise statutory language, which reveals a gap in the statutory scheme or a situation not foreseen by the draftsmen (even though the situation is within the general area covered by the statute), then the court should put the statute out of mind and reason its way to decision according to the basic principles of the common law. A "code," let us say, is a legislative enactment which entirely pre-empts the field and which is assumed to carry within it the answers to all possible questions: thus when a court comes to a gap or an unforeseen situation, its duty is to find, by extrapolation and analogy, a solution consistent with the policy of the codifying law; the pre-Code common law is no longer available as an authoritative source. We may take another, subsidiary distinction between "statute" and "code." When a "statute," having been in force for a time, has been interpreted in a series of judicial opinions, those opinions themselves become part of the statutory complex: the meaning of the statute must now be sought not merely in the statutory text but in the statute *plus* the cases that have been decided under it. A "code," on the other hand, remains at all times its own best evidence of what it means: cases decided under it may be interesting, persuasive, cogent, but each new case must be referred for decision to the undrafted code text.<sup>17</sup>

A true code, as Gilmore defined it, cannot be drafted.<sup>18</sup> The infinite variety of commercial transactions and the innumerable potential problems arising from these transactions would require the drafting of an infinite number of

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11. Llewellyn, *supra* note 5, at 373; Gilmore, *supra* note 5, at 379.

12. Llewellyn, *supra* note 5, at 369; Schnader, *The New Commercial Code: Modernizing Our Uniform Commercial Acts*, 36 A.B.A. J. 179 (1950).

13. Schnader, *supra* note 12 at 182; *see also* Leary, *Commercial Paper: Article III*, 16 ARK. L. REV. 33, 35 (1961).

14. *See supra* note 2.

15. *See supra* note 2.

16. Gilmore, *supra* note 4, at 1043.

17. *Id.*

18. 1 STATE OF NEW YORK, *supra* note 2, at 37 n.2 (1955); Patterson, *supra* note 2, at 67.

rules.<sup>19</sup> Even if a true code could be drafted, it is doubtful whether it ever would be accepted in a country with a common-law tradition as strong as ours. Our long tradition of leaving to the judiciary the task of alleviating the harshness of general rules and of molding those rules to accommodate changes in business practices is too strong to give way to an inflexible set of totally preemptive and comprehensive rules. Yet, a statutory scheme could be drafted that possesses enough characteristics of a true code to be called a "code"<sup>20</sup> and which would permit, in most instances, the use of a code methodology.<sup>21</sup>

To achieve the goals desired by the drafters, the U.C.C. must have certain code characteristics. First, to reduce greatly the need for case law research, the U.C.C. has to contain rules governing virtually all of the commonly arising problems.<sup>22</sup> Second, the scope of the rules has to be clear to both judges and lawyers.<sup>23</sup> Each rule must make clear the extent to which non-U.C.C. law is displaced by the rule and must be specific enough to enable a judge or lawyer to know the cases in which the legislature has dictated the legal consequences of particular conduct (as opposed to leaving the decision to the courts).<sup>24</sup> Unless the scope of each rule is clear, courts will be required, on an ad hoc basis, to interpret ambiguous rules and to determine which non-U.C.C. rules are still in effect. With little guidance to the appropriate answers, different courts could reach conflicting results. Certainty and uniformity would be lost.<sup>25</sup>

Third, the rule chosen has to be general enough to permit courts to shape predictable answers to unforeseen questions.<sup>26</sup> It has to be flexible enough both to accommodate changes in business practices or relations<sup>27</sup> and to enable a court, in an appropriate case, to grant relief when grave injustice would otherwise result from application of the rule.<sup>28</sup> This flexibility could be achieved by incorporating an element of judicial discretion into the rule or by making clear which type of transactions or business practices or relations the rule was intended to govern. Without this flexibility a court would be en-

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19. 1 STATE OF NEW YORK, *supra* note 2, at 37 n.2; Patterson, *supra* note 2, at 67.

20. See *supra* note 2 for a discussion of the term "code." "Code" has also been defined as "an orderly and authoritative statement of the leading rules of law on a given subject." 1 STATE OF NEW YORK, *supra* note 18, at 37, (quoting H. GOODRICH, *Restatement and Codification in FIELD CENTENARY ESSAYS* 241, 243 (1949)).

21. See *supra* text accompanying note 17. As long as a statutory system attempted to set forth in an orderly manner virtually all of the leading rules composing a body of law, reasoning by means of extrapolation and analogy from the rules stated would be the proper means of deciding any issue within the scope of one of the stated rules. As long as the specific rules stated are intended to displace all other rules related to the principle involved, a code methodology would be appropriate. It is not essential that every potential type of problem in the specific subject matter be covered by a rule. Excluded issues—as long as it is clear which issues are excluded—could be treated as problems of common law without in any way negating the propriety of using the code methodology when preemptive rules are provided.

22. 1 STATE OF NEW YORK, *supra* note 2, at 37.

23. Llewellyn, *supra* note 5, at 375; Patterson, *supra* note 2, at 68.

24. Llewellyn, *supra* note 5, at 375; Patterson, *supra* note 2, at 68.

25. Llewellyn, *supra* note 5, at 369-70.

26. Llewellyn, *supra* note 5, at 368.

27. U.C.C. § 1-102 comment 1; Mentschikoff, *Highlights of the Uniform Commercial Code*, 27 MOD. L. REV. 167, 171 (1964).

28. Hawkland, *supra* note 2, at 304-09; Mentschikoff, *supra* note 27, at 171.

couraged to stretch or misapply a rule either to accommodate unforeseen situations or to prevent injustice in a particular case,<sup>29</sup> further reducing certainty even in cases in which the rule clearly was intended to apply. When a court stretches or misapplies a rule in one case, a lawyer cannot know whether the court is adopting generally that interpretation of the rule or whether the interpretation was intended to be limited to the specific facts of that case.

The drafters of the U.C.C. believed that they successfully had endowed the U.C.C. with the characteristics of a code.<sup>30</sup> Karl Llewellyn, Chief Reporter of the U.C.C., in praising the drafters' accomplishments, stated that certainty had been increased by the adoption of the U.C.C. because one no longer needed case law knowledge but could rely upon the text of the U.C.C. and practice guides alone.<sup>31</sup> The "General Provisions" contained in Article 1 further demonstrate this belief.<sup>32</sup> For instance, Section 1-102(1) states: "This Act shall be liberally construed and applied to promote its underlying purposes and policies." Section 1-102(2) stated these purposes and policies:

- (a) to simplify, clarify and modernize the law governing commercial transactions;
- (b) to permit the continued expansion of commercial practices through customs, usage and agreement of the parties;
- (c) to make uniform the law among the various jurisdictions.

Furthermore, the comments to section 1-104, in referring to the resistance of sections of the U.C.C. to implied repeal, note that the U.C.C. is "carefully integrated and intended as a uniform codification of permanent character covering an entire 'field' of law . . . ."

Finally, section 1-103 provides that the rules contained in the U.C.C. should be interpreted as preempting the common law whenever the two conflict: "unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions."

### III. THE DRAFTING OF ARTICLE 3

Since each article of the U.C.C. was drafted by a different set of drafters,<sup>33</sup> it is not surprising that the eight substantive articles each exhibit the characteristics of a code to very different degrees. Thus, although a code methodology may be appropriate in dealing with one article it may not be appropriate when another article is involved. A code methodology is not appropriate in interpreting Article 3 because Article 3 probably exhibits fewer of the characteristics of a code than any of the other articles. In order to formulate a more appropriate methodology for applying Article 3, it is essential to understand the manner in which Article 3 was drafted.

Although the drafters of Article 3 may have intended to draft a code, they

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29. Hawkland, *supra* note 2, at 304-05.

30. Llewellyn, *supra* note 5, at 377; Franklin, *supra* note 2.

31. Llewellyn, *supra* note 5, at 377.

32. Franklin, *supra* note 2.

33. J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 1, at 3 (2d ed. 1980).

did not do so. Their failure can be attributed to an erroneous perception that there was no need to redraft completely the then-present law of negotiable instruments to achieve their goals.<sup>34</sup> When the U.C.C. was being drafted, the law of negotiable instruments had already been codified in the Uniform Negotiable Instruments Law ("N.I.L."). The N.I.L. had been adopted by all forty-eight states.<sup>35</sup> Lawyers and bankers alike had felt that the N.I.L. generally worked well.<sup>36</sup> It provided answers to many of the more frequently encountered questions,<sup>37</sup> and provided some uniformity between the laws of the several states.<sup>38</sup> While there were several statutory variations in the versions adopted by the different states, the statutory language adopted was reasonably uniform.<sup>39</sup> Uniformity of the law was not fully achieved, though, because of the roughly eighty judicial conflicts among the state courts interpreting the N.I.L.<sup>40</sup>

Believing that the N.I.L. had worked reasonably well, the drafters apparently did not question whether either its structure or its basic premises needed substantial revision.<sup>41</sup> They instead set out to accomplish four, more limited, objectives. First, they needed to find a way to treat investment securities. Since the N.I.L. covered all negotiable instruments, an instrument had to comply with all the requirements of the N.I.L. in order to be negotiable.<sup>42</sup> Thus, in order for investment securities, like corporate bonds, to be negotiable, they had to meet the same requirements for negotiability as did ordinary negotiable instruments, such as personal promissory notes.<sup>43</sup> But corporate bonds would not be marketable if they did not contain certain provisions for the protection of bondholders.<sup>44</sup> These provisions were inappropriate for ordinary promissory notes.<sup>45</sup> The N.I.L., having been drafted with ordinary promissory notes in mind, prohibited many of these provisions.<sup>46</sup> Yet corporate bonds also needed to be negotiable to be marketable.<sup>47</sup> Courts found themselves in a dilemma. They either had to find that the inclusion of these provisions made the bonds nonnegotiable, which would thereby destroy their marketability, or

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34. Llewellyn, *supra* note 5, at 380; Leary, *supra* note 13, at 34-35.

35. The Uniform Negotiable Instruments Law was first adopted in 1897 by New York and by 1924 had been adopted by all forty-eight states. 2 STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION FOR 1955: STUDY OF THE UNIFORM COMMERCIAL CODE 775 (1955) [hereinafter cited as 2 STATE OF NEW YORK].

36. *Id.* at 776; Llewellyn, *supra* note 5, at 368.

37. Llewellyn, *supra* note 5, at 368.

38. *Id.*

39. 2 STATE OF NEW YORK, *supra* note 35, at 775.

40. 2 STATE OF NEW YORK, *supra* note 35, at 776; Schnader, *supra* note 12, at 181; Leary, *supra* note 13, at 34-35.

41. Llewellyn, *supra* note 5, at 380; Leary, *supra* note 13, at 34-35.

42. Leary, *Commercial Paper: Some Aspects of Article 3 of the Uniform Commercial Code*, 48 KY. L.J. 198, 203-04 (1960).

43. *Id.* at 204; Sherman & Feeny, *An Examination of the Negotiability Concept of the Uniform Commercial Code*, 1953 WASH. U.L.Q. 297, 306-07.

44. See *supra* note 43.

45. See *supra* note 43.

46. See *supra* note 43.

47. See *supra* note 43.

had to distort the requirements for negotiability under the N.I.L., thereby finding the bonds to be negotiable.<sup>48</sup> But adopting the latter approach would have made it possible for promissory notes containing these same provisions, which were clearly inappropriate for ordinary promissory notes, to be negotiable also. To solve this problem, the drafters decided to provide separately for investment securities by drafting Article 8.<sup>49</sup> Article 3 consequently was drafted to cover only ordinary negotiable instruments.<sup>50</sup> The drafters' second objective was to ensure uniformity among the various states.<sup>51</sup> To accomplish this objective, they attempted to provide a single uniform rule to eliminate the conflicts of judicial construction that existed under the N.I.L.<sup>52</sup> Third, to a very limited extent, they wanted to modernize some of the more outdated rules contained in the N.I.L.<sup>53</sup> Finally, they wanted to reorganize and simplify some of the N.I.L.'s more cumbersome provisions.<sup>54</sup>

The failure of the drafters to question the structure or premises underlying the N.I.L. prevented them from making Article 3 a code. The N.I.L. was not a code.<sup>55</sup> Rather it was a set of specific statutes heavily supplemented by case law.<sup>56</sup> At a time when there was not a great proliferation of cases, a statutory scheme supplemented by case law might, as did the N.I.L., work reasonably well.<sup>57</sup> But when the number of cases become great enough to make legal research cumbersome, reliance upon too many rules of the common law undermines any attempt at codification.<sup>58</sup> By not questioning whether the N.I.L. was drafted in the nature of a code, the drafters did not realize that merely restating the rules already found in the N.I.L., together with providing resolutions for conflicting judicial interpretations, would not

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48. See *supra* note 43.

49. U.C.C. § 3-103(1).

50. *Id.*

51. Llewellyn, *supra* note 5, at 380; Schnader, *supra* note 12, at 180-82; Leary, *supra* note 13, at 34-35.

52. 2 STATE OF NEW YORK, *supra* note 35, at 776; Schnader, *supra* note 12, at 181; Leary, *supra* note 13, at 34-35.

53. Leary, *supra* note 13, at 35; Schnader, *supra* note 12, at 182.

54. Cosway, *Negotiable Instruments in the Uniform Commercial Code*, 1 BUS. L. REV. 222, 224 (1954).

55. Hawkland, *supra* note 2, at 297. Professor Beutel believes that the N.I.L. was a code. He contends that only because the courts interpreting the N.I.L. failed to treat it as a code did the law become as unsettled as it ultimately did under the N.I.L. F. BEUTEL, BEUTEL'S BRANNAN NEGOTIABLE INSTRUMENTS LAW 80 (7th ed. 1948). Although it is possible that the N.I.L. was a code in many respects, it did neglect to provide rules in many areas including, for instance, rules for conversion and negligence. The extent of these omissions would appear to be sufficient to prevent it from being a comprehensive code. As can be seen in the remainder of this article, correcting the problems that arose under the N.I.L. was not enough to make Article 3 a Code. Chancellor Hawkland contends in his article, *supra* note 2, that since negotiable instruments are not an entire field of law, any statutory enactment would be only a fragmentary code and could never be comprehensive. Contrary to his contentions, it appears that a comprehensive set of rules which indicates the specific areas in which the rules governing negotiable instruments are subject to rules of law in other fields can be developed. Hawkland, *supra* note 2, at 310.

56. See *supra* note 55.

57. Gilmore, *supra* note 4, at 1041.

58. *Id.*



make Article 3 a code.<sup>59</sup> The task of making Article 3 a code may have been possible without a whole reworking of the N.I.L. If the drafters had attempted simply to incorporate into Article 3 all of the specific common-law rules they had desired to retain and had indicated what areas they wanted to leave for judicial discretion, the product may have been a code. But instead, probably because of their own familiarity with the common-law principles that supplemented the N.I.L., they apparently assumed that all those using Article 3 likewise would be familiar with these principles. Very little thought was given to whether the provisions of Article 3 could be understood without an understanding of the N.I.L. and its accompanying case law.

Since little thought was given to whether the basic premises underlying the N.I.L. were still appropriate in 1950 or would remain appropriate in 1980 or 1990, it is not surprising that Article 3 was not equipped to handle changes in commercial practices and relations. Furthermore, courts were given no direction by the drafters about whether the rules of Article 3 should be applied literally to problems unforeseen at the time of its drafting.

#### IV. ARTICLE 3 METHODOLOGY

Most courts, scholars, and lawyers, being unfamiliar with the manner in which Article 3 was drafted, have employed a methodology in interpreting Article 3 that would be appropriate only if it were a code. Article 3 has been treated as though its rules contained an answer for virtually every commercial paper question. Each rule has been interpreted broadly. Often, when no answer has been readily apparent, any rule has been applied whose terms possibly could be interpreted to cover the situation, even when it was fairly clear that the situation did not fall within the intended coverage of the rule.<sup>60</sup> There has been a consistent refusal to look to the common law in cases in which Article 3 does not appear to be applicable.<sup>61</sup> Because Article 3 was not drafted as a code, a code methodology cannot be employed. There are, in particular, three serious deficiencies in the drafting of Article 3 that make the application of a code methodology clearly inappropriate.

First, the terminology used in Article 3, even when specifically defined in the U.C.C. itself, is not used in a consistent manner. Since many of the rules found in Article 3 were drafted for the specific purpose of resolving a particular conflict that had existed under the N.I.L., the drafters' choice of terminology was directed to resolving that conflict.<sup>62</sup> The choice of a specific term did provide the intended answer to the question the drafters sought to resolve. But, unfortunately, the drafters did not examine sufficiently whether the desired results were achieved when the chosen term was applied literally to all possible situations arising under the rule. As a result, applying a code method-

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59. Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334, 338 (1952).

60. See *infra* pt. V, C(1).

61. *Id.*

62. See Beutel, *supra* note 59, at 338.

ology, which requires interpreting consistently all terminology used in the same code, dictates questionable answers to many problems as well as answers that clearly were not intended by the drafters.<sup>63</sup>

Second, many sections of Article 3 do not state the general rules governing the subject matter intended to be covered by that section.<sup>64</sup> Instead, these sections were drafted merely to provide rules when the case law under the N.I.L. was in conflict.<sup>65</sup> Thus, under these sections, answers to questions other than those specifically covered cannot be deduced by a broad literal application of the rules stated.<sup>66</sup> As with the terminology of Article 3, attempting to generalize from rules chosen to resolve very specific questions will not result in reaching answers intended by the drafters.

Third, since the drafters simply accepted, with rare exception, the basic premises of the N.I.L., Article 3 is drafted against a background of commercial transactions and practices existing in 1895, the year the N.I.L. was drafted.<sup>67</sup> To the extent that these commercial transactions or practices have changed, rules that were designed for them are being applied to new types of unanticipated transactions or practices. This results in applying value judgments made about one situation to another situation about which no such value judgments have yet been made.

The manner in which Article 3 was drafted necessitates use of a methodology substantially different than the one used in applying a code. One cannot rely upon deducing answers to particular problems from the generally stated rules.<sup>68</sup> Although many problems may be answered by applying literally the appropriate section of Article 3, many problems cannot be approached in this manner. The only simple rule is that whenever common sense and a literal reading of the section reach the same result, it is likely that the result reached was the one intended by the drafters.

A more appropriate methodology<sup>69</sup> for applying Article 3 is first to determine how the particular problem would be answered under the N.I.L. To discover the result under the N.I.L., a judge or lawyer may consult numerous legal treatises on the N.I.L.<sup>70</sup> and the 1955 Report of the New York Law Revision Commission. The drafters intended to change very few of the rules contained in the N.I.L. They were instead content, in general, to vary from the N.I.L. only to the extent of choosing one of the conflicting judicial interpreta-

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63. See *infra* pt. V, A. See generally, Patterson, *supra* note 2, at 64-65.

64. See *infra* pt. V, B.

65. See *supra* note 59.

66. See generally, Patterson, *supra* note 2, at 65-67.

67. F. BEUTEL, *supra* note 55, at 74.

68. See Hawkland, *supra* note 2, for a discussion of the application of the code methodology to interpretation of the U.C.C.

69. Professor Beutel has suggested use of a similar methodology for interpretation of the N.I.L. F. BEUTEL, *supra* note 55, at 93-101.

70. Some of the numerous treatises on the N.I.L. include W. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES (2d ed. 1961); F. BEUTEL, *supra* note 55; J. OGDEN, THE LAW OF NEGOTIABLE INSTRUMENTS (5th ed. 1947). For a treatise on the law of negotiable instruments, see J. DANIEL, A TREATISE ON THE LAW OF NEGOTIABLE INSTRUMENTS (4th ed. 1891).

tions of ambiguous provisions of the N.I.L.<sup>71</sup> It is therefore usually safe to assume that the drafters intended to adopt the same rule as that found under the N.I.L. if they did not affirmatively indicate their intent to change the rule. When a literal reading of Article 3 yields the same answer as that found under the N.I.L., it is usually safe to assume that the drafters intended to retain the N.I.L. rule. But when a section of Article 3 suggests a different answer, it is necessary to determine whether a change in result was in fact intended. To ascertain this, it is necessary to discover the precise problems intended to be covered by the particular section by finding the corresponding section of the N.I.L.<sup>72</sup> and then to determine the precise scope and interpretation the courts have given the section. As part of this inquiry it is necessary to focus on any conflicting judicial interpretations of the section. Sometimes it will be clear by looking at the text together with the comments whether the drafters generally intended to change the N.I.L. rule or instead simply were providing a resolution for some unrelated conflict that existed under the N.I.L. When a reading of the text and comments do not indicate the precise intent, reference to the earlier drafts of Article 3,<sup>73</sup> together with the comments to these drafts, often will make the answer clear.<sup>74</sup> In virtually every situation, this type of historical inquiry will disclose precisely why the drafters chose to express the rule in the particular terms employed and whether change of the existing rule under the N.I.L. was one of these reasons.

When the drafters intended to change the rule found under the N.I.L., the question whether a court should honor this intention is simply the traditional question about the degree to which a court should be bound by legislative intent. Without very strong reasons to the contrary, the need for certainty in commercial transactions dictates that a court should honor the legislative intention. When it is discovered that the section, although seemingly applicable to the situation, was originally intended to resolve some unrelated conflict, a

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71. Llewellyn, *supra* note 5, at 380; Leary, *supra* note 13, at 34-35.

72. This task is made considerably easier since the "Official Comment" to each section of Article 3 contains a reference to the corresponding sections of the N.I.L. in a section entitled "Prior Uniform Statutory Provisions."

73. There are numerous prior drafts of Article 3. Most of these drafts and supplements to drafts include notes and comments by the drafters. The following is a list of most of these prior drafts and supplements: Tentative Draft No. 1 (1946); Tentative Draft No. 2 (1947); Tentative Draft No. 3 (1947); Proposed Final Draft No. 1 (1948); Proposed Final Draft No. 2 (1948); May 1949 Draft; Spring 1950 Draft; Final Text Edition (November 1951); Official Draft (1952); Recommendations of The Editorial Board for Changes in the Text and Comments (April 30, 1953); Supplement No. 1 to the 1952 Official Draft (January 1955); 1956 Recommendations of the Editorial Board for the U.C.C.; 1957 Official Edition; 1958 Supplement to the 1957 Official Text (December 1958); 1958 Official Text; 1962 Official Text.

74. The notes and comments to the earlier drafts and the specific wording of the earlier drafts are extremely helpful in attempting to discover the specific problems that the drafters were trying to resolve in the section at issue. Determining what specific problem the drafters intended to solve usually will explain why particular language was employed. By the same token, the omission of any mention of a problem may at times indicate that the drafters did not have that problem in mind when they chose to employ the particular terminology. The notes and comments to the earlier drafts often contain insightful statements omitted from the Official Comment to the most recent Official Text. It is usually fairly easy to determine whether the omission of the statement in the Official Comment was because the drafters intended to reject the statement or for some unrelated reason.

different approach must be adopted. Under these circumstances, a court should determine whether the problem presented is similar enough to the problems intended to be covered by the section to compel application of the section by analogy. If not, then even though a literal application of the section would seem to govern the problem, the section should be ignored and a court should analyze the question as it would any common-law question. While a court should not disregard the general policies of the U.C.C., it should not feel bound by the general policies when a different result is dictated by the particularities of the question. Similarly, when the types of transactions or practices that the particular section was drafted to cover are substantially different from those involved in the case at bar, a court should consider itself free to ignore the section and approach the problem as a common law question.

Although application of this methodology defeats the purposes of the drafters of the U.C.C. by requiring reference to both pre-U.C.C. law and non-U.C.C. common law, such a reference is unavoidable since the rules were drafted in light of the pre- and non-U.C.C. law. It is unfortunate that a lawyer or judge cannot read Article 3 and thereby deduce the answer to most of his questions. But since Article 3 was not intended to be interpreted in this manner, the results reached by a code methodology are often not those intended by the drafters. The suggested approach does ensure uniformity and certainty as to all of those rules intended by the drafters to be included in Article 3. By not misconstruing sections to cover situations not intended to be covered by the section, courts are freed to fashion answers to unforeseen situations consistent with the general policies of the U.C.C., but in light of new problems and changing conditions. An analysis of problems generated by applying a code methodology to specific questions arising under Article 3 discloses the need to follow the suggested methodology. This analysis is undertaken in the next section.

## V. PROBLEMS WITH APPLYING A CODE METHODOLOGY

### A. *Inconsistent Terminology*

One of the primary objectives of the drafters of the U.C.C. was to reduce greatly the need for case law research by enabling a practitioner to rely upon a literal interpretation of the U.C.C.<sup>75</sup> Another objective was to make the proper interpretation of each section so clear that different judges could not adopt conflicting interpretations.<sup>76</sup> To accomplish these objectives, it was essential that terms be used consistently throughout Article 3.<sup>77</sup> Otherwise, courts would not know when they were supposed to interpret a term literally and when a special definition of a term was intended. Different courts would at times reach contrary conclusions.<sup>78</sup> Practitioners would thus need to re-

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75. Llewellyn, *supra* note 5, at 373; Gilmore, *supra* note 5, at 379.

76. Llewellyn, *supra* note 5, at 369, 370, 377.

77. Patterson, *supra* note 2, at 64-65.

78. *Id.*

search the case law to see how courts in the relevant jurisdiction were interpreting the term.

Article 3 gives the appearance of using consistent terminology when in fact it fails to do so. Since the terminology is not used consistently, attempting to apply the same definition each time a term is used results in undesirable and unintended interpretations of many of the rules. Since Article 3 does not indicate when the standard definition of a term is not intended, a judge or practitioner cannot rely safely upon a literal reading of many of the rules. A judge must therefore seriously contemplate the ramifications of adopting the standard definition of any term. A practitioner must research case law to determine how a court in his jurisdiction has chosen to interpret the relevant section.

### 1. "Holder"

The term "holder" is one of the most important and basic terms in Article 3. "Holder" is defined in section 1-201(20) as "a person who is in possession of . . . an instrument drawn, issued, or indorsed to him or his order or to bearer or in blank." Unfortunately, this definition cannot be applied literally to every use of this term in Article 3. The most notorious example of the problems encountered in literally applying this definition of holder is its use in section 3-406. Under section 3-406, "[a]ny person who by his negligence substantially contributes to a material alteration of the instrument or to the making of an unauthorized signature is precluded from asserting the alteration or lack of authority against a holder in due course or against a drawee or other payor . . . ."

A purchaser must qualify as a holder in due course in order to assert the preclusion of a negligent party.<sup>79</sup> To be a holder in due course, the purchaser first must qualify as a holder.<sup>80</sup> If he traces his title through a forged or otherwise unauthorized indorsement, however, he cannot be a holder.<sup>81</sup> Thus, if the definition of holder is applied literally, a purchaser of an instrument bearing an unauthorized indorsement is not permitted to preclude the payee or drawer from denying the unauthorized nature of the indorsement, even

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79. As discussed in the text accompanying note 101 *infra*, some courts have held that a purchaser of an instrument bearing a forged indorsement is an "other payor" and therefore can use § 3-406 to preclude the negligent party. Although "other payor" may have been intended to include any indorser who takes up the instrument, it certainly does not appear that it was intended to include any purchaser. If it were intended to include any purchaser, the inclusion of holders in due course within the class of persons protected under § 3-406 would be superfluous.

80. U.C.C. § 3-302(1).

81. *Perini Corp. v. First Nat'l Bank*, 553 F.2d 398 (5th Cir. 1977); *Sumiton Bank v. Funding Sys. Leasing Corp.*, 512 F.2d 774 (5th Cir. 1975); *Girard Bank v. Mount Holly State Bank*, 474 F. Supp. 1225 (D.N.J. 1979); *Tubin v. Rabin*, 382 F. Supp. 193 (N.D. Tex. 1974); *Riggs Nat'l Bank v. Security Bank*, 10 U.C.C. REP. SERV. 460 (D.C. Super. Ct. 1972); *Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust Co.*, 345 Mass. 1, 184 N.E.2d 358 (1962); *Foremost Ins. Co. v. First City Savings and Loan Ass'n*, 374 So. 2d 840 (Miss. 1979); *Salsman v. National Community Bank*, 102 N.J. Super. 482, 246 A.2d 162 (1968); *Bank of the West v. Wes-Con Dev. Co.*, 15 Wash. App. 238, 548 P.2d 563 (1976); *Atlas Bldg Supply Co., v. First Indep. Bank*, 15 Wash. App. 367, 550 P.2d 26 (1976); *Thieme v. Seattle-First Nat'l Bank*, 7 Wash. App. 845, 502 P.2d 1240 (1972).

though their negligence substantially contributed to the making of the unauthorized indorsement. Therefore, if the term holder were given its literal definition in section 3-406, the resultant interpretation of section 3-406 would manifest some very questionable policy decisions. For example, in a case in which a drawer negligently mails a check to a wrong person, with the same name as the payee, the depository bank, which could not possibly discover the error, would suffer the loss and not the negligent drawer.<sup>82</sup> Similarly, a payee could recover for conversion from a purchaser of the instrument, including the depository bank, even though the payee negligently hired and failed to supervise a known forger who had previously, to the payee's knowledge, forged the payee's indorsement on other checks.

Clearly, these results are unacceptable. There is no reason to deny the purchasers of instruments bearing forged indorsements the benefits of section 3-406 while granting these same benefits to purchasers of altered instruments.<sup>83</sup> It does not appear that the drafters of Article 3 intended to interpret "holder" literally in section 3-406. By adopting a literal interpretation of "holder," a difference in the allocation of loss results from, for instance, the negligent payee's choice to sue the payor bank rather than the collecting bank. When the payee's negligence substantially contributes to the making of his forged indorsement, he is precluded from asserting the forgery in his suit against the payor bank for conversion.<sup>84</sup> But if he sues the collecting bank instead he will not be precluded under a literal reading of "holder." Similarly, assume that the negligent drawer, who mailed the check to the wrong person with the same name as the payee, convinces the payor bank to ignore his negligence and recredit his account. The payor bank can then recover from the collecting bank for breach of their warranty of good title.<sup>85</sup> Since section 4-406(5) does not bar the payor bank from recovering from a collecting bank when the payor bank fails to raise the negligence of its customer under section 3-406,<sup>86</sup> the payor bank will recover from the collecting bank. The collecting bank, not being a holder, cannot assert the negligence of the drawer under a literal application of section 3-406 and therefore cannot recover on the instrument from the drawer.<sup>87</sup> Since they can not assert the drawer's negligence to

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82. Even under the N.I.L., the drawer was precluded from asserting the unauthorized nature of the payee's signature in this situation. *Citizens Union Nat'l Bank v. Terrell*, 244 Ky. 16, 50 S.W.2d 60 (1932); *Slattery & Co. v. National City Bank*, 114 Misc. 48, 186 N.Y.S. 679 (1920). *But see* F. BEUTEL, *supra* note 55, at 465.

83. A purchaser of an altered instrument may be a holder in due course as long as he has obtained all necessary indorsements and otherwise complied with the requirements of U.C.C. § 3-302(1).

84. *Cooper v. Union Bank*, 9 Cal. 3d. 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973); U.C.C. § 3-406.

85. U.C.C. § 4-207(1)(a); *id.* § 3-417 comment 3.

86. *Girard Bank v. Mount Holly State Bank*, 474 F. Supp. 1225 (D.N.J. 1979); *Mellon Nat'l Bank & Trust Co. v. Merchants Bank*, 15 U.C.C. REP. SERV. 691 (S.D.N.Y. 1972); U.C.C. § 4-406(5); *id.* § 4-406 comment 7.

87. Although it can be argued that the bank can sue the drawer for common-law negligence, permitting an action for negligence outside of § 3-406 could cause problems. Persons not intended to be able to preclude the negligent party under § 3-406 might circumvent this prohibition by suing on a theory of common-law negligence.

establish the authenticity of the forged indorsement, they cannot become a holder.<sup>88</sup> The collecting bank therefore suffers the loss. But if the payor bank decides to assert the drawer's negligence and refuses to recredit his account, as they have the option to do under section 3-406,<sup>89</sup> the drawer and not the collecting bank will suffer the loss. The drafters could not have intended the allocation of loss to depend upon these factors.

How does one then explain the use by the drafters of the term "holder in due course?" Under the N.I.L., although there were not many cases on point, a purchaser of an instrument bearing a forged indorsement usually could preclude the negligent party from asserting the forgery.<sup>90</sup> The controversial issue under the N.I.L. did not involve forged indorsements but was whether a drawer owed a duty of care to a holder in due course to prevent alterations.<sup>91</sup> A majority of the courts held that he did not owe this duty.<sup>92</sup> The drafters of Article 3 disagreed with this position.<sup>93</sup> To ensure that holders in due course would be able to assert the drawer's negligence, holders in due course were expressly mentioned as beneficiaries under section 3-406.<sup>94</sup> Their inclusion in section 3-406 was intended to extend the coverage of section 3-406 and not to limit it.<sup>95</sup> The comments to section 3-406 and the comments to earlier drafts of the section fail to reveal that any thought was given to the allocation of the loss resulting from forged indorsements.<sup>96</sup> Had the drafters wanted to reject the decisions under the N.I.L. that held that a purchaser of an instrument bearing a forged indorsement could preclude the negligent party, they at least would have mentioned it.

Virtually every court deciding this issue under Article 3 has permitted a purchaser of an instrument bearing a forged indorsement to preclude the negligent party from asserting the forgery.<sup>97</sup> Some courts<sup>98</sup> have ignored section

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88. See *supra* note 81.

89. *Stone & Webster Eng'g Corp. v. First Nat'l Bank & Trust Co.*, 345 Mass. 1, 184 N.E.2d 358 (1962); *United States Fidelity & Guar. Co. v. Merchant's Bank & Trust Co.*, 28 U.C.C. REP. SERV. 108 (Conn. Super. Ct. 1979); U.C.C. § 3-406.

90. See *supra* note 82.

91. U.C.C. § 3-406 comment 2; U.C.C., Notes and Comments to Article III, at 15 (Proposed Final Draft No. 1, 1948).

92. U.C.C., Notes and Comments to Article III, at 15 (Proposed Final Draft No. 1, 1948).

93. *Id.*

94. See *supra* note 82.

95. See *supra* note 82.

96. See *supra* note 82.

97. *Hermetic Refrigeration Co. v. Central Valley Nat'l Bank, Inc.*, 493 F.2d 476 (9th Cir. 1974); *East Gadsden Bank v. First City Nat'l Bank*, 281 So. 2d 431 (Ala. 1973); *Trust Co. v. Port Terminal & Warehousing Co.*, 153 Ga. App. 735, 266 S.E.2d 259 (1980); *Insurance Co. v. Purdue Nat'l Bank*, 401 N.E.2d 708 (Ind. Ct. App. 1980); *Koerner & Lambert v. Allstate Ins. Co.*, 374 So. 2d 179 (La. Ct. App. 1979); *Mott Grain Co. v. First Nat'l Bank & Trust Co.*, 259 N.W.2d 667, 23 U.C.C. REP. SERV. 104 (N.D. 1977); *Do All Dallas Co. v. Trinity Nat'l Bank*, 498 S.W.2d 396 (Tex. Civ. App. 1973); *Swiss Baco Skyline Logging, Inc. v. Haliewicz*, 18 Wash. App. 21, 567 P.2d 1141 (1977); *Fidelity & Deposit Co. v. First Nat'l Bank*, 98 Wis. 2d 474, 297 N.W. 2d 46 (1980); *Continental Bank v. Wa-Ho Truck Brokerage*, 26 U.C.C. REP. SERV. 101 (Ariz. Ct. App. 1979); *Empire Moving & Warehouse Corp. v. Hyde Park Bank & Trust Co.*, 20 U.C.C. REP. SERV. 480 (Ill. Ct. App. 1976). See also *Sun 'N Sand, Inc. v. United California Bank*, 21 Cal. 3d 671, 148 Cal. Rptr. 329, 582 P.2d 920 (1978).

98. *Cooper v. Union Bank*, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973).

3-406 and have held that a party's negligence may preclude him under section 3-404, which contains no requirement that the purchaser be a holder in due course.<sup>99</sup> It is possible that the drafters did intend to provide protection for purchasers of instruments bearing forged indorsements under section 3-404. Indeed, some cases under the N.I.L. found that negligence was a ground for preclusion.<sup>100</sup> The problem with this interpretation is that it makes section 3-406 completely superfluous as to unauthorized signatures. Since a person need not be a holder in due course to invoke the protection of section 3-404, a purchaser always would claim preclusion under section 3-404, rather than section 3-406, to avoid the requirement of proving "due course" status. This would permit a transferee who either had notice of a claim or defense or had not even taken for value to assert the preclusion of the negligent party. It is extremely unlikely that the drafters intended these consequences. Other courts have held that the purchaser is an "other payor" under section 3-406 and thus is entitled to assert the preclusion of the negligent party.<sup>101</sup> Adopting this rationale clearly distorts the meaning of "payor."<sup>102</sup> Less distortion is involved if it is recognized that the drafters did not have this issue in mind when they drafted section 3-406. Although they intended to limit protection to holders in due course, when a forged indorsement is involved the determination of holder in due course status should be made after the negligent party is precluded from asserting the unauthorized nature of the signature.<sup>103</sup>

A similar problem exists with adopting a literal definition of the term "holder" in section 3-417(2). Under section 3-417(2) "[a]ny person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent *holder* who takes the instrument in good faith that (a) he has good title to the instrument . . . ." By interpreting "holder" literally, a subsequent transferee of an instrument bearing a forged indorsement, not being a holder,<sup>104</sup> is not entitled to the transferor's warranty of good title from any person other than his immediate transferor.<sup>105</sup> For instance, assume that A makes a note payable to B. C forges B's indorsement and transfers the note to D. D indorses the note to E who then indorses it to F. Even though F may have relied upon D's indorsement, since F is not a subsequent "holder," D makes no warranty to him.

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99. U.C.C. § 3-404 provides in part:

(1) Any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it; but it operates as the signature of the unauthorized signer in favor of any person who in good faith pays the instrument or takes it for value.

100. F. BEUTEL, *supra* note 55, at 456-60.

101. *Trust Company v. Port Terminal & Warehousing Co.*, 153 Ga. App. 735, 266 S.E.2d 259 (1980); *Mott Grain Co. v. First Nat'l Bank & Trust Co.*, 259 N.W.2d 667, 23 U.C.C. REP. SERV. 104 (N.D. 1977); *Fidelity & Deposit Co. v. First Nat'l Bank*, 98 Wis. 2d 474, 297 N.W.2d 46 (1980); *Empire Moving & Warehouse Corp. v. Hyde Park Bank & Trust Co.*, 20 U.C.C. REP. SERV. 480 (1976). See also *Sun 'N Sand, Inc. v. United California Bank*, 21 Cal. 3d 671, 582 P.2d 920, 148 Cal. Rptr. 329 (1978).

102. See *supra* note 79.

103. *Koerner & Lambert v. Allstate Ins. Co.*, 374 So. 2d 179 (La. Ct. App. 1979).

104. See *supra* note 81.

105. U.C.C. § 3-417 comments 7, 8.



Thus F must sue E who is then required to sue D. D suffers the loss in the end, but two law suits are required. If E is insolvent, because F has no cause of action against D, F must suffer the loss.

Clearly, F should not be made to suffer the loss. F reasonably relied upon D's indorsement of the note. E's insolvency should not shift the loss from D to F. The drafters do not seem to have intended to deny F recovery against D.<sup>106</sup> Comment 8 to section 3-417 states: "Where there is an indorsement the warranty runs with the instrument and the remote holder may sue the indorser-warrantor directly and thus avoid a multiplicity of suits which might be interrupted by the insolvency of an intermediate transferor." Although the comment again refers to "holders," it is probable, as in the case of section 3-406, that the drafters intended to limit protection to those subsequent transferees holding under the chain of title running through the indorser-warrantor. The word "holder," except in the case of a breach of the warranty of good title, does describe correctly the newly intended beneficiaries of the transferor's warranties. Although there is no mention of this issue in the comments to the present or to earlier drafts<sup>107</sup> of this section, there was substantial discussion whether a subsequent holder should be able to proceed against a prior indorser. These comments indicate that the drafters intended to extend the class of persons entitled to the benefits of the warranties of indorsers and not to limit them.<sup>108</sup>

Finally, the definition of "holder"<sup>109</sup> itself is technically inaccurate since it denies "holder" status to a payee of a note or thief or finder of a note payable to bearer when there has been no delivery. Although non-delivery is a defense against any person not having the rights of a holder in due course,<sup>110</sup> holders in due course take free of the defense of non-delivery.<sup>111</sup> As one of the necessary steps in effecting this distinction, the drafters provided that a person may become a holder in due course even when there has been no delivery.<sup>112</sup> A "holder" is a person who is in possession of "an instrument drawn [or] issued . . . to him or his order or to bearer or in blank."<sup>113</sup> As long as a person has possession of the instrument, and it is drawn to his order, or to bearer or in blank, he is the holder. There is no requirement that the instrument be deliv-

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106. See U.C.C., Notes and Comments to Article III, at 36 (Proposed Final Draft No. 1, 1948).

107. *Id.*

108. U.C.C. § 3-417, comment 8; U.C.C., Notes and Comments to Article III, at 36 (Proposed Final Draft No. 1, 1948).

109. "Holder" is defined in U.C.C. § 1-201(20) as "a person who is in possession of a document of title or an instrument or a certificated investment security drawn, issued, or indorsed to him or his order or to bearer or in blank."

110. U.C.C. § 3-306(C).

111. *Id.* § 3-305(2).

112. The drafters clearly intended to enable a person to become a holder even though there has been no delivery of the instrument to him. U.C.C., Notes and Comments to Article III, at 147 (Tentative Draft No. 1, 1946). Although a thief or finder of an instrument payable to bearer has not taken for value and has notice of the owner's claim of ownership and thereby can not be a holder in due course, a person to whom the thief or finder has negotiated the instrument can very possibly fulfill the requirements for holder in due course status established in U.C.C. § 3-302(1).

113. U.C.C. § 1-201(20).

ered to him.<sup>114</sup> A payee of a check or other draft thus can be a holder since he would be in possession of a draft drawn to his order. But neither a payee in possession of an undelivered note nor a finder of a note payable to bearer is technically a holder. A note is "made" and not "drawn" and therefore it is not drawn to his order or to bearer. Since the note was not delivered, it was not "issued" to his order or to bearer. It is extremely unlikely that the drafters intended to make this distinction. The word "drawn" in section 1-201(20) should be read as "drawn or made."

## 2. "Paid"

Neither the term "pays" nor any of its derivative forms (*i.e.*, "paid," "payor," or "payment") is defined in the U.C.C. Yet these terms form the foundation for several important provisions of Article 3.<sup>115</sup> The omission of a definition would not necessarily create a problem if the drafters used the term consistently throughout Article 3. But it is impossible to find one definition that would be satisfactory for all uses of the term.

Under section 3-603(2), "Payment or satisfaction may be made with the consent of the holder by any person including a stranger to the instrument. Surrender of the instrument to such a person gives him the rights of a transferee (section 3-201)." The payor is, upon his payment and surrender of the instrument, thereby given the rights of a transferee.<sup>116</sup> The comments to an earlier draft of this section make it clear that the payor gets all of the rights of any ordinary transferee:

If there is an indorsement by the holder, it is a simple case of negotiation and the payer [sic] becomes himself a holder. If there is no indorsement but the payer [sic] receives the instrument, his position is the same as that of a transferee without indorsement under Section 28 [3-201].<sup>117</sup>

These rights would seem to include the transferor's warranties under section 3-417(2). Under section 3-417(2)(b), "Any person who transfers an instrument and receives consideration warrants to his transferee and if the transfer is by indorsement to any subsequent holder who takes the instrument in good faith that (b) all signatures are genuine or authorized."

Section 3-603(2) does not exclude by its terms payment by a drawee, drawer or maker. But if payment by any of these parties is to be included within section 3-603(2), these parties would be given a warranty by the person paid about the genuineness of the signature of drawer and maker. In so doing,

114. See *supra* note 112.

115. See, *e.g.*, U.C.C. § 3-603(1) & (2); *id.* § 3-419(1)(c); *id.* § 3-418; *id.* 3-417(1); *id.* § 3-406.

116. Jacobson v. FDIC, 407 F. Supp. 821 (S.D. Iowa 1976); Griffin v. Griffin, 250 Ark. 845, 467 S.W.2d 737 (1971); Collection Control Bureau v. Weiss, 50 Cal. App. 2d 865, 123 Cal. Rptr. 625 (1975); Ertel v. Radio Corp., 297 N.E.2d 446 (Ind. Ct. App. 1973); Citizens Fidelity Bank and Trust Co. v. Stark, 431 S.W.2d 722 (Ky. 1968); Commercial Sav. Bank v. G. and J. Wood Prods. Co., 46 Mich. 133, 207 N.W.2d 401 (1973); Simson v. Bilderbeck, Inc., 76 N.M. 667, 417 P.2d 803 (1966); Eikel v. Bristow Corp., 529 S.W.2d 795 (Tex. Civ. App. 1975); U.C.C. § 3-603(2).

117. U.C.C., Notes and Comments to Article III, at 101 (Tent. Draft No. 3, 1947).

the specific allocation of loss for payment over the unauthorized signatures of the drawer or maker established in section 3-417(1)(b) and section 3-418 would be circumvented. Section 3-417(1) together with section 3-418 codifies the doctrine of *Price v. Neal*<sup>118</sup> under which the drawee assumes the risk of payment over the forged signature of the drawer.<sup>119</sup> These sections extend the doctrine to include payment by the maker or drawer.<sup>120</sup> To provide for this result, section 3-418 makes payment final in favor of a holder in due course and a person who has in good faith relied on the payment.<sup>121</sup> Finality under section 3-418 is subject only<sup>122</sup> to the presenter's warranties under section 3-417(1), which do not include the warranty that all signatures are genuine or authorized but only the warranty that the warrantor has no knowledge that the signature of the drawer or maker is unauthorized.<sup>123</sup> As a consequence, "payment" in U.C.C. section 3-603(2) should be read as excluding payment by a drawee, drawer, or maker.

The question whether a drawee, drawer, or maker should be entitled to the rights of a transferee is not the only ambiguity involving the term "pays." Questions also arise about the precise relationship between the holder and a stranger who makes payment to him. Section 3-603(2) itself is fairly clear in stating that when a stranger makes payment to the holder the holder is deemed to have transferred the instrument to him.<sup>124</sup> Thus, the holder gives him transferor's warranties under section 3-417. As a consequence, loss from payment by the stranger over a forgery of the maker's or drawer's signature rests upon the holder and not the stranger. Unfortunately, there are indications in both sections 3-417(1) and 3-418 that the loss is to fall on the stranger instead. Comment 1 to section 3-418 states: "The rule stated in the section [as to finality of payment] is not limited to drawees, but applies equally to the maker of a note or *any party who pays* an instrument."<sup>125</sup> An earlier draft of section 3-417(1), in describing the beneficiaries of the presenter's warranties, used the phrase "party who in good faith pays."<sup>126</sup> This phrase was changed in the official version to "person who in good faith pays." This change can only be explained if, for purposes of section 3-418 and section 3-417(1), payment may be made by a non-party, or in other words, a stranger to the instrument.<sup>127</sup> If the stranger was entitled already to the warranties in section 3-417(2), it would be superfluous to treat him as a payor under section 3-418 and section 3-417(1), which has the sole intended affect of *limiting* the warranties otherwise

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118. 97 Eng. Rep. 871, 3 Burr. 1354 (K.B. 1762).

119. U.C.C. § 3-418 comment 1.

120. *Id.*

121. *Id.* § 3-418.

122. *Id.*; *id.* comment 5. The finality of payment is also subject to recovery of provisional payments made under U.C.C. § 4-301. This exception is not relevant to the issue discussed in the text above.

123. U.C.C. § 3-417(1)(b); *id.* § 3-417 comment 4.

124. See *supra* note 117 and accompanying text.

125. Emphasis added.

126. U.C.C. § 3-417(1) (Official Draft 1952).

127. 2 STATE OF NEW YORK, *supra* note 35, at 1075.

available under section 3-417(2).<sup>128</sup> There are also policy reasons to impose this risk of forgery of the drawer's or maker's signature upon the payor-stranger and not the holder. If the holder wants to obtain payment and a stranger, to accommodate the drawer or maker, makes payment, why should the holder be deprived of the opportunity to discover immediately whether his signature is genuine? Had he presented the instrument to the drawer or maker directly and obtained payment, he would not have had to bear the risk of their unauthorized signature.<sup>129</sup> When payment is made by a prior party to the instrument other than an irregular indorser,<sup>130</sup> and not by a stranger, the holder does not bear this risk. A prior party, other than an irregular indorser, will have warranted to the holder that all signatures are genuine.<sup>131</sup> Therefore, if the prior party sues the holder for breach of his transferor's warranty, the holder may counterclaim against the prior party on his transferor's warranty to the holder. A stranger or irregular indorser does not make any warranties to the holder.<sup>132</sup> Therefore, the holder bears this risk only when he agrees to receive payment from a stranger or an irregular indorser, and not when payment is made by a prior party.

The inconsistency of allocation of loss that exists when a stranger pays the holder seems to have resulted from the attempt of the drafters to remedy two very different problems in the same section. Section 3-603(2) was intended to deal with two specific problems.<sup>133</sup> The first problem concerned a practice that originated under the pre-N.I.L. common law called "payment for honor." As continued in the N.I.L.,<sup>134</sup> upon dishonor and protest<sup>135</sup> any person could pay a draft and, if he followed the required formalities,<sup>136</sup> could be subrogated to the rights of the party paid.<sup>137</sup> The drafters recognized that the practice was obsolete because of the cumbersome formalities that had to be followed.<sup>138</sup> The drafters noted that parties had stopped using this practice and began instead to arrange to have a prior party pay the instrument and take the indorsement of the holder.<sup>139</sup> They saw no reason why a stranger, rather than a party, should not be able to pay off the holder, as could be done by a payment for honor, and then step into the holder's shoes.<sup>140</sup> At the same time the drafters wanted to solve the problem of an accommodation indorser who, under some decisions, had been denied the right to recover against the party accom-

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128. U.C.C. § 4-207 comment 4.

129. Payment would have been final. U.C.C. § 3-418; *id.* comment 1.

130. An irregular indorser, one whose indorsement is not in the chain of title, does not "transfer" the instrument and therefore does not give the transferor's warranty under U.C.C. § 3-417(2)(b) that all signatures are genuine or authorized. *Id.* § 3-414 comment 2.

131. U.C.C. § 3-417(2)(b).

132. *See supra* note 130.

133. *See supra* text accompanying note 117.

134. N.I.L. §§ 171-77.

135. *Id.* § 171.

136. *Id.* §§ 172-73.

137. *Id.* § 175.

138. U.C.C., Notes and Comments to Article III, at 101 (Tentative Draft No. 3, 1947).

139. *Id.*

140. *Id.*

modated after his payment to the holder.<sup>141</sup> Section 3-603(2) attempted to solve both of these problems at one time by providing that payment may be made by any person and that upon surrender of the instrument the payor obtains the rights of a transferee. What the drafters overlooked was that in every one of those situations, the holder himself and all intervening parties between himself, the reacquiring party,<sup>142</sup> or the party accommodated or the party for whose honor payment was made,<sup>143</sup> were discharged. The payor stepped into the shoes of the holder only as to the holder's rights as against the party whose benefit payment had been made and parties prior thereto.<sup>144</sup> Thus, the risk of loss from a forgery of the drawer's or maker's signature was not imposed upon the holder, who had been discharged, but upon the party making payment. Under section 3-603(2) when a stranger acquires the instrument, none of these parties are discharged. The stranger steps into the shoes of the holder as to all parties and not just as to the party for whose benefit payment had been made and parties prior thereto. The apparent inconsistency between section 3-418 and section 3-603(2) makes it extremely difficult for a court to determine the result intended by the drafters. By applying a code methodology a court could reach either of these two conflicting results depending upon whether they began their analysis with section 3-603(2) or section 3-418.

### 3. "Value"

The term "value" is used in several sections of Article 3. For a holder to qualify as a holder in due course, section 3-302(1)(a) requires that the holder take for value. Under section 3-201(3) a transferee of an unindorsed instrument payable to order or specially indorsed must give value in order to acquire the right to compel his transferor to indorse the instrument. In addition, under section 3-415(2) an accommodation party is liable in the capacity in which he has signed only when the instrument has been taken for value before it is due.

The U.C.C. contains two definitions of "value." In the general provisions of Article 1, section 1-201(44) defines "value" as including "any consideration sufficient to support a simple contract." Section 3-303, on the other hand, states that a holder takes the instrument for value only "to the extent that the agreed consideration has been performed . . . ."<sup>145</sup> The primary distinction between the two definitions of value is that under section 1-201(44) an executory promise is value while under section 3-303(a) it is not. For determining whether a holder has taken for value to qualify as a holder in due course, the definition of "value" found in section 3-303 and not the one in section 1-201(44) applies. Section 3-302 explicitly contains a cross reference to section 3-303. Similarly, the comments to section 3-303 indicate that the section was

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141. *Id.* at 101-02.

142. U.C.C. § 3-208.

143. N.I.L. § 175.

144. W. BRITTON, *supra* note 70, at 607.

145. U.C.C. § 3-303(a).

drafted for determining whether a holder is in due course and specifically state that a holder who has taken only for an executory promise is not a holder in due course.<sup>146</sup>

Neither section 3-201(3) nor section 3-415(2) indicate in their text, comments, or definitional cross-references which definition was intended to apply. An examination of section 1-201(44) and section 3-303 does not disclose any conclusive answer either. The comments to section 1-201(44) do state that section 1-201(44) does not apply to Article 3.<sup>147</sup> On the other hand, by its terms, section 3-303 applies only when "*a holder takes the instrument for value . . .*"<sup>148</sup> In section 3-201(3) the transferee is, by definition, not a holder. Under section 3-415(2) the taker does not necessarily have to be a holder. Similarly, all of the comments to section 3-303, except one,<sup>149</sup> indicate that its specific provisions were drafted to deal with the problem whether a holder qualifies as a holder in due course. Comment 1 to section 3-303 does refer to accommodation parties but gives no real indication whether section 3-303 is applicable to section 3-415(2).<sup>150</sup> Furthermore, the policies underlying section 3-303(a) are not at stake in section 3-201(3) or section 3-415(2). Permitting an executory promise to qualify as value would not undermine the purpose of either section. The comments to section 3-201(3) state that the section "applies only to the transfer for value of an instrument payable to order or specially indorsed. It has no application to a gift . . ." <sup>151</sup> Permitting only a transferee for value to compel an indorsement of his transferor seems to serve the purpose of relieving any transferor who has given an instrument as a gift from being required to indorse the gratuitously given instrument and thereby risk incurring liability as an indorser to a holder in due course. That the promise has not yet been performed does not seem to rebut the presumption that in bargaining for the instrument the transferee and transferor intended that the transferee receive an instrument that he could negotiate further. In other words, the transferee, after making a promise that could be enforced by the transferor, has every reason to expect a freely negotiable instrument. Similarly, the requirement in section 3-415(2) that an instrument be taken for value before it is due is an effort to incorporate into Article 3 the defense found in the general law of suretyship that "the obligation of the surety is terminated at the [date the instrument is due] unless in the meantime the obligation of the principal has become effective."<sup>152</sup> The principal's obligation is effective once the principal receives consideration. The consideration need not be per-

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146. *Id.* § 3-303 comment 3.

147. *Id.* § 1-201 comment 44.

148. Emphasis added.

149. U.C.C. § 3-303 comment 1.

150. U.C.C. § 3-303 comment 1 provides:

The original Section 26 which had reference to the liability of accommodation parties is omitted as erroneous and misleading, since a holder who does not himself give value cannot qualify as a holder in due course in his own right merely because value has previously been given for the instrument.

151. U.C.C. § 3-201 comment 6.

152. *Id.* § 3-415 comment 3; W. BRITTON, *supra* note 70, at 600-02.

formed. The term "value," rather than consideration, seems to have been used in sections 3-415(2) and 3-201(3) for the purpose of ensuring that a pre-existing debt, which is not usually deemed to be consideration, would be sufficient to uphold the surety's promise and the transferor's duty to indorse. This purpose is satisfied by using the definition in section 1-201(44), since preexisting debt is value under both section 1-201(44)<sup>153</sup> and section 3-303.<sup>154</sup> Finally, the N.I.L. did make a distinction between the requirements for value for holder in due course status and for other purposes. Value was defined generally to include even executory promises.<sup>155</sup> But a holder who received notice before paying the full amount agreed to be paid was only a holder in due course to the extent of the amount paid prior to receiving the notice.<sup>156</sup> The drafters wanted to ensure that a holder could only be a holder in due course to the extent that he performed his promise, thus they consolidated the two N.I.L. sections into one. But this does not evidence an intention to change the rules under the N.I.L. that defined what constituted value for other uses of the term "value."

*B. Many Rules Supplement, Rather than Preempt, the Common Law*

As already noted, one of the primary objectives of the drafters of the U.C.C. was to eliminate the need for substantial case law research in order to answer common questions of commercial law.<sup>157</sup> The drafters intended that practitioners be able to discern most of these answers from the U.C.C. alone. The U.C.C. has been held out as enabling a practitioner to do this.<sup>158</sup> But a practitioner cannot discern the answer to many of his commercial paper questions by reference to Article 3 alone because several sections of Article 3 do not attempt to state comprehensively the rules governing their particular area. Rather, these sections merely state a few specific rules resolving the particular questions on which courts under the N.I.L. were in conflict.<sup>159</sup> For the general rules intended to govern, reference must be made to the common law of the particular jurisdiction. Allowing judges to decide these issues as questions of common law tends to destroy uniformity between the states and certainty of results within states. To add to the problem, the drafters did not indicate which sections were intended to preempt and which were meant only to supplement the common law. In most instances, though, a careful analysis of the sections themselves and the specific problems under the N.I.L. they were intended to solve will disclose whether the section was intended to be preemptive.

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153. U.C.C. § 1-201(44)(b).

154. *Id.* § 3-303(b).

155. N.I.L. § 25.

156. *Id.* § 54.

157. *See supra* note 11 and accompanying text.

158. *See supra* note 30 and accompanying text.

159. *See* Beutel, *supra* note 59, at 353.

## 1. Conversion

One of the clearest examples of a section that merely supplements rather than preempts the common law is section 3-419, which lists three situations in which an instrument has been converted. Under section 3-419(1):

An instrument is converted when (a) a drawee to whom it is delivered for acceptance refuses to return it on demand; or (b) any person to whom it is delivered for payment refuses on demand either to pay or return it; or (c) it is paid on a forged indorsement.

Use of the words "[a]n instrument is converted when," gives the impression that what follows is a comprehensive list of all acts that constitute conversion of an instrument.<sup>160</sup> But closer inspection reveals that this is not the case. To begin with, section 3-419 itself implicitly acknowledges that there are acts of conversion that are not listed in section 3-419(1). Both sections 3-419(3) and (4) provide that certain acts by designated persons do not constitute conversion. Yet none of these acts are listed in section 3-419(1) as a conversion of the instrument.<sup>161</sup> If section 3-419(1) were intended to be comprehensive, sections 3-419(3) and (4) would be superfluous. Section 3-419(3) provides that an agent is not liable for conversion beyond the proceeds remaining in his hands when he deals with an instrument or its proceeds on behalf of one who is not the true owner of the instrument if he has acted in good faith and in accordance with the reasonable commercial standards of his business.<sup>162</sup> But the agent is not liable for conversion under section 3-419(1), even when he fails to act in accordance with the reasonable commercial standards of his business.<sup>163</sup> Similarly, section 3-419(4) provides that an intermediary bank or a payor bank that is not also a depository bank is not liable for conversion for failing to pay or to apply the proceeds of an instrument restrictively indorsed consistently with the indorsement of an indorser other than its immediate transferor.<sup>164</sup> Yet section 3-419(1) does not make the failure to pay or to apply the proceeds of an instrument in a manner consistent with a restrictive indorsement a con-

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160. 2 STATE OF NEW YORK, *supra* note 35, at 1082.

161. *Id.*

162. U.C.C. § 3-419(3) provides:

Subject to the provisions of this Act concerning restrictive indorsements a representative, including a depository or collecting bank, who has in good faith and in accordance with the reasonable commercial standards applicable to the business of such representative dealt with an instrument or its proceeds on behalf of one who was not the true owner is not liable in conversion or otherwise to the true owner beyond the amount of any proceeds remaining in his hands.

163. Clearly, U.C.C. § 3-419(1)(a) & (b) are inapplicable to an agent obtaining payment. Although it could be argued that a purchaser has "paid" the instrument and is therefore liable under U.C.C. § 3-419(1)(c), this argument is weak. First "paid" in its most expansive reading probably includes an indorser who takes the instrument up, but it is hard to see how it could be stretched to include a purchaser before maturity. Furthermore, if the agent was involved in the sale but not in the purchase of the instrument, the agent certainly would not have "paid" the instrument.

164. U.C.C. § 3-419(4) provides:

An intermediary bank or payor bank which is not a depository bank is not liable in conversion solely by reason of the fact that proceeds of an item indorsed restrictively (Sections 3-205 and 3-206) are not paid or applied consistently with the restrictive indorsement of an indorser other than its immediate transferor.



version. There are, in addition, many other acts that clearly constitute conversion which likewise are not listed in section 3-419(1). For instance, theft of a negotiable instrument must be an act of conversion.<sup>165</sup> Similarly, sale of a stolen instrument, at least by one with notice of the theft, must be an act of conversion.<sup>166</sup> It is extremely doubtful that the drafters intended to deny the true owner an action for conversion against these parties. If section 3-419(1) were intended to be exclusive, however, no such actions would lie.

From an examination of the law of conversion under the N.I.L. and the comments to the present and prior drafts of section 3-419, it becomes clear that section 3-419(1) was not intended to be a comprehensive list of all acts of conversion. The N.I.L. did not contain any rules for conversion. The law of conversion was left to the common law.<sup>167</sup> Dean William Prosser, the Reporter for Article 3, was, as a noted authority on torts, obviously very familiar with the law of conversion. Seeing no need to state the entire law of conversion in section 3-419, he simply decided to set out the particular changes that the drafters desired to institute while leaving the remainder of the law of conversion to be incorporated into Article 3 by virtue of section 1-103.<sup>168</sup> Thus, section 3-419(1)(a) was included because a drawee who refused to return upon demand an instrument delivered for acceptance was not liable for conversion under the N.I.L., but was deemed to have constructively accepted the instrument.<sup>169</sup> The drafters wanted to eliminate the doctrine of constructive acceptance and instead to impose liability on the basis of conversion.<sup>170</sup> Subsection (1)(b) was added simply to extend the rule of (1)(a) to instruments delivered for payment rather than for acceptance.<sup>171</sup> Finally, section 3-419(1)(c) was intended to resolve a conflict in the common law whether payment on a forged indorsement by the drawee or an indorser who takes up the instrument was conversion.<sup>172</sup>

Unfortunately section 3-419 gives no indication about which particular rules of the common law of conversion are displaced by Article 3. A court is faced with the difficult task of ensuring that its decision does not conflict with the policies underlying other sections of Article 3. For example, a holder in due course of a stolen note payable to bearer takes free of all claims of ownership.<sup>173</sup> A court would be undercutting this policy decision if it made the holder in due course liable to the original owner for conversion. On the other

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165. W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 81, 82-84 (4th ed. 1971).

166. *Id.* at 87.

167. 2 STATE OF NEW YORK, *supra* note 35, at 1082.

168. *Id.*; see also *Commercial Credit Corp. v. University Nat'l Bank*, 590 F.2d 849, 852 (10th Cir. 1979).

169. U.C.C. § 3-419 comment 1; U.C.C., Notes and Comments to Article III, at 91 (Tentative Draft No. 3, 1947).

170. U.C.C. § 3-419 comment 1; U.C.C., Notes and Comments to Article III, at 91 (Tentative Draft No. 3, 1947).

171. U.C.C., Notes and Comments to Article III, at 40 (Proposed Final Draft No. 1, 1948).

172. U.C.C. § 3-419 comment 3; U.C.C., Notes and Comments to Article III, at 41 (Proposed Final Draft No. 1, 1948); W. BRITTON, *supra* note 70, at 418-22.

173. U.C.C. § 3-305(1).

hand, if the holder is not in due course, he takes subject to all valid claims of ownership.<sup>174</sup> Therefore a court would not offend any policy found in Article 3 if it held such a person liable for conversion. Yet the court cannot rely simply upon section 3-306 for its answer since that section gives no insight into whether a prior holder of a stolen bearer instrument should be liable to the true owner for conversion. Similarly, section 3-306 gives no indication whether a person not having the rights of a holder in due course should be liable for conversion when he sells an instrument with knowledge of an equitable claim of ownership. It is clear that a payor who pays an instrument with knowledge of a legal or equitable claim of ownership should be liable for conversion only when he is not entitled to a discharge under section 3-603(1).<sup>175</sup> For instance, a maker who pays the holder with knowledge of an equitable claim of ownership is liable for conversion to the true owner only when the owner either properly indemnified the payor or obtained an injunction.

## 2. Defenses of Accommodation Parties

An accommodation party is a person who signs an instrument "for the purpose of lending his name to another party to it."<sup>176</sup> An accommodation party, to put it another way, is a surety<sup>177</sup> who evidences his liability by signing an instrument that the party he is accommodating has signed also.<sup>178</sup> When a person has signed as an accommodation party, there are two separate transactions underlying the obligations evidenced by the instrument: (1) the agreement between the accommodation and the accommodated parties under which the accommodation party agrees to act as such; and (2) the transaction out of which the obligation of the accommodated party to the creditor arose for which obligation the instrument was given. The accommodation party

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174. *Id.* § 3-306(a).

175. *Id.* § 3-603(1) provides:

The liability of any party is discharged to the extent of his payment or satisfaction to the holder even though it is made with knowledge of a claim of another person to the instrument unless prior to such payment or satisfaction the person making the claim either supplies indemnity deemed adequate by the party seeking the discharge or enjoins payment or satisfaction by order of a court of competent jurisdiction in an action in which the adverse claimant and the holder are parties. This subsection does not, however, result in the discharge of the liability

- (a) of a party who in bad faith pays or satisfies a holder who acquired the instrument by theft or who (unless having the rights of a holder in due course) holds through one who so acquired it; or
- (b) of a party (other than an intermediary bank or a payor bank which is not a depository bank) who pays or satisfies the holder of an instrument which has been restrictively indorsed in a manner not consistent with the terms of such restrictive indorsement.

176. U.C.C. § 3-415(1); see *Wilmot v. Central Okla. Gravel Corp.*, 620 P.2d 1350 (Okla. Ct. App. 1980); *Beneficial Fin. Co. v. Marshall*, 551 P.2d 315 (Okla. Ct. App. 1976).

177. The RESTATEMENT OF SECURITY § 82 (1937) defines suretyship as "the relation which exists where one person has undertaken an obligation and another person is also under an obligation or other duty to the obligee, who is entitled to but one performance, and as between the two who are bound, one rather than the other should perform."

178. U.C.C. § 3-415(1). See *Bank of America v. Superior Court*, 4 Cal. App. 3d 435, 84 Cal. Rptr. 421 (1970); *McIntosh v. White*, 447 S.W.2d 75 (Mo. Ct. App. 1969); *Bucks County Bank & Trust Co. v. DeGroot*, 226 Pa. Super. 419, 313 A.2d 357 (1973).

may have defenses he would like to assert arising out of one or both of these transactions.

Determining which defenses the accommodation party may raise appears to require reference to rules other than those contained in Article 3. This becomes evident when one tries to apply the code sections that appear to be relevant. Section 3-415(2) sets out the contract of the accommodation party: "When the instrument has been taken for value before it is due the accommodation party is liable in the capacity in which he has signed even though the taker knows of the accommodation." Thus, as long as value has been given for the instrument before it is due, the accommodation party is liable in whatever capacity he has signed (*i.e.*, drawer, maker, acceptor or indorser).<sup>179</sup> Assume that A agreed to purchase a car from C. C demands that B guaranty repayment by indorsing the note. A makes a note payable to C which is indorsed by B. Since the car constitutes value, the instrument has been taken for value before it is due. B is therefore liable as an indorser, which is the capacity in which he signed. As an indorser, B's promise to pay the instrument is conditioned, under the indorser's contract, upon dishonor of the instrument by A and upon any necessary notice of dishonor.<sup>180</sup>

Section 3-414(1), which sets forth the indorser's contract, does not dictate what defenses an indorser may raise. To determine what defenses are available, section 3-305 and section 3-306 must be consulted. Section 3-415(2), with one exception, does not attempt to spell out which defenses an accommodation party may raise. The comments to section 3-415 expressly make reference to the "provisions subjecting one not a holder in due course to all simple contract defenses."<sup>181</sup> The one exception is that the "obligation of the accommodation party is supported by any consideration for which the instrument is taken before it is due."<sup>182</sup> Thus, B in our example may not raise lack of consideration as a defense against C, even if A gave no consideration to B.<sup>183</sup>

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179. U.C.C. § 3-415 comment 1; *Oak Park Currency Exch., Inc. v. Maropoulos*, 48 Ill. App. 3d 437, 363 N.E.2d 54 (1977); *Nevada State Bank v. Fischer*, 93 Nev. 317, 565 P.2d 332 (1977); *First Nat'l Bank v. Linn*, 282 S.E.2d 52 (W. Va. 1981).

180. U.C.C. § 3-414(1). *See also supra* note 179.

181. U.C.C. § 3-415 comment 1.

182. *Id.* § 3-415 comment 3. Although this exception is not spelled out in the text of U.C.C. § 3-415, the comments to the section clearly indicate that the drafters intend U.C.C. § 3-415(2) to be read as including this defense.

183. U.C.C. § 3-415 comment 3; *Gavin v. Hinrichs*, 375 So. 2d 1063 (Ala. 1979); *Bank of America v. Superior Court*, 4 Cal. App. 3d 435, 84 Cal. Rptr. 421 (1970); *Fairfield County Trust Co. v. Steinbrecher*, 5 Conn. Cir. Ct. 405, 255 A.2d 144 (1968); *Seaboard Fin. Co. v. Dorman*, 4 Conn. Cir. Ct. 154, 227 A.2d 441 (1966); *Motz v. Landmark First Nat'l Bank*, 154 Ga. App. 858, 270 S.E.2d 81 (1980); *Burke v. Burke*, 89 Ill. App. 3d 826, 412 N.E.2d 204 (1980); *Stockwell v. Bloomfield State Bank*, 174 Ind. App. 307, 367 N.E.2d 42 (1977); *Turfers, Inc. v. Frederick Prod. Credit Ass'n*, 265 Md. 679, 291 A.2d 643 (1972); *Berger v. Norad Enters., Inc.* 6 U.C.C. REP. SERV. 161 (N.Y. Sup. Ct. 1969); *Franklin Nat'l Bank v. Eurez Constr. Corp.*, 60 Misc. 2d 499, 301 N.Y.S.2d 845 (Sup. Ct. 1969)(mem.); *First Nat'l City Bank v. Valentine*, 61 Misc. 2d 554, 306 N.Y.S.2d 227, 7 U.C.C. REP. SERV. 53 (Sup. Ct. 1969); *Delbrook Assocs., Inc. v. Law*, 4 U.C.C. REP. SERV. 88 (N.Y. Sup. Ct. 1967); *Abby Fin. Corp. v. Weydig Auto Supplies Unlimited, Inc.*, 4 U.C.C. REP. SERV. 858 (N.Y. Sup. Ct. 1967); *Shulman v. Steve Lynn, Inc.*, 2 U.C.C. REP. SERV. 1046 (N.Y. Sup. Ct. 1965); *Hybertsen v. Reimann*, 262 Or. 116, 496 P.2d 917 (1972)(en banc); *James Talcott, Inc. v. Fred Ratowsky Assocs., Inc.*, 84 Dauph. 258, 38 Pa. D. & C.2d 624, 2 U.C.C.

Suppose, though, B had indorsed and delivered the note to A for the special purpose of enabling A to pay his college tuition. If the note is used to purchase a car instead, should this furnish a defense to B against C? Under section 3-306(c), delivery for a special purpose is a defense against a person not having the rights of a holder in due course. A literal application of section 3-306(c) would make this defense available against C if he is not a holder in due course. But if C is unaware of this special purpose, C's reasonable expectations would be defeated if he were subjected to this defense. As was the rule under the N.I.L.,<sup>184</sup> courts under Article 3 have held that such a defense is not available against any taker who at the time he took the instrument was unaware of the condition or special purpose.<sup>185</sup> When the taker knew of the special purpose, however, his reasonable expectations have not been defeated. Under the N.I.L., the holder therefore took subject to the defense.<sup>186</sup> One would expect that most courts under Article 3 would similarly hold.<sup>187</sup> But under section 3-306 no distinction is made between takers with notice of a condition or special purpose and takers without notice. It would therefore appear that either the defense would be available against both holders with and without notice of the special purpose or it would be available against neither type of holder. Since section 3-306 was not drafted with accommodation parties in mind, it cannot be expected to deal satisfactorily with this issue. The rule under the N.I.L. appears to make good sense and since there is no indication that the drafters intended to reject these decisions, they probably should be good law under Article 3.

A similar problem arises in determining whether the accommodation party can raise the accommodated party's defenses arising out of the latter's transaction with the creditor. When the accommodation party is sued on the instrument by the creditor, he may want to set up the defense of failure of consideration flowing to the accommodated party or some other defense of the accommodated party arising from the underlying transaction with the creditor. For instance, if A would have had the defense that C has breached the warranty of merchantability had A been sued, can B raise this breach of warranty as a defense to his own liability on the note? Under section 3-306(d), B technically cannot raise the defense since it is a defense of a third party. But since the consideration running to A is deemed sufficient to support B's promise, B should be permitted to raise at least the defense that there was a partial or total failure of consideration to A.<sup>188</sup> Even if section 3-306(d) were applied literally, B could still raise this defense under section 3-415(2), since the instrument

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REP. SERV. 1134 (1965); *Gill v. Commonwealth Nat'l Bank*, 504 S.W.2d 521 (Tex. Civ. App. 1973).

184. J. OGDEN, *supra* note 70, at 249-50.

185. *Franklin Nat'l Bank v. Eurez Constr. Corp.*, 60 Misc. 2d 499, 301 N.Y.S.2d 845 (Sup. Ct. 1969); *Delbrook Assocs., Inc. v. Law*, 4 U.C.C. REP. SERV. 88 (N.Y. Sup. Ct. 1967).

186. J. OGDEN, *supra* note 70, at 249.

187. *But see* *Perfect Picture Frames, Inc. v. Consolidated Fine Arts, Ltd.*, 9 U.C.C. REP. SERV. 283 (N.Y. Sup. Ct. 1971) (not available even where holder knew of condition).

188. *See* *McIntosh v. White*, 447 S.W.2d 75 (Mo. Ct. App. 1969); Peters, *Suretyship Under Article 3 of the Uniform Commercial Code*, 77 YALE L.J. 833, 862-65 (1968).

had not been taken "for value." But what about other defenses, such as mistake, misrepresentation, breach of warranty, or unconscionability? It does not make any sense to permit C to recover from B when C could not have recovered from A because of one of these defenses. But under section 3-306(d), B is not permitted to raise these defenses of A. It could be argued that since the consideration flowing to A is deemed to go also to B, B steps into A's shoes and may raise any defense that A could. But this argument goes too far in the other direction. Assume that A has the defense of infancy<sup>189</sup> or discharge in bankruptcy.<sup>190</sup> Clearly B cannot be permitted to raise these defenses.<sup>191</sup> Under the N.I.L., the accommodation party was denied the right to raise any defense of the accommodated party the risk of which the creditor was attempting to shift to the accommodation party by the obtaining of his signature on the instrument.<sup>192</sup> This would permit B to raise the former set of defenses but not the latter. Is this still the law under Article 3? Since we do not know precisely how the drafters intended to treat accommodation parties under section 3-306, this question cannot be answered. Because accommodation parties do not fit neatly within the scheme established by the drafters in section 3-305 and section 3-306, however, it would be dangerous to assume that the drafters intended to displace the common-law rules with section 3-305 and section 3-306.

### 3. Finality of Payment and Acceptance

When a person pays or accepts an instrument upon a mistaken belief about the propriety of the payment or acceptance, a question arises whether the payment may be recovered or the acceptance avoided. Subject to two exceptions,<sup>193</sup> payment or acceptance is final under section 3-418 in favor of a holder in due course, or a person who has in good faith changed his position in reliance on the payment.<sup>194</sup> When payment or acceptance is final, the payment may not be recovered by the payor<sup>195</sup> nor the acceptance avoided by the acceptor unless there is a breach of a presenter's warranty.<sup>196</sup>

When payment is not final, there is no prohibition against its recovery by the payor. But nothing in section 3-418 or in any other section of Article 3 affirmatively authorizes recovery of the payment. As under the N.I.L., the ability of a payor to recover payments made by mistake must rest upon a

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189. *Murphy v. Bank of Dahlonge*, 151 Ga. App. 264, 259 S.E.2d 670 (1979); *Peters, supra* note 188, at 862.

190. *Delbrook Assocs., Inc. v. Law*, 4 U.C.C. REP. SERV. 88 (N.Y. Sup. Ct. 1967); *Peters, supra* note 188, at 862.

191. *See supra* notes 189 and 190.

192. *Peters, supra* note 188, at 862.

193. The first exception is for the recovery, under U.C.C. § 4-301, of provisional payments made by a bank. U.C.C. § 3-418 comment 5. The second exception is for breach of one of the presenters warranties under U.C.C. § 3-417(1). *Id.* § 3-418 comment 5.

194. U.C.C. § 3-418.

195. *Id.* comment 1.

196. 2 STATE OF NEW YORK, *supra* note 35, at 1073.

common-law right of restitution for monies paid under a mistake of fact.<sup>197</sup> No indication is given by the drafters whether section 3-418 is intended to have any affect upon these common-law rules of restitution.<sup>198</sup> For instance, if the common law of a jurisdiction denies restitution when the mistaken payment is a result of the payor's negligence, is a negligent drawee denied restitution when he has paid an insufficient funds check to a person not having the rights of a holder in due course?<sup>199</sup>

Even more troubling questions surround the ability of an acceptor to raise defenses to his liability on an acceptance that is not final. No guidance is given about whether the acceptor may only raise those defenses that would constitute grounds for restitution had the instrument been paid rather than accepted, or whether his ability to raise defenses is governed, like the liability of all other parties, by section 3-306.<sup>200</sup> As a result, courts are divided over which of these answers is correct.<sup>201</sup> The drafters seem to have focused on common mistakes made by payor banks and completely neglected to provide comprehensive rules governing the liability of acceptors.

### C. *Difficulty of Applying Article 3 to Unforeseen Situations*

Learning from the problems with investment securities encountered under the N.I.L., the drafters made Article 3 non-exclusive.<sup>202</sup> Thus, courts or legislatures can create negotiable instruments that do not comply with the requirements for negotiability found in Article 3. But the drafters failed to foresee the problem with this new approach: any writing that does meet the requirements of section 3-104 and is not expressly excluded under section 3-103(1) is governed by Article 3. As a consequence, even when instruments negotiable under Article 3 are used in transactions or for purposes different from those foreseen when Article 3 was drafted, they are nonetheless governed by the rules found in Article 3. Since the drafters made little effort to anticipate the possible new uses of negotiable instruments or possible changes in commercial relationships, it was not long before courts were confronted with the task of applying Article 3 to situations not anticipated by the drafters. Courts were placed in a dilemma. Literal application of the rules would in some of these situations defeat either public expectations or important social policies. Since the drafters had not foreseen these situations, the balancing of interests evidenced by the rules did not necessarily apply to these new situations. On the other hand, if the courts did not apply a rule to situations falling

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197. 2 STATE OF NEW YORK, *supra* note 35, at 1072-75; 3 G. PALMER, THE LAW OF RESTITUTION 290, 307-08 (1978).

198. See 3 G. PALMER, *supra* note 197, at 307-08.

199. For an affirmative answer to this question, see G. PALMER, *supra* note 197, at 307.

200. For a thorough discussion of this question, see Lawrence, *Making Cashier's Checks and Other Bank Checks Cost-Effective: A Plea For Revision of Articles 3 and 4 of the Uniform Commercial Code*, 64 MINN. L. REV. 275, 327-31 (1980).

201. Compare *Rockland Trust Co. v. South Shore Nat'l Bank*, 366 Mass. 74, 314 N.E.2d 438 (1974) (applying U.C.C. § 3-306) with *Admiral Leather Corp. v. Manchester Modes, Inc.*, 422 F. Supp. 387 (S.D.N.Y. 1976) (mem.) (not applying U.C.C. § 3-306).

202. U.C.C. § 3-104 comment 1.

literally within the rule, the ability of practitioners to rely upon the rule is undermined.

Two substantial problems along these lines have already become apparent: (1) the emergence of bank checks<sup>203</sup> (*i.e.*, cashier's checks<sup>204</sup> and teller's checks<sup>205</sup>) as cash substitutes, and (2) the changing relationships between consumers and merchants.

### 1. Bank Checks

Although they were in use when Article 3 was drafted, there is no mention in Article 3 of cashier's checks or teller's checks.<sup>206</sup> To the extent that they are subject to the provisions of Article 3, they therefore are covered by the same rules as personal checks. Thus a holder of a cashier's or teller's check, if not a holder in due course, takes subject to all defenses of the issuer and any third party claims of ownership.<sup>207</sup> When the drafters decided to subject a holder of a personal check or promissory note to all defenses of the obligor as well as third party claims, they balanced the need to protect the drawer or maker who has a defense arising from the underlying transaction with the need to encourage the acceptance of negotiable instruments, which required shielding a purchaser from the assertion of defenses that would defeat his right to payment. The drafters concluded that in the case of ordinary negotiable instruments, a person who does not have the rights of a holder in due course should take subject to the defenses listed in section 3-306.

But bank checks are not viewed by the public as ordinary negotiable instruments. Rather, they are viewed more in the nature of cash.<sup>208</sup> These checks are usually purchased from the issuing bank for use in transactions in which the payee, often a merchant, refuses to take a personal check from the purchaser. These checks are accepted by merchants in lieu of cash for two reasons: 1) the obligor (*e.g.* issuing bank on a teller's or cashier's check) is almost always solvent; and (2) the merchant's belief that payment can not be refused because of a defense of the obligor or of the remitter.<sup>209</sup> If section 3-306 is deemed applicable to bank checks, the public's expectations will be dis-

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203. Certified checks would also probably qualify as "bank checks." Unlike cashier's or teller's checks, certified checks, being accepted drafts, are technically covered by U.C.C. § 3-418. Thus, certified checks present slightly different, though similar, problems than do cashier's and teller's checks. The specific issue is whether § 3-418 was intended to govern the question whether the certifying bank can raise any defenses to its obligation to pay on the certification. This issue is comprehensively discussed in Lawrence, *supra* note 200, at 320-33.

204. A cashier's check is a negotiable instrument drawn by a bank upon itself as drawee.

205. A teller's check is a check drawn by a bank, usually a savings and loan association, upon a commercial bank. Thus, the drawer bank is not the drawee bank.

206. There is a reference to cashier's checks in U.C.C. § 4-211(1), which enumerates the types of payment that collecting banks may take in settlement of an instrument for the payment of money.

207. U.C.C. § 3-306.

208. See Lawrence, *supra* note 200, at 279-81. Traveller's checks are probably more consistently accepted in lieu of cash than are bank checks. Traveller's checks, like certified checks, present problems similar to bank checks. For a comprehensive discussion of traveller's checks, see Hawkland, *American Travellers Checks*, 15 BUFF. L. REV. 501 (1966).

209. Lawrence, *supra* note 200, at 279-81.

appointed.<sup>210</sup> A merchant who did not qualify as a holder in due course would take subject to any defense the issuing bank had against the remitter and any claim of ownership to the instrument asserted by the remitter. Even if the merchant were a holder in due course, he may need to fight a law suit to prove his status as such. Should a court find that section 3-306 applies to bank checks or should it ignore the section and preserve the public's expectation by denying the right of the issuer to raise any defenses to its obligation to pay? Courts have differed greatly in their response to this question.<sup>211</sup>

Although cashier's and teller's checks appear to be treated similarly by the public and by merchants, their treatment by the courts has been anything but similar. Notwithstanding the public's expectations, most courts have treated teller's checks like ordinary negotiable instruments, applying section 3-306 to determine what defenses may be raised against a person not having the rights of a holder in due course.<sup>212</sup> Some courts have treated cashier's checks in this manner.<sup>213</sup> It is unclear whether these courts believe that cashier's and teller's checks are like ordinary instruments or whether they felt compelled to treat them like ordinary negotiable instruments on account of the absence of any separate treatment of them under Article 3. In either case, possibly because of a nagging realization that the public does view bank checks as cash substitutes, these courts have sought support for their decisions in any code section that is even arguably applicable. In the case of cashier's checks, some of these courts<sup>214</sup> have found support in section 3-118(a): "[a] draft drawn on the drawer is effective as a note." From this premise, they have reasoned that since the ability of a maker to raise defenses is governed by section 3-305 and section 3-306, these sections also govern the liability of the issuer of a cashier's check. Section 3-118(a) was not intended to describe the defenses that may be raised by an issuing bank on a cashier's check. Section 3-118(a) was intended simply to dispense with the need to present to the drawee a draft drawn upon the drawer or to give the drawer notice of the dishonor.<sup>215</sup> Like a maker, the

210. See Lawrence, *supra* note 200, at 316-19.

211. See *infra* notes 212, 213, 219, and accompanying text.

212. Courts uniformly permit the drawer bank to raise any defense it has arising out of the transaction in which the teller's check was issued as against any person not having the rights of a holder in due course. *Rubin v. Walt Whitman Fed. Sav. & Loan Ass'n*, 21 U.C.C. REP. SERV. 610 (N.Y. Sup. Ct. 1977); *Smith v. New York Bank for Sav.*, 11 U.C.C. REP. SERV. 1210 (N.Y. Sup. Ct. 1973). There are two separate lines of decisions dealing with whether a drawer bank may raise the purchaser's claims or defenses. One line applies § 3-306(d). See, e.g., *Fulton Nat'l Bank v. Delco Corp.*, 128 Ga. App. 16, 195 S.E.2d 455 (1973). The other line of cases, composed solely of cases from New York, flatly prohibits the bank from raising any claims or defenses of the purchaser. See *Manhattan Imported Cars, Inc. v. Dime Sav. Bank*, 70 Misc. 2d 889, 335 N.Y.S.2d 356 (App. Term 1972) (per curiam); *Meckler v. Highland Falls Sav. & Loan Ass'n*, 64 Misc. 2d 407, 314 N.Y.S.2d 681 (Sup. Ct. 1970); *Ruskin v. Central Fed. Sav. & Loan Ass'n*, 3 U.C.C. REP. SERV. 150 (N.Y. Sup. Ct. 1966); *Malphrus v. Home Sav. Bank*, 44 Misc. 2d 705, 254 N.Y.S.2d 980 (Sup. Ct. 1965). See also Lawrence, *supra* note 200, at 333-39.

213. See, e.g., *TPO Inc. v. FDIC*, 487 F.2d 131 (3d Cir. 1973); *Banco Ganadero y Agricola v. Society Nat'l Bank*, 418 F. Supp. 520 (N.D. Ohio 1976) (mem.); *Laurel Bank & Trust Co. v. City Nat'l Bank*, 33 Conn. Supp. 641, 365 A.2d 1222 (1976); *Wilmington Trust Co. v. Delaware Auto Sales*, 271 A.2d 41 (Del. 1970); *State Bank v. American Nat'l Bank*, 266 N.W.2d 496 (Minn. 1978); *Thompson Poultry, Inc. v. First Nat'l Bank*, 199 Neb. 8, 255 N.W.2d 856 (1977).

214. See *supra* note 213.

215. U.C.C., Notes and Comments to Article III, § 14, at 62-3 (Tentative Draft No. 1, 1946).



drawer is not harmed by a delay in presentment and has notice of dishonor since he himself dishonors the draft. In the case of teller's checks, some courts have found support in the sections that seem to hold that the order given by the drawer bank to the drawee bank is revocable.<sup>216</sup> Under section 4-104(1)(e), "customer" is specifically defined as including "a bank carrying an account with another bank." Since under section 4-403, a "customer" has the right to stop payment on any item payable for his account, these courts hold that the drawer bank, once payment is stopped, can raise any defense that any other drawer could raise.<sup>217</sup> The right to stop payment simply resolves the question whether the drawee bank must refuse to pay the instrument upon request of the drawer. Granting the drawer bank this right to stop payment does not evidence a judgment that the drawer bank should have the same right to raise defenses as drawers on personal checks.<sup>218</sup>

On the other hand, many courts have treated cashier's checks as cash equivalents and, as a consequence, have refused to permit the issuing bank to raise any defenses to its obligation to pay even when the instrument is not held by a holder in due course.<sup>219</sup> But courts do not recognize straightforwardly that the public treats cashier's checks differently than personal checks and that, notwithstanding section 3-306, the bank must be precluded from raising any defenses. Instead they have attempted to find support in code sections that only superficially lend support to their analysis. For instance, many courts state that a cashier's check is accepted by the act of its issuance.<sup>220</sup> From this premise, they reason either that having been accepted it is irrevocable or that since a stop payment order is not effective after acceptance, a bank may not raise any defense to its obligation to pay.<sup>221</sup> Clearly the inability to stop payment on an instrument does not answer the question whether the issuing bank can raise its defenses once payment is refused.<sup>222</sup> As indicated by section 3-418, the fact that an instrument is accepted does not make it irrevocable.<sup>223</sup>

It is a mistake for courts on either side of this issue to base their decision

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216. *Fulton Nat'l Bank v. Delco Corp.*, 128 Ga. App. 16, 195 S.E.2d 455 (1973).

217. *Id.*

218. *See* Lawrence, *supra* note 200, at 290-92.

219. *See, e.g.,* Goldstein v. McLean Bank, 552 F.2d 1072, 1078 (4th Cir. 1977); *Swiss Credit Bank v. Virginia Nat'l Bank*, 538 F.2d 587, 588 (4th Cir. 1976) (per curiam); *Munson v. American Nat'l Bank & Trust Co.*, 484 F.2d 620, 624 (7th Cir. 1973); *Kaufman v. Chase Manhattan Bank*, 370 F. Supp. 276, 278 (S.D.N.Y. 1973); *State ex rel. Chan Siew Lai v. Powell*, 536 S.W.2d 14, 16 (Mo. 1976) (en banc); *National Newark & Essex Bank v. Giordano*, 111 N.J. Super. 347, 350, 268 A.2d 327, 329 (1970); *Tranarg v. Banca Commerciale Italiana*, 90 Misc. 2d 829, 835-36, 396 N.Y.S.2d 761, 764 (Sup. Ct. 1977); *Moon Over the Mountain, Ltd. v. Marine Midland Bank*, 87 Misc. 2d 918, 920, 386 N.Y.S.2d 974, 975 (Civ. Ct. 1976); *Wertz v. Richardson Heights Bank & Trust*, 495 S.W.2d 572, 574 (Tex. 1973).

220. *See* *Munson v. American Nat'l Bank & Trust Co.*, 484 F.2d 620 (7th Cir. 1973); *Kaufman v. Chase Manhattan Bank*, 370 F. Supp. 276 (S.D.N.Y. 1973); *State ex rel. Chan Siew Lai v. Powell*, 536 S.W.2d 14 (Mo. 1976) (en banc); *National Newark & Essex Bank v. Giordano*, 111 N.J. Super. 347, 268 A.2d 327 (1970); *Wertz v. Richardson Heights Bank & Trust*, 495 S.W.2d 572 (Tex. 1973).

221. *See supra* note 220.

222. *See* Lawrence, *supra* note 200, at 290-92.

223. *See supra* notes 193-201 and accompanying text.

on superficially appropriate code provisions intended to resolve very different problems. Courts are distracted thereby from the real question whether bank checks should be treated differently than ordinary negotiable instruments. By basing policy decisions on technical arguments, the court is hardpressed to reach the same result when the technical argument is inapplicable. For instance, teller's checks probably are treated just as much like cash as are cashier's checks. Yet, if a court wanted to deny the drawer bank the right to raise a defense to its obligation on a teller's check, it could not use the same argument that it used in the case of cashier's checks, namely that the drawer cannot stop payment once a check has been accepted.<sup>224</sup> Courts would be better advised to recognize that section 3-306 was not drafted with bank checks in mind and that they must decide whether it is desirable to apply section 3-306 to such checks.<sup>225</sup>

## 2. Consumer Protection

Even when Article 3 was being drafted, the pressing need to protect consumers from overreaching by merchants had been recognized. Special rules protecting consumers from such overreaching were being drafted in other Articles of the U.C.C.<sup>226</sup> For some reason, though, the drafters of Article 3 did not provide any special rules for consumer transactions. They provided only one set of rules which governed all transactions involving negotiable instruments. It is doubtful that this failure to provide different rules for consumer transactions evidenced a conscious decision by the drafters to treat consumer transactions the same as business transactions. It is more likely that in attempting to cure only those problems that had plagued the N.I.L., the drafters simply failed to give substantial thought to the problem of consumers.

In drafting the sections setting forth the requirements for holder in due course status, and in allowing such a holder to take free of all defenses, the drafters probably had in mind a typical commercial transaction. The obligor was pictured as choosing to give up his right to raise defenses in exchange for a reduction in the cost of credit. On the other side of the transaction was pictured an assignee of the instrument who, as an independent businessman, was willing to assume the risk of the maker's insolvency but not willing to assume the risk of non-payment on account of a maker's defense. If he was forced to assume this latter risk, he would pay a lower price for the instrument. This would require the seller to charge a higher price for the goods to obtain the same net proceeds after selling the note. In formulating the requirements for holder in due course status, the drafters made a substantial effort to avoid this consequence, thereby encouraging the purchase of negotiable instruments at a

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224. At least one court has expressly held that teller's checks are not to be treated like cashier's checks especially because they are not accepted by their act of issuance and therefore the drawer bank has the right to stop payment. *Fulton Nat'l Bank v. Delco Corp.*, 128 Ga. App. 16, 195 S.E.2d 455 (1973).

225. See generally Lawrence, *supra* note 200.

226. See, e.g., U.C.C. § 9-206(1); *id.* § 2-719(3).

reasonable price. To accomplish this result, they defined both good faith<sup>227</sup> and notice<sup>228</sup> in generally subjective terms. Thus, a purchaser may qualify as a holder in due course as long as he subjectively acted in good faith, even though a reasonable man may have suspected the existence of the defense. A purchaser would be discouraged from purchasing instruments if juries, in hindsight, could deny him holder in due course status by finding that the purchaser should have known of the claim or defense.

In consumer transactions these underlying assumptions are often inaccurate.<sup>229</sup> A consumer usually is unaware that he is relinquishing his right to raise defenses. Even when he is aware of the consequences of signing a negotiable instrument, his relinquishment of defenses may not have been bargained for. On the other hand, the purchasers of consumer notes sometimes are related so closely to the merchant-payee that they have good reason to know of the possibility that the consumer has a defense and are not relying upon his right to take free of the defense in making their decision to purchase the instrument.<sup>230</sup> Again courts were placed in a dilemma. If the court applied the provisions of Article 3 literally, these purchasers would take free of the consumer's defenses. But often this would be a miscarriage of justice. As a result, many courts started to try to find ways to allow the consumer to raise his defenses. As a general rule courts simply did not acknowledge that section 3-305 was not drafted with consumer transactions in mind and thereby find that even though the holder qualified as a holder in due course, he would take subject to the consumer's defenses.<sup>231</sup> Instead, they manipulated the concepts of "good faith"<sup>232</sup> and "notice"<sup>233</sup> by implying an objective element. But these courts often did not limit their interpretation of these concepts to consumer transactions.<sup>234</sup> As a result, it is unclear whether these interpretations are also applicable in non-consumer cases. Once a code section is misapplied

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227. *Id.* § 1-201 (19).

228. *Id.* § 1-201(25). Although there is an objective element to some extent in the definition of "notice," *id.* § 1-201(25)(c), it is clear that to a great degree the drafters intended "notice" to be interpreted subjectively. U.C.C., Notes and Comments to Article III, § 46, at 62 (Tentative Draft No. 2, 1947); U.C.C., Notes and Comments to Article III, § 43, at 162 (Tentative Draft No. 1, 1946).

229. *See* *Jones v. Approved Bancredit Corp.*, 256 A.2d 739 (Del. 1969); *Sullivan v. United Dealers Corp.*, 486 S.W.2d 699 (Ky. Ct. App. 1972); *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967); *American Plan Corp. v. Woods*, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968).

230. *See supra* note 229.

231. Some courts did hold that even if a holder met all of the requirements contained in U.C.C. § 3-302(1) for holder in due course status, the holder did not acquire the rights of a holder in due course if he was "closely connected" to the payee. *Sullivan v. United Dealers Corp.*, 486 S.W.2d 699 (Ky. Ct. App. 1972); *American Plan Corp. v. Woods*, 16 Ohio App. 2d 1, 240 N.E.2d 886 (1968).

232. *Mountain Fin. Co. v. Powell*, 474 P.2d 172, 7 U.C.C. REP. SERV. 1223 (Colo. Ct. App. 1970); *Kennard v. Reliance, Inc.*, 257 Md. 654, 264 A.2d 832 (1970); *General Inv. Corp. v. Angelini*, 58 N.J. 396, 278 A.2d 193 (1971).

233. *United States Fin. Co. v. Jones*, 229 So.2d 495 (Ala. 1969); *Cromwell v. All State Credit Corp.*, 10 U.C.C. REP. SERV. 403 (D.C. 1971); *HIMC Inv. Co. v. Siciliano*, 103 N.J. Super. 27, 246 A.2d 502 (1968).

234. *United States Fin. Co. v. Jones*, 229 So.2d 495 (Ala. 1969); *Mountain Fin. Co. v. Powell*, 474 P.2d 172, 7 U.C.C. REP. SERV. 1223 (Colo. Ct. App. 1970); *HIMC Inc. Co. v. Siciliano*, 103 N.J. Super. 27, 246 A.2d 502 (1968).

or stretched, even in an effort to reach a correct result, a practitioner can no longer rely upon the results dictated by the code section. He never knows when a court will stretch the language of a section to reach the desired result. When a section is stretched, a later court may take the court at its word and reach results that the drafters meant to avoid. These problems can be avoided by simply acknowledging, as some courts have done, that consumer transactions should not be treated the same as business transactions.<sup>235</sup>

## VI. NEW PAYMENTS CODE: SUGGESTED AMENDMENTS TO ARTICLE 3

Amendments to Articles 3 and 4 now are being considered for adoption in the form of a New Payments Code. The primary impetus for the drafting of the New Payments Code is the proliferation of new payment systems, such as electronic fund transfer systems, which the Permanent Editorial Board of the U.C.C. wants to bring within the coverage of Articles 3 and 4.

The drafters of the New Payments Code (the "revisers"), thus have an opportunity to accomplish what the original drafters of Article 3 attempted but failed to do. With the making of little substantive change in Article 3, these revisers can create "a relatively compact, relatively accessible, relatively stable body of law which will not cost a week's research for each ten-minute consultation."<sup>236</sup> By making the following proposed revisions they also can make the law more uniform and more certain.

The revisers should begin by attempting to remedy the previously discussed problems that have prevented Article 3 from being a code. First, the revisers should go through Article 3 with the objective of ensuring that all terminology, including, but not limited to, the terms "holder," "paid," and "value," is used consistently. There is no reason to use terms that do not accurately describe a desired concept. Nothing is gained and a great deal is lost when one word is used that inaccurately describes a concept which could have been described accurately with two words.

Second, since many sections of Article 3 merely supplement rather than preempt the common law, a practitioner or judge is required to research the common law. This research is, for the most part, unnecessary. With virtually no revision of the substantive law, the revisers can eliminate the need for most of this research. The revisers need only redraft Article 3 by incorporating into its provisions the common-law rules that already supplement it. If the revisers comprehensively state applicable rules and any exceptions thereto, a practi-

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235. With the promulgation in 1975 by the Bureau of Consumer Protection of the Federal Trade Commission of the Rule, Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433 (1983), reprinted in CONSUMER CRED. GUIDE (CCH) ¶ 11,380, and the state statutory enactments preserving the right of consumers to raise their claims and defenses against holders or assignees of notes given in payment for the purchase of goods or services, the need of courts to stretch or misapply the requirements for holder in due course status in an effort to protect consumers is no longer pressing. See, e.g., GA. CODE ANN. §§ 10-1-9 (1981); N.C. GEN. STAT. § 25A-25 (Cum. Supp. 1981); OHIO REV. CODE ANN. §§ 1317.03.1 and 1317.03.2 (Page 1982); WASH. REV. CODE ANN. § 63.14.020 (1983).

236. See *supra* note 7 and accompanying text.

tioner will be able to rely upon the answer dictated by the particular section. In addition to the rules relating to conversion, defenses of accommodation parties, and the finality of payment and acceptance, it would be helpful to also incorporate the rules governing, among other things, damages for breach of the transferor's warranties<sup>237</sup> and the introduction of parol evidence.<sup>238</sup> There will be situations in which room must be made in a rule for judicial discretion or for differences of state policy. When this is desired, the section should indicate specifically which issues are of this nature.

Third, separate rules should be drafted specifically to provide for instruments serving different purposes, i.e., traveller's, cashier's, certified, and teller's checks. In addition, since the New Payments Code will be incorporating into Article 3 new payment systems, it is essential that the differences in the operation and purposes of these payment systems be reflected in the specific provisions governing each. Although the revisers will not be able to anticipate all the potential new payment systems, foresight will prevent the rapid outdateding that has already afflicted Article 3.

There are two other types of amendments that would make Article 3 far more accessible: (1) the elimination of the use of inaccessible terms and concepts; and (2) the revising of some archaic rules that are contrary to common sense. The terminology of Article 3 is needlessly inaccessible to anyone who is not familiar with the N.I.L. Many terms used in Article 3 are terms of art that may have been familiar to lawyers practicing law in 1950 but are certainly not familiar to lawyers now. Many of these terms and concepts are not defined anywhere in the U.C.C. A few examples of needlessly inaccessible terms or concepts are the "finality" of payment or acceptance,<sup>239</sup> "taking up" an instrument,<sup>240</sup> "lending one's name to another,"<sup>241</sup> "after sight,"<sup>242</sup> and "claim."<sup>243</sup> To take one example, what does it mean to say that payment or acceptance is "final"? Presumably, to say that payment is "final" simply means that the payment cannot be recovered. Would it not have been far clearer to express the concept in these terms? Acceptance is "final" may mean that the acceptor

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237. U.C.C. § 3-417(2) does not establish any measure of damages for breach of the transferor's warranties. Comment 1 to § 3-417 indicates that all usual remedies for breach of warranty are available. But difficult questions arise that are peculiar to negotiable instruments. See Comment, *Warranties on the Transfer of a Negotiable Instrument—U.C.C. 3-417(2)*, 17 STAN. L. REV. 77, 87-90 (1964); Note, *Measure of Damages for Breach of Implied Warranty by Transferor of a Negotiable Instrument*, 25 ALB. L. REV. 110 (1961). There is no reason why a decision about the measure of damages should not be made by the revisers and incorporated into Article 3.

238. Since Article 3 contains no general parol evidence rule, in most situations reference must be made to the state's general law of parol evidence. *Brames v. Crates*, 399 N.E.2d 437 (Ind. Ct. App. 1980); *American Underwriting Corp. v. Rhode Island Hosp. Trust Co.*, 111 R.I. 415, 303 A.2d 121 (1973). Courts have been anything but consistent in their admission of parol evidence. See generally Jordan, "Just Sign Here—It's Only a Formality": *Parol Evidence in the Law of Commercial Paper*, 13 GA. L. REV. 53 (1978). There appears to be no reason to leave the law in this state of confusion. Even if the revisers only provided rules for more common situations, a great deal of confusion could be avoided.

239. U.C.C. § 3-418.

240. *Id.* § 3-414(1); *id.* § 3-413(2).

241. *Id.* § 3-415(1).

242. *Id.* § 3-503(1)(b).

243. *Id.* § 3-306(d); *id.* § 3-305(1); *id.* § 3-603(1).

has no right to refuse to pay upon presentment. If it does, does this mean that a discharge in bankruptcy and other defenses under section 3-305(a)(a)-(e) can not be asserted by the acceptor? If the revisers attempt to define these terms, they will be forced to answer such questions.

Some important rules found in Article 3 may have made sense in a time when negotiable instruments were used mainly by merchants familiar with the rules of law governing negotiable instruments. But in a time when a vast majority of the population has checking accounts, and payment by check is the rule rather than the exception, rules that may affect substantial rights of the public must have some basis in common sense. If a person cannot know that he may be jeopardizing valuable rights by his actions, it is unfair to penalize him for these actions. There are two notable examples of this problem in Article 3.

First, a holder of a check discharges all indorsers unless he makes timely presentment and gives timely notice of dishonor.<sup>244</sup> Presentment must be made within a reasonable time.<sup>245</sup> In the case of an uncertified check, this is presumed to be seven days after the indorsement.<sup>246</sup> Notice of dishonor must be given before midnight of the third business day after dishonor or receipt of notice of dishonor.<sup>247</sup> An unexcused delay in either proceeding will completely discharge any indorser on the instrument<sup>248</sup> and on the underlying obligation.<sup>249</sup> Many people forget to deposit checks quickly and are often totally ignorant that they must promptly give notice of dishonor. It is doubtful that these delays are excused under section 3-511(1).<sup>250</sup> If they are not, the indorser is completely discharged. This result may make sense when the indorser has been harmed by the delay. It may be unfair to require the indorser to prove this loss. But there is no reason why the holder should not be permitted to prove that the indorser in fact suffered no loss. When the drawer and all prior indorsers were insolvent at a date within which notice of dishonor or presentment would have been timely, it is reasonably certain that no loss has been suffered. In this situation the indorser and not the holder should suffer the loss.

Second, the formal requirements for negotiability make very little sense.<sup>251</sup> The form required for negotiability gives an obligor no indication

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244. *Id.* § 3-502(1)(a).

245. *Id.* § 3-503(1)(e).

246. *Id.* § 3-503(2)(b).

247. *Id.* § 3-508(2).

248. *Id.* § 3-502(1)(a).

249. *Id.* § 3-802(1)(b).

250. *Id.* § 3-511(1) provides that delay in presentment or notice of dishonor is excused when the party is without notice that "it is due." Although this section can be read technically as excusing the delay when a party does not know that presentment or notice of dishonor is required, the section was not intended to be read in this manner. Comment 2 to U.C.C. § 3-511 clearly implies that the party must be ignorant that the instrument is due. The two examples that are given are when (1) an instrument has been accelerated without the knowledge of the holder and (2) a prior holder has already demanded payment. Both of these examples involve ignorance about whether the instrument itself is due.

251. U.C.C. § 3-104 to 115.

that by signing the instrument he is giving up his right to raise any defenses against a holder in due course. No one except a student of Article 3 would know that the difference between a non-negotiable and a negotiable instrument is the use of a magical word like "bearer,"<sup>252</sup> "order,"<sup>253</sup> "cash"<sup>254</sup> or "exchange."<sup>255</sup> Instead of these words of negotiability, it would make more sense to require, at least where the transaction is not between two businessmen, a statement like "Signing of this instrument may deprive you of the right to raise any defense you may have on the underlying transactions or otherwise." At the other extreme, it is unclear why negotiability should be denied to instruments that either are not payable on demand or at a definite time<sup>256</sup> or for a sum certain<sup>257</sup> or unconditional.<sup>258</sup> A holder is not required to purchase an instrument. Although an instrument may be unmarketable because it is conditional, in a sum uncertain or indefinite as to date of payment, it may similarly be unmarketable because of the questionable financial condition of the obligor. If a holder wants to assume certain specified risks only, there appears to be no reason to refuse negotiability to such instruments. A holder in due course should be able to purchase such an instrument free of all defenses except those expressly assumed. This also would enable all of the other rules of Article 3 to be applied to such instruments as they already are applied to section 3-805 instruments that fail to be negotiable because they are not payable to order or to bearer.

## VII. CONCLUSION

Since its enactment, Article 3 has confused and confounded lawyers and judges. The reason for this confusion has been a misconception about the methodology to be employed in applying its provisions. Most courts, commentators, and lawyers have viewed Article 3 as a comprehensive code, when actually it is a group of statutes addressed to specific problems that existed in the judicial interpretation of the N.I.L. The proper methodology is to read the sections of Article 3 against the background of the particular problems that the sections were intended to remedy. Since most of the difficulty in understanding Article 3 can be attributed to its drafting and not to the specific rules it has adopted, the current drafters of the New Payments Code can remedy most of these problems virtually without making any substantive changes in Article 3. Simply because many current lawyers are familiar with the rules and terminology of Article 3 is no reason to leave Article 3 in a condition bound to confuse future generations of lawyers and judges.

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252. *Id.* § 3-111(a) and (b); *id.* § 3-104(1)(d).

253. *Id.* § 3-110(1); *id.* § 3-104(1)(d).

254. *Id.* § 3-111(c); *id.* § 3-104(1)(d).

255. *Id.* § 3-110(1); *id.* § 3-104(1)(d).

256. *Id.* § 3-104(1)(c); *id.* § 3-108; *id.* § 3-109.

257. *Id.* § 3-104(1)(b); *id.* § 3-106.

258. *Id.* § 3-104(1)(b); *id.* § 3-105.