THE LAW OF PAYMENT SYSTEMS

SUPPLEMENTAL READINGS

Class 13

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PAYMENT SYSTEMS

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Summary of Contents

CHAPTER 1
WHAT IS A NEGOTIABLE INSTRUMENT?

I. WHAT IS A NEGOTIABLE INSTRUMENT?

A. **Definition:** A negotiable instrument is a cross between a contract and money.

1. **Primary difference from ordinary contract right:** An assignee of an ordinary contract right takes subject to all the defenses to which his assignor took subject. A holder in due course of a negotiable instrument takes the instrument free from virtually all defenses. [1]

2. **Other differences:** Simpler to plead and prove case on a negotiable instrument. [2]

II. GOVERNING LAW

A. **The U.C.C.:** The basic law governing negotiable instruments is contained in Articles 3 and 4 of the Uniform Commercial Code. In 2002, the American Law Institute and the National Conference of Commissioners on Uniform State Laws proposed several amendments to Articles 3 and 4. However, until enacted by the particular state, these amendments will not be the law in that state. [2]

1. **Coverage of Article 3:** Article 3 governs writings meeting the requirements of U.C.C. §3-104(a). U.C.C. §3-102 specifically excludes from the scope of Article 3 the following writings that otherwise may qualify as negotiable instruments: (1) investment securities governed by Article 8, (2) money, and (3) payment orders governed by Article 4A. U.C.C. §3-102(a). [2]

2. **Coverage of Article 4:** Article 4 governs the bank collection process. The coverage of Article 4 is limited to items. Any promise or order to pay money handled by a bank for collection or payment is an item whether or not the promise or order would qualify as a

negotiable instrument under Article 3. U.C.C. §4-104(a)(9). "Item" does not include payment orders governed by Article 4A or debit and credit card slips. U.C.C. §4-104(a)(9). [2]

3. **Article 4 prevails over Article 3:** When the results reached under an applicable provision of Article 4 conflict with the results reached under a provision of Article 3, Article 4 controls. U.C.C. §3-102(b); U.C.C. §4-102(a). [2-3]

4. **Federal common law:** In the absence of a federal statute or regulation, if the United States is a party to an instrument, its rights and duties are governed by federal common law and not by the Code. U.C.C. §4-102, Official Comment 1. [3]

III. TYPES OF NEGOTIABLE INSTRUMENTS

Article 3 negotiable instruments are classified into two basic categories: **Notes and drafts**. [3-6] Negotiable instruments include:

- **Notes:** A note is a promise by one party (called the "***maker*** ") to pay to another party (called the "payee") a sum of money. The usual purpose of a note is to evidence a debt. Notes thus primarily serve a credit rather than a payment function. [3]

- **Certificates of deposit:** A certificate of deposit is a note issued by a bank. It is defined as "an acknowledgment by a bank of the receipt of money together with an engagement by the bank to repay the money." U.C.C. §3-104(j). Certificates of deposit are the means by which banks raise money and depositors assure themselves of a good return on their money. [3-4]

- **Drafts:** A "*draft*", sometimes known as a bill of exchange, is a three-party instrument by which a person called a "***drawer*** " (the person who typically signs the draft in the lower right-hand corner) orders a person called a "***drawee*** " (the person named in the draft to whom the order is directed) to pay the payee. Drafts are usually payment instruments by which the drawer makes payment to the payee. [4]

- **Checks:** A check is a draft drawn on a bank (called either the "***drawee bank*** " or the "***payor bank*** ") and payable on demand.

U.C.C. §3-104(f). Because all checks are drafts, unless the Code specifically provides otherwise, checks are governed by the same rules that govern drafts. [4]

- **Bank checks (including cashier's checks, teller's checks, and certified checks):** Bank checks are treated differently from ordinary checks for several purposes including: (1) the ability of the issuing bank to refuse payment; (2) the loss or destruction of a bank check; (3) the effect of taking a bank check on the underlying obligation, and (4) the statute of limitations on bringing an action against the issuing bank. [4]
- **Traveler's checks:** To be a traveler's check, the check must require, as a condition to payment, a countersignature by the person whose specimen signature appears on the instrument. U.C.C. §3-104(i). A holder in due course does not take subject to the risk that the traveler's check was stolen and the countersignature forged. U.C.C. §3-106(c); U.C.C. §3-106, Official Comment 2. [4-5]
- **Personal money order:** A personal money order is a draft sold by the drawee to a person who typically does not have an account with the drawee. It is, in effect, a single-transaction checking account. If the drawee is a bank, the personal money order is a check; if a non-bank, a personal money order is a draft. The drawee bank is not liable on a personal money order because the bank has not signed the order. [5]
- **Time drafts:** A time draft is a draft payable at a definite time. [5]
- **Sight drafts:** A sight draft is a draft payable on demand. [5]
- **Documentary drafts:** A documentary draft is a draft, whether payable at a definite time or on demand, which is accompanied by a letter containing instructions that the draft is not to be paid unless the holder presents to the drawee certain designated documents. [5]
- **Banker's acceptances:** A banker's acceptance is a draft drawn on and accepted by a bank. By accepting the draft, the bank becomes liable to pay the draft. U.C.C. §3-413(a). [5]
- **Trade acceptances:** A trade acceptance is a draft drawn on and accepted by a person other than a bank. [5]

- **Payable through items:** The bank through which the item is payable, having no right to pay the item, is a collecting bank and not the payor bank. U.C.C. §4-106(a); U.C.C. §4-106, Official Comment 1. [5]
- **Payable at items:** Article 4 provides two alternative provisions that a state may adopt as to the manner in which instruments payable at a bank are to be treated. The first alternative provision treats a "payable at" item as a check. U.C.C. §4-106(b), Alternative A. Under the second alternative, a payable at item is treated as though it is "payable through" the designated bank. U.C.C. §4-106(b), Alternative B. [5-6]
- **Remotely created consumer item:** The 2002 amendments have added a new type of negotiable instrument. A "remotely created consumer item" is "an item drawn on a consumer account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer." [Rev] U.C.C. §3-103(a)(16). [6]

IV. REQUIREMENTS FOR NEGOTIABILITY

Only a writing complying with the requirements of U.C.C. §3-104(a) is a negotiable instrument under Article 3. U.C.C. §3-104, Official Comment 1. Negotiability is determined solely by reference to the four corners of the instrument. A separate agreement cannot affect the negotiability of an instrument. U.C.C. §3-104(a) sets forth the following requirements for negotiability. [6-7]

1. **A signed writing:** As long as the signer intends for it to be her signature, she may use any name, word, or mark as her signature including a fictitious name, a trade name, or the signer's first name. A signature may be in the form of printing, handwriting, typing, or even the imprinting of a thumbprint. U.C.C. §1-201, Official Comment 39; U.C.C. §3-401(b); U.C.C. §3-401, Official Comment 2. [7]
2. **An unconditional promise or order:** A promise or an order that is expressly conditioned upon the happening of a specified event is not unconditional. A promise or order is regarded as unconditional if the promise or order is subject only to an implied or constructive condition. U.C.C. §3-106(a); U.C.C. §3-106, Official Comment 1. A promise or an order is not unconditional if it states that the promise or order is subject to, or governed by, another writing or if

rights of the parties are stated in another writing. U.C.C. §3-106(a)(ii) and (iii). An instrument that merely refers to the existence of another writing may be negotiable. U.C.C. §3-106(a). An instrument may retain its negotiability while referring to another writing for rights as to collateral, acceleration, or prepayment. U.C.C. §3-106(b)(i). [8-9]

3. **Principal sum must be payable in a fixed amount of money:** An instrument is not payable in a fixed amount if the terms used in the instrument to express the sum payable or any component thereof are ambiguous or if reference must be made to an outside source or writing to determine the principal amount. Interest and other charges do not have to be payable in a fixed amount. U.C.C. §3-112, Official Comment 1. Virtually any type of provision for the payment of interest is permissible. An instrument may state the obligation to pay interest as a fixed or variable amount of money or as a fixed or variable rate or rates. The amount or rate of interest may be stated or described in the instrument in any manner and may require reference to information not contained in the instrument. U.C.C. §3-112(b); U.C.C. §3-112, Official Comment 1. Provisions for attorneys' fees and costs incurred in the collection of the instrument are permissible “other charges” even though they do not specify a particular sum. Provisions for prepayment penalties, late payment penalties, or other penalties, discounts, or rebates are also permissible “other charges.” A duty to pay taxes or to pay to insure collateral are probably not permissible other charges and, therefore, their inclusion will defeat an instrument's negotiability. An instrument is not negotiable unless it is payable in money. U.C.C. §3-104(a). [9-11]

4. **Must be payable to bearer or to order:** An instrument that is payable to bearer may take one of several forms: (a) state that it is payable “to bearer”; (b) use language indicating that the person in possession of it is entitled to payment, e.g., to “holder,” to “cash,” or to the “order of cash”; or (c) does not name a payee, e.g., “pay to order of ________.” U.C.C. §3-109(a). An instrument is payable to order if it is payable to the “order of [an identified person]” or to an “[identified person] or order.” U.C.C. §3-109(b). When an

instrument is payable both to order and to bearer, the instrument is payable to bearer. U.C.C. §3-109(b); U.C.C. §3-109, Official Comment 2. Instruments containing the following designations are payable to bearer: (a) “bearer or order,” (b) “order of bearer,” (c) “John Doe or bearer,” or (d) “order of cash.” U.C.C. §3-109(a) and Official Comment 2. However, a check that meets all the requirements of U.C.C. §3-104(a), except for not being made payable to “order” or “bearer,” is a negotiable instrument governed by Article 3. U.C.C. §3-104(c). [11-12]

5. **Must be payable on demand or at a definite time:** A promise or an order is payable on demand if it states that it is (a) payable on demand, on presentation, or at sight; (b) otherwise indicates that it is payable at the will of the holder; or (c) fails to state when payment is due. U.C.C. §3-108(a). An instrument otherwise payable on demand remains payable on demand even if it is postdated or antedated. U.C.C. §3-113(a). A promise or an order is payable at a definite time if it is payable (a) at a fixed date; (b) a definite period after a stated date, or; (c) on “elapse of a definite period of time after sight or acceptance.” U.C.C. §3-108(b). An instrument is payable at a definite time as long as the date is readily ascertainable at the time the promise or order is issued even if the date is not specified in the instrument. A note or draft payable a fixed period “after date” that does not state a date is an incomplete instrument. Once the note or draft is completed by the addition of a date, the instrument becomes payable at a definite time. An instrument that is otherwise payable at a definite time remains so even if the time of payment is subject to acceleration. Any type of acceleration clause is permissible. U.C.C. §3-108(b)(ii). An instrument that is subject to prepayment by the obligor remains payable at a definite time. U.C.C. §3-108(b)(i). An instrument remains payable at a definite time even if the holder has the right to extend the time of payment indefinitely. U.C.C. §3-108(b)(iii); U.C.C. §3-108, Official Comment. In contrast, when the maker or the acceptor has the right to extend the time for payment or the time is automatically extended upon the occurrence of a specified event, the instrument is payable at a definite time only if the right to extend is limited to extension to a further definite time. U.C.C. §3-

108(b)(iii) and (iv); U.C.C. §3-108, Official Comment. [12-14]

6. **Can contain no other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money:** Inclusion in an instrument of a promise, an obligation, an order, or a power not authorized by Article 3 defeats the instrument's negotiability. U.C.C. §3-104(a)(3); U.C.C. §3-104, Official Comment 1. The prohibition against additional terms is limited to undertakings and instructions given by the person promising or ordering payment. A promise by the holder does not violate this prohibition. U.C.C. §3-104(a)(3). A negotiable instrument may also contain an undertaking or a power to give, maintain, or protect collateral to secure payment. This would include provisions granting the holder a security interest in the collateral or securing both the obligation evidenced by the instrument itself and any other obligation of the obligor. A negotiable instrument may also contain an authorization or power to the holder to confess judgment or realize on, or dispose of, collateral, or a waiver of the benefit of any law intended for the advantage or protection of an obligor. U.C.C. §3-104(a)(3); U.C.C. §3-104, Official Comment 1. [14-15]

CHAPTER 2

HOLDER-IN-DUE-COURSE STATUS AND AVAILABLE CLAIMS, DEFENSES, CLAIMS IN RECOUPMENT,AND DISCHARGES

I. INTRODUCTION

To obtain holder-in-due-course status, a purchaser of an instrument must take the instrument as a holder, for value, in good faith, and without notice of certain proscribed facts. U.C.C. §3-302(a). [19-20]

II. HOLDER STATUS

A. General rule: For a person to qualify as the holder of an instrument, the person must have possession of the instrument, and the obligation evidenced by the instrument must run to him. [20]

B. Ways of acquiring holder status: A person can become a holder either through issuance or negotiation. [20-21]

1. **Issuance:** An instrument is "issued" when it is first delivered by the maker or drawer to either a holder or nonholder for the purpose of giving rights on the instrument to any person. U.C.C. §3-105(a). [20]

2. **Negotiation:** "Negotiation" is a transfer of possession of an instrument, whether voluntary or involuntary, by a person, other than the issuer (i.e., maker or drawer), to another person who thereby **becomes** its holder. U.C.C. §3-201(a). When an instrument is payable to bearer, transfer of possession alone is sufficient for its negotiation. A thief or finder of an instrument payable to bearer becomes the holder even though the transfer of possession was involuntary. U.C.C. §3-201, Official Comment 1. To negotiate an instrument payable to order, the instrument must also be indorsed to that person or to bearer. U.C.C. §3-201(b). [20-21]

C. Indorsement: An "indorsement" sufficient to negotiate an instrument must be written by or on behalf of the holder. U.C.C. §3-201(b). A forged or unauthorized indorsement is not effective to negotiate the instrument. Thus, if an indorsement in the chain of title is forged or unauthorized, no transferee subsequent to the unauthorized or forged indorsement can become a holder. [21]

1. **Types of indorsements:** Two types of indorsements can be used to negotiate an instrument. [21]

    a. **Special indorsement:** A "special indorsement" identifies the person to whom the instrument is payable. U.C.C. §3-205(a). [21]

    b. **Blank indorsement:** A "blank indorsement" is an indorsement that is not payable to an identified person. An instrument indorsed in blank becomes payable to bearer and any person who possesses the instrument becomes its holder. A blank indorsement can consist of the unaccompanied signature of the holder; the signature of the holder accompanied by such phrases as "pay to bearer," "pay to holder," "pay to bank," or "pay to cash"; or use of the words "pay to _______" with no one's name filled in. U.C.C. §3-205(b). [21]

    c. **Conversion of blank to special indorsement:** Any holder of an instrument indorsed in blank may convert the blank indorsement into a special indorsement by writing over the signature of the indorser the name of an indorsee. U.C.C. §3-205(c); U.C.C. §3-205, Official Comment 2. [22]

2. **Indorsement must be written on instrument:** An indorsement must be written on the instrument itself. However, as long as the separate piece of paper is affixed to the instrument (called an "***allonge*** "), the indorsement on that separate piece of paper is sufficient to negotiate the instrument. U.C.C. §3-204(a). [22]

3. **Manner of negotiation depends on last indorsement:** An instrument becomes payable to order or payable to bearer depending on whether the last indorsement is a special or a blank indorsement. U.C.C. §3-205. [22]

4. **To whom an instrument is payable:** The basic rule is that the person to whom an instrument is initially payable is determined by the intent of the person signing the instrument as the issuer (i.e. drawer or maker), in the name of the issuer, or on behalf of the issuer whether or not that person is authorized. U.C.C. §3-110(a). [22]

   a. **Need not be real name of payee:** An instrument is payable to the person intended by the signer even if the payee is identified by a name other than her real name. U.C.C. §3-110(a). [22]

   i. **Indorsement in either name effective:** When a payee is designated in a name other than her true name, an indorsement in either the payee's true name or the name appearing on the instrument (or in both) is effective to negotiate the instrument. U.C.C. §3-204(d); U.C.C. §3-204, Official Comment 3. [22]

   b. **More than one person signing as issuer:** If an instrument is signed by more than one person as maker or drawer and each signer intends that a different person be the person designated as the payee, the instrument is payable to any person intended by any one of the signers. U.C.C. §3-110(a). [23]

   c. **Intent of forger determinative:** When the drawer's signature on the check is forged, the payee is the person to whom the forger intended that payment be made. [23]

   d. **Checkwriting machine:** When the signature of the issuer is made by automated means, such as by a checkwriting machine, the identity of the payee is determined by the intent of the person who supplied the name (or other identification) of the payee, whether or not the person was an authorized agent or even connected with the issuer. U.C.C. §3-110(b). [23]

5. **Two or more payees:** An instrument payable to two or more persons is payable to them either jointly or in the alternative. [24]

a. **Jointly:** If an instrument is payable jointly, all payees must participate in any negotiation, discharge, or enforcement of the instrument. U.C.C. §3-110(d); U.C.C. §3-110, Official Comment 4. [24]

b. **Alternative:** An instrument payable in the alternative may be negotiated, discharged, or enforced by any payee who is in possession of the instrument. U.C.C. §3-110(d); U.C.C. §3-110, Official Comment 4. Instruments payable "to P or R," "to P and R in the alternative," or "to P/R" ("/" means either/or) are payable to P or R in the alternative. [24]

c. **Ambiguous:** When it is unclear whether an instrument is payable alternatively or jointly, e.g., "to P and/or R," the instrument is deemed to be payable in the alternative. U.C.C. §3-110(d). [24]

D. **Depositary bank's status as holder:** If a customer delivers an item to a depositary bank for collection, whether or not the customer indorses the item, the depositary bank becomes a holder of the item at the time it receives the item if the customer, at the time of delivery, was a holder of the item. U.C.C. §4-205(1); U.C.C. §4-205, Official Comment. [25]

III. VALUE

An instrument is issued or transferred for value when it is taken for the following:

A. **Promise of performance:** The instrument is issued or transferred for a promise of performance, to the extent the promise has been performed. Any promise that would constitute consideration under contract law constitutes a "promise of performance" under Article 3. U.C.C. §3-303(a)(1). When a holder has only partially performed the agreed-on consideration, the holder has the rights of a holder in due course to the extent of the fraction of the amount payable under the instrument equal to the value of the partial performance divided by the value of the promised performance. U.C.C. §3-302(d). [26]

B. **Security interest or lien:** A holder takes for value to the extent that she acquires a security interest in, or other lien on, the instrument other than a lien obtained by judicial proceeding. [26-27]

1. **Security interest in instrument:** The holder may acquire a security interest in, or a lien on, an instrument in two ways: a voluntary transfer by the debtor, usually an Article 9 security interest, U.C.C. §3-303(a)(2); U.C.C. §3-303, Official Comment 3; or a security interest that a collecting bank automatically acquires under U.C.C. §4-210(a). A collecting bank acquires a security interest in an item and any accompanying documents or the proceeds of either the item or the documents. The collecting bank acquires a security interest only to the extent that the bank allows the customer to use the funds. A collecting bank also acquires a security interest when it applies the item in part or in full in payment of a debt owed to it by its customer. U.C.C. §4-210(a)(1). If the credit given for the item is available for withdrawal as a matter of right, the collecting bank has a security interest in the item whether or not the credit is drawn on or there is a right of chargeback. U.C.C. §4-210(a)(2). When the bank makes an advance against the item, a security interest arises whether or not the item is deposited into the customer's account. U.C.C. §4-210(a). When credits given for several items deposited at one time, or pursuant to a single agreement, are withdrawn or applied in part, the bank's security interest applies to all the items. U.C.C. §4-210(b). Credits first given are deemed to be first drawn on. U.C.C. §4-210(b). Thus, when items are not deposited simultaneously, the security interest attaches to the items in the order in which they were deposited. [26]

2. **Lien on instrument:** A person who has a lien on an instrument by operation of law takes the instrument for value. The most typical type of lien is a common law or statutory banker's lien. U.C.C. §3-303(a)(2); U.C.C. §3-303, Official Comment 3. In contrast, a lien acquired by judicial process, e.g., attachment, garnishment, or execution, does not constitute value. U.C.C. §3-303(a)(2); U.C.C. §3-303, Official Comment 3. [26-27]

3. **Value only to extent of amount owed:** A lienholder or secured party takes the instrument for value only to the extent of the amount owed on the underlying debt. U.C.C. §3-302(e). [27]

C. **For antecedent claim:** The instrument is issued or transferred as payment of, or as security for, an antecedent claim against any person, whether or not the claim is due. [27]

D. **Negotiable instrument or irrevocable commitment:** An instrument is taken for value if it is issued or transferred in exchange for a negotiable instrument or for the incurring of an irrevocable commitment to a third person by the person taking the instrument. U.C.C. §3-303(a). [27]

IV. GOOD FAITH

The standard of good faith adopted by the Code is partially subjective and partially objective. [29]

1. **Subjective element:** The subjective part of the standard is found in the requirement that the particular holder be honest in fact in the transaction. A person is honest in fact if she honestly is unaware of the claim or defense even though a reasonable person would have been aware under the circumstances. [29]

2. **Objective element:** The objective element of good faith requires "the observance of reasonable commercial standards of fair dealing." U.C.C. §3-103(a)(4). The duty of the holder to comply with reasonable commercial standards extends only to its obligation of fair dealing. The holder has no duty to exercise due care with respect to the purchase. U.C.C. §3-103, Official Comment 4. The issue is not whether the holder was negligent in its actions but rather whether it was attempting to take advantage of the obligor. [29-30]

V. NOTICE

A. **Notice of infirmity:** A holder cannot become a holder in due course if it has notice of any infirmity in the instrument or in the underlying transaction in which the instrument was issued or negotiated. [30]

B. **Notice need not relate to defense or claim raised:** A purchaser who has notice of a proscribed fact is completely denied holder-in-due-course status and therefore takes subject to all claims, defenses, and claims in recoupment whether or not related to the defense or claim of which he has notice. [30]

C. **Effect of subsequent notice:** Once a purchaser becomes a holder in due course, notice subsequently obtained does not destroy its holder-in-due-course status. [30]

D. **When notice imputed to organization:** Notice to an organization is effective for a particular transaction from the earlier of the time the notice either: (1) is brought to the attention of the individual conducting the transaction; or (2) should have been brought to her attention had the organization exercised due diligence. U.C.C. §1-201(27); [Rev] U.C.C. §1-202(f). As long as the organization is in reasonable compliance with its established procedures, notice will not be imputed to the organization until the information actually reaches the party conducting the transaction. If there are no established procedures or if the procedures are not generally followed, notice will be effective from the moment that the information would have reached the party conducting the transaction had reasonable procedures been in place at the time. [30-31]

E. **Manner of obtaining notice:** A purchaser may obtain notice in three possible ways: [32]

1. **Actual knowledge:** A purchaser has actual knowledge of an infirmity when she is subjectively aware of the existence of the claim, defense, or claim in recoupment. [32]

2. **Notification:** A person receives a notice or notification when it comes to her attention or when it is duly delivered at the place of business through which the contract was made or at any other place held out by her as the place for receipt of such communications. U.C.C. §1-201(26); [Rev] U.C.C. §1-202(e). Notification is effective even if the holder did not actually read the notification and thereby acquire actual knowledge of the claim, defense, or claim in recoupment. [32]

3. **Reason to know:** A purchaser may also have notice of an infirmity if, from all the facts and circumstances known to him at the time in

question, he has reason to know that the infirmity exists. U.C.C. §1-201(25)(c); [Rev] U.C.C. §1-202(a)(3). [32]

a. **Subjective element:** The standard has a subjective element in that the test is whether "from all the facts and circumstances ***known to him*** ": the purchaser has reason to know of the infirmity. [32]

b. **Two tests:** Two tests have been adopted by courts for determining whether a purchaser has reason to know of a claim, defense, or claim in recoupment. [32]

i. **Inferable knowledge test:** Under the inferable knowledge test, a holder has reason to know of a claim, claim in recoupment, or defense only if the only reasonable conclusion the holder could reach from the facts known to the holder is that the claim, claim in recoupment, or defense exists. The holder has no duty to inquire into suspicious circumstances. The holder may assume an innocent explanation for a suspicious circumstance. [32-33]

ii. **Duty to inquire test:** The duty to inquire test is whether a reasonable person, considering all the facts and circumstances known to the holder, would have further investigated and thereby discovered the existence of the claim, defense, or claim in recoupment. This test is an objective test allowing the court to determine whether the holder, as a reasonable person, should have, through the exercise of reasonable diligence, discovered the defense, claim, or claim in recoupment. The holder must investigate to determine whether the suspicious circumstances indicate that some infirmity exists in the instrument or underlying transaction. [33]

F. **Notice of claim or defense:** A purchaser cannot be a holder in due course if she has notice of any claim to the instrument as described in U.C.C. §3-306 or of any defense or claim in recoupment described in U.C.C. §3-305(a). U.C.C. §3-302(a)(2). [33]

1. **Notice not obtained from public filing:** Public filing or recording

of a document does not, by itself, constitute notice of a defense, claim in recoupment, or claim to the instrument. U.C.C. §3-302(b); U.C.C. §9-309. [33]

2. **Notice not obtained from executory promise:** Knowledge that an instrument was issued or negotiated in return for an executory promise (a promise to perform in the future) or accompanied by a separate agreement does not give a purchaser notice of a claim, defense, or claim in recoupment. The purchaser does not have a duty to inquire as to whether the promise has been performed. The purchaser has notice of a defense or claim in recoupment only if she has notice that a breach has already occurred. [33]

3. **Notice from defenses in other transactions:** Under the "***inferable knowledge test*** ", notice of a defense to the specific instrument that the holder is purchasing will not be imputed to her even if the holder knew of many complaints from the makers of other instruments purchased from the payee. Under the "***duty to inquire test*** ", a court may find that the numerous prior complaints give rise to a duty on the part of the holder to investigate this specific transaction. If the investigation would have revealed a defense, the holder will be deemed to have notice of the defense. [33]

4. **Purchase at a discount:** Under the inferable knowledge test, the purchaser is not imputed with notice of a claim, defense, or claim in recoupment solely because of her knowledge that the instrument was purchased at a substantial discount. The holder has the right to assume, for example, that the large discount is a result of a substantial risk that the maker is insolvent or of the seller's urgent need for immediate cash. Under the ***duty to inquire test*** , a purchaser is required to investigate why the instrument is selling at such a large discount. [33]

5. **Notice of breach of fiduciary duty:** Certain conditions must be met before the purchaser will be deemed to have notice of a breach of fiduciary duty. [33-34]

   a. **Represented person must make claim to instrument:** If the fiduciary breaches his duty by negotiating the instrument for his own or for some third-party's benefit, the represented person has an equitable claim of ownership to the instrument or its proceeds. U.C.C. §3-307, Official Comment 2. A purchaser is deemed to have notice of a breach of fiduciary claim only if the represented person makes a claim to the instrument. Notice is not imputed to the purchaser if no such claim is made. U.C.C. §3-307(b)(iii). [34]

b. **Taker must know that person with whom he is dealing is a fiduciary:** The rules for determining whether the holder has ***notice*** of a breach of fiduciary duty apply only when the taker of the instrument from the fiduciary ***knows*** that the person with whom he is dealing is a fiduciary. U.C.C. §3-307(b)(ii). [34]

c. **Three situations involving notice of breach of fiduciary duty:**

i. **When instrument made payable to represented party or to fiduciary as such:** A taker of an instrument payable to the represented party, or to the fiduciary as such, has notice of a breach of fiduciary duty if the instrument is taken in payment of, or as security for, a debt known by the taker to be the personal debt of the fiduciary, taken in a transaction known by the taker to be for the personal benefit of the fiduciary, or deposited in an account other than that of the fiduciary as such or of the represented person. U.C.C. §3-307(b)(2). The holder is not deemed to have notice unless it knows that the value is being given for the personal benefit of the fiduciary. The fact that the holder has knowledge that a person is a fiduciary neither gives notice to nor imposes a duty on it to inquire as to the use of the instrument. [34-35]

ii. **When instrument drawn or made by represented person or fiduciary as such to taker:** The same rules apply when an instrument is issued by the represented person or the fiduciary as such directly to the taker. U.C.C. §3-307(b)(4). [35]

iii. **When payable to fiduciary personally:** A different rule applies when the instrument is payable to the fiduciary personally, whether drawn by the represented person or by the fiduciary himself. In these cases, the taker has notice of a breach of fiduciary duty only if it has ***actual knowledge*** of the breach. U.C.C. §3-307(b)(3). The holder must therefore know not only that the value is being applied for the personal benefit of the fiduciary but also that such application is a breach of her fiduciary duty. [35]

6. **Notice that an instrument is forged, altered, or otherwise irregular:** A purchaser cannot be a holder in due course if the instrument, when issued or negotiated to the holder, bears such apparent evidence of forgery or alteration or is otherwise so irregular or incomplete as to call into question its authenticity. U.C.C. §3-302(a)(1). The test is whether the instrument on its face is so suspect that a reasonable person would question its authenticity. [35]

7. **Notice that instrument is overdue or has been dishonored:** A purchaser is denied holder-in-due-course status if he has notice that an instrument is overdue or has been dishonored. U.C.C. §3-302(a)(2)(iii). [35]

   a. **When an instrument is "overdue":**

   i. **Checks:** A check is ***overdue*** the day after the day demand for payment is duly made or 90 days after its stated date, whichever is earlier. U.C.C. §3-304(a)(1)-(2). [36]

   ii. **Other demand instruments:** Any other instrument payable on demand becomes overdue at the earlier of either: (1) the day after the day demand for payment is duly made or (2) when the instrument has been outstanding for a period of time after its date that is unreasonably long. U.C.C. §3-304(a)(1), (3). [36]

   iii. **When date accelerated:** Once an instrument has been accelerated causing the entire principal amount to be immediately due, the instrument becomes overdue on the day after the accelerated due date. U.C.C. §3-304(b)(3).

[36]

- **iv. Payable in installments:** Absent acceleration, an instrument payable in installments becomes overdue upon default for nonpayment of an installment. The instrument remains overdue until the default is cured. U.C.C. §3-304(b)(1). [36]
- **v. Not payable in installments:** Absent acceleration, an instrument not payable in installments is overdue on the day after its due date. U.C.C. §3-304(b)(2). [36]
- **vi. Default in interest only:** As long as there is no default in the payment of the principal amount, the instrument is not overdue simply because there is a default in the payment of interest. U.C.C. §3-304(c). [36]

8. **Notice of discharge:** Notice of the discharge of a party, other than a discharge in an insolvency proceeding, is not notice of a defense. U.C.C. §3-302(b). However, a holder who has notice of a discharge will take subject to any discharge of which he has notice. U.C.C. §3-302(b). If a taker knows that either the maker, drawer, or acceptor (the people ultimately liable on an instrument) has been discharged in insolvency proceedings, the taker is denied holder-in-due-course status. U.C.C. §3-302, Official Comment 3. [36]

VI. DENIAL OF HOLDER-IN-DUE-COURSE STATUS TO CERTAIN CLASSES OF PURCHASERS

Four categories of holders do not become holders in due course even after meeting all the requirements contained in U.C.C. §3-302(a) for holder-in-due-course status. [37]

1. **Acquisition by taking over estate:** A person who acquires an instrument by taking over an estate or other organization that previously held the instrument cannot, by such acquisition, become a holder in due course. U.C.C. §3-302(c)(iii). [37]
2. **Purchase in execution, bankruptcy, or creditor's sale:** A purchaser of an instrument in an execution, bankruptcy or creditor's sale, or similar proceeding, or under legal process, cannot become a

holder in due course. U.C.C. §3-302(c). [37]

3. **Purchase in bulk transaction:** A person cannot become a holder in due course by purchase of an instrument as part of a bulk transaction not in the regular course of the transferor's business. U.C.C. §3-302(c)(ii). Two types of bulk transactions are prohibited. The first type is a bulk sale of instruments for the purpose of liquidating the holder's assets in preparation for the termination of its business. In contrast, a sale in the seller's ordinary course of business is not a bulk transfer. The second prohibited type of bulk transfer occurs when there is a change in the organizational structure of the holder so that, even though the same actual entity retains the instruments, there has technically been a transfer from one entity to another. U.C.C. §3-302, Official Comment 5. [37-38]

4. **Consumer notes:** The Federal Trade Commission and most state legislatures have enacted rules or statutes affecting the ability of a holder of an instrument, issued in a consumer transaction, to take the instrument free from the consumer's defenses. [38]

   a. **FTC rule:** The Federal Trade Commission promulgated a rule aimed at preventing financiers of negotiable instruments from taking instruments free from consumers' defenses. A seller in the business of selling goods to consumers must include a legend in its consumer credit contracts that provides that any assignee of the instrument takes subject to all claims and defenses the debtor could assert against the assignor of the instrument. [39]

   i. **When legend omitted:** A holder in due course takes free of the consumer's defenses. [39]

   ii. **When legend included:** When the required language is included, the holder takes subject to the consumer's claims and defenses. The note remains negotiable, but there can be no holder in due course, thus enabling the consumer to assert any of his defenses against the holder. U.C.C. §3-106(d). Furthermore, the holder is liable to the consumer up to, but no more than, the funds received by the holder from the consumer pursuant to the instrument. [39]

b. State legislation: Many states have also enacted legislation that preserves, to varying degrees, the ability of a consumer to raise defenses against a holder of the note. This legislation has taken diverse forms. Under the 1969 version of the Uniform Consumer Credit Code ("UCCC"), a seller or lessor in a consumer credit sale or consumer lease may not take in payment a negotiable instrument (other than a check). A holder is not in good faith, and thus cannot qualify as a holder in due course, if it takes a negotiable instrument with notice that the instrument is issued in violation of the UCCC. Some state legislation, including those of states adopting the 1974 version of the UCCC, make an assignee of a consumer credit sale, whether or not a holder in due course, subject to all of the consumer's claims and defenses. Uniform Consumer Credit Code §3-404 (1974). Other states adopt statutory schemes that preserve the right of a consumer to raise defenses and claims against a holder in due course to the extent that the consumer gives notice of his claim or defense to the holder within a set period of time, either after his purchase or after notice of the negotiation to the holder. [39-40]

c. 2002 amendments: The 2002 amendments have added a new rule governing the ability of consumers to raise their claims or defenses in consumer transactions. A ***"consumer transaction"*** is "a transaction in which an individual incurs an obligation primarily for personal, family, or household purposes." [Rev] U.C.C. §3-103(a)(3). [40]

i. Instrument treated as if proper notice given: In a consumer transaction, a negotiable instrument that omits the notice required by the Federal Trade Commission (or other similar legend required by any other applicable law) is to be treated as if the instrument had included the required notice. As a result, a consumer can raise the same claims and defenses that it could if the FTC language was included even though the instrument does not contain the required notice requirement. [Rev] U.C.C. §3-305(e) and Official

Comment 6. [40]

ii. **Nothing in [Rev] U.C.C. §3-305 limits right of consumer to raise claims:** Thus, to the extent that a consumer protection statute gives the consumer the right to raise claims in recoupment or defenses, nothing in [Rev] U.C.C. §3-305 limits that right. In other words, [Rev] U.C.C. §3-305 is subject to any other law that establishes a different rule for consumer transactions. [Rev] U.C.C. §3-305(f) and Official Comment 7. [40]

VII. DEFENSES, CLAIMS TO THE INSTRUMENT, CLAIMS IN RECOUPMENT, AND DISCHARGES

A. **Recovering from the obligor:** Any holder or person with the rights of a holder (collectively called ***a "person entitled to enforce an instrument"***) may recover from the obligor in the absence of a claim to the instrument, defense, claim in recoupment, or discharge. U.C.C. §3-308(b). [40]

B. **Defenses and claims in recoupment to which all persons take subject:** Any person, whether or not the person qualifies as a holder in due course, takes subject to the following defenses or claims in recoupment. [41]

1. **Defenses and claims in recoupment assertible against holder itself:** The person entitled to enforce the instrument takes subject to any defense or claim in recoupment assertible against the holder himself arising from the transaction out of which the instrument was issued. U.C.C. §3-305(a)(3), (b). [41]

2. **Real defenses:** Four defenses are known as "***real defenses*** ", which all holders, even ones acquiring the status of holder in due course, take subject. [41]

a. **Infancy:** To the extent that the obligor's infancy is a defense to a simple contract, it is also a defense available against any party (including a holder in due course). U.C.C. §3-305(a)(1)(i). [41-42]

b. **Incapacity, duress, or illegality:** Legal incapacity (e.g., mental incompetency or statutory incapacity to execute the instrument arising from a corporation's exceeding its corporate powers), duress, or illegality (e.g., the use of the instrument to pay a gambling debt, as a bribe, or to purchase known stolen property), to the extent that such defenses render the obligation of the obligor a nullity, are defenses assertible against any person. U.C.C. §3-305(a)(1)(ii). Unlike infancy, these defenses are real defenses *only if statutory or case law makes the transaction void*. U.C.C. §3-305, Official Comment 1. [42]

c. **Fraud in the factum:** The obligor may raise against any person the defense that he has been induced by fraud to sign the instrument with neither knowledge, nor reasonable opportunity to learn, of the instrument's character or its essential terms. U.C.C. §3-305(a)(1)(iii). An obligor is ignorant of an instrument's character if he is under the impression that he is signing something other than a promise to pay money. An obligor would be ignorant of the instrument's essential terms if he believes, for example, that he is signing a note payable in 2 years when, in fact, it is payable on demand. U.C.C. §3-305, Official Comment 1. The obligor cannot raise the defense if he, under the circumstances, knew or should have discovered the character and essential terms of the instrument. If the obligor had the opportunity to, but did not, read the instrument, the defense will seldom be available. [42-43]

d. **Discharge in insolvency proceeding:** The obligor's discharge in insolvency proceedings is a defense assertible against any person. U.C.C. §3-305(a)(1)(iv). [43]

C. **Defenses available only against a person without the rights of a holder in due course:** The following defenses are available only against persons who do not have the rights of a holder in due course. All these defenses are cut off when the instrument is acquired by a holder in due course. U.C.C. §3-305(b). [43]

1. **Ordinary defenses:** A person not having the rights of a holder in due course takes subject to virtually any defense, including: (1) that the instrument was not issued, conditionally issued, or issued for a special purpose, U.C.C. §3-105(b); U.C.C. §3-305(b)(1)-(3); or (2) any defense that would be available to him if the obligation arose out of an ordinary contract. U.C.C. §3-305(a)(2). No consideration is necessary for an instrument given in payment of, or as security for, an antecedent obligation of any kind. U.C.C. §3-303(a)(3). [43-44]

2. **Claims in recoupment:** A claim in recoupment is assertible against any person not having the rights of a holder in due course. The claim of recoupment may be asserted against the transferee only to the extent that it reduces the amount owing on the instrument at the time the action is brought. U.C.C. §3-305(a)(3). As against the transferee, the obligor cannot raise a set-off from a transaction other than the one that gave rise to the instrument. U.C.C. §3-305, Official Comment 3. [44-45]

3. **Defenses and claims in recoupment of other persons:** With the exception of an accommodation party, an obligor may only raise his own defenses. He may not attempt to raise a defense or claim in recoupment of another party to the instrument, nor may the other party intervene in the action to raise the defense himself. U.C.C. §3-305(c); U.C.C. §3-305, Official Comment 4. [45]

4. **Claims to the instrument:** A person with the rights of a holder in due course takes free of all claims to the instrument. U.C.C. §3-306. A person who lacks the rights of a holder in due course takes the instrument subject to all valid claims of a property or possessory interest in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. U.C.C. §3-306. This includes both legal and equitable claims of ownership as well as a secured party's claim to a security interest in the instrument. [45]

5. **Third-party claims:** When the party being sued on the instrument does not have a claim of her own, the obligor may not use a third-party claim to defeat the holder's action unless the claimant is made

a party to the action and asserts her own claim to the instrument. U.C.C. §3-305(c). The obligor may, however, without the third party being a party to the action, assert a third-party claim if the obligor knows that the holder is in wrongful possession of a stolen instrument. U.C.C. §3-602(b)(2). [46]

D. Discharges: A discharge is effective against any person except a holder in due course who was without notice of the discharge when she took the instrument. U.C.C. §3-601(b). [46]

1. **Discharge by payment:** An instrument is discharged to the extent that payment is made by, or on behalf of, a party obliged to pay the instrument and to a person entitled to enforce the instrument. U.C.C. §3-602(a); U.C.C. §3-602, Official Comment. [46]

   a. **Payment must be made to a person entitled to enforce the instrument:** Being the person entitled to enforce the instrument, payment to a thief of an instrument payable to bearer discharges the party making the payment. In contrast, the party making payment is not discharged if she pays someone who is not a person entitled to enforce the instrument. [46]

   b. **Adverse claim to instrument:** Subject to certain exceptions, the obligor is discharged to the extent of her payment to the person entitled to enforce the instrument even though payment is made with knowledge of a claim to the instrument by the true owner. U.C.C. §3-602(a). Payment to the person entitled to enforce the instrument does not discharge the person making payment if the adverse claimant's claim is valid and enforceable against the person entitled to enforce the instrument and either: (a) the claimant obtains an injunction against payment and the obligor pays the person entitled to enforce the instrument even though she has knowledge of the injunction; or (b) the obligor accepts from the claimant indemnity against any loss resulting from the obligor's refusal to pay the person entitled to enforce the instrument. A court will not grant an injunction unless the person entitled to enforce the instrument, the claimant, and the party obliged to pay are all subject to the court's jurisdiction. When the obligor accepts indemnity from the claimant, the obligor is not discharged if she pays in spite of the indemnity. However, the obligor has no duty to accept indemnity from the claimant. Indemnification of the obligor is not effective to prevent the obligor's discharge if the instrument involved is a bank check. Even if the claimant does not obtain an injunction or supply indemnity, the obligor is not discharged if she knows that the instrument is stolen and pays the person entitled to enforce the instrument knowing that he is in wrongful possession of the instrument. U.C.C. §3-602(b)(2). Because a holder in due course takes the instrument free from all claims to the instrument, payment to a holder in due course always discharges the obligor. [47-48]

e. **2002 amendments:** A new subsection (b) has been added to [Rev] U.C.C. §3-602. [49]

i. **When payment to former holder discharges note:** Subject to [Rev] U.C.C. §3-602(e), a note is paid to the extent payment is made to a person that formerly was entitled to enforce the note only if, at the time of the payment, the party obliged to pay has not received adequate notification that the note has been transferred and that payment is to be made to the transferee. [Rev] U.C.C. §3-602(b) and Official Comment 2. [49]

ii. **Adequacy of notification:** For the notification to be adequate, it must:

(a) be signed by either the transferor or the transferee;

(b) reasonably identify the transferred note; and

(c) provide an address at which subsequent payments are to be made. [Rev] U.C.C. §3-602(b). [49]

iii. **Demand for proof of transfer:** Upon request, a transferee is required to seasonably furnish reasonable proof that the note has been transferred. [49]

iv. **Effect of failure to provide proof of transfer:** Unless the transferee complies with the request, a payment to the person that formerly was entitled to enforce the note results in the obligor's discharge even if the obligor has received a notification of the transfer. [Rev] U.C.C. §3-602(b). [49]

v. **Imputed notice of payment:** [Rev] U.C.C. §3-602(d) provides that a transferee, or any party that has acquired rights in the instrument directly or indirectly from a transferee, is deemed to have notice of any payment that is made under [Rev] U.C.C. §3-602(b) between the date that the note is transferred to the transferee and before the party obliged to pay the note receives adequate notification of the transfer. It does not matter that the transferee is, or is not, a holder in due course. [49]

2. **Discharge by tender of payment:** An effective tender of payment discharges the obligation of the obligor to pay interest accruing after the due date on the amount tendered. U.C.C. §3-603(c). Upon the holder's refusal of the obligor's tender, an indorser or an accommodation party who has a right of recourse with respect to the obligation to which the tender relates is discharged to the extent of the amount tendered. U.C.C. §3-603(b); U.C.C. §3-603, Official Comment. The law governing tender of payments under a simple contract determines whether a co-maker, co-acceptor, or co-indorser is discharged to the extent of his right of contribution. The law generally provides that a co-obligor is discharged to the extent of his right of contribution. The law generally provides that a co-obligor is discharged to the extent of his right of recourse. [49-50]

3. **Discharge by cancellation or renunciation:** A person entitled to enforce an instrument may, without consideration, discharge any party to the instrument in any manner apparent on the face of the instrument or the indorsement U.C.C. §3-604(a). A person entitled to enforce the instrument may, without consideration, discharge any party to the instrument by renouncing his rights in a signed writing. U.C.C. §3-604(a)

A party is discharged upon surrender of the instrument to the party to be discharged. U.C.C. §3-604(a). A cancellation, renunciation, or surrender of an instrument is ineffective if it is unintentional, unauthorized, or procured by fraud or mistake. In determining whether a mistake vitiates the discharge, all the rules of equity come into play. For example, the holder may not assert mistake as a grounds for denying the obligor a discharge if the obligor in good faith changed his position in good faith reliance on the cancellation, renunciation, or surrender. [51]

2002 amendments: The 2002 amendments have changed the requirement of a "signed writing" to a "signed record." [Rev] U.C.C. §3-604(a). A "***record*** " is "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." [Rev] U.C.C. §3-103(a)(14). [51]

Additional amendment: In addition a new [Rev] U.C.C. §3-604(c) has been added that defines ***signed*** , with respect to a record that is not a writing, as including the attachment to, or logical association with, the record of an electronic symbol, sound, or process to or with the record with the present intent to adopt or accept the record. [51]

4. **Discharge of simple contract:** A party is discharged from liability on an instrument to another party by any act or agreement with such party that would discharge a simple contract for the payment of money. U.C.C. §3-601(a). Although not effective as a renunciation, an oral agreement supported by consideration is usually sufficient to discharge a party on a contract to pay money. [52]

VIII. ADMISSIBILITY OF EVIDENCE EXTRINSIC TO THE INSTRUMENT

A. **Effect of separate agreements:** Subject to the parol evidence rule, an obligor's duty to pay an instrument may be modified, supplemented, or nullified by a separate agreement (whether oral or written) between the obligor and a person entitled to enforce the instrument if the instrument was issued or, the obligation incurred, either: (1) in reliance on the agreement; or (2) as part of the same transaction giving rise to the agreement. U.C.C. §3-117. [52]

B. **Agreement as defense:** The agreement would be a defense available against any person other than a holder in due course without notice of the agreement. U.C.C. §3-117. [52]

C. **Same transaction:** An agreement can be part of the same transaction even if the agreement was neither executed contemporaneously with the instrument or obligation nor referred to in the instrument. [52]

D. **The parol evidence rule:** The parol evidence rule generally provides that no prior written agreement and no prior, or contemporaneous, oral agreement is admissible to vary, or contradict, the terms found in a writing intended by the parties to be the final expression of the parties' agreement as to those terms. A negotiable instrument, by its nature, is seldom intended to include the complete terms of the parties' agreement. Therefore, the parol evidence will seldom bar introduction of additional terms that do not contradict the terms of the instrument. Most courts hold that parol evidence is not admissible to prove a condition precedent to the obligation to pay. Courts differ as to whether evidence tending to show that the promise to pay is a sham or that the note would never be enforced against the obligor is admissible. Evidence that delivery of the instrument was for a special purpose or is conditional on some act or event may always be introduced. U.C.C. §3-305(a)(2). Evidence of any defense may always be introduced. Evidence to explain ambiguities contained in the instrument may always be introduced. [52-53]

IX. TRANSFER OF INSTRUMENT AND SHELTER PROVISION

A. **Rights of the transferee:** When an instrument is transferred, the transfer vests in the transferee all the rights of his transferor. U.C.C. §3-203(b). [53-54]

B. **Right to transferor's indorsement:** If the transferee does not become the holder of the instrument because the transferor failed to supply a necessary indorsement, absent a contrary agreement, if the transfer is for value, the transferee has the specifically enforceable right to obtain the transferor's unqualified indorsement. U.C.C. §3-203(c). [54]

C. **The shelter provision:** Under the "***shelter provision,*** " a transferee may acquire the rights of a holder in due course through the transfer even if the transferee does not himself qualify as a holder in due course. U.C.C. §3-203(b). This includes the right to take free of all claims to the instrument, defenses, and claims in recoupment to the same extent as would his transferor/holder in due course. U.C.C. §3-305(b); U.C.C. §3-306. The transferee also is entitled to any rights the transferor inherited from his own transferor. Because the rights vested in the transferee are purely derivative, they can be no greater than those possessed by his transferor and are subject to the same limitations. The transferee takes subject to any claim of ownership, claim in recoupment, or defense to which his transferor/holder in due course would take subject. However, no transferee, who has engaged in any fraud or illegality affecting the instrument, can acquire the rights of a holder in due course through a transfer directly or indirectly from a holder in due course. U.C.C. §3-203(b). [54-55]

D. **Reacquisition by prior holder:** On reacquisition of an instrument, the reacquirer is given the right to cancel any indorsement not necessary to its chain of title, thereby enabling it to become the holder of the instrument and have the right to further negotiate the instrument. U.C.C. §3-207. The reacquirer's cancellation of intervening indorsements discharges any indorser whose indorsement has been canceled. By virtue of the cancellation, subsequent purchasers are deemed to have notice of the canceled indorser's discharge. U.C.C. §3-207. [55-56]

X. DEFENSES AND CLAIMS TO BANK CHECKS

A. **Right of bank to raise defenses:** The obligated bank retains the same right as a drawer of a personal check to raise defenses or third-party claims. However, certain penalties are assessed against the bank if it wrongfully refuses to pay a bank check. When a bank issues a cashier's check or teller's check to pay one of its own obligations, these special rules do not apply. For example, if a bank issues a cashier's check to pay its attorney, U.C.C. §3-411 does not apply. [56]

B. **Penalty for wrongfully refusing to pay:** An obligated bank that wrongfully refuses to pay a bank check is liable to the person asserting the right to enforce the check for any expenses, including attorneys' fees and loss of interest resulting from the nonpayment. U.C.C. §3-411(b); U.C.C. §3-411, Official Comment 2. The holder may recover consequential damages if the obligated bank refuses to pay the check after receiving notice of the particular circumstances giving rise to these damages. U.C.C. §3-411(b). [57]

C. **Bank's defenses to liability for expenses and consequential damages:** The obligated bank is not liable for expenses or consequential damages if its refusal to pay occurs in any one of four situations: (a) the obligated bank suspends payments (i.e., is insolvent); (b) the obligated bank has reasonable grounds to believe that the bank's claim or defense is available against the person entitled to enforce the instrument (If the bank has a defense of its own arising out of the issuance of the bank check and reasonably believes that this defense would be assertible against the holder, the bank is not liable for either consequential damages or expenses, whether or not it is successful in raising the defense. However, the bank is liable for the holder's loss of interest on the funds. In contrast, the obligated bank receives no protection against liability for expenses and consequential damages if it unsuccessfully attempts to raise a third-party's claim to the instrument.); (c) the obligated bank has a reasonable doubt that the person is entitled to payment; or (d) the obligated bank is prohibited by law from making payment. U.C.C. §3-411(c). [57]

XI. FEDERAL HOLDER-IN-DUE-COURSE STATUS

A. **Introduction:** Under the federal holder-in-due-course doctrine, federal common law, and not the Code, determines whether the FDIC or the RTC, in purchasing instruments, is a holder in due course. [58]

B. **Federal holder-in-due-course doctrine:** Under the federal holder-in-due-course doctrine, the FDIC and the RTC can qualify as a holder in due course even when they purchase, in bulk, a failed bank's instruments. Most courts seem to require that the FDIC and the RTC take the instrument in good faith and without actual knowledge of any defense to the instrument. Courts differ as to whether the FDIC or the RTC could be a holder in due course of an overdue instrument. The status of the federal holder-in-due-course doctrine has been put into question by the United States Supreme Court's decision in O'Melveny & Myers v. FDIC, 114 S. Ct. 2048 (1994). [58-59]

C. **D'Oench, Duhme doctrine:** Under the D'Oench, Duhme doctrine, defenses against the FDIC or the RTC have to be based on documents and not on secret agreements. The continued vitality of the D'Oench, Duhme doctrine was put into question by the enactment of FIRREA. Under 12 U.S.C. §1823(e), no agreement that had the result of diminishing the interests of the FDIC in any assets acquired by it (whether as a purchaser or as a receiver of an insured bank or savings and loan) was valid against the FDIC unless such agreement was (a) in a writing that was (b) executed by the bank contemporaneously with the acquisition of the note, (c) approved by the board of directors of the bank, and (d) reflected in the minutes of the board. [59]

Chapter 3
NATURE OF LIABILITY ON INSTRUMENTS

I. LIABILITY OF ISSUER, DRAWER, ACCEPTOR, AND INDORSER

A. **Introduction:** A party may sign a negotiable instrument in four basic capacities: an issuer of a note or cashier's check, a drawer of a draft, an acceptor of a draft, and an indorser. [67]

B. **Obligation of issuer of note or cashier's check:** There are no conditions to the issuer's obligation to pay a note or cashier's check. An issuer of a note or cashier's check is liable to pay the instrument when it is due. [68]

C. **Obligation of drawer:** Dishonor by the drawee must occur before a drawer is liable on a draft. U.C.C. §3-414(b). Liability as a drawer is not conditioned on notice of dishonor. U.C.C. §3-414(b); U.C.C. §3-414, Official Comment 2. When a draft is accepted by a nonbank, a drawer is treated as an indorser under U.C.C. §3-415(a) and (c). U.C.C. §3-414(d). In contrast, a drawer is completely discharged when a draft is accepted by a bank. U.C.C. §3-414(c). A drawer may disclaim liability on any draft (other than a check) by writing, on the draft, the words "without recourse." U.C.C. §3-414(e). [68]

D. **Drawee:** A check or other draft does not of itself operate as an assignment of any of the drawer's funds held by the drawee. A drawee is not liable to the holder unless the drawee accepts the draft. U.C.C. §3-408. [68]

E. **The obligation of an acceptor:** There are no conditions to an acceptor's obligation to make payment. Once a draft is due, the acceptor is obligated to make payment. An effective acceptance must be: (a) in writing; (b) on the instrument; (c) signed by the drawee; and (d) either delivered to the holder or the holder must be notified. The acceptance may consist of the drawee's signature alone. U.C.C. §3-409(a). [68-69]

F. Obligation of indorser: A signature is deemed to be an indorsement regardless of the signer's intent unless the accompanying words, terms of the instrument, place of signature, or other circumstances unambiguously indicate that the signature is made for a purpose other than as an indorsement. U.C.C. §3-204(a). A person may indorse an instrument to negotiate the instrument or to incur liability on the instrument. An anomalous indorser is an indorser who is not the holder of the instrument. An indorser's obligation to pay is owed to the person who is entitled to enforce the instrument or to a subsequent indorser who pays the instrument. U.C.C. §3-415(a). An indorser may disclaim liability on his indorser's contract by indorsing the instrument without recourse. U.C.C. §3-415(b). An indorser is not liable until the instrument has been dishonored and, unless excused, notice of dishonor is given. U.C.C. §3-415(a); U.C.C. §3-503. [69-70]

II. PRESENTMENT, DISHONOR, NOTICE OF DISHONOR

A. Introduction: Dishonor of an instrument is a condition to the liability of both a drawer and an indorser. U.C.C. §3-414(b); U.C.C.§3-415(a); U.C.C. §3-502, Official Comment 1. An instrument is dishonored when the drawee, acceptor, or maker refuses, or fails, to pay or accept the instrument on a proper presentment for payment or acceptance. When presentment is excused, dishonor occurs if the instrument is not duly accepted or paid. U.C.C. §3-502(e); U.C.C. §3-502, Official Comment 7. [71]

B. Presentment: ***Presentment*** is a demand for payment or acceptance made by, or on behalf of, the person entitled to enforce the instrument. U.C.C. §3-501(a). Presentment for payment must be made to the drawee or to a party obliged to pay the instrument (*e.g.*, the maker of a note or the acceptor of an accepted draft). U.C.C. §3-501(a). Presentment for acceptance must be made to the drawee. U.C.C. §3-501(a). [71]

1. Manner and time of presentment: Presentment may be made by any commercially reasonable means including orally, in writing, or by electronic communication. U.C.C. §3-501(b)(1). [71]

2. **Where presentment can be made:** In the absence of a Federal Reserve Regulation, clearinghouse rule or contrary agreement, presentment can be made wherever the drawee, maker, or acceptor can be found, even if the instrument specifies a particular place of payment or acceptance. If the party expected to pay or accept cannot be found, the instrument may be presented at its place of payment. U.C.C. §3-501(b)(1). Regulation CC determines where a check may be presented. U.C.C. §3-111. [71]

3. **Rights of party to whom presentment is made:** Once a demand for payment or acceptance is made, the party to whom presentment is made has the right to demand, without thereby dishonoring the instrument, that the presenter exhibit the instrument, show reasonable identification, and give a signed receipt on the instrument or surrender the instrument on full payment. U.C.C. §3-501(b)(2). [71-72]

4. **Effect of delay in presentment:** The effect of a delay in presentment depends on the type of instrument as well as on whether the obligor is an indorser or the drawer. An indorser of a check is discharged from her indorser's liability if the check is not presented for payment or given to a depositary bank for collection within 30 days after her indorsement. U.C.C. §3-415(e). A drawer of a check is discharged only when the check is not presented for payment or given to a depositary bank for collection within 30 days of the check's stated date and only to the extent that she is deprived of funds maintained with the drawee bank because the drawee bank has suspended payment after the expiration of the 30-day period and failed to make payment on the check. U.C.C. §3-414(f); U.C.C. §3-414, Official Comment 6. A delay in presenting any instrument other than a check discharges neither the drawer nor an indorser. [72]

5. **When presentment excused:** When a presentment or a delay in presentment is excused, presentment is treated as having been made within the prescribed time limits. Presentment is excused if it cannot be made by the exercise of reasonable diligence. U.C.C. §3-

504(a)(i). Presentment is also excused as to the drawer when the drawer has instructed the drawee not to pay or accept a draft. U.C.C. §3-504(a)(v). Presentment is not excused as to an indorser (assuming that he did not order payment stopped). In addition, presentment is excused when the drawer or an indorser has no reason to expect or right to require that the instrument be paid or accepted. U.C.C. §3-504(a)(iv). When presentment is waived under the terms of the instrument or otherwise, presentment is excused as to the drawer or indorser. U.C.C. §3-504(a)(iii). Presentment is also excused when the maker or acceptor repudiates the obligation to pay the instrument or is in insolvency proceedings or has died. U.C.C. §3-504(a)(ii). [72-73]

C. **Dishonor:** The manner in which an instrument is dishonored depends on the type of instrument. [73]

1. **Dishonor of demand note:** A note payable on demand is dishonored if the note is not paid on the day of presentment. U.C.C. §3-502(a)(1). [73]

2. **Dishonor of note not payable on demand:** A note that is not payable on demand is dishonored if it is not paid on the day it becomes payable. U.C.C. §3-502(a)(3). No presentment is required. [73]

3. **Dishonor of check:** There are two ways in which a check presented to the payor bank (other than for immediate payment over the counter) may be dishonored. [73]

   a. **Returns check:** A properly presented check is dishonored if the payor bank properly returns the check or sends notice of dishonor or nonpayment in compliance with U.C.C. §§4-301 and 4-302. U.C.C. §3-502(b)(1). [73]

   b. **Fails to return check or settle:** A payor bank that fails not only to promptly return the check (or send notice of nonpayment) but also to provisionally settle for the check, and, thus, becomes accountable for the check, dishonors the check. U.C.C. §3-502(b)(1); U.C.C. §3-502, Official Comment 4. [73]

4. **Dishonor of other demand draft:** A draft payable on demand is dishonored if presentment for payment is duly made to the drawee and the draft is not paid on the day of presentment. U.C.C. §3-502(b)(2). This applies to checks presented over the counter for immediate payment in cash. U.C.C. §3-502(b)(2); U.C.C. §3-502, Official Comment 4. [73]

5. **Dishonor of draft not payable on demand:** A draft not payable on demand is dishonored in two ways. [73]

    a. **Not paid on presentment:** If the draft is presented for payment and it is not paid on the day it is due or the day of presentment, whichever is later, it is dishonored. U.C.C. §3-502(b)(3)(i). However, payment or acceptance of an unaccepted documentary draft may be delayed without dishonor until no later than the close of the drawee's third business day following the day on which payment or acceptance is required under U.C.C. §3-502(b). U.C.C. §3-502(c). [73-74]

    b. **Presented for acceptance:** An unaccepted draft payable at a stated date, or a stated period after acceptance, is dishonored if the draft is presented for acceptance and acceptance is refused. U.C.C. §3-502(b)(3)(ii), (4); U.C.C. §3-502, Official Comment 4. [74]

6. **Dishonor of accepted draft:** Once a draft is accepted, the holder must present the draft to the acceptor for payment. [74]

    a. **Payable on demand:** An accepted draft payable on demand is dishonored if presentment for payment is duly made and the draft is not paid on the day of presentment. U.C.C. §3-502(d)(1); U.C.C. §3-502, Official Comment 6. [74]

    b. **Not payable on demand:** An accepted draft not payable on demand is dishonored if presentment for payment is duly made and payment is not made on the day it becomes payable or on the day of presentment, whichever is later. U.C.C.§3-502(d)(2);U.C.C.§3-503, Official Comment 6.

[74]

D. Notice of dishonor: Notice of dishonor may be given by any commercially reasonable means. It may be oral, electronic, by telephone, or in writing. U.C.C. §3-503(b). Unless excused, a delay in giving notice of dishonor discharges an indorser on any type of instrument. U.C.C. §3-415(c). A delay in giving notice of dishonor does not discharge a drawer. U.C.C. §3-503, Official Comment 1. [74]

1. **Time within which notice of dishonor must be given:** When an instrument *is not* taken by a collecting bank for collection, notice of dishonor must be given within 30 days after the day on which the instrument is dishonored. U.C.C. §3-503(c). When an instrument is taken by a collecting bank for collection, the collecting bank must give notice of dishonor before midnight of the next banking day following the banking day on which the bank receives notice of dishonor. Persons, other than a collecting bank, must give notice of dishonor within 30 days following the day on which the person receives notice of dishonor. U.C.C. §3-503(c); U.C.C. §3-503, Official Comment 2. [74-75]

2. **When delay in notice of dishonor excused:** A delay in giving notice of dishonor is excused if the delay is caused by circumstances beyond the control of the person giving the notice and the person giving notice exercises reasonable diligence after the cause of the delay ceases to operate. U.C.C. §3-504(c). [75]

3. **When notice of dishonor excused:** Notice of dishonor is excused whenever it is waived in the instrument or otherwise. U.C.C. §3-504(b)(ii). [75]

III. TRANSFER WARRANTIES

A. Introduction: Any person who transfers an instrument for consideration makes the transfer warranties. U.C.C. §3-416(a). These warranties are made whether or not the transferor indorses the instrument and even when he indorses the instrument "without recourse." [75-76]

B. **To whom transfer warranties are made:** A transferor, who does not indorse the instrument, only makes the transfer warranties to his transferee. If he indorses the instrument, he makes the warranties to all subsequent transferees. If the instrument enters the bank collection process, any customer (whether or not indorsing the item) that transfers the item and receives a settlement, or other consideration, makes the warranties to its transferee and to any subsequent collecting bank. U.C.C. §4-207(a). [76]

C. **Content of transfer warranties:** A transferor makes five warranties:

1. **Transferor is a person entitled to enforce the instrument:** A transferor warrants that he is a person entitled to enforce the instrument. U.C.C. §4-207(a)(1); U.C.C. §3-416(a)(1). [76-77]

2. **All signatures are authentic and authorized:** A transferor warrants that all signatures are authentic and authorized. U.C.C. §4-207(a)(2); U.C.C. §3-416(a)(2). [77]

3. **No alteration:** A transferor warrants that the instrument has not been altered. U.C.C. §3-416(a)(3); U.C.C. §4-207(a)(3). An alteration includes the unauthorized addition of words or numbers to an incomplete instrument. [77]

4. **Transferor not subject to any defense or claim in recoupment:** A transferor warrants that the instrument is free from any defense or claim in recoupment of any party that can be asserted against the warrantor. U.C.C. §3-416(a)(4); U.C.C. §4-207(a)(4); U.C.C. §3-416, Official Comment 3. In essence, the transferor warrants that if he were to sue any party on the instrument, none of these parties would have a defense or claim in recoupment that could be asserted against him. The transferor breaches this warranty even if the transferee is a holder in due course who would take the instrument free from the particular defense or claim in recoupment. U.C.C. §3-416, Official Comment 3. [77-78]

5. **No knowledge of insolvency proceedings:** A transferor warrants that it has no knowledge of insolvency proceedings with respect to the maker, acceptor, or drawer of an unaccepted item. U.C.C. §3-416(a)(5); U.C.C. §4-207(a)(5); U.C.C. §3-416, Official Comment

4. [78]

6. **2002 amendments:** The 2002 amendments to Articles 3 and 4 have added a new transfer warranty with respect to a remotely created consumer item. As to such items, the transferor warrants that the person on whose account the item is drawn has authorized the issuance of the item in the amount for which the item is drawn. [Rev] U.C.C. §3-416(a)(6) and [Rev] U.C.C. §4-207(a)(6). A "***remotely created consumer item*** " is an item payable out of a consumer's account which is created by a merchant or telemarketer with the consumer's signature not appearing on the item. [Rev] U.C.C. §3-103(a)(16). [78]

IV. SURETIES AND ACCOMMODATION PARTIES

A. **What is an accommodation party?** If an instrument is issued for value given for the benefit of a party to the instrument ("the ***accommodated party*** ") and another party to the instrument (the "accommodation party") signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument, the instrument is signed by the accommodation party "for accommodation." U.C.C. §3-419(a). [78]

1. **Both surety and debtor must sign instrument:** A person is an accommodation party only when both the surety and the debtor sign the same instrument. U.C.C. §3-419(a). [78]

2. **When both do not sign same instrument:** If the surety does not sign the same instrument as the debtor, he is not an accommodation party. He is still a surety with his rights, as a surety, being governed by the general law of suretyship. [78]

3. **Collection guaranteed:** When "collection guaranteed" or equivalent words are added to a signature that unambiguously indicate an intention to guarantee collection only, the signer undertakes only a guaranty of collection. U.C.C. §3-419(d). A guarantor of collection is obliged to pay the amount due only if the holder cannot collect from the accommodated party. U.C.C. §3-419(d); U.C.C. §3-419, Comment 4. [79]

2002 amendments: Under [Rev] U.C.C. §3-419(d), a party who adds words like "collection guaranteed" to its signature is obligated to make payment only when the holder is unable to recover from the other party to the instrument. [Rev] U.C.C. §3-419(e) is simply intended to make it clear that, unless the person clearly indicates that he or she is guaranteeing collection, rather than payment, the creditor may proceed directly against the guarantor without first proceeding against the accommodated party. [79]

4. **Accommodation party cannot receive direct benefit from instrument:** A person is an accommodation party only if he has not received a direct benefit from the value given for the instrument. U.C.C. §3-419, Official Comment 1. Receiving an indirect benefit from the value given for the instrument will not deny that person accommodation party status. U.C.C. §3-419, Official Comment 1. [79]

5. **Accommodation party liable in capacity in which she signs:** An accommodation party is liable in whatever capacity she has signed, *i.e.*, indorser, maker, acceptor, or drawer. U.C.C. §3-419(b); U.C.C. §3-419, Official Comment 1. [79]

6. **2002 amendments:** Definitions of "principal obligor" and "secondary obligor" have been added. [79]

   a. **Principal obligor:** A "***principal obligor*** " is the accommodated party or any other party to the instrument against whom a secondary obligor has recourse under [Rev] Article 3. [Rev] U.C.C. §3-103(a)(11). [79]

   Example: Mary makes a note payable to Joe. Joe indorses the note to Sally. Mary is a principal obligor because Joe has a right of recourse against her.

   b. **Secondary obligor:** A "***secondary obligor*** " is any of the following:

   i. **Indorser:** An indorser is a secondary obligor because it has a right to recover from the maker, drawer, or prior indorser. [80]

   ii. **Accommodation party:** An accommodation party is a secondary obligor because it may recover from the accommodated party. [80]

iii. **Drawer of an accepted draft:** Where a draft is accepted by a person (other than a bank), the drawer is treated as an indorser with the acceptor having the primary responsibility to pay the draft. As a result, the drawer is in the position of an indorser. [Rev] U.C.C. §3-414(d). Where the draft is accepted by a bank, the drawer is discharged. [Rev] U.C.C. §3-414(c). [80]

iv. **Right to contribution:** Any other party to the instrument that has a right of recourse against another party to the instrument under [Rev] U.C.C. §3-116(b) is a secondary obligor to the extent of such a right. Under the latter section, a party having joint and several liability who pays the instrument is entitled to receive from another party having the same joint and several liability contribution in accordance with applicable law. [Rev] U.C.C. §3-103(a)(17). Because of the right of a party having joint and several liability who pays an instrument to receive contribution from his co-obligors, such a co-obligor is, in part, a secondary obligor and, also in part, a principal obligor. [Rev] U.C.C. §3-116, Revised Official Comment 1. [80]

Example: John and Mary are co-makers of a note payable to Phil in the amount of $1,000. Upon Phil's demand, Mary pays the entire amount of the note. Mary, subject to an agreement to the contrary, has the right to recover $500 from John.

B. **Relationship between accommodation and accommodated parties:** An accommodation party is not liable on the instrument to the party accommodated, nor is he liable for contribution to the accommodated party in the event of payment by the accommodated party. U.C.C. §3-419(e). [80]

1. **Right of reimbursement:** On payment, the accommodation party has a right to be reimbursed by the accommodated party. This promise is implied in the relationship whether or not the

accommodated party makes an express promise to that effect. [80]

2. **Right of subrogation:** The accommodation party, on full payment of the instrument, is entitled to enforce the instrument against the party accommodated. The accommodation party obtains all the rights of the party he paid both on the instrument and to any collateral. U.C.C. §3-419(e); U.C.C. §3-419, Official Comment 5. [80]

3. **2002 amendments:** Under the 2002 amendments, the accommodation party may, in proper circumstances, have the court order the accommodated party to specifically perform its obligation to pay the instrument. [Rev] U.C.C. §3-419(e) [now subsection "(f)" under the 2002 amendments]. [81]

C. **Relationship between accommodation parties:** In the absence of an agreement to the contrary, two parties who sign in the same capacity in accommodation for another party are co-sureties. As co-sureties, they are jointly and severally liable. [81]

1. **Right of contribution:** A co-surety who pays more than his proportional share of the obligation has a right of contribution from the other co-surety. U.C.C. §3-116(b). [81]

2. **Subsuretyship:** An accommodation party may attempt to prove that he was the accommodation party not only for the original debtor but also for the other accommodation party (called "***subsuretyship*** "). To do so, he must prove an express or implied understanding to that effect. [81]

D. **Defenses available to accommodation party**

1. **May not raise lack of consideration:** As long as the instrument was issued for value for the benefit of the accommodated party, the accommodation party may not raise the defense of lack of consideration even though he has, in fact, received no benefit in any form. U.C.C. §3-303; U.C.C. §3-419. [81]

2. **Right of accommodation party to raise accommodated party's defenses:** The accommodation party may raise any of the accommodated party's defenses or claims in recoupment. U.C.C. §3-305(d). However, the accommodation party may not raise, as a

defense to his own obligation to pay, the accommodated party's discharge in insolvency proceedings, infancy, or lack of legal capacity. U.C.C. §3-305(d). [81-82]

E. Discharge of indorsers and accommodation parties ("suretyship defenses")

1. **Limited to accommodation parties and indorsers:** The right to a discharge under U.C.C. §3-605 is limited to accommodation parties and indorsers. U.C.C. §3-605(a). An accommodation party is discharged only if the person entitled to enforce the instrument has actual knowledge of its status as an accommodation party or has notice of the accommodation from an indication on the instrument that the party has signed as "guarantor," "surety," or "accommodation party," or from the fact that the signature is an anomalous indorsement that is presumed to be made in the capacity of an accommodation party. U.C.C. §3-419(c); U.C.C. §3-605(h). [82]

   a. **2002 amendments:** The 2002 amendments to U.C.C. §3-605 have significantly changed the rules, as well as the terminology, for determining the effect on secondary obligors of an impairment of collateral, a release of the primary obligor, an extension granted to the primary obligor and a modification of the obligations of the primary obligor. [82]

   i. **Party to instrument:** [Rev] U.C.C. §3-605 only applies where the secondary obligor is a party to an instrument. Where the secondary obligor is not a party to the instrument, general suretyship law applies. [Rev] U.C.C. §3-605, Official Comment 1. [82]

   ii. **Terminology:** Unlike original U.C.C. §3-605, which discusses these issues in terms of the effect that a discharge of a party under U.C.C. §3-604 has on the liability of an indorser or accommodation party having a right of recourse against the discharged party, [Rev] U.C.C. §3-605(a) speaks in terms of the effect that a "***release*** " of the "principal obligor" has on the liability of a "secondary obligor." A "***principal obligor*** " is the accommodated party or any other party to the instrument against whom a secondary obligor has recourse under Article 3. [Rev] U.C.C. §3-103(a)(11). [82-83]

iii. Secondary obligors: [Rev] U.C.C. §3-605 applies to the following five secondary obligors:

(1) An accommodation party;

(2) An indorser of a note who is not an accommodation party;

(3) A drawer of a draft that is accepted by a party that is not a bank;

(4) An indorser of a check; and

(5) A co-maker of an instrument, whether or not an accommodation party. [Rev] U.C.C. §3-103(a)(17). [83]

Note: A co-maker's right of contribution under [Rev] U.C.C. §3-116(b) makes a co-maker a secondary obligor to the extent of its right of contribution. [Rev] U.C.C. §3-605, Official Comment 3.

2. Release of principal debtor: Release of the principal debtor (technically called "***discharge by cancellation or renunciation*** ") does not discharge the accommodation party or indorser under U.C.C. §3-605(b). Notwithstanding release of the principal debtor, the accommodation party or indorser retains both her right of recourse on the instrument and her right of reimbursement against the principal debtor. U.C.C. §3-419(e); U.C.C. §3-605, Official Comment 3. [83]

a. 2002 amendments: The 2002 amendments have complicated the rules as to the effect that a release of the principal obligor has on the liability of a secondary obligor. [83]

i. Liability of principal obligor to secondary obligor as to previous payments: Notwithstanding release of the principal obligor by the person entitled to enforce an instrument, the obligations of the principal obligor to the secondary obligor with respect to any previous payment made by the secondary obligor are not affected. [Rev] U.C.C. §3-605(a)(1). As a result, despite the release, the secondary obligor may recover from the principal obligor for any payments already made by the secondary obligor. [Rev] U.C.C. §3-605, Official Comment 4. [83]

ii. **Liability of principal obligor to secondary obligor as to other obligations:** Subject to the exception discussed below, the principal obligor is also discharged, to the extent of the release, from any unperformed obligations owed to the secondary obligor. [Rev] U.C.C. §3-605(a)(1). This includes not only the principal obligor's liability as an obligor on the instrument (e.g., as a maker, drawer, or indorser) but also as to any obligations under U.C.C. §§3-116 and 3-419. [Rev] U.C.C. §3-605, Official Comment 4. [83-84]

Rationale: Because the secondary obligor no longer faces liability on the instrument, the principal obligor can, likewise, have no liability to the secondary obligor. The secondary obligor's voluntary decision to pay the instrument, when not legally obligated to, should not impose an obligation on the principal obligor to reimburse him. [Rev] U.C.C. §3-605, Official Comment 4.

Exception: Where the terms of the release reserve the person entitled to enforce the instrument's recourse against the secondary obligor as well as the secondary obligor's recourse against the principal obligor, the principal obligor's obligation to the secondary obligor is not discharged. [Rev] U.C.C. §3-605(g).

Rationale: Where the person entitled to enforce the instrument's recourse against the secondary obligor is preserved, it would be unfair if the secondary obligor did not retain its rights against the principal obligor despite the principal obligor's release by the person entitled to enforce the instrument.

iii. **Liability of secondary obligor as to unperformed obligations:** Where a person entitled to enforce the instrument releases the obligation of the principal obligor in whole or in part, unless the terms of the release provide that the person entitled to enforce the instrument retains the right to enforce the instrument against the secondary obligor, the secondary obligor is discharged to the same extent as the principal obligor from any unperformed portion of its obligation on the instrument. [Rev] U.C.C. §3-605(a)(2) and Official Comment 4. [84]

(a) **Exception as to consideration given:** Even where the secondary obligor is not discharged under this section, the secondary obligor is discharged to the extent of the value of the consideration given for the release. [Rev] U.C.C. §3-605(a)(3) and Official Comment 4. [84]

(b) **Exception for harm caused to secondary obligor:** The secondary obligor is also discharged to the extent that the release would otherwise cause the secondary obligor a loss. [Rev] U.C.C. §3-605(a)(3) and Official Comment 4. The secondary obligor may be hurt by the release in that there is no longer the possibility that the primary obligor would make further payments that would reduce the remaining obligation of the secondary obligor. [Rev] U.C.C. §3-605, Official Comment 4. [84]

(c) **Effect of consent:** The secondary obligor is not discharged where it has consented to the release or is deemed to have consented to thereto under [Rev] U.C.C §3-605(f). [Rev] U.C.C. §3-605, Official Comment 4. [84]

(d) **Effect of failure to reserve recourse:** Unless the release reserves the secondary obligor's recourse against the principal obligor, the release eliminates the secondary obligor's claims against the principal obligor with respect to any future payment by the secondary obligor. [Rev] U.C.C. §3-605, Official Comment 4. [84]

Rationale: Permitting releases to be negotiated between the principal obligor and the person entitled to enforce the instrument without regard to the consequences to the secondary obligor would create an undue risk of opportunistic behavior by the obligee and principal obligor. [Rev] U.C.C. §3-605, Official Comment 4.

Exception for checks: Where a person entitled to enforce an instrument releases the obligation of a principal obligor on a check, in whole or in part, the secondary obligor whose liability is based upon its indorsement of the check is discharged without regard to the language or circumstances of the discharge or release. [Rev] U.C.C. §3-605(a)(2). The person entitled to enforce the instrument can avoid discharge of the indorser by contracting with the indorser for a different result at the time that she grants the release to the principal obligor. [Rev] U.C.C. §3-605, Official Comment 4.

3. **Extensions and modifications:** An accommodation party or indorser, having a right of recourse against a principal debtor, may be entitled to a discharge in the event that the person entitled to enforce the instrument modifies the obligation of, or grants an extension to, the principal debtor. U.C.C. §3-605(c), (d). [85]

4. **Extensions—extent of discharge:** An extension granted to the principal debtor only discharges the accommodation party or indorser to the extent that the extension causes the accommodation party or indorser a loss with respect to his right of recourse against the principal debtor. U.C.C. §3-605(c); U.C.C. §3-605, Official Comment 4. [85]

   a. **Form of agreement:** The extension must take the form of an agreement, whether or not binding, under which the person entitled to enforce the instrument gives more time to the principal debtor to pay the instrument. The mere failure to enforce the instrument when due or to foreclose on the collateral does not constitute an extension. [85]

b. **Proof of loss:** The burden is placed on the accommodation party or indorser to prove that he suffered a loss by virtue of the extension. U.C.C. §3-605, Official Comment 4. [85]

c. **2002 amendments**

   i. **Effect of extension on secondary obligor:** Where a person entitled to enforce an instrument grants the principal obligor an extension of time, the secondary obligor is discharged to the extent that the extension would otherwise cause the secondary obligor a loss. [Rev] U.C.C. §3-605(b)(2) and Official Comment 5. [85]

   Example: Principal obligor becomes insolvent during the extension. Had the extension not been granted, principal obligor would have been able to pay $1,000 of the $5,000 note. Assuming that secondary obligor can prove this, secondary obligor would be discharged to the extent of $1,000. [Rev] U.C.C. §3-605, Official Comment 5.

   Exception: An extension of time has no effect on the obligations of the principal obligor to the secondary obligor with respect to any previous payment made by the secondary obligor. [Rev] U.C.C. §3-605(b)(1). The rationale for this exception is that the secondary obligor, upon payment, has an independent right to recover the amount paid from the principal obligor.

   ii. **Effect on principal obligor's duty to secondary party:** Unless the terms of the extension preserve the secondary obligor's recourse against the principal obligor, any extension granted to the principal obligor extends the time for performance of any other duties owed to the secondary obligor by the principal obligor under Article 3. [Rev] U.C.C. §3-605(b)(1). As a result, if the secondary obligor pays the person entitled to enforce the instrument, the secondary obligor may not recover from the principal obligor during the time in which the time for payment was extended. [86]

iii. Secondary party's options: When the time for payment by the principal obligor has been extended by the person entitled to enforce payment, the secondary obligor has the following options:

(a) Perform as if no extension: Assuming that the secondary obligor is not discharged under [Rev] U.C.C. §3-605(b)(2), the secondary obligor may perform its obligations on the instrument as if the time for payment had not been extended. [Rev] U.C.C. §3-605(b)(3). [86]

(b) Treat time for performance as extended: Unless the terms of the extension provide that the person entitled to enforce the instrument retains the right to enforce the instrument against the secondary obligor as if the time for payment had not been extended, the secondary obligor may treat the time for performance of its obligations as having been extended to the same extent as that of the primary obligor. [Rev] U.C.C. §3-605(b)(3). [86]

(c) Reservation of rights: Where the terms of the extension provide that the person entitled to enforce the instrument retains its right to enforce the instrument against the secondary obligor on the original due date, the secondary obligor has the obligation to pay on the original due date. As a result, the secondary obligor may not delay payment until the extended due date. [Rev] U.C.C. §3-605, Official Comment 5. However, unless the extension agreement effects a reservation of the secondary obligor's right of recourse, the secondary obligor has no right to recover from the principal obligor until the extended due date. Because of the loss of its right to immediate recourse, the secondary obligor is discharged to the extent that this delay causes a loss to the secondary obligor. [Rev] U.C.C. §3-605(b)(2) and Official Comment 5. [86]

(d) **Secondary obligor's option:** Where the secondary obligor has the right, but not the duty, to pay the instrument on the original due date, the secondary obligor may assert its rights to discharge under [Rev] U.C.C. §3-605(b)(2) even if it does not exercise its option to pay on the original due date. [Rev] U.C.C. §3-605, Official Comment 5. In determining its loss, the fact that the secondary obligor did not exercise its option to pay on the original due date, and then recover from the principal obligor, may affect the loss resulting from the extension. [Rev] U.C.C. §3-605, Official Comment 5. [86]

Example: Holder grants extension to Maker by which the due date of the note is extended from January 15 to May 15. On February 15, Maker is solvent. Indorser has reason to know that Maker may not be solvent on May 15. Indorser's failure to make payment on January 15 and then demand reimbursement from Maker may diminish Indorser's right to a discharge. If Holder can prove that Maker would have paid Indorser some of the money had Indorser demanded payment on the original due date, Indorser's right to a discharge would be diminished to the extent that its failure to make payment and pursue Maker mitigated its loss. This is especially true if the secondary obligor has been given prompt notice of the extension and there is a preservation of rights so that the secondary obligor could have recovered from the principal obligor had it so done. [Rev] U.C.C. §3-605, Official Comment 5.

iv. **Reservation of rights:** A release or extension preserves a secondary obligor's recourse against the principal obligor if the terms of the release or extension provide both that: (1) the person entitled to enforce the instrument retains the right to enforce the instrument against the secondary obligor; and (2) recourse of the secondary obligor continues as though the release or extension had not been granted. [Rev] U.C.C. §3-605(g) and Official Comment 10. [87]

(a) **Manner of reservation:** No particular language is necessary to preserve the secondary parties' recourse against the principal obligor. [Rev] U.C.C. §3-605, Official Comment 4. However, the reservation must be contained in the terms of the release. Parol evidence is not admissible to prove that the parties intended that the secondary obligor remain liable. [Rev] U.C.C. §3-605, Official Comment 4. [87]

Examples: Statements such as the parties "intend to release the principal obligor but not the secondary obligor" or that the person entitled to enforce the instrument "reserves its rights" against the secondary obligor are sufficient. [Rev] U.C.C. §3-605, Official Comment 4.

5. **Modifications—extent of discharge:** When the person entitled to enforce the instrument agrees to materially modify the obligation of the principal debtor, with or without consideration, the accommodation party or indorser is discharged to the extent that the modification causes a loss with respect to her right of recourse against the principal debtor. U.C.C. §3-605(d); U.C.C. §3-605, Official Comment 5. [87]

   a. **Burden of proof:** The loss suffered by the accommodation party or indorser is presumed to be equal to the amount of her right of recourse. As a result, unless the person entitled to enforce the instrument can prove that the loss is a lesser amount, the accommodation party or indorser is completely discharged. U.C.C. §3-605(d); U.C.C. §3-605, Official Comment 5. [87]

   b. **Burden of proof where both modification and extension:** Because of the presumption of total loss in the case of a modification, if an agreement both materially modifies the obligation of the principal debtor and also grants an extension to him, the accommodation party or indorser will be completely discharged unless the person entitled to enforce the instrument can prove that the loss was in a lesser amount. U.C.C. §3-605, Official Comment 5. [87-88]

c. **2002 amendments** [88]

   i. **Discharge of secondary obligor:** If a person entitled to enforce an instrument agrees, with or without consideration, to a modification of the obligation of a principal obligor, the secondary obligor is discharged from any unperformed portion of its obligation to the extent that the modification would otherwise cause the secondary obligor a loss. [Rev] U.C.C. §3-605(c)(2). [88]

   ii. **Effect of modification on unperformed obligations:** The modification modifies any other duties owed to the secondary obligor by the principal obligor under Revised Article 3 to the same extent that the modification modifies the obligations of the principal obligor to the person entitled to enforce the instrument. [Rev] U.C.C. §3-605(c)(1) and Official Comment 6. [88]

   iii. **Consideration irrelevant:** Whether the modification was with or without consideration is irrelevant. [Rev] U.C.C. §3-605(c)(1). [88]

   iv. **No effect on prior payments:** Obligations of the principal obligor to the secondary obligor with respect to any previous payment by the secondary obligor are not affected by the modification. [Rev] U.C.C. §3-605(c)(1). [88]

   v. **Secondary party's options where not discharged:** To the extent that the secondary obligor is not discharged from performance under [Rev] U.C.C. §3-605(c)(2), the secondary obligor may satisfy its obligation on the instrument as if the modification had not occurred, or may treat its obligation on the instrument as having been correspondingly modified. [Rev] U.C.C. §3-605(c)(3) and Official Comment 6. [88]

d. **2002 amendments as to burden of proof:** With one exception, a secondary obligor asserting the right to a discharge has the burden of proof both with respect to the occurrence of the acts alleged to harm the secondary obligor and the loss or prejudice caused by those acts. [Rev] U.C.C. §3-605(h). [88]

Exception: If the secondary obligor demonstrates prejudice caused by an impairment of its recourse, and the circumstances of the case indicate that the amount of loss is not reasonably susceptible of calculation or requires proof of facts that are not ascertainable, it is presumed that the act impairing the recourse caused a loss or impairment equal to the full liability of the secondary obligor on the instrument. [Rev] U.C.C. §3-605(i). In that event, the burden of proof as to any lesser amount of the loss shifts to the person entitled to enforce the instrument. [Rev] U.C.C. §3-605(i).

6. **Consent and waiver:** Any party who consents to a modification or to an extension is not discharged. U.C.C. §3-605(i); U.C.C. §3-305, Official Comment 8. [89]

   a. **2002 amendments:** A secondary obligor is not discharged under [Rev] U.C.C. §3-605 if the secondary obligor either consents to the event or conduct or the instrument or a separate agreement of the party provides for a waiver of discharge. The waiver may, but does not have to, specifically mention [Rev] U.C.C. §3-605. [Rev] U.C.C. §3-605(f). To the extent that the circumstances indicate otherwise, consent by the principal obligor to an act that would lead to a discharge under [Rev] U.C.C. §3-605 constitutes consent to that act by the secondary obligor if the secondary obligor controls the principal obligor or deals with the person entitled to enforce the instrument on behalf of the principal obligor. [Rev] U.C.C. §3-605(f). [89]

7. **Impairment of collateral:** If the obligation to pay an instrument is secured by an interest in collateral and the person entitled to enforce the instrument impairs the value of the collateral, the obligation of an indorser or an accommodation party having a right of recourse against the obligor is discharged to the extent of the impairment. U.C.C. §3-605(e); U.C.C. §3-605, Official Comment 6. [89]

   a. **Discharge of accommodation parties and indorsers:** An accommodation party or indorser is discharged under U.C.C. §3-

605(e) only if the person entitled to enforce the instrument knows of the accommodation or has notice of the accommodation under U.C.C. §3-419(c). U.C.C. §3-605(h). [89]

2002 amendments: A secondary obligor is not discharged under [Rev] U.C.C. §3-605 (a)-(d) unless the person entitled to enforce the instrument knows that the person is a secondary obligor or has notice under [Rev] U.C.C. §3-419(c) that the instrument was signed for accommodation. [Rev] U.C.C. §3-605(e). [89-90]

Rationale: A secondary obligor can, if it desires, always make its status clear to third parties. Unless the person entitled to enforce the instrument knows that he/she is hurting the right of recourse of the secondary obligor, he/she should not be punished for actions that will usually only benefit the primary obligor.

Example: Because Allen knows that his credit is suspect, Allen asks his friend Larry if Larry would act as the "borrower" in obtaining a loan from Bank. Larry makes a note to Bank evidencing a loan of $5,000. Allen signs the note as an anomalous indorser. When it is due, Bank accepts Allen's offer to pay Bank $1,000 in exchange for his release. Larry is not released by Bank's release of Allen because Bank had no way of knowing that it was hurting Larry by releasing Allen.

b. **Discharge of co-obligors:** If a person entitled to enforce the instrument impairs the value of the interest in the collateral, the obligation of any party who is jointly and severally liable with respect to the secured obligation is discharged to the extent that the impairment causes the party asserting the discharge to pay more than he would have been obliged to pay. U.C.C. §3-605(f); U.C.C. §3-605, Official Comment 7. [90]

8. **When is collateral impaired?** Impairment of collateral occurs when some unjustifiable act or omission on the part of the person entitled to enforce the instrument causes the collateral no longer to be available to satisfy the instrument. U.C.C. §3-605(g). [90]

a. **Duty of reasonable care:** Unless otherwise agreed, if the collateral is property in the possession of the person entitled to enforce the instrument, that person has the duty to use reasonable care in its custody and possession of the collateral. U.C.C. §3-605(g). [90]

b. **Acts constituting impairment:** Article 3 contains a nonexclusive list of acts that constitute impairment of collateral. [90]

   i. **Failure to perfect:** The failure to obtain or maintain perfection or recordation of the interest in collateral. [90-91]

   ii. **Release of collateral:** The release of collateral without substitution of collateral of equal value. [91]

   iii. **Duty to preserve:** The failure to perform a duty to preserve the value of the collateral owed to the debtor, accommodation party, or indorser. [91]

   iv. **Improper disposal:** The failure to comply with an applicable law (e.g., Article 9) in disposing of collateral. U.C.C. §3-605(g). [91]

c. **2002 amendments:** Although [Rev] U.C.C. §3-605(d) represents no substantive change from original [Rev] U.C.C. §3-605(e), there have been some changes of note. The 2002 amendments have substituted "***principal obligor*** " for the party primarily liable and "***secondary obligor*** " for accommodation party, "indorser," or "person who is secondarily liable." [Rev] U.C.C. §3-605(d). Similarly, in [Rev] U.C.C. §3-605(e)(i), the term "***secondary party*** " has been substituted for "indorser or accommodation party having a right of recourse against the obligor." [Rev] U.C.C. §3-605(d). [91-92]

   Note: The 2002 amendments have also added to the situations in which the value of collateral is impaired by including, as an act of impairment, the failure to comply with applicable law in otherwise enforcing an interest in collateral. [Rev] U.C.C. §3-605(d) and Official Comment 7.

   Note: The 2002 amendments also make it clear that [Rev]

U.C.C. §3-605(d) applies to collateral that is realty (and not just personal property) as long as the obligation in question is in the form of a negotiable instrument. [Rev] U.C.C. §3-605, Official Comment 7. As a result, this section would be applicable where the collateral is a note secured by a trust deed.

9. **Extent of discharge for impairment of collateral:** An accommodated party or indorser is discharged to the extent that he has been hurt by an impairment of the value of the collateral. The party seeking the discharge bears the burden of proof as to both the fact of impairment and the amount of the loss. U.C.C. §3-605(e); U.C.C. §3-605(f). The Code provides three alternative formulas for determining the extent of the impairment. [91]

   a. **Formula when debt fully secured:** When the debt is fully secured, the value of an interest in collateral is impaired to the extent that the value of the interest is reduced to an amount less than the amount of the right of recourse of the party asserting the discharge. U.C.C. §3-605(e)(i); U.C.C. §3-605, Official Comment 6. [91]

   b. **Formula when debt undersecured:** The value of an interest in collateral is impaired to the extent that the reduction in value of the interest causes an increase in the amount by which the amount of the right of recourse exceeds the value of the interest. U.C.C. §3-605(e)(ii). [91]

   c. **Formula where co-obligors:** Where the party seeking the discharge is jointly and severally liable with the person who gave the collateral to the person entitled to enforce the instrument, the co-obligor is discharged only to the extent that the impairment causes him to pay more than he would otherwise have been obliged to pay, taking into account his right of contribution. U.C.C. §3-605(f). [92]

10. **Consent to impairment of collateral:** A party is denied a discharge if he has consented to the act constituting the impairment. U.C.C. §3-605(i). [92]

V. LIABILITY OF AGENTS, PRINCIPALS, AND CO-OBLIGORS

A. **Liability of represented person:** A represented person is liable on an instrument if the representative is authorized to sign for the represented person. U.C.C. §3-402(a); U.C.C. §3-402, Official Comment 1. Any mark or symbol used by the representative that is intended to signify the represented person is sufficient to bind the represented person. U.C.C. §3-402(a); U.C.C. §3-401, Official Comment 1. [92]

1. **In name of represented person:** The representative may sign the name of the represented person either with, or without, adding the agent's own name or capacity. U.C.C. §3-402(a); U.C.C. §3-401, Official Comment 1. [92-93]

2. **Undisclosed principal:** To the extent the representative is authorized to act on the represented person's behalf, an undisclosed principal is liable on the instrument even though neither his signature nor his identity appears on the instrument. U.C.C. §3-401(a); U.C.C. §3-401, Official Comment 1; U.C.C. §3-402, Official Comment 1. [93]

B. **Liability of representative**

1. **Unauthorized signature:** If the representative is not authorized to sign for the represented person or exceeds his authority in making the signature, the signature will operate as the signature of the representative personally. U.C.C. §3-403(a); U.C.C. §3-403, Official Comment 1. [93]

2. **Authorized signatures**

a. **Not liable if agent signs represented person's name only:** If an authorized representative signs the represented person's name only, the representative is not personally liable. U.C.C. §3-401(a). [93]

b. **Unambiguously signs in representative capacity:** An authorized representative who signs his own name to an instrument is not personally liable if the signature shows unambiguously that it is made on behalf of a represented person who is identified in the instrument. U.C.C. §3-402(b). [93]

i. **Capacity and name of represented person:** When the representative signs his name together with his representative capacity and the represented person's name, it is clear that the representative is not personally liable. U.C.C. §3-402(b)(1). [93]

ii. **Office not necessary:** It is not necessary for the representative to indicate the office he occupies as long as he clearly indicates that he is signing on behalf of the represented party. [93]

c. **Ambiguous signature:** When the representative does not make it clear that he is signing on behalf of the represented person, the representative is personally liable to a holder in due course who takes the instrument without notice that the representative was not intended by the original parties to the instrument to be personally liable. U.C.C. §3-402(b); U.C.C. §3-402, Official Comment 2. [94]

i. **As to other persons:** As to any other person, the representative is liable on the instrument unless he proves an actual agreement, whether express or implied, with the payee that he was not to be personally liable. U.C.C. §3-402(b)(2). [94]

ii. **Exception for checks:** An authorized representative who signs as drawer on a check that is payable from an account of the represented person without indicating his representative status is not liable as long as the represented person is identified somewhere on the check. U.C.C. §3-402(c); U.C.C. §3-402, Official Comment 3. [94]

C. **Liability of persons signing in the same capacity in the same transaction:** Except as otherwise specified in the instrument, two or more persons who sign an instrument as makers, acceptors, or drawers are liable jointly and severally in the capacity in which they sign. U.C.C. §3-116(a). [94]

1. **Right of contribution:** Unless the parties otherwise agree, a party having joint and several liability is entitled to contribution from his joint and several obligors to the extent available under applicable

law. U.C.C. §3-116(b). Even if a party having joint and several liability is discharged by some act of the holder, his discharge does not affect the right of his joint and several obligor to receive contribution from the discharged party. U.C.C. §3-116(c); U.C.C. §3-116, Official Comment 1. [94-95]

2. **Liability of indorsers:** Subject to certain exceptions, indorsers are not jointly and severally liable. U.C.C. §3-116(a). Indorsers who are copayees and anomalous indorsers are jointly and severally liable unless one payee is accommodating the other payee or they agree to be liable otherwise than as jointly and severally. U.C.C. §3-116(a); U.C.C. §3-116, Official Comment 2. [95]

2002 amendments: U.C.C. §3-116(c) has been omitted:

(c) Discharge of one party having joint and several liability by a person entitled to enforce the instrument does not affect the right under subsection (b) of a party having the same joint and several liability to receive contribution from the party discharged.

Note: Parties that are jointly and severally liable are each, in part, a secondary obligor and, in part, a principal obligor. As a result, to the extent that each party is a secondary obligor, [Rev] U.C.C. §3-605 determines the effect of a release, an extension of time, or a modification of the obligation of one of the joint and several obligors, as well as the effect of an impairment of collateral provided by one of those obligors. [Rev] U.C.C. §3-116, Official Comment 1.

VI. EFFECT OF TAKING INSTRUMENT ON THE UNDERLYING OBLIGATION

A. Ordinary instruments

1. **Obligation suspended:** Unless the parties otherwise agree, when the person entitled to enforce the instrument takes an ordinary instrument for an underlying obligation, the obligation is suspended to the same extent that the obligation would be discharged if payment had been made in money. U.C.C. §3-310(b); U.C.C. §3-310(c). [96]

a. **Checks:** When an uncertified check is taken, suspension of the obligation continues until the check is dishonored, paid, or certified. If the check is paid or certified, the obligation is discharged to the extent of the amount of the check. U.C.C. §3-310(b)(1). [96]

b. **Notes:** When a note is taken, suspension of the obligation continues until dishonor or payment of the note. The obligation is discharged to the extent that the note is paid. U.C.C. §3-310(b)(2). [96]

2. **Effect of dishonor:** When the person entitled to enforce the instrument is also the person to whom the underlying obligation is owed, the person may enforce either the instrument or the obligation once the instrument is dishonored. U.C.C. §3-310(b)(3); U.C.C. §3-310, Official Comment 3. When the person entitled to enforce the instrument is not the person to whom the underlying obligation is owed, the person entitled to enforce the instrument may enforce only the instrument. U.C.C. §3-310(4). [96]

3. **Effect of discharge:** When the underlying obligor is discharged on the instrument, she is also discharged on the underlying obligation. U.C.C. §3-310(a), (b)(1), (2). [97]

B. **Bank checks:** Unless otherwise agreed, if a bank check (or any other instrument on which a bank is a maker or an acceptor) is taken for an obligation, the obligation is discharged to the same extent as had payment been made in cash. U.C.C. §3-310(a), (c); U.C.C. §3-310, Official Comments 2 and 5. If the debtor indorses the instrument, although the underlying obligation is discharged, his liability as an indorser on the instrument is not discharged. U.C.C. §3-310(a); U.C.C. §3-310, Official Comment 2. [97]

C. **Taking instrument for underlying obligation:** For an instrument to affect the underlying obligation, the instrument must be taken for the underlying obligation. U.C.C. §3-310(a), (b). Mere delivery of the instrument to the obligee by the obligor does not result in the obligee having taken the instrument for the underlying obligation. The obligee must, by her action or inaction, indicate that she has accepted the instrument in conditional or final payment of the obligation. [97]

VII. ACCORD AND SATISFACTION BY USE OF INSTRUMENT

A. Conditions for discharging of tendered instrument: Subject to two exceptions, tendering of an instrument discharges the underlying claim for which it was tendered if the following conditions are met:

- the debtor tenders the instrument in good faith and in full satisfaction of the claim;
- the claim is either unliquidated or subject to a bona fide dispute;
- the instrument is paid; and the instrument, or accompanying written communication, contains a conspicuous statement
- that the instrument is tendered in full satisfaction of the debt. U.C.C. §3-311(a), (b). [98]

B. Exception for lockbox accounts: If an organization informs a debtor that checks or other communications regarding disputed debts must be sent to a designated person, office, or place, the claim is not discharged if the instrument or communication was not received by the designated person, office, or place. U.C.C. §3-311(c)(1). [98]

C. Exception for returning payment: If a creditor does not require that claims be sent to a special address, the claim is not discharged if the creditor tenders repayment of the amount of the instrument within 90 days of its payment. U.C.C. §3-311(c)(2). [98]

D. Limitation on exceptions: Both exceptions are subject to a limitation. The claim is discharged if the debtor proves that, within a reasonable time before collection of the instrument was initiated, the creditor or its agent who had direct responsibility with respect to the disputed obligation knew that the instrument was tendered in full satisfaction. U.C.C. §3-311(d); U.C.C. §3-311, Official Comment 7. [98]

VIII. PROCEDURAL ISSUES INVOLVING NEGOTIABLE INSTRUMENTS

A. **Persons entitled to enforce instrument:** Persons entitled to enforce an instrument include the holder, a transferee of a holder, an accommodation party or indorser who pays the holder, the owner of a lost instrument under U.C.C. §3-309, and a person from whom payment has been recovered under U.C.C. §3-418(d). [99]

B. **Burden of proof in negotiable instruments cases:** A person entitled to enforce an instrument establishes a prima facie case for recovery by establishing that the obligor's signature is effective, producing the instrument, and proving that he is a person entitled to enforce the instrument. U.C.C. §3-308(a), (b). [99]

1. **Exception to producing instrument:** The plaintiff does not have to produce the instrument if the instrument has been lost, destroyed, or stolen, or if he is a person from whom a payment has been recovered pursuant to U.C.C. §3-418. [99]

2. **Proving signatures:** There are special rules regarding proof of the authenticity of a signature. Unless the defendant specifically denies that a signature is authentic, the signature is deemed to be authentic. Even if the defendant makes a specific denial, the plaintiff is entitled to a presumption that the signature is genuine and authorized. Once sufficient evidence is introduced to support a finding that the signature is either not genuine or is unauthorized, the presumption completely disappears. To rebut the presumption, the defendant need only testify that her signature is not genuine and submit a sample of her true signature. U.C.C. §3-308(a), U.C.C. §1-201(31); U.C.C. §3-308, Official Comment 1. [99]

3. **Burden on obligor to prove defense:** Once the plaintiff has established her prima facie case, she will recover against the obligor unless the obligor establishes a defense or a claim in recoupment. U.C.C. §3-308(b); U.C.C. §3-308, Official Comment 2. [100]

4. **After defense proved, duty of plaintiff to prove holder-in-due-course status:** Even if the obligor has established a defense or claim in recoupment, the plaintiff will recover if she proves that she is a holder in due course or has the rights of a holder in due course (unless the defense is one that is good against a holder in due

course). U.C.C. §3-308(b); U.C.C. §3-308, Official Comment 2. [100]

IX. ENFORCEMENT OF LOST, DESTROYED, OR STOLEN INSTRUMENTS

A. Lost, destroyed, or stolen ordinary instruments: The person entitled to enforce an instrument that is lost by destruction, theft, or otherwise, may maintain an action as if he had produced the instrument. U.C.C. §3-309(b); U.C.C. §3-309, Official Comment. [100]

1. **Adequate protection:** To protect the obligor, a court can require the claimant to indemnify the obligor against any loss or expense. U.C.C. §3-309(b). [100]

2. **Right to recover on instrument only:** The claimant may recover on the instrument only. He may not enforce the obligation for which the instrument was given. U.C.C. §3-310(b)(4); U.C.C. §3-310, Official Comment 4. [100]

3. **What claimant must prove:** The claimant must prove that

   - he was either a holder or had the rights of a holder at the time he lost possession;
   - the loss of possession was not a result of his transfer of the instrument or of a lawful seizure of the instrument;
   - he cannot reasonably obtain possession of the instrument because it was either destroyed, lost, or in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process; and
   - the terms of the instrument include any terms necessary to make the instrument negotiable. U.C.C. §3-309(b). [100-101]

4. **2002 amendments:** The 2002 amendments permit a person not in possession of an instrument to enforce the instrument if the person has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of

possession occurred. [Rev] U.C.C. §3-309(a)(1)(B). [101]

Rationale: This permits a person who lost the instrument but has the right to enforce it under [Rev] U.C.C. §3-309 to transfer its right to enforce the instrument to another.

Required proof: A transferee of a lost instrument need only prove that its transferor was entitled to enforce the instrument. There is no need for the transferee to prove that it was in possession of the instrument at the time the instrument was lost. [Rev] U.C.C. §3-309, Official Comment 2.

Declaration of loss: The 2002 amendments substitute the term "***record*** " for "writing." As a result, a declaration of loss may be made in a record that is not a writing. A "record" is "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." [Rev] U.C.C. §3-103(a)(14).

B. Lost, destroyed, or stolen bank checks: A different set of rules applies when a bank check (i.e., a cashier's, teller's, or certified check) is lost, destroyed, or stolen. U.C.C. §3-312. [101]

1. **Who may use U.C.C. §3-312:** Only the drawer or payee of a certified check and the remitter or payee of a teller's or cashier's check (the "***claimant*** ") may proceed under U.C.C. §3-312. U.C.C. §3-312(a)(3)(ii). An indorsee of a bank check is denied the advantages of U.C.C. §3-312 and must proceed as if he were suing on an ordinary lost or stolen instrument. [101]

2. **Manner of asserting claim:** The claimant must send a communication to the issuing bank asserting the claim and be accompanied by a declaration of loss. U.C.C. §3-312(b). [101]

3. **When claim is effective:** The claim is not valid for 90 days. During this 90-day waiting period, the bank may, with impunity, pay the person entitled to enforce the check. U.C.C. §3-312(b)(2). After the 90-day period, the issuing bank becomes liable to the claimant if the bank has not already paid a person entitled to enforce the check. U.C.C. §3-312(b)(4); U.C.C. §3-312, Official Comment 4. [101-102]

4. **Bank discharged by payment to claimant:** Payment to the claimant discharges the bank's liability to a person entitled to enforce the check. U.C.C. §3-312(b)(4). If a holder in due course presents the bank check after the bank pays the claimant, the issuing bank may pay the holder in due course. The claimant is then obliged to repay the bank. If the bank refuses to pay the holder in due course, the claimant must pay the holder. U.C.C. §3-312(b); U.C.C. §3-312, Comment 3. [102]

CHAPTER 4
FORGERY, ALTERATION, AND OTHER FRAUDULENT ACTIVITY

I. UNAUTHORIZED SIGNATURES

A. Introduction: Subject to certain exceptions, an unauthorized signature is ineffective as the signature of the person whose name is signed. U.C.C. §3-403(a). An unauthorized signature may be an outright forgery or a signature by an agent in excess of her actual or apparent authority. U.C.C. §1-201(43); U.C.C. §3-403, Official Comment 1. An unauthorized signature is effective as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value. U.C.C. §3-403(a). [107]

B. Two consequences of unauthorized signature: The fact that an unauthorized signature has no effect as the signature of the person whose name is signed has two distinct consequences. First, the person whose signature is signed is not liable on the instrument. Second, if the unauthorized signature is an indorsement in the chain of title, no person following the unauthorized indorsement can be a holder of the instrument. [107-108]

C. Transfer warranties: A transferor warrants that the transferor is the person entitled to enforce the instrument, U.C.C. §4-207(a)(1); U.C.C. §3-416(a)(1), and also that all signatures are authentic and authorized. U.C.C. §4-207(a)(2); U.C.C. §3-416(a)(2). [108]

2002 amendments: A new transfer warranty has been added as to remotely created consumer items. With respect to a remotely created consumer item, the transferor warrants that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. [Rev] U.C.C. §3-416(a)(6) and [Rev] U.C.C. §4-208(a)(4). As a result, the risk of the item not being authorized by the person upon whose account it was drawn rests upon the person initially transferring the item. [108]

D. Presentment warranties: The person who obtains payment or acceptance, as well as any prior transferor, makes certain presentment warranties to any payor or acceptor who acts in good faith. U.C.C. §4-208(a), (d); U.C.C. §3-417(a), (d)(1). [108-109]

1. **Warranties made to drawee of unaccepted draft:** The payor bank on a check (as well as any drawee of an unaccepted draft) is given three warranties: (1) that the warrantor is entitled to enforce the draft or authorized to obtain payment or acceptance on behalf of a person entitled to enforce the draft; (2) that the warrantor has no knowledge that the signature of the drawer is unauthorized; and (3) that the draft has not been altered. U.C.C. §4-208(a); U.C.C. §3-417(a). If the payor bank could have asserted the drawer's negligence against the drawer, the person against whom the payor bank is bringing the breach of presentment warranty action may assert the drawer's negligence as a defense to the payor bank's action. U.C.C. §4-208(c); U.C.C. §3-417(c). [109-110]

   2002 amendments: A new presentment warranty has been added as to remotely created consumer items under which the person obtaining the payment or acceptance and prior transferors warrant, as to remotely created consumer items, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. The effect of this warranty is to impose ultimate liability on the depositary bank that accepted the unauthorized remotely created item rather than on the payor bank, which had no means of determining whether it was authorized. This warranty applies not only when the item is unauthorized, but also when the consumer authorized the item in a different amount than that in which payment was made. [Rev] U.C.C. §3-417(a)(4); [Rev] U.C.C. §4-208(a)(4). [110]

2. **Warranties made to other payors:** All payors, other than drawees of unaccepted drafts, receive only the warranty that the warrantor is entitled to enforce the instrument or is authorized to obtain payment on behalf of a person entitled to enforce the instrument. U.C.C. §4-208(d); U.C.C. §3-417, Official Comment 4. No warranty is given that the presenter lacks knowledge of the unauthorized nature of the maker's or drawer's signature. U.C.C.

§3-417, Official Comment 4. [110]

E. Recovery by payor of payment made by mistake: Even absent a presentment warranty, the payor may be able to recover the mistaken payment from its recipient under U.C.C. §3-418. A drawee can revoke its acceptance in the identical circumstances that it could recover the payment had payment been made instead. [111]

1. **Typical mistakes:** Typical mistaken payments by a drawee include payment over a forged drawer's signature, payment of a check drawn on insufficient funds, and payment over a valid stop payment order. [111]
2. **Protected persons under U.C.C. §3-418:** Payment may not be recovered from two classes of protected persons: any person who takes the instrument in good faith and for value, or any person who has, in good faith, changed position in reliance on the payment. U.C.C. §3-418(c). [111]
3. **Consequences when payment is recovered:** In the event that payment is recovered, the instrument is treated as having been dishonored. The person from whom payment is recovered can enforce the instrument against the drawer, maker, or indorser just as if the instrument had been dishonored on its initial presentment. U.C.C. §3-418(d); U.C.C. §3-418, Official Comment 2. [111]

2002 amendments: A new presentment warranty has been added as to remotely created consumer items under which the person obtaining the payment or acceptance and prior transferors warrant, as to remotely created consumer items, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. The effect of this warranty is to impose ultimate liability on the depositary bank that accepted the unauthorized remotely created item rather than on the payor bank, which had no means of determining whether it was authorized. This warranty applies not only when the item is unauthorized, but also when the consumer authorized the item in an amount different than that in which payment was made. [Rev] U.C.C. §3-416, Official Comment 8. As a result, the risk of the item not being authorized by the person upon whose account it was drawn rests upon the person initially transferring the item. [110]

F. Conversion: An instrument is converted if it is taken by transfer, other than by negotiation, from a person not entitled to enforce the instrument. An instrument is also converted if a payor bank or other payor makes payment with respect to the instrument to a person not entitled to enforce the instrument or to receive payment. U.C.C. §3-420(a). [111]

If an indorsement in the chain of title is unauthorized or missing, the instrument is converted. Because an instrument payable to bearer is negotiated by transfer of possession alone, there can be no conversion of an instrument payable to bearer.

1. **When taking instrument by agent is conversion:** A person who holds an instrument solely as a representative of another person (other than a depositary bank) who has, in good faith, dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce the instrument is not liable in conversion or otherwise beyond the amount of any proceeds that it has not paid out. U.C.C. §3-420(c). A depositary bank is liable for conversion whether or not it acts in good faith or retains any of the proceeds from the check. U.C.C. §3-420(c). [111-112]

2. **Who may bring an action for conversion:** The proper party to bring an action for conversion of an instrument is the person who, before the theft or loss, was the person entitled to enforce the instrument. A payee may bring the action only if the instrument has been delivered to her. U.C.C. §3-420(a)(ii); U.C.C. §3-420, Official Comment 1. An action for conversion may not be brought by the drawer, acceptor, or other issuer of the instrument. U.C.C. §3-420(a)(i). [112-113]

3. **Defenses to conversion action:** The person sued for conversion may defend by proving that the owner is precluded from denying that the forged indorsement is effective as the owner's indorsement. [113]

G. Application of rules when signature of maker or acceptor unauthorized: In the absence of estoppel, ratification, or negligence, the maker or acceptor is not liable on an instrument on which his signature is forged or unauthorized because he did not sign the instrument. U.C.C. §3-401(a). If the maker or acceptor makes payment, the maker or acceptor will suffer the loss if the person to whom payment is made is a protected person under U.C.C. §3-418. Neither the maker nor the acceptor is given a presentment warranty as to the authenticity of his own signature. [113]

H. **Application of rules when signature of drawer unauthorized:** When the drawee makes payment of a check or other draft bearing the forged signature of the purported drawer, the drawee will usually suffer the loss. Neither the presenter nor prior transferors warrant to the drawee that the drawer's signature is genuine. The only warranty they make to the drawee is that they have no knowledge that the drawer's signature is unauthorized. U.C.C. §4-208(a)(3); U.C.C. §3-417(a)(3). The drawee or payor bank may not debit the drawer's account because, bearing his unauthorized signature, the draft is not properly payable. The drawee can only recover the mistaken payment from a person who is not a protected party. U.C.C. §3-418(c). If the drawee does not make payment, the loss will go back down the chain of title to the first solvent party after the forger (assuming that the forger is not solvent). The mechanism for passing the loss down the chain of title is the transfer warranty, given by each transferor, that all signatures are genuine and authorized. U.C.C. §3-416(a)(2); U.C.C. §4-207(a)(2). [114-115]

I. **Application of rules when indorsement is unauthorized**

1. **Allocation of loss when check not delivered to payee:** When the check or other draft has not been delivered to the payee, the payee has no right to sue for conversion. U.C.C. §3-420(a). She, however, retains whatever rights she had against the drawer on the underlying obligation for which the check was taken. The drawer has no right to sue the depositary or other collecting bank for either conversion, U.C.C. §3-420(a), or for breach of the presentment warranty that she is a person entitled to enforce the instrument. U.C.C. §3-417, Official Comment 2. The drawer has not suffered a loss because the payor bank may not debit its account. The allocation of loss is the same whether or not the payor bank pays

the check because, even if the check is paid, the payor bank may recover from the presenting bank and prior transferors for breach of their presentment warranty that they are a person entitled to enforce the instrument. U.C.C. §4-208 (a)(1); U.C.C. §3-417(a)(1). Whether or not the check is paid, the loss will flow back to the first solvent transferor following the forgery because each transferor warrants that it is a person entitled to enforce the instrument. U.C.C. §4-207(a)(1). [115]

2. **Allocation of loss after delivery to payee:** After delivery to the payee, the payee's rights depend on whether the instrument has been paid. [115]

   a. **Payee's rights if instrument not paid:** If the check is still missing, the payee may recover on the check from the drawer by complying with the requirements for the enforcement of lost, destroyed, or stolen instruments. U.C.C. §3-309. However, the payee may not recover from the drawer on the underlying obligation. U.C.C. §3-310(b)(4); U.C.C. §3-310, Official Comment 4. If the check is found prior to payment, the payee may recover possession of the check from the possessor. Once the payee recovers possession of the check, she may present the check for payment, and if it is not paid, she can recover from the drawer on her drawer's contract or on the underlying obligation. The party required to return the check can then recover from her transferor and any prior transferors for breach of their transfer warranty that they are a person entitled to enforce the instrument. U.C.C. §3-416(a)(1); U.C.C. §4-207(a)(1). [116]

   b. **Payee's rights if instrument paid:** If the check is paid, the payee may recover from the payor bank, the depositary bank, or any nonbank transferor for conversion. U.C.C. §3-420(a); U.C.C. §3-420, Official Comment 3. Ultimately, the first solvent party after the person who made the unauthorized indorsement bears the loss. The payor bank can recover from the presenter or prior transferors for breach of their presentment warranty that they are a person entitled to enforce the instrument. U.C.C. §4-208(a)(1). Each transferee can recover from prior transferors for breach of their transfer warranty that they are a person entitled to enforce the instrument. U.C.C. §3-416(a)(1); U.C.C. §4-207(a)(1). [116]

II. ALTERATIONS AND INCOMPLETE INSTRUMENTS

A. **What is an alteration?** An alteration is any unauthorized change in an instrument that attempts to modify, in any respect, the obligation of any party. This includes any unauthorized addition of words or numbers or other change to an incomplete instrument. U.C.C. §3407(a). [116]

B. **Allocation of loss in case of alteration:** In the absence of her own negligence, assent, or preclusion, a party who signs an instrument only promises to pay the instrument according to its terms at the time she signed the instrument. U.C.C. §3-412; U.C.C. §3-413(a); U.C.C. §3-414(b); U.C.C. §3-415(a). [117]

1. **Payment by drawee:** In the case of a check or other unaccepted draft, the allocation of loss does *not* depend on whether the drawee has paid or accepted the check or draft. If the drawee pays the check or draft, the drawee may debit the drawer's account only in the amount as originally drawn by the drawer unless the drawer is negligent or otherwise precluded from asserting the alteration. U.C.C. §4-401(d)(1). In the absence of grounds for precluding the drawer, the drawee may recover from any person obtaining payment or acceptance or any previous transferor for breach of the presentment warranty that the draft has not been altered. U.C.C. §3-417(a)(2); U.C.C. §4-208(a)(2). The party from whom the drawee recovers can recover from his transferor and any prior transferors for breach of their transfer warranty that the draft had not been altered. U.C.C. §3-416(a)(3); U.C.C. §4-207(a)(3). [117]

2. **When drawer, maker, or acceptor pays:** When the drawer, maker, or acceptor makes payment, the party making payment will suffer the loss if payment has been made to a protected person under U.C.C. §3-418(c). This is because no warranty is given to the drawer, maker, or acceptor that the instrument has not been altered. U.C.C. §3-417, Comment 4. [117-118]

3. **When instrument not paid:** If an instrument is not paid, the

person entitled to enforce the instrument may recover from any prior transferor for breach of its transfer warranty of no alteration. The person entitled to enforce the instrument may also recover, up to the amount for which the instrument was payable at the time of engagement, from prior indorsers, the maker, the drawer, or the acceptor on their respective obligations. U.C.C. §3-415(a); U.C.C. §3-412; U.C.C. §3-414(b); U.C.C. §3-413(a). [118]

C. Discharge of party whose obligation is affected: A fraudulently made alteration discharges a party whose obligation is affected by the alteration unless that party assents to the alteration or is precluded from asserting the alteration. Any transferee, other than one who takes the instrument for value, in good faith, and without notice of the alteration, also takes subject to the discharge. U.C.C. §3-407(c); U.C.C. §3-203(b). When an alteration is not fraudulent, the instrument may be enforced according to its original terms. U.C.C. §3-407(b). A payor bank, or other drawee, paying a fraudulently altered instrument or a person taking it for value, in good faith, and without notice of the alteration may enforce the instrument according to its original terms. U.C.C. §3-407(c); U.C.C. §3-407, Official Comment 2. [118]

D. Incomplete instruments: When the completion of an incomplete instrument is authorized, the instrument may be enforced as completed. U.C.C. §3-115(b). When the completion is unauthorized, a payor bank, acting in good faith, may enforce the instrument as completed. U.C.C. §3-407(c). Similarly, a person taking the instrument for value, in good faith, and without notice of the improper completion may enforce the instrument according to its terms as completed. U.C.C. §3-407(c). As to any other persons, the obligor is discharged and, therefore, is not liable on the instrument at all. U.C.C. §3-407(b). [118-119]

III. GROUNDS OF PRECLUSION

A. Ratification: An unauthorized signature may become effective as the signature of the person whose name is signed if ratified by that person. U.C.C. §3-403(a). [119]

B. Estoppel: A party may be estopped to deny the authenticity of a signature. U.C.C. §1-103 [Rev] U.C.C. 1-103(b). [119]

C. Preclusion through negligence: A person whose failure to exercise ordinary care substantially contributes to an alteration or to the making of a forged signature is precluded from asserting the alteration or forgery against a person who, in good faith, pays the instrument or takes it for value or for collection. U.C.C. §3-406(a). [119-120]

1. **Comparative negligence:** The negligent party may prove that the person asserting the preclusion failed to exercise ordinary care and that the failure substantially contributed to the loss. In this event, the loss is allocated according to principles of comparative negligence. U.C.C. §3-406(b). [120]

2. **Failure to exercise ordinary care:** The test as to whether a party has exercised ordinary care is the traditional tort test for negligence. [120]

   a. **Giving check to third party:** In some situations, the giving of a check to a third party for delivery to the payee so greatly increases the possibility of a forgery that the drawer will be precluded from asserting the subsequent forgery. [120]

   b. **Careless business practices:** Careless business practices can result in an increased possibility of forgery. [120]

   c. **Negligence in hiring or supervising employees:** An employer may also be precluded from denying the effectiveness of a signature forged by an employee if the employer has failed to exercise ordinary care in either hiring or supervising the employee. [120]

   d. **Guarding check forms:** It is unlikely that a court would hold a drawer to have failed to exercise ordinary care simply because he was not careful in guarding his blank check forms. [121]

   e. **Preventing alterations:** A party has a duty to use reasonable care in drawing or making an instrument such that it cannot be easily altered. U.C.C. §3-406, Official Comment 1. [121]

3. **Failure of payor bank to exercise ordinary care:** A drawer who

is precluded from asserting that a signature is unauthorized may attempt to prove that the payor bank also failed to exercise ordinary care so as to cause the loss to be split between them under the principle of comparative negligence. [121]

a. **Duty to discover forged indorsements:** When the payor bank is also the depositary bank or when the item is presented over the counter for payment, the bank fails to exercise ordinary care if it does not discover obvious irregularities in the identification of the person presenting the item for payment. Unless the payor bank is also the depositary bank, it is unlikely that it will be found to have failed to exercise ordinary care in failing to discover a forged indorsement. [121]

b. **When drawer's signature forged:** When there is an obvious forgery of the drawer's signature and the bank does not discover it because it processes checks for payment by computer without visually inspecting the checks, the fact that the payor bank does not visually examine the check does not mean that the payor bank is negligent as long as its procedure is reasonable and commonly followed by other comparable banks in the area. U.C.C. §4-406, Revised Official Comment 4. [121-122]

c. **Substantially contributes:** For the failure to exercise ordinary care to preclude the negligent party, the failure must substantially contribute to the making of the forgery or alteration. U.C.C. §3-406(a). This requires that the negligence must have been a contributing cause, and a significant factor, in enabling the forgery or alteration to have been made. U.C.C. §3-406, Official Comment 2. [122]

D. Impostors, fictitious payees, and employer's responsibility for unauthorized indorsements by employees

1. **The impostor rule:** An impostor is one who represents himself to be the named payee and by such representation induces the issuer to issue the instrument to him or to a person acting in concert with him. A person is also an impostor if she falsely represents herself to be the agent of the named payee. U.C.C. §3-404(a). The impostor rule applies whether the impostor acts in person, by mail, by

telephone, or otherwise. U.C.C. §3-404(a). [122-123]

a. **Need for indorsement:** An indorsement by any person in the name of the payee is effective in favor of a person who, in good faith, pays the instrument or takes it for value or for collection. U.C.C. §3-404(a). As long as the instrument is deposited in a depositary bank to an account in a name substantially similar to that of the payee, the depositary bank is the holder of the instrument regardless of whether the instrument is indorsed. U.C.C. §3-404(c)(ii). [123]

b. **Who may assert that the indorsement is effective:** An indorsement by any person in the name of the payee is effective to negotiate the instrument, thus making the indorsee the holder. [123-124]

i. **Good faith required:** A payor or taker who does not act in good faith may not assert that the indorsement is effective. U.C.C. §3-404(b)(2). [124]

ii. **Comparative negligence:** When the taker or payor is negligent, the loss is allocated under comparative negligence principles between the drawer and the negligent party. U.C.C. §3-404(d); U.C.C. §3-404, Official Comment 3. [124]

2. **Fictitious payee rule:** There are three distinct situations in which a payee is regarded as a fictitious payee: [124]

- **Nonexistent payee:** The person identified as the payee does not, in fact, exist. U.C.C. §3-404(b)(ii). [124]
- **Payee intended to have no interest:** The maker or drawer issues an instrument intending that the named payee have no interest in the instrument. U.C.C. §3-404(b)(i). [124]
- **Employee signing instrument intends payee to have no interest:** An agent, employee, or officer signs on behalf of the drawer or maker intending the payee to have no interest in the instrument. [124]

a. **Relevant intent is of party making signature:** In determining whether a payee is a fictitious payee, it is necessary to look at the intent of the person whose intent determines to whom an instrument is payable as determined under U.C.C. §3-110(a), (b). [124-125]

b. **Form of required indorsement:** The same rules as to the need for an indorsement governing impostors also apply to fictitious payees except that because no person was the intended payee, any person in possession of the instrument is its holder. U.C.C. §3-404(b)(1). [125]

c. **Who may assert that the indorsement is effective:** The same rule applies as in the case of impostors. [125]

d. **Double forgeries:** When a person who forges the drawer's name also intends that the payee have no interest in the check, the payee is a fictitious payee. U.C.C. §3-404, Official Comment 2, Case #4. As a result, the payor bank, rather than the depositary bank, suffers the loss when there is both a forged drawer's signature and a forged indorsement. [125]

3. **Employer's responsibility for fraudulent indorsement by employee:** When an employer hires an employee and gives the employee responsibility regarding instruments, the employer is liable when the employee makes a fraudulent indorsement. A "***fraudulent indorsement*** " is either (1) an indorsement made in the name of the employer on an instrument payable to the employer; or (2) an indorsement in the name of the payee on an instrument issued by the employer. U.C.C. §3-405(a)(2). [125]

a. **Rule:** An indorsement in the name of the payee is effective in favor of any person who in good faith pays an instrument or takes it for value or for collection whenever an employer entrusts an employee with responsibility with respect to the instrument, and the employee, or a person acting in concert with him, makes a fraudulent indorsement. U.C.C. §3-405(b). [126]

b. **Need for indorsement:** The requirements are the same as in the case of impostors. U.C.C. §3-405(b), (c). [126]

c. **Contributory negligence:** If the person paying, or taking, the instrument fails to exercise ordinary care and the failure substantially contributes to the loss, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent that her failure contributed to the loss. U.C.C. §3-405, Official Comments 2 and 4. [126]

d. **Employee must have responsibility with respect to instruments:** For the indorsement to be effective under this rule, the employer must entrust an employee with responsibility with respect to instruments. U.C.C. §3-405(a)(1); U.C.C. §3-405(b). Responsibility means authority to do any of the following:

- sign or indorse instruments on behalf of the employer;
- process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition;
- prepare or process instruments for issue in the name of the employer;
- supply information for determining the names or addresses of payees;
- control the disposition of instruments issued in the name of the employer;
- act otherwise with respect to instruments in a responsible capacity. U.C.C. §3-405(a)(3).

An employee does not have responsibility with respect to an instrument just because he has access to instruments, or to blank or incomplete forms, as part of incoming or outgoing mail or otherwise. U.C.C. §3-405(3). [126-127]

E. **Customer's duty to review bank statement:** Certain duties are imposed on a customer if its bank sends, or makes available, to the customer a statement of account showing payment of items for her account. To trigger these duties, the bank must either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer to reasonably identify the items paid. U.C.C. §4-406(a). When neither the item nor its image is returned, the bank fulfills its duty to provide sufficient information if it gives to the customer the number of the item, its amount, and the date of payment. U.C.C. §4-406(a); U.C.C. §4-406, Revised Official Comment 1. [127]

1. **Customer's duty to examine bank statement:** Once the bank sends, or makes available, a statement of account or the items themselves, the customer has the duty to exercise reasonable promptness in examining the statement or the items to determine whether any payment was unauthorized due to an alteration or because a purported signature by, or on behalf of, the customer was unauthorized. If the customer should reasonably have discovered the unauthorized payment from the statement or items provided, the customer must promptly notify the bank of the relevant facts. U.C.C. §4-406(c); U.C.C. §4-406, Revised Official Comment 1. [127-128]

2. **Duty of bank to prove loss:** Even when a customer fails to reasonably discover or report a forgery or alteration, the customer is only precluded from asserting its unauthorized signature or alteration if the bank proves that it suffered a loss by reason of the failure. U.C.C. §4-406(d)(1); U.C.C. §4-406, Revised Official Comment 2. [128]

3. **Forgery or alteration by same wrongdoer:** The customer is also precluded from asserting an unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank before it received notice from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank. U.C.C. §4-406(d)(2); U.C.C. §4-406, Revised Official Comment 2. [128]

4. **Good faith and comparative negligence:** If the customer proves that the bank failed to act in good faith in paying an item, the loss falls completely on the bank. U.C.C. §4-406(e); U.C.C. §4-406, Revised Official Comment 2. In addition, the doctrine of comparative negligence applies to split the loss in the event that the bank has failed to exercise ordinary care in paying the item and that

the failure substantially contributed to the loss. U.C.C. §4-406(e); U.C.C. §4-406, Revised Official Comment 2. [128]

5. **1-year preclusion:** If the customer does not discover and report the customer's unauthorized signature or any alteration on an item within 1 year after the statement or item is made available to the customer, the customer is precluded from asserting the alteration or unauthorized signature against the bank whether or not the bank exercised ordinary care. U.C.C. §4-406(f). [128-129]

6. **Duty of payor bank to raise defenses:** When a payor bank has the right to debit its customer's account because the customer is precluded under U.C.C. §3-406 or §4-406, the payor bank is not allowed to shift the loss from its customer to the presenting or depositary bank by recrediting the customer's account and recovering from the presenting bank for breach of its presentment warranty. U.C.C. §4-406(f); U.C.C. §4-406, Official Comment 5; U.C.C. §4-208(c); U.C.C. §4-406, Revised Official Comment 5. [129]

IV. RESTRICTIVE INDORSEMENTS

A. **Introduction:** A "***restrictive indorsement*** " is an indorsement written by, or on behalf of, the holder that limits negotiation of the instrument to a specific use. [129]

B. **Two types of restrictive indorsements:**

1. **For deposit:** An indorsement that signifies a purpose of deposit or collection is a restrictive indorsement. U.C.C. §3-206(c). A "***for deposit*** " indorsement indicates that the proceeds of the instrument can be credited only to the indorser's bank account. A blank "***for collection*** " indorsement or a "for collection" indorsement that specifically designates a bank also similarly indicates an intention that the proceeds be deposited into the indorser's bank account. [129]

2. **Trust indorsement:** An indorsement that states that payment is to be made to the indorsee as agent, trustee, or other fiduciary for the

benefit of the indorser or another person ("***trust indorsement*** ") is a restrictive indorsement. U.C.C. §3-206(d). [129]

C. Effect of "for deposit" or "for collection" indorsement: Any bank in the bank collection process, except a depositary bank, may disregard a "for deposit" or similar indorsement. U.C.C. §3-206(c)(4). The depositary bank, whether it purchases the instrument or takes it for collection, converts the instrument unless it pays the indorser or applies the proceeds consistently with the indorsement by applying it to the indorser's account. U.C.C. §3-206(c)(2). The depositary bank can only become a holder in due course to the extent that it applies the funds for the indorser's benefit. U.C.C. §3-206(e). This even applies to a depositary bank that is also the payor bank. When a check is presented for immediate payment over the counter, the payor bank is liable for conversion unless the funds are received by the indorser. [130]

1. **Bank must credit proper account:** To be consistent with the terms of a "for deposit" indorsement, the depositary bank must credit the bank account designated by the indorser. [130]

2. **Nonbank:** Any person, other than a bank, who purchases an instrument restrictively indorsed for collection or deposit is treated just like the depositary bank. U.C.C. §3-206(c)(1); U.C.C. §3-206, Official Comment 3. [130]

D. Effect of trust indorsement: When the taker or payor deals directly with the indorsee, unless the taker has ***notice*** of the indorsee's breach of fiduciary duty, the payor can pay, or the taker can apply its value, without regard to whether the indorsee is violating a fiduciary duty to the indorser. U.C.C. §3-206(d)(1). A person who does not take the instrument directly from the indorsee is neither given notice nor otherwise affected by the restriction contained in the indorsement unless it *knows* that the fiduciary dealt with the instrument or its proceeds in breach of his fiduciary duty. U.C.C. §3-206(d)(2). A payor that makes payment of the check is only liable for conversion if it has actual knowledge that the indorsee has misused the funds. [130-131]

Chapter 5
PAYOR BANK/CUSTOMER RELATIONSHIP

I. WHEN ITEM PROPERLY PAYABLE

A. Introduction: A payor bank may charge against its customer's account only items that are ***properly payable.*** An item is properly payable if it is both authorized by the customer and complies with the bank/customer agreement. U.C.C. §4-401(a); U.C.C. §4-401, Official Comment 1. [141]

B. Items creating overdrafts: The bank may charge its customer's account for an item, even though it creates an overdraft, as long as the item is otherwise properly payable. U.C.C. §4-401(a); U.C.C. §4-401, Official Comment 1. Although having the right, the bank has no duty to pay an item that creates an overdraft, absent an agreement to the contrary. U.C.C. §4-402(a). [142]

C. Postdated checks: A payor bank may charge against its customer's account a check that is otherwise properly payable, even though payment was issued before the date of the check. U.C.C. §4-401(c). The payor bank may not properly pay a postdated check prior to its date if the customer has given notice to the bank of the postdating. The procedure for giving notice of postdating and the consequences of the bank paying a check contrary to a proper notice of postdating is the same as for placing a stop payment order on an item. U.C.C. §4-401(c), U.C.C. §4-401(c). [142]

D. Bank not obligated to pay check 6 months old: A bank is under no obligation to its customer to pay a check presented more than 6 months after its date (a ***stale check***). If in good faith, a bank may pay a stale check and charge its customer's account for the amount of the check. U.C.C. §4-404. [142-143]

E. Bank's right of set-off: The bank has the right to set off against its customer's account any matured debt the customer owes to the bank. Set-off is available only if both the debt the customer owes the bank and the debt the bank owes the customer have matured. There is no requirement that the bank give notice within any specified time before, or after, the set-off absent a statutory requirement. [143-144]

F. **Death or incompetence of customer:** A customer's death or incompetence does not revoke the bank's authority to pay or collect an item or account for proceeds of its collection until the bank knows of the death or the adjudication of incompetence and has a reasonable opportunity to act on it. U.C.C. §4-405(a). Even after the bank learns of its customer's death, the bank may, for 10 days after the date of death, pay a check, unless the bank is ordered to stop payment by a person claiming an interest in the account. U.C.C. §4-405(b). Although a bank can pay a check after the customer's death, the bank has no duty to pay the check. [144-145]

II. VARIATION BY AGREEMENT

A. **Introduction:** Because Article 4 is not a regulatory statute, it neither regulates the terms of, nor prescribes consumer protection constraints on, bank/customer agreements. U.C.C. §4-101, Official Comment 3. Although such an agreement may set the standards by which the bank's responsibility is to be measured, if those standards are not manifestly unreasonable, such an agreement may not disclaim a bank's liability for its own lack of good faith or failure to exercise ordinary care or limit the measure of damages resulting from its lack of good faith or failure to exercise ordinary care. U.C.C. §4-103(a). [145]

III. WRONGFUL DISHONOR

A. **Bank's liability:** A payor bank is liable to its customer for wrongful dishonor if it dishonors an item that is properly payable. However, a payor bank has no duty to pay an item that, although properly payable, would create an overdraft. U.C.C. §4-402(a). [146]

B. **Pivotal issue is whether sufficient funds are in the account:** In determining whether an item has been wrongfully dishonored, the pivotal question is whether there are adequate funds in the customer's account to cover payment of the dishonored item. The bank wrongfully dishonors a check if the reason that the customer's account did not contain sufficient funds was that the bank wrongfully debited the account as a result of, for example, a wrongful set-off, an improper honoring of a writ of garnishment, or the payment of a check bearing a forged signature. [146]

1. **Bank may pay checks in any order:** The payor bank has the right to pay checks drawn on its customer's account in any order that it desires. U.C.C. §4-303(b). [146]

2. **Time for determining whether sufficient funds exist:** A bank need only examine a customer's account once in deciding whether to dishonor an item for insufficient funds. U.C.C. §4-402(c). Any credits added to the customer's account after the bank has examined the account are not considered in determining whether the account contains sufficient funds. U.C.C. §4-402, Official Comment 4. [146]

C. **Duty owed only to customer:** A bank is liable only to its customer for wrongful dishonor of an item. U.C.C. §4-402(b). [146]

1. **Payee has no right:** A payee or other holder of the item has no cause of action against the bank for wrongful dishonor of an item. [146]

2. **Corporate officers or partners not customers:** Because "***customer*** " is defined to include organizations, when a check drawn on a corporate, trust, or partnership account is dishonored, the person having the right to sue for the wrongful dishonor is the corporation, trust, or partnership and not the corporate officer, trustee, or partner who signed the check. However, nothing in Article 4 displaces any common law cause of action the officer, trustee, or partner may have against the bank. U.C.C. §4-402, Official Comment 5. [146-147]

D. **Damages:** A payor bank that wrongfully dishonors an item is liable to its customer for all damages proximately caused by the wrongful dishonor. U.C.C. §4-402(b). Damages may include loss of profits, damage to reputation, emotional distress damages, and punitive damages. U.C.C. §4-402, Official Comment 1. [147]

IV. CUSTOMER'S RIGHT TO STOP PAYMENT

A. Introduction: A customer has the right to stop payment of any item drawn on its account. U.C.C. §4-403(a). When there are two or more persons, each of whom is individually entitled to write items on an account, any of these persons may order payment stopped even if she is not the person who signed the item. U.C.C. §4-403, Official Comment 5. Neither a payee, an indorsee, nor a remitter has a right to stop payment on a check or other item. U.C.C. §4-403, Official Comments 2, 4. [147-148]

B. Requirements for stop payment order: To be effective, a stop payment order describing the item with reasonable certainty must be received at a time and in a manner that affords the bank a reasonable opportunity to act on the order before any of the actions described in U.C.C. §4-403(a) have been taken by the bank with respect to the item. The information that a bank may require a customer to supply is the information that the bank must have under current technology to identify the item with reasonable certainty. Most banks require that the customer supply either the precise amount of the check or the number of the check. U.C.C. §4-403, Official Comment 5. A stop payment order may be either written or oral. A written stop payment order is effective for 6 months from the date that it is given, whereas an oral stop payment lapses after 14 calendar days. U.C.C. §4-403(b). [148-149]

2002 amendment: The 2002 amendments substitute the term "record" for "writing." A "***record*** " is "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." [Rev] U.C.C. §3-103(a)(14). [149]

C. Timeliness of stop payment orders: Under U.C.C. §4-303(a), a stop payment order arrives too late to terminate the bank's right or duty to pay an item if it comes after any of certain events. These events include:

- When the bank accepts or certifies an item.
- When the bank has paid the item (which includes payment in cash and as well as the bank's settlement for the item without having a right to revoke the settlement under statute, clearinghouse rule, or agreement).
- When a bank becomes accountable for the amount of the item under U.C.C. §4-302.
- When, with respect to checks only, the stop payment order arrives after a cut-off hour established by the bank or, if no cut-off hour has been established, after the close of the next banking day after the banking day on which the bank receives the check. A bank may not establish a cut-off hour earlier than 1 hour after the opening of the next banking day following the banking day on which the bank received the check. U.C.C. §4-303(a). [149-150]

1. **Reasonable time to act:** Because a bank needs time to process stop payment orders and other legals (except for set-offs), the stop payment order must arrive early enough to give the bank a reasonable time to act on it prior to the time that the bank has done any of the specified acts. U.C.C. §4-303(a). Considering the pervasive presence of computers, "reasonable time" is probably a relatively short period. U.C.C. §4-303, Official Comment 6. Branches or separate offices of banks are treated as separate banks for most purposes, including for computing the time within which an action must be taken, in determining where an action may be taken or directed, or where notices or orders must be given. U.C.C. §4-107. [150]

2. **Effect of stop payment order arriving on time:** If the stop payment order arrives prior to any of the specified events, the payor bank has neither the right to pay the check nor a duty to the drawer to pay the check. The bank is liable to the drawer if, in spite of the timely stop payment order, it pays the check. [150-151]

3. **Effect of stop payment order arriving too late:** If a stop payment order comes too late, the payor bank has the right to pay the check

or other item and incurs no liability to the drawer if it does so. However, the payor bank does not have to pay the check in that it may waive its right. The payor bank, thus, has the option as to whether or not to honor the stop payment order up until the point at which it would be liable to the holder under U.C.C. §4-215 or U.C.C. §4-302(a) for not paying or returning the check. [151]

4. **Same rules apply to other legals:** The same rules apply to the other legals. These other legals include:

- Legal process, such as writs of garnishment or execution.
- The payor bank acquiring knowledge that the drawer has filed a petition in bankruptcy, died, or become incompetent.
- The bank's right to set off against the customer's account a debt owed to it by the customer.
- When a writ of attachment, garnishment, execution, or set-off comes in time, the bank no longer has a duty to the customer to pay the check. If it refuses to pay the check, the bank is not liable to its customer for wrongful dishonor. [149]

5. **Differences in consequences of legal arriving too late:** There is a minor difference in the consequences between a legal arriving too late and a stop payment order arriving too late. The payor bank is liable to the drawer if it refuses to pay an item when the attachment, garnishment, or set-off occurs or knowledge of bankruptcy is obtained after one of the same events applicable in the case of a stop payment order. The reason for this different treatment is that, unlike in the case of a stop payment order, the customer will not have waived the duty the bank owes to the customer to pay the item. [151]

D. **Damages for payment in violation of stop payment order:** A payor bank is liable to its customer for any damages suffered by the customer when it pays an item over a valid stop payment order. The burden of proving the amount of loss is placed on the customer. U.C.C. §4-403(c). The measure of damages is the difference between the amount paid by the bank and the amount that the customer would have been obligated to pay on the item had payment been stopped.

Losses from the payment of an item contrary to a stop payment order may also include damages for the wrongful dishonor of subsequent items. U.C.C. §4-403(c). [151-152]

E. Payor bank's right of subrogation on improper payment: When a payor bank makes a payment for which it cannot debit its customer's account, to prevent unjust enrichment, the bank is subrogated to the rights of any party who otherwise would be unjustly enriched. [152]

1. What constitutes improper payment: The bank's subrogation rights arise when a payor bank has paid a check or other item in any situation in which it cannot properly debit its customer's account. These situations include, among others, the following:

- payment in violation of a valid stop payment order
- early payment of a postdated check in violation of a proper notice of the postdating, U.C.C. §4-401(c)
- payment, with knowledge of its customer's death, of a check more than 10 days after the death, U.C.C. §4-405(b) [152]

2. Payor bank subrogated to other parties' rights against drawer: To prevent the drawer from being unjustly enriched, the payor bank is subrogated to the rights of any holder in due course of the item against the drawer, U.C.C. §4-407(1), or of the payee or any other holder of the item against the drawer either on the item or from the transaction out of which the item arose. U.C.C. §4-407(2). [152-153]

3. Payor bank subrogated to drawer's rights: To prevent the payee or other holder from being unjustly enriched, the payor bank is also subrogated to the drawer's rights against the payee or any other holder of the item with respect to the transaction out of which the item arose. U.C.C. §4-407(3). [153]

V. FUNDS AVAILABILITY UNDER REGULATION CC

A. Mandatory availability schedule: Regulation CC provides mandatory availability schedules under which depositary banks must permit their depositors use of deposited funds within certain expedited deadlines. 12 C.F.R. §229.14(a). The mandatory availability schedule provides reasonable time periods within which a customer must be allowed use of the funds represented by a deposit corresponding with the likely time within which the bank would obtain notice of the item's nonpayment. [154]

1. **Provide maximum hold time only:** A depositary bank may allow its customer immediate use of funds deposited even though it has the right to delay availability of the funds under the mandatory availability schedule. 12 C.F.R. §229.19(c), app. E at 493 (1995). [154]

2. **Subject to chargeback:** The depositary bank's obligation to make funds available to its customer is subject to its right to charge back the customer's account in the event that the check is returned unpaid. [154]

B. **Funds subject to next-day availability:** The following types of deposits must be given next-day availability:

- cash deposits made directly to a teller
- deposits by electronic payment
- deposit of a United States government check, e.g., Federal Reserve Bank or U.S. Treasury check
- deposit of a state or local government check
- deposit of a cashier's check, certified check, or teller's check in person
- deposit of an on-us check
- $100 of the aggregate amount of all checks deposited (not counting those that are otherwise entitled to next-day availability) in any one banking day. 12 C.F.R. §229.10. [154-155]

C. **Second-day and fifth-day availability:** When a check is not entitled to next-day availability, it is entitled to availability either on the second or fifth business day after its deposit depending on whether the check is a local or nonlocal check.

1. Funds from a deposit of a local check must be made available on the second business day following the banking day of deposit. 12

C.F.R. §229.12(b)(1).

2. Funds from a deposit of a nonlocal check must be made available on the fifth business day following the banking day of deposit. 12 C.F.R. §229.12(c)(1)(i). [155]

D. Extensions of mandatory availability schedule: There are several situations in which the mandatory availability schedule can be extended for a reasonable period of time, which is presumed to be 5 business days for local checks and 6 business days for nonlocal checks. 12 C.F.R. §229.13(h). [155]

1. **Extension for cash withdrawal:** The time within which funds must be made available may be extended for 1 business day for funds represented by deposited checks if the depositor attempts to withdraw the funds in cash or by similar means. 12 C.F.R. §229.12(d). [155]

2. **New account exception:** The time within which funds must be made available can be extended when the funds are deposited in a new account. 12 C.F.R. §229.13(a). [155]

3. **Large deposit exception:** A bank may extend the hold for local and nonlocal checks to the extent that the aggregate deposit on any banking day is more than $5,000. The mandatory availability schedule still applies to the first $5,000 of deposits on that day. 12 C.F.R. §229.13(b). [156]

4. **Returned and redeposited check exception:** There is an exception for previously returned and redeposited checks because when a check has been dishonored once, there is a good chance that it will be dishonored again. 12 C.F.R. §229.13(c). [156]

5. **Repeatedly overdrawn exception:** This exception applies whenever any account or combination of accounts of a single customer has been repeatedly overdrawn. 12 C.F.R. §229.13(d). [156]

6. **Reasonable cause to doubt collectability exception:** This exception applies when the bank has reasonable cause to doubt that the check will be collected. 12 C.F.R. §229.13(e). [156]

7. **Emergency condition exception:** This exception is applicable in emergency conditions when there is an interruption of communications or computer or other equipment facilities, suspension of payments by another bank, war, or other emergency conditions beyond the control of the depositary bank. 12 C.F.R. §229.13(f). [156]

8. **Automated teller machines ("ATMs"):** Deposits of cash in a night depositary or at an ATM owned or controlled by the depositary bank are entitled to second-day availability. Deposits of cash or checks deposited in an ATM not owned or controlled by the depositary bank are entitled to fifth-day availability. 12 C.F.R. §229.12(f). [156]

E. Availability under Article 4: Article 4 or other state availability laws govern to the extent that they allow quicker availability of funds than allowed under Regulation CC. 12 C.F.R. §229.20(a). Because U.C.C. §4-214(f) makes a deposit of cash available at the opening of the bank's next banking day after receipt, it prevails over Regulation CC as to cash deposited by mail, in a night depositary, or in an ATM owned by the depositary bank. [156]

CHAPTER 6
THE BANK COLLECTION PROCESS

I. INTRODUCTION TO THE CHECK COLLECTION PROCESS

A. Introduction: The process by which the holder of a check converts the check into cash when he deposits the check into his bank account and his bank, acting as his agent, either directly or through one or more other banks, presents the check to, and obtains payment from, the bank on which the check is drawn is called the "***check collection process.*** " [161]

B. Types of banks under Article 4: Article 4 classifies banks into five categories.

1. **Payor bank:** A "payor bank" is "a bank that is a drawee of a draft." U.C.C. §4-105(3). [162]

2. **Depositary bank:** A "depositary bank" is "the first bank to take an item even though it is also the payor bank unless the item is presented for immediate payment over the counter." U.C.C. §4-105(2). [162]

3. **Collecting bank:** A "collecting bank" is "any bank handling an item for collection except the payor bank." U.C.C. §4-105(5). A depositary bank, as long as it is not also the payor bank, is a collecting bank. [162]

4. **Intermediary bank:** An "intermediary bank" is "any bank to which an item is transferred in the course of collection except the depositary or payor bank." U.C.C. §4-105(4). [162]

5. **Presenting bank:** A "presenting bank" is "any bank presenting an item except a payor bank." U.C.C. §4-105(6). [162-163]

C. Types of banks under Regulation CC: Regulation CC has created two classifications of banks.

1. **Paying bank:** Under Regulation CC, paying banks have duties

above and beyond those imposed on payor banks under Article 4. “Paying bank” is a broader concept than “payor bank.” The definition of a “paying bank” includes the bank whose routing number appears on a check even if it is not the true drawee bank. In addition, for bank collection functions, a bank through which a check is payable is a paying bank, even if the check is drawn on another bank. 12 C.F.R. §229.2(z). [163]

2. **Returning bank:** A “returning bank” is any bank other than the paying or depositary bank that handles the item on its return. 12 C.F.R. §229.2(cc). [163]

II. LAW GOVERNING THE CHECK COLLECTION PROCESS

A. **Introduction:** The bank collection aspects of Article 4 have been preempted to a fairly substantial extent by Congress's enactment of the Expedited Funds Availability Act, 12 U.S.C. §§4001 et seq., and by the Federal Reserve Board's promulgation of Regulation CC thereunder. To a lesser degree, Article 4 is preempted by Regulation J, which was promulgated under the authority granted to the Board of Governors of the Federal Reserve System by the Federal Reserve Act. 12 U.S.C. §§221 et seq. Regulation J's rules largely resemble Article 4's rules. When a check is sent for collection through a Federal Reserve Bank, both Regulations J and CC apply. When a check is not collected through a Federal Reserve Bank, only Regulation CC applies. When an item, other than a check, is collected through a Federal Reserve Bank, only Regulation J applies. When an item, other than a check, is not collected through a Federal Reserve Bank, neither Regulation J nor CC applies. [163-164]

III. VARIATION BY AGREEMENT

The rules set out in Article 4 and in Regulation CC can be varied by an agreement between the affected parties. U.C.C. §4-103(a); 12 C.F.R. §229.37. With rare exception, as long as the agreement is with respect to the item being handled, the bank's customer (usually the owner of the item) is bound by any agreement that is made by the bank in the process of collecting the item for him even though he is not a party to the agreement. U.C.C. §4-103, Official Comment 3. ***Clearinghouse rules*** have the effect of agreements varying the rules of Article 4 for items collected through the clearinghouse, whether or not specifically assented to by all parties interested in the items handled. U.C.C. §4-103(b); U.C.C. §4-103, Official Comment 3. [164]

IV. DUTIES OF PAYOR BANK

A. Duty to pay or settle on day of presentment: When a check is presented for payment, the payor bank can either pay or return the check on the day of presentment or defer posting of the check. When a payor bank defers posting of a check, the bank waits until the next banking day to decide whether to pay or return the check. To defer posting a check, the payor bank must settle with the presenting bank before midnight of the banking day of receipt or before any earlier time required by Regulation CC or J. This settlement can be revoked if the payor bank decides the next day to return the check. U.C.C. §4-301(a). [164-165]

1. **Exception for immediate payment over the counter:** When a demand item is presented for immediate payment over the counter, a payor bank has no right to defer its decision as to whether to pay the item. U.C.C. §4-301(a); U.C.C. §4-301, Official Comment 2. [165]

2. **Exception for "on-us" checks:** A payor bank does not need to provisionally settle for an ***on-us*** check on the day of receipt to have the right to defer the decision as to whether to pay or return the on-us item until the next banking day. U.C.C. §4-301(b); U.C.C. §4-301, Official Comment 4. [165]

3. **Failure to settle for demand item on day of receipt:** If the payor bank neither settles for the item nor returns the item by midnight of the banking day of receipt, the payor bank is penalized by being made accountable (liable) for the amount of the item. U.C.C. §4-302(a)(1). [165]

4. **Means of dishonoring item:** If the payor bank, after properly settling for the item on the day of its receipt, decides that it will not pay the item, it may revoke the settlement and recover the payment if it returns the item before it has finally paid the item and before its ***midnight deadline***. U.C.C. §4-301(a)(1), (2). [165]

   a. **Cut-off hour:** A bank may fix 2:00 P.M. or later as a ***cut-off hour*** for the handling of money and items and the making of entries on its books. The bank may treat any item received after the cut-off hour as having been received on the next banking day. U.C.C. §4-108(a), (b). [165-166]

   b. **Extensions of midnight deadline for emergencies:** A payor bank may be excused from failing to meet the midnight deadline when:

      - unanticipated circumstances beyond the bank's control prevented it from doing so;
      - the circumstances could not be prevented by the bank through the exercise of reasonable care; and
      - the bank exercised such reasonable diligence as the circumstances required in both anticipating the effects of any foreseeable events and in dealing with the circumstances once they arose. U.C.C. §4-109(b); 12 C.F.R. §229.38(e). [166]

   c. **Special extensions under Regulation CC:** Regulation CC specifically provides for extensions of the midnight deadline in returning a check in two situations:

      i. **Rapid means of return:** The midnight deadline is extended by 1 day if the paying bank uses a means of delivery that would ordinarily result in the check being received by the bank to which it is sent on or before the next banking day following the midnight deadline. 12 C.F.R. §229.30(c)(1). [166]

      ii. **Highly expeditious means:** The midnight deadline is extended further if a paying bank uses a highly expeditious means of transportation, even if this means of transportation would ordinarily result in delivery after the receiving bank's next banking day. 12 C.F.R. §229.30(c)(1). [166-167]

5. **Manner of payment:** Because the payor bank has already settled for the item on the day of its receipt, once the midnight deadline (or any earlier deadline set by agreement, clearinghouse rule, Federal Reserve regulation, or circular) has passed, the check is deemed to be paid. U.C.C. §4-215(a)(3). At this point, the payor bank is precluded from revoking its settlement. U.C.C. §4-301(a). [167]

6. **Failure to settle or timely return item:** If the payor bank fails to settle for a demand item on the day of receipt or fails to pay or return the item by its midnight deadline, the bank becomes accountable for the item whether or not the item is properly payable. U.C.C. §4-302(a)(1). The payor bank may defend against its accountability for the item under the same conditions that it could recover, under U.C.C. §3-418(d), a payment made by mistake. In addition, the payor bank may defend by proving that the presenter breached one of the presentment warranties or by proving that the presenter presented or transferred the check intending to defraud the payor bank. U.C.C. §4-302(b); U.C.C. §4-302, Official Comment 3. [167]

2002 amendments: A new [Rev] U.C.C. §4-301(a)(2) has been added to encourage the electronic processing of checks. Under this new subsection, an image of the item, rather than the item itself, may be returned if the party to which the item is to be returned has entered into an agreement under which it will accept an image as return of the item and the image is returned in accordance with the agreement. As a result, the holder may not claim that because the item itself was not returned, the payor bank has missed its midnight deadline, thereby making the payment final as to all parties. [Rev] U.C.C. §4-301, Official Comment 8. Original [Rev] U.C.C. §4-301(a)(2) has been renumbered as (a)(3). In addition, the payor bank may, instead of sending a "written notice" of dishonor or nonpayment send a "record." [167-168]

Note: The 2002 amendments define "***record*** " in [Rev] U.C.C. §3-103(a)(14) as "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.” [168]

7. **Payor bank's liability on documentary drafts and items not payable on demand:** A payor bank is accountable for the amount of a documentary draft (whether payable on demand or at a stated time) or other item not payable on demand only if the item is properly payable and the payor bank does not pay or accept the item or return it and any accompanying documents within the time limits allowed. U.C.C. §4-302(a)(2). [168]

8. **Final payment:** When the payor bank finally pays an item, the payment process has been completed. The payor bank may no longer revoke its settlement. The depositary bank becomes accountable to its customer for the amount of the item. U.C.C. §4-215(d). The drawer and indorsers are discharged from liability. U.C.C. §4-215, Comment 8. [168]

9. **Acts constituting final payment:** The payor bank finally pays an item when it has done any one of three acts:

   a. **Pays in cash:** A payor bank finally pays an item when it makes payment in cash. [168-169]

   b. **Settles for item without reserving right to revoke:** A payor bank finally pays an item when the bank settles for the item without reserving a right to revoke the settlement under statute, clearinghouse rule, or agreement. Article 4 gives the payor bank an automatic right to revoke a settlement it has made if it meets the requirements specified in U.C.C. §4-301. U.C.C. §4-215, Official Comment 4. This does not apply to checks presented for payment over the counter. [169]

   c. **Fails to revoke provisional settlement by midnight deadline:** A payor bank finally pays an item when the bank has made a provisional settlement for the item and fails to revoke the settlement by the midnight deadline (or an earlier time established by clearinghouse rule or agreement). U.C.C. §4-215(a). [169]

10. **Duties of paying banks under Regulation CC in returning unpaid items:** Regulation CC imposes two duties on a paying bank

to ensure that the depositary bank quickly learns of a check's dishonor: the "***duty to expeditiously return*** unpaid items and the duty to give "prompt ***notice of the nonpayment*** of any item" in the amount of $2,500 or greater. [169]

a. Duty of expeditious return: A paying bank may meet either of two tests to satisfy its duty of expeditious return: the ***2-day/4-day test*** or the ***forward collection test.*** 12 C.F.R. §229.30(a). [170]

i. 2-day/4-day test: The 2-day/4-day test requires that the paying bank return an item in a manner such that the item will normally be received by the depositary bank within certain time limits. 12 C.F.R. §229.30(a)(1). [170]

- The time limit for the depositary bank to receive the return of a local check is not later than 4:00 P.M. on the second business day after the check was presented to the paying bank. 12 C.F.R. §229.30(a)(1)(i).
- The time limit for the depositary bank to receive the return of a nonlocal check is not later than 4:00 P.M. on the fourth business day after presentment. 12 C.F.R. §229.30(a)(1)(ii).

ii. The forward collection test: The forward collection test provides that a paying bank returns a check in an expeditious manner if it does so in a manner in which a similarly situated bank would normally handle a check drawn on the depositary bank and deposited for forward collection in that bank by noon on the banking day following the banking day on which the check was presented to the paying bank. 12 C.F.R. §229.30(a)(2)(iii). [170-171]

b. Duty to send notice of nonpayment: The paying bank has a duty to send notice of the nonpayment of any check in the amount of $2,500 or greater directly to the depositary bank. 12 C.F.R. §229.33(a). The notice may be communicated in any way as long as it is received by the depositary bank by 4:00 P.M. on the second business day following the banking day on which the check was presented to the paying bank. 12 C.F.R. §229.33(a).

[171]

c. **Liability for violation of paying bank's duties of expeditious return and notice of nonpayment:** A paying bank is liable for damages for breach of its duties of expeditious return or of transmitting notice of nonpayment only if the bank fails to exercise ordinary care or to act in good faith. 12 C.F.R. §229.38(a). A paying bank that violates its duty of ordinary care is liable to the injured party for the amount of the check less the amount of loss that would have been incurred had ordinary care been exercised. 12 C.F.R. §229.38(a). [171]

V. DUTIES OF COLLECTING BANKS

A. Collecting bank's status as agent: When a customer deposits an item into her bank account, the depositary bank automatically becomes the customer's agent for the purpose of collecting the item. U.C.C. §4-201(a). Subsequent collecting banks become the subagent for the customer. The agency status of the depositary bank and other collecting banks terminates when they finally settle for the item. U.C.C. §4-201(a); U.C.C. §4-214(a); U.C.C. §4-214, Official Comment 3. [172]

B. Right of chargeback: The depositary bank may charge back its customer's account, or obtain a refund for the amount of any provisional settlement given to the customer, if, for any reason, the item is not finally paid by the payor bank. U.C.C. §4-214(a). The right to chargeback exists even if the depositary bank's failure to exercise ordinary care in sending the item for collection caused the dishonor. The bank remains liable to the customer for any damages caused by its failure to exercise ordinary care in collecting the deposited item. U.C.C. §4-214(d)(2); U.C.C. §4-214, Official Comment 6. [172-173]

1. **Requirements for chargeback:** To exercise its right of chargeback or refund, the depositary bank must, by its midnight deadline (or within a longer reasonable time after it learns the facts), either return the item or send notification of the facts if the item is not available for return. U.C.C. §4-214(a). If the bank is both the depositary bank and the payor bank, it must act by its midnight deadline. U.C.C. §4-214(c); U.C.C. §4-301(a), (b). [173]

2. **Consequences of failing to meet requirements:** Even if the depositary bank fails to act within the required time, it may still revoke its settlement, charge back its customer's account, or obtain a refund. The only consequence of the untimely act is that it is liable for any loss to the customer resulting from the delay. U.C.C. §4-214(a); U.C.C. §4-214, Official Comment 3. [173]

C. **Duty of collecting bank to use ordinary care in collecting and returning items:** Collecting banks owe a duty of ordinary care to their customers in performing their collection and return duties. U.C.C. §4-202(a). A collecting bank must take proper action before its midnight deadline following receipt of the item, notice, or settlement. Taking action within a longer time may be considered reasonable, but the burden of establishing the timeliness of the action is on the collecting bank. U.C.C. §4-202(b); U.C.C. §4-202, Official Comment 3. As in the case of a payor bank, a collecting bank is allowed additional time in the case of emergencies. U.C.C. §4-109(b). The measure of damages for a collecting bank's failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount that could not have been realized by the use of ordinary care. On a showing of bad faith, damages may include any other damages the party has suffered as a proximate consequence. U.C.C. §4-103(e). [173-174]

D. **Electronic presentment:** ***Electronic presentment*** (or "***check truncation*** ") involves the transferring of the contents of the item through the information contained on the MICR-encoded line rather than transferring of the item itself. When an item is presented electronically, a "***presentment notice*** " is sent in the place of the item itself. U.C.C. §4-110(a). [174]

E. **Encoding warranties:** To enable a check to be processed by computer, the depositary bank must encode the face amount of the check on the MICR line. The depositary bank may, by mistake, encode the check in a greater amount than it is actually payable ("***overencoding*** ") or encode the check in a lesser amount than actually payable ("***underencoding*** "). To protect the payor bank and subsequent collecting banks from losses from the misencoding, any person who encodes information on an item warrants to any subsequent collecting bank and to the payor bank or other payor that the information is correctly encoded. U.C.C. §4-209(a). Under Regulation CC, any bank that handles a check or a returned check warrants that the encoded information is correct. 12 C.F.R. §229.34(c)(3). A person misencoding an item is liable to any person taking the item in good faith for the loss suffered, plus expenses and loss of interest incurred. U.C.C. §4-209(c); 12 C.F.R. §229.34(d). [174-175]

CHAPTER 7
WHOLESALE FUNDS TRANSFERS

I. WHAT IS A FUNDS TRANSFER?

A. Introduction: A "***funds transfer*** " is "the series of transactions, beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order." The term "funds transfer" includes all payment orders issued for the purpose of carrying out the originator's payment order. U.C.C. §4A-104(a). With certain exceptions, funds transfers are governed by Article 4A of the Uniform Commercial Code. U.C.C. §4A-102. [179]

B. Funds transfers must be between banks: A funds transfer is limited to payments made through the banking system. A transfer of funds by, or to, an entity other than a bank is excluded. U.C.C. §4A-104, Official Comment 2. [181]

C. Requirements for a payment order: To be a payment order, an instruction must meet the following three requirements:

1. **Unconditional:** The instruction cannot state a condition to the obligation to pay the beneficiary other than as to the time of payment. U.C.C. §4A-103(a)(1)(i).

2. **Reimbursed by sender:** The receiving bank must be paid or reimbursed by the sender. U.C.C. §4A-103(a)(1)(ii).

3. **Transmitted directly to receiving bank:** The instruction must be transmitted by the sender directly to the receiving bank. U.C.C. §4-103(a)(1)(iii). This requirement eliminates credit cards and checks from coverage under Article 4A. U.C.C. §4A-104, Official Comment 5. [181-182]

D. Consumer transactions excluded: The Electronic Fund Transfer Act of 1978 (EFTA) covers most consumer funds transfers. Article 4A does not apply to any transaction if any part of the transaction is covered by EFTA. U.C.C. §4A-108. [182]

II. PAYMENT OBLIGATIONS IN CHAIN OF TITLE

A. Introduction: Acceptance of a payment order by a receiving bank, other than the beneficiary's bank, obligates the sender to pay the bank the amount of the sender's order. U.C.C. §4A-402(c).The obligation of the sender is excused if the funds transfer is not completed because, for any reason, the beneficiary's bank does not accept the payment order. U.C.C. §4A-402(c). This is called a "***money-back guarantee***." U.C.C. §4A-402, Official Comment 2. When a payment order is issued to the beneficiary's bank, acceptance of the order by the beneficiary's bank obligates the sender to pay the beneficiary's bank the amount of the order. U.C.C. §4A-402(b); U.C.C. §4A-402, Official Comment 1. On acceptance by the beneficiary's bank, the obligation of the originator to pay the beneficiary on the underlying obligation is discharged and the obligation of the beneficiary's bank to pay the beneficiary is substituted for it. [182-183]

III. DUTIES AND LIABILITIES OF RECEIVING BANK

A. Introduction: A receiving bank is not obligated to accept a payment order. U.C.C. §4A-209, Official Comment 1. It has no duties until it accepts the order. U.C.C. §4A-212. The receiving bank (unless it is also the beneficiary's bank) accepts a payment order only when it executes the order. U.C.C. §4A-209(a). Because a receiving bank accepts the order only by executing it, notice of rejection is not necessary to avoid acceptance. [183]

B. Duty to issue payment order: A receiving bank, on the acceptance of a payment order, must issue a payment order on the execution date complying with the sender's order. U.C.C. §4A-302(a)(1). [183]

1. **Time when payment order can be accepted:** The originator's bank cannot accept the originator's payment order until the execution date. If the receiving bank is also the beneficiary's bank, it cannot accept the payment order until the payment date. U.C.C. §4A-209(d). [183-184]

2. **Damages for breach of duty by receiving bank:** If the receiving

bank breaches its duty to properly execute an order, the receiving bank is liable for the sender's expenses in the funds transfer and for incidental expenses and interest lost as a result of its failure to properly execute the order. Absent an express written agreement to the contrary, consequential damages are not available to the sender. U.C.C. §4A-305(a), (b), (d). [184]

C. Erroneous execution of payment order

1. **Duplicative order, order in greater amount than authorized, or order to wrong beneficiary:** When the receiving bank executes a payment order in an amount greater than the amount of sender's order, issues a duplicate order to the beneficiary, or issues an order to the wrong beneficiary, the sender, not having authorized these erroneous orders, is only obligated to reimburse the receiving bank for whatever payment was properly made according to the sender's original order. U.C.C. §4A-303(a), (c); U.C.C. §4A-402(c). [184]

   a. **Recovery from recipient:** Whether the receiving bank can recover the excess payment from the beneficiary or the improper payment from the recipient depends on the common law governing mistake and restitution. U.C.C. §4A-303(a). Courts apply two rules in determining whether the receiving bank may recover from the beneficiary. [184]

      i. **Mistake of fact rule:** Under the ***mistake of fact rule*** , the receiving bank may recover from the beneficiary unless the beneficiary has detrimentally relied on the payment. [184]

      ii. **Discharge for value rule:** Under the ***discharge for value rule*** , the beneficiary (or recipient) is entitled to retain the funds as long as it had given value to the sender (whether from this or some other transaction), had made no misrepresentations to the receiving bank, and had no notice of the bank's mistake. [185]

   b. **Right of subrogation:** If, under the law of restitution, the beneficiary or recipient can retain the excess payment, the receiving bank becomes subrogated to any rights that the beneficiary had against the sender. U.C.C. §4A-303, Official

Comment 2. [185]

2. **Payment in a lesser amount:** If the receiving bank issues a payment order in a lesser amount than authorized, it is entitled to payment from the sender in the lesser amount only unless the receiving bank issues an additional payment order for the remaining difference. U.C.C. §4A-303(b). [185]

IV. DUTIES OF BENEFICIARY'S BANK

A. **Overview:** A funds transfer is complete once the beneficiary's bank accepts the originator's bank's payment order. U.C.C. §4A-104(a); U.C.C. §4A-406(a). On its acceptance of the payment order, the beneficiary's bank becomes indebted to the beneficiary in the amount of the order on the payment date. U.C.C. §4A-404(a). Once this occurs, the originator's debt to the beneficiary on the underlying contract is discharged. [186]

B. **Manner in which beneficiary's bank accepts payment order:** Acceptance cannot take place before the payment date. U.C.C. §4A-209(d). Once the beneficiary's bank accepts the payment order, it may not later reject the order. U.C.C. §4A-210(d). Acceptance of a payment order by the beneficiary's bank occurs when the first of any of the following acts occur:

1. **Payment:** When the beneficiary's bank pays the beneficiary. U.C.C. §4A-209(b)(1)(i). [186]

2. **Acceptance by notification:** When the beneficiary's bank notifies the beneficiary of the receipt of the order or that its account has been credited for the order. U.C.C. §4A-209(b)(1)(ii). [186]

3. **Acceptance by receipt of payment:** When the beneficiary's bank receives payment of the entire amount of the order. U.C.C. §4A-209(b)(2). [186]

4. **By inaction:** Unless the beneficiary's bank rejects the order within 1 hour after the opening of the beneficiary's bank's next funds-transfer business day after the payment date, acceptance occurs automatically on the opening of the beneficiary's bank's next funds-

transfer business day following the payment date of the order if either the amount of the order is covered by sufficient funds in an authorized account that the sender maintains with the beneficiary's bank or the beneficiary's bank has otherwise received full payment from the sender. U.C.C. §4A-209(b)(3). [186]

C. **Liability for failure to make prompt payment:** If the beneficiary's bank refuses to pay the beneficiary after proper demand by the beneficiary and receipt of notice of the particular circumstances giving rise to such damages, the beneficiary may recover consequential damages. U.C.C. §4A-404, Official Comment 2. However, the beneficiary's bank is not liable for consequential damages if it proves that it did not pay because of a reasonable doubt concerning the right of the beneficiary to payment. U.C.C. §4A-404(a). [187]

D. **Duty to notify beneficiary:** If the beneficiary's bank accepts a payment order that requires payment to an account of the beneficiary, it must give notice to the beneficiary of the receipt of the order before midnight of the next funds-transfer business day following the payment date. U.C.C. §4A-404(b). If the order does not instruct payment to an account of the beneficiary, the beneficiary's bank is required to notify the beneficiary only if the order requires notification. U.C.C. §4A-404(b). [187]

V. EFFECT OF ACCEPTANCE ON UNDERLYING OBLIGATION

A. **Generally:** Payment by the originator to the beneficiary occurs when the order is accepted by the beneficiary's bank. U.C.C. §4A-406(a). Payment by a funds transfer does not discharge the underlying obligation if all the following conditions are met:

- the means of payment was prohibited under the contract governing the underlying obligation;
- within a reasonable time after receiving notice of the order, the beneficiary notified the originator of its refusal to accept the means of payment;
- the funds were neither withdrawn by the beneficiary nor applied

to its debt; and

- the beneficiary would suffer a loss that could have reasonably been avoided if payment had been made in a way that complied with the contract. U.C.C. §4A-406(b). [188]

VI. CANCELLATION (STOPPING PAYMENT) OF PAYMENT ORDER

A. Introduction: A cancelled payment order cannot be accepted. When an accepted order has been cancelled, the acceptance is nullified, and no person has any right or obligation based on the acceptance. U.C.C. §4A-211(e). [188]

B. Right to cancel unaccepted orders: Before the receiving bank has accepted the order, the sender has the absolute right to cancel the order if the sender gives timely notice of cancellation. U.C.C. §4A-211(b). [188-189]

1. **Manner of cancellation:** The sender may cancel its order orally, electronically, or in writing. U.C.C. §4A-211(a). Unless the receiving bank agrees otherwise, when there is a security procedure in effect between the sender and the receiving bank, the cancellation is not effective unless it is verified pursuant to the security procedure. U.C.C. §4A-211(a). [189]

2. **Cancellation by operation of law:** An unaccepted payment order is cancelled by operation of law at the close of the fifth funds-transfer business day of the receiving bank after the execution date or payment date of the order. U.C.C. §4A-211(d). [189]

C. Cancellation of order accepted by receiving bank: A receiving bank has no obligation to cancel an accepted order. U.C.C. §4A-211(c). Even if it chooses to do so, the cancellation is not effective unless the receiving bank cancels the payment order it sent in execution of the sender's order. U.C.C. §4A-211(c)(1); U.C.C. §4A-211, Official Comment 3. [189]

D. Cancellation of order after acceptance by beneficiary's bank: Once the beneficiary's bank has accepted an order, it has no obligation to agree to cancel the order. Although having no duty to agree to a cancellation, the beneficiary's bank may agree to a cancellation in four situations:

- if the payment order is unauthorized;
- if the payment order is duplicative of a payment order previously sent;
- if the payment order is mistakenly sent to a beneficiary who is not entitled to payment from the originator; or
- if a payment order is issued by mistake in an amount greater than the beneficiary is entitled to receive from the originator. U.C.C. §4A-211(c)(2). [189-190]

VII. LIABILITY FOR AUTHORIZED PAYMENT ORDERS

A. Introduction: The sender has the duty to reimburse the receiving bank for the amount of any authorized payment order. U.C.C. §4A-203, Official Comment 1. A payment order is authorized if the sender either actually or apparently authorized the order or is otherwise bound by the order under agency law. U.C.C. §4A-202(a). [190]

VIII. LIABILITY FOR UNAUTHORIZED PAYMENT ORDERS

A. Introduction: A sender is liable for an unauthorized order if it qualifies as a "***verified payment*** " order. U.C.C. §4A-202(b). An order that passes on being properly tested according to a security procedure is called a "***verified payment order***." U.C.C. §4A-202(b). [190]

B. Requirements for sender's liability for verified payment orders: Determining whether the customer is liable to the receiving bank for an unauthorized but verified payment order is a two-step process.

1. **First step:** The receiving bank must prove that the order is a verified payment order by proving the following:

a. **Agreement with customer:** The bank had an agreement with its customer providing that orders would be verified pursuant to a security procedure.

b. **Commercially reasonable procedure:** The security procedure is a commercially reasonable method of providing security against unauthorized payment orders.

c. **Bank complied with procedure:** The bank accepted the payment order in good faith and in compliance with the security procedure and any written agreement or instructions of the customer. U.C.C. §4A-202(b). [191]

2. **Second step:** If the bank proves that the order was a verified order, the order is effective as the order of the customer whether or not it was authorized by the customer. The customer is, therefore, liable to the receiving bank for the amount of the order. U.C.C. §4A-202(b). However, the customer can avoid liability by proving that the breach of security was not in any way attributable to the customer itself. To do so, the customer must prove that the order was not caused, directly or indirectly, by a person who falls into one of two categories.

a. **Entrusted with duties as to payment orders:** The first category includes any person who was entrusted, at any time, with duties to act for the customer with respect to payment orders or to the security procedure. U.C.C. §4A-203(a)(2)(i).

b. **Access to source or facilities:** The second category comprises any person who: (a) obtained access to the customer's transmitting facilities; or (b) obtained, from a source controlled by the customer and without authority of the receiving bank, information facilitating breach of the security procedure, regardless of how the information was obtained or whether the customer was at fault. Information includes any access device, computer software, or the like. U.C.C. §4A-203(a)(2). [191]

C. **Summary of when loss falls on bank:** The loss caused by an unauthorized payment order falls on the bank, and not on the customer, in four situations.

- No commercially reasonable procedure was in effect.
- The bank did not comply with the security procedure in place.
- The customer can prove that the wrongdoer did not obtain the information from it.
- The bank agreed to assume all or part of the loss. U.C.C. §4A-204, Official Comment 1. [192]

IX. ERRONEOUS PAYMENT ORDERS

A. **Introduction:** An erroneous payment occurs when the sender makes a mistake in the amount of the payment order it sends or in the identity of the beneficiary to whom the order is sent and the receiving bank accepts the order without noticing the error. [192]

B. **Allocation of loss when no security procedure in place:** The sender suffers the loss in the event that there is no established security procedure to determine the accuracy of the order. U.C.C. §4A-205, Official Comment 1. [192]

C. **Allocation of loss when security procedure in place:** When an established security procedure is in place to detect such errors, the loss shifts to the receiving bank if the sender proves that it had complied with the security procedure and that the error would have been detected if the receiving bank had also complied with the security procedure. U.C.C. §4A-205(a)(1). [192-193]

D. **Duty of sender on receipt of notice of acceptance:** On receipt of notice of the executed order or of the debiting of its account, the sender has the duty to exercise ordinary care to determine, on the basis of the information available to it, whether the order was erroneously executed or unauthorized or contained any other error and, if so, to notify the receiving bank of the relevant facts within a reasonable time not exceeding 90 days after the notification is received by the sender. With one exception, the only penalty for the sender's failure to perform this duty is that the receiving bank is not obligated to pay interest on any amount refundable to the sender for the period prior to the time before the bank learns of the execution error. U.C.C. §4A-304; U.C.C. §4A-204(a).

In the case of an erroneous payment order, the sender is also liable for any loss, not exceeding the amount of the order, which the receiving bank proves that it incurred as a result of the failure. U.C.C. §4A-205(b). However, the sender may be precluded from objecting to the receiving bank's retention of its payment for the order if the sender does not notify the receiving bank of its objection within 1 year after the sender received a notification reasonably identifying the order. U.C.C. §4A-505; U.C.C. §4A-505, Official Comment. [193]

X. MISDESCRIPTIONS

A. Nonexistent or unidentifiable person or account: If the name, bank account number, or other identification of the beneficiary refers to a nonexistent or unidentifiable person or account, no person has rights as the beneficiary of the order. U.C.C. §4A-207(a). As a result, the beneficiary's bank cannot accept the order and the funds transfer cannot be completed. U.C.C. §4A-207; U.C.C. §4A-207, Official Comment 1. Each sender in the funds transfer is relieved of liability and is entitled to a refund to the extent of any payment. U.C.C. §4A-207, Official Comment 1. [193]

B. When beneficiary identified by both name and number: When the beneficiary is identified by both a name and an identifying or bank account number and the name and number identify different persons, the beneficiary's bank may rely on the number as the proper identification of the beneficiary and credit the account number. U.C.C. §4A-207(b)(1). The loss will generally then fall on the bank sending the order. The customer is not obligated to pay the order unless the receiving bank proves that, before acceptance of the customer's order, the customer received notice from the receiving bank that payment might be made on the basis of the identifying number or bank account number even if it identifies a different person. U.C.C. §4A-207(c)(2). When the beneficiary's bank either pays the person identified by name or knows that the name and the number identify different persons, the beneficiary's bank assumes the risk that it has failed to pay the person intended by the sender. If it pays the proper person, the beneficiary's bank is entitled to payment.

If it does not, no acceptance can occur and the originator's bank has no obligation to pay the beneficiary's bank. U.C.C. §4A-207(b)(2). [193-194]

C. Misdescription of intermediary bank or beneficiary's bank: Similar problems arise when the intermediary or beneficiary's bank is improperly described.

1. **Identification by number only:** When a payment order identifies an intermediary bank or the beneficiary's bank by an identifying number only and that number is wrong, the bank sending the order will suffer any loss caused by the order being accepted by the wrong bank. U.C.C. §4A-208(a)(1). If the originator supplied only the number and not the name of the beneficiary's bank, the originator would be obligated to reimburse the originator's bank. U.C.C. §4A-208(a)(2). [194]

2. **Conflict between name and number:** When there is a conflict between the name of the beneficiary's bank (or intermediary bank) and the identifying number, the receiving bank may rely on the number as the proper identification of the beneficiary's bank (or intermediary bank) if it does not know, at the time it executes the order, that the name and number identify different persons. U.C.C. §4A-208(b). The sending bank thus suffers the loss and may not recover from its customer. If a nonbank sender had included the conflicting description of the beneficiary's bank in its order to the sending bank, it would be obligated to reimburse the sending bank for any losses or expenses incurred in executing or attempting to execute the order if the sender received notice that the sending bank might rely on the identifying number only before its order was accepted by the sending bank. U.C.C. §4A-208(b)(2). If the receiving bank knows that the name and the number identify different banks, reliance on either the name or the number, if incorrect, is a breach of its duties in executing the sender's payment order. U.C.C. §4A-208(b)(4). [194-195]

XI. INJUNCTION

Availability of injunction: A creditor can obtain an injunction preventing the originator from issuing a payment order initiating a funds transfer to the beneficiary, the originator's bank from executing the originator's payment order, the beneficiary's bank from releasing funds to the beneficiary, or the beneficiary from withdrawing the funds. U.C.C. §4A-503. However, no intermediary bank can be enjoined from executing a payment order or a receiving bank from accepting the order or receiving payment from the sender. U.C.C. §4A-503, Official Comment. [195]

CHAPTER 8
CONSUMER ELECTRONIC FUND TRANSFERS

I. LAW GOVERNING CONSUMER ELECTRONIC FUND TRANSFERS

A. Governing law: Consumer electronic fund transfers are governed, for the most part, by the Electronic Fund Transfer Act ("EFTA"), 15 U.S.C. §1693, and Regulation E promulgated thereunder. [199]

II. WHAT IS AN ELECTRONIC FUND TRANSFER?

A. Introduction: An "***electronic fund transfer*** " is any transfer of funds that is initiated through an electronic terminal, a telephone, or computer or magnetic tape for the purpose of instructing a financial institution to debit or credit a consumer asset account. 15 U.S.C. §1693a(6); 12 C.F.R. §205.3(b). The transfer must be initiated through an electronic terminal, a telephone, or computer or magnetic tape. A transfer from a consumer account initiated through use of a debit card is covered even though the transaction does not involve an electronic terminal, magnetic tape, or computer. 12 C.F.R. §205.3(b)(5). [199-200]

III. CONSUMER'S LIABILITY FOR UNAUTHORIZED TRANSFERS

A. Introduction: A consumer has only limited liability for unauthorized transfers out of her account. [201]

B. What is an unauthorized fund transfer? An electronic fund transfer is unauthorized if the transfer is initiated by a person without actual authority to initiate the transfer and the consumer did not receive a benefit from the transfer. 15 U.S.C. §1693a(11); 12 C.F.R. §205.2(k). An electronic fund transfer is not unauthorized if the consumer gave to the person initiating the transfer an access device unless the consumer has notified the financial institution involved that transfers by that person are no longer authorized. 15 U.S.C. §1693a(11); 12 C.F.R. §205.2(k)(1). [201]

1. **No longer authorized after notification:** Any transfer becomes an unauthorized transfer once the cardholder notifies the card issuer that the person having the card is no longer authorized to use the access device. [201]

2. **Obtained through robbery or fraud:** Any transfer is an unauthorized electronic fund transfer if it is made with an access device that was obtained either through robbery or through fraudulent inducement. 12 C.F.R. §205.2(k)(3), Official Staff Commentary. [201]

C. **Conditions to consumer's liability for unauthorized fund transfers:** Before a consumer is liable for an unauthorized fund transfer, three conditions must be met. 15 U.S.C. §1693g(a); 12 C.F.R. §205.6(a). [201]

1. **Transfer through accepted access device:** The unauthorized transfer must have been made by an accepted access device. [201]

2. **Means to identify consumer:** The financial institution must have provided some means by which the consumer can be identified when she uses the device. 12 C.F.R. §205.6(a). [201]

3. **Disclosures:** The financial institution must have provided the consumer with certain written disclosures as to her liability for unauthorized transfers. 12 C.F.R. §205.6(a). [201]

D. **Limitation of consumer liability:** If these conditions are met, the consumer is liable for the lesser of (a) the amount of any unauthorized fund transfers or (b) $50. 15 U.S.C. §1693g(a); 12 C.F.R. §205.6(b). The consumer is not liable for any unauthorized fund transfers that occur after the consumer has given notice to the financial institution that an unauthorized electronic fund transfer involving her account has been or may be made. 15 U.S.C. §1693g(a); 12 C.F.R. §205.6(b). The limitations on liability apply whether or not the consumer is negligent. 12 C.F.R. §205.6(b)-2, Official Staff Commentary. [202]

E. **Failure to report loss of device:** If the consumer does not notify its financial institution of the loss or theft of the access device within 2 business days after learning of the loss or theft, the consumer's liability increases to the lesser of (a) $500 or (b) the sum of (i) $50 or the amount of unauthorized electronic fund transfers that occur before the close of the 2 business days, whichever is less, and (ii) the amount of unauthorized electronic fund transfers that the financial institution establishes would not have occurred but for the consumer's failure to notify the institution within 2 business days after it learns of the loss or theft of the access device, and that occur after the close of the 2 business days and before notice to the financial institution. 12 C.F.R. §205.6(b)(2). [202]

F. **Failure to report unauthorized transfers on periodic statement:** In the event that the consumer fails to report within 60 days of a statement's transmittal any unauthorized electronic fund transfer that appears on the periodic statement, the consumer is liable to the financial institution for (a) up to $50 of any unauthorized transfer or transfers that appear on the statement, plus (b) the full amount of any unauthorized transfers that occur after the close of the 60 days after transmittal of the statement and before the consumer gives notice to the financial institution. 12 C.F.R. §205.6(b)(3). [202]

G. **Combination of failure to report lost device and failure to report unauthorized transfers:** When there is a combination of a failure to report a lost or stolen access device and a failure to report the loss after the receipt of a periodic statement, the provisions that impose liability for the failure to report the lost or stolen access device govern the amount of liability for transfers that appear on the periodic statement and for transfers that occur before the close of 60 days after the consumer first received a periodic statement showing an unauthorized transfer. The provisions imposing liability for the failure to report the losses that appear on a periodic statement govern thereafter. 12 C.F.R. §205.6(b)(3). [202-203]

IV. STOPPING PAYMENT OF ELECTRONIC FUND TRANSFERS

A. No right to reverse ordinary fund transfers: The EFTA gives a consumer no right to reverse an electronic fund transfer (other than a preauthorized electronic fund transfer). A few states do allow an electronic fund transfer initiated by a consumer to be reversed under certain conditions. [203]

B. Stopping payment on preauthorized electronic fund transfers: There is a right to stop payment of any preauthorized electronic fund transfer from the consumer's account. A consumer can stop payment of a preauthorized electronic fund transfer by giving oral or written notice to its financial institution at any time up to 3 business days before the scheduled date of the transfer. 12 C.F.R. §205.10(c). If the notice is oral, the financial institution may require that written confirmation of the stop payment order be given within 14 days of the oral notification. 12 C.F.R. §205.10(c). Neither the EFTA nor Regulation E spell out clearly what type of damages may be available if the financial institution fails to stop a preauthorized transfer. [203-204]

V. CONSUMER LIABILITY TO THIRD PARTIES IN THE EVENT OF SYSTEM MALFUNCTION

A. Introduction: If there is a malfunction in the fund transfer system that prevents a preauthorized payment from being made, the consumer's obligation to make the payment is suspended until the system malfunction is corrected and the electronic fund transfer may be completed. 15 U.S.C. §1693j. The consumer must pay the bill if, at any time before the malfunction is corrected, the creditor demands in writing that payment be made by means other than an electronic fund transfer. 15 U.S.C. §1693j. [204-205]

VI. RESTRICTIONS ON ISSUANCE OF ACCESS DEVICES

A. Introduction: An access device not requested by the consumer may be issued only if it is not validated. 15 U.S.C. §1693i(b); 12 C.F.R. §205.5(b)(1). Issuance by the financial institution of an unrequested access device must be accompanied by a complete disclosure: (1) as to the consumer's rights and liabilities once the device is validated; (2) clearly explaining that the access device is not validated; and (3) instructing the consumer on how to dispose of the device in the event that the consumer does not wish to use the device. 12 C.F.R. §205.5(b). [205]

VII. SPECIAL RULES FOR PREAUTHORIZED TRANSFERS

A. **Transfers to consumer's account:** If the consumer's account is to be credited by a preauthorized electronic fund transfer from the same payor at least once every 60 days, the bank must give notice of the deposit by one of the following means:

1. **Notice that transfer made:** Oral or written notice within 2 business days after the transfer that the transfer has occurred.

2. **Notice that transfer not made:** Notice within 2 business days after a scheduled fund transfer that the transfer has not occurred.

3. **Readily available telephone line:** The bank may provide a readily available telephone line that the consumer may call to ascertain whether or not the preauthorized transfer occurred. 12 C.F.R. §205.10(a). [205]

B. **Transfers from consumer's account:** When the debit is in the same amount each month, no notification is required. If debits are in a varying amount, the consumer has the right to receive notice if a transfer varies in amount from the previous transfer or from the preauthorized amount. 12 C.F.R. §205.10(d). Notice must be given either by the bank or by the payee at least 10 days before the scheduled transfer date so as to enable the consumer not only to verify whether the amount is correct but also to deposit funds in the account to cover any deficit. 12 C.F.R. §205.10(d). [205-206]

VIII. DOCUMENTATION REQUIREMENTS

A. **Receipts at electronic terminals:** When the consumer initiates an electronic fund transfer at an electronic terminal, the financial institution itself, or through another party (for example, the merchant at a POS terminal), must provide a written receipt containing certain basic information as to the transaction. [206]

B. Periodic statements: The financial institution must provide periodic statements to the consumer providing certain basic information for each transfer occurring during the period covered for each account to, or from which, electronic fund transfers can be made. 15 U.S.C. §1693d(e); 12 C.F.R. §205.9(b). [206]

IX. ERROR RESOLUTION PROCEDURES

A. Introduction: The consumer must give oral or written notice of error to the financial institution no later than 60 days after the bank provided the consumer with the periodic statement indicating the error. 15 U.S.C. §1693f(a); 12 C.F.R. §205.11(b)(1)(i). [206]

B. Bank's duty to investigate: On receipt of the notice of error, the financial institution has the duty to promptly investigate and determine whether an error has occurred. 15 U.S.C. §1693f(a); 12 C.F.R. §205.11(c).

1. **Does not recredit:** If the financial institution does not provisionally recredit the consumer's account during the investigation, it must transmit the results of its investigation to the consumer within 10 business days. 15 U.S.C. §1693f(a); 12 C.F.R. §205.11(c)(1).

2. **Recredits:** If the bank provisionally recredits the account in the amount of the alleged error (including any applicable interest) within 10 business days after receipt of the notice of error, the financial institution may, as long as it acts promptly, take up to 45 calendar days to transmit the results of its investigation to the consumer. 15 U.S.C. §1693f(c); 12 C.F.R. §205.11(c)(2). [206-207]

C. After the bank makes its determination: If the bank determines that an error has occurred, it must promptly, and no later than 1 business day after this determination, correct the error and, whether or not the bank determines that an error has occurred, mail or deliver to the consumer a written explanation of its findings within 3 business days after concluding its investigation. 15 U.S.C. §1693f(b), (d); 12 C.F.R. §205.11(c)(2)(iii), (iv). [207]

X. LIABILITY FOR FAILING TO MAKE CORRECT FUND TRANSFER

A. Introduction: A financial institution is liable to its customer if it fails to make a fund transfer in the correct amount and in a timely manner. If the bank's failure was unintentional and occurred despite reasonable precautions established by the institution to guard against such failures, damages are limited to actual damages proved. This does not include consequential damages. 15 U.S.C. §1693h(c). [207]

XI. CIVIL LIABILITY

A. Introduction: The provisions of the EFTA may be enforced by administrative action. Besides administrative enforcement, the EFTA also provides for both individual and class civil actions by consumers. 15 U.S.C. §§1693m-1693n. [207]

- Under certain conditions, damages may be trebled when: (1) the noncompliance is a failure to comply with the error resolution rules; or (2) the financial institution knowingly and willfully concluded that the consumer's account was not in error when such a conclusion could not reasonably have been drawn from the evidence available to the financial institution at the time of its investigation. 15 U.S.C. §1693f(e). [207-208]
- A financial institution is not liable if its noncompliance resulted in an error that was properly resolved pursuant to the EFTA error resolution procedures. 15 U.S.C. §1693m(a). [208]
- A financial institution is also not liable if it proves, by a preponderance of the evidence, that the noncompliance was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid such

noncompliance. 15 U.S.C. §1693m(c). [208]

- A financial institution is likewise not liable if it both notifies the consumer of the noncompliance prior to the consumer bringing an action and pays to the consumer his actual damages. 15 U.S.C. §1693m(e). [208]

CHAPTER 9
LENDER CREDIT CARDS

I. TERMINOLOGY IN CREDIT CARD TRANSACTIONS

The person who uses a credit card to make a purchase is the “cardholder.” The bank that issued the card to the cardholder is the “issuing bank.” The store or other party that takes the credit card in payment is the “merchant.” The bank at which the merchant maintains its account is the “merchant's bank.” [211]

II. LAW GOVERNING CREDIT CARD TRANSACTIONS

A. Introduction: The basic law of credit cards is federal law and can be found in the Truth in Lending Act, 15 U.S.C. §§1601 et seq., as amended both by the Fair Credit and Charge Card Disclosure Act and the Fair Credit Billing Act, and Regulation Z, 12 C.F.R. part 226, promulgated pursuant to the Truth in Lending Act. With two exceptions, these statutes and regulations cover only consumer use of credit cards. Business credit cards are also subject to the rules governing liability for unauthorized use and limitations on the right of the card issuer to issue unrequested cards. [211-212]

III. LIABILITY FOR UNAUTHORIZED USE

A. Introduction: A cardholder has very limited liability for an unauthorized use of her card. A cardholder is liable only for the lesser of (1) $50 or (2) the amount of money, property, labor, or services obtained by the unauthorized use. There is no liability for any unauthorized charges incurred after the consumer gives notice to the bank of the unauthorized use. 15 U.S.C. §1643(a)(1); 12 C.F.R. §226.12(b). With one exception, the rules governing liability for unauthorized use of a credit card apply to credit cards used for business purposes as well as for consumer purposes. 15 U.S.C. §1645. The one exception involves issuance by a card issuer of 10 or more credit cards for use by the employees of an organization. In this situation, the card issuer and the organization may contractually set liability for unauthorized use at an amount greater than otherwise permitted by law. However, an employee of the organization has the same limited liability as does a consumer as to both his employer and the card issuer. 15 U.S.C. §1645; 12 C.F.R. §226.12(b)(5). [212]

B. **Conditions to liability:** A cardholder has no liability whatsoever for an unauthorized use of her card unless three conditions are met.

1. **Accepted card:** The card must be an accepted credit card. 12 C.F.R. §226.12(b)(2)(i). [212]

2. **Disclosures:** The card issuer must have provided the cardholder with adequate notice of its maximum potential liability and of the means by which it can notify the card issuer of the loss or theft of its card. 12 C.F.R. §226.12(b)(2)(ii). [212]

3. **Merchant identification:** The card issuer must have provided a means by which the merchant could have identified the cardholder as the authorized user of the card. 12 C.F.R. §226.12 (b)(2)(iii) and Official Staff Commentary. [212-213]

C. **Unauthorized use:** "***Unauthorized use*** " is defined as the use of a credit card by a person, other than the cardholder, who does not have actual, implied, or apparent authority for such use, and from which the cardholder receives no benefit. 12 C.F.R. §226.12(b), n.22. The card issuer has the burden of proving that use of a card was authorized. 15 U.S.C. §1643(b). [213]

D. **Authorized use:** A use is "***authorized*** " when the user has either actual or apparent authority to use the card.

1. **Actual authority:** The user has actual authority to use a credit card when the cardholder either expressly or by implication gives the user authority to use the card. [213]

2. **Apparent authority:** A user has apparent authority when the cardholder gives the impression to third parties that the user is authorized to use the card. [213]

a. **Knowingly giving card to user:** Some courts find that if the cardholder voluntarily and knowingly gives the card to another person, the person to whom the card is given has apparent authority to use the card. [213-214]

b. **Informs card issuer:** Courts are split as to whether the cardholder is liable for purchases made by the user after the cardholder informs the card issuer that the user no longer has actual authority to use the card. [214]

IV. RIGHT TO REFUSE PAYMENT

A. **Consumer's right to refuse payment:** If a consumer fails to satisfactorily resolve a dispute as to a product purchased with his credit card, the consumer can assert against the card issuer all claims (other than tort claims) and defenses arising out of the transaction and relating to the failure to resolve the dispute. 15 U.S.C. §1666i; 12 C.F.R. §226.12(c)(1). [214]

B. **Conditions to right to withhold payment:** There are three conditions to a consumer's right to withhold payment of her credit card bill for a purchase:

1. **Good-faith attempt to resolve dispute:** The consumer must make a good-faith attempt to resolve the dispute with the merchant. 12 C.F.R. §226.12(c)(3)(i). [214]

2. **More than $50:** The charge for the purchase must be more than $50. 12 C.F.R. §226.12(c)(3)(ii). [215]

3. **Purchase within same state or within 100 miles:** The purchase must have occurred in the same state as the consumer's current designated address or, if not within the same state, within 100 miles of that address. 12 C.F.R. §226.12(c)(3)(ii). [215]

C. **Exceptions:** The geographical and monetary limitations do not apply when the merchant (a) is the same person as the card issuer; (b) is directly or indirectly controlled by or controls the card issuer; (c) is a franchised dealer of the card issuer's products or services; or (d) has obtained the order for the disputed transaction through a mail solicitation made or participated in by the card issuer. 12 C.F.R. §226.12(c)(3), n.26. [215]

D. Limited to amount of credit outstanding: The amount of the claim or defense that may be asserted cannot exceed the amount of credit outstanding for the disputed transaction at the time the cardholder first notifies the card issuer or the merchant of the existence of the claim or defense. 12 C.F.R. §226.12(c)(1); 12 C.F.R. §226.12(c)(1), n.25. [215]

V. ERROR RESOLUTION PROCEDURES

A. What cardholder must do on noticing billing error: If the cardholder wants to activate the error resolution procedure, the cardholder must send written notice of the billing error so that it is received by the card issuer no later than 60 days after the card issuer transmitted the statement that reflected the billing error. 12 C.F.R. §226.13(b)(1). [215-216]

B. What the card issuer must do on receipt of billing error notice: Within 30 days after receiving the billing error notice, the card issuer must either:

- mail or deliver to the cardholder a written acknowledgment of receipt of the notice, or
- comply with the appropriate resolution procedures. 12 C.F.R. §226.13(c)(1). [216]

1. **If error is found:** If the card issuer determines that the billing error mentioned in the notice has occurred, the card issuer must, within two complete billing cycles (but in no event later than 90 days) after receiving the billing error notice, correct the billing error and credit the cardholder's account with any disputed amount and related finance or other charges, if any. The card issuer must also, during this period, mail or deliver to the cardholder a correction notice. 12 C.F.R. §226.13(e)(1), (2). [216]

2. **If no error found:** Before the card issuer may determine that no billing error has occurred, it must conduct a reasonable investigation. 12 C.F.R. §226.13(f). If, after conducting a reasonable investigation, the card issuer determines that no billing error occurred, it must, within two complete billing cycles (but in no event later than 90 days) after receiving the billing error notice,

mail or deliver to the cardholder an explanation that sets forth the reasons for its belief that the alleged billing error notice is incorrect in whole or in part. 12 C.F.R. §226.13(f)(1). It must also promptly notify the cardholder in writing of the time when payment is due and the portion of the disputed amount and related finance or other charges that are owed. 12 C.F.R. §226.13(g)(1). The cardholder has the same grace period within which to pay the amount due without incurring additional finance or other charges that it would have had had it just received the periodic statement showing the charge. 12 C.F.R. §226.13(g)(2). [216]

C. **Remedy:** Failure to comply with the requirements of the billing error resolution procedure results in the card issuer forfeiting the right to collect from the cardholder the amount of the alleged error together with any finance charges on that amount. The amount of the forfeiture, however, cannot exceed $50. 15 U.S.C. §1666(e). [216]

CHAPTER 1
WHAT IS A NEGOTIABLE INSTRUMENT?

ChapterScope

This chapter is an introduction to negotiable instruments. It examines how a negotiable instrument is different from an ordinary contract, the law governing negotiable instruments, the different types of negotiable instruments, and the requirements for negotiability. The key points in this chapter are:

- **Merger of debt into negotiable instrument:** Once a debt has been evidenced by a negotiable instrument, the negotiable instrument becomes the debt. As a result, payment or transfer of the negotiable instrument is payment or transfer of the debt.
- **Negotiable instrument as cash substitute:** A negotiable instrument differs from an ordinary contract in that a holder in due course obtains substantially greater rights and protections than does an assignee of an ordinary contract right.
- **U.C.C. Articles 3 and 4:** The basic law governing negotiable instruments is contained in Articles 3 and 4 of the Uniform Commercial Code, although some federal regulations also have an impact on the law of negotiable instruments.
- **Drafts and Notes:** The two basic types of negotiable instruments, drafts (primarily used as means of making payment) and notes (primarily used as a means of evidencing a debt), come in many different types.
- **Formal requirements for writing to qualify as a negotiable instrument:** Strict requirements must be met for a writing to qualify as a negotiable instrument. The primary requirements are that the writing be an unconditional promise or order to pay a fixed sum of money and that it contain certain key words indicating that the writing is payable to the order of an identified person or to the bearer.

I. WHAT IS A NEGOTIABLE INSTRUMENT?

A. Introduction: A negotiable instrument is a cross between a contract and money. On the one hand, a negotiable instrument is a simple contract by which a person either promises to make payment or orders someone to make payment on their behalf. On the other hand, the right sort of holder of a negotiable instrument (the person who has the right to collect on the instrument) is freed from many of the risks and burdens associated with being the assignee of an ordinary contract right.

B. Primary difference from ordinary contract right: An assignee of an ordinary contract right takes subject to all the defenses to which his assignor took subject. A holder in due course of a negotiable instrument takes the instrument free from virtually all defenses.

Example: Buyer purchases equipment from Equipment Dealer for $5,000 pursuant to an ordinary contract of sale. Equipment Dealer assigns the contract to Finance Company. The equipment is defective in breach of the warranty of merchantability. Finance Company takes subject to Buyer's breach of warranty claim. Restatement (Second) of Contracts §336(1) (1979). If, instead, Buyer executed a negotiable note that Equipment Dealer negotiated to Finance Company, Finance Company would take free of Buyer's breach of warranty claim if, and only if, Finance Company is a holder in due course. U.C.C. §3-305(b).

C. Other differences: The assignee of an ordinary contract right assumes the risk that the obligor has already paid the assignor. A holder in due course of a negotiable instrument who is without notice of the payment can recover from the obligor even if the obligor has previously paid the original creditor. U.C.C. §3-602(a). In addition, pleading and proving a case on a negotiable instrument is far simpler than on an ordinary contract. U.C.C. §3-308.

II. GOVERNING LAW

A. Basic governing law: The basic law governing negotiable instruments is contained in Articles 3 and 4 of the Uniform Commercial Code. The bank collection process is also governed by Federal Reserve Board Regulations CC and J. See Chapter 6. In 2002, the American Law Institute and the National Conference of Commissioners on Uniform State Laws proposed several amendments to Articles 3 and 4. Until enacted by the particular state, these amendments will not be the law in that state. However, in anticipation that these amendments could be enacted by many states, this book includes references to the new amendments throughout. The references are clearly identified as "2002 amendments" and include discussions on whatever impact the amendments will have on application of the law.

B. **Coverage of Article 3:** Subject to certain exclusions, Article 3 governs writings meeting the requirements of U.C.C. §3-104(a).

1. **Exclusions:** Section 3-102 specifically excludes from the scope of Article 3 the following writings that otherwise qualify as negotiable instruments: (1) investment securities governed by Article 8, (2) money, and (3) payment orders governed by Article 4A. U.C.C. §3-102(a).

C. **Coverage of Article 4:** Article 4 governs the bank collection process. The coverage of Article 4 is limited to items. An item is defined as "an instrument or other written promise or order to pay money handled by a bank for collection or payment." U.C.C. §4-104(a)(9).

1. **Item:** "Item" covers more than just Article 3 negotiable instruments. U.C.C. §4-104(c); U.C.C. §4-104, Official Comment 8.

a. **Any promise or order:** Any promise or order to pay money handled by a bank for collection or payment is an item whether or not the promise or order would qualify as a negotiable instrument under Article 3.

b. **Not negotiable items:** The following orders or promises are items even though not negotiable instruments under Article 3: a conditional promise or order, a savings account withdrawal slip, and certain bonds and other investment securities governed by

Article 8.

2. **Exclusions:** "Item" does not include payment orders governed by Article 4A and debit and credit card slips. U.C.C. §4-104(a)(9).

D. **Article 4 prevails over Article 3:** When an instrument governed by Article 3 is handled by a bank for collection or payment, Article 3 and Article 4 both apply. Because Article 4 was specifically drafted to govern problems arising in the bank collection process, when the results reached under an applicable provision of Article 4 conflict with the results reached under a provision of Article 3, Article 4 controls. U.C.C. §3-102(b); U.C.C. §4-102(a).

E. **Federal common law:** In the absence of a federal statute or regulation, if the United States is a party to an instrument, its rights and duties are governed by federal common law and not by the Code. U.C.C. §4-102, Official Comment 1.

1. **Basically same as Article 3:** Generally, federal common law is virtually identical to Articles 3 and 4. U.C.C. §3-102, Official Comment 4.

2. **Differences:** Sometimes courts have been unwilling to apply the provisions of the Code.

   Examples: Although put into question by a recent Supreme Court decision, courts had adopted the federal holder-in-due-course doctrine (see Chapter 2) instead of applying the standards found in U.C.C. §3-302. In addition, courts have refused to apply some of the doctrines precluding a drawer from claiming that an indorsement is forged. Compare United States v. Bank of Am. Natl. Trust & Sav. Assn., 438 F.2d 1213, 8 U.C.C. Rep. Serv. 962 (9th Cir. 1971) (§3-405 not applicable) with Bank of Am. Natl. Trust & Sav. Assn. v. United States, 552 F.2d 302, 21 U.C.C. Rep. Serv. 812 (9th Cir. 1977) (§3-405 applicable).

3. **Not involving rights and duties of United States:** If the dispute does not involve the rights or duties of the United States government but rather those of other parties to a U.S. government instrument, Articles 3 and 4 apply.

III. TYPES OF NEGOTIABLE INSTRUMENTS

A. Introduction: Article 3 negotiable instruments are classified into two basic categories: notes and drafts. A ***draft*** is any instrument that contains an order (a written instruction by one person to another to pay a third person). U.C.C. §3-104(e); U.C.C. §3-103(a)(6). [[Rev] U.C.C. §3-103(a)(8).] A ***note*** is any instrument that contains a promise (a written undertaking to pay money). U.C.C. §3-104(e); U.C.C. §3-103(a)(9). [[Rev] U.C.C. §3-103(a)(12).]

B. Notes: A note is a promise by one party (called the ***maker***) to pay to another party (called the ***payee***) a sum of money.

1. **Purpose:** The usual purpose of a note is to evidence a debt. Notes thus primarily serve a credit rather than a payment function.

2. **Diversity of form:** Notes may be as simple as a one-sentence writing that reads, "I promise to pay to the order of Aspen Publishers the sum of $20. (s) Law Student." Notes can, on the other hand, be several pages long and contain provisions, among others, for collateral securing the loan, conditions under which the note may be accelerated, the payment of attorneys' fees in the event of default, or interest before and after default.

3. **Certificate of deposit:** A certificate of deposit is a note issued by a bank. It is defined as "an acknowledgment by a bank of the receipt of money together with an engagement by the bank to repay the money." U.C.C. §3-104(j).

   a. **Purpose:** Certificates of deposit are the means by which banks raise money and depositors assure themselves of a good return on their money.

   b. **Coverage under Article 3:** Article 3, in fact, does not cover most certificates of deposit. Some certificates of deposit are not negotiable and therefore are not governed by Article 3. Other certificates of deposit qualify as investment securities under Article 8 and thus are excluded from the coverage of Article 3.

C. Drafts: A ***draft***, sometimes known as a bill of exchange, is a three-party instrument by which a person called a ***drawer*** (the person who typically signs the draft in the lower right-hand corner) orders a person called a ***drawee*** (the person named in the draft to whom the order is directed) to pay the payee.

1. **Purpose:** Drafts are usually payment instruments by which the drawer makes payment to the payee.

2. **Checks:** The most common type of draft is a check. A ***check*** is a draft drawn on a bank (called either the ***drawee bank*** or the ***payor bank***) and payable on demand. U.C.C. §3-104(f). A ***bank*** is "a person engaged in the business of banking, including a savings bank, savings and loan association, credit union and trust company." U.C.C. §4-105(1). [[Rev] U.C.C. §1-201(b)(4).] Because all checks are drafts, unless the Code specifically provides otherwise, checks are governed by the same rules that govern drafts.

3. **Bank checks:** There are three types of checks (cashier's, teller's, and certified checks) on which a bank makes a promise to pay (called ***bank checks***). Bank checks are treated differently from ordinary checks for several purposes, including (1) the ability of the issuing bank to refuse payment, (2) the loss or destruction of the check, (3) the effect of taking a bank check on the underlying obligation, and (4) the statute of limitations on bringing an action against the issuing bank.

   a. **Cashier's checks:** A cashier's check is a check for which the drawer and the drawee are the same bank or branches of the same bank. U.C.C. §3-104(g).

   b. **Teller's checks:** A teller's check is a check drawn by one bank on another bank or "payable at" or "payable through" the other bank. U.C.C. §3-104(h).

   c. **Certified check:** A certified check is a check drawn by the bank's customer and accepted by the drawee bank. Certification of the check constituted Chase's acceptance of the obligation to pay, and limited its right to refuse to honor the check. *See* Industrial Bank of Korea, N.Y. Branch v. JP Morgan and Chase Manhattan Corp., 3 Misc. 3d 128(A) (N.Y. Sup. App. Term Apr.

2004). Once a check is certified, a bank customer may not unilaterally stop payment by what is commonly referred to as a “stop-payment order.” Dalessio v. Kressler, 6 A.D.3d 57 (N.Y.A.D. 2 Dept. 2004).

Example: Chris requests that First Interstate Bank certify his personal check drawn on First Interstate Bank. By certifying the check (the equivalent of “accepting” a draft), First Interstate Bank promises to pay the check.

4. **Traveler's checks:** A traveler's check is “an instrument that (i) is payable on demand, (ii) is drawn on or payable at or through a bank, (iii) is designated by the term “traveler's check” or by a substantially similar term, and (iv) requires, as a condition to payment, a countersignature by a person whose specimen signature appears on the instrument.” U.C.C. §3-104(i).

   a. **Purpose:** A traveler's check is purchased by a person for use as a substitute for cash virtually anywhere in the world.

   b. **Differences from ordinary checks:** Unlike an ordinary check or draft, a traveler's check has two lines for the signature of the purchaser. The countersignature must be present before the check can be negotiated. To preserve the cash-like nature of traveler's checks, as long as the check is taken by a holder in due course, the countersignature need not be made by the purchaser. U.C.C. §3-106(c); U.C.C. §3-106, Official Comment 2. A holder in due course, as a result, does not take subject to the risk that the traveler's check was stolen and the countersignature forged.

5. **Personal money order:** A personal money order is a draft sold by the drawee to a person who typically does not have an account with the drawee. It is, in effect, a single-transaction checking account. If the drawee is a bank, the personal money order is a check; if a nonbank, a personal money order is a draft.

6. **Drafts (other than checks):** Many other types of drafts are used in various types of situations.

   a. **Time and sight drafts:** A time draft is a draft payable at a definite time. In contrast, a draft payable on demand is called a sight draft.

b. Documentary drafts: A documentary draft is a draft, whether payable at a definite time or on demand, which is accompanied by a letter containing instructions that the draft is not to be paid unless the holder presents to the drawee certain designated documents.

c. Banker's and trade acceptances: A banker's acceptance is a draft drawn on and accepted by a bank. By accepting the draft, the bank becomes liable to pay the draft. U.C.C. §3-413(a). A trade acceptance is a draft drawn on and accepted by a person other than a bank.

Example: If Omaha State Bank accepted the draft drawn on it by Grain Broker, the resulting instrument would be a banker's acceptance. If Farmer drew a draft on Grain Broker and Grain Broker accepted the draft, the resulting instrument would be a trade acceptance.

7. Payable through items: A payable through item is a draft or note that names a specified bank as the person authorized to present the item to the drawer or maker. The bank through which the item is payable has no right to pay the item without the drawer's or maker's consent. U.C.C. §4-106(a); U.C.C. §4-106, Official Comment 1.

8. Payable at items: An instrument similar to a payable through item is a note or an acceptance "payable at" a bank. To be a payable at a bank, the note or acceptance must explicitly state that it is payable at a bank, for example, "Payable at Continental Bank."

a. Two different treatments: Historically, banks in different states treated payable at items differently. To accommodate this difference in treatment, Article 4 provides two alternative provisions that a state may adopt as to the manner in which instruments payable at a bank are to be treated.

i. First alternative: The first alternative provision treats a note or an acceptance payable at a bank as a draft drawn on that bank. U.C.C. §4-106(b), Alternative A; U.C.C. §4-106, Comment 2. The maker of the note (or the acceptor of the draft) is treated as the drawer of a draft and the bank at which the instrument is payable is treated as the drawee. Therefore, a note or an acceptance payable on demand is a check.

ii. **Second alternative:** Under the second alternative, a note or an acceptance payable at a bank is treated as though it is "payable through" the bank. U.C.C. §4-106(b), Alternative B. The maker of the note (or acceptor of the draft) is treated as both the drawer and the drawee of a draft, while the bank at which the instrument is payable is the only person who may present the instrument to the maker or acceptor for payment.

9. **Remotely created consumer item:** The 2002 Amendments have added a new type of negotiable instrument. A "remotely created consumer item" is "an item drawn on a consumer account, which is not created by the payor bank and does not bear a handwritten signature purporting to be the signature of the drawer." [Rev] U.C.C. §3-103(a)(16). A "consumer account" is an account established by an individual primarily for personal, family, or household purposes, including a joint account established by more than one individual. [Rev] U.C.C. §3-103(a)(2) and Official Comment 6.

Example: Consumer purchases vacation package over the telephone from Telemarketer. In payment for the package, Consumer authorizes Telemarketer to have Consumer's bank debit Consumer's bank account. In so ordering, Telemarketer warrants to Depositary Bank that Consumer authorized the debit. [Rev] U.C.C. §3-416(a)(6). Depositary Bank, in presenting the item to Payor Bank, also warrants that the consumer authorized issuance of the item in the amount for which it is drawn. [Rev] U.C.C. §3-417(a)(4). As a result, in the event the consumer did not in fact authorize the debit, the payor bank may recover the payment from the depositary bank who then may recover it from the telemarketer, assuming that it is solvent.

IV. REQUIREMENTS FOR NEGOTIABILITY

A. Introduction: Because the legal consequences of the use of a negotiable instrument are quite different from those attending the use of a simple contract to pay money, negotiable instruments law had to devise a clear means by which a person could distinguish a negotiable instrument from a simple contract. A person purchasing an instrument has to know with ease and certainty whether the instrument is negotiable or not. Similarly, a person signing an instrument has to know that she or he is thereby giving up certain very important rights. Negotiable instruments law chose to have the form of the writing be the distinguishing mark between negotiable writings and nonnegotiable writings. With rare exception, all writings that comply with the required form are negotiable, whereas all writings that do not comply are not negotiable.

B. Compliance with U.C.C. §3-104(a): Only a writing complying with the requirements of U.C.C. §3-104(a) is a negotiable instrument under Article 3. U.C.C. §3-104, Official Comment 1. A writing that does not meet these requirements can still be an enforceable obligation, although it is not governed by Article 3.

Examples: Typical assignments, sales agreements, guaranty agreements, and letters of credit often either include provisions not authorized by Article 3 or omit provisions required thereby and therefore do not qualify as negotiable instruments under Article 3.

C. Requirements for negotiability: Section 3-104(a) sets forth the requirements for negotiability:

- a signed writing;
- containing an unconditional promise or order;
- payable in a fixed amount of money, with or without interest or other charges described in the promise or order;
- payable to bearer or to order at the time it is issued or first comes into possession of a holder;
- payable on demand or at a definite time; and

- containing no other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, except (a) an undertaking or a power to give, maintain, or protect collateral to secure payment; (b) an authorization or a power to the holder to confess judgment or realize on or dispose of collateral; or (c) a waiver of the benefit of any law intended for the advantage or protection of an obligor.

D. **Instrument must be in writing:** A negotiable instrument must take the form of a writing signed by the maker or drawer. U.C.C. §3-104, Official Comment 1.

Analysis: This requirement is not explicit. However, an instrument must contain a promise or an order. The definition of "promise" requires that the promise be in a writing signed by the person promising to pay (the maker), and the definition of "order" requires that the order be in a writing signed by the person giving the order (the drawer). U.C.C. §3-103(a)(9), (6). [[Rev] U.C.C. §3-103(a)(12), (a)(8).]

1. **What is a writing?** A writing is a "printing, typewriting or any other intentional reduction to tangible form." [[Rev] U.C.C. §1-201(b)(43).] Any form of marking on paper or similar material qualifies as a writing.

Exception: Neither a phonograph record nor a tape recording, nor an electronic funds transfer that might take the form of impulses on tapes or computer disks is a writing.

Rationale: The rules of Article 3, especially those for allocating losses for forgery and alteration, were formulated for more traditional "written" instruments and were not intended to be applied to recorded or computerized "instruments."

2. **Signed:**"Signed" includes "any symbol executed or adopted by a party with present intention to adopt or accept a writing." [[Rev.] U.C.C. §1-201(b)(37).]

a. **Real name need not be used:** As long as the signer intends that the name, words, or mark be her signature, she may use any name, words, or mark as her signature, including a fictitious name, a trade name, or her first name. U.C.C. §3-401(b)(ii); U.C.C. §3-401, Official Comment 2.

b. **Any form:** A signature may be in the form of printing, handwriting, typing, or even the imprint of a thumbprint. [Rev.] U.C.C. §1-201, Official Comment 37; U.C.C. §3-401(b); U.C.C. §3-401, Official Comment 2.

c. **Any place on instrument:** The mark or symbol may appear anywhere on the instrument.

Example: An instrument in handwriting stating "I, John Doe, promise to pay…" has been signed if no signature line is found on the bottom of the instrument. U.C.C. §3-401, Official Comment 2.

Example: Although a signature may be typed, neither the name of the drawer (or maker) contained in a letterhead nor his typed name under the signature line is usually regarded as a signature.

E. **Promise or order:** To be negotiable, an instrument must contain a promise or an order. U.C.C. §3-104(a).

1. **Promise:** A promise is an undertaking to pay money. U.C.C. §3-103(a)(9). [[Rev] U.C.C. §3-103(a)(12).] Although the word "promise" need not be used, the language must be promissory in nature.

Example: The words "I owe you $500, which I hope to repay within a month" are not a promise because a mere acknowledgment of a debt is not sufficient to constitute a promise.

2. **Order:** An order is an instruction to pay money. U.C.C. §3-103(a)(6). [[Rev] U.C.C. §3-103(a)(8).] Although the word "order" does not have to be used, the language must demand that the drawee make payment and not merely authorize or request her to make payment.

F. **The promise or order must be unconditional:** Unless a negotiable instrument is payable unconditionally, it cannot serve its functions. A check will not be accepted in lieu of cash if there are conditions attached to its payment. Similarly, a purchaser of a note will require a substantial discount from the note's face value if payment of the note is subject to a contingency.

1. **Express condition:** A promise or an order that is expressly conditioned on the happening of a specified event is not unconditional. U.C.C. §3-106(a). Even if the condition is fulfilled, the instrument is still denied negotiability. The purchaser should not be required to refer to extrinsic facts to determine whether the condition has been fulfilled.

   Example: A check does not contain an unconditional order if the drawer has written that payment is conditioned on the delivery of a car whether or not the car has already been delivered. U.C.C. §3-106, Official Comment 1.

2. **Implied condition:** The promise or order is regarded as unconditional where the promise or order is subject only to an implied or constructive condition. U.C.C. §3-106, Official Comment 1.

   Example: If the maker makes a note in payment for a car to be delivered, the note is deemed to be negotiable even though, under contract law, a court may imply that payment of the note is constructively conditioned on delivery of the car. The result would be the same even if the maker recited in the note that it was in payment for a "car to be delivered." In neither case does the note expressly state a condition to payment.

3. **Payment out of particular fund:** A promise or an order is not made conditional merely because payment is to be made solely out of a particular fund or source. U.C.C. §3-106(b)(ii); U.C.C. §3-106, Official Comment 1.

   Rationale: If the purchaser does not like the source or fund out of which payment is to be made, he does not have to purchase the instrument. U.C.C. §3-106, Official Comment 1.

   Example: A negotiable note could read "This note is payable only out of the proceeds of a mortgage executed by Donald Buyer to Sam Seller dated January 15, 2002." In contrast, if the note read "This note is payable only if Donald Buyer makes payments to Sam

Seller from the mortgage executed on January 15, 2002," it would not be unconditional because it is subject to an express condition.

4. **Reference to separate agreement:** The purchaser of a negotiable instrument is supposed to be able to determine its rights on the instrument, with certain exceptions, by looking at the instrument itself. Therefore, if the purchaser's rights are contained in a separate writing, the instrument is not negotiable.

   a. **Subject to or stated in another writing:** A promise or an order is not unconditional if it states that the promise or order is subject to, or governed by, another writing or stated in another writing. U.C.C. §3-106(a)(ii), (iii). [The 2002 amendments substitute the term "record" for "writing."]

      Rationale: The mere existence of the requirement that another writing be consulted is sufficient to destroy negotiability; it is irrelevant that examination of the other writing does not reveal a condition precedent to payment. U.C.C. §3-106, Official Comment 1.

      Example: A note that states "Payment of this note is subject to the terms of the Master Finance Agreement dated February 1, 2000" is not negotiable whether or not the agreement contains any conditions to payment because the holder must consult the Master Finance Agreement to determine her right to repayment of the note.

   b. **Reference to another writing:** An instrument that merely refers to the existence of another writing or record may be negotiable. U.C.C. §3-106(a).

      Example: A note stating that it is made "pursuant to" the Master Franchise Agreement dated February 1, 2000 is considered to contain an unconditional promise. The term "pursuant to" does not indicate that the note is controlled in any manner by the Master Franchise Agreement.

   c. **Distinction between "subject to" and "refers to":** In distinguishing between whether a promise or an order is subject to or merely refers to another writing, look to see whether the maker or drawer, by the language used in the instrument, is indicating an intention to make its rights and duties under the instrument conditional on terms found in the separate writing. If so, the instrument is subject to the other writing. If not, it is a permissible reference that will not destroy the negotiability of the writing.

d. **Exceptions:** An instrument may retain its negotiability while referring to another writing for rights as to (a) collateral, (b) acceleration, or (c) prepayment. U.C.C. §3-106(b)(i).

e. **2002 amendments:** To accommodate modern technology, the term "record" has been substituted for "writing." The 2002 amendments to Revised Article 3 define "record" in [Rev] U.C.C. §3-103(a)(14) as "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form."

G. **Fixed amount:** The principal sum must be payable in a fixed amount. U.C.C. §3-104(a).

1. **Determined by reference to instrument alone:** An instrument is not payable in a fixed amount if the terms used in the instrument to express the sum payable, or any component thereof, are ambiguous or if reference must be made to an outside source or writing to determine the principal amount.

Rationale: Unless a purchaser can determine how much he will be paid under the instrument, he will be unable to determine a fair price to pay for it, thus defeating the basic purpose of negotiable instruments as a money substitute (in the case of drafts) or as a freely transferable promise of repayment (in the case of notes).

Example: A note is not negotiable when it guarantees "all indebtedness" or a "sum not to exceed."

2. **Exceptions:** Interest and other charges do not have to be payable in a fixed amount. U.C.C. §3-112, Official Comment 1.

Rationale: Certain types of provisions may make the ultimate amount payable unascertainable at the time the instrument is issued, although the provision must be included for the parties to make the deal.

a. **Provisions for interest:** Virtually any type of provision for the payment of interest is permissible. An instrument may state the obligation to pay interest as a fixed or variable amount of money or as a fixed or variable rate or rates. U.C.C. §3-112(b); U.C.C. §3-112, Official Comment 1.

   i. **Interest need not be determinable from instrument alone:** The amount or rate of interest may be stated or described in the instrument in any manner and may require reference to information not contained in the instrument. U.C.C. §3-112(b); U.C.C. §3-112, Official Comment 1.

      Example: A note payable with interest at the rate of "2% over the Bank of America prime rate" is negotiable. Similarly, interest can be stated as a described percentage of the profits of a specified business.

   ii. **Time from when interest payable:** When it is clear that the parties intended that interest be paid on the instrument but the instrument does not make clear the time from which interest is to be paid, interest on an interest-bearing instrument is payable from the date of the instrument. U.C.C. §3-112(a). Interest runs on an undated instrument from the date that the instrument was issued. U.C.C. §3-113(b).

   iii. **No means of determining interest:** When an instrument provides that it is payable "with interest" but the description in the instrument does not allow for its calculation, interest is payable at the judgment rate applicable at the place of payment and at the time interest first accrues. U.C.C. §3-112(b); U.C.C. §3-112, Official Comment 1.

b. **Provisions for other charges:** An instrument is payable in a fixed amount even if it is payable with other charges that are not in a fixed amount.

   i. **Attorneys' fees and costs:** Provisions for attorneys' fees and costs of collection incurred in the collection of the instrument are permissible “other charges” even if they do not specify a particular sum.

Example: A provision for attorneys' fees may provide for a percentage of the principal balance due, “reasonable attorneys' fees,” or “attorneys' fees.”

ii. **Penalties and discounts:** Provisions for prepayment penalties, late payment penalties, or other penalties, discounts, or rebates are also permissible “other charges.”

iii. **Taxes and insurance not permissible:** A duty to pay taxes or to pay to insure collateral will probably not be found to be permissible other charges and therefore will defeat an instrument's negotiability.

H. **Payable in money:** An instrument is not negotiable unless it is payable in money. U.C.C. §3-104(a).

1. **Money:**“Money” is defined as “a medium of exchange authorized or adopted by a domestic or foreign government and includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more nations.” [Rev] U.C.C. §1-201(b)(24).

Example: A note payable in Euros issued by the European Union is payable in money.

Example: An instrument payable in the United States in Swiss francs and an instrument payable in Canada in U.S. dollars are both payable in money. The instrument does not have to be payable in the country in whose currency the instrument is payable.

2. **Payable in either currency:** Unless it otherwise provides, an instrument that states the amount payable in foreign currency may be paid either in that foreign currency or in an equivalent amount of U.S. dollars. U.C.C. §3-107.

I. **Payable to order or to bearer:** A negotiable instrument must either be “payable to order” or “payable to bearer.” U.C.C. §3-104(a)(1).

Rationale: For both a prospective purchaser and the obligor to know quickly and with certainty whether a writing is a negotiable instrument, Article 3 requires that certain key words be used for a writing to qualify as a negotiable instrument.

Exception for checks: A check that meets all the requirements of U.C.C. §3-104(a) except for not being made payable to "order" or "bearer" is a negotiable instrument governed by Article 3. U.C.C. §3-104(c).

Rationale: The transaction in which a check is taken is usually fairly quick. A taker of a check, including a depositary bank, would probably not notice if the check omitted the words "to the order of" and would likely believe that the check was negotiable. U.C.C. §3-104, Official Comment 2.

1. **Payable to bearer:** An instrument that is payable to bearer may take one of several forms.

   a. **To bearer:** The instrument may simply state that it is payable "to bearer." U.C.C. §3-109(a)(1).

   b. **Words indicating to possessor:** The instrument may use language indicating that the person in possession of it is entitled to payment. U.C.C. §3-109(a)(1).

      Example: Instruments payable to "holder," to "cash," or to the "order of cash" are payable to bearer. U.C.C. §3-109(a)(3).

   c. **Blank:** An instrument that does not name a payee, e.g., "pay to order of _______," is payable to bearer. U.C.C. §3-109(a)(2).

      Note: The instrument, although negotiable, is also an incomplete instrument until the name of the payee is inserted. U.C.C. §3-109, Official Comment 2.

2. **Payable to order:** An instrument is payable to order if it is payable to the "order of [an identified person]" or to an "[identified person] or order." U.C.C. §3-109(b).

   Example: Instruments payable to "order of John Jones" or "John Jones or order" are payable to order.

3. **Payable to both order and bearer:** When an instrument is payable both to order and to bearer, the instrument is payable to

bearer. U.C.C. §3-109(b); U.C.C. §3-109, Official Comment 2.

Example: Instruments containing the following designations are payable to bearer: (1) “bearer or order,” (2) “order of bearer,” (3) “John Doe or bearer,” or (4) “order of cash.” U.C.C. §3-109(a), Official Comment 2.

Rationale: Use of bearer words like “cash” or “bearer” more likely evidence the issuer's intention than does the word “order.” This is especially likely where the drawer of a check clearly desired to make the check payable to cash but simply neglected to cross out the words “order of” on the check form. By treating these instruments as payable to bearer, subsequent transferees, who believe that the instrument is payable to bearer, and, thus, fail to obtain their transferor's indorsement, are protected. U.C.C. §3-109, Official Comment 2.

J. **Payable on demand or at a definite time:** An instrument is not negotiable unless it is payable either at a definite time or on demand. U.C.C. §3-104(a)(2).

1. **Payable on demand:** A promise or order is “payable on demand” if it states that it is payable on demand or at sight or otherwise indicates that it is payable at the will of the holder. U.C.C. §3-108(a).

Test: An instrument is payable on demand when the time payment is due is determined at the sole discretion of the holder.

Example: An instrument is not payable on demand if it is payable upon a contingency limiting the discretion of the holder to determine the time of payment, e.g., instruments payable “upon an acceptable permanent loan being secured” or “at the earliest convenience of the maker.”

a. **Expressly payable on demand:** The following designations expressly indicate that the instrument is payable on demand: (a) “on demand,” (b) “on presentation,” or (c) “at sight.”

b. **No date of payment:** An instrument that fails to state when payment is due is deemed to be payable on demand. U.C.C. §3-108(a)(ii).

Rationale: It is presumed that the failure of the parties to state the date on which payment is due means that the parties intended that the instrument be payable on demand.

Example: A note that states "I promise to pay to the order of Jill the sum of $200" is payable on demand.

c. **Fixed date and on demand:** An instrument that is payable both at a fixed date and also on demand before the fixed date is payable on demand.

Example: A note payable "on June 1, 2003 or earlier on demand of the holder" is payable on demand.

Note: An instrument otherwise payable on demand remains payable on demand even if it is postdated or antedated. U.C.C. §3-113(a).

2. **Payable at a definite time:** A promise or an order is "payable at a definite time" if it is payable at a time readily ascertainable when the promise or order is issued. U.C.C. §3-108(b). The following instruments are payable at a definite time: at a fixed date ("on February 1, 2005"), a definite period after a stated date ("30 days after date"), or on "elapse of a definite period of time after sight or acceptance" ("45 days after acceptance").

a. **Date readily ascertainable:** An instrument is payable at a definite time as long as the date is readily ascertainable at the time the promise or order is issued even if the date is not specified in the instrument.

Example: An instrument payable on "the day that the 2008 Summer Olympic Games commence" is payable at a definite time if the date the 2008 Summer Olympic Games begin has been set at the time that the instrument is issued.

b. **Incomplete instrument:** A note or draft payable a fixed period "after date" that does not state a date is an incomplete instrument. Once the note or draft is completed by the addition of a date, the instrument becomes payable at a definite time.

Example: "30 days after date."

Exception: A draft payable a fixed period "after sight" or "after acceptance" is a complete and negotiable instrument. U.C.C. §3-108(b). "After sight" means after the drawee has accepted the draft.

Rationale: Even if no time for payment can be determined at the time of the instrument's issuance, the holder has it within her ability to set the date of payment by presenting the draft for acceptance.

c. Subject to acceleration: An instrument that is otherwise payable at a definite time remains so even if the time of payment is subject to acceleration. U.C.C. §3-108(b)(ii).

Definition: The time of payment is subject to acceleration when a clause, either in the instrument or in another writing referred to in the instrument, allows the holder to demand, under specified conditions, payment prior to the time set in the instrument for payment.

Rationale: Allowing the holder this right does not make the time of payment uncertain because it is usually within the holder's discretion to decide whether to accelerate the time of payment. Any type of acceleration clause is permissible. Great leeway is given for acceleration clauses because of the importance of these clauses to lenders. A lender, especially a bank, needs to have the ability to accelerate the time payment is due when any of numerous possible risks materialize.

Example: An acceleration clause may provide for acceleration at the unrestricted option of the holder or limit acceleration to circumstances in which an installment has not been paid or the holder "deems himself insecure."

d. Subject to prepayment: An instrument that is subject to prepayment by the obligor remains payable at a definite time. U.C.C. §3-108(b)(i).

Rationale: Despite the fact that the obligor reserves the right to make early payment of the instrument, the holder knows the latest date by which the instrument will be paid.

e. **Subject to extension:** An instrument is payable at a definite time even if it is subject to extension at the option of the holder, maker, or acceptor or automatically upon, or after, a specified act or event. U.C.C. §3-108(b)(iii), (iv).

i. **Right of holder to extend:** An instrument remains negotiable even if the holder has the right to extend the time of payment indefinitely. U.C.C. §3-108(b)(iii); U.C.C. §3-108, Official Comment.

Rationale: Like a demand instrument, the holder still retains control over when the instrument is due.

ii. **Right of maker or acceptor to extend:** When the maker or the acceptor has the right to extend the time for payment, the instrument is payable at a definite time only if the right to extend is limited to extension to a further definite time. U.C.C. §3-108(b)(iv); U.C.C. §3-108, Official Comment. The same rule applies when the time for payment is automatically extended upon the occurrence of a specified event.

Example: A clause providing that the maker may "extend the time of payment for a period of two additional years" will not destroy negotiability because the holder knows that he will receive payment no later than two years after the original due date. In contrast, a clause allowing the maker to "extend payment until the maker has sufficient cash to make payment" defeats the instrument's negotiability. When the maker or acceptor has the option to extend the time of payment or when the time is extended automatically upon a specified act or event, the holder has no power to determine when payment will be made. Thus, unless the option to extend is limited to an extension to a definite time, the holder will not know when he can expect payment.

K. **No other promises or orders:** To be negotiable an instrument can contain "no other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money." U.C.C. §3-104(a)(3); U.C.C. §3-104, Official Comment 1.

1. **Clauses defeating negotiability:** Inclusion in an instrument of a promise, an obligation, an order, or a power not authorized by Article 3 defeats the instrument's negotiability.

   Example: A promise to pay taxes or to maintain a minimum working capital will defeat an instrument's negotiability.

2. **Permissible promises and instructions:** The following promises or instructions are authorized by Article 3. U.C.C. §3-104(a)(3); U.C.C. §3-104, Official Comment 1.

   a. **Collateral:** An undertaking or a power to give, maintain, or protect collateral to secure payment will not defeat an instrument's negotiability. This would include provisions granting the holder a security interest in the collateral or securing both the obligation evidenced by the instrument itself and any other obligation of the obligor.

   b. **Confession of judgment:** An authorization or a power to the holder to confess judgment or realize on, or dispose of, collateral will not destroy negotiability.

   c. **Waiver:** A waiver of the benefit of any law intended for the advantage or protection of an obligor will not destroy negotiability.

3. **Limited to maker or drawer:** The prohibition against additional terms is limited to undertakings and instructions given by the person promising or ordering payment. A promise by the holder does not violate this prohibition. U.C.C. §3-104(a)(3).

   Example: Giving the holder the right to purchase, at the holder's own cost, a life insurance policy on the maker's life does not defeat negotiability. However, if the promise of the maker is made expressly conditional on the holder's purchase of the life insurance policy, the maker's promise is thereby made conditional.

4. **Conditional sales contracts:** Under a conditional sales contract, the buyer usually agrees to pay for goods in installments with the seller retaining title to the goods until payment in full has been made. Conditional sales contracts, being much more like Article 2 contracts for the sale of goods rather than negotiable instruments,

are not the type of writing that should be governed by Article 3. Article 3 is not meant to apply to contracts for the sale of goods or services or for the sale or lease of real property or to similar writings that may contain a promise to pay money. U.C.C. §3-104, Official Comment 2. In most situations, these contracts will omit the required "order" or "bearer" language. However, even if these words are present, a court will more than likely find that a conditional sales contract is not covered by Article 3.

L. Negotiability determined by writing itself: Negotiability is determined solely by reference to the four corners of the instrument. A separate agreement cannot affect the negotiability of an instrument.

1. **Not negotiable by agreement alone:** A writing that fails to otherwise conform to the requirements of U.C.C. §3-104(a) does not become negotiable simply because the parties have agreed that it should be negotiable.

   Example: An instrument is not made negotiable merely by inclusion of phrases like "This instrument is negotiable," or "I will not raise any claim or defense."

2. **May be treated as negotiable:** However, even absent formal compliance with U.C.C. §3-104, a writing of the parties may be treated by a court as having the characteristics of a negotiable instrument.

   Example: A court could, by applying the doctrine of estoppel or ordinary principles of contract law, deny the obligor the right to raise any of her defenses against the assignee if the writing contains a provision denying the obligor a right to raise defenses against a subsequent assignee. U.C.C. §3-104, Official Comment 2.

3. **Writing "not negotiable" defeats negotiability:** By contrast, a legend such as "Not Negotiable" defeats an instrument's negotiability even if the instrument otherwise complies with U.C.C. §3-104(a). U.C.C. §3-104(d); U.C.C. §3-104, Official Comment 3.

   Exception: This latter rule does not apply to checks. U.C.C. §3-104(d); U.C.C. §3-104, Official Comment 3. Because of the cash-like nature of checks and the swiftness of their negotiation and payment, there is no justification for allowing a drawer to deny negotiability to a check.

Quiz Yourself on
WHAT IS A NEGOTIABLE INSTRUMENT?

1. Bank of America draws a check on itself. It is both the drawer and the drawee. What type of check is this?_________

2. Home Savings, as drawer, draws a check on Wells Fargo Bank, as drawee. What type of check is this? _______

3. Grain Broker agrees to purchase grain from Farmer to be delivered on February 1 with payment due on March 1. Grain Broker draws a draft on its bank, Omaha State Bank, payable to Farmer on March 1.

  a. What type of draft would this be?_________

  b. If it was payable on presentment or on demand, what type of draft would it be?_________

4. If Grain Broker does not want to make payment until it is assured of obtaining possession of the grain, what can Grain Broker do and how will he do it?_________

5. State Farm Insurance Company draws a draft on itself as drawee by which it orders itself to pay the insured who is named as the payee. The draft is made payable through Bank of America. For the insured to collect the draft, the insured or the insured's depositary bank must send the draft to Bank of America, which will present the draft to State Farm Insurance. What else could State Farm have done to reach the same result?_________

6. Answer the questions below as to the following instrument:_________

“To Bank of America
Pay to Mick Jagger the sum of $100.

/s/ Keith Richards”

  a. What type of instrument is it?_________

b. Is the instrument negotiable?_________

c. What are the Article 3 and 4 names of Bank of America, Mick Jagger, and Keith Richards?_________

7. Answer the questions below as to the following instrument:

"January 1, 2004

One year from this date, I promise to pay to cash the sum of $1,000 together with interest. This promise arises from the agreement I made with Lucy Sky Diamonds in which she promised to handle my personal injury case. In addition, in the event that this instrument is not paid when due, I promise to pay any attorneys' fees and costs incurred in the collection of this instrument.

/s/ Timothy Leary"

a. Is the instrument negotiable?_________

b. What type of instrument is it?_________

c. In what capacity did Timothy Leary sign?_________

Answers

1. **A cashier's check.** A check is a cashier's check where both the drawer and the drawee are the same bank or branches of the same bank.

2. **A teller's check.** A teller's check is a check drawn by one bank, here Home Savings, and "payable at" or "payable through" the other bank, here Wells Fargo Bank.

3.a. **A time draft.** A time draft is a draft payable at a definite time.

b. A sight draft. A draft payable on demand is called a sight draft.

4. **Issue Farmer a documentary draft.** To do so, Grain Broker will issue to Farmer an ordinary draft accompanied by a letter containing instructions to Omaha State Bank, the drawee bank, that it should pay the draft only if Farmer delivers to Omaha State Bank a negotiable warehouse receipt for the requisite number of bushels of grain. By requiring delivery of a negotiable warehouse receipt before payment, Grain Broker is thereby guaranteed that it will be entitled to possession of the grain on the draft's payment.

5. **Issue a note.** Drafts drawn on the drawer and notes are treated the same way, so State Farm could have used a note made payable through Bank of America and avoided having to issue a draft.

6.a. **A check.** A check is a draft drawn on a bank payable on demand. U.C.C. §3-104(f). It is a draft because it is an order. U.C.C. §3-104(e). An order is a written instruction signed by the person giving the instruction. U.C.C. §3-103(a)(6). [[Rev] U.C.C. §3-103(a)(8).] It is drawn on a bank because it is directed to Bank of America. It is payable on demand because it is undated. U.C.C. §3-108(a).

b. **Yes.** There is an unconditional order to pay a fixed amount of money. Although the writing does not include the word "order," it is still negotiable because a check does not need to be payable to order or bearer. U.C.C. §3-104(a)(1). An instrument can be negotiable even if it is not dated. U.C.C. §3-113(b).

c. **Bank of America is the drawee**, U.C.C. §3-103(a)(2) [[Rev] U.C.C. §3-103(a)(4).], **and the payor bank**, U.C.C. §4-105(3). **Mick Jagger is the payee**. **Keith Richards is the drawer**. U.C.C. §3-103(a)(3). [[Rev] U.C.C. §3-103(a)(5).]

7.a. **Yes.** By being payable to "cash," it is payable to bearer. U.C.C. §3-109(a)(3). By being payable one year from a stated date, it is payable at a definite time. U.C.C. §3-108(b). An instrument may be payable with interest. If the rate of interest cannot be determined from the description, interest is payable at the judgment rate. U.C.C. §3-112. An instrument is payable in a fixed amount even if it is payable with other charges. U.C.C. §3-104(a). Other charges include attorneys' fees and costs of collection. Because the promise is not conditioned on the transaction with Lucy Sky Diamonds, the instrument contains an unconditional promise even though it refers to the transaction as the origins of the instrument. U.C.C. §3-106(b).

b. **A note.** It is a negotiable instrument that contains a promise. U.C.C §3-104(e).

c. **Maker.** The maker is the person who signs a note as the person undertaking to pay. U.C.C. §3-103(a)(5). [[Rev] U.C.C. §3-103(a)(7.]

Exam Tips on WHAT IS A NEGOTIABLE INSTRUMENT?

- **Requirements for negotiability:** Always look to see whether the instrument is negotiable. If it fails in any way to meet the requirements for negotiability, none of the rules of Article 3 apply. However, because Article 4 applies to "items" and not just to negotiable instruments, Article 4 still applies.
  - When determining negotiability, always ask:
    - Is the instrument a signed writing?
    - Does it contain an unconditional promise or order?
    - Is it payable in a fixed amount of money, with or without interest or other charges described in the promise or order?
    - Is it payable to bearer or to order at the time it is issued or first comes into possession of a holder?
    - Is it payable on demand or at a definite time?
    - Does it contain no other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, except (a) an undertaking or a power to give, maintain, or protect collateral to secure payment; (b) an authorization or a power to the holder to confess judgment or realize on or dispose of collateral; or (c) a waiver of the benefit of any law intended for the advantage or protection of an obligor?
- **Exceptions to negotiability requirement:** Be aware, however, that there are exceptions to these rules.
  - A check can be negotiable even if it is not payable to order or to bearer.
  - An instrument that is subject to another writing in regard to rights as to collateral, acceleration, or prepayment can still be negotiable.

CHAPTER 2
HOLDER-IN-DUE-COURSE STATUS AND AVAILABLE CLAIMS, DEFENSES, CLAIMS IN RECOUPMENT, AND DISCHARGES

ChapterScope

This chapter covers the requirements for obtaining holder-in-due-course status (the negotiable instrument equivalent to a good-faith purchaser for value) and the defenses, claims, claims in recoupment, and discharges to which a purchaser of an instrument takes subject. The key points in this chapter are:

- **Special rights of holder in due course:** A holder in due course is given special rights including the right to take free from virtually all claims to the instrument, defenses, and claims in recoupment as well as from any discharge of which she does not have notice.
- **Holder-in-due-course requirements:** There are strict requirements for obtaining holder-in-due-course status, including obtaining any necessary indorsement, taking for value, and being without notice of any claim, defense, or claim in recoupment.
- **Rights of persons denied holder-in-due-course status:** Certain purchasers, although meeting its requirements, are denied holder-in-due-course status. A person not qualifying as a holder in due course can still obtain the rights of a holder in due course if he takes the instrument through a transfer from a holder in due course.
- **Bank checks:** Special rules govern the right of a bank to raise defenses to its obligation to pay a bank check.
- **Federal negotiable instruments law:** Federal common law, not Uniform Commercial Code Articles 3 and 4, governs the rights of the United States on a negotiable instrument.

I. INTRODUCTION

A. Holder-in-due-course status: The primary value of a negotiable instrument is that it can free its possessor of many of the risks associated with cash or ordinary contract rights. However, in order not to be a vehicle for the perpetuation of injustice, the only type of possessor who obtains these protections is a holder in due course (the negotiable instrument's version of a good-faith purchaser for value). Because these protections are at the expense of another party, Article 3 imposes stringent requirements for obtaining holder-in-due-course status.

B. General requirements for holder-in-due-course status: To obtain holder-in-due-course status, the purchaser of an instrument must take the instrument:

1. as a holder,
2. for value,
3. in good faith, and
4. without notice of certain proscribed facts. U.C.C. §3-302(a).

Example: Abe, the original holder of a note payable to bearer, loses the note. The note is found by Bill, who negotiates the note to Carl, who, paying value for the note in good faith and without notice of Bill's lack of title, qualifies as a holder in due course. Carl takes the note free from Abe's claim of ownership. U.C.C. §3-306. By protecting Carl, Abe (the innocent original owner of the note) loses the value of the note.

II. HOLDER STATUS

A. Introduction: Negotiable instruments law greatly reduces the risks of theft or loss associated with the use of cash by creating the status of holder, which ensures the person to whom an instrument is payable that the instrument cannot be paid without his signature (called an indorsement).

B. Holder need not own instrument: The status of holder is independent of that of the owner of the instrument. Although most holders are probably also the owner of the instrument, a holder does not have to be the owner. Holder status is acquired by meeting certain formalistic requirements apparent from the instrument itself, not by having any legal or equitable right to the instrument.

Rationale: A person paying or purchasing the instrument must be able to determine immediately from the face of the instrument itself, together with the person's identification, whether she can safely deal with that person. The primary advantage of using a negotiable instrument—that is, the ease by which it can be sold or converted into cash—would be defeated if a person could not safely pay or purchase the instrument without investigating whether the person with whom she is dealing is truly the owner of the instrument.

C. Requirements for holder status: For a person to qualify as the holder of an instrument, the person must have possession of the instrument, and the obligation evidenced by the instrument must run to him.

D. Ways of acquiring holder status: There are two ways of acquiring holder status:

1. **Issuance of instrument:** An instrument is ***issued*** when it is first delivered by the maker or drawer to either a holder or nonholder for the purpose of giving rights on the instrument to any person (the latter called a "remitter"). U.C.C. §3-105(a).

   a. ***Delivery*** is "the voluntary transfer of possession." [Rev] U.C.C. §1-201(b)(15).

   b. ***Remitter*** is a person who purchases an instrument from its issuer if the instrument is payable to an identified person other than the purchaser. U.C.C. §3-103(a)(11). [[Rev] U.C.C. §3-103(a)(15).]

2. **Negotiation of instrument:** Negotiation is a transfer of possession of an instrument, whether voluntary or involuntary, by a person other than the issuer (i.e., maker or drawer) to another person who thereby becomes its holder. U.C.C. §3-201(a).

   Note: Negotiation can take place through involuntary transfer of possession. Although an actual transfer of possession is necessary for the transferee to become a holder, the transfer need not be voluntary. U.C.C. §3-201, Official Comment 1.

Example: A thief or finder of an instrument payable to bearer becomes the holder even though the transfer of possession was involuntary. U.C.C. §3-201, Official Comment 1. Of course, the thief, not qualifying as a holder in due course, would be subject to the true owner's claim of ownership. U.C.C. §3-305(a)(2).

E. Obligation must run to possessor: In addition to having possession of the instrument, the obligation contained in the instrument must run to that person if he is to be the holder. When an instrument is payable to bearer, transfer of possession alone is sufficient for its negotiation. To negotiate an instrument payable to order, the instrument must also be indorsed to that person or to bearer. U.C.C. §3-201(b).

F. Indorsement: An indorsement sufficient to negotiate an instrument must be written by or on behalf of the holder. U.C.C. §3-201(b).

Note: An indorsement written by one other than a holder is sufficient for the undertaking of the indorser's contract, but it is not sufficient to negotiate the instrument. U.C.C. §3-415(a); U.C.C. §3-204(a). A signature is an indorsement unless it unambiguously indicates otherwise. Chicago Title Ins. Co. v. Allfirst Bank, 394 Md. 270 (Md. 2006).

Note: A forged or unauthorized indorsement is not effective to negotiate the instrument. Thus, if an indorsement in the chain of title is forged or unauthorized, no transferee subsequent to the unauthorized or forged indorsement can become a holder. An unauthorized signature is not sufficient as an indorsement as to make the person possessing the instrument a holder thereof. *See* Money Stop Financial Services v. AFT Trucking, LLC, 2007 WL 702238 (N.J. Super. A.D. 2007).

Example: Dan, the payee, loses a check. Fred, the finder, forges Dan's indorsement on the check and transfers the check to Gina. Because Dan's indorsement was forged, neither Fred nor Gina is a holder of the check.

1. **Types of indorsements:** Two types of indorsements can be used to negotiate an instrument.

   a. **Special indorsement:** A special indorsement identifies the person to whom it is payable. U.C.C. §3-205(a).

      Example: If the check is payable to Bill, Bill specially indorses the check by making it payable to John and by signing his own name.

      Note: No words of negotiability, e.g., "order of," are required for a special indorsement. Both "Pay to the order of John Jones /s/ Bill," and "Pay to John Jones /s/ Bill" are special indorsements.

   b. **Blank indorsement:** A blank indorsement is an indorsement that is not payable to an identified person. An instrument indorsed in blank becomes payable to bearer and any person who possesses the instrument becomes its holder. A blank indorsement can consist of:

      - the unaccompanied signature of the holder;
      - the signature of the holder accompanied by such phrases as "pay to bearer," "pay to holder," "pay to bank," or "pay to cash"; or
      - use of the words "pay to _______" with no one's name filled in. U.C.C. §3-205(b).

   c. **Conversion of blank indorsement to special indorsement:** Any holder of an instrument indorsed in blank may convert the blank indorsement into a special indorsement by writing over the signature of the indorser the name of an indorsee. U.C.C. §3-205(c); U.C.C. §3-205, Official Comment 2.

2. **Indorsement must be written on instrument:** An indorsement must be written on the instrument itself.

   Exception: As long as the separate piece of paper, called an ***allonge,*** is affixed to the instrument, an indorsement on that separate piece of paper is sufficient to negotiate the instrument. U.C.C. §3-204(a).

Example: When John attempts to indorse the check to Brian, John discovers that there is not sufficient room on the check to write the indorsement. As a result, John writes "Pay to Brian, /s/ John" on a separate piece of paper. John staples the piece of paper to the check. The separate piece of paper qualifies as an allonge and is sufficient to negotiate the check to Brian.

3. **Manner of negotiation depends on last indorsement:** An instrument becomes payable to order or payable to bearer depending on whether the last indorsement is a special or a blank indorsement. U.C.C. §3-205. If the last indorsement is a special indorsement, the instrument is payable to the order of the special indorsee and can be negotiated only by her indorsement. U.C.C. §3-109(c). An instrument originally payable to an identified person may be negotiated by delivery alone if the last indorsement is in blank. U.C.C. §3-109(c).

Example: Assume that Shelan receives a check payable to "cash." Shelan may indorse the check "Pay to Gina, /s/Shelan" and deliver the check to Gina. The check is now payable to the order of Gina. For Gina to negotiate the check, she must indorse it. If Gina indorses the check by simply writing "Gina," the check is again payable to bearer and may be negotiated by delivery alone.

4. **To whom an instrument is payable:** The basic rule is that the person to whom an instrument is initially payable is determined by the intent of the person signing the instrument whether as the issuer (drawer or maker), in the name of the issuer, or on behalf of the issuer, whether or not that person is authorized. U.C.C. §3-110(a).

Example: If the drawer of the check intends John Smith, the lawyer who used to teach at Loyola Law School, to be the person to whom the instrument is payable, an indorsement by another John Smith is not effective to negotiate the check. U.C.C. §3-110, Official Comment 1.

a. **Need not be real name of payee:** An instrument is payable to the person intended by the signer even if the payee is identified by a name other than his real name or if her name is misspelled. U.C.C. §3-110(a).

i. **Indorsement in either name effective:** When a payee is designated in a name other than her true name, an indorsement in either the payee's true name or the name appearing on the instrument (or in both) is effective to negotiate the instrument. U.C.C. §3-204(d); U.C.C. §3-204, Official Comment 3.

Example: If the drawer mistakenly designates John Smith as Donald Dove, John Smith's indorsement in either the name of John Smith or Donald Dove would be effective to negotiate the instrument.

ii. **Transferee or payor can require a signature for both names:** Subsequent transferees for value or collection or the payor can require the payee to sign in both names. U.C.C. §3-204(d); U.C.C. §3-204, Official Comment 3.

b. **More than one person signing as issuer:** If an instrument is signed by more than one person as maker or drawer and each signer intends that a different person be the person designated as the payee, the instrument is payable to any person intended by any one of the signers. U.C.C. §3-110(a).

Example: If a check made payable to "John Smith" is signed by two trustees of a trust, one of whom intends that the payee be John Smith, former law professor, and the other intends that the payee be John Smith, the former track star, the check is payable to either the former law professor or the former track star. The indorsement of either person will effectively negotiate the instrument. U.C.C. §3-110, Official Comment 1.

c. **Intent of forger determinative:** When the drawer's signature on the check is forged, the payee is the person to whom the forger intended that payment be made.

Example: If Henry forges the drawer's name, making the check payable to "John Smith" while intending the check to be payable to Henry himself, the check is payable to Henry.

d. **Checkwriting machine:** When the signature of the issuer is made by automated means, such as by a checkwriting machine, the identity of the payee is determined by the intent of the person who supplied the name (or other identification) of the payee, whether or not the person was an authorized agent or even connected with the company. U.C.C. §3-110(b).

5. **When payable to account number:** When a check is made payable to a specific account number either with or without the name of the account owner, the following rules apply.

   a. **Account number only:** When only the account number is identified, the check is payable to the person who owns the bank account so numbered. U.C.C. §3-110(c)(1).

      Example: Even if the drawer intends that the check go to Mary Jones, if the check is made payable to account #1234 and that account belongs to John Smith, the check is payable to John Smith and not to Mary Jones.

   b. **Conflicting account number and name:** When an instrument states both a name and an account number, and the name and the account number refer to different persons, the instrument is payable to the named person whether or not the person in fact owns the account. U.C.C. §3-110(c)(1).

      Example: When a check is made payable to Jane Jones, account #5678, even if Jane Jones does not have an account #5678 (the account being owned by Fran George), the check is payable to Jane Jones.

6. **Payable to agent for identified person:** When an instrument is made payable to a named person with words describing her as an agent or a representative of a specified person, the instrument is payable to either the represented person, the representative, or a successor of the representative. U.C.C. §3-110(c)(2)(ii); U.C.C. §3-110, Official Comment 3.

   Example: When an instrument is payable to "Gary Williams, President of Blue Note Records," either (1) Blue Note Records through any authorized agent; (2) Gary Williams, whether or not he is, or ever was, the president of Blue Note; or (3) the current president of Blue Note Records may act as the holder of the instrument. U.C.C. §3-110(c)(2)(ii); U.C.C.§3-110, Official Comment 3.

7. **Payable to office or officer:** An instrument made payable to an office or officer is payable to the named person, the present officeholder, or the successor to the named person.

   Example: An instrument made payable to “Gloria Williams, Mayor of Los Angeles” is payable to either (1) Gloria Williams, whether she is, or ever was, mayor; (2) the present mayor; or (3) a successor to the mayor. U.C.C. §3-110(c)(2)(iv).

8. **Payable to fund or organization:** When an instrument is payable to a fund or an organization that is not a legal entity, including any informal organization or club, the instrument is payable to any representative of the members of the fund or organization. U.C.C. §3-110(c)(2)(iii).

9. **Payable to trust or estate:** When an instrument is payable to a trust, an estate, or a person described as trustee or representative of a trust or an estate, the instrument is payable to the trustee, the representative, or the successor of either, whether or not the instrument also names the beneficiary or estate. U.C.C. §3-110(c)(2)(i); U.C.C. §3-110, Official Comment 3. The person designated as the beneficiary has no right to negotiate, discharge, or enforce the instrument.

10. **Other words of description:** When a description does not fit into one of the categories of U.C.C. §3-110(c), the additional words can be ignored.

    Example: An instrument payable to “John Smith, Father of Jane Smith” is payable to John Smith whether or not he is the father of Jane Smith.

11. **Two or more payees:** When an instrument is payable to more than one person, whether one of the named payees alone may negotiate, enforce, or discharge the instrument or whether all the payees must act together depends on whether the instrument is payable to the payees jointly or in the alternative.

    a. **Jointly:** If an instrument is payable jointly, all payees must participate in any negotiation, discharge, or enforcement of the instrument. U.C.C. §3-110(d); U.C.C. §3-110, Official Comment 4.

Example: An instrument payable to "John and Mary" may be negotiated only if John and Mary both indorse the instrument.

b. Alternative: An instrument payable in the alternative may be negotiated, discharged, or enforced by any payee who is in possession of the instrument. U.C.C. §3-110(d); U.C.C. §3-110, Official Comment 4. Instruments payable "to P or R" or "to P and R in the alternative" or "to P/R" ("/" means either/or) are payable to P or R in the alternative.

Example: An instrument made payable to "John or Mary" may be negotiated by either John's or Mary's indorsement. U.C.C. §3-110(d); U.C.C. §3-110, Official Comment 4.

c. Ambiguous: When it is unclear whether an instrument is payable alternatively or jointly, e.g., "to P and/or R," the instrument is deemed to be payable in the alternative. U.C.C. §3-110(d).

G. Depositary bank's status as holder: If a customer delivers an item to a depositary bank for collection, the depositary bank becomes the holder of the item at the time it receives the item if the customer at the time of delivery was a holder of the item. U.C.C. §4-205(1); U.C.C. §4-205, Official Comment.

1. No indorsement necessary: It is irrelevant whether the customer or the depositary bank indorses the item. U.C.C. §4-205(1).

Rationale: Often a customer may forget to indorse a check that she has deposited in her bank for collection. By depositing the check, the customer implicitly requests that the bank do whatever is necessary to collect the check for her. To require the depositary bank to indorse in the name of the customer would be a waste of the bank's resources. U.C.C. §4-205, Official Comment.

2. Customer liable as indorser: Whether or not her indorsement appears on the check, the customer is liable on the check in the event of its dishonor as though she had indorsed the check. U.C.C.

§4-207(b).

3. **Depositary bank's warranty:** The depositary bank warrants to subsequent collecting banks, the payor, and the drawer that the amount of the item was paid to the customer or deposited in the customer's account. U.C.C. §4-205(2).

4. **Delivered for collection:** U.C.C. §4-205 applies only if the holder of the item delivers the item to the depositary bank for the purpose of engaging the bank to collect the item for her.

   Example: If a check is made payable jointly to a contractor and a subcontractor in payment for work performed jointly by them and the contractor deposits the check into its bank account, the bank does not become a holder of the check if the subcontractor did not authorize the contractor to deposit the check in its bank account. This is because the subcontractor did not, either by itself or through the contractor, deliver the check to the bank for the purpose of engaging the bank to collect the check for it.

III. VALUE

A. Issued or transferred for value: An instrument is issued or transferred for value if:

- the instrument is issued or transferred for a promise of performance, to the extent the promise has been performed;
- the transferee acquires a security interest or other lien in the instrument other than a lien obtained by judicial proceeding;
- the instrument is issued or transferred as payment of, or as security for, an antecedent claim against any person, whether or not the claim is due;
- the instrument is issued or transferred in exchange for a negotiable instrument; or
- the instrument is issued or transferred in exchange for the incurring of an irrevocable commitment to a third person by the person taking the instrument. U.C.C. §3-303(a).

B. Consideration vs. value: Value is related to, but not identical with, consideration. ***Value*** is viewed from the perspective of what the holder gave for the instrument. ***Consideration*** is viewed from the perspective of what the obligor received for his original issuance or transfer of the instrument.

C. Promise of performance as value: Any promise that would constitute consideration under the contract law of the applicable jurisdiction constitutes a "promise of performance" under Article 3.

D. Value to the extent performed: A promise of performance is only value to the extent that the promise has been performed. U.C.C. §3-303(a)(1).

Example: Assume that Sue issues a note for $1,000 to Car Dealer in payment for a car to be delivered. The car is not delivered. Car Dealer sells the note to Bank in exchange for which Bank promises to pay Car Dealer $800. Bank does not take the note for value until it pays Car Dealer the $800. Until Bank pays Car Dealer for the note, Bank loses nothing by not being allowed to recover from Sue on the note. Once Bank discovers that the note is subject to a claim, defense, or claim in recoupment, it has the right, under ordinary contract law, to suspend the remainder of its counterperformance. By refusing to make the payment, Bank can prevent the loss to Sue. Bank has the right to recover any loss from Car Dealer.

1. **Formula when partial performance by holder:** When a holder has only partially performed the agreed-on consideration, the holder has the rights of a holder in due course to the extent of the fraction of the amount payable under the instrument equal to the value of the partial performance divided by the value of the promised performance. U.C.C. §3-302(d).

Example: Bank promises to pay Car Dealer in two installments of $400 each. If Bank learns of Sue's defense after paying the first installment, Bank can refuse to pay Car Dealer the second installment of $400. Because, prior to learning of Sue's defense, Bank had paid Car Dealer $400 of the promised $800, Bank is a holder in due course to the extent of half of the agreed consideration ($400/$800). Bank can therefore recover $500, which is one-half of the amount due ($1,000/2 = $500). U.C.C. §3-302, Official Comment 6.

E. **Security interest in instrument as value:** A holder who has a security interest in, or certain types of liens on, the instrument takes the instrument for value.

1. **Security interest in instrument:** The holder may acquire a security interest in, or a lien on, an instrument in two basic ways. The first is by means of a voluntary transfer by the debtor, usually an Article 9 security interest. U.C.C. §3-303(a)(2); U.C.C. §3-303, Official Comment 3. The second is the security interest that a collecting bank automatically acquires under U.C.C. §4-210(a).

   Example: Because Target needs additional cash to purchase new inventory, it borrows the money from Wedontcare Bank by negotiating Allen's note as security for repayment of the loan. Wedontcare Bank becomes a holder for value to the extent that it has acquired a security interest in the note.

2. **Lien on instrument:** A person who has a lien on the instrument by operation of law takes the instrument for value. The most typical type of lien is a common law or statutory banker's lien. U.C.C. §3-303(a)(2); U.C.C. §3-303, Official Comment 3. In contrast, a lien acquired by judicial process, e.g., attachment, garnishment, or execution, does not constitute value. U.C.C. §3-303(a)(2); U.C.C. §3-303, Official Comment 3.

   Rationale: In contrast to a banker who may rely on the existence of its statutory or common law lien in the manner in which it conducts its business, a lien by judicial process is acquired after the debt to the creditor arose. The creditor does not rely on the lien in advancing the credit or in otherwise refraining from collecting the debt.

3. **Value only to extent of amount owed:** A lienholder or secured party takes the instrument for value only to the extent of the amount owed on the underlying debt. U.C.C. §3-302(e).

   Formula: If the person obliged to pay the instrument has a defense, claim in recoupment, or claim to the instrument that may be asserted against the person who granted the security interest, those rights may be asserted only to the amount payable under the instrument that exceeds the amount of the unpaid obligation secured at the time of enforcement. U.C.C. §3-302(e).

Example: The above formula sounds more complex than it is. Assume that as security for a loan from Bank, Car Dealer grants to Bank a security interest in Sue's note in the amount of $5,000. The car is not delivered and Sue refuses to pay the note. At the time of enforcement, Car Dealer owes Bank $1,000. Bank acquires holder-in-due-course status only for the amount that is owed on the underlying obligation ($1,000). After Bank is paid the $1,000, it is made whole. The remainder of any funds recovered from Sue would, in any event, have to be refunded by Bank to Car Dealer. U.C.C. §3-302(e), Official Comment 6, Case # 6.

F. Payment or security for antecedent debt as value: The taking of the instrument in payment of, or as security for, an antecedent claim is value whether or not the claim is due. U.C.C. §3-303(a)(3).

Rationale: If a person who takes a check or note for a debt could not be assured that she would take it free from any claims or defenses to the instrument, she would refuse to take the instrument in payment and would demand cash instead. Because most debts are paid by check or other negotiable instrument, chaos may ensue.

Example: Assume that Target owes money to Sally Lawyer for legal services rendered. If Target negotiates Allen's note to Sally in payment for her services, Allen's note has been transferred for value.

Note: The antecedent claim need not be against the transferor. A claim the holder has against any person is sufficient. U.C.C. §3-303, Official Comment 4.

Example: If Robert, president of Target, makes a note payable to Sally in payment for Target's debt to Sally, Sally takes the note for value even though the debt was owed by Target and not by Robert.

G. Negotiable instrument or irrevocable obligation as value: When a negotiable instrument or an irrevocable obligation to a third person is given in exchange for an instrument, the holder takes the instrument for value. U.C.C. §3-303(a)(4), (5).

Example: A bank that issues a letter of credit in exchange for a negotiable instrument transferred to it by the purchaser of the letter of credit takes the instrument for value even though it has yet to perform under the letter of credit. This is because, like a negotiable instrument, an ***irrevocable commitment to a third person*** is a commitment that cannot be rescinded in the event that the holder learns of a claim, defense, or claim in recoupment to the instrument in return for which the holder had given his commitment.

H. Taking for value by collecting bank: A collecting bank takes an item for value by acquiring a security interest in the item under Article 4. U.C.C. §4-211.

1. **Manner of acquiring a security interest:** A collecting bank acquires a security interest in an item and any accompanying documents or the proceeds of either the item or the documents:

- in the case of an item deposited in an account to the extent to which credit given for the item has been withdrawn or applied;
- in the case of an item for which it has been given credit available for withdrawal as of right, to the extent of the credit given whether or not the credit is drawn on or there is a right of charge-back; or
- if it makes an advance on, or against, the item. U.C.C. §4-210(a).

Rationale: U.C.C. §4-210 grants a security interest to a collecting bank specifically to encourage the bank to give its customers immediate use of funds represented by the deposited item. By allowing its customer to draw against the uncollected funds, the collecting bank may become a holder in due course and therefore recover from the drawer of the item despite any defense she may have against the customer.

2. **U.C.C. §4-210 not exclusive:** A collecting bank may also acquire a security interest under Article 9 or by other means.

3. **To extent credit given has been withdrawn or applied:** The collecting bank only acquires a security interest to the extent that

the bank allows the customer to use the funds.

4. **Applies to debt of customer:** A collecting bank also acquires a security interest when it applies the item in part, or in full, payment of a debt owed to it by its customer. U.C.C. §4-210(a)(1).

Example: Assume that at the time that a check in the amount of $5,000 is deposited in the customer's account, the account is overdrawn in the amount of $3,000. If the bank applies the check to the $3,000 overdraft, the collecting bank has a security interest in the check in the amount of $3,000.

5. **Withdrawal as a matter of right:** If the credit given for the item is available for withdrawal as a matter of right, the collecting bank has a security interest in the item whether or not the credit is drawn on or there is a right of charge-back. U.C.C. §4-210(a)(2).

Example: The bank may have an arrangement with its customer under which the customer has the right to draw on funds that have not yet been collected by the bank or the bank may have a duty under U.C.C. §4-215(e) or under Regulation CC to allow the customer to draw on uncollected funds. Because the bank, whether or not the check is good, may be forced to allow its customer to withdraw the funds, the bank is at risk even though it has not yet actually released the funds.

6. **Makes advance against item:** When the bank makes an advance against the item, a security interest arises whether or not the item is deposited into the customer's account. U.C.C. §4-210(a).

7. **Simultaneous deposits:** When credits given for several items deposited at one time, or pursuant to a single agreement, are withdrawn or applied in part, the bank's security interest remains on all the items, any accompanying documents, or the proceeds of either. U.C.C. §4-210(b).

Example: Assume that when the customer's account contains no funds, the customer simultaneously deposits five items in the amounts of $1,000, $2,000, $3,000, $4,000, and $5,000. The customer withdraws $3,000. The bank has a security interest on each of the five items to the extent of $3,000. As soon as $3,000 is collected from any of the items, the bank is made whole and the security interest in all the items is extinguished.

8. **Order withdrawn when deposits not simultaneous:** Credits first given are deemed to be first drawn on. U.C.C. §4-210(b). Thus, when items are not deposited simultaneously, the security interest attaches to the items in the order in which they were deposited.

Example: Assume that the items in our last example were each deposited on different days in the order in which they are listed. Of the $3,000 withdrawn, the first $1,000 would be deemed to have been withdrawn against the $1,000 check. As a result, the bank would have a security interest in the check for its entire face amount of $1,000. The remaining $2,000 would be deemed to have been withdrawn against the second check deposited, the $2,000 check. The bank would then have a security interest in the $2,000 check for its entire face amount. The bank would have no security interest in the remaining three checks.

IV. GOOD FAITH

A. **Definition:** ***Good faith*** is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. §3-103(a)(4). [[Rev] U.C.C. §3-103(a)(6); [Rev] U.C.C. §1-201(b)(20).] This standard is partially subjective and partially objective.

B. **Subjective element:** The subjective part of the standard is found in the requirement that the particular holder be honest in fact in the transaction.

Example: Assume that a very naive person is approached on the street by a person who, in offering to sell him a $1,000 paycheck for $300 tells the naive prospective purchaser that his baby was sick and that the seller needed cash immediately to have the baby admitted into the hospital. If the naive person, in purchasing the check, truly believes the story, the purchase would be in good faith, despite the fact that no other person in the world may have believed the story.

Note: Although the failure to inquire into suspicious circumstances does not, by itself, amount to a lack of good faith, the facts may be so suspicious that the trier of fact will not believe the holder's assertion that he was honest in fact.

Example: Absent a plausible justification for such a large discount, when a $3,000 note is purchased by the holder for $500, the trier of fact may not believe the holder's assertion that he was unaware of any defect in the transaction.

Note: When the trier of fact concludes that the holder desired to evade the knowledge that an investigation would disclose, the holder may be found to have lacked good faith.

C. Objective element: The objective element of good faith requires "the observance of reasonable commercial standards of fair dealing." U.C.C. §3-103(a)(4). [[Rev] U.C.C. §3-103(a)(6); [Rev] U.C.C. §1-201(b)(20).] The duty of the holder to comply with reasonable commercial standards extends *only* to her obligation of fair dealing. The holder has no duty to exercise due care with respect to the purchase. U.C.C. §3-103, [Rev] Official Comment 4.

Example: A sinister-looking character named Simon asks a bank officer at Bank of Gotham to cash a $2,000 paycheck payable to, and indorsed by, one of the bank's own customers. Simon has no account at the bank and presents no identification to the officer. The officer, believing Simon's story that he had lost his wallet, cashes the check. Even though the officer was negligent, the officer was not attempting to obtain an unfair advantage for the bank and therefore acted in good faith. If, instead, the officer agreed to cash the check only at a substantial discount, the bank would have failed to observe reasonable commercial standards of fair dealing. By purchasing the check at a large discount, the bank officer would have attempted to profit at its customer's expense.

Note: A holder may lack good faith even though she has no notice of a claim or defense. Although the bank had no notice or knowledge that the instrument was stolen, it did not act in good faith.

V. NOTICE

A. Notice of infirmities: A holder cannot become a holder in due course if he has notice of the following infirmities in the instrument or in any underlying transaction in which the instrument was issued or negotiated:

- the instrument has been forged or altered;
- the instrument is irregular or incomplete;
- the instrument has been dishonored or is overdue;
- there is a claim to the instrument; or
- any party has a defense or claim in recoupment to the instrument.

B. Notice need not relate to defense or claim raised: A purchaser who has notice of a proscribed fact is completely denied holder-in-due-course status and, therefore, takes subject to all claims, defenses, and claims in recoupment whether or not related to the defense or claim of which she has notice.

Example: If the purchaser knows that there is a small breach of warranty claim in recoupment that could be asserted by the maker against the payee, she also takes subject to an unrelated third-party claim of ownership of the instrument.

C. When notice effective: For notice to be effective, it must be received at such time and manner as to give the purchaser a reasonable opportunity to act on it. U.C.C. §3-302(f).

D. Effect of subsequent notice: Once a purchaser becomes a holder in due course, notice subsequently obtained does not destroy his holder-in-due-course status.

E. When notice imputed to organization: Notice to an organization is effective for a particular transaction from the earlier of the time the notice either (a) is brought to the attention of the individual conducting the transaction or (b) should have been brought to his attention had the organization exercised due diligence. U.C.C. §1-201(27). [[Rev] U.C.C. §1-202(f).]

1. **Organization:** "Organization" is defined as including "a corporation, government or governmental subdivision or agency, business trust, estate, trust, partnership or association, two or more persons having a joint or common interest, or any other legal or commercial entity." U.C.C. §1-201(28). [[Rev] U.C.C. §1-201(b)(25).]

   Note: The same rules should also apply when the represented person is an individual.

2. **Due diligence:** Due diligence requires (1) that the organization maintain reasonable routines for the communication of significant information from individuals who have the duty to forward information to the person conducting the transaction and (2) reasonable compliance with the procedures established.

   a. **Duty to forward information:** Two groups of individuals are required to forward information that they have received.

      i. **Part of regular duties:** The first group are those individuals who have actual authority, as part of their regular duties, to receive and communicate such information. U.C.C. §1-201(27). [[Rev] U.C.C. §1-202(f).]

         Example: A bank teller, the bank president, or a receptionist, but not a janitor or a security guard, would seem to have, as part of his or her duties, the obligation to forward any type of mail or other notification he or she receives.

      ii. **Reason to know of importance:** The second group includes any person who has reason to know of the transaction and that the transaction would be materially affected by the information. U.C.C. §1-201(27). [[Rev] U.C.C. §1-202(f).]

   b. **Reasonable routines:** The organization must have reasonable routines established for the forwarding of relevant information.

      Example: If it is a reasonable business practice to deliver mail twice a day, the individual conducting the transaction, and thus the organization, is deemed to obtain notice when that individual receives the mail and has had a reasonable time to review the mail, and not when the mail was first delivered to the mail room.

Example: If an officer of a bank learns that a person has just attempted to sell a stolen certificate of deposit to a neighboring bank, the officer should inform the tellers of this fact immediately rather than through interoffice mail the next day. In this case, the teller should be deemed to have notice of the theft shortly after the officer learned of it.

c. **Reasonable compliance:** As long as the organization is in reasonable compliance with its established procedures, notice will not be imputed to the organization until the information actually reaches the party conducting the transaction. If there are no established procedures or if the established procedures are not generally followed, notice will be effective from the moment that the information would have reached the party conducting the transaction had reasonable procedures been in place at the time.

Example: If the organization has a reasonable routine for distributing mail, notice will be effective only when a misplaced letter is actually delivered and not when it should have been delivered had it not been misplaced.

F. **Manner of obtaining notice:** A purchaser may obtain notice in three possible ways:

- actual knowledge of the infirmity;
- receipt of notification of the infirmity; or
- from all the facts and circumstances known to him at the time in question he has reason to know that the infirmity exists. U.C.C. §1-201(25)(a)-(c). [[Rev] U.C.C. §1-202(a).]

1. **Actual knowledge:** A purchaser has actual knowledge of an infirmity when she is subjectively aware of the existence of the claim, defense, or claim in recoupment.

2. **Notification:** A person receives a notice or notification when (1) it comes to his attention or (2) it is duly delivered at the place of

business through which the contract was made or at any other place held out by him as the place for receipt of such communications. U.C.C. §1-201(26). [[Rev] U.C.C. §1-202(e).]

a. **Effective even if not read:** Notification is effective even if the holder did not actually read the notification and thereby acquire actual knowledge of the claim, defense, or claim in recoupment.

Example: If a letter informing the purchaser of a defense is delivered to the purchaser's office, the purchaser is deemed to have notice of the defense even though he never reads the letter.

b. **Notification on receipt:** A purchaser receives a notice or notification when it is duly delivered to either (a) the place of business through which the contract was made or (b) any other place held out by the purchaser as the place of receipt for such communications. U.C.C. §1-201(26)(b).

Note: One's home address or post office box should be found to be a place held out by the purchaser as the place for receipt of such communications.

3. **Reason to know:** A purchaser may also have notice of an infirmity if, from all of the facts and circumstances known to the person at the time in question, he has reason to know that the infirmity exists. U.C.C. §1-201(25)(c). [[Rev] U.C.C. §1-202(a)(3).]

a. **Subjective element:** There is a subjective element to the standard in that the test is whether "from all the facts and circumstances *known*" *to the person* [emphasis added], the purchaser has reason to know of the infirmity. These facts and circumstances include, among others, those comprising the claim, defense, or claim in recoupment; the reliability of the source of the information; the purchaser's knowledge of the business or type of transaction involved; and any facts the purchaser discovers from his own investigation.

Example: An attorney may have reason to know of a defense under circumstances in which an elderly widow who has never engaged in a business transaction might not.

b. **Two tests:** Two tests have been adopted by courts for determining whether a purchaser has ***reason to know*** of a claim, defense, or claim in recoupment.

i. **Inferable knowledge test:** A majority of courts have adopted the "inferable knowledge" test. Under the inferable knowledge test, a person has reason to know of a claim, claim in recoupment, or defense only if the only reasonable conclusion she could reach from the facts known to her is that the claim, claim in recoupment, or defense exists. She has no duty to inquire into suspicious circumstances. The holder may assume an innocent explanation for a suspicious circumstance.

ii. **Duty to inquire test:** The duty to inquire test is whether a reasonable person, considering all the facts and circumstances known to the purchaser, would have further investigated and thereby discovered the existence of the claim, defense, or claim in recoupment. This test is an objective test allowing the court to determine whether the holder, as a reasonable person, should have, through the exercise of reasonable diligence, discovered the defense, claim, or claim in recoupment. The purchaser must investigate to determine whether the suspicious circumstances indicate that some infirmity exists in the instrument or underlying transaction.

G. **Notice of claim or defense:** A purchaser cannot be a holder in due course if she has notice of any claim to the instrument as described in U.C.C. §3-306 or of any defense or claim in recoupment described in U.C.C. §3-305(a). U.C.C. §3-302(a)(2).

1. **Notice not obtained from public filing:** Public filing or recording of a document does not, by itself, constitute notice of a defense, claim in recoupment, or claim to the instrument. U.C.C. §3-302(b).

2. **Notice not obtained from executory promise:** Knowledge that an instrument was issued or negotiated in return for an executory promise (a promise to perform in the future) or accompanied by a separate agreement does not give a purchaser notice of a claim, defense, or claim in recoupment. Knowledge of an executory

promise does not impose upon the purchaser the duty to inquire as to whether the promise has been performed. The purchaser has notice of a defense or claim in recoupment only if she has notice that a breach has already occurred.

Example: Simply because Finance Company knows that Car Dealer has agreed to deliver a Mercedes 500SL to Maker does not impose on Finance Company an affirmative duty to determine whether the car has been delivered.

3. **Notice from defenses from other transactions:** Whether the purchaser has notice of a defense to a particular instrument because she has dealt with the payee in the past and knows that many of payee's transactions are subject to defenses depends on which of the two tests the court adopts.

4. **Purchase at a discount:** When an instrument is purchased at a substantial discount, whether the purchaser will be deemed to have notice of a claim or defense depends on which test the court adopts. Under the ***inferable knowledge test***, the purchaser is not imputed with notice of a claim, defense, or claim in recoupment solely because of her knowledge of the discount alone. The holder has the right to assume, for example, that the large discount is a result of a substantial risk that the maker is insolvent or of the seller's urgent need for immediate cash. In contrast, under the ***duty to inquire test***, a purchaser is required to investigate why the instrument is selling at such a large discount.

5. **Notice of breach of fiduciary duty:** When a fiduciary in breach of her fiduciary duty negotiates an instrument for her own use, a question arises as to under what circumstances the purchaser is deemed to have notice of the breach and, therefore, takes subject to the claim of the represented person.

   Examples: A treasurer of a corporation who writes a corporate check to American Express Company to pay her own personal credit card bill as well as a president of a small corporation who deposits a check payable to the corporation into his own personal bank account may be in breach of their fiduciary duties.

Example: Company that issued checks, on which the company's comptroller forged the signature, failed to allege that depository bank had knowledge of comptroller's breach of fiduciary duty, so as to support a claim for aiding and abetting the breach of fiduciary duty where the company merely asserted that bank knew of comptroller's fiduciary duty, but failed to allege that bank knew comptroller did not have company's authority to draw the checks to herself. Halifax Corp. v. Wachovia Bank, 268 Va. 641 (Va. 2004).

a. **Definitions**

i. **Represented person:** A represented person is the principal, beneficiary, partnership, corporation, or other person to whom the fiduciary owes a duty. U.C.C. §3-307(a)(2).

ii. **Fiduciary:** A fiduciary is "an agent, trustee, partner, corporate officer or director, or other representative owing a fiduciary duty with respect to an instrument." U.C.C. §3-307(a)(1). Fiduciaries include, among others, an executor of an estate; a guardian of a minor or an incompetent; any officer or other agent of a corporation, trust, or partnership; or an attorney.

b. **Conditions to purchaser having notice:** Certain conditions must be met before the purchaser will be deemed to have notice of a breach of fiduciary duty.

i. **Represented person must make claim to instrument:** If the fiduciary breaches her duty by negotiating the instrument for her own, or someone else's, benefit, the represented person has an equitable claim of ownership to the instrument or its proceeds. U.C.C. §3-307, Official Comment 2. A purchaser is deemed to have notice of a breach of fiduciary claim only if the represented person makes a claim to the instrument. Notice is not imputed to the purchaser if no such claim is made. U.C.C. §3-307(b)(iii).

ii. **Taker must know that person with whom she is dealing is a fiduciary:** The rules for determining whether the holder has ***notice*** of a breach of fiduciary duty only apply if the taker of the instrument from the fiduciary ***knows*** that the person with whom she is dealing is a fiduciary. U.C.C. §3-307(b)(ii).

Example: Assume that Jennifer Jones, the treasurer of Oasis Corporation, deposits a check payable to Oasis Corporation into her personal bank account at Bank of America. If Bank of America does not have actual knowledge that Jennifer Jones is the treasurer of Oasis Corporation, Bank of America does not have notice that Jennifer Jones breached her fiduciary duty to Oasis Corporation in depositing the check into her own bank account.

c. **Three situations involving breach of fiduciary duty:**

i. **When instrument made payable to the represented party or to the fiduciary as such:** A taker of an instrument payable to the represented party, or to the fiduciary as such, has notice of a breach of fiduciary duty if the instrument is (1) taken in payment of or as security for a debt known by the taker to be the personal debt of the fiduciary; (2) taken in a transaction known by the taker to be for the personal benefit of the fiduciary; or (3) deposited in an account other than that of the fiduciary as such or of the represented person. U.C.C. §3-307(b)(2).

ii. **When instrument drawn or made by represented person or fiduciary as such to taker:** The same rules apply when an instrument is issued by the represented person, or the fiduciary as such, directly to the taker. U.C.C. §3-307(b)(4).

Example: If Jennifer as treasurer of Oasis Corporation writes a check payable to Mastercard in payment for her own personal credit card bill, the same rules apply as were applicable when the check was payable to Oasis Corporation itself.

Example: Steve Smith as guardian for Samantha Smith writes a check to Harry's Men's Store. If Steve attempts to pay for a suit with a check drawn on Samantha Smith's guardianship account, Harry's Men's Store should inquire as to whether this use of guardianship funds is proper.

iii. **When payable to fiduciary personally:** A different rule applies when the instrument is payable to the fiduciary personally, whether drawn by the represented person or by the fiduciary herself. In these cases, the taker has notice of a breach of fiduciary duty only if it has ***actual knowledge*** of the breach. U.C.C. §3-307(b)(3).

6. **Notice that an instrument is forged, altered, or otherwise irregular:** A purchaser cannot be a holder in due course if the instrument, when issued or negotiated to the holder, bears such apparent evidence of forgery or alteration or is otherwise so irregular or incomplete as to call into question its authenticity. U.C.C. §3-302(a)(1).

a. **Reasonable person standard:** Although the standard is whether the instrument on its face is so suspect that a reasonable person would question its authenticity, the purchaser's particular knowledge is relevant in determining whether the particular irregularity should have alerted the taker to the fact that something is wrong.

Example: Because a bank officer might know that the signature of a certain bank on a cashier's check is always printed, the bank officer will be deemed to have notice of a forgery if the signature is handwritten while most other purchasers will not be deemed to have such notice from the appearance of the check itself.

b. **Innocent alterations:** There will be times when even a clear alteration will not incite suspicion in a reasonable person.

Example: The crossing out of “1998” and the adding of “1999” on an instrument negotiated in January 1999 may indicate simply that the maker had forgotten that the year had changed.

7. **Notice that instrument is overdue or has been dishonored:** A purchaser is denied holder-in-due-course status if she has notice that an instrument is overdue or has been dishonored. U.C.C. §3-302(a)(2)(iii).

Rationale: Despite the fact that there may be many innocent explanations for why an instrument is overdue or has been dishonored, there is little commercial reason to encourage the purchase of overdue or dishonored instruments.

a. **When an instrument is overdue:**

i. **Checks:** A check is ***overdue*** the day after the day demand for payment is duly made or 90 days after its stated date, whichever is earlier. U.C.C. §3-304(a)(1), (2).

Example: If a check dated March 1 is presented for payment on April 1, the check is overdue if it is not paid by April 2. If presentment is not made by June 1 (90 days after the check's date), the check is overdue on that date.

ii. **Other demand instruments:** Any other instrument payable on demand becomes overdue at the earlier of either (1) the day after the day demand for payment is duly made or (2) when the instrument has been outstanding for a period of time after its date that is unreasonably long. U.C.C. §3-304(a)(1) and (3). To determine if an unreasonably long period of time has passed, courts are instructed to look at the circumstances of the particular case in light of the nature of the instrument and usage of trade. U.C.C. §3-304(a)(3); U.C.C. §3-304, Official Comment 1.

iii. **When date accelerated:** Once an instrument has been accelerated, causing the entire principal amount to be immediately due, the instrument becomes overdue on the day after the accelerated due date. U.C.C. §3-304(b)(3).

iv. **Payable in installments:** Absent acceleration, an instrument payable in installments becomes overdue on default for nonpayment of an installment. The instrument remains overdue until the default is cured. U.C.C. §3-304(b)

(1).

Example: If a note is payable monthly in 10 installments on the first of every month and the first installment date passes without payment, the note becomes overdue. Once payment of that installment is made, the note is no longer overdue.

v. **Not payable in installments:** Absent acceleration, an instrument not payable in installments is overdue on the day after its due date. U.C.C. §3-304(b)(2).

vi. **Default in interest only:** As long as there is no default in the payment of the principal amount, the instrument is not overdue simply because there is a default in the payment of interest. U.C.C. §3-304(c).

Rationale: This is because cash-flow problems often cause a maker to be late in the payment of interest and do not indicate that there is any problem in the underlying transaction.

b. **Purchaser must have notice that the instrument is overdue:** The purchaser must have notice that the instrument is overdue. For example, if the purchaser does not have notice that an installment was not paid, he does not have notice that the instrument is overdue.

8. **Notice of discharge:** Notice of the discharge of a party, other than a discharge in an insolvency proceeding, is not notice of a defense. As a result, a holder who has notice of a party's discharge can still qualify as a holder in due course. U.C.C. §3-302(b).

Rationale: In many situations a party is discharged from liability on an instrument under circumstances that do not cast doubt on the obligation of any other party.

Example: A co-maker may have been released by the holder and the release noted on the note. This has no effect on whether his co-maker is likewise discharged.

a. **Holder in due course takes subject to discharge of which he has knowledge:** Despite the fact that he may qualify as a holder in due course, a holder who has notice of a discharge takes subject to the discharge of which he has notice. U.C.C. §3-302(b).

b. **Discharge in insolvency proceedings:** If a taker knows that the maker, drawer, or acceptor (the people ultimately liable on an instrument) has been discharged in insolvency proceedings, the taker is denied holder-in-due-course status. U.C.C. §3-302, Official Comment 3.

VI. DENIAL OF HOLDER-IN-DUE-COURSE STATUS TO CERTAIN CLASSES OF PURCHASERS

A. **Introduction:** Four categories of holders, even after meeting all the requirements contained in U.C.C. §3-302(a) for holder-in-due-course status, do not thereby become holders in due course. Even though not qualifying as a holder in due course in his own right, such a purchaser is a transferee and therefore, under the shelter provision, is entitled to all of his transferor's rights. If his transferor was a holder in due course, the transferee is entitled to all of his transferor's rights as a holder in due course. U.C.C. §3-302, Official Comment 5.

B. **Acquisition by taking over estate:** A person who acquires an instrument by taking over an estate or other organization that previously held the instrument cannot by such acquisition become a holder in due course. U.C.C. §3-302(c)(iii).

Example: Assume that Jones made a note payable to Smith. Upon Smith's death, his executor takes subject to all the claims in recoupment and defenses to which Smith would have been subject. Smith's death should not deprive Jones of his right to raise his defenses or claims in recoupment.

C. **Purchase in execution, bankruptcy, or creditor's sale:** A purchaser of an instrument in an execution, a bankruptcy or creditor's sale or similar proceeding, or under legal process, cannot become a holder in due course. U.C.C. §3-302(c).

Example: When a state bank becomes insolvent, the state bank commissioner sells the bank's assets, including its negotiable instruments, at a judicial sale. Another bank or other financial institution may purchase all or some of these negotiable instruments. The purchasing institution realizes that, because of the bank's insolvency, it is quite possible that the obligors on the purchased instruments may have a claim or defense against the payee bank. For this reason, the purchasing institution does not deserve protection from these claims or defenses.

D. **Purchase in bulk transaction:** A person cannot become a holder in due course by purchase of an instrument as part of a bulk transaction not in the regular course of the transferor's business. U.C.C. §3-302(c)(ii). There are two types of bulk transactions:

1. **Liquidation sale:** The first type of prohibited bulk transfer is a bulk sale of instruments for the purpose of liquidating the holder's assets in preparation for the termination of his business.

Example: When Stereo Shack, a retailer of stereo equipment, decides to go out of business, it offers to sell to Finance Company all notes received from the purchasers of stereo equipment. The mere fact that Stereo Shack is going out of business should alert Finance Company that purchasers of stereos may have defenses to the notes being offered to it. Thus, there is no reason to encourage Finance Company to purchase these notes by offering it holder-in-due-course status.

Note: The purchaser is denied holder-in-due-course status regardless of whether it knows, or has reason to know, that its purchase is part of a bulk transaction not in the regular course of the seller's business.

Exception: A sale in the seller's ordinary course of business is not a bulk transfer.

Example: New Car Dealership, as part of its regular business practice, sells all notes obtained from the sale of its cars to a factor (a person who is engaged in the business of buying accounts, notes, or chattel paper at a discount) so as to acquire sufficient cash to purchase new inventory. Financing of this type is desirable and should be encouraged. For this reason, the factor, by its purchase, can acquire holder-in-due-course status as long as it meets all other requirements.

2. **Organizational change:** The second prohibited type of bulk transfer occurs when the organizational structure of the holder changes so that, even if the same actual entity retains the instruments, there has technically been a transfer from one entity to another. U.C.C. §3-302, Official Comment 5.

Example: When a partner is added to, or withdraws from, a partnership, the new partnership is deemed to be a different entity than the old partnership. For the new partnership to be the holder of the instrument, it is necessary that the instrument be indorsed from the old partnership to the new partnership. The new partnership should not, by the transfer, acquire holder-in-due-course status. Similar situations include the reorganization or merger of a corporation or the purchase by one bank of the assets of another bank facing insolvency.

Exception: An exception to these rules involves the purchase by the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), or the Resolution Trust Corporation (RTC) of the assets of an insolvent bank. Under federal common law, the FDIC, the FSLIC, or the RTC may become a holder in due course of a note even if it purchased the note in a bulk transaction not in the regular course of the seller's business or acquired the note by taking over an insolvent bank. *See* Federal Sav. & Loan Ins. Corp. v. Murray, 853 F.2d 1251, 8 U.C.C. Rep. Serv. 2d 56 (5th Cir. 1988). U.C.C. §3-302, Official Comment 5. In light of O'Melveny & Myers v. FDIC, 114 S. Ct. 2048 (1994), the continued viability of this exception is questionable. *See* Calaska Partners Ltd. v. Corson, 672 A.2d 1099 (Me. 1996) (FDIC not a holder in due course when it takes notes in bulk transfer).

E. **Consumer notes:** The Federal Trade Commission (FTC), as well as most state legislatures, has enacted rules or statutes affecting the ability of a holder of an instrument, issued in a consumer transaction, to take free of the consumer's defenses. The following scenario illustrates the problem that the rule is intending to prevent. A thinly capitalized retailer or contractor, usually through sharp sales practices, convinces a consumer to pay for goods or services to be delivered or rendered in the future by executing a promissory note. The retailer or contractor immediately sells the note to a finance company. The services are never rendered nor the goods delivered. When the consumer attempts to raise failure of consideration as a defense, the finance company claims immunity from the defense by claiming to be a holder in due course. When the consumer attempts to recover from the retailer or contractor, the consumer discovers that the retailer or contractor either cannot be found or is insolvent.

1. Definitions under FTC rule:

a. **Consumer transaction:** A consumer transaction is one in which a natural person uses a negotiable instrument (other than a check that is not postdated) to purchase goods or services to be used primarily for personal, family, or household purposes.

b. **Consumer credit contract:** A consumer credit contract is an instrument that evidences a debt arising from either a loan by the seller to the consumer to purchase the goods or a loan from a creditor related to the seller to enable the consumer to purchase the goods. 16 C.F.R. §433.1. To be related to the seller, the creditor must have established a formal or informal relationship with the seller aimed at financing consumer purchases.

2. **FTC rule:** The Federal Trade Commission promulgated a rule aimed at preventing financiers of negotiable instruments from taking instruments free from consumers' defenses. A seller in the business of selling goods to consumers must include a legend in its consumer credit contracts that states: "Any holder of this Consumer Credit Contract is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained [pursuant hereto or] with the proceeds hereof. Recovery hereunder by the Debtor shall not exceed amounts paid by the Debtor hereunder." 16 C.F.R. §433.2(a), (b).

a. **Where legend omitted:** A seller who fails to include such a legend commits an unfair or deceptive act or practice within the meaning of §5 of the Federal Trade Commission Act. The seller is subject to either a cease and desist order (an order forbidding it from engaging in such practices) or a civil action by the FTC. 15 U.S.C. §§45, 57b. Unless authorized by state law, a consumer has no private right of action for violation of this rule. *See* Holloway v. Bristol-Myers, 485 F.2d 986 (D.D.C. 1973).

Note: Although a holder in due course takes free of the consumer's defenses, some courts may find that a person in the business of financing consumer sales has notice that the legend should have been included and, therefore, is not a holder in due course.

b. **When legend included:** When the required language is included, the holder takes subject to the consumer's claims and defenses. The note remains negotiable, but there can be no holder in due course thereby enabling the consumer to assert any of his defenses against the holder. U.C.C. §3-106(d). Furthermore, the holder is liable to the consumer for damages up to, but no more than, the funds received by the holder from the consumer pursuant to the instrument.

Example: Assume that Jean purchases home improvements from ABC Construction Co., in payment for which she executes a note for $3,000. The note is sold to House Finance. Jean has paid $1,000 on the note to House Finance and $1,000 to ABC Construction Co. If the note contains the FTC legend, House Finance takes subject to Jean's defense that the improvements were never made. Furthermore, Jean could assert her counterclaim against House Finance to the extent of $1,000 (the amount paid by her to House Finance), but not as to the $1,000 she paid to ABC Construction Co.

3. **State legislation:** Many states have also enacted legislation that preserves, to varying degrees, the ability of a consumer to raise defenses against a holder of the note. This legislation has taken diverse forms:

a. **Uniform Consumer Credit Code:** The most influential legislation, which has been adopted by many states, is the 1969 version of the Uniform Consumer Credit Code (UCCC), which provides that a seller or lessor in a consumer credit sale or consumer lease may not take, in payment, a negotiable instrument (other than a check). A holder is not in good faith, and, thus, cannot qualify as a holder in due course, if she takes a negotiable instrument with notice that the instrument is issued in violation of the UCCC. Regular financiers of negotiable instruments who know of this rule are, as a result, prevented from becoming holders in due course.

b. **All assignees take subject to consumers' claims and defenses:** Some state legislation, including those states adopting the 1974 version of the UCCC, make an assignee of a consumer credit sale, whether or not a holder in due course, subject to all of the consumers' claims and defenses. Uniform Consumer Credit Code §3-404 (1974).

c. **Set time for consumer to raise defenses:** Other states adopt statutory schemes that preserve the right of a consumer to raise defenses and claims against a holder in due course to the extent that the consumer gives notice of her claim or defense to the holder within a set period of time, either after her purchase or after notice of the negotiation to the holder. See, e.g., Ariz. Rev. Stat. Ann. §44-145 (1987) (a holder cannot be a holder in due course for a period of 90 days after receipt by the debtor of the goods or services).

4. **2002 amendments and consumer transactions:** The 2002 amendments have added a new rule governing the ability of consumers to raise their claims or defenses in consumer transactions. A "consumer transaction" is "a transaction in which an individual incurs an obligation primarily for personal, family, or household purposes." [Rev] U.C.C. §3-103(a)(3).

a. **Instrument treated as if proper notice existed:** In a consumer transaction, a negotiable instrument that omits the notice required by the Federal Trade Commission (or other similar legend required by any other applicable law) is to be treated as if the instrument had included the required notice. As a result, a consumer can raise the same claims and defenses that he could if the FTC language was included even though the instrument does not contain the proper notice requirement. [Rev] U.C.C. §3-305(e) and Official Comment 6.

b. **Nothing in [Rev] U.C.C. §3-305 limits right of consumer to raise claims:** Thus, to the extent that a consumer protection statute gives the consumer the right to raise claims in recoupment or defenses, nothing in [Rev] U.C.C. §3-305 limits that right. In other words, [Rev] U.C.C. §3-305 is subject to any other law that establishes a different rule for consumer transactions. [Rev] U.C.C. §3-305(f) and Official Comment 7.

VII. DEFENSES, CLAIMS TO THE INSTRUMENT, CLAIMS IN RECOUPMENT, AND DISCHARGES

A. **Introduction:** Any holder or person with the rights of a holder (collectively called a ***person entitled to enforce an instrument***) may recover from the obligor in the absence of a claim to the instrument, defense, claim in recoupment, or discharge. U.C.C. §3-308(b). In the event that the obligor has grounds to refuse payment, whether the person entitled to enforce the instrument may recover from the obligor depends on both whether the person entitled to enforce the instrument qualifies as a holder in due course and the ground on which the obligor seeks to refuse payment. Four categories of grounds may be asserted by the obligor in its attempt to defeat the person entitled to enforce the instrument's right to payment: defenses, claims in recoupment, claims to the instrument, and discharges.

- **Defenses:** A defense is any ground a party may have that is sufficient to permit him to avoid all or some of his liability on the instrument. For example, the duty of a buyer of goods to pay for the goods is usually conditioned on the seller delivering the goods. If the seller fails to deliver the goods, the buyer may raise failure of consideration as a defense to the note that he gave evidencing his obligation to pay for the goods.

- **Claim in recoupment:** A claim in recoupment is a set-off that arises from the same transaction out of which the instrument arose. In our example above, if the goods turn out to be defective and in breach of the seller's warranty that the goods are merchantable, the buyer cannot use breach of warranty as a defense to his obligation to pay for the goods. Once the goods are delivered, the buyer is obligated to pay for the goods notwithstanding a subsequent breach of warranty. U.C.C. §3-305, Official Comment 3. However, the buyer does have a claim for damages that can be asserted against the seller as a set-off against the buyer's duty to pay for the goods. This set-off is called, under Article 3, a "claim in recoupment."
- **Claim to the instrument:** A claim to the instrument is any claim of a property or possessory interest in the instrument or in its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. When an instrument payable to bearer is stolen from the owner, the owner has a claim to the instrument.
- **Discharges:** Certain acts result in the obligor being excused from the duty to pay all, or a part, of his obligation to pay. These acts are called "discharges." For example, when the obligor makes payment of the instrument to the person entitled to enforce the instrument, he is discharged to the extent of his payment. U.C.C. §3-602(a).

B. **Defenses and claims in recoupment to which all persons take subject:** There are certain defenses to which any person takes subject whether or not the person qualifies as a holder in due course.

1. **Defenses and claims in recoupment assertible against holder itself:** The person entitled to enforce the instrument (sometimes called a "holder"), whether or not qualifying as a holder in due course, takes subject to any defense or claim in recoupment assertible against the holder himself. U.C.C. §3-305(a)(3), (b).

Example: Assume that Bob issues a check to Carl's Auto in payment for a used car. The car has a defective transmission. Because it arose out of the transaction in which the check was issued, Bob may assert the breach of warranty as a claim in recoupment against Carl's Auto even if Carl's Auto is a holder in due course. However, if Carl's Auto negotiates the check to Don, who takes the check as a holder in due course, Bob may not raise his claim in recoupment as a defense to Don's action on the check because the claim in recoupment is not one assertible against Don himself.

2. **Real defenses:** Four defenses, called ***real defenses,*** are regarded as protecting such important interests that all holders, even ones acquiring the status of holder in due course, take subject.

   a. **Infancy:** To the extent that the obligor's infancy is a defense to a simple contract, it is also a defense available against any party (including a holder in due course). U.C.C. §3-305(a)(1)(i). The infant's right to raise infancy as a defense is subject to all the state's limitations on his right to defend against liability on a simple contract.

      Example: If, in the applicable jurisdiction, a 16-year-old boy can defend against liability on an ordinary contract because he is under the age of majority, he may likewise defend against his liability on a negotiable instrument on the same basis.

   b. **Incapacity, duress, or illegality:** Legal incapacity, duress, or illegality, to the extent that such defenses render the obligation of the obligor a nullity, are defenses assertible against any person. U.C.C. §3-305(a)(1)(ii).

      Note: Unlike in the case of infancy, these defenses are real defenses *only if statutory or case law makes the transaction void.* A transaction is void when it has no effect whatsoever. In contrast, a transaction is voidable when a party has the option to either enforce or avoid the contract. If the transaction is merely voidable, the defense is a personal defense that is not available against a person having the rights of a holder in due course. U.C.C. §3-305, Official Comment 1.

i. **Incapacity:** Incapacity may include, among others, mental incompetency arising from the party's insanity or statutory incapacity to execute the instrument arising from a corporation's exceeding its corporate powers under its articles of incorporation or under state law. U.C.C. §3-305, Official Comment 1.

ii. **Duress:** In most states, the threat of physical injury makes an obligation void while a threat of economic injury (for example, to prosecute the obligor's son for theft) only makes the obligation voidable. U.C.C. §3-305, Official Comment 1.

iii. **Illegality:** Because the illegality must make the obligation obligor void, illegality will qualify as a real defense in few situations. In most situations, illegality will only make the obligation voidable. The type of illegality that most often constitutes a real defense is the use of the instrument to pay a gambling debt, as a bribe, or to purchase known stolen property.

c. **Fraud in the factum:** The obligor may raise as against any person the defense that he has been induced by fraud to sign the instrument with neither knowledge nor reasonable opportunity to learn of the instrument's character or its essential terms. U.C.C. §3-305(a)(1)(iii). This defense is almost never successful. To preserve the value of negotiable instruments and to encourage their purchase, an obligor is denied the right to raise fraud as a defense against a holder in due course if he intentionally or negligently signs a negotiable instrument. Where the obligor has been defrauded into believing that the writing that he signed is not a negotiable instrument, or at least does not contain the basic terms he believes it contains, he is relieved of liability if he has not acted carelessly in the transaction.

i. **Ignorance of instrument's character:** An obligor is ignorant of an instrument's character if she is under the impression that she is signing something other than a promise to pay money.

ii. **Ignorant of essential terms:** An obligor would be ignorant of the instrument's essential terms if she believes, for example, that she is signing a note payable in two years when, in fact, it is payable on demand. U.C.C. §3-305, Official Comment 1.

iii. **Knowledge:** In determining whether the obligor had either knowledge or a reasonable opportunity to learn of the character or essential terms of the instrument, the obligor's education, business experience, literacy, and intelligence are taken into consideration. U.C.C. §3-305, Official Comment 1.

iv. **Reasonable opportunity:** The obligor cannot raise the defense if she, under the circumstances, should have discovered the character and essential terms of the instrument. If the obligor had the opportunity to, but did not, read the instrument, the defense will seldom be available.

Example: If the obligor is illiterate and cannot read the instrument, he will not be able to raise this defense if a third person, such as a spouse or friend, was available to read the instrument to him. U.C.C. §3-305, Official Comment 1.

Example: One of the hundreds of fans who, on any given day, ask Justin Timberlake for an autograph has Justin sign a piece of paper that, unknown to him, contains a promissory note. Because Justin cannot be expected to read the printing on every piece of paper he is handed for his autograph, Justin can assert the defense of fraud in the factum.

v. **Distinguished from fraud in the inducement:** Fraud in the factum must be distinguished from fraud in the inducement. Fraud in the inducement occurs when the obligor, although knowing that he is signing a negotiable instrument, is defrauded into entering the transaction by misrepresentations concerning the nature of the transaction itself. Fraud in the inducement is not a defense against a person who has the rights of a holder in due course. It is, however, a defense against a person not having the rights of a holder in due course.

d. **Discharge in insolvency proceeding:** The obligor's discharge in insolvency proceedings is a defense assertible against any person. U.C.C. §3-305(a)(1)(iv). An insolvency proceeding is defined as including bankruptcy regardless of whether the debtor is insolvent. U.C.C. §1-201(22). [[Rev] U.C.C. §1-201(b)(23).] The discharge is effective against all takers of the instrument because a discharge in bankruptcy or other insolvency proceeding is for the purpose of allowing the obligor to make a new start. However, the obligor has a defense only as to those debts that are actually discharged in the insolvency proceeding.

C. **Defenses available only against a person without the rights of a holder in due course:** The following defenses are available only against persons who do not have the rights of a holder in due course. All these defenses are cut off when the instrument is acquired by a holder in due course. U.C.C. §3-305(b).

1. **Ordinary defenses:** A person not having the rights of a holder in due course takes subject to virtually any defense.

a. **Conditional issuance or nonissuance:** A person without the rights of a holder in due course takes subject to the defenses that the instrument was not issued, conditionally issued, or issued for a special purpose. U.C.C. §3-105(b); U.C.C. §3-305(b)(1)-(3).

Example: A note is delivered by John to Sam on the condition that Sam pay certain of John's bills. Sam fails to pay any of John's bills. Sam, despite failing to meet the condition, negotiates the note to Carol. If Carol does not have the rights of a holder in due course, she takes subject to the defense that the issuance of the note was conditional. U.C.C. §3-305(a)(2).

b. **Any contract defense:** A person without the rights of a holder in due course takes subject to any defenses that would be available to him if the obligation arose out of an ordinary contract. U.C.C. §3-305(a)(2). These defenses include, among others: nonperformance of a condition precedent; want of consideration; partial or complete failure of consideration; and mistake, unconscionability, fraud, duress, illegality, infancy, incapacity, or usury. U.C.C. §3-303(b).

Exception: No consideration is necessary for an instrument given in payment of or as security for an antecedent obligation of any kind. U.C.C. §3-303(a)(3). The debt may be one owed by the obligor herself or it may be a debt owed by some third person (e.g., the obligor's husband, mother, brother, or a corporation of which the obligor is a shareholder). Because the instrument is, in effect, given in consideration for the debt, the obligor may raise any defense she has arising out of the antecedent obligation as a defense to her liability on the instrument.

Example: Assume that Karen has purchased goods from Sally pursuant to an oral contract under which Karen agrees to pay for the goods in 90 days. A week later, Karen sends Sally a check. Because the check was given in payment for an antecedent debt (the duty to pay for the goods), the promise contained in Karen's check is enforceable despite the absence of consideration. This conclusion is reached in a circuitous manner. U.C.C. §3-303(b) states that an instrument issued for value is also issued for consideration. U.C.C. §3-303(a)(3) then provides that an instrument is issued or transferred for value if it is issued or transferred as payment for, or as security for, an antecedent claim against any person, whether or not the claim is due. In our example, therefore, the promise to pay the check was supported by consideration even though Karen's debt was not due for 90 days.

2. **Claims in recoupment:** A claim in recoupment is assertible against any person not having the rights of a holder in due course.

Example: Assume that Buyer issues a note to Car Dealer for $10,000 in payment for a new car. Car Dealer transfers the note to Finance Company, which, having purchased the note after it is overdue, does not qualify as a holder in due course. The car has a defective transmission that would cost $1,500 to repair. Finance Company takes subject to the claim in recoupment that Buyer has against the payee Car Dealer because the claim arose from the transaction that gave rise to the instrument. U.C.C. §3-305(a)(3). If Finance Company had qualified as a holder in due course, it would have taken free of the claim of recoupment. U.C.C. §3-305(b).

Limitation: The claim of recoupment may be asserted against the transferee only to the extent that it reduces the amount owing on the instrument at the time the action is brought. U.C.C. §3-305(a)(3). There is no right to an affirmative recovery for amounts already paid. U.C.C. §3-305, Official Comment 3.

Example: Assume that Sally makes a note payable to Charley Contractor for work performed on her house. The note is payable $100 per month for 36 months. Charley negotiates the note to his cousin Vinny, who, knowing that Charley's work was faulty, does not qualify as a holder in due course. Sally pays $500 to Vinny. Sally now discovers that the work is faulty and has a breach of contract claim in recoupment for the entire $3,600. However, because there is no affirmative recovery for amounts already paid (the $500 paid to Vinny), Sally can defeat Vinny's action for the remaining $3,100 but can recover nothing from him. She would have to recover the $500 from Charley Contractor.

Limitation: As against the transferee, the obligor cannot raise a set-off from a transaction other than the one that gave rise to the instrument in that it is unfair to make the transferee bear the risk of wholly unrelated claims because the transferee was not a party to the unrelated transaction. U.C.C. §3-305, Official Comment 3.

Example: If Charley had also sold Sally a car that proved to be defective, Sally could not raise the claim arising from the sale of the car as a claim in recoupment in Vinny's action.

3. **Defenses and claims in recoupment of other persons:** With the exception of an accommodation party, an obligor may only raise her own defenses. She may not attempt to raise a defense or claim in recoupment of another party to the instrument, nor may the other party intervene in the action to raise the defense himself. U.C.C.

§3-305(c); U.C.C. §3-305, Official Comment 4.

Example: Assume that David issues a check to Paul. Paul negotiates the check to Henry in payment for a car. Because the car has a defective transmission, Paul has a claim in recoupment against Henry for breach of the warranty of merchantability. David may not raise Paul's breach of warranty claim against Henry. Similarly, Paul may not intervene and raise his breach of warranty claim in Henry's action against David. If Henry sues Paul on his indorser's contract, Paul may raise the breach of warranty as a claim in recoupment. In this event, Paul is raising his own claim in recoupment to defend against his own liability.

4. **Claims to the instrument:** A person with the rights of a holder in due course takes free of all claims to the instrument. U.C.C. §3-306. A person who lacks the rights of a holder in due course takes the instrument subject to all valid claims of a property or possessory interest in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. U.C.C. §3-306.

   a. **What is a claim?** Determining what constitutes a valid claim to an instrument is left to the subject jurisdiction's personal property law. In most jurisdictions, claims to an instrument include both equitable and legal claims of ownership as well as a secured party's right to possession of the instrument under her security agreement and the right of a lienholder to possession of the instrument. U.C.C. §3-306, Official Comment.

   b. **Legal claim of ownership:** A legal claim of ownership arises when the owner of an instrument claims that she has been wrongfully and involuntarily deprived of its possession.

      i. **Payable to order:** When an instrument payable to order lacks the owner's indorsement at the time it is lost or stolen, the owner will always have the right to recover the instrument because there can be no holder in due course of such an instrument.

      ii. **Payable to bearer:** When an instrument is payable to bearer or indorsed in blank, whether the owner of the lost or stolen instrument can recover it from the possessor depends on whether the instrument was acquired by a holder in due course.

c. **Equitable claim:** An equitable claim of ownership arises when a prior owner claims that, although she voluntarily negotiated the instrument, she has the right to rescind the negotiation and regain title to the instrument. An equitable claim of ownership can arise from any ground that, under state law, gives the party a right to rescind the transaction in which she negotiated the instrument. U.C.C. §3-306, Official Comment. These grounds might include, among others, fraud, duress, mistake, illegality, breach of trust, infancy, incapacity, and nondelivery of the instrument.

d. **Third-party claims:** When the party being sued on the instrument does not have a claim of her own, the obligor may not use the claim to defeat the holder's action unless the claimant is made a party to the action and asserts her own claim to the instrument. U.C.C. §3-305(c).

Exception: A third-party claim may be asserted when the obligor knows that the holder is in wrongful possession of a stolen instrument. U.C.C. §3-602(b)(2). [[Rev] U.C.C. §3-602(e)(2).]

D. **Discharges:** An obligor may defend against her liability by contending that she has been partially or fully discharged from liability on the instrument. There are numerous grounds of discharge.

1. **Effect of discharge:** A discharge is effective against any person except a holder in due course who was without notice of the discharge when she took the instrument. U.C.C. §3-601(b).

Example: Assume that Joe makes a note payable to Paul who indorses the note to Hank. Hank releases Paul from liability on the instrument by a writing renouncing Paul's obligation to pay the instrument. Thereafter, Hank negotiates the note to Ralph. Paul's discharge is not effective against Ralph if Ralph qualifies as a holder in due course and does not have notice of the discharge when he takes the instrument. U.C.C. §3-601(b). In contrast, Paul's discharge would be effective against Ralph even if Ralph is a holder in due course if Ralph has notice of the discharge.

2. **Discharge by payment:** An instrument is discharged (1) to the extent that payment is made (2) by or on behalf of a party obliged to pay the instrument and (3) to a person entitled to enforce the instrument. U.C.C. §3-602(a); U.C.C. §3-602, Official Comment 1.

   a. **Discharge personal to party making payment:** Discharge is personal to the person making payment. Only the person making payment is discharged.

      Example: Assume that Paul makes a note payable to Sam, who indorses the note to Sela. Sam pays Sela. Sam's payment to Sela provides him with a discharge of his indorser's liability. Paul is not discharged by Sam's payment. On payment, Sam may recover from Paul. U.C.C. §3-412.

   b. **Payment must be made to person entitled to enforce instrument:** Payment discharges the party obliged to pay only if payment is made to the person entitled to enforce the instrument. U.C.C. §3-602(a). As long as the person to whom payment is made is the person entitled to enforce the instrument, it is irrelevant whether the person entitled to enforce the instrument is the owner of the instrument. That is why payment to a thief of an instrument payable to bearer discharges the party making the payment. In contrast, the party making payment is not discharged if she pays someone who is not a person entitled to enforce the instrument.

      Example: Assume that because Paul does not know that Sam has negotiated the note to Sela, Paul pays Sam without first demanding to see the note. Paul is not discharged by his payment. Sam, not being in possession of the note, is not a person entitled to enforce the instrument, and therefore, payment to Sam does not discharge Paul. Paul remains liable to Sela, the person entitled to enforce the instrument.

   c. **Discharge to extent of payment:** The person making payment is discharged to the extent of the payment. U.C.C. §3-602(a).

Example: Payment of each installment of an installment note discharges the maker to the extent of the payment made. U.C.C. §3-602(a).

d. Adverse claim to instrument: Subject to certain exceptions, the obligor is also discharged to the extent of her payment to the person entitled to enforce the instrument even though payment is made with knowledge of a claim to the instrument by the true owner. U.C.C. §3-602(a).

Example: Sela defrauds Sam into indorsing a note to her. Sam calls up Paul and requests that he not pay Sela. Paul may ignore Sam's plea and pay Sela. Paul is not liable to Sam for conversion even if it turns out that Sam was the rightful owner of the instrument.

Rationale: It is not fair to the obligor to place him in the predicament of either being liable to the adverse claimant or facing a lawsuit by the person entitled to enforce the instrument.

i. Right of adverse claimant to prevent payment: The person claiming ownership of the instrument (also called the ***adverse claimant***) has the ability to prevent payment. Payment to the person entitled to enforce the instrument does not discharge the person making payment if the adverse claimant's claim is valid and enforceable against the person entitled to enforce the instrument and either (1) the claimant obtains an injunction against payment and the obligor pays the person entitled to enforce the instrument even though he has knowledge of the injunction, or (2) the obligor accepts from the claimant indemnity against any loss resulting from the obligor's refusal to pay the person entitled to enforce the instrument.

ii. Injunction against payment: A court will not grant an injunction unless the person entitled to enforce the instrument, the claimant, and the party obliged to pay are all subject to the court's jurisdiction. In addition, the obligor is only denied a discharge if he has knowledge of the injunction.

Rationale: By requiring all parties to be present, the court's determination as to whether the person entitled to enforce the instrument or the adverse claimant is entitled to be paid will be binding on all of the parties concerned. This eliminates the possibility of inconsistent results that might occur if each person filed a separate lawsuit against the obligor.

Example: Assume that Sam obtains an injunction enjoining Paul from paying Sela. The injunction denies Paul a discharge only if he has knowledge of the injunction. Until Paul has knowledge of the injunction, Paul is discharged by his payment to Sela. However, once Paul has knowledge of the injunction, Paul will be liable to Sam if Sam ultimately proves that he is entitled to rescind the negotiation to Sela and, therefore, is the true owner of the instrument.

iii. Indemnification of obligor: If the obligor accepts indemnity from the claimant, the obligor is not discharged if she pays in spite of the indemnity. However, the obligor has no duty to accept indemnity from the claimant.

Example: Sam asks that Paul refuse to pay Sela. Sam offers to indemnify Paul against any losses and expenses incurred in defending against Sela's action. If Paul refuses the offer of indemnity, he is discharged by his payment to Sela. If, however, Paul accepts the indemnity but still pays Sela, Paul will be liable to Sam provided that Sam has a valid claim to the instrument enforceable against Sela.

Exception: Indemnification of the obligor is not effective to prevent the obligor's discharge if the instrument involved is a bank check.

Example: Assume that Norma acquires a cashier's check from Bank of America for the purpose of purchasing a car from Rick's Auto. Norma discovers, immediately upon handing over the cashier's check to Rick's Auto, that she has been defrauded. If Norma has sufficient time to obtain an injunction, she could prevent Bank of America from being discharged by its payment to Rick's Auto. U.C.C. §3-602, Official Comment 1. Not having time to obtain an injunction, however, Norma offers to indemnify Bank of America if it will refuse to pay Rick's Auto on the cashier's check. Bank of America agrees. Bank of America pays the cashier's check by mistake. Despite its agreement to accept the indemnity, Bank of America is discharged by its payment to Rick's Auto. Bank of America may, however, be liable to Norma for breach of the indemnity agreement. U.C.C. §3-602, Official Comment 1.

Rationale: The exception for cashier's and other bank checks is intended to discourage an obligated bank from refusing to pay a bank check.

iv. **Discharge if no valid claim:** The obligor is discharged even if she pays in violation of an injunction or after being indemnified if the claimant does not prove she has a valid claim of ownership.

Example: If Sam has no right to rescind the negotiation to Sela, he has no valid claim of ownership and Sela is, therefore, rightfully entitled to payment.

v. **Discharge where payment to subsequent holder in due course:** Because a holder in due course takes the instrument free from all claims to the instrument, payment to a holder in due course discharges the obligor.

Example: If Sela had negotiated the instrument to Gary, a holder in due course, payment to Gary would discharge Paul, the maker, from liability to Sam even if Sam had a valid claim to the instrument. U.C.C. §3-306.

vi. **Exception for stolen instruments:** Even if the claimant does not obtain an injunction or supply indemnity, the obligor is not discharged if she knows that the instrument is stolen and pays the person entitled to enforce the instrument knowing that he is in wrongful possession of the instrument. U.C.C. §3-602(b)(2). [[Rev] U.C.C. §3-602(e)(2).]

Example: If Sam informs Paul that Sela had stolen the instrument from him, Paul is not discharged even if Sam neither offers to indemnify Paul nor obtains an injunction against payment.

Rationale: An exception is made for stolen instruments for two reasons. First, by denying the obligor a discharge, she will be less likely to pay a thief or a person holding through a thief. This will make it more difficult for a thief to profit from his activity. Second, it is usually a fairly straightforward factual matter as to whether a theft has occurred. This limits the possibility of inconsistent results in the obligor's actions against the holder and against the owner.

e. **2002 amendments:** A new subsection (b) has been added to [Rev] U.C.C. §3-602.

i. **When payment to former holder discharges note:** Subject to [Rev] U.C.C. §3-602(e), a note is paid to the extent payment is made to a person who formerly was entitled to enforce the note only if, at the time of the payment, the party obliged to pay has not received adequate notification that the note has been transferred and that payment is to be made to the transferee. [Rev] U.C.C. §3-602(b) and Official Comment 2.

Example: April makes a note payable to May. May immediately transfers the note to June. Neither May nor June inform April of the transfer. April is discharged by her payment to May even though May is no longer the person entitled to enforce the note. Had either May or June informed April of the transfer, April would be discharged only by her payment to June.

ii. **Adequacy of notification:** For the notification to be adequate, it must:

(a) be signed by either the transferor or the transferee;

(b) reasonably identify the transferred note; and

(c) provide an address at which subsequent payments are to be made. [Rev] U.C.C. §3-602(b).

iii. Demand for proof of transfer: Upon request, a transferee is required to seasonably furnish reasonable proof that the note has been transferred.

iv. Effect of failure to provide proof of transfer: Unless the transferee complies with the request, a payment to the person that formerly was entitled to enforce the note results in the obligor's discharge even if the obligor has received a notification of the transfer. [Rev] U.C.C. §3-602(b).

v. Imputed notice of payment:[Rev] U.C.C. §3-602(d) provides that a transferee, or any party that has acquired rights in the instrument directly or indirectly from a transferee, is deemed to have notice of any payment that is made under [Rev] U.C.C. §3-602(b) between the date that the note is transferred to the transferee and before the party obliged to pay the note receives adequate notification of the transfer. It does not matter that the transferee is, or is not, a holder in due course.

Example: In the example above, June is deemed to have notice of the payment to May because the payment was made before April was notified of the transfer. It does not matter that June purchased the note in a transaction by which June became a holder in due course. June should have notified April of the transfer. By failing to do so, June misled April into believing that May was still the person entitled to payment of the note.

3. Discharge by tender of payment: A tender of payment is an offer to make payment coupled with the willingness and ability to immediately transfer the money. There is no legitimate reason for the person entitled to enforce an instrument to refuse to accept a tender of payment of the instrument on its due date.

a. **Tender discharges obligation to pay interest:** An effective tender of payment discharges the obligation of the obligor to pay interest accruing after the due date on the amount tendered. U.C.C. §3-603(c).

Exception: The person entitled to enforce the instrument may refuse a tender of payment before the instrument is due if she is not paid the full interest due under the instrument.

Example: James makes a note in the principal sum of $10,000 with interest at 15 percent per annum payable in 6 years. The next year the rate of interest drops to 6 percent. James has no right to pay the note off unless he pays all of the agreed-on interest. The holder bargained for the right to be paid the full interest for the duration of the term of the instrument and is entitled to be paid such interest. U.C.C. §3-603(b).

b. **Indorsers and accommodation parties discharged:** Upon the holder's refusal of the obligor's tender, an indorser or an accommodation party who has a right of recourse with respect to the obligation to which the tender relates is discharged to the extent of the amount tendered. U.C.C. §3-603(b); U.C.C. §3-603, Official Comment.

Example: Assume that Jane's cousin had indorsed the note as a favor to Jane. Jane, as maker, tenders full payment on the due date of the note. The holder, for some reason, refuses the tender. Immediately thereafter, Jane runs into an economic reversal and can no longer pay the holder. The holder then demands that Jane's cousin pay the note. Jane's cousin is not liable to the holder. The holder should not be permitted to deny Jane's cousin (or any other indorser or accommodation party) a discharge by refusing to accept the tender. No legitimate reason existed for the holder's refusal to accept the tender.

c. **Co-obligors:** The law governing tender of payment under a simple contract determines whether a co-maker, co-acceptor, or co-indorser is discharged to the extent of her right of contribution. The law generally provides that a co-obligor is discharged to the extent of her right of recourse.

Example: Assume that Bill and Bruce were co-makers of a note. Bill offers to pay the entire amount of the note. The holder refuses the tender. Because Bruce would have a right to contribution in the amount of one-half of the note in the event that he had paid the note in full, Bruce would be discharged in the amount of one-half of the amount due under the note.

d. **Requirements for tender:** A tender of payment must be made to the person entitled to enforce the instrument. Other than that, the manner and effect of the tender is governed by the principles of law applicable to tender of payment under a simple contract. U.C.C. §3-603(a); U.C.C. §3-603, Official Comment. The obligor need not tender the full amount of the instrument.

Example: Assume that John made a note to Bill in the amount of $1,000 payable with interest. John tenders partial payment in the amount of $500. At the time of tender, John owed $100 in interest on the note. Between the time of tender and the time of trial, additional interest in the amount of $300 accrued. John is discharged for $150, which is the amount of interest accruing after his tender on the amount tendered. He is not discharged as to the principal amount ($1,000), interest accruing prior to the time payment was tendered ($100), interest on the principal amount that was not tendered ($150), or costs or attorneys' fees.

4. **Discharge by cancellation or renunciation:** The person entitled to enforce the instrument may, if she desires, discharge any party to the instrument even though she has received no payment or other consideration for the discharge. The manner of doing so will usually be by cancellation or renunciation.

a. **Discharge by cancellation:** A person entitled to enforce an instrument may, without consideration, discharge any party to the instrument in any manner apparent on the face of the instrument or the indorsement. The holder may cancel the instrument by, for example, tearing it up; writing “void,” “discharged,” “paid,” or other such language on the instrument;

or by crossing out the party's signature. U.C.C. §3-604(a).

b. **Discharge by renunciation:** A person entitled to enforce the instrument may, without consideration, discharge any party to the instrument by renouncing her rights in a signed writing. The writing must evidence a present intention to renounce the rights rather than merely a promise to renounce the rights in the future. U.C.C. §3-604(a).

Example: I could discharge you from liability on a note by writing, “I release Reader from liability on the note executed on January 1, 2003.”

Exception: A renunciation is ineffective unless the party intends to renounce her rights. The requisite intent may be proven by delivery of the renunciation to the party sought to be discharged. However, as long as the party intends to renounce her rights, the renunciation need not be delivered to the person discharged thereby.

2002 amendments: The 2002 amendments have changed the requirement of a “signed writing” to a “signed record.” [Rev] U.C.C. §3-604(a). A “record” is “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.” [Rev] U.C.C. §3-103(a)(14).

Additional amendment: In addition a new [Rev] U.C.C. §3-604(c) has been added that defines “signed,” with respect to a record that is not a writing, as including the attachment to or logical association with the record of an electronic symbol, sound, or process to or with the record with the present intent to adopt or accept the record.

c. **Discharge by surrender:** A party is discharged on surrender of the instrument to the party to be discharged. U.C.C. §3-604(a). To constitute a surrender, the instrument must be returned to the party with the intent to discharge her. Possession by the obligor raises a presumption of discharge in the absence of a satisfactory explanation for the obligor's possession of the instrument.

d. **Unintentional, mistaken, or fraudulently procured cancellation, renunciation, or surrender:** A cancellation, renunciation, or surrender of an instrument is ineffective if it is unintentional, unauthorized, procured by fraud, or mistaken.

Example: Accidentally tearing or mutilating an instrument does not discharge the affected parties. There is also no discharge if an instrument is mistakenly marked "Paid" either as a result of a clerical error or because the person entitled to enforce the instrument mistakenly believed that payment had been made in full. In determining whether a mistake vitiates the discharge, the rules of equity come into play.

Example: Assume that Mary makes a note payable to Gail, who negotiates the note to Hank. Hank's secretary, believing that Hank had told her that the note had been paid, marked the note "Paid" and notified Gail that payment had been made. Believing the note to be paid, Gail makes a new loan to Mary. Because of the mistake by Hank's secretary, Gail was induced to make loans she would not have made had she known that she may be required to pay Hank on this note. Hank may not assert mistake as a grounds for denying Gail a discharge after Gail has relied on Hank's notification that the note had been paid by Mary.

5. **Discharge of simple contract:** A party is discharged from liability on an instrument to another party by any act or agreement with such party that would discharge a simple contract for the payment of money. U.C.C. §3-601(a).

Example: Although not effective as a renunciation, an oral agreement supported by consideration is usually sufficient to discharge a party on a contract to pay money. Similarly, satisfaction by means other than the payment of money also provides a discharge under U.C.C. §3-601(a).

VIII. ADMISSIBILITY OF EVIDENCE EXTRINSIC TO THE INSTRUMENT

A. **Introduction:** Subject to the parol evidence rule, an obligor's duty to pay an instrument may be modified, supplemented, or nullified by a separate agreement (whether oral or written) between the obligor and a person entitled to enforce the instrument if the instrument was issued or the obligation incurred either (1) in reliance on the agreement or (2) as part of the same transaction giving rise to the agreement. U.C.C. §3-117.

Example: Assume that Mary issues a note to Bret in the sum of $1,000 in payment for the purchase of a car. Mary can introduce evidence in Bret's action on the note that they had a separate oral agreement that she be entitled to a $200 deduction if the car does not pass a smog inspection if the evidence is admissible under the parol evidence rule.

B. Agreement as defense: The agreement would be a defense available against any person other than a holder in due course who is without notice of the agreement. U.C.C. §3-117.

Example: If Bret negotiates the note to a bank, the agreement may be asserted as a defense against the bank if it either does not qualify as a holder in due course or has notice of the agreement.

C. Same transaction: An agreement can be part of the same transaction even if the agreement was neither executed contemporaneously with the instrument or obligation nor referred to in the instrument. The transaction can be any transaction in which a party undertakes liability on the instrument.

Example: If, at the same time that Bob indorses a draft to Carl, Bob and Carl agree that Bob will not be called on to pay the draft unless Carl is unable to collect from Abe, Bob's liability is conditioned on Carl's inability to collect from Abe.

D. The parol evidence rule: The parol evidence rule generally provides that no prior written agreement and no prior or contemporaneous oral agreement is admissible to vary or contradict the terms found in a writing intended by the parties to be the final expression of the parties' agreement as to those terms. Evidence of a written agreement entered into contemporaneously with the instrument is always admissible.

1. Consistent additional terms admissible: A negotiable instrument, by its nature, is seldom intended to include the complete terms of the parties' agreement. Therefore, the parol evidence rule will seldom bar introduction of additional terms that do not contradict the terms of the instrument.

Example: An agreement giving the holder a right to obtain attorneys' fees will not be barred by the parol evidence rule as long as the instrument does not specifically provide otherwise.

2. **Conditions precedent:** Most courts hold that parol evidence is not admissible to prove a condition precedent to the obligation to pay. *See* Akin v. Dahl, 661 S.W.2d 914 (Tex. 1983) (prior written agreement under which the maker and payee had agreed that any note would be payable only on death of maker was not admissible into evidence); Metro Natl. Bank v. Roe, 675 P.2d 331 (Colo. Ct. App. 1983) (holder will look to the other obligor first for payment).

3. **Sham:** Courts differ as to whether evidence tending to show that the promise to pay is a sham or that the note would never be enforced against the obligor is admissible. *Compare* Grossman v. Banco Industrial de Venezuela, C.A., 534 So. 2d 773 (Fla. Dist. Ct. App. 1988) (maker may not introduce evidence that payee told him that he would not have to pay note) *with* Herzog Contracting Corp. v. McGowen Corp., 976 F.2d 1062 (7th Cir. 1992) (maker may introduce evidence that note was not intended to create legal obligation).

Rationale: The courts that allow evidence that a note is a sham reason that the obligor is not attempting to change the terms of the instrument when the obligor attempts to prove that the instrument was never intended to create a legal obligation.

4. **Special purpose or conditional delivery:** Evidence that delivery of the instrument was for a special purpose or is conditional on some act or event may always be introduced. U.C.C. §3-305(a)(2).

Example: An indorser may show that his indorsement was not to be effective until four other indorsers/guarantors also signed. *See* Long Island Trust Co. v. International Inst. for Packaging Educ., Ltd., 38 N.Y.2d 493, 381 N.Y.S.2d 445, 344 N.E.2d 377 (1976).

5. **Defenses:** Evidence of any defense may also be introduced.

   Example: Proof that goods were not delivered and, therefore, that there was a failure of consideration, does not attempt to vary the terms of the agreement.

6. **Ambiguities:** Evidence offered to explain ambiguities in the instrument is always admissible.

IX. TRANSFER OF INSTRUMENT AND SHELTER PROVISION

A. **Introduction:** When an instrument is transferred, the transfer vests in the transferee all of the rights of his transferor. U.C.C. §3-203(b). In other words, the transferee steps into the shoes of his transferor.

   Rationale: Vesting the rights of the transferor in the transferee makes sense. It makes no difference which particular person is attempting to enforce the instrument as long as the transferee has no more rights than the transferor.

B. **What is a transfer?** An instrument is transferred when it is delivered by a person other than its issuer (i.e., the maker or drawer), for the purpose of giving to the person receiving delivery the right to enforce the instrument. U.C.C. §3-203(a).

   1. **No transfer until delivery:** Until the instrument is delivered, the intended transferee obtains no rights in the instrument.

   2. **Intent to vest rights in transferee:** The transferor does not have to intend to vest rights of ownership in his transferee. The transferor must merely intend, by the delivery, to vest in the transferee the right to enforce the instrument so that, of the two of them, the transferee is the proper party to enforce the obligation. U.C.C. §3-203, Official Comment 1.

      Example: If Joe delivers an instrument to Tom for the purpose of having Tom collect the instrument for him, the requisite intent is present. In contrast, if Joe asks his attorney to safeguard the instrument for him, Joe does not transfer the instrument to his attorney because he does not intend for his attorney to have the right to enforce the instrument.

C. Right to transferor's indorsement: If the transferee does not become the holder of the instrument because the transferor failed to supply a necessary indorsement, absent a contrary agreement and if the transfer is for value, the transferee has the specifically enforceable right to obtain the transferor's unqualified indorsement. U.C.C. §3-203(c).

Rationale: The presumption is that, unless otherwise agreed, whenever a transfer is for value, the parties intended that the transferee become the holder of the instrument.

Exception: Absent a contrary agreement, the transferee has no right to require an indorsement of an instrument payable to bearer. U.C.C. §3-203, Official Comment 3.

Rationale: Because there is no need to have the transferor's indorsement to make the transferee the holder, the only purpose would be for the transferor to undertake liability as an indorser. Absent an agreement to the contrary, the presumption is that no such liability was intended.

Exception: Absent a contrary agreement, the transferee has no right to require an indorsement of an instrument payable to order that is not transferred for value. U.C.C. §3-203, Official Comment 3.

Rationale: When a transfer is not for value, the transferee is lucky to get what he already received and should not have the right to impose anything further upon the transferor.

D. The shelter provision: The most important aspect of the rule that the transferee obtains the rights of his transferor is a corollary rule called the shelter provision.

1. **Transferee acquires rights of holder in due course:** Under the shelter provision, a transferee may acquire the rights of a holder in due course through a transfer even though the transferee does not himself qualify as a holder in due course. U.C.C. §3-203(b).

2. **Same rights as transferor:** A transferee of a holder in due course

obtains all of the transferor's rights including the right to take free of all claims to the instrument, defenses, and claims in recoupment to the same extent as would his transferor/holder in due course. U.C.C. §3-305(b); U.C.C. §3-306.

a. **Includes inherited rights:** The transferee also is entitled to any rights the transferor inherited from his own transferor.

   Example: If Joe, a holder in due course, gave a note as a gift to Mary, who subsequently gave the note to Jane, Jane acquires all of Joe's rights as a holder in due course.

b. **Transferee's rights no greater than transferor's:** Because the rights vested in the transferee are purely derivative, they can be no greater than those possessed by his transferor and are subject to the same limitations. The transferee obtains only the rights of his transferor as a holder in due course; he does not obtain the status of a holder in due course. He can only obtain the status of a holder in due course by meeting its requirements himself. The transferee takes subject to any claim of ownership, claim in recoupment, or defense to which his transferor/holder in due course would take subject.

   Example: Ellen issues a note payable to Beth, who qualifies as a holder in due course. Beth gives the note as a gift to Charles. Not having taken the note for value, Charles does not become a holder in due course. He does, though, step into Beth's shoes and may recover from Ellen to the same extent as could Beth. If Ellen has a claim in recoupment that is assertible against Beth, Charles takes subject to this same claim in recoupment. If, however, Charles gave value for the note and, thus, independently met the requirements for holder-in-due-course status, he would take the note free of Ellen's claim in recoupment. U.C.C. §3-305(b).

3. **Exceptions to shelter provision:** No transferee who has himself engaged in any fraud or illegality affecting the instrument can acquire the rights of a holder in due course through transfer directly or indirectly from a holder in due course. U.C.C. §3-203(b).

Example: Hank defrauds Linda into issuing a note. Hank negotiates the note to Marla, who not having notice of the fraud, takes the note as a holder in due course. Hank repurchases the note from Marla. Hank, despite his purchase from Marla, does not take free of Linda's defenses.

Qualification: A person who has not engaged in fraud can acquire the rights of a holder in due course even though he had notice of the fraud.

Example: Georgia, knowing of Hank's fraud, purchases the note from Marla. Georgia acquires Marla's rights as a holder in due course.

E. **Reacquisition by prior holder:** Some unique issues arise when an instrument is reacquired by a person who previously held the instrument.

1. **Reacquisition by negotiation:** If the reacquisition is by negotiation, the reacquiring party thereby becomes the holder of the instrument.

Example: Janna makes a note payable to Ace Business Machines (ABM) in payment for the purchase of a computer. ABM sells the note to Crest Financial. When Janna begins missing payments, Crest Financial requests that ABM repurchase the note. Crest indorses the note to ABM. ABM is now the holder of the note. U.C.C. §3-207.

Note: Although a few courts have held otherwise, most courts hold that reacquisition of an instrument does not give the reacquirer his prior status as a holder in due course. He only becomes a holder in due course in his own right if he fulfills the requirements for becoming a holder in due course at the time he reacquires the instrument.

2. **Reacquisition by transfer:** If the reacquisition is by transfer only, the reacquirer would not, by the transfer alone, become the holder of the instrument.

Example: If, in our example above, Crest Financial forgets to indorse the note to ABM, ABM cannot become the holder until

Crest Financial indorses the note.

a. **Right to cancel intervening indorsements:** To relieve the reacquirer of the largely unnecessary act of obtaining missing prior indorsements, the reacquirer is given the right to cancel any indorsement not necessary to its chain of title, thereby enabling it to become the holder of the instrument and have the right to further negotiate the instrument. U.C.C. §3-207.

Example: Assume that Crest Financial had sold the note to Home Finance, which transferred the note back to ABM. ABM may cancel its own indorsement to Crest Financial and Crest Financial's indorsement to Home Finance. By canceling these indorsements, ABM is once again the holder.

b. **Intervening indorsers discharged:** The reacquirer's cancellation of intervening indorsements discharges any indorser whose indorsement has been cancelled. By the cancellation, subsequent purchasers are deemed to have notice of the cancelled indorser's discharge. U.C.C. §3-207.

X. DEFENSES AND CLAIMS TO BANK CHECKS

A. **Introduction:** When a customer makes payment by a bank check, the person receiving the bank check assumes that she has the same protections as she would have had had she received payment in cash. To protect this sense of security, special rules govern the bank's right to refuse payment on a bank check when used in a transaction by its customer. U.C.C. §3-411, Official Comment 1.

Example: Jamie wants to purchase a car from Nissan World. Nissan World demands a cashier's check in payment. Jamie buys the cashier's check from Wells Fargo Bank. Jamie negotiates the check to Nissan World. Nissan World gives possession of the car to Jamie.

B. **Rules not applicable if bank uses bank check:** A bank will issue a cashier's check or teller's check to pay one of its own obligations much in the same way that a customer uses a personal check. When a bank uses a cashier's or teller's check for its own purposes, these special rules do not apply.

Example: If Bank of America wants to pay its attorney, it will issue a cashier's check to its attorney. Bank of America is treated as though it was an ordinary drawer on a personal check.

C. **Terminology:** The drawer bank of a teller's or cashier's check and the accepting bank on a certified check are called the ***obligated bank***. U.C.C. §3-411(a). Cashier's, teller's, and certified checks are called ***bank checks***.

D. **Rules governing obligated bank's right to refuse payment on a bank check:** The rules found in U.C.C. §3-411 attempt to strike a balance between discouraging fraud and yet maintaining the cash-like nature of bank checks, thus retaining, for the holder of a bank check, its benefits. The obligated bank retains the same right as a drawer of a personal check to raise defenses or third-party claims. However, certain penalties are assessed against the bank if it wrongfully refuses to pay a bank check.

1. **Penalty for wrongfully refusing to pay:** An obligated bank that wrongfully refuses to pay a bank check is liable to the person asserting the right to enforce the check for any expenses, including attorneys' fees and loss of interest, resulting from the nonpayment. U.C.C. §3-411(b); U.C.C. §3-411, Official Comment 2.

   Example: In our example above, assume that, for some reason, Wells Fargo Bank refuses to pay Nissan World on the cashier's check that Jamie purchased from it. Wells Fargo Bank's right to raise any defense is governed by the same rules that would apply if Wells Fargo Bank was an ordinary drawer being sued on its personal check. If, however, Nissan World is successful in recovering from Wells Fargo Bank either because Nissan World qualified as a holder in due course or Wells Fargo Bank did not establish a defense, Nissan World could recover from Wells Fargo Bank its expenses, including attorneys' fees and interest.

2. **Consequential damages:** The holder may recover consequential damages if the obligated bank refuses to pay the check after receiving notice of the particular circumstances giving rise to such

damages. U.C.C. §3-411(b).

Example: If Nissan World needed the funds to purchase another car for sale to a subsequent purchaser, Nissan World's loss of profits on this sale could be recovered as damages if notice of this fact was communicated to Wells Fargo Bank in time enough for Wells Fargo Bank to make payment to Nissan World thereby avoiding the loss.

3. **Bank's defenses to liability for expenses and consequential damages:** The obligated bank is not liable for expenses or consequential damages if its refusal to pay occurs in any one of four situations:

- the obligated bank suspends payments (i.e., is insolvent);
- the obligated bank has reasonable grounds to believe that the bank's claim or defense is available against the person entitled to enforce the instrument;
- the obligated bank has reasonable doubt that the person is entitled to payment; or
- the obligated bank is prohibited by law from making payment. U.C.C. §3-411(c).

Example: If Wells Fargo Bank has a defense of its own in that Jamie had paid for the cashier's check with a forged check, Wells Fargo Bank would be able to raise this defense against Nissan World if Nissan World does not qualify as a holder in due course. Wells Fargo Bank is not liable for either consequential damages or expenses, whether or not it is successful in raising the defense, as long as the bank reasonably believes both that it has such a defense and that Nissan World is subject to the defense. U.C.C. §3-411, Official Comment 3. This requires that Wells Fargo Bank have reasonable grounds to believe that Nissan World is not a holder in due course. Even if Wells Fargo Bank was reasonable in its belief, because Wells Fargo Bank had use of the funds during the delay, it is liable to Nissan World for interest on the funds.

4. **Third-party claims:** The obligated bank receives no protection against liability for expenses and consequential damages if it unsuccessfully attempts to raise a third-party claim to the

instrument. However, the bank will, more than likely, be indemnified from liability either through an indemnity agreement or, if the claimant obtained an injunction, through the bond posted by the claimant in the injunctive action.

Example: Jamie believes that Nissan World defrauded her into purchasing a defective car. If Jamie has the right to rescind the transaction because of Nissan World's fraud, Wells Fargo Bank could raise Jamie's claim as a defense to Nissan World's action on the cashier's check. U.C.C. §3-202; U.C.C. §3-411, Official Comment 3. Under U.C.C. §3-305(c), Wells Fargo Bank may raise Jamie's claim as a defense to its liability to Nissan World if Jamie defends the action for the bank by successfully asserting her claim. If, however, Jamie cannot prove that she has the right to rescind, Jamie's mere breach of warranty defense cannot be used by Wells Fargo Bank as a defense. Even if Jamie does have a valid claim to the cashier's check, if the cashier's check has been negotiated by Nissan World to a holder in due course, the holder in due course will take free of Jamie's claim to the check. U.C.C. §3-306; U.C.C. §3-411, Official Comment 3. The reason for this result is that if Wells Fargo Bank could assert with impunity what turns out to be Jamie's invalid claim, the cash-like nature of bank checks would be defeated. Nissan World would have gained little by taking a cashier's check rather than Jamie's personal check. As a result, Wells Fargo Bank is given a choice. If Jamie's claim turns out to be valid, Wells Fargo Bank has no liability to Nissan World or any subsequent nonholder in due course. However, if the claim is invalid or if a subsequent holder in due course acquires the check, Wells Fargo Bank is liable to the person entitled to enforce the check for expenses and consequential damages, as appropriate. U.C.C. §3-207; U.C.C. §3-207, Official Comment.

XI. FEDERAL HOLDER-IN-DUE-COURSE STATUS

A. Introduction: One exception to the holder-in-due-course requirements set out in U.C.C. §3-302 is the ***federal holder-in-due-course doctrine.*** The federal holder-in-due-course doctrine was developed to govern the holder-in-due-course status of federal agencies that acquire negotiable instruments. In particular, the Federal Deposit Insurance Corporation (FDIC), and the Resolution Trust Company (RTC) acquire instruments in two different roles when a bank fails. The FDIC, as a ***receiver*** of the failed bank, may manage and protect the failed bank's assets. The FDIC, *in its corporate capacity,* insures the depositor's accounts. All of the powers that the FDIC has regarding banks, the RTC has regarding savings and loan associations.

B. Federal law governs: Under the federal holder-in-due-course doctrine, federal common law, and not the Code, determines whether the FDIC or the RTC in purchasing notes is a holder in due course. *See* Federal Deposit Ins. Corp. v. Wood, 758 F.2d 156 (6th Cir. 1985).

Note: The status of the federal holder-in-due-course doctrine has been put into question by the United States Supreme Court's decision in O'Melveny & Myers v. FDIC, 114 S. Ct. 2048 (1994). The court in *O'Melveny & Myers* held that California law, rather than federal law, governed the issue as to whether the FDIC, as receiver for a failed California bank, could recover from a law firm representing the bank for malpractice and breach of fiduciary duty. Since the decision in *O'Melveny & Myers,* several federal circuit courts have held that the federal holder-in-due-course doctrine has been preempted by 12 U.S.C. §1823(e), as amended in 1989 by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). *See* Divall Insured Income Fund Ltd. Partnership v. Boatmen's First Natl. Bank, 69 F.3d 1398 (8th Cir. 1995); RTC v. Maplewood Inv., 31 F.3d 1276 (4th Cir. 1994); and FDIC v. Massingill, 30 F.3d 601 (5th Cir. 1994). Some state courts are now holding that whether the RTC, FSLIC, or FDIC is a holder in due course is determined by state law. *See* Calaska Partners Ltd. v. Corson, 672 A.2d 1099 (Me. 1996).

C. Federal holder-in-due-course doctrine: Under the federal holder-in-due-course doctrine (at least as it existed before *O'Melveny & Myers*), notwithstanding U.C.C. §3-302(c), the FDIC and the RTC could qualify as a holder in due course even when they purchased in bulk a failed bank's instruments. However, courts differed as to the precise requirements that they must meet to qualify as a holder in due course. Most courts seemed to require that the FDIC and the RTC take the instrument in good faith and without actual knowledge of any defense to the instrument. *See* Federal Saving & Loan Ins. Corp. v. Mackie, 949 F.2d 818 (5th Cir. 1992). Courts differed as to whether the FDIC or the RTC could be a holder in due course of an overdue instrument. *Compare* Federal Deposit Ins. Corp. v. Wood, 758 F.2d 156 (6th Cir. 1985) (the FDIC qualified as a holder in due course even though it took the instrument with notice that it was overdue) *with* Federal Deposit Ins. Corp. v. Blue Rock Shopping Ctr., 849 F.2d 599 (3d Cir. 1988) (the FDIC was not a holder in due course when it acquired an instrument that was overdue).

Note: The federal holder-in-due-course doctrine applies only to negotiable instruments. *See* Resolution Trust Corp. v. 1601 Partners, Ltd., 796 F. Supp. 238 (N.D. Tex. 1992).

Note: A transferee from the FDIC or the RTC obtains all the rights that the FDIC or the RTC had as a holder in due course under the federal holder-in-due-course doctrine. *See* Federal Deposit Ins. Corp. v. Newhart, 892 F.2d 47 (8th Cir. 1989) (when FDIC is granted holder-in-due-course status under federal common law, its transferee obtains the rights of a holder in due course).

D. D'Oench, Duhme doctrine: Even when the FDIC or the RTC does not qualify as a holder in due course, proof of a defense against the FDIC or the RTC was made more difficult by the ***D'Oench, Duhme doctrine***. Under this doctrine, defenses had to be based on documents and not on secret agreements. *See* Resolution Trust Corp. v. Montross, 944 F.2d 227 (5th Cir. 1991). Many courts required not only that any defenses be proved through the failed bank's formal and board-approved records but that the FDIC or the RTC had to have actual knowledge of the defense. *See* Resolution Trust Corp. v. Juergens, 965 F.2d 149 (7th Cir. 1992).

Note: The continued vitality of the D'Oench, Duhme doctrine was put into question by the enactment of FIRREA. Under 12 U.S.C. §1823(e), no agreement that had the result of diminishing the interests of the FDIC in any assets acquired by it (whether as a purchaser or as a receiver of any insured bank or savings and loan) was valid against the FDIC unless such agreement (a) was in a writing that was (b) executed by the bank contemporaneously with the acquisition of the note, (c) was approved by the board of directors of the bank, and (d) was reflected in the minutes of the board. Many federal circuits have held that D'Oench, Duhme, other than as codified in 12 U.S.C. §1823(e), has been preempted by FIRREA. *See* Divall Insured Income Fund Ltd. Partnership v. Boatmen's First Natl. Bank, 69 F.3d 1398 (8th Cir. 1995).

Quiz Yourself on HOLDER-IN-DUE-COURSE STATUS AND AVAILABLE CLAIMS, DEFENSES, CLAIMS IN RECOUPMENT, AND DISCHARGES

8. Joan buys a cashier's check from Bank of America payable to Southwest Auto to purchase a car.

a. Is Joan a remitter?_________

b. Is Joan a holder?_________

c. Bank of America issues the check when it delivers the check to Joan. What makes Bank of America the issuer?_________

d. Would Bank of America still be the issuer if the check was made payable to Joan directly?_______

9. Joan delivers a cashier's check made payable to Southwest Auto to them.

a. Is this a negotiation of the check?_________

b. If the check is payable to Joan, what else would Joan have to do for her transfer of possession to be a negotiation?_______

10. Bill indorses a check in blank and delivers the check to John.

a. What can John do to avoid the risk of losing the check while indorsed in blank?_________

b. Does allowing John to convert Bill's indorsement in blank into a special indorsement affect Bill's liability on the check? __________

11. Assume that Allen issues a note to Target in payment for a television set to be delivered to him by Target. Target immediately sells the note to Finance Company.

a. If the television set is not delivered to Allen, what defense does Allen have?__________

b. Has the finance company taken the note for value?__________

12. Assume that Wedontcare Bank purchases the note that Allen gave to Target in payment for the television set by issuing a check payable to Target. After receiving the check, Target negotiates the check to a holder in due course.

a. Even though Wedontcare Bank discovers that Target never delivered the television set to Allen, is it still deemed to have taken the note for value?__________

b. Would Wedontcare Bank have a right to refuse to pay the holder in due course on its check if, prior to payment of the check, Wedontcare Bank receives notice of Allen's defense?__________

13. Assume that a customer opens a checking account at her bank with the deposit of a check in the amount of $5,000. Before the deposited check is collected from the payor bank, the collecting bank pays a $4,000 check drawn by its customer.

a. To what extent is the depositary bank a holder for value of the check?__________

b. Why is the bank not a holder for value as to the remaining $1,000?__________

14. A purchaser receives her mail at 9:00 a.m. The day's mail includes a list of stolen certificates of deposit. The purchaser does not open her mail and read the list until after she purchases a certificate of deposit found on the list. She makes the purchase at 9:30 a.m.

a. If she has not in fact read the list before her purchase, will she be deemed to have had notice of the theft?__________

b. If the purchaser of the certificate of deposit reads the list at 10:00 a.m. and discovers that the certificate was stolen, does this subsequently discovered knowledge destroy her holder-in-due-course status?__________

15. A finance company or bank that regularly purchases notes from the same retailer may know of defenses previously asserted by other customers of the retailer.

a. Under the "inferable knowledge" test, will notice of a defense be imputed to the finance company or bank in this situation? __________

b. Would your answer change under the "duty to inquire" test? __________

16. Assume that Jennifer Jones, treasurer of Oasis Corporation, negotiates a check made payable either to "Oasis Corporation" (the represented person) or to "Jennifer Jones, Treasurer of Oasis Corporation" (the fiduciary in her fiduciary capacity) in payment of a loan that Bank of America *knows*, from the loan application, to be for her personal benefit.

a. Does Bank of America have notice of her breach of fiduciary duty?__________

b. Assuming that Jennifer Jones negotiates a check payable to Oasis Corporation to Mastercard in payment of her personal credit card bill, under what circumstances would Mastercard be on notice that the transaction was for Jennifer Jones's personal benefit?__________

c. Assume that a check issued by Oasis Corporation and payable to Jennifer Jones is negotiated by Jennifer Jones to Bank of America in payment for her personal bank loan. Under what circumstances does Bank of America have notice of a breach of fiduciary duty?__________

17. Assume that Bob issues a check to Carl's Auto in payment for a used car and that the car has a defective transmission.

a. Can Bob assert a breach of warranty claim against Carl's Auto if

Carl's Auto was unaware that the transmission was defective? __________

b. If Carl's Auto negotiates the check to Don, who takes the check as a holder in due course, can Bob raise his claim in recoupment as a defense to Don's action on the check?__________

c. In contrast, assume that Bob had done business with Carl's Auto before. A few months earlier, Bob had purchased a truck for his business. The truck has defective brakes in violation of the warranty that Carl's Auto gave to Bob on the truck. Can Bob raise the breach of warranty on the truck as a claim in recoupment in Carl's Auto's action on the check?__________

18. Gullible Gil is told by Lying Larry that the land that Gil is purchasing contains substantial oil reserves. Lying Larry knows that this is not true. Gil signs a note in payment for the land. Can Gil raise Lying Larry's fraud as a defense against a holder in due course? __________

19. Assume an instrument payable to Carla is stolen by Ted, who forges Carla's indorsement and then sells the instrument to Jane, who purchases the instrument in good faith and without notice of the forgery or of any other infirmity.

a. Can Carla recover the instrument from Jane?__________

b. If Carla had indorsed the instrument prior to Ted's theft, would Jane be a holder, and take free of Carla's claim of ownership? __________

c. If Jane sues Sam, the maker of the note, can Sam raise Carla's claim of ownership to the instrument? __________

d. If Carla told Sam that Ted stole the instrument from her, can Sam raise Carla's claim of ownership against Jane even if Carla is not a party to the action?__________

20. Jane loses her paycheck. Fred finds the check, indorses the check in Jane's name, and negotiates the check to Check Cashing Service, which pays Fred the face amount of the check less a small fee. Check Cashing Service has no reason to believe that Jane's signature is forged or that Fred was not entitled to cash the check. Is Check Cashing Service a holder in due course?_________

21. On March 1, Bill issues a check to Hillary. On March 2, Hillary goes to the payor bank, which refuses to pay the check. On May 15, Hillary negotiates the check to Albert in payment for legal services to be rendered in the future. Is Albert a holder in due course?_________

22. Deleyla makes a note to Car Dealer payable in full on December 1. On November 1, Deleyla sends a check to Car Dealer in full payment for the car. Car Dealer sends Deleyla a receipt for the payment. On November 10, Finance Company purchases the note from Car Dealer. On December 1, Finance Company demands that Deleyla pay the note. Can Finance Company recover from Deleyla?_________

23. John Jones is the treasurer of Orange Computer Company. Every Sunday night, John takes his family to Chasens Restaurant, where he has a charge account. Chasens sends John a bill for the $2,000 he charged the preceding month. John writes a check to Chasens on Orange Computer Company's checking account. Although authorized to write checks, John has no authority to use company funds to pay his personal expenses. When the check is presented for payment, it is dishonored. Can Chasens recover on the check from Orange Computer Company?_________

24. Susan purchases land from Max in exchange for which Susan executes a note in the sum of $30,000. Bank purchases the note from Max for $25,000. Unknown to Bank, Max did not own the land. After discovering the fraud, Bank decides that it wants to sell the note. It sells the note to Scott, a con artist, who sees a quick profit. Scott pays Bank $12,000 for the note. Scott demands payment from Susan. Can Susan raise her defense of fraud against Scott?_________

Answers

3.a. **Yes.** Joan is a remitter because the check is payable to someone other than herself.

b. **Yes.** Joan, being the payee, is a holder because she is in possession of an instrument payable to herself.

c. **Delivery of the check to Joan.** Bank of America is the issuer because it delivered the check to Joan, a nonholder, for the purpose of giving rights on the check to Southwest Auto.

d. **Yes.** If the check was payable to Joan herself, Bank of America would have issued the check when it delivered the check to her. The drawer has issued the instrument in that the drawer has delivered it to the holder (the payee) for the purpose of giving rights on the instrument to the holder (the payee).

9.a. **Yes.** It is a negotiation of the check because Southwest Auto, now having possession of a check made payable to itself, becomes the holder of the check.

b. **Indorse the check.** In addition to delivering the check, Joan would have to indorse the check to Southwest Auto.

10.a. **John may write over Bill's indorsement the words "Pay to John."** The check is now payable to John, and he must indorse the check before anyone else can become its holder.

b. **No.** By indorsing the check in blank, Bill undertakes the indorser's obligation. This obligation is not changed by the addition of the words "Pay to John."

11.a. **Failure of consideration.** Allen has the defense of ***failure of consideration*** because he never received the television set.

b. **Depends on if finance company gave Target anything for the note.** Whether Finance Company has taken the note ***for value*** depends not on whether Allen received consideration but on whether Finance Company has given anything to Target for the note.

12.a. **Yes.** Wedontcare Bank gives value simply by issuing a negotiable instrument. This is because Wedontcare Bank itself is exposed to personal liability in that, even if it has a defense, it will not be able to raise that defense against a subsequent holder in due course of the check.

b. **No.** Wedontcare Bank has no right to refuse to pay the check. The possibility that a holder in due course might acquire the check and thereby deny Wedontcare Bank the right to refuse to pay the check is the reason why Wedontcare Bank is deemed to have given value.

13.a. **$4,000.** The depositary bank is a holder for value of the check to the extent of $4,000, the amount of the deposited check on which the customer drew.

b. **Because the bank can debit the account for remaining $1,000.** The bank is not a holder for value as to the remaining $1,000 because if the $5,000 check is returned unpaid, the bank can debit (charge back) its customer's account for the remaining $1,000. As a result, it only needs holder-in-due-course protection for $4,000. U.C.C. §4-210(a)(1).

14.a. **No.** The purchaser will not be deemed to have had notice of the theft before the purchase. A purchaser is deemed to have notice only when she has had a reasonable opportunity to act on the notice. Because 30 minutes after receipt of the mail is probably not a reasonable time within which to require a person to open up and read all her mail, the purchaser will not be deemed to have notice simply because she had received the notification before she purchased the certificate of deposit.

b. **No.** Once the holder has given value, it is too late for her to do anything about the notice when it is finally received. As a result, the holder is still deemed to be a holder in due course.

15.a. **No.** Notice of a defense to any specific note will not be imputed merely from the fact that the finance company or bank had notice of prior complaints. Even if the finance company or bank knew of many complaints from other customers, such complaints would not indicate that there is a defense to the specific instrument at issue.

b. **Maybe.** Under the duty to inquire test, a court may find that the numerous prior complaints gave rise to a duty on the part of the finance company or bank to investigate the transaction at hand. If the investigation would have revealed a defense, the finance company or bank will be deemed to have notice of the defense.

16.a. **Yes.** However, if Bank of America does not know that the debt is

Jennifer's personal debt, the fact that it has knowledge that Jennifer is a fiduciary neither gives notice to, nor imposes a duty on, it to inquire as to the use of the instrument.

b. Mastercard would only be put on notice if it had actual knowledge that Jennifer Jones is a fiduciary and that the credit card purchases were personal rather than business related. Otherwise, Mastercard does not have knowledge.

c. Bank of America only has notice of the breach of fiduciary duty if it knows both that the check was used for the benefit of Jennifer personally, and that the check was not intended by Oasis Corporation to be so used. The difference in rules is justified because it is not unusual for the represented party to pay or reimburse the fiduciary by issuing a check directly to her. U.C.C. §3-307, Official Comment 4.

17.a. **Yes.** Because it arose out of the transaction in which the check was issued, Bob may assert the breach of warranty as a claim in recoupment against Carl's Auto even if Carl's Auto qualifies as a holder in due course.

b. **No.** Bob may not raise his claim in recoupment as a defense to Don's action on the check because Don is a holder in due course and the claim in recoupment is not one that is assertible against Don himself.

c. **No.** Because the transaction in which Bob purchased the truck was a different one from the transaction out of which the check was issued, Bob may not raise the breach of warranty on the truck as a claim in recoupment in Carl's Auto's action on the check. U.C.C. §3-305(b).

18. **No.** Because Gil intentionally executed the note, Gil, rather than a holder in due course, should suffer the loss. Gil had knowledge of the character and essential terms of the note that he signed. As a result, the fraud cannot be asserted against a holder in due course.

19.a. **Yes.** Carla can recover from Jane because Jane, lacking a proper indorsement by Carla, is not a holder, and therefore not a holder in due course of the instrument. Not having the rights of a holder in due course, she takes subject to any valid claim to the instrument. Carla, being the true owner of the instrument, has a valid claim of ownership to it.

b. **Yes.** Although Carla would have a legal claim of ownership to the instrument, Jane would qualify as a holder in due course, and would, thus, take free of Carla's claim of ownership. If, however, Jane did not qualify as a holder in due course, Carla would be able to reclaim the instrument from Jane. For example, if Carla was defrauded into indorsing the instrument, and Jane had notice of that fact, then Jane would not qualify as a holder in due course, and would thus take subject to Carla's claim to the instrument. Under these circumstances, Carla could recover the instrument from Jane.

c. **No.** However, if Carla intervenes in the action, Carla may assert her own claim. If the claim is valid and if Jane is not a holder in due course, Sam will be required to pay Carla and not Jane.

d. **Yes.** If Sam pays Jane notwithstanding his knowledge of the claim of theft, Sam is not discharged and remains liable to Carla. Because of this risk of liability, the obligor (Sam) needs to be able to defend against the holder's (Jane's) action even when the true owner (Carla) is not a party to the action.

20. **No.** Even though Check Cashing Service took the check for value, in good faith, and without notice of the theft, it does not qualify as a holder in due course. Jane's indorsement, being unauthorized, did not negotiate the check. U.C.C. §3-201(b). As a result, Check Cashing Service, not being a holder, cannot be a holder in due course.

21. **No.** Despite the fact that the check was dishonored on presentment by Hillary, Albert is not denied holder-in-due-course status because Albert did not know of the dishonor. U.C.C. §3-302(a)(2)(iii). Because he purchased the check within 90 days of its date, the date of the check did not give Albert notice that it was overdue. However, Albert did not give value for the check in that his promise to perform legal services was not yet performed. U.C.C. §3-303(a)(1).

22. **Yes.** Although Deleyla is discharged by her payment to Car Dealer, U.C.C. §3-602(a), Finance Company, being a holder in due course without notice of the discharge, takes free of the discharge. U.C.C. §3-601(b).

23. **Yes.** Orange has a claim that it is the equitable owner of the funds because the funds were used in violation of John's fiduciary duties. Chasens would take free of this claim to the funds if Chasens is a holder in due course. Chasens would be a holder in due course if it does not have notice that John was in breach of his fiduciary duty by using a company check to pay his personal restaurant bills. This situation is covered by U.C.C. §3-307(b)(4). For Chasens to have notice of the breach, it is necessary that Chasens both know that John is a fiduciary and that the transaction is for his personal benefit. Considering that the only person who may know that the transaction is for John's personal benefit is the waiter, while the person taking the check is the bookkeeper, it is unlikely that Chasens would be deemed to have such knowledge. Under [Rev] U.C.C. §1-202, the bookkeeper is the person whose knowledge or lack thereof is relevant. The knowledge of the waiter would not be imputed to the bookkeeper because the waiter neither had a duty to communicate such information nor knew that payment of the charge account bill would be materially affected by such knowledge. Furthermore, Chasens gave value for the check in that it applied the check to an antecedent claim. U.C.C. §3-303(a)(3). Therefore, Chasens would qualify as a holder in due course and take the check free of Orange's claim to the funds.

24. **No.** Although Scott, having notice of the defense, does not qualify as a holder in due course, he is the transferee of Bank and thereby obtains all of its rights. Not being a party to the fraud, Scott is not disqualified from acquiring Bank's rights. U.C.C. §3-203(b). As a holder in due course, Bank (and Scott, its transferee) can recover free from any of Susan's defenses except for real defenses. U.C.C. §3-305(a)(1), (b). Because Max's fraud was not fraud in the factum, it is not a real defense assertible against a person having the rights of a holder in due course.

Exam Tips on HOLDER-IN-DUE-COURSE STATUS AND AVAILABLE CLAIMS, DEFENSES, CLAIMS IN RECOUPMENT, AND DISCHARGES

- **Transferees:** Remember that even when the transferee takes an instrument (assuming it is payable to order) from the true owner, the transferee does not become a holder unless she acquires any necessary indorsement.
  - Also note that if the transferee obtains notice of a claim or defense prior to obtaining the indorsement, the transferee can *never* qualify as a holder in due course.
  - This does not mean that all is necessarily lost! Even though the transferee cannot become a holder in due course in her own right, she may acquire the rights of a holder in due course through the shelter provision. This would allow her to take free of any claim or defense as to which her transferor would take free.
- **Breach of fiduciary duty:** In determining whether a holder has notice of a breach of fiduciary duty, you should remember that the holder must have *actual knowledge* that the person is a fiduciary. In addition, the holder must, depending on the circumstance, *know* that the debt is the personal debt of the fiduciary or that the transaction is a breach of the person's fiduciary duty.
- **Breach and holder-in-due-course status:** Remember that it is possible for a payee to qualify as a holder in due course even though the payee has delivered defective goods or otherwise breached its contract with the maker or drawer. For example, a payee who sells a car to the maker may be a holder in due course even though she has breached the warranty of merchantability. Once the payee delivers the car, the payee has given value for the instrument. If the payee was without notice that the car is defective, the payee may qualify as a holder in due course. However, note that because the payee has dealt with the maker, the maker may raise the breach of warranty as a claim in recoupment in the payee's action on the note.

CHAPTER 3
NATURE OF LIABILITY ON INSTRUMENTS

ChapterScope

This chapter covers the nature of a party's liability on a negotiable instrument. It examines the liability of signers and transferors, the effect that taking a negotiable instrument has on the underlying obligation, accord and satisfaction, procedural issues, and the enforcement of lost or stolen instruments. The key points in this chapter are:

- **Effect of signature on negotiable instrument:** The mere act of signing one's name to a negotiable instrument can obligate the signer to pay the instrument. However, there are differences in the conditions precedent to the signer's duty to pay depending on the capacity in which the person signs.
- **Parties secondarily liable:** An indorser or a drawer is entitled to have the instrument dishonored by the maker or drawee before being obligated to pay the instrument. An indorser is discharged from liability when a necessary presentment or notice of dishonor is delayed.
- **Transferor's warranties:** A person who transfers an instrument for consideration makes certain warranties as to the enforceability of the instrument whether or not the transferor indorses the instrument.
- **Rights of surety:** A person who signs an instrument as a surety (called “an accommodation party” under Article 3) has certain special rights and defenses. Many of these same rights and defenses are available to an indorser.
- **Effect of discharge:** Discharge of an instrument also discharges the underlying obligation for which the instrument was given.
- **Procedure:** Several procedural advantages are available to a person maintaining an action on a negotiable instrument.

- **Lost or stolen instruments:** Special rules enable the owner of a lost or stolen instrument to recover on the instrument.

I. LIABILITY OF ISSUER, DRAWER, ACCEPTOR, AND INDORSER

A. Introduction: The mere act of signing one's name anywhere on a negotiable instrument will, generally, obligate the signer to pay the instrument. However, the conditions precedent to a signer's liability vary depending on the capacity in which the party signs. A party may sign a negotiable instrument in four basic capacities: (1) an issuer of a note or cashier's check, (2) a drawer of a draft, (3) an acceptor of a draft, and (4) an indorser.

B. Obligation of issuer of note or cashier's check: The maker of a note or the drawer of a cashier's check (called the ***issuer***) promises to pay the instrument according to its terms at the time the instrument was issued. U.C.C. §3-412. An issuer's liability is what may be called "primary." There are no conditions to the issuer's obligation to pay an instrument. He is liable to pay the instrument when it is due.

Note: For that purpose, the obligation of an issuer of a cashier's check is identical to that of a maker of a note. Although a cashier's check seems like any other check, the issuing bank is both the drawer and the drawee of the check. This means that, just like the maker of a note, the holder will demand payment directly from the issuing bank.

C. Obligation of drawer: The drawer promises that if the draft is dishonored, she will pay the unaccepted draft according to its terms at the time it was issued. U.C.C. §3-414(b). Dishonor by the drawee must occur before the drawer is liable. U.C.C. §3-414(b). Liability as a drawer is not conditioned on notice of dishonor, as the drawer knows, or will find out soon from the drawee, if the draft is not paid. U.C.C. §3-414(b); U.C.C. §3-414, Official Comment 2.

1. **Effect of acceptance:** When a draft is accepted by a nonbank, the drawer is treated as an indorser under U.C.C. §3-415(a), (c). U.C.C. §3-414(d). In contrast, the drawer is completely discharged when a

draft is accepted by a bank. U.C.C. §3-414(c).

Analysis: The drawer is discharged when a bank accepts the draft because the holder will look to the bank's assets instead of to the drawer's assets. If the holder wants both the drawer's and the bank's promise to pay the draft, the holder may achieve this goal by having the drawer indorse the accepted draft. In contrast, the drawer is not discharged if a draft is accepted by a nonbank because there is no reason to assume that the holder would be satisfied in looking to the acceptor's assets only rather than also to the drawer's assets. However, because the holder has, by presenting the draft for acceptance, impliedly agreed to look initially to the acceptor for payment, the drawer's obligation becomes the same as that of an indorser. U.C.C. §3-414(d); U.C.C. §3-414, Official Comment 4.

2. **Disclaimer of liability:** A drawer may disclaim liability on any draft (other than a check) by writing, on the draft, the words ***without recourse***. U.C.C. §3-414(e). A drawer is not permitted to draw a check without recourse because that would leave no one liable on the check. U.C.C. §3-414, Official Comment 5.

D. **Obligation of drawee:** The drawee is the person whom the drawer orders to pay the draft. The mere fact that a person is named as drawee of a draft does not, by itself, impose any obligation on that person to pay the holder of the draft.

Analysis: A check or other draft does not, of itself, operate as an assignment of any of the drawer's funds held by the drawee. U.C.C. §3-408. The holder has no right to proceed directly against the drawee. The drawee is only liable to the drawer. The drawee is not liable to the holder unless the drawee accepts the draft. U.C.C. §3-408.

E. **The obligation of an acceptor:** When a draft is presented to the drawee for acceptance and the drawee accepts the draft, the drawee becomes liable as an acceptor. An acceptor promises to pay the draft according to its terms at the time of its acceptance. U.C.C. §3-413(a). Acceptance is the drawee's signed agreement to pay the draft as presented. U.C.C. §3-409(a). On acceptance, the acceptor becomes the primary party obligated to pay the draft. There are no conditions to the acceptor's obligation to make payment. Once the draft is due, the acceptor is obligated to make payment. If the acceptor fails to make payment on the date due, the person entitled to enforce the draft may immediately commence an action against the acceptor without giving notice to, or making a demand on, the acceptor to make payment.

1. **Acceptance vs. payment:** Acceptance of a draft must be distinguished from payment of a draft. When a draft is presented for payment, the drawee honors the draft by making payment to the person entitled to enforce the draft. Once payment is made, the drawee has no further obligation to that person. In contrast, when a draft is presented for acceptance, the person entitled to enforce the draft is not asking that the drawee pay the draft. Rather, she is asking that the drawee obligate itself to pay the draft in the future.

2. **Manner of acceptance:** An effective acceptance must be (1) in writing, (2) on the instrument, (3) signed by the drawee, and (4) either delivered to the holder or the holder must be notified. The acceptance may consist of the drawee's signature alone. Unlike the obligation of other parties to a negotiable instrument, an acceptance can become effective when the holder is notified of the acceptance even if the accepted draft has not yet been delivered to him. U.C.C. §3-409(a).

F. **Obligation of indorser:** An indorser promises that if the instrument is dishonored, he will pay the amount of the instrument according to its terms at the time of his indorsement. U.C.C. §3-415(a).

1. **What is an indorser?**"Indorser" is a catch-all category that covers anyone who signs an instrument in any capacity other than as a drawer, an acceptor, or a maker. A signature is deemed to be an indorsement regardless of the signer's intent unless the accompanying words, terms of the instrument, place of signature, or other circumstances unambiguously indicate that the signature is made for a purpose other than as an indorsement. U.C.C. §3-204(a).

2. **Two purposes of indorsement:** A person may indorse an instrument for two distinct purposes: (1) to negotiate an instrument and (2) to incur liability on the instrument. An indorsement can be

made for any one or both of these purposes. An ***anomalous indorser*** is an indorser who is not the holder of the instrument. As a result, her indorsement, not being needed to negotiate the instrument, is simply for the purpose of incurring liability.

3. **To whom obligation owed:** An indorser's obligation to pay is owed to the person who is entitled to enforce the instrument or to a subsequent indorser who pays the instrument. U.C.C. §3-415(a).

Example: Assume that a check drawn by Bob and payable to Jill is indorsed by Jill to Sally. Sally indorses the check to Grocer who indorses and deposits the check into his bank account at Crocker Bank. On presentment to Wells Bank, the check is dishonored. Because Crocker Bank is the person entitled to enforce the check, Crocker Bank may recover from any indorser, which includes Grocer, Sally, and Jill. If Sally pays Crocker Bank, Sally may recover from Jill. Jill's obligation runs to Sally because Sally is a subsequent indorser. However, Sally may not recover from Grocer because Grocer's obligation does not run to Sally; Sally is not a subsequent indorser. See Figure 3-1.

Figure 3-1

4. **Indorsement without recourse:** An indorser may disclaim liability on his indorser's contract by indorsing the instrument “without recourse.” U.C.C. §3-415(b). An indorser may want to indorse without recourse when he is intending only to transfer title to the instrument and does not wish to incur any personal liability on the instrument.

Example: If a check is made payable jointly to an attorney and her client, the attorney may want to indorse the check so that her client can cash the check. However, because the attorney has no desire to become liable to subsequent purchasers of the check, she indorses the check “Attorney, without recourse.”

Note: Despite indorsing without recourse, the indorser still faces the possibility of liability as a transferor of the check. A person who receives consideration for transferring an instrument makes certain warranties to subsequent parties.

5. **Dishonor and notice of dishonor required:** An indorser is not liable until the instrument has been dishonored and, unless excused, notice of dishonor is given. U.C.C. §3-415(a); U.C.C. §3-503. An indorser is discharged with respect to any instrument if a necessary notice of dishonor is not given. U.C.C. §3-415(c); U.C.C. §3-503(a).

Rationale: An indorser is not the primary party expected to make payment. Her contract requires payment only if the maker, drawee, or acceptor refuses to make payment. Thus, unless the instrument is dishonored by one of these parties, the indorser has no duty to pay. Because an indorser will not usually know that payment has not been made, notice of dishonor is made a condition to the indorser's liability.

6. **Discharge if presentment on check delayed:** An indorser is discharged if a check is not presented for payment or given to a depositary bank for collection within 30 days after her indorsement. U.C.C. §3-415(e).

Example: Assume that a check drawn by Bob is delivered to Jill on March 1. Jill indorses the check on March 5 and delivers it to Sally, who indorses the check on April 1 and delivers the check to Grocer. Grocer deposits the check in its account at Crocker Bank on April 27. The check is presented to Wells Bank for payment on May 3. Because the check was not deposited for collection or presented for payment within 30 days after her indorsement, Jill is discharged. However, Sally is not discharged. Although the check was not presented for payment within 30 days of her indorsement, it was deposited for collection within the 30-day period. See Figure 3-2.

Figure 3-2

Limitation: This 30-day rule applies only to checks. A delay in presenting any instrument, other than a check, does not discharge an indorser.

7. **Liable in any order:** The person entitled to enforce the instrument may commence an action to recover from any of the indorsers, no matter in what order they signed.

Example: In our example above, Crocker Bank may recover from Jill without attempting to recover from Sally or Grocer.

II. PRESENTMENT, DISHONOR, NOTICE OF DISHONOR

A. **Dishonor:** Dishonor of an instrument is a condition to the liability of a drawer and an indorser. U.C.C. §3-414(b); U.C.C. §3-415(a); U.C.C. §3-502, Official Comment 1. An instrument is ***dishonored*** when the drawee, acceptor, or maker refuse or fail to pay or accept the instrument upon a proper presentment for payment or acceptance. When presentment is excused, dishonor occurs if the instrument is not duly accepted or paid. U.C.C. §3-502(e); U.C.C. §3-502, Official Comment 7.

B. **Presentment:** Presentment is a demand for payment or acceptance made by or on behalf of the person entitled to enforce the instrument. U.C.C. §3-501(a). A mere demand for payment or acceptance is sufficient to constitute presentment. Presentment for payment must be made to the drawee or to a party obliged to pay the instrument (the maker of a note or the acceptor of an accepted draft). U.C.C. §3-501(a). Presentment for acceptance must be made to the drawee. U.C.C. §3-501(a).

1. **Manner and time of presentment:** Presentment may be made by any commercially reasonable means including oral (telephone),

written (mail), or electronic communication. U.C.C. §3-501(b)(1). Presentment is effective when the demand for payment or acceptance is received by the person to whom presentment is made. U.C.C. §3-501(b)(1). If the party to whom presentment is made has a cut-off hour for the receipt and processing of instruments and presentment is made after the cut-off hour, the party may treat the presentment as having occurred on the next business day. U.C.C. §3-501(b)(4).

Example: If presentment is made at 3 p.m. on Friday and the bank has established a 2 p.m. cut-off hour, presentment is deemed to have been made on Monday because Saturday and Sunday are not business days.

2. **Where presentment can be made:** In the absence of a Federal Reserve Regulation, clearinghouse rule, or contrary agreement, presentment can be made wherever the drawee, maker, or acceptor can be found, even if the instrument specifies a particular place of payment or acceptance. If the party expected to pay or accept cannot be found, the instrument may be presented at its place of payment. U.C.C. §3-501(b)(1).

Exception: Regulation CC determines where a check may be presented. U.C.C. §3-111.

3. **Rights of party to whom presentment is made:** Once the demand for payment or acceptance is made, the party to whom presentment is made has the right to demand, without thereby dishonoring the instrument, that the presenter do certain things. If the presenter fails within a reasonable time to comply with one of these authorized requests, the presentment is invalidated. Once all authorized demands have been satisfied, the time within which acceptance or payment must be made commences to run. The person to whom presentment is made may demand that the presenter do any of the following:

   a. **Exhibit the instrument:** This ensures that the presenter has actual possession of the instrument. U.C.C. §3-501(b)(2)(i).

   b. **Reasonable identification:** To be assured that the proper person is being paid, the person to whom presentment is made may demand reasonable identification from the presenter and, if presented on behalf of another, reasonable evidence of the agent's authority. U.C.C. §3-501(b)(2)(ii).

c. **Receipt or surrender:** To protect herself against the claim that payment was not made, a person who makes payment may demand a signed receipt on the instrument or surrender of the instrument if payment in full is made. U.C.C. §3-501(b)(2)(iii).

4. **Effect of delay in presentment:** An indorser and, under very limited circumstances, the drawer, is discharged when presentment for payment of a check is delayed beyond the required time. A delay in presenting any instrument, other than a check, discharges neither the drawer nor an indorser.

a. **Discharge of indorser:** An indorser of a check is discharged from her indorser's liability if the check is not presented for payment or given to a depositary bank for collection within 30 days after her indorsement. U.C.C. §3-415(e).

b. **Discharge of drawer:** A drawer of a check is discharged only when (a) the check is not presented for payment or given to a depositary bank for collection within 30 days from the check's stated date and (b) only to the extent that she is deprived of funds maintained with the drawee bank because the drawee bank has suspended payment after the expiration of the 30-day period and, thus, failed to make payment on the check. U.C.C. §3-414(f); U.C.C. §3-414, Official Comment 6.

Rationale: The drawer is only hurt if the drawee bank has gone insolvent (suspends payment) during the delay in presentment, thereby depriving the drawer of funds otherwise available to pay the check.

Example: Assume that a check dated July 1 was not given to a depositary bank for collection until August 15. If the payor bank went insolvent on August 8, the drawer would be entitled to a discharge. However, if the bank went insolvent on July 29, the drawer would not have been discharged. This is because, even if the check had been presented within the 30-day period (by July 30), the drawer would have still lost her funds.

5. **When presentment excused:** When a presentment or a delay in presentment is excused, presentment is treated as having been made within the prescribed time limits.

   a. **Reasonable diligence:** Presentment is excused if it cannot be made by the exercise of reasonable diligence. U.C.C. §3-504(a)(i).

      Example: The typical situation in which this excuse applies is when the presenter cannot locate the party to whom presentment must be made. When no place of payment is specified in the instrument, presentment is excused if the presenter cannot, with reasonable diligence, locate either the home or business address of the party to whom presentment is to be made.

   b. **Stop payment order:** Presentment is excused as to the drawer if the drawer has instructed the drawee not to pay or accept a draft. U.C.C. §3-504(a)(v).

      Note: Presentment is not excused as to an indorser (assuming that she did not order payment stopped).

   c. **No reason to expect payment:** Presentment is excused if the drawer or an indorser has no reason to expect or right to require that the instrument be paid or accepted. U.C.C. §3-504(a)(iv).

      Examples: An indorser has no reason to expect that an instrument will be paid when she asserts an adverse claim upon the party obliged to pay. Presentment is also excused if a drawer knows that she has insufficient funds in her account to cover the check.

   d. **When excused or waived:** When presentment is waived under the terms of the instrument or otherwise, presentment is excused as to the drawer or indorser. U.C.C. §3-504(a)(iii).

   e. **When maker or acceptor dead, insolvent, or repudiates:** Presentment is excused when the maker or acceptor repudiates the obligation to pay the instrument, is in insolvency proceedings, or has died. U.C.C. §3-504(a)(ii).

C. **Dishonor:** The manner in which an instrument is dishonored depends on the type of instrument.

1. **Dishonor of demand note:** A note payable on demand is dishonored if the note is not paid on the day of presentment. U.C.C. §3-502(a)(1).

2. **Dishonor of note not payable on demand:** A note that is not payable on demand is dishonored if it is not paid on the day it becomes payable. U.C.C. §3-502(a)(3). No presentment is required for the note to be dishonored.

   Example: A note payable on January 1, 2004 is dishonored if it is not paid on that date. The holder can commence a lawsuit against the maker on January 2, even though payment was never demanded.

3. **Dishonor of check:** A check presented to the payor bank (other than for immediate payment over the counter) may be dishonored in two ways.

   a. **Returns check:** A properly presented check is dishonored if the payor bank properly returns the check or sends notice of dishonor or nonpayment in compliance with U.C.C. §§4-301 and 4-302. U.C.C. §3-502(b)(1). U.C.C. §§4-301 and 4-302 set out the time and procedure that a payor bank must follow to make a proper dishonor of a check. Under this procedure, the payor bank must promptly return the check to the presenting bank with an indication that payment has been refused.

   b. **Fails to return check or settle:** A payor bank that fails not only to promptly return the check (or send notice of nonpayment) but also to provisionally settle for the check, and, thus, becomes accountable for the check, dishonors the check. U.C.C. §3-502(b)(1); U.C.C. §3-502, Official Comment 4.

4. **Dishonor of other demand draft:** A draft payable on demand is dishonored if presentment for payment is duly made to the drawee and the draft is not paid on the day of presentment. U.C.C. §3-502(b)(2). This applies to checks presented over the counter for immediate payment in cash. Such checks are dishonored if they are

not paid on the day of presentment. U.C.C. §3-502(b)(2); U.C.C. §3-502, Official Comment 4.

5. **Dishonor of draft not payable on demand:** A draft that is not payable on demand is dishonored in two ways.

   a. **Not paid upon presentment:** If the draft is presented for payment and it is not paid on the day it is due or the day of presentment, whichever is later, it is dishonored. U.C.C. §3-502(b)(3)(i).

      Exception: Payment or acceptance of an unaccepted documentary draft may be delayed without dishonor until no later than the close of the drawee's third business day following the day on which payment or acceptance is required under U.C.C. §3-502(b). U.C.C. §3-502(c).

      Rationale: A drawee of a documentary draft is given a longer period to determine whether to pay a draft because of the time necessary to examine the accompanying documents. The period given coincides with the one prescribed under U.C.C. §5-112 for documentary drafts drawn under a letter of credit. U.C.C. §3-502, Official Comment 5.

   b. **Presented for acceptance:** An unaccepted draft payable at a stated date or a stated period after acceptance, e.g., 45 days after sight, is dishonored if the draft is presented for acceptance and acceptance is refused. U.C.C. §3-502(b)(3)(ii), (4); U.C.C. §3-502, Official Comment 4.

      Rationale: The holder has the right to know whether the drawee will honor the draft when it becomes due. Therefore, the holder has the right to present the draft for acceptance any time before the due date. If the drawee refuses to accept the draft on the day it is presented, the holder has an immediate cause of action against the drawer on the draft. When a draft is payable a fixed number of days after acceptance (called ***after sight***), the exact date payment is due is not fixed until the draft has been accepted. A draft payable a fixed number of days after sight must therefore be presented for acceptance to determine when payment is due.

6. **Dishonor of accepted draft:** Once a draft is accepted, the holder must present the draft to the acceptor for payment.

   a. **Payable on demand:** An accepted draft payable on demand is dishonored if presentment for payment is duly made and the draft is not paid on the day of presentment. U.C.C. §3-502(d)(1); U.C.C. §3-502, Official Comment 6.

   b. **Not payable on demand:** An accepted draft not payable on demand is dishonored if presentment for payment is duly made and payment is not made on the day it becomes payable or on the day of presentment, whichever is later. U.C.C. §3-502(d)(2); U.C.C. §3-503, Official Comment 6.

   Example: An accepted draft payable on August 1 but presented for payment on July 25 is not dishonored until August 1.

D. **Notice of dishonor:** Notice of dishonor may be given by any person. Notice of dishonor may be given by any commercially reasonable means. It may be oral, electronic, or in writing. U.C.C. §3-503(b). Unless excused, a delay in giving notice of dishonor discharges an indorser on any type of instrument. U.C.C. §3-415(c).

Note: A delay in giving notice of dishonor does not discharge a drawer. U.C.C. §3-503, Official Comment 1.

1. Time within which notice of dishonor must be given:

a. **Not taken by collecting bank for collection:** When an instrument is not taken by a collecting bank for collection, notice of dishonor must be given within 30 days after the day on which the instrument is dishonored. U.C.C. §3-503(c).

Example: Assume that Paul indorses a note to Kate, who indorses the note to Dan. The note is dishonored on April 1 by the maker. On April 23, Dan gives notice of dishonor to Kate only. Kate has until May 1 to give notice of dishonor to Paul. If Kate does not give notice to Paul by May 1, Paul is discharged from liability as an indorser. U.C.C. §3-415(c).

b. **Taken by collecting bank:**

i. **Collecting bank:** When an instrument is taken by a collecting bank for collection, the collecting bank must give notice of dishonor before midnight of the next banking day following the banking day on which the bank receives notice of dishonor. U.C.C. §3-503(c).

Example: If a collecting bank receives notice of dishonor on Friday, it must give notice of dishonor by midnight on Monday, the next banking day.

ii. **Persons other than a collecting bank:** Persons other than a collecting bank must give notice of dishonor within 30 days following the day on which the person receives notice of dishonor. U.C.C. §3-503(c); U.C.C. §3-503, Official Comment 2.

2. **When delay in notice of dishonor excused:** A delay in giving notice of dishonor is excused if the delay is caused by circumstances beyond the control of the person giving the notice and if the person giving notice exercises reasonable diligence after the cause of the delay ceases to operate. U.C.C. §3-504(c).

Example: The following are examples of some of the circumstances that might excuse a delay in the giving of notice of dishonor:

- illness
- suspension of communication facilities
- war
- suspension of commercial intercourse between countries
- unforeseen absenteeism of employees or strike
- inability to locate the party to whom notice must be given. U.C.C. §4-109(b).

3. **When notice of dishonor excused:** Notice of dishonor is excused

whenever it is waived in the instrument or otherwise. U.C.C. §3-504(b)(ii). A waiver of presentment also waives notice of dishonor. U.C.C. §3-504(b).

III. TRANSFER WARRANTIES

A. **Creating transfer warranties:** A negotiable instrument is a type of personal property. A purchaser of an instrument expects the instrument to be authentic and to provide for legally enforceable obligations. When a person receives consideration for transferring an instrument, he makes certain warranties, called ***transfer warranties***, as to the authenticity and the enforceability of the instrument.

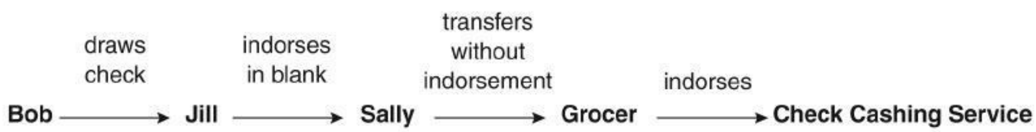
B. **Who makes the transfer warranties:** Any person who transfers an instrument for consideration makes the transfer warranties. U.C.C. §3-416(a). The warranties are made whether or not the transferor indorses the instrument and even when he indorses the instrument without recourse. Because these warranties are given only by transferors who receive consideration, neither anomalous indorsers nor transferors who have given the instrument as a gift make the transfer warranties.

C. **To whom transfer warranties are made:** Outside of the bank collection process, a transferor who does not indorse the instrument makes the transfer warranties to his transferee. If he indorses the instrument, he makes the warranties to all subsequent transferees.

Rationale: An indorser's warranties run to all subsequent transferees because these subsequent parties may have relied on his signature when purchasing the instrument.

Example: Assume that Jill receives a check from Bob and indorses it in blank. Jill then transfers the check to Sally who transfers it without indorsement to Grocer. Grocer indorses and transfers the check to Check Cashing Service. Because Sally did not indorse the check, she makes the transfer warranties only to Grocer. In the event of a breach of warranty, Check Cashing Service may sue Grocer or Jill, but not Sally. The inability of Grocer to sue Sally will probably not affect the ultimate allocation of the loss. In the first place, because Jill is liable to Sally, if Check Cashing Service recovers from Jill directly, the loss falls on the person who is ultimately liable for breach of the warranty (Jill). If Check Cashing Service sues Grocer, Grocer may recover from Sally. Because Grocer is Sally's immediate transferee, Sally makes the warranties to Grocer. Sally will then recover from Jill. See Figure 3-3.

Figure 3-3



Exception: If the instrument enters the bank collection process, any customer (whether or not indorsing the item) of a collecting bank that transfers the item and receives a settlement or other consideration makes the warranties to its transferee and to any subsequent collecting bank. U.C.C. §4-207(a).

Example: Assume that Check Cashing Service deposits the check in its account in Crocker Bank and Crocker Bank transfers the check to Interstate Bank for presentment to Wells Bank. Even if Check Cashing Service does not indorse the check, it makes the transfer warranties to both Crocker Bank and Interstate Bank.

D. Content of transfer warranties: A transferor makes five warranties:

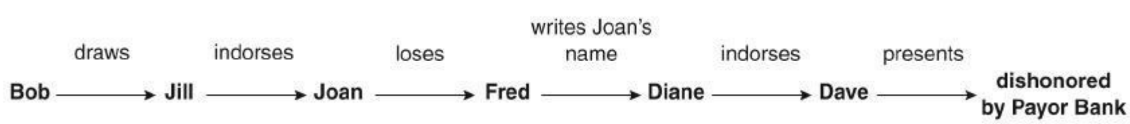
- that the transferor is a person entitled to enforce the instrument;
- that all signatures are authentic and authorized;
- that the instrument has not been altered;
- that the transferor is not subject to any defense or claim in recoupment; and
- that the transferor has no knowledge of insolvency proceedings instituted with respect to the maker, acceptor, or drawer of an unaccepted item.

1. **Warranty that transferor is a person entitled to enforce the instrument:** A transferor warrants that she is a person entitled to

enforce the instrument. U.C.C. §4-207(a)(1); U.C.C. §3-416(a)(1). This is basically a warranty that there are no unauthorized or missing indorsements that prevent the transferee from becoming a person entitled to enforce the instrument. U.C.C. §3-416, Official Comment 2.

Example: Bob draws a check payable to Jill, who indorses and transfers the check to Joan. Joan loses the check. Fred finds the check and forges an indorsement in Joan's name to Diane. Diane indorses the check to Dave. On presentment, the check is dishonored. Dave sues Diane, Fred, Joan, and Jill. Jill does not breach her warranty because she was a person entitled to enforce the instrument when she transferred the instrument. Because Joan did not voluntarily deliver the check to Fred, Joan did not transfer the check and therefore does not make the transfer warranties. Because Joan's indorsement is forged, Fred is not a person entitled to enforce the instrument. He therefore breaches his transfer warranty. Fred makes this warranty to Diane and to Dave. Under U.C.C. §3-403(a), Fred's unauthorized signing of Joan's name is effective as Fred's own signature. Even though Diane was unaware that the indorsement was forged, she nonetheless breaches this warranty because she is not a person entitled to enforce the instrument. See Figure 3-4.

Figure 3-4



2. **Warranty that all signatures are authentic and authorized:** A transferor warrants that all signatures are authentic and authorized. U.C.C. §4-207(a)(2); U.C.C. §3-416(a)(2). A forged or unauthorized signature of a drawer, a maker, an indorser, or an acceptor breaches this warranty.

3. **Warranty of no alteration:** A transferor warrants that the instrument has not been altered. U.C.C. §3-416(a)(3); U.C.C. §4-

207(a)(3). Alteration includes the unauthorized addition of words or numbers to an incomplete instrument.

4. **Warranty that transferor not subject to any defense or claim in recoupment:** A transferor warrants that the instrument is free from any defense or claim in recoupment of any party that can be asserted against the warrantor. U.C.C. §3-416(a)(4); U.C.C. §4-207(a)(4); U.C.C. §3-416, Official Comment 3. In essence, the transferor warrants that if she were to sue any party on the instrument, none of these parties would have a defense or claim in recoupment that could be asserted against her. A transferor who is a holder in due course breaches this warranty only to the extent that she would be subject to a defense or claim in recoupment. The transferor breaches this warranty even if her transferee is a holder in due course who takes the instrument free from the particular defense or claim in recoupment. U.C.C. §3-416, Official Comment 3.

Example: Assume that Bob draws a check payable to Jill for the purchase of a car. Because the car has a defective transmission, Bob has a claim in recoupment against Jill. Jill has no notice of the defect in the transmission and therefore is a holder in due course. Jill negotiates the check to Sally, who takes the check as a holder in due course. Sally sues Jill for breach of the warranty that no defenses or claims in the check recoupment are good against Jill. Even though Jill is a holder in due course, because she dealt with Bob, she is subject to his claim in recoupment and, therefore, breaches this warranty. Furthermore, Jill breaches the warranty even though Sally, being a holder in due course, does not take subject to Bob's claim. If Sally negotiates the check to Wells Bank, she is not liable for breach of the warranty she made to Wells Bank because Bob's claim in recoupment is not good against her.

5. **Warranty of no knowledge of insolvency proceedings:** A transferor warrants that it has no knowledge of insolvency proceedings with respect to the maker, acceptor, or drawer of an unaccepted item U.C.C. §3-416(a)(5); U.C.C. §4-207(a)(5); U.C.C. §3-416, Official Comment 4. No warranty is made as to the transferor's lack of knowledge of any insolvency proceedings

instituted against an indorser.

Rationale: A transferor who knows that insolvency proceedings have been instituted against the drawer, maker, or acceptor commits a fraud by not informing her transferee of this fact because the transferee more than likely expects to recover from one of these parties. U.C.C. §3-416, Official Comment 4. In contrast, it is unlikely that the transferee expects to recover from prior indorsers.

6. **2002 amendments:** The 2002 official amendments to Articles 3 and 4 have added a new transfer warranty with respect to a remotely created consumer item. As to such items, the transferor warrants that the person on whose account the item is drawn has authorized the issuance of the item in the amount for which the item is drawn. [Rev] U.C.C. §3-416(a)(6) and [Rev] U.C.C. §4-207(a)(6). A remotely created consumer item is an item payable out of a consumer's account that is created by the merchant or telemarketer with the consumer's signature not appearing of the item. [Rev] U.C.C. §3-103(a)(16).

IV. SURETIES AND ACCOMMODATION PARTIES

A. **Introduction:** A surety is, in general terms, a person who guarantees the debt of another. If Son wants to purchase a car from Car Dealer, Car Dealer may require that Dad sign an agreement guaranteeing to repay the loan if Son fails to do so. Dad is a surety. Article 3 has its own rules regarding suretyship. Under Article 3, a surety is called an ***accommodation party***. The debtor (the son) is called the ***accommodated party***.

B. **What is an accommodation party?** If an instrument is issued for value given for the benefit of a party to the instrument (accommodated party) and another party to the instrument (accommodation party) signs the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument, the instrument is signed by the accommodation party ***for accommodation***. U.C.C. §3-419(a).

1. **Both surety and debtor must sign instrument:** A person is an

accommodation party only when both the surety and the debtor sign the same instrument. U.C.C. §3-419(a).

Example: If both Dad and Son sign the same promissory note, Dad is the accommodation party and Son is the accommodated party.

2. **When both do not sign same instrument:** If the surety does not sign the same instrument as the debtor, he is not an accommodation party. He is still a surety but his rights as a surety are governed by the general law of suretyship. Under the general law of suretyship, Dad will be entitled to most of the same rights to which an accommodation party is entitled under Article 3.

Example: If Dad signs a *separate* guaranty agreement or a separate note from the one signed by Son, Dad is not an accommodation party.

3. **Collection guaranteed:** When ***collection guaranteed*** or equivalent words are added to a signature and they unambiguously indicate an intention to guarantee collection only, the signer undertakes only a guaranty of collection. U.C.C. §3-419(d). A guarantor of collection is obliged to pay the amount due only if the holder cannot collect from the accommodated party. The holder must show that either execution of judgment against the accommodated party was returned unsatisfied or that it would be futile to attempt to recover from the accommodated party. U.C.C. §3-419(d); U.C.C. §3-419, Comment 4.

2002 amendments: Under [Rev] U.C.C. §3-419(d), a party who adds words like "collection guaranteed" to its signature is obligated to make payment only when the holder is unable to recover from the other party to the instrument. [Rev] U.C.C. §3-419(e) is simply intended to make it clear that unless the person clearly indicates that he or she is guaranteeing collection, rather than payment, that the creditor may directly proceed against the guarantor without first proceeding against the accommodated party.

4. **Accommodation party cannot receive direct benefit from instrument:** The test to determine that a person is an accommodation party is whether he has received a direct benefit

from the value given for the instrument. Only if he is not a direct beneficiary of the value given for the instrument can he be an accommodation party. U.C.C. §3-419, Official Comment 1.

Example: Because the car went to Son and not Dad, Dad did not receive a direct benefit from the value given for the note. In contrast, if the car was to be used by both Dad and Son, Dad would be a direct beneficiary of the proceeds paid for the instrument and, therefore, would not be an accommodation party.

Note: Receiving an indirect benefit from the value given for the instrument will not deny that person accommodation party status. U.C.C. §3-419, Official Comment 1.

Example: Even if Dad benefited indirectly because he no longer had to drive Son to school, Dad would still be an accommodation party.

5. **Accommodation party liable in capacity in which she signs:** An accommodation party is liable in whatever capacity she has signed, i.e., indorser, maker, acceptor, or drawer. U.C.C. §3-419(b); U.C.C. §3-419, Official Comment 1.

   Example: An accommodation party who signs as an indorser undertakes the indorser's contract under which the accommodation party's promise to pay is conditioned on dishonor and notice of dishonor. U.C.C. §3-415. The liability of an accommodation party who signs as a maker or an acceptor is not conditioned on dishonor or notice of dishonor.

6. **2002 amendments:** New definitions of “principal obligor” and “secondary obligor” have been added.

   a. **Principal obligor:*****A principal obligor*** is the accommodated party or any other party to the instrument against whom a secondary obligor has recourse under [Rev] Article 3. [Rev] U.C.C. §3-103(a)(11).

      Example: Mary makes a note payable to Joe. Joe indorses the note to Sally. Mary is a principal obligor because Joe has a right of recourse against her.

b. **Secondary obligor: A *secondary obligor*** is any of the following:

i. **Indorser:** An indorser is a secondary obligor because it has a right to recover from the maker, drawer, or prior indorser.

ii. **Accommodation party:** An accommodation party is a secondary obligor because it may recover from the accommodated party.

iii. **Drawer of an accepted draft:** Where a draft is accepted by a person (other than a bank), the drawer is treated as an indorser with the acceptor having the primary responsibility to pay the draft. As a result, the drawer is in the position of an indorser. [Rev] U.C.C. §3-414(d). Where the draft is accepted by a bank, the drawer is discharged. [Rev] U.C.C. §3-414(c).

iv. **Right to contribution:** Any other party to the instrument that has a right of recourse against another party to the instrument pursuant to [Rev] U.C.C. §3-116(b) is a secondary obligor to the extent of such a right. Under the latter section, a party having joint and several liability who pays the instrument is entitled to receive from any party having the same joint and several liability contribution in accordance with applicable law. [Rev] U.C.C. §3-103(a)(17). Because of the right of a party having joint and several liability who pays an instrument to receive contribution from his co-obligors, such a co-obligor is, in part, a secondary obligor and, also in part, a principal obligor. [Rev] U.C.C. §3-116, Revised Official Comment 1.

Example: John and Mary are co-makers of a note payable to Phil in the amount of $1,000. Upon Phil's demand, Mary pays the entire amount of the note. Mary, subject to an agreement to the contrary, has the right to recover $500 from John.

C. **Relationship between accommodation and accommodated parties:** An accommodation party is not liable on the instrument to the party accommodated, nor is he liable for contribution to the accommodated party in the event of payment by the accommodated party. U.C.C. §3-419(e). [[Rev] U.C.C. §3-419(f).]

Rationale: The accommodated party is the person who is benefiting from the accommodation party undertaking liability on the instrument and, therefore, should ultimately be the one to pay the instrument.

1. **Right of reimbursement:** On payment, the accommodation party has a right to be reimbursed by the accommodated party. This promise is implied in the relationship whether or not the accommodated party makes an express promise to that effect.

   Example: If Dad pays the car dealer $100 of the $2,000 loan balance, Dad can recover the $100 from Son.

2. **Right of subrogation:** The accommodation party, on full payment of the instrument, is entitled to enforce the instrument against the party accommodated. The accommodation party obtains all the rights of the party he paid both on the instrument and as to any collateral. U.C.C. §3-a419(e) [[Rev] U.C.C. §3-419(f)]; U.C.C. §3-419, Official Comment 5. In other words, on payment of the instrument, the accommodation party takes the place of the holder as regards the accommodated party.

   Example: On full payment of the loan, Dad, as the accommodation party, obtains the car dealer's rights as holder of the note. If the car dealer retained a security interest in the car to secure the note, Dad now has the security interest and becomes the secured party.

3. **2002 amendments:** Under the 2002 amendments, the accommodation party may, in proper circumstances, go to court to have the accommodated party specifically perform its obligation to pay the instrument. [Rev] U.C.C. §3-419(e) [now subsection “(f)” under the 2002 amendments].

D. Relationship between accommodation parties: In the absence of an agreement to the contrary, two parties who sign in the same capacity in accommodation for another party are co-sureties. As co-sureties, they are jointly and severally liable.

Example: Assume that both Dad and Uncle sign as accommodation makers for Son. Because neither Dad nor Uncle received a direct benefit, both are accommodation parties. In addition, both are presumed to be co-sureties and, as such, are jointly and severally liable. U.C.C. §3-116(a).

1. **Right of contribution:** A co-surety who pays more than his proportional share of the obligation has the right of contribution from the other co-surety. U.C.C. §3-116(b).

   Example: If Dad makes full payment, Dad can obtain half the amount he paid from Uncle.

2. **Subsuretyship:** An accommodation party may attempt to prove that he was not only the accommodation party for the original debtor but also for the other accommodation party. To do so, he must prove an express or implied understanding to that effect. This is called a ***subsuretyship relationship***.

   Example: Dad and Uncle may have an express (or implied) understanding that because Son is Dad's child, Dad, and not Uncle, will be ultimately liable in the event that Son does not pay. In this event, Uncle is an accommodation party for both Dad and Son. If Uncle makes payment, Uncle may recover fully from Dad. U.C.C. §3-116(b). If Dad makes payment, even though he may recover from Son, he may not recover from Uncle. U.C.C. §3-419(e). Although both Dad and Uncle are sureties for Son, Uncle is a subsurety for Dad.

E. Defenses available to accommodation party

1. **May not raise lack of consideration:** The obligation of an accommodation party may be enforced whether or not the accommodation party himself received any consideration. U.C.C. §3-419(b); U.C.C. §3-419, Official Comment 2. As long as the instrument was issued for value for the benefit of the accommodated party, the accommodation party may not raise the defense of lack of consideration even though he has, in fact, received no benefit in any form.

Rationale: Because an accommodation party incurs liability so that the accommodated party can receive the benefit, the accommodation party is deemed, for practically all purposes, to have bargained for whatever consideration is received by the accommodated party.

Example: Because Son received the car from Car Dealer in exchange for the note that he issued, Dad may not raise lack of consideration as a defense. U.C.C. §3-303; U.C.C. §3-419.

2. **Right of accommodation party to raise accommodated party's defenses:** With a few exceptions, the accommodation party may raise any of the accommodated party's defenses or claims in recoupment. U.C.C. §3-305(d).

Example: If the car is not delivered, Son has the defense of failure of consideration. If the car has defective brakes, Son has a claim in recoupment for breach of warranty. Dad may raise both the defense and the claim in recoupment.

Exception: The accommodation party may not raise, as a defense to his own obligation to pay, the accommodated party's discharge in insolvency proceedings, infancy, or lack of legal capacity. U.C.C. §3-305(d).

Rationale: These are the precise risks that the creditor was attempting to avoid by obtaining the signature of the accommodation party.

Example: Dad cannot raise Son's defense of infancy. If he could, Car Dealer never would have sold Son the car.

F. **Discharge of indorsers and accommodation parties (suretyship defenses):** Both an accommodation party and an indorser who pay an instrument step into the shoes of the person who was paid and acquire that person's rights through the doctrine of ***subrogation***. These rights include any rights that person had on the instrument and to any collateral acquired from the primary obligor. Because indorsers and accommodation parties step into his shoes, they are hurt if the person entitled to enforce the instrument does anything to impair their right to recover against any prior parties.

1. **Suretyship defenses:** To the extent an indorser or accommodation party is injured by any unjustifiable action of the person entitled to enforce the instrument, the injured indorser or accommodation party may be discharged under U.C.C. §3-605. The various rules found in U.C.C. §3-605, by which an indorser or accommodation party may be discharged, are commonly referred to as ***suretyship defenses.***

2. **Limited to accommodation parties and indorsers:** The right to a discharge under U.C.C. §3-605 is limited to accommodation parties and indorsers. U.C.C. §3-605(a). Other parties in the position of a surety and persons who sign separate guaranty agreements or other instruments that are not negotiable are not covered by U.C.C. §3-605.

   a. **Note:** An accommodation party is only discharged if the person entitled to enforce the instrument either (1) has actual knowledge of the accommodation or (2) has notice of the accommodation (a) from an indication on the instrument that the party has signed as "guarantor," "surety," or "accommodation party," or (b) from the fact that the signature is an anomalous indorsement that is presumed to be made in the capacity of an accommodation party. U.C.C. §3-419(c); U.C.C. §3-605(h).

   b. **2002 amendments:** The 2002 amendments to U.C.C. §3-605 have significantly changed the rules, as well as the terminology, for determining the effect upon secondary obligors of an impairment of collateral, a release of the primary obligor, an extension granted to the primary obligor and a modification of the obligations of the primary obligor.

      i. **Party to instrument:**[Rev] U.C.C. §3-605 only applies where the secondary obligor is a party to an instrument. Where the secondary obligor is not a party to the instrument, general suretyship law applies. [Rev] U.C.C. §3-605, Official Comment 1.

         (a) **Terminology:** Unlike original U.C.C. §3-605, which discusses these issues in terms of the effect that a discharge of a party under U.C.C. §3-604 has upon the liability of an indorser or accommodation party having a right of recourse against the discharged party, [Rev] U.C.C. §3-605(a) speaks in terms of the effect that a ***release*** of the "principal obligor" has on the liability of a "secondary obligor." A ***principal obligor*** is the accommodated party or any other party to the instrument against whom a secondary obligor has recourse under Article 3. [Rev] U.C.C. §3-103(a)(11). A ***secondary obligor*** is either: (a) an indorser or an accommodation party; (b) a drawer on a draft that is accepted by a person other than a bank [Rev] U.C.C. §3-414(d); or (c) any other party to the instrument that has recourse against another party to the instrument pursuant to [Rev] U.C.C. §3-116(b). A party having joint and several liability who pays the instrument is entitled to receive from any party having the same joint and several liability contribution in accordance with applicable law. [Rev] U.C.C. §3-116(b).

(b) Secondary obligors: [Rev] U.C.C. §3-605 applies to the following five secondary obligors:

1. An accommodation party;
2. An indorser of a note who is not an accommodation party;
3. A drawer of a draft that is accepted by a party that is not a bank;
4. An indorser of a check; and
5. A co-maker of an instrument, whether or not an accommodation party. [Rev] U.C.C. §3-103(a)(17).

Note: A co-maker's right of contribution under [Rev] U.C.C. §3-116(b) makes a co-maker a secondary obligor to the extent of its right of contribution. [Rev] U.C.C. §3-605, Official Comment 3.

3. Release of principal obligor: Release of the principal obligor (technically called ***discharge by cancellation or renunciation***) does not discharge the accommodation party or indorser under U.C.C. §3-605(b). Notwithstanding release of the principal debtor, the surety retains both her right of recourse on the instrument and her right of reimbursement against the principal debtor. U.C.C. §3-419(e); U.C.C. §3-605, Official Comment 3.

Example: Cindy, the person entitled to enforce the note, releases Alice, the maker of the note. Release of Alice does not release Betty, the accommodation party. After Betty pays Cindy, Betty may proceed against Alice.

a. **2002 amendments:** The 2002 amendments have complicated the rules as to the effect that a release of the principal obligor has on the liability of a secondary obligor.

   i. **Liability of principal obligor to secondary obligor as to previous payments:** Notwithstanding release of the principal obligor by the person entitled to enforce an instrument, the obligations of the principal obligor to the secondary obligor with respect to any previous payment made by the secondary obligor are not affected. [Rev] U.C.C. §3-605(a)(1). As a result, despite the release, the secondary obligor may recover from the principal obligor for any payments already made by the secondary obligor. [Rev] U.C.C. §3-605, Official Comment 4.

   ii. **Liability of principal obligor to secondary obligor as to other obligations:** Subject to the exception discussed below, the principal obligor is also discharged, to the extent of the release, from any unperformed obligations owed to the secondary obligor. [Rev] U.C.C. §3-605(a)(1). This includes not only the principal obligor's liability as an obligor on the instrument (e.g., as a maker, drawer, or indorser) but also any obligations under U.C.C. §§3-116 and 3-419. [Rev] U.C.C. §3-605, Official Comment 4.

   Rationale: Because the secondary obligor no longer faces liability on the instrument, the principal obligor can, likewise, have no liability to the secondary obligor. The secondary obligor's voluntary decision to pay the instrument, when not legally obligated to, should not impose an obligation on the principal obligor to reimburse him. [Rev] U.C.C. §3-605, Official Comment 4.

Exception: Where the terms of the release reserve the person entitled to enforce the instrument's recourse against the secondary obligor as well as the secondary obligor's recourse against the principal obligor, the principal obligor's obligation to the secondary obligor is not discharged. [Rev] U.C.C. §3-605(g).

Rationale: Where the person entitled to enforce the instrument's recourse against the secondary obligor is preserved, it would be unfair if the secondary obligor did not retain its rights against the principal obligor despite the principal obligor's release by the person entitled to enforce the instrument.

iii. Liability of secondary obligor as to unperformed obligations: Where a person entitled to enforce the instrument releases the obligation of the principal obligor in whole or in part, unless the terms of the release provide that the person entitled to enforce the instrument retains the right to enforce the instrument against the secondary obligor, the secondary obligor is discharged to the same extent as the principal obligor from any unperformed portion of its obligation on the instrument. [Rev] U.C.C. §3-605(a)(2) and Official Comment 4.

(a) Exception as to consideration given: Even where the secondary obligor is not discharged under this section, the secondary obligor is discharged to the extent of the value of the consideration given for the release. [Rev] U.C.C. §3-605(a)(3) and Official Comment 4.

(b) Exception for harm caused to secondary obligor: The secondary obligor is also discharged to the extent that the release would otherwise cause the secondary obligor a loss. [Rev] U.C.C. §3-605(a)(3) and Official Comment 4. The secondary obligor may be hurt by the release in that there is no longer the possibility that the primary obligor would make further payments that would reduce the remaining obligation of the secondary obligor. [Rev] U.C.C. §3-605, Official Comment 4.

(c) **Effect of consent:** The secondary obligor is not discharged where it has consented to the release or is deemed to have consented to it under [Rev] U.C.C. §3-605(f). [Rev] U.C.C. §3-605, Official Comment 4.

(d) **Effect of failure to reserve recourse:** Unless the release reserves the secondary obligor's recourse against the principal obligor, the release eliminates the secondary obligor's claims against the principal obligor with respect to any future payment by the secondary obligor. [Rev] U.C.C. §3-605, Official Comment 4.

Rationale: Permitting releases to be negotiated between the principal obligor and the person entitled to enforce the instrument without regard to the consequences to the secondary obligor would create an undue risk of opportunistic behavior by the obligee and principal obligor. [Rev] U.C.C. §3-605, Official Comment 4.

Exception for checks: Where a person entitled to enforce an instrument releases the obligation of a principal obligor on a check, in whole or in part, the secondary obligor whose liability is based on its indorsement of the check is discharged without regard to the language or circumstances of the discharge or release. [Rev] U.C.C.§3-605(a)(2). The person entitled to enforce the instrument can avoid discharge of the indorser by contracting with the indorser for a different result at the time that she grants the release to the principal obligor. [Rev] U.C.C. §3-605, Official Comment 4.

4. **Extensions and modifications:** An accommodation party or indorser having a right of recourse against a principal obligor may be entitled to a discharge in the event that the person entitled to enforce the instrument modifies the obligation of, or grants an extension to, the principal debtor. U.C.C. §3-605(c), (d).

5. **Extensions—extent of discharge:** An extension granted to the principal debtor only discharges the secondary obligor to the extent that the extension causes the surety a loss with respect to her right of recourse against the principal obligor. U.C.C. §3-605(c); U.C.C. §3-605, Official Comment 4.

   a. **Form of agreement:** The extension must take the form of an agreement, whether or not binding, under which the person entitled to enforce the instrument gives more time to the principal debtor to pay the instrument. The mere failure to enforce the instrument when due, or to foreclose on the collateral, does not constitute an extension.

      Example: If the person entitled to enforce the instrument, whether intentionally or by neglect, fails for 2 years to attempt to collect from the principal debtor, the person entitled to enforce the instrument's failure is not an extension and does not discharge the accommodation party even if the principal debtor does not go insolvent until long after the due date. In contrast, the accommodation party will be discharged if the person entitled to enforce the instrument agrees that the principal debtor may delay payment for a week, and the delay causes a loss.

   b. **Proof of loss:** The burden is placed on the accommodation party or indorser to prove that she suffered a loss by virtue of the extension. U.C.C. §3-605, Official Comment 4.

      Example: Cindy agrees to extend the due date from January 1 to February 1. On January 16, Alice leaves the country with enough cash to pay the note. Betty is entitled to a discharge to the extent that she could prove that, had she paid the note on January 1, she could have recovered the money from Alice.

   c. **2002 amendments**

      i. **Effect of extension on secondary obligor:** Where a person entitled to enforce an instrument grants the principal obligor an extension of time, the secondary obligor is discharged to the extent that the extension would otherwise cause the secondary obligor a loss. [Rev] U.C.C. §3-605(b)(2) and

Official Comment 5.

Example: Principal obligor becomes insolvent during the period of the extension. Had the extension not been granted, principal obligor would have been able to pay $1,000 of the $5,000 note. Assuming that secondary obligor can prove this, secondary obligor would be discharged to the extent of $1,000. [Rev] U.C.C. §3-605, Official Comment 5.

Exception: An extension of time has no effect on the obligations of the principal obligor to the secondary obligor with respect to any previous payment made by the secondary obligor. [Rev] U.C.C. §3-605(b)(1). The rationale for this exception is that the secondary obligor, upon payment, has an independent right to recover the amount paid from the principal obligor.

ii. Effect on principal obligor's duty to secondary party: Unless the terms of the extension preserve the secondary obligor's recourse against the principal obligor, any extension granted to the principal obligor extends the time for performance of any other duties owed to the secondary obligor by the principal obligor under Article 3. [Rev] U.C.C. §3-605(b)(1). As a result, if the secondary obligor pays the person entitled to enforce the instrument, the secondary obligor may not recover from the principal obligor during the time in which the time for payment was extended.

iii. Secondary party's options: When the time for payment by the principal obligor has been extended by the person entitled to enforce payment, the secondary obligor has the following options:

(a) Perform as if no extension: Assuming that the secondary obligor is not discharged under [Rev] U.C.C. §3-605(b)(2), the secondary obligor may perform its obligations on the instrument as if the time for payment had not been extended. [Rev] U.C.C. §3-605(b)(3).

(b) Treat time for performance as extended: Unless the terms of the extension provide that the person entitled to enforce the instrument retains the right to enforce the instrument against the secondary obligor as if the time for payment had not been extended, the secondary obligor may treat the time for performance of its obligations as having been extended to the same extent as that of the primary obligor. [Rev] U.C.C. §3-605(b)(3).

(c) Reservation of rights: Where the terms of the extension provide that the person entitled to enforce the instrument retains its right to enforce the instrument against the secondary obligor on the original due date, the secondary obligor has the obligation to pay on the original due date. As a result, the secondary obligor may not delay payment until the extended due date. [Rev] U.C.C. §3-605, Official Comment 5. However, unless the extension agreement affects a reservation of the secondary obligor's right of recourse, the secondary obligor has no right to recover from the principal obligor until the extended due date. Because of this loss of its right to immediate recourse, the secondary obligor is discharged to the extent that this delay causes a loss to the secondary obligor. [Rev] U.C.C. §3-605(b)(2) and Official Comment 5.

(d) Secondary obligor's option: Where the secondary obligor has the right, but not the duty, to pay the instrument on the original due date, the secondary obligor may assert its rights to discharge under [Rev] U.C.C. §3-605(b)(2) even if it does not exercise that option to pay on the original due date. [Rev] U.C.C. §3-605, Official Comment 5. In determining its loss, the fact that the secondary obligor did not exercise its option to pay on the original due date, and then recover from the principal obligor, may affect its loss resulting from the extension. [Rev] U.C.C. §3-605, Official Comment 5.

Example: Holder grants extension to Maker by which the due date of the note is extended from January 15 or May 15. On February 15, Maker is solvent. Indorser has reason to know that Maker may not be solvent on May 15. Indorser's failure to make payment on January 15 and then demand reimbursement from Maker may diminish Indorser's right to a discharge. If Holder can prove that Maker would have paid Indorser some of the money had Indorser demanded payment on the original due date, Indorser's right to a discharge would be diminished to the extent that its failure to make payment and pursue Maker would have mitigated its loss. This is especially true if the secondary obligor has been given prompt notice of the extension and there is a preservation of rights so that the secondary obligor could have recovered from the principal obligor had it so done. [Rev] U.C.C. §3-605, Official Comment 5.

iv. **Reservation of rights:** A release or extension preserves a secondary obligor's recourse against the principal obligor if the terms of the release or extension provide both that: (1) the person entitled to enforce the instrument retains the right to enforce the instrument against the secondary obligor; and (2) recourse of the secondary obligor continues as though the release or extension had not been granted. [Rev] U.C.C. §3-605(g) and Official Comment 10.

(a) **Manner of reservation:** No particular language is necessary to preserve the secondary parties' recourse against the principal obligor. [Rev] U.C.C. §3-605, Official Comment 4. However, the reservation must be contained in the terms of the release. Parol evidence is not admissible to prove that the parties intended that the secondary obligor remain liable. [Rev] U.C.C. §3-605, Official Comment 4.

Example: Statements such as the parties "intend to release the principal obligor but not the secondary obligor" or that the person entitled to enforce the instrument "reserves its rights" against the secondary obligor are sufficient. [Rev] U.C.C. §3-605, Official Comment 4.

6. **Modifications—extent of discharge:** When the person entitled to enforce the instrument agrees to materially modify the obligation of the principal debtor, with or without consideration, an accommodation party or indorser is discharged to the extent that the modification causes a loss with respect to her right of recourse against the principal debtor. U.C.C. §3-605(d); U.C.C. §3-605, Official Comment 5.

   a. **Burden of proof:** The loss suffered by the accommodation party or indorser is presumed to be equal to the amount of her right of recourse. As a result, unless the person entitled to enforce the instrument can prove that the loss is a lesser amount, the accommodation party or indorser is completely discharged. U.C.C. §3-605(d); U.C.C. §3-605, Official Comment 5.

      Rationale: Modifications are treated differently than extensions because they are less common than extensions and are more likely to be detrimental to the accommodation party or indorser. U.C.C. §3-605, Official Comment 5.

      Example: Assume that the principal sum of the note is increased from $100,000 to $125,000. The accommodation party has the benefit of the presumption that the increase in principal caused her a loss in the entire amount of $100,000 (the amount for which she would otherwise be liable). In other words, it is presumed that had the note not been modified, the accommodated party would have been able to pay the entire $100,000. However, the person entitled to enforce the instrument may introduce evidence that, for example, the accommodated party's inability to pay was caused by a total collapse of her business and that the collapse would have occurred no matter what the amount of the principal was. In this case, the person entitled to enforce the instrument has rebutted the presumption that the modification caused the loss, thus denying the accommodation party a discharge.

   b. **2002 amendments**

      i. **Discharge of secondary obligor:** If a person entitled to enforce an instrument agrees, with or without consideration, to a modification of the obligation of a principal obligor, the secondary obligor is discharged from any unperformed portion of its obligation to the extent that the modification would otherwise cause the secondary obligor a loss. [Rev] U.C.C. §3-605(c)(2).

ii. **Effect of modification on unperformed obligations:** The modification modifies any other duties owed to the secondary obligor by the principal obligor under Revised Article 3 to the same extent that the modification modifies the obligations of the principal obligor to the person entitled to enforce the instrument. [Rev] U.C.C. §3-605(c)(1) and Official Comment 6.

iii. **Consideration irrelevant:** Whether the modification was with or without consideration is irrelevant. [Rev] U.C.C. §3-605(c)(1).

iv. **No effect on prior payments:** Obligations of the principal obligor to the secondary obligor with respect to any previous payment by the secondary obligor are not affected by the modification. [Rev] U.C.C. §3-605(c)(1).

v. **Secondary party's options where not discharged:** To the extent that the secondary obligor is not discharged from performance under [Rev] U.C.C. §3-605(c)(2), the secondary obligor may satisfy its obligation on the instrument as if the modification had not occurred, or may treat its obligation on the instrument as having been correspondingly modified. [Rev] U.C.C. §3-605(c)(3) and Official Comment 6.

c. **2002 amendments as to burden of proof:** With one exception, a secondary obligor asserting discharge has the burden of proof both with respect to the occurrence of the acts alleged to harm the secondary obligor and the loss or prejudice caused by those acts. [Rev] U.C.C. §3-605(h).

Exception: If the secondary obligor demonstrates prejudice caused by an impairment of its recourse, and the circumstances of the case indicate that the amount of loss is not reasonably susceptible of calculation or requires proof of facts that are not ascertainable, it is presumed that the act impairing the recourse caused a loss or impairment equal to the full liability of the secondary obligor on the instrument. [Rev] U.C.C. §3-605(i). In that event, the burden of proof as to any lesser amount of the loss shifts to the person entitled to enforce the instrument. [Rev] U.C.C. §3-605(i).

d. **Burden of proof where both modification and extension:** Because of the presumption of total loss in the case of a modification, if an agreement both materially modifies the obligation of the principal debtor and also grants an extension to her, the accommodation party or indorser will be completely discharged unless the person entitled to enforce the instrument can prove that the loss was in a lesser amount. U.C.C. §3-605, Official Comment 5.

7. **Consent and waiver:** Any party who consents to a modification or to an extension is not discharged. U.C.C. §3-605(i); U.C.C. §3-605, Official Comment 8.

a. **2002 amendments:** A secondary obligor is not discharged under [Rev] U.C.C. §3-605 if the secondary obligor either consents to the event or conduct or the instrument or a separate agreement of the party provides for a waiver of discharge. The waiver may, but does not have to, specifically mention [Rev] U.C.C. §3-605. [Rev] U.C.C. §3-605(f). To the extent that the circumstances indicate otherwise, consent by the principal obligor to an act that would lead to a discharge under [Rev] U.C.C. §3-605 constitutes consent to that act by the secondary obligor if the secondary obligor controls the principal obligor or deals with the person entitled to enforce the instrument on behalf of the principal obligor. [Rev] U.C.C. §3-605(f).

8. **Impairment of collateral:** If the person entitled to enforce the instrument has impaired the collateral that the debtor gave to secure repayment of the instrument, a person having a right of recourse against the debtor may be discharged by the impairment. Separate

rules apply to indorsers and accommodation parties, on the one hand, and to co-obligors on the other hand.

a. **Discharge of accommodation parties and indorsers:** If the obligation to pay an instrument is secured by an interest in collateral and the person entitled to enforce the instrument impairs the value of the collateral, the obligation of an indorser or an accommodation party having a right of recourse against the obligor is discharged to the extent of the impairment. U.C.C. §3-605(e); U.C.C. §3-605, Official Comment 6.

Example: If Betty acts as an accommodation party for Alice and is called on to pay Cindy, Betty acquires Cindy's rights on the instrument and to any collateral Alice may have given to secure the loan. Betty can, therefore, obtain repayment of the money she paid Cindy by selling the collateral Alice gave to secure the loan. Betty will suffer a loss only if the collateral is insufficient to repay the debt and Alice is unable to pay the deficiency. If Cindy causes harm to Betty's recourse against Alice or to the collateral, Betty is injured to the extent of the harm.

Note: An accommodation party is discharged under U.C.C. §3-605(e) only if the person entitled to enforce the instrument knows of the accommodation or has notice of the accommodation under U.C.C. §3-419(c). U.C.C. §3-605(h).

Rationale: Without notice of the party's accommodation status, the creditor may have no reason to suspect that her actions will harm the accommodation party.

2002 amendments: A secondary obligor is not discharged under [Rev] U.C.C. §3-605(a)-(d) unless the person entitled to enforce the instrument knows that the person is a secondary obligor or has notice under [Rev] U.C.C. §3-419(c) that the instrument was signed for accommodation. [Rev] U.C.C. §3-605(e).

Rationale: A secondary obligor can, if it desires, always make its status clear to third parties. Unless the person entitled to enforce the instrument knows that he or she is hurting the right of recourse of the secondary obligor, he or she should not be punished for actions that will usually only benefit the primary obligor.

Example: Because Allen knows that his credit is suspect, Allen asks his friend Larry to act as the "borrower" in obtaining a loan from Bank. Larry makes a note to Bank evidencing a loan of $5,000. Allen signs the note as an anomalous indorser. When it is due, Bank accepts Allen's offer to pay Bank $1,000 in exchange for his release. Larry is not released by Bank's release of Allen because Bank had no way of knowing that it was hurting Larry by releasing Allen.

b. Discharge of co-obligors: If a person entitled to enforce the instrument impairs the value of an interest in the collateral, the obligation of any party who is jointly and severally liable with respect to the secured obligation is discharged to the extent that the impairment causes the party asserting the discharge to pay more than he would have otherwise been obliged to pay. U.C.C. §3-605(f); U.C.C. §3-605, Official Comment 7.

Example: Assume that you and your sister co-make a note to borrow money to start a business. Being jointly and severally liable, on your payment in full, you may recover one-half of your payment from your sister. Assume that your sister pledged certain stock certificates to secure this loan. The creditor impairs the collateral by returning the stock certificates to your sister. If you had made payment, the stock certificates could have been sold by you and the proceeds used to pay the debt. Your loss is not in the entire amount of the debt because had the entire amount been paid by the selling of the certificates, your sister could have recovered one-half of the amount from you. You are therefore only discharged to the extent that you are harmed by the impairment.

Note: An accommodation party who is denied a discharge because the person entitled to enforce the instrument does not know, or have notice, of his accommodation status may use this rule to achieve a partial discharge. U.C.C. §3-605, Official Comment 7.

Example: You may have co-made the note with your sister to enable her to start a business. You neither indicated on the note itself, nor told the holder, that you were acting as an accommodation party for your sister. However, as a co-maker, you are entitled to a discharge to the extent discussed above.

9. **When is collateral impaired?** Impairment of collateral occurs when some unjustifiable act or omission on the part of the person entitled to enforce the instrument causes the collateral to no longer be available to satisfy the instrument. The person entitled to enforce the instrument impairs the collateral only if he has breached some duty respecting the collateral. U.C.C. §3-605(g). This duty may arise from an agreement, a common law duty of due care, or some statutorily imposed duty.

   Example: If the collateral is destroyed by fire or stolen, the creditor impairs the collateral only if he has breached a duty to insure against, or to use reasonable care to protect against, such loss. Contrast Commerce Union Bank v. May, 503 S.W.2d 112 (Tenn. 1973) (bank had no contractual duty) with Arlington Bank & Trust v. Nowell Motors, Inc., 511 S.W.2d 415 (Tex. Ct. App. 1974) (bank had contractual duty to insure).

   a. **Duty of reasonable care:** Unless otherwise agreed, if the collateral is property in the possession of the person entitled to enforce the instrument, that person has the duty to use reasonable care in its custody and possession of the collateral. If the collateral is personal property, the standard of reasonable care is governed by U.C.C. §9-207. U.C.C. §3-605(g).

   b. **Acts constituting impairment:** Article 3 contains a nonexclusive list of certain acts that constitute impairment of collateral.

      i. **Failure to perfect:** The failure to obtain or maintain perfection or recordation of a security interest in the collateral.

Example: The person entitled to enforce the instrument's failure to file an Article 9 financing statement, which results in the creditor not acquiring a perfected security interest in the collateral, impairs the collateral.

ii. **Release of collateral:** The release of collateral without substitution of collateral of equal value impairs the collateral.

Example: If the person entitled to enforce the instrument obtains from the debtor a diamond ring as collateral for a loan, he has impaired the value of the collateral if he releases the diamond ring to the debtor without obtaining any substitute collateral of equal value.

iii. **Duty to preserve:** The failure to perform a duty to preserve the value of the collateral owed to the debtor, accommodation party, or indorser impairs the collateral.

Example: If the person entitled to enforce the instrument had the duty to insure the collateral and has failed to do so, he has impaired the value of the collateral.

iv. **Improper disposal:** The failure to comply with an applicable law in disposing of collateral impairs the value of the collateral. U.C.C. §3-605(g).

Example: If the person entitled to enforce the instrument has violated the rules contained in Article 9 for selling collateral on default, he impairs the value of the collateral.

10. **Extent of discharge for impairment of collateral:** An accommodated party or indorser is discharged to the extent that he has been hurt by an impairment of the value of the collateral. The party seeking the discharge bears the burden of proof as to both the fact of impairment and the amount of the loss. U.C.C. §3-605(e); U.C.C. §3-605(f). The Code provides two alternative formulas for determining the extent of the impairment.

a. **Formula when debt fully secured:** A debt is fully secured when the value of the collateral is equal to, or greater than, the amount owed on the obligation. When the debt is fully secured, the value of an interest in collateral is impaired to the extent that the value of the interest is reduced to an amount less than the amount of the right of recourse of the party asserting the discharge. U.C.C. §3-605(e)(i); U.C.C. §3-605, Official Comment 6.

b. Formula when debt undersecured: A debt is undersecured whenever the debt is greater than the value of the collateral. The measure of loss is, in this event, phrased in terms of how much greater the debt is undersecured because of the impairment. The value of an interest in collateral is impaired to the extent that the reduction in value of the interest causes an increase in the amount by which the amount of the right of recourse exceeds the value of the interest. U.C.C. §3-605(e)(ii). [[Rev] U.C.C. §3-605(d).]

2002 amendments: Although [Rev] U.C.C. §3-605(d) represents no substantive change from original [Rev] U.C.C. §3-605(e), there have been some changes of note. The 2002 amendments have substituted principal obligor for the party primarily liable and secondary obligor for "accommodation party," "indorser," or "person who is secondarily liable." [Rev] U.C.C. §3-605(d). Similarly, in [Rev] U.C.C. §3-605(e)(i), the term secondary party has been substituted for "indorser or accommodation party having a right of recourse against the obligor." [Rev] U.C.C. §3-605(d).

Note: The 2002 amendments have also added to the situations in which the value of collateral is impaired by including, as an act of impairment, the failure to comply with applicable law in otherwise enforcing an interest in collateral. [Rev] U.C.C. §3-605(d) and Official Comment 7.

Note: The 2002 amendments also make it clear that [Rev] U.C.C. §3-605(d) applies to collateral that is realty (rather than personal property) as long as the obligation in question is in the form of a negotiable instrument. [Rev] U.C.C. §3-605, Official Comment 7. As a result, this section would be applicable where the collateral is a note secured by a trust deed.

c. **Formula where co-obligors:** When the party seeking the discharge is jointly and severally liable with the person who gave the collateral to the person entitled to enforce the instrument, the co-obligor is discharged only to the extent that the impairment causes him to pay more than he would otherwise have been obliged to pay, taking into account his right of contribution. U.C.C. §3-605(f) and Official Comment 3, paragraph 4.

11. **Consent to impairment of collateral:** A party is denied a discharge if he has consented to the act constituting the impairment. This consent may be given in advance, in the instrument itself, or after the act of impairment. U.C.C. §3-605(i). [[Rev] U.C.C. §3-605(f).] The consent may be express or implied. *See* McGhee v. First State Bank & Trust Co., 793 S.W.2d 133 (Ky. Ct. App. 1990) (when accommodation party actively negotiated renewal, question of fact whether accommodation party consented to extension).

V. LIABILITY OF AGENTS, PRINCIPALS, AND CO-OBLIGORS

A. **Represented person and representative:** For purposes of Article 3, a principal is referred to as the ***represented person***. An agent is referred to as the ***representative***. "Representative" includes an agent, an officer of a corporation or association, a trustee, an executor or administrator of an estate, or any other person empowered to act for another. U.C.C. §1-201(35). [[Rev] U.C.C. §1-201(b)(33).]

B. **Liability of represented person:** A represented person is liable on an instrument if the representative is authorized to sign for the represented person. An authorized signature by an agent or other representative is effective as the signature of the represented person. U.C.C. §3-402(a); U.C.C. §3-402, Official Comment 1.

1. **Types of authority:** Under the law of agency, the authority of the representative may be actual authority, apparent authority, or inherent agency power. If the representative was, however, not authorized to sign for the represented person, the signature will not operate as the represented person's signature unless the represented

person ratifies it or is otherwise precluded from contesting it. U.C.C. §3-403(a).

2. **Manner of signing:** Any mark or symbol used by the representative that is intended to signify the represented person is sufficient to bind the represented person. U.C.C. §3-402(a); U.C.C. §3-401, Official Comment 1.

a. **In name of represented person:** The representative may sign the name of the represented person either with, or without, adding the agent's own name or capacity. U.C.C. §3-402(a); U.C.C. §3-401, Official Comment 1.

Example: "Simon Industries," "Simon Industries, by Paul, President," or "Simon Industries, by Paul" are all sufficient to bind Simon Industries.

b. **Undisclosed principal:** If a representative is authorized to sign on behalf of the represented person, the representative may sign his own name alone, e.g., "Paul." U.C.C. §3-402(a); U.C.C. §3-401, Official Comment 1. To the extent the representative is authorized to act on his behalf, the undisclosed principal is liable on the instrument even though neither his signature nor his identity appears thereon. U.C.C. §3-401(a); U.C.C. §3-401, Official Comment 1; U.C.C. §3-402, Official Comment 1.

C. **Liability of representative:** Whether the representative is liable depends both on whether he was authorized to sign for the represented person and the manner in which he signs the instrument.

1. **Unauthorized signature:** If the representative is not authorized to sign for the represented person or exceeds his authority in making the signature, the signature operates as the signature of the representative personally. U.C.C. §3-403(a); U.C.C. §3-403, Official Comment 1. As a consequence, the representative will be personally liable in whatever capacity the signature was made. U.C.C. §3-403(a); U.C.C. §3-403, Official Comment 1.

Example: If a purchasing agent for a buyer is authorized to negotiate the purchase but is not authorized to sign or issue negotiable instruments, the agent's unauthorized drawing of a check in the buyer's name will make the purchasing agent personally liable as drawer of the check.

2. **Authorized signature:** Even when the representative is authorized to sign for the represented person, a failure to sign in the proper form may subject him to personal liability on the instrument.

   a. **Not liable if agent signs represented person's name only:** If the authorized agent signs the represented person's name only, the representative is not personally liable.

      Example: Paul, president of Simon Industries, is authorized to sign instruments on its behalf. If Paul signs the instrument "Simon Industries" without adding his own name, Paul is not personally liable on the instrument because his signature does not appear on the instrument. U.C.C. §3-401(a).

   b. **Unambiguously signs in representative capacity:** An authorized representative who signs his own name to an instrument is not personally liable if the signature unambiguously shows that it is made on behalf of a represented person who is identified in the instrument. U.C.C. §3-402(b).

      i. **Capacity and name of represented person:** When the representative signs his name together with his representative capacity and the represented person's name, it is clear that the representative is not personally liable. U.C.C. §3-402(b)(1).

         Example: A signature such as "Simon Industries, by Paul, President" unambiguously indicates that the representative is signing on behalf of the represented party. U.C.C. §3-402, Official Comment 2.

      ii. **Office not necessary:** It is not necessary for the representative to indicate the office he occupies as long as he clearly indicates that he is signing on behalf of the represented party, e.g., "Simon Industries by Paul" or "Simon Industries, Paul, Authorized Signer."

   c. **Ambiguous signature:** When the representative does not make it clear that he is signing on behalf of the represented person, the representative is personally liable to a holder in due course who takes the instrument without notice that the representative was not intended, by the original parties to the instrument, to be personally liable. U.C.C. §3-402(b); U.C.C. §3-402, Official Comment 2.

Rationale: Subsequent purchasers of the instrument may be misled into believing that Paul is personally liable on the instrument. The expectations of these parties should be and, in fact, are protected. Even though Paul did not intend to be personally liable, his carelessness may have misled subsequent purchasers, and therefore he, rather than they, should suffer any loss.

Example: When the name "Simon Industries" does not directly precede or follow Paul's name and capacity, it may not be clear whether Paul is signing for himself personally or for Simon Industries. Similarly, if Paul signs a note "Simon Industries, Paul," it is unclear whether Paul is signing his name as an agent for Simon Industries or whether he is signing for the purpose of undertaking personal liability.

i. As to other persons: As to any other person, the representative is liable on the instrument unless he proves that the original parties to the instrument did not intend that he be personally liable. U.C.C. §3-402(b); U.C.C. §3-402, Official Comment 2.

Note: The representative must prove an actual agreement, whether express or implied, with the payee that he was not to be personally liable. U.C.C. §3-402(b)(2). The representative's undisclosed intention not to undertake personal liability is not sufficient.

ii. Exception for checks: An authorized representative who signs as drawer on a check that is payable from an account of the represented person without indicating his representative status is not liable as long as the represented person is identified on the check and the signature is an authorized signature of the represented person. U.C.C. §3-

402(c); U.C.C. §3-402, Official Comment 3.

Example: If Paul, in signing a check on the account of Simon Industries and bearing its name, signs only "Paul" without any indication that he is acting on behalf of Simon Industries, Paul does not incur personal liability. The reason is simple. No one is going to assume that Paul, when signing a Simon Industries check, intends to incur personal liability.

D. Liability of persons signing in the same capacity in the same transaction: Except as otherwise specified in the instrument, two or more persons who sign an instrument as makers, acceptors, or drawers are liable jointly and severally in the capacity in which they sign. U.C.C. §3-116(a).

1. **Right of contribution:** Unless the parties otherwise agree, a party having joint and several liability is entitled to contribution from his joint and several obligors to the extent available under applicable law. U.C.C. §3-116(b).

Example: If Paul and Art are co-obligors, and Paul is forced to pay the note, he may recover half of the payment from Art. Of course, if the note was made by Paul, Art, and Carly, then each would be liable, as between each other, for one-third of the amount.

a. **Exception:** The presumption of equal liability may be overcome by evidence that the parties had agreed, between themselves, to a different allocation or had benefited in unequal portions.

b. **Not affected by discharge:** Even if a party (Paul) having joint and several liability is discharged by some act of the holder, his discharge does not affect the right of his joint and several obligor to receive contribution from the discharged party. U.C.C. §3-116(c); U.C.C. §3-116, Official Comment 1.

2002 amendments: U.C.C. §3-116(c) has been omitted from [Rev.] U.C.C. §3-116:

> (c) Discharge of one party having joint and several liability by a person entitled to enforce the instrument does not affect the right under subsection (b) of a party having the same joint and several liability to receive contribution from the party discharged.

Note: Under the 2002 amendments, parties that are jointly and severally liable are each, in part, a secondary obligor and, in part, a principal obligor. As a result, to the extent that each party is a secondary obligor, [Rev] U.C.C. §3-605 determines the effect of a release, an extension of time, or a modification of the obligation of one of the joint and several obligors, as well as the effect of an impairment of collateral provided by one of those obligors. [Rev] U.C.C. §3-116, Official Comment 1.

2. **Liability of indorsers:** Subject to certain exceptions, indorsers are not jointly and severally liable. U.C.C. §3-116(a).

Example: Assume that a note is made by Mick payable to Rod who indorses the note to Elton who indorses it to John, the holder. On default by Mick, John sues Rod and Elton. Although both Elton and Rod have indorsed the note, it is clear that Elton, being a subsequent indorser in the chain of title, has a right to recover in full from Rod. Elton was relying on Rod's indorsement when he purchased the note.

Exception: Co-payees who indorse an instrument are jointly and severally liable unless one payee is accommodating the other payee or they agree to be liable otherwise than as jointly and severally. U.C.C. §3-116(a); U.C.C. §3-116, Official Comment 2.

Example: If a note is made payable to Paul and Art and both indorse the note to Carly, it is presumed that upon payment by Paul, Paul can recover half of the payment from Art.

Exception: Persons who sign as anomalous indorsers for the purpose of accommodating the maker are jointly and severally liable unless one anomalous indorser is acting as a subsurety for the other anomalous indorser. U.C.C. §3-116, Official Comment 2.

Example: If Paul makes a note to Bank of Liverpool for the purpose of obtaining a loan and Ringo and George indorse the note as an accommodation to Paul, it is presumed that Ringo and George are, as between each other, agreeing to be equally liable. If, however, Ringo asks that George indorse the note as a favor to both him and Paul, George may be the surety for Paul and the subsurety for Ringo, in which case George, upon payment, may recover in full from Ringo.

VI. EFFECT OF TAKING INSTRUMENT ON THE UNDERLYING OBLIGATION

A. Introduction: The effect that the taking of an instrument has on the underlying obligation depends on whether the instrument is a bank instrument, such as a cashier's check or teller's check, or an instrument on which a bank is not the obligor.

B. Ordinary instruments

1. Obligation suspended: Unless the parties otherwise agree, when the person entitled to enforce the instrument takes an ordinary nonbank instrument (referred to as an ***ordinary instrument***) for an underlying obligation, the obligation is suspended to the same extent that the obligation would be discharged if payment had been made in money. U.C.C. §3-310(b); U.C.C. §3-310(c).

a. No action to enforce: While the underlying obligation is suspended, no action of any type, including lawsuits or set-offs, may be taken to enforce the obligation. The obligation is treated as not yet due.

Example: When John gave his note to the car dealer, the car dealer could not, until dishonor, sue him on the underlying sales contract.

b. Checks: When an uncertified check is taken, suspension of the obligation continues until the check is either dishonored, paid, or certified. If the check is paid or certified, the obligation is discharged to the extent of the amount of the check. U.C.C. §3-310(b)(1).

c. Notes: When a note is taken, suspension of the obligation continues until dishonor of the note or until it is paid. The obligation is discharged to the extent that the note is paid. U.C.C.

§3-310(b)(2).

2. **Effect of dishonor:** The effect of dishonor depends on whether the person who is enforcing the instrument is also the person to whom the underlying obligation is owed.

   a. **Person entitled to enforce instrument also underlying creditor:** When the person entitled to enforce the instrument is also the person to whom the underlying obligation is owed (the car dealer brings the action on the note), the person (the car dealer) may enforce either the instrument or the obligation once the instrument is dishonored. U.C.C. §3-310(b)(3); U.C.C. §3-310, Official Comment 3.

   b. **Not also underlying creditor:** When the person entitled to enforce the instrument is not the person to whom the underlying obligation is owed, the person entitled to enforce the instrument may enforce only the instrument. U.C.C. §3-310(4).

      Example: Assume that Car Dealer sells the note to Finance Company. In this case, because the person entitled to enforce the instrument (Finance Company) is not the person to whom the underlying obligation is owed (Car Dealer), it (Finance Company) may only enforce the instrument. Thus, for example, if the note does not contain a provision for attorneys' fees or interest, Finance Company, having neither the right to enforce the attorneys' fees provision nor the provision for interest found in the contract, has no right to interest or attorneys' fees.

3. **Effect of discharge:** When the underlying obligor is discharged on the instrument, she is also discharged on the underlying obligation. U.C.C. §3-310(a), (b)(1), and (2).

   Example: When John pays the note, he is discharged on the note and on the underlying sales contract.

   Note: Discharge is available even if the underlying obligor is not a party to the instrument. U.C.C. §3-310(b)(1), and (2).

   Example: Assume that instead of borrowing money from Car Dealer, John had borrowed money directly from Finance Company. Finance Company makes a check payable to Car Dealer on John's behalf. Discharge of Finance Company on the check discharges John on the underlying sales contract. If the check is dishonored, Car Dealer may maintain an action against John on the underlying sales contract and against Finance Company on the check. Car Dealer, of course, can be paid only once. If the check had instead been made payable to John who indorsed it to Car Dealer, discharge of John on the check would also discharge John on the underlying sales contract. U.C.C. §3-310(b)(3); U.C.C. §3-310, Official Comment 3.

C. **Bank checks:** Unless otherwise agreed, if a certified check, cashier's check, teller's check, or any other instrument on which a bank is a maker or an acceptor is taken for an obligation, the obligation is discharged to the same extent as had payment been made in cash. U.C.C. §3-310(a), (c); U.C.C. §3-310, Official Comments 2, 5.

1. **Only bank liable:** The debt is discharged and the taker of the bank instrument is left with only his right to recover on the instrument against the bank.

2. **Party liable if indorses:** If the debtor indorses the instrument, although the underlying obligation is discharged, her liability as an indorser on the instrument is not discharged. U.C.C. §3-310(a); U.C.C. §3-310, Official Comment 2.

Rationale: The parties intended, by use of a bank instrument, to allocate the risk of the bank's insolvency to the taker, who could immediately present the bank instrument for payment. Any delay is her fault. If the taker does not want to assume the risk of the bank's insolvency, the parties may either expressly agree that the debtor remains liable on the underlying obligation despite payment by bank instrument, or the debtor may indorse the bank instrument.

D. **Taking instrument for underlying obligation:** For an instrument to affect the underlying obligation, the instrument must be "taken" for the underlying obligation. U.C.C. §3-310(a), (b). Mere delivery of the instrument to the obligee by the obligor does not result in the obligee having taken the instrument for the underlying obligation. The obligee must, by her action or inaction, indicate that she has accepted the instrument in conditional or final payment of the obligation. *See*

Savings & Loan Assn. v. Tear, 435 A.2d 1083 (Me. 1981) (Bank teller accepted a money order in payment of an overdue installment on a mortgage. Although the bank immediately returned the money on review of its files by the appropriate employee, the bank was deemed to have taken the instrument in payment of the mortgage.).

Example: Unless previously authorized by Car Dealer as an acceptable form of payment, Car Dealer's receipt by mail of an instrument does not constitute taking of the instrument for the underlying obligation. Car Dealer can promptly return the instrument to John. John cannot unilaterally impose on Car Dealer payment by a negotiable instrument. However, if Car Dealer deposits or negotiates the instrument, Car Dealer will have taken the instrument for the obligation.

VII. ACCORD AND SATISFACTION BY USE OF INSTRUMENT

A. Introduction: Article 3 provides a procedure whereby a debtor can use a check for the purpose of reaching an accord and satisfaction with a creditor. Subject to two exceptions, tendering of an instrument discharges the underlying claim for which it was tendered if the following conditions are met:

- the debtor must tender the instrument in good faith and in full satisfaction of the claim;
- the claim must either be unliquidated or subject to a bona fide dispute;
- the instrument must be paid; and
- the instrument, or accompanying written communication, must contain a conspicuous statement that the instrument is tendered in full satisfaction of the debt. U.C.C. §3-311(a), (b).

B. Good faith required: An insurance company does not act in good faith when it sends a check in an unreasonably small amount knowing that the insured is destitute. U.C.C. §3-311, Official Comment 4.

C. **Debtor discharged even if language stricken:** The debtor is discharged even if the creditor strikes out the language indicating payment in full or otherwise indicates her protest.

D. **Exception for lockbox accounts:** If an organization informs a debtor that checks or other communications regarding disputed debts must be sent to a designated person, office, or place, the claim is not discharged if the instrument or communication was not received by the designated person, office, or place. U.C.C. §3-311(c)(1).

Rationale: Large companies often require customers to make payments directly to a lockbox located at its depositary bank or to one of its own post office boxes from which a clerk receives the checks, records the payment, and forwards the check to the depositary bank. Efficiency requires that the employee not read any accompanying correspondence or anything written on the back of the check. U.C.C. §3-311, Official Comment 5.

E. **Exception for returning payment:** If a creditor does not require that claims be sent to a special address, the claim is not discharged if the creditor tenders repayment of the amount of the instrument within 90 days of its payment. U.C.C. §3-311(c)(2).

F. **Limitation on exceptions:** Both exceptions are subject to a limitation. The debtor may prove that, within a reasonable time before collection of the instrument was initiated, the creditor or its agent who had direct responsibility with respect to the disputed obligation knew that the instrument was tendered in full satisfaction. U.C.C. §3-311(d); U.C.C. §3-311, Official Comment 7.

Example: Because a clerk processing checks sent to a lockbox account does not have authority to settle matters, the debt would not be discharged even if the clerk saw the full satisfaction language before depositing the check. U.C.C. §3-311, Official Comment 7.

VIII. PROCEDURAL ISSUES INVOLVING NEGOTIABLE INSTRUMENTS

A. **Procedural differences for actions on negotiable instruments:** There are several differences between the procedures applicable to actions on ordinary contracts and those applicable to actions on negotiable instruments.

B. **Persons entitled to enforce instrument:** A person who has the right to enforce an instrument is called a "person entitled to enforce the instrument." A "person entitled to enforce" an instrument includes, in addition to the holder of the instrument, three other groups of persons:

   1. **Rights of a holder:** A nonholder in possession of the instrument who has the rights of a holder. This category includes:

      a. **Transferee:** A transferee of a holder who, by the transfer, acquires the rights of a holder.

      b. **Accommodation party:** An accommodation party who pays the holder and thereby obtains the rights of the holder through subrogation.

      c. **Indorser:** An indorser who pays the holder and thereby acquires the right to enforce the instrument against prior parties.

   2. **Owner of lost instrument:** The owner of a lost instrument who brings an action under U.C.C. §3-309.

   3. **Person from whom payment recovered:** A person from whom payment has been recovered under U.C.C. §3-418(d). U.C.C. §3-418 allows a payor who made payment by mistake to recover its payment from certain recipients. In the event that payment is recovered, the instrument is treated as if it had originally been dishonored and the person from whom the payment has been recovered becomes the person entitled to enforce the instrument. U.C.C. §3-418(d).

C. **Burden of proof in negotiable instruments cases:** A person entitled to enforce an instrument establishes a prima facie case for recovery where he:

   - establishes that the obligor's signature is effective,
   - produces the instrument, and

- proves that he is a person entitled to enforce the instrument. U.C.C. §3-308(a), (b).

1. **Exception to producing instrument:** The plaintiff does not have to produce the instrument if the instrument has been lost, destroyed, or stolen, or if he is a person from whom a payment has been recovered pursuant to U.C.C. §3-418.

2. **Proving signatures:** Unless the defendant specifically denies that a signature is authentic, the signature is deemed to be authentic. Even if the defendant makes a specific denial, the plaintiff is entitled to a presumption that the signature is genuine and authorized. U.C.C. §3-308(a). The presumption requires that the trier of fact find the signature to be genuine or authorized unless and until the obligor has introduced sufficient evidence to support a finding that the signature is either not genuine or unauthorized. U.C.C. §1-201(31) [[Rev] U.C.C. §1-206)]; U.C.C. §3-308, Official Comment 1. Once sufficient evidence is introduced, the presumption completely disappears. To rebut the presumption, the defendant need only testify that his signature is not genuine and submit a sample of his true signature.

3. **Burden on obligor to prove defense:** Once the plaintiff has established his prima facie case by (1) establishing that he is a person entitled to enforce the instrument, (2) producing the instrument, and (3) proving the authenticity of the obligor's signature, he will recover against the obligor unless the obligor establishes a defense or a claim in recoupment. U.C.C. §3-308(b); U.C.C. §3-308, Official Comment 2.

4. **After defense proved, duty of plaintiff to prove holder-in-due-course status:** Even if the obligor has established a defense or claim in recoupment, the plaintiff will still recover if he proves that he is a holder in due course or has the rights of a holder in due course. U.C.C. §3-308(b); U.C.C. §3-308, Official Comment 2. To accomplish this, he must prove that he satisfies every requirement for holder-in-due-course status. Even if the plaintiff succeeds in proving that he is a holder in due course, the plaintiff will be denied recovery if the defendant proves a defense effective against a

person having the rights of a holder in due course such as a real defense, defenses or claims in recoupment that the defendant has against the plaintiff itself, or a discharge of which the plaintiff has notice. U.C.C. §3-305(b).

IX. ENFORCEMENT OF LOST, DESTROYED, OR STOLEN INSTRUMENTS

A. **Lost, destroyed, or stolen ordinary instruments:** The person entitled to enforce an instrument that is lost by destruction, theft, or otherwise, may maintain an action as if he had produced the instrument. To protect the obligor against the risk that the instrument had been indorsed in blank before being lost, a court cannot enter judgment in favor of the person entitled to enforce the instrument unless it finds that the obligor is adequately protected against any loss that might occur by reason of a claim by another person to enforce the instrument. U.C.C. §3-309(b); U.C.C. §3-309, Official Comment. The obligor cannot know whether the claimant had either previously negotiated the check or had indorsed it in blank before losing it. In either event, the obligor would be exposed to double liability if it was forced to pay the claimant and the instrument was subsequently presented by a holder in due course who would then take free of the obligor's claim of discharge by payment.

1. **Adequate protection:** To protect the obligor, a court can require the claimant to indemnify the obligor against any losses or expenses. U.C.C. §3-309(b). The amount should be sufficient to protect the obligor not only against liability in the face amount of the instrument but also for all expenses incurred to defend the action, including attorneys' fees and court costs.

2. **Right to recover on instrument only:** If the claimant proves certain facts, he may recover on the instrument as though he had produced the instrument itself. U.C.C. §3-309(b). However, the holder may not enforce the obligation for which the instrument was given. U.C.C. §3-310(b)(4); U.C.C. §3-310, Official Comment 4.

3. **What claimant must prove:** The claimant must prove that:

a. **In possession and entitled to enforce:** He was in possession of the instrument and entitled to enforce it when the instrument was lost. This requires that he prove that he was either a holder or had the rights of a holder at the time he lost possession.

b. **Neither transferred nor seized:** The loss of possession was not a result of his transfer of the instrument or of a lawful seizure of the instrument.

c. **Cannot obtain possession:** He cannot reasonably obtain possession of the instrument because it was either destroyed, lost, or in the wrongful possession of an unknown person or a person who cannot be found or is not amenable to service of process. The claimant cannot maintain this type of action if he is able to reacquire possession of the instrument. U.C.C. §3-309(a).

   Rationale: When the person entitled to enforce the instrument knows who has possession of the instrument, he must bring an action against that person to recover the instrument. Similarly, the owner of an instrument who has been paid by a payor bank over a forged indorsement has no action under U.C.C. §3-309. His action is against the payor bank or the depositary bank for conversion.

d. **Terms:** The terms of the instrument include any terms necessary to make the instrument negotiable. U.C.C. §3-309(b).

e. **2002 amendments:** The 2002 amendments permit a person not in possession of an instrument to enforce the instrument if the person has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred. [Rev] U.C.C. §3-309(a)(1)(B).

   Rationale: This permits a person who lost the instrument but has the right to enforce it under [Rev] U.C.C. §3-309 to transfer its right to enforce the instrument to another.

   Required proof: A transferee of a lost instrument need only prove that its transferor was entitled to enforce the instrument. There is no need for the transferee to prove that it was in possession of the instrument at the time the instrument was lost. [Rev] U.C.C. §3-309, Official Comment 2.

Declaration of loss: The 2002 amendments substitute the term ***record*** for "writing." As a result, a declaration of loss may be made in a record that is not a writing. A record is "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form." [Rev] U.C.C. §3-103(a)(14).

B. Lost, destroyed, or stolen bank checks: A different set of rules apply when a bank check (a cashier's, teller's, or certified check) is lost, destroyed, or stolen. The owner of a bank check who loses the bank check may not have the ability to post a bond in an amount sufficient to indemnify the obligated bank. To make it possible for the owner to recover from the bank, a procedure had to be devised to protect the bank against double liability while at the same time making it possible for the owner to recover from the bank. U.C.C. §3-312 provides such a procedure.

1. **Who may use U.C.C. §3-312:** Only the drawer or payee of a certified check and the remitter or payee of a teller's or cashier's check (***claimant***) may proceed under U.C.C. §3-312. U.C.C. §3-312(a)(3)(ii). An indorsee of a bank check is denied the advantages of U.C.C. §3-312 and must proceed as if he were suing on an ordinary lost or stolen instrument.

2. **Manner of asserting claim:** The claimant must send a communication to the bank issuing the bank check describing the check with reasonable certainty and requesting payment of the amount of the check. This communication must be accompanied by a declaration of loss. U.C.C. §3-312(b).

3. **When claim is effective:** By complying with these simple requirements, the declarer has asserted a claim under U.C.C. §3-312. The claim, however, is not valid for 90 days. During this 90-day waiting period, the bank may, with impunity, pay the person entitled to enforce the check. U.C.C. §3-312(b)(2). After the 90-day period, the issuing bank becomes liable to the claimant if the bank had not already paid a person entitled to enforce the check. U.C.C.

§3-312(b)(4); U.C.C. §3-312, Official Comment 4.

4. **Bank discharged by payment to claimant:** Payment to the claimant discharges the bank's liability to a person entitled to enforce the check. U.C.C. §3-312(b)(4). If a holder in due course presents the bank check after the bank pays the claimant, the issuing bank may pay the holder in due course. The claimant is then obliged to repay the bank. If the bank refuses to pay the holder in due course, the claimant must pay the holder. The declaration of loss made by the claimant is a warranty of the truth of the statements contained therein. U.C.C. §3-312(b); U.C.C. §3-312, Comment 3.

Quiz Yourself on NATURE OF LIABILITY ON INSTRUMENTS

25. Bob draws a check payable to Jill. Jill indorses the check to Sally.

a. What is the effect of Jill's indorsement of the check to Sally? __________

b. If Sally refuses to purchase the check unless Jim, Jill's brother, also promises to pay the check, what is Jim's signature called? __________

26. Assume that Bank of America issues a cashier's check payable to Bill. When Bill wants to be paid, Bill will demand that Bank of America pay the check. Can Bank of America expect that anyone else will be called on to make payment?__________

27. When Bob draws a check payable to Jill for $300, Bob is ordering Wells Bank to pay $300 to Jill. What is Bob impliedly promising? __________

28. Assume that Son asks Dad to sign in accommodation so that he can purchase a car from Car Dealer. Car Dealer asks Dad to sign as maker and Son to indorse the note. Car Dealer takes a security interest in the car as collateral. Car Dealer sells the note, along with its security interest in the car, to Finance Company. Finance Company releases title of the car to Son. Is Dad discharged by the Finance Company releasing the title?__________ Would the result be any different under the 2002 amendments?__________

29. Assume that a person entitled to enforce an instrument released his security interest in his collateral, a car worth $20,000. The principal debtor then sells the car and loses the money. The remaining debt is $15,000. To what extent is the accommodation party discharged? __________ Would the result be different under the 2002 amendments?__________

30. The person entitled to enforce the instrument releases his security interest in the collateral, a car, when the car was worth $20,000 and the debt was $50,000. To what extent is the accommodation party discharged?__________ Would the result be different under the 2002 amendments?__________

31. Junior wants to purchase a car. From what Junior has heard from his college friends, he realizes that he will not be able to obtain a loan unless Father co-signs on the loan. Father and Junior go to Cal's Cars. Father tells the salesman that they want to purchase a car. The salesman has Father and Junior sign the note as co-makers. The note is payable to Cal's Cars. Cal's Cars takes a security interest in the car to secure the note. Father asks that the car be put in Junior's name. Cal's Cars fails to properly perfect its security interest in the car. One of Junior's creditors executes on the car to satisfy a judgment he has against Junior. Immediately thereafter, Junior files for bankruptcy. To what extent can Cal's Cars recover from Father on the note? __________

32. Assume, instead, that Cal's Cars released Son from liability in payment of a portion of the amount due under the note. Can Cal's Cars sue Father for the remainder? If so, does Father have any recourse against Son?__________

33. On January 1, Charlie issues a check to Carmona. On January 10, Carmona indorses the check to Casey. On February 7, Payor Bank sets off a debt owed to it by Charlie against his bank account. No funds remain in the account when, on February 8, Casey presents the check to Payor Bank. Payor Bank therefore dishonors the check. May

Casey recover from Charlie or Carmona?_________

34. Yonas issues a check in payment for a television set purchased from Jessee. The check is made payable to cash. Jessee, without indorsing the check, cashes it at Check Cashing Service. Discovering that the television set was stolen by Jessee, Yonas stops payment on the check. May Check Cashing Service recover from Jessee?_________

35. Hanook, as authorized agent for Masai Corporation, enters into a contract for the purchase by Masai of certain equipment from Tigist Machinery. In payment for the purchase, Hanook executes a promissory note payable to Tigist Machinery. The note states that "I (We) promise to pay.…" The note is signed "Masai Corporation, Hanook." Tigist Machinery sells the note to Genet Finance Company. Is Hanook personally liable on the note?_________

36. Danielle agreed to purchase a new Jaguar from Fisseha Automobile for $60,000 under a sales contract. Fisseha Automobile takes from Danielle a note for the purchase price payable in one year in 12 equal monthly installments. After 2 months, although Danielle is current in her payments, Fisseha Automobile demands payment of the entire purchase price under the sales contract. Is Danielle obligated to immediately pay the remainder of the purchase price?_________

37. In fact, Danielle does not make any additional payments on the note. Fisseha Automobile brings a legal action against Danielle for the remaining payments. In her answer, Danielle generally denies any liability on the note. Fisseha Automobile produces the note in court. Danielle introduces no evidence. Fisseha Automobile requests that the court enter a judgment for it as a matter of law. Is Fisseha Automobile entitled to such a judgment?_________

38. Assume that a check is indorsed by Paul to Kate to Dan. Assume that Dan receives notice of dishonor on August 1. Dan gives notice of dishonor to Kate on August 15.

a. Is the notice of dishonor timely as to Kate?_________

b. By what date does Kate have to give timely notice of dishonor to Paul?_________

39. Assume that Bob and Abe co-make a note in the amount of $5,000.

As collateral, Abe grants to Carl, the payee, a security interest in property worth $1,000. Because Carl fails to perfect the security interest, the security interest is avoided by the trustee in Abe's bankruptcy. To what extent, if any, is Bob discharged?_________

40. Alice, as payee, gives, as a gift, the note to Beth but fails to indorse the note.

a. Is Beth a holder of the note?_________

b. What rights does Beth have on the note?_________

Answers

25.a. **It makes Sally the holder of the check and obligates Jill to pay the check if dishonored.** If Jill wants to avoid liability while still negotiating the check, Jill can indorse the check without recourse.

b. **An anomalous indorser.** Jim's signature is anomalous because it was not necessary to make Sally the holder of the check. Jill's indorsement alone was sufficient.

26. **No.** Being a cashier's check, the check is drawn by Bank of America, as drawer, on itself as drawee. Bill will demand payment directly from Bank of America, and just like the maker of a note, they are obligated to make payment.

27. **To make payment.** By drawing the check, Bob is impliedly promising that if Wells Bank does not pay the check on presentment, Bob will pay Jill.

28. **Dad is not discharged by the action of Finance Company unless Finance Company knew or had notice of his accommodation status.** Without such notice, when Finance Company released the car to Son, Finance Company did not know that it was hurting Dad. Because Dad signed as maker of the note, Finance Company believed that Dad was to be ultimately liable and that on Dad's payment, he would have no recourse against Son who signed as an indorser. The result would be the same under the 2002 amendments. Unless the person entitled to enforce the instrument either knows or has notice under [Rev] U.C.C. §3-419(c) that the instrument was signed for accommodation, the accommodation party is not discharged by an impairment of the collateral. [Rev] U.C.C. §3-605(e).

29. **$15,000.** Had the security interest not been released, the accommodation party, on payment, could have looked to the car for repayment. Because the car is no longer subject to the security interest, the accommodation party has no way of recovering the $15,000 he has to pay to the person entitled to enforce the instrument. Using the terminology found in the Code, the value of the interest in the collateral has been reduced to $0, which is $15,000 less than the amount of the right of recourse. Therefore, the accommodation party would be discharged as to the entire $15,000. The result would be the same under the 2002 amendments. Under [Rev] U.C.C. §3-605(d), when collateral is impaired and the debt is oversecured, the secondary obligor is discharged to the extent that the impairment causes the value of the collateral to be reduced to an amount less than the amount of the secondary party's right of recourse, which is $15,000.

30. **$20,000.** The accommodation party loses $20,000 as a result of the release of the security interest. The right of recourse is $50,000 and the present value of the collateral is $0. Because of the impairment, the deficiency is now $50,000 rather than $30,000. Therefore, the increase in the amount by which the amount of the right of recourse exceeds the value of the interest is $20,000. The result would be the same under the 2002 amendments. Under [Rev] U.C.C. §3-605(d), collateral is impaired to the extent that the reduction in value of the interest causes an increase in the amount by which the amount of the recourse exceeds the value of the interest. Because the amount by which the amount of recourse exceeds the value of the interest has been increased from $30,000 to $50,000, the value has been impaired by $20,000.

31. An accommodation party is discharged when the person entitled to enforce the instrument impairs the collateral. Cal's Cars' failure to properly perfect its security interest in the car did impair the collateral. Even though Father is an accommodation party, Cal's Cars does not seem to have notice of his status. Therefore, Father is not discharged by its impairment. U.C.C. §3-605(h). [[Rev] U.C.C. §3-

605(e).] However, Father would be treated as a person who is jointly and severally liable with Junior and therefore would be discharged up to the value of the car but for not more than half of the obligation. U.C.C. §3-605(f).

32. **Yes.** Discharge by renunciation or cancellation (in other words, a “release”) of the accommodated party does not discharge the accommodation party. U.C.C. §3-605(b). Notwithstanding Son's release, once Father pays Cal's Cars, he is entitled to enforce the instrument against Son. U.C.C. §3-419(e).

33. **Yes.** Neither Charlie nor Carmona are discharged by Casey's delay in presenting the check for payment. Although the check was not presented within 30 days of its date, Charlie, as drawer, is not discharged because Payor Bank did not go insolvent. As a result, Charlie was not harmed by the delay. Carmona is not discharged because Casey presented the check within 30 days of his indorsement and therefore the presentment was timely as to Carmona.

34. **Yes.** Even though Jessee did not indorse the check, he still makes the transfer warranty to Check Cashing Service that the check is not subject to any defenses good against him. Because Jessee would take subject to Yonas's defense of failure of consideration, Jessee has breached the warranty he gave to Check Cashing Service. U.C.C. §3-416(a)(4).

35. **Yes.** A representative, even if authorized, who signs her name to an instrument may be personally liable unless the form of the signature unambiguously indicates that she is signing only as representative for the represented person. Because it is ambiguous as to whether Hanook is signing only in a representative capacity, he is liable to a holder in due course who takes the note without notice that he was not intended to be personally liable. U.C.C. §3-402(b)(2). As a result, only if Genet Finance Company has notice that Tigist Machinery and Hanook did not intend Hanook to be personally liable can Hanook avoid liability.

36. **No.** When Fisseha Automobile took the note in payment of Danielle's obligation under the sales contract, Danielle's obligation became suspended until dishonor of the note. Because Danielle is current in her payments, the note has not been dishonored, and, therefore, Fisseha Automobile cannot sue on the underlying obligation. U.C.C. §3-310(b)(2).

37. **Yes.** Danielle's signature as maker is admitted because Danielle did not specifically deny in the pleadings the validity of the signature. U.C.C. §3-308(a). Because Fisseha Automobile, the payee, produced the note, it is entitled to a judgment unless Danielle proves a defense or claim in recoupment. Because Danielle introduced no evidence of any possible defense or claim in recoupment, Fisseha Automobile is entitled to its judgment. U.C.C. §3-308(b).

38.a. **Yes.** Persons other than a collecting bank must give notice of dishonor within 30 days following the day on which the person receives notice of dishonor. U.C.C. §3-503(c); U.C.C. §3-503, Official Comment 2. Dan received notice on August 1 and gave notice 15 days later.

b. **September 14.** Kate has until September 14 (30 days from the date she received notice of dishonor) to give notice of dishonor to Paul.

39. **$500.** Unless the parties otherwise agree, a party having joint and several liability is entitled to contribution from his joint and several obligors to the extent available under applicable law. U.C.C. §3-116(b). Even if a party having joint and several liability is discharged by some act of the holder, his discharge does not affect the right of his joint and several obligor to receive contribution from the discharged party. U.C.C. §3-116(c); U.C.C. §3-116, Official Comment 1. Although the result is the same, the analysis is different under the 2002 amendments. U.C.C. §3-116(c) has been omitted. Under the 2002 amendments, parties that are jointly and severally liable are each, in part, a secondary obligor and, in part, a principal obligor. As a result, to the extent that each party is a secondary obligor, [Rev] U.C.C. §3-605 determines the effect of a release, an extension of time, or a modification of the obligation of one of the joint and several obligors, as well as the effect of an impairment of collateral provided by one of those obligors. [Rev] U.C.C. §3-116, Official Comment 1. Under the 2002 amendments, Bob is also discharged to the extent of $500.

40.a. **No.** Beth is missing a necessary indorsement, and is, therefore, not a holder of the note.

b. Because Alice transferred the note to her, Beth has all of Alice's rights as a holder and is, in her own right, a person entitled to enforce the instrument.

Exam Tips on *NATURE OF LIABILITY ON INSTRUMENTS*

- **Raising suretyship defenses:** Always remember that the ability of an accommodation party to raise the suretyship defenses depends on whether the holder has notice of his status as an accommodation party.
- **Discharge of an indorser:** Notice that an indorser is only discharged if a check is not presented for payment or given to a depositary bank for collection within 30 days of *his indorsement*. The time for presentment does not run from the date of the check.
  - Notice also that as long as the check is deposited for collection within 30 days of his indorsement, the indorser cannot claim a discharge even if the check is not presented for payment until after the 30-day period.

CHAPTER 4
FORGERY, ALTERATION, AND OTHER FRAUDULENT ACTIVITY

ChapterScope

This chapter examines the loss allocation in the event of a forged signature or alteration, the warranties made on presentment and transfer, conversion, the grounds precluding a party from claiming that a signature or an alteration is unauthorized, and the effect of restrictively indorsing an instrument. The key points in this chapter are:

- **Forgery ineffective:** A forged or unauthorized signature is wholly inoperative as the signature of the person whose name is signed.
- **Effect of unauthorized indorsement:** A person cannot be a holder of an instrument that contains an unauthorized indorsement in her chain of title.
- **Transfer warranty:** A person who transfers an instrument warrants that all signatures are authentic and that the instrument has not been altered.
- **Presentment warranty:** A person who presents a check for payment warrants that she is a person entitled to enforce the instrument and that the instrument has not been altered.
- **Conversion where indorsement forged:** A person who pays or purchases an instrument bearing a forged indorsement converts the instrument.
- **Preclusion through negligence:** A person may be precluded by her negligence from asserting the unauthorized nature of a signature or an alteration.
- **Preclusion of drawer to assert forged indorsement:** A drawer of a check, whether or not negligent, may be precluded by certain of her actions from claiming that an indorsement is forged.

- **Effect of restrictive indorsement:** The owner of a restrictively indorsed instrument may recover from the depositary bank or other taker of the instrument in the event that the instrument is transferred in violation of the restriction.

I. UNAUTHORIZED SIGNATURES

A. Introduction: Subject to certain exceptions, an unauthorized signature is ineffective as the signature of the person whose name is signed. U.C.C. §3-403(a). An unauthorized signature may be an outright forgery or a signature by an agent in excess of her actual or apparent authority. U.C.C. §1-201(43); U.C.C. §3-403, Official Comment 1.

B. Two consequences of unauthorized signature: The fact that an unauthorized signature has no effect as the signature of the person whose name is signed has two distinct consequences: (a) the person whose signature is signed is not liable on the instrument; and (b) if the unauthorized signature is an indorsement in the chain of title, no person following the unauthorized indorsement can be a holder of the instrument.

C. Person whose name is signed not liable: The person whose signature is unauthorized is not liable on the instrument whether the signature appears in the capacity of drawer, maker, acceptor, or indorser. U.C.C. §3-401(a).

1. **Unauthorized signer liable:** An unauthorized signature is effective as the signature of the unauthorized signer in favor of a person who, in good faith, pays the instrument or takes it for value. U.C.C. §3-403(a).

2. **Loss shifted:** The loss may be shifted to the person whose name is forged if that person is negligent or is otherwise precluded from claiming that the signature is not authorized.

D. Effect of forged indorsement in chain of title: When an indorsement in the chain of title is forged, no person following the forged indorsement can become a holder of the instrument.

Note: This does not apply when the instrument is payable to bearer or indorsed in blank. In these cases, no indorsement is necessary to make the transferee a holder because the instrument is negotiated by delivery alone.

1. **Person whose signature forged still owner:** Absent grounds for preclusion, the person whose indorsement is forged remains the owner of the instrument.

2. **Different result if precluded:** When a person is precluded from claiming that her indorsement is forged, the forged indorsement is effective to negotiate the instrument.

E. **Transfer warranties:** Two transfer warranties are relevant in determining the allocation of loss when a signature is forged.

1. **Person entitled to enforce instrument:** A transferor warrants that she is a person entitled to enforce the instrument. U.C.C. §4-207(a)(1); U.C.C. §3-416(a)(1). This is basically a warranty that there are no unauthorized or missing indorsements that prevent the transferee from becoming a person entitled to enforce the instrument. U.C.C. §3-416, Official Comment 2.

2. **All signatures are authentic:** A transferor warrants that all signatures are authentic and authorized. U.C.C. §4-207(a)(2); U.C.C. §3-416(a)(2). A forged or unauthorized drawer's, maker's, indorser's, or acceptor's signature breaches this warranty.

3. **2002 amendments:** A new transfer warranty has been added as to remotely created consumer items. With respect to a remotely created consumer item, the transferor warrants that "the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn." [Rev] U.C.C. §3-416(a)(6) and [Rev] U.C.C. §4-208(a)(4). As a result, the risk of the item not being authorized by the person upon whose account it was drawn rests upon the person initially transferring the item.

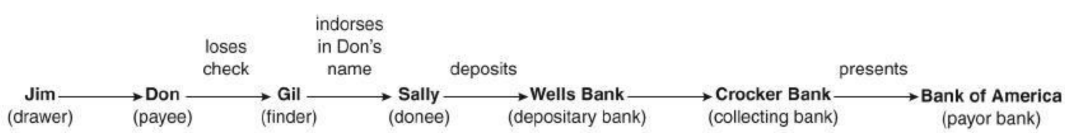
F. **Presentment warranties:** Certain risks should not be borne by the person making payment. To protect the person making payment, she is given certain warranties when an instrument is presented for payment. These warranties are called the ***presentment warranties***.

The same presentment warranties are contained in both Articles 3 and 4. The warranties under U.C.C. §3-417 are identical to those given under U.C.C. §4-208 except that U.C.C. §4-208 extends its coverage to items and not just to negotiable instruments.

1. **Persons who make presentment warranties:** The presentment warranties are made by the person who obtains payment or acceptance as well as by any prior transferor. U.C.C. §4-208(a), (d); U.C.C. §3-417(a), (d).

   Example: Assume that Jim draws a check payable to Don. Don loses the check. Don's indorsement is forged by Gil, who indorses the check in blank and gives the check as a present to his daughter Sally. Sally deposits the check in her bank account at Wells Bank, which sends the check for collection to Crocker Bank, which presents the check for payment to Bank of America. Bank of America pays the check. See Figure 4-1.

Figure 4-1



Crocker Bank, as the entity that obtained payment, in addition to prior transferors Gil, Sally, and Wells Bank, all make the presentment warranties to Bank of America. Even though Gil did not receive consideration for the check, he still makes the presentment warranties. Even though Sally did not indorse the check, she still makes the presentment warranties. Furthermore, Wells Bank, although only an agent for collection, also makes the presentment warranties.

2. **To whom presentment warranties are made:** The presentment warranties are made to any payor or acceptor who acts in good faith. U.C.C. §4-208(a), (d); U.C.C. §3-417(a), (d)(1). The fact that the payor or acceptor was negligent in making payment or acceptance does not deny it the right to receive these warranties. U.C.C. §4-208(b); U.C.C. §3-417(b).

Example: Even if an alteration is so obvious that it should have been noticed by the payor bank, the payor bank may still recover from the presenter for breach of the warranty that the check has not been altered.

3. **Warranties made to drawee of unaccepted draft:** The payor bank on a check (as well as any drawee of an unaccepted draft) is given three warranties:

- the warrantor is entitled to enforce the draft or authorized to obtain payment or acceptance on behalf of a person entitled to enforce the draft;
- the warrantor has no knowledge that the signature of the drawer is unauthorized;
- the draft has not been altered. U.C.C. §4-208(a); U.C.C. §3-417(a).

Example: The depositary bank, rather than the drawer bank, was liable for payment made on altered check, even though the drawer bank destroyed the paper check, absent a showing that the check was forged, rather than altered, or that duplication of the entire check, rather than just physical alteration of the payee's name on the original check, was a common method of bank fraud. Wachovia Bank, N.A. v. Foster Bancshares, Inc., 457 F.3d 619 (7th Cir. Ill.) (2006).

a. **Measure of damages:** The basic measure of damages for breach of a warranty made to the drawee is an amount equal to the amount paid less the amount that the drawee is entitled to receive from the drawer plus expenses and loss of interest arising from the breach. U.C.C. §4-208(b); U.C.C. §3-417(b). Although no express provision authorizes them, attorneys' fees are not necessarily excluded. U.C.C. §3-417, Official Comment 5. The drawee may have the right to recover attorneys' fees under the phrase “expenses . . . resulting from the breach.” U.C.C. §3-417, Official Comment 5.

b. **Drawer's negligence may be asserted against payor bank:** If the payor bank could have asserted against the drawer that the drawer was negligent, the person against whom the payor bank is bringing the breach of presentment warranty action may assert the drawer's negligence as a defense to the payor bank's action. U.C.C. §4-208(c); U.C.C. §3-417(c).

4. **2002 amendments:** A new presentment warranty has been added as remotely created consumer items under which the person obtaining the payment or acceptance and prior transferors warrant, as to remotely created consumer items, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. The effect of this warranty is to impose ultimate liability on the depositary bank that accepted the unauthorized remotely created item rather than on the payor bank, which had no means of determining whether it was authorized. This warranty applies not only when the item is unauthorized, but also when the consumer authorized the item in a different amount than that in which payment was made. [Rev] U.C.C. §3-417(a)(4); [Rev] U.C.C. §4-208(a)(4).

5. **Warranties made to other payors:** Any payor, other than a drawee of an unaccepted draft, receives only the warranty that the warrantor is entitled to enforce the instrument or is authorized to obtain payment on behalf of a person entitled to enforce the instrument. U.C.C. §4-208(d); U.C.C. §3-417, Official Comment 4.

   a. **Persons entitled to warranty:** These payors include drawers or indorsers to whom a dishonored draft has been presented for payment, makers of notes, and acceptors of drafts. U.C.C. §4-208(d); U.C.C. §3-417(d).

   b. **No warranty as to unauthorized signature:** Neither the drawer nor the maker is given a warranty that the presenter lacks knowledge of the unauthorized nature of the maker's or drawer's signature. U.C.C. §3-417, Official Comment 4.

      Rationale: A drawer or maker should be able to determine whether her signature is authentic. U.C.C. §3-417, Official Comment 4.

      Note: Even absent a warranty, a drawer or maker could recover, under U.C.C. §3-418(a) or (b), any payment made to a presenter who had knowledge of the forgery at the time she took the instrument. Having such knowledge, the presenter would not have taken the instrument in good faith, and therefore, would not be protected under U.C.C. §3-418(c).

c. **Warranty not given to acceptor:** No warranty is made to the acceptor of a draft that the warrantor lacked knowledge of the unauthorized nature of the drawer's signature.

Note: The acceptor as the drawee of an unaccepted draft is given a warranty that the warrantor lacked knowledge as to the unauthorized nature of the drawer's signature. U.C.C. §3-417, Official Comment 4. As a result, the acceptor may recover both from the person presenting the draft for acceptance, if she knew of the unauthorized nature of the drawer's signature, and from persons who transferred the draft prior to its acceptance who had such knowledge. U.C.C. §3-417, Official Comment 4. The acceptor could also recover under U.C.C. §3-418(a) from any person, presenting the acceptance for payment, who had knowledge of the unauthorized nature of the drawer's signature when she took the acceptance.

d. **Accrual and notice of breach:** A cause of action for breach of a presentment warranty accrues when the claimant has reason to know of the breach. U.C.C. §4-208(f); U.C.C. §3-417(f). The breach occurs when the item is paid or accepted. Notice of a claim for breach of a presentment warranty must be given to the warrantor within 30 days after the claimant had reason to know of the breach and could ascertain the warrantor's identity. Failure to give notice discharges the warrantor's liability to the extent of any loss caused by the delay in giving notice of the claim. U.C.C. §4-208(e); U.C.C. §3-417, Official Comment 7.

G. **Recovery by payor of payment made by mistake:** Even absent a presentment warranty, the payor may be able to recover the mistaken payment from its recipient under U.C.C. §3-418. A drawee who pays a draft on a mistaken belief may recover the amount of the draft from the person to whom payment was made or for whose benefit payment was made. U.C.C. §3-418(a); U.C.C. §3-418, Official Comment 1. The drawee can revoke its acceptance in the identical circumstances that it could recover the payment had payment been made instead.

1. **Typical mistakes:** Typical mistaken payments by a drawee include payment over a forged drawer's signature, payment of a check drawn on insufficient funds, and payment over a valid stop payment order.

2. **Protected persons under U.C.C. §3-418:** Payment may not be recovered from a ***protected person***. U.C.C. §3-418(c). There are two classes of protected persons.

   a. **Good-faith takers for value:** The first class includes any person who takes the instrument in good faith and for value. U.C.C. §3-418(c).

   b. **Good-faith reliance:** The second class includes any person who has, in good faith, changed position in reliance on the payment. U.C.C. §3-418(c).

      Note: The issue is not whether the person acted in good faith in the transaction in which he acquired the instrument, but whether his act of reliance on the payment is in good faith. A person who obtains payment with knowledge of the mistake does not act in good faith when he changes position in reliance on the payment.

3. **Consequences when payment is recovered:** In the event that payment is recovered, the instrument is treated as having been dishonored. The person from whom payment is recovered is given the rights of a person entitled to enforce the dishonored instrument. U.C.C. §3-418(d); U.C.C. §3-418, Official Comment 2. As a result, this person can enforce the instrument against the drawer, maker, or indorser just as if the instrument had been dishonored on its initial presentment.

H. Conversion: Article 3 expressly states that the law of conversion of personal property applies to instruments. In addition, Article 3 specifically provides that certain acts constitute conversion. U.C.C. §3-420.

1. **When taking by transfer constitutes conversion:** An instrument

is converted if it is taken by transfer, other than by negotiation, from a person not entitled to enforce the instrument. U.C.C. §3-420(a). Because an instrument payable to bearer is negotiated by transfer of possession alone, there can be no conversion of an instrument payable to bearer. When an instrument is payable to the order of a specified person, that person must indorse the instrument for it to be negotiated. Therefore, if an instrument is transferred without the indorsement of the person to whom it is payable, it may be converted.

Exception: An instrument is not converted if the transferee is a person entitled to enforce the instrument because he is a transferee of a holder.

Example: If Jim had transferred the check to Don but had neglected to indorse the check, Don, being a transferee of a holder, would be a person entitled to enforce the check. Gene, therefore, would not be liable for conversion.

2. **When payment constitutes conversion:** An instrument is converted if a payor bank, or other payor, makes payment with respect to the instrument to a person not entitled to enforce the instrument or to receive payment. U.C.C. §3-420(a).

Example: If Bank of America makes payment of a check bearing Jim's unauthorized indorsement, Bank of America has converted the instrument. This would also be true if Gene was not a person entitled to enforce the instrument because Jim's indorsement was missing.

3. **When taking instrument by agent is conversion:** A person who holds an instrument solely as a representative of another person (other than a depositary bank) who has, in good faith, dealt with an instrument or its proceeds on behalf of one who was not the person entitled to enforce the instrument is not liable in conversion or otherwise beyond the amount of any proceeds that it has not paid out. U.C.C. §3-420(c).

Example: A messenger who was not aware that the person for whom he was acting was not entitled to enforce the instrument is not liable for conversion. If the messenger retains a portion of the proceeds, he is liable for the amount retained.

4. **Taking instrument for collection:** Although a depositary bank acts as its customer's agent in collecting the instrument, a depositary bank is liable for conversion whether or not it acts in good faith or retains any of the proceeds from the check. U.C.C. §3-420(c). An intermediary collecting bank is relieved of liability for conversion when it acts in good faith and retains none of the proceeds from the check.

   Example: If Gene deposits the check in his account at Wells Bank, which transfers the check for collection to First Interstate Bank, Wells Bank, but not First Interstate Bank, would be liable for conversion.

   Rationale: By having only the depositary bank, and not intermediary banks, liable for conversion, the loss falls on the person who would ultimately suffer the loss without having to involve intermediary banks (and possibly the payor bank) in the action. Had Jim sued the payor bank, the payor bank would have recovered from the intermediary bank for breach of its presentment warranty. The intermediary bank would recover from the depositary bank for breach of its transfer warranty that it is a person entitled to enforce the instrument. By allowing Jim, the owner, to directly sue the depositary bank, these other two banks are relieved of the burden of unnecessary litigation.

5. **Who may bring an action for conversion?** The proper party to bring an action for conversion of an instrument is the person who, before the theft or loss, was the person entitled to enforce the instrument.

   a. **Delivery required:** A payee may bring the action only if the instrument has been delivered to him. U.C.C. §3-420(a)(ii); U.C.C. §3-420, Official Comment 1.

      Example: If the check had not been delivered to Jim, he would have no property rights in the check and, thus, may not bring an action for conversion. Until the instrument has been delivered, Jim still retains the right to sue the drawer on the underlying obligation. U.C.C. §3-420, Official Comment 1.

b. **Issuer has no right to bring action for conversion:** An action for conversion may not be brought by the drawer, acceptor, or other issuer of the instrument. U.C.C. §3-420(a)(i).

Example: Assume, in our example above, that before the check was delivered to Jim, the check was stolen from the mail. The check is cashed by the thief. Bank of America debits the drawer's account and remits the funds to Wells Bank. The drawer may not sue Wells Bank for conversion. Because the indorsement was forged, Bank of America has no right to debit the drawer's account. The drawer's remedy is against Bank of America for recrediting of his account. The drawer, therefore, suffers no loss from the improper payment and cannot sue the depositary bank.

6. **Defenses to conversion action:** The person sued for conversion may defend by proving that the forged indorsement is effective as the indorsement of the owner. This may be accomplished by proving that the owner's negligence substantially contributed to the making of the forged indorsement (U.C.C. §3-406(a)), that the owner is precluded by estoppel or ratification from denying that the indorsement is authentic, that the owner has received the proceeds from the instrument, or that the indorsement is effective under U.C.C. §3-404 (Impostors and Fictitious Payees) or U.C.C. §3-405 (Employer's Responsibility for Indorsements by Employees).

7. **Measure of damages for conversion:** The measure of damages for conversion is presumed to be the amount payable including interest, but recovery may not exceed the amount of plaintiff's interest in the instrument. U.C.C. §3-420(b); U.C.C. §3-420, Official Comment 2. The defendant may prove liability in a lesser amount by introducing evidence of the insolvency of all of the obligors or proving a defense that is valid against the owner. Because conversion is a tort, punitive damages may be available in an appropriate case. *See* McAdam v. Dean Witter Reynolds, Inc., 896 F.2d 750 (3d Cir. 1990) (account executive of Dean Witter

forged indorsements of checks payable to its customers. Depositary bank cashed checks for account executive in amounts as large as $475,000. Bank was in bad faith because it deliberately broke its own rules. Jury award of punitive damages affirmed.).

8. **Statute of limitations for conversion:** The statute of limitations on an action for conversion of an instrument expires 3 years after the cause of action accrues. The cause of action accrues when the act of conversion occurred. In the case of a payor, the cause of action accrues on the date of payment. In the case of a purchaser, the cause of action accrues on the date of his purchase. U.C.C. §3-118(g). The discovery rule, which provides that a cause of action accrues when the plaintiff knew or, in the exercise of ordinary diligence, could have discovered that an injury had been sustained as a result of the act of another, should not apply to claims for conversion of a negotiable instrument. Auto-Owners Ins. Co. v. Bank One, 852 N.E.2d 604 (Ind. App. 2006).

I. **Application of rules when signature of maker or acceptor unauthorized:** The allocation of loss when an instrument bears the unauthorized signature of the maker or acceptor depends, to a large degree, on whether the maker or acceptor pays the instrument. The same analysis applies when a draft is presented to the drawer itself for payment or acceptance.

1. **When payment not made:** In the absence of estoppel, ratification, or negligence, the maker or acceptor is not liable on an instrument on which his signature is forged or unauthorized because he did not sign the instrument. U.C.C. §3-401(a). Thus, the person presenting the note or acceptance for payment will suffer the loss unless that person can recover from a prior transferor on the warranty that all signatures are authentic or authorized.

2. **When payment made:** If the maker or acceptor makes payment, the maker or acceptor will suffer the loss if the person to whom payment is made is a protected person under U.C.C. §3-418. Neither the maker nor the acceptor is given a presentment warranty as to the authenticity of his own signature.

J. **Application of rules when signature of drawer unauthorized:**

When the signature of the drawer is forged or otherwise unauthorized, which party suffers the loss depends in large part on whether the drawee (payor bank in the case of a check) pays the draft (or check).

1. **When drawee makes payment:** When the drawee makes payment of a check or other draft bearing the forged signature of the purported drawer, the drawee will usually suffer the loss. Neither the presenter nor prior transferors warrant that the drawer's signature is genuine. The only warranty they make is that they have no knowledge that the drawer's signature is unauthorized. U.C.C. §4-208(a)(3); U.C.C. §3-417(a)(3). The drawee or payor bank may not debit the account of the drawer because, bearing his unauthorized signature, the draft is not properly payable. The drawee can only recover the mistaken payment from a recipient of the payment who is not a protected party. U.C.C. §3-418(c).

   Rationale: Although it can be argued that a payor bank is in a better position than the holder to determine whether the drawer's signature is valid in that a payor bank may have a sample of its customer's signature, liability is imposed on the payor bank even if the forgery is perfect. The true explanation for imposing the loss on the payor bank lies in history. Lord Mansfield, in Price v. Neal, 97 Eng. Rep. 871 (K.B. 1752), first held that the drawee suffers the loss when it pays a draft over a forged drawer's signature. Thereafter, courts, without question, began following the holding. Banks, being the parties primarily affected by the rule, began obtaining insurance covering this risk. Once banks factored the cost of insurance into the price charged for checking accounts, there became no reason to change the rule.

   2002 amendments: A new presentment warranty has been added as remotely created consumer items under the person obtaining the payment or acceptance and prior transferors warrant, as to remotely created consumer items, that the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn. The effect of this warranty is to impose ultimate liability on the depositary bank that accepted the unauthorized remotely created item rather than on the payor bank, which had no means of determining whether it was authorized. This warranty applies not only when the item is unauthorized, but also when the consumer authorized the item in a different amount than that in which payment was made. [Rev] U.C.C. §3-416, Official Comment 8. As a result, the risk of the item not being authorized by the person upon whose account it was drawn rests on the person initially transferring the item.

2. **When drawee does not make payment:** If the drawee does not make payment, the loss will go back down the chain of title to the first solvent party after the forger (assuming that the forger is not solvent). The mechanism for passing down the loss is the transfer warranty, given by each transferor, that all signatures are genuine and authorized. U.C.C. §3-416(a)(2); U.C.C. §4-207(a)(2).

3. **2002 amendments:** A new transfer warranty has been added as to remotely created consumer items. With respect to a remotely created consumer item, the transferor warrants that "the person on whose account the item is drawn authorized the issuance of the item in the amount for which the item is drawn." [Rev] U.C.C. §3-416(a)(6) and [Rev] U.C.C. §4-208(a)(4). As a result, the risk of the item not being authorized by the person upon whose account it was drawn rests on the person initially transferring the item.

K. Application of rules when indorsement is unauthorized: The rights of the parties when there is an unauthorized indorsement in the chain of title depend on whether the instrument has been delivered to the payee.

1. **Allocation of loss when check not delivered to payee:** When the check or other draft has not been delivered to the payee, the payee has no right to sue for conversion of the check. U.C.C. §3-420(a). The payee still retains whatever rights she had against the drawer on the underlying obligation for which the check was taken. Similarly, the drawer has no right to sue the depositary or other collecting bank for either conversion, U.C.C. §3-420(a), or for breach of the presentment warranty that it is a person entitled to enforce the instrument. U.C.C. §3-417, Official Comment 2. The drawer has not suffered a loss because the payor bank has no right to debit her account. The allocation of loss is the same whether or

not payor bank pays the check. Upon payment of the check, the payor bank may recover the amount paid from the presenting bank and prior transferors for breach of their presentment warranty that they are a person entitled to enforce the instrument. U.C.C. §4-208(a)(1); U.C.C. §3-417(a)(1). The loss flows back to the first solvent transferor following the forgery because each transferor warrants that it is a person entitled to enforce the instrument. U.C.C. §4-207(a)(1).

Example: Assume a check payable to Paula is drawn by Dan on his account at Security Bank. Fred steals the check prior to its delivery to Paula. Fred forges Paula's indorsement and cashes the check with Local Grocer, who deposits the check in his checking account at Wells Bank, which sends the check for collection to Crocker Bank, which presents it for payment to Security Bank. Security Bank pays the check. Because the check was not delivered to Paula, Paula has no rights to, or on, the check. However, Paula retains whatever rights she had against Dan on the underlying obligation. Security Bank cannot debit Dan's account because the check was not properly payable. Security Bank's recourse is against Crocker Bank, Wells Bank, or Local Grocer for breach of their presentment warranty that they are a person entitled to enforce the instrument. Crocker Bank may recover from Wells Bank or Local Grocer on their transfer warranty that they are a person entitled to enforce the instrument. If Crocker Bank recovers from Wells Bank, Wells Bank, in turn, can recover from Local Grocer for breach of its transfer warranty.

Note: If the draft or check is dishonored, each transferee in turn will have the same right to recover from prior transferors on their transfer warranty that they are a person entitled to enforce the instrument. U.C.C. §3-416(a)(1); U.C.C. §4-207(a)(1).

2. **Allocation of loss after delivery to payee:** After delivery of the draft or check to the payee, the payee's rights depend on whether the instrument has been paid.

   a. **Payee's rights if instrument not paid:** If the check is still missing, the payee may recover on the check from the drawer by complying with the requirements for the enforcement of lost, destroyed, or stolen instruments. U.C.C. §3-309. However, the payee may not recover from the drawer on the underlying obligation. U.C.C. §3-310(b)(4); U.C.C. §3-310, Official Comment 4. If the check is found prior to payment, the payee may recover possession of the check from the possessor. Because her indorsement is forged, no subsequent possessor can qualify as a holder in due course. As a result, any subsequent possessor would take subject to the payee's claim of ownership. Once the payee recovers possession of the check, she may present the check for payment, and, if it is not paid, she can recover from the drawer on either its drawer's contract or on the underlying obligation. The party required to return the check can then recover from her transferor and any prior transferors for breach of their transfer warranty that they are a person entitled to enforce the draft. U.C.C. §3-416(a)(1); U.C.C. §4-207(a)(1).

Example: Assume, in our example above, that Fred Forger steals the check from Paula Payee, forges Paula Payee's indorsement, and cashes the check with Local Grocer, which deposits the check in its own account at Wells Bank. Paula recovers possession of the check from Wells Bank. Wells Bank can recover from Local Grocer for breach of its transfer warranty that it is a person entitled to enforce the instrument. U.C.C. §4-207(a)(1).

b. **Payee's rights if instrument paid:** If the check is paid, the payee may recover from the payor bank, the depositary bank, or any nonbank transferor for conversion. U.C.C. §3-420(a); U.C.C. §3-420, Official Comment 3. Ultimately, the first solvent party after the person who made the unauthorized indorsement will bear the loss. The payor bank can recover from the presenter or prior transferors for breach of their presentment warranty that they are a person entitled to enforce the instrument. U.C.C. §4-208(a)(1). Each transferee can recover from prior transferors for breach of their transfer warranty that they are a person entitled to enforce the instrument. U.C.C. §3-416(a)(1); U.C.C. §4-207(a)

(1).

II. ALTERATIONS AND INCOMPLETE INSTRUMENTS

A. **What is an alteration?** An alteration is any unauthorized change in an instrument that attempts to modify in any respect the obligation of any party. U.C.C. §3-407(a). Any change in the terms of an instrument that changes the contract of any party is an alteration. In addition, any unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of any party is also an alteration. U.C.C. §3-407(a).

> **Example:** Polly draws a check in the amount of $50 payable to Jean. Jean alters the check by raising the amount to $500 and negotiates the check to Dentist in payment of her bill. By raising the amount of the check from $50 to $500, Jean has altered the check. It would also be an alteration if Jean changed the date of the check or the payee's name.

Note: Any change, no matter how small or benign, is an alteration. An increase in the amount payable by one penny is an alteration. Similarly, a reduction in the amount payable is also an alteration.

B. **Allocation of loss in case of alteration:** In the absence of his own negligence, assent, or preclusion, a party who signs an instrument only promises to pay the instrument according to its terms at the time he signed the instrument. U.C.C. §3-412; U.C.C. §3-413(a); U.C.C. §3-414(b); U.C.C. §3-415(a).

> **Example:** Return to our example above. Assume that Dentist deposits the check in her account at Wells Bank, which presents the check to Bank of America. Bank of America pays the check and debits Polly's account. Because the check was payable for $50 when Polly signed it, Bank of America may only debit Polly's account in the amount of $50. In the event that Bank of America had refused to pay the check, Wells Bank could recover only $50 from Polly. However, because Jean and Dentist indorsed the check when it was payable in the amount of $500, Wells Bank could have recovered $500 from either of

these parties.

1. **Preclusion to assert alteration:** A party whose failure to exercise ordinary care substantially contributes to an alteration is precluded from asserting the alteration as against a person who in good faith pays the instrument or takes it for value or collection. U.C.C. §3-406(a). In addition, a party who assents to the alteration or a party who is otherwise precluded from asserting the alteration may be liable on the instrument as altered. U.C.C. §3-407(b); U.C.C. §3-407, Official Comment 1.

2. **Payment by drawee:** In the case of a check or other unaccepted draft, the allocation of loss *does not* depend on whether the drawee has paid or accepted the draft. If the drawee pays the draft, the drawee may debit the drawer's account only in the amount for which the draft was originally drawn by the drawer unless the drawer is negligent or otherwise precluded from asserting the alteration. U.C.C. §4-401(d)(1). In the absence of grounds for precluding the drawer, the drawee may recover from any person obtaining payment or acceptance or any previous transferor for breach of the presentment warranty that the draft has not been altered. U.C.C. §3-417(a)(2); U.C.C. §4-208(a)(2). The party from whom the drawee recovers can recover from his transferor and any prior transferors for breach of their transfer warranty that the draft had not been altered. U.C.C. §3-416(a)(3); U.C.C. §4-207(a)(3).

   Example: In our example, Bank of America may only debit Polly's account in the amount of $50. Bank of America may recover the remaining $450 from Wells Bank, Dentist, or Jean. Wells Bank can recover from either Dentist or Jean.

3. **When drawer, maker, or acceptor pays:** When either the drawer, maker, or acceptor makes the payment, the party making payment will suffer the loss if payment has been made to a person protected under U.C.C. §3-418(c). This is because no warranty is given to the drawer, maker, or acceptor that the instrument has not been altered. U.C.C. §3-417, Comment 4.

Rationale: These individuals should know what the terms of the instrument were at the time they signed it and should not pay the instrument if it has been altered. U.C.C. §3-417, Comment 4.

Example: Assume that a note is made in the amount of $50 by Sam and payable to Gabriel. Gabriel raises the note to $500 and negotiates the note to Hank for value. Hank presents the note to Sam for payment. If Sam recognizes that the note has been altered and refuses to pay Hank, Hank can recover only $50 from Sam. Hank must recover the remaining money from Gabriel for breach of his transfer warranty that the note has not been altered. However, if Sam pays the note for the entire $500, he may have to suffer the loss unless he can recover from Gabriel. Hank does not warrant to Sam that the note has not been altered. Sam may have the right to recover the $450 from Hank under U.C.C. §3-418 if the law of restitution allows such recovery, but only if Hank does not qualify as a person who took the instrument in good faith and for value or has not, in good faith, changed position in reliance on the payment. U.C.C. §3-418(b), (c).

4. **When instrument not paid:** If an instrument is not paid, the person entitled to enforce the instrument may recover from any prior transferors for breach of their transfer warranty of no alteration and, in addition, may recover up to the amount for which the instrument was payable at the time of their engagement against prior indorsers, the maker, the drawer, or the acceptor. U.C.C. §3-415(a); U.C.C. §3-412; U.C.C. §3-414(b); U.C.C. §3-413(a).

Example: In our earlier example, Wells Bank can recover $50 from Polly. It can recover $450 from Jean or Dentist on their transfer warranty that the instrument has not been altered. It can recover $500 from either Jean or Dentist on their indorser's contract.

C. **Discharge of party whose obligation is affected:** A fraudulently made alteration discharges a party whose obligation is affected by the alteration unless that party assents to the alteration or is precluded from asserting the alteration. When an alteration is not fraudulent, the instrument may be enforced according to its original terms. U.C.C. §3-407(b).

Example: In our earlier example, Gabriel cannot enforce the instrument whatsoever against Sam.

Rationale: The party affected is discharged as a means of discouraging the holder from attempting to alter the instrument. The holder is punished for his attempt to gain an advantage from the fraudulent alteration by being completely denied the right to enforce the instrument against the party whose contract has been changed. U.C.C. §3-407(b).

1. **Against whom discharge effective:** Any transferee, other than one who takes the instrument for value, in good faith, and without notice of the alteration, also takes subject to the discharge. U.C.C. §3-407(c); U.C.C. §3-203(b). A payor bank or other drawee paying a fraudulently altered instrument or a person taking it for value, in good faith, and without notice of the alteration may enforce the instrument according to its original terms. U.C.C. §3-407(c); U.C.C. §3-407, Official Comment 2.

   Example: From our earlier example, if Hank took the instrument for value, in good faith, and without notice of the alteration, he could recover $50 from Sam. Otherwise, he would simply stand in Gabriel's shoes and recover nothing from Sam.

2. **Alteration must be fraudulent:** An alteration does not discharge the party whose obligation is affected unless the alterer had a fraudulent intent in making the alteration. U.C.C. §3-407(b); U.C.C. §3-407, Official Comment 1. An alteration is fraudulent when the alterer intends to achieve an advantage for himself to which he has reason to know he is not entitled.

   Example: If the holder erroneously believes that the party has authorized or consented to the alteration or that he has the right to alter the instrument to reflect the true agreement of the parties, the fact that no such consent or authorization actually exists or that he has no such right does not make the alteration fraudulent U.C.C. §3-407, Official Comment 1.

D. Incomplete instruments: When the signer intends that the instrument as signed be completed by the addition of words or numbers, the instrument is called an incomplete instrument. For an instrument to be an incomplete instrument, it must contain a blank space for the missing term to be inserted. U.C.C. §3-115(a). The effect of completing an incomplete instrument depends on whether the completion was authorized.

1. **When completion authorized:** When the completion of an incomplete instrument is authorized, the instrument may be enforced as completed. U.C.C. §3-115(b).

   Example: Assume that you authorize your neighbor to write a check up to $500 for the repair of your furnace. If your neighbor fills in the sum of $400, the check may be enforced in the amount completed. The payor bank that pays the check may debit your account for $400. U.C.C. §4-401(d)(2); U.C.C. §4-401, Official Comment 4.

2. **When completion unauthorized:** When the completion is unauthorized, a payor bank acting in good faith may enforce the instrument as completed. U.C.C. §3-407(c). Similarly, a person taking the instrument for value, in good faith, and without notice of the improper completion may enforce the instrument according to its terms as completed. U.C.C. §3-407(c). As to any other persons, the obligor is discharged and, therefore, is not liable on the instrument at all. U.C.C. §3-407(b).

   Example: In our example above, assume that your neighbor filled in the check for $600. Even though the completion was unauthorized, the payor bank may debit your account for the entire $600. Assuming that the payor bank refused to pay the check, if the repair company is unaware of this limitation, it could enforce the check for the entire $600.

Rationale: By leaving open a blank or space, the issuer has made it easy for the alterer to pass off the completion as authentic. For this reason, the issuer takes the risk that the instrument will be completed contrary to his authority.

III. GROUNDS OF PRECLUSION

A. Introduction: There are many grounds that can cause an unauthorized signature or alteration to be treated as though it was authorized: ratification (U.C.C. §3-403(a)), estoppel (U.C.C. §1-103), negligence (U.C.C. §3-406), failure of customer to examine her bank statement (U.C.C. §4-406), making instrument payable to impostor or fictitious payee (U.C.C. §3-404), and employer's responsibility for fraudulent indorsement by an employee (U.C.C. §3-405).

B. Ratification: An unauthorized signature may become effective as the signature of the person whose name is signed if ratified by that person. U.C.C. §3-403(a). ***Ratification*** is the election by the person whose name is signed to treat the unauthorized signature as though it were originally authorized by her. U.C.C. §3-403, Official Comment 3. The law of agency of the subject jurisdiction determines whether a person has ratified an unauthorized signature.

C. Estoppel: A party may be estopped to deny the authenticity of a signature. A party is estopped when she represents that the signature is authentic and the holder or payor relies to her detriment on such representation. U.C.C. §1-103.

D. Preclusion through negligence: A person whose failure to exercise ordinary care substantially contributes to an alteration or to the making of a forged signature is precluded from asserting the alteration or forgery against a person who, in good faith, pays the instrument or takes it for value or for collection. U.C.C. §3-406(a). The party claiming that the negligent party is precluded from asserting that the unauthorized signature or alteration is not effective must prove two separate elements: (a) that the party to be precluded failed to exercise ordinary care and (b) that the failure substantially contributed to the making of the forged signature or alteration.

1. **Who may assert the preclusion?** Three classes of persons may assert the preclusion:

   - any person who in good faith pays the instrument,
   - any person who in good faith takes the instrument for value, or
   - any person who in good faith takes the instrument for collection. U.C.C. §3-406(a); U.C.C. §3-406, Official Comment 1.

2. **Comparative negligence:** The party who is negligent may prove that the person asserting the preclusion, whether it be the payor bank, depositary bank, or holder itself, failed to exercise ordinary care and that the failure substantially contributed to the loss. In this event, the loss is allocated according to principles of comparative negligence. U.C.C. §3-406(b). The Code gives, however, absolutely no guidance as to how this split should take place.

3. **Failure to exercise ordinary care:** ***Ordinary care*** in the case of a person engaged in business means the observance of the reasonable commercial standards prevailing in the area in which the person is located with respect to the business in which the person is engaged. U.C.C. §3-103(a)(7).

   a. **Tort test of negligence:** The test as to whether a party has exercised ordinary care is the traditional tort test for negligence: whether the party's actions were reasonable considering the foreseeability of the loss, the magnitude of the potential loss, and the cost of the means required to eliminate the risk of loss. The following are some typical situations of negligence.

      i. **Giving check to third party:** In some situations, giving a check to a third party for delivery to the payee so greatly increases the possibility of a forgery that the drawer will be precluded from asserting the subsequent forgery. Whether the drawer has failed to exercise ordinary care depends on the likelihood that, under the circumstances, the third party would forge the payee's indorsement.

      ii. **Careless business practices:** Careless business practices can result in an increased possibility of forgery.

      Example: A company fails to exercise ordinary care when it allows a signature stamp to be accessible to nonauthorized personnel even though the stamp is not used by the drawer to sign checks. Use of the signature stamp by the nonauthorized personnel would give the appearance to third parties that the drawer had, in fact, signed the check.

      iii. **Negligence in hiring or supervising employees:** An employer may also be precluded from denying the effectiveness of a signature forged by an employee if the employer has failed to exercise ordinary care in either hiring or supervising the employee.

Example: A company should not, without good reason, hire a bookkeeper who has a background of forgery or embezzlement or who has a gambling or drug problem. If such a bookkeeper is hired, she should be watched carefully.

Example: When a bookkeeper is authorized both to write checks and to reconcile the books, a periodic audit by another person should be performed.

iv. **Guarding check forms:** It is unlikely that a court would hold a drawer to have failed to exercise ordinary care simply because she was not careful in guarding her blank check forms. This is because anyone can have checks printed up with another person's name and account number imprinted on them. Losing a checkbook without the loss of accompanying identification does not greatly increase the chance of a forgery.

v. **Preventing alterations:** A party has a duty to use reasonable care in drawing or making an instrument such that it cannot be easily altered. U.C.C. §3-406, Official Comment 1.

Example: When the numbers or words signifying the amount due on an instrument are written so as to leave space open for additional words or numbers to be inserted, the party drawing or making the instrument will usually be found to have failed to exercise ordinary care. U.C.C. §3-406, Official Comment 3, Case No. 3. If the instrument reads "in the amount of _______ two dollars," a subsequent party can add the words "two thousand and," thereby easily raising the amount to $2,002.

b. **Failure of payor bank to exercise ordinary care:** A drawer who is precluded from asserting that a signature is unauthorized may attempt to prove that the payor bank also failed to exercise ordinary care so as to cause the loss to be split between them under the principle of comparative negligence.

i. **When indorsement forged:** Whether the payor bank has failed to exercise ordinary care in discovering a forged indorsement depends, to a large extent, on whether the payor bank is also the depositary bank.

- When the payor bank is also the depositary bank or when the item is presented over the counter for payment, the bank fails to exercise ordinary care if it does not discover obvious irregularities in the identification of the person presenting the item for payment. *See* Consolidated Pub. Water Supply Dist. No. C-1 v. Farmers Bank, 686 S.W.2d 844 (Mo. Ct. App. 1985) (payor bank that cashes checks payable to corporation containing handwritten indorsements may be found to have not acted in accordance with reasonable commercial standards).

- Unless the payor bank is also the depositary bank, it is unlikely that it will be found to have failed to exercise ordinary care. The payor bank has no duty to determine whether every indorsement in the chain of title is present and authentic. A payor bank cannot know if an indorsement is forged and, thus, may rely on the presenting bank's guaranty of prior indorsements in paying the check.

ii. **When drawer's signature forged:** Because the payor bank has a copy of its customer's signature, there is at least some possibility that the payor bank may be able to detect a forgery of the drawer's signature. When payor banks used to visually examine a check in the process of deciding whether to pay the check, the payor bank had a duty to use ordinary care to discover any forgery or alteration. However, few banks now visually examine any checks other than extremely large ones. As a result, there is no way in which the bank will discover the forgery. To allow banks to achieve the efficiency available only by computer processing, the Code has provided a special rule when checks are processed by computer.

Even when there is an obvious forgery of the drawer's signature and the bank does not discover it because it processes checks for payment by computer without visually inspecting the checks, the bank still exercises ordinary care as long as "the failure to examine such instrument does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by Article 3 or Article 4." U.C.C. §3-103(a)(7). [[Rev] U.C.C. §3-103(a)(9).]

4. **Substantially contributes:** For the failure to exercise ordinary care to preclude the negligent party, the failure must substantially contribute to the making of the forgery or alteration. U.C.C. §3-406(a).

Example: The simplest case in which the failure to exercise ordinary care substantially contributes to a forgery is when the drawer is negligent in allowing unauthorized personnel access to a facsimile signature machine. By allowing such access, the forgery, looking identical to an authentic signature, is impossible to detect.

a. **Test:** Although the negligence does not have to make detection of the forgery or alteration more difficult, as in the example of the facsimile signature machine, the negligence must have been a contributing cause and a significant factor in enabling the forgery or alteration to have been made. U.C.C. §3-406, Official Comment 2.

Example: When Brother and Sister are in a bitter estate contest and Brother is in dire need of money, Drawer's negligence in handing a check to Brother for delivery to Sister would be a significant factor and a contributing cause in Brother's forging Sister's indorsement. Although Brother still has to convince a subsequent purchaser (or the payor) that Sister's indorsement is authentic, Drawer's negligence in delivering the check to a person of questionable integrity made the forgery more likely.

b. **Does not significantly increase likelihood of loss:** If the negligence has no effect on the likelihood of the forgery or alteration being made or of its success, the negligence will not have substantially contributed to the making of the forgery or alteration.

Example: Generally, the mailing of a check to a person other than the payee does not substantially contribute to the resultant forgery even though it may constitute the failure to exercise ordinary care. The forger must still convince the purchaser or payor that she is the payee. When the check is mailed to a different person having the same name as the intended payee, however, the ability of the forger to pass herself off as the payee is greatly increased. Thus, if the sender fails to exercise ordinary care in sending the check to a person bearing the same name as the payee, the sender's failure will be deemed to substantially contribute to the forged indorsement. U.C.C. §3-406, Official Comment 3, Case No. 2.

E. **Impostors, fictitious payees, and employer's responsibility for unauthorized indorsements by employees:** There are three situations in which, even absent proof of any specific negligence regarding the instrument, a forged indorsement is deemed to be effective to negotiate the instrument. In any of these three situations, if the person taking the instrument or paying the instrument is negligent, comparative negligence principles apply to split the loss.

1. **The impostor rule:** ***Impostor*** is defined as a person who "by use of the mails or otherwise induces the issuer to issue the instrument to the impostor, or to a person acting in concert with the impostor, by impersonating the payee of the instrument or a person authorized to act for the payee." U.C.C. §3-404(a).

Rationale: Impostors are subject to a separate rule because the drawer has made it extremely likely that the check will be cashed on a forged indorsement. The impostor chose the name either because she has already established a bank account under the chosen name or because she believes that she has other means of successfully cashing the check. The drawer's fault in not making sure that he was dealing with the real payee allowed the impostor to accomplish her fraud.

a. **What is an impostor?** An impostor is one who represents herself to be the named payee or a person authorized to act for the named payee and, by such representation, induces the issuer to issue the instrument to her or to a person acting in concert with her. U.C.C. §3-404, Official Comment 1. In essence, the drawer or maker is deemed to have made the instrument payable to the impostor under the assumed name of the named payee.

   Example: Ivan Impostor is an impostor if he pretends to be Newt Gingrich and asks the drawer to give him a check for his upcoming Congressional campaign. Ivan Impostor would also be an impostor if he claimed that he was a member of Gingrich's campaign committee and asked for a check payable to Gingrich. In contrast, if Ivan steals a check intended for Gingrich from the drawer's mailbox and, thereafter in cashing the check, pretends to be Gingrich, the impostor rule would not apply.

b. **Purports to be agent:** A person is also an impostor when she falsely represents herself to be the agent of the named payee. U.C.C. §3-404(a).

c. **Manner of impostor:** The impostor rule applies whether the impostor acts in person, by mail, by telephone, or otherwise. U.C.C. §3-404(a). The manner of the imposture is irrelevant.

   Example: If, on receipt of a campaign contribution solicitation letter from Ivan Impostor, signed by him under the name of Newt Gingrich, the drawer mails a check payable to Newt Gingrich to the designated address, any person's indorsement in the name of Newt Gingrich will be sufficient to negotiate the check.

   Example: Courts differ as to whether the impostor rule applies when Wife, in filling out a loan application, forges Husband's signature and then forges Husband's indorsement on a check payable to Husband. Compare Broward Bank v. Commercial Bank, 547 So. 2d 687 (Fla. Dist. Ct. App. 1989) (impostor rule does not apply because husband took home papers for loan, brought them back with appearance of his wife's signature, and thereafter forged his wife's indorsement on check) with Franklin Natl. Bank v. Shapiro, 7 U.C.C. Rep. Serv. 317 (N.Y. Sup. Ct. 1970) (impostor rule applies because wife forged husband's signature on loan documents and on check).

d. Need for indorsement: An indorsement by any person in the name of the payee is effective in favor of a person who in good faith pays the instrument or takes it for value or for collection. U.C.C. §3-404(a). The indorsement need not be in the exact name of the payee as long as it is in a name substantially similar to that of the named payee. U.C.C. §3-404(c). As long as the instrument is deposited in a depositary bank to an account in a name substantially similar to that of the payee, the depositary bank is the holder of the instrument regardless of whether the instrument is indorsed. U.C.C. §3-404(c)(ii).

e. When indorsement effective: An indorsement by any person in the name of the payee is effective to negotiate the instrument, thus making the indorsee the holder.

Example: Assume, in our example above, that Ivan Impostor indorses the check to Local Grocer, who deposits the check into his bank account at Wells Bank, which presents the check for payment to Bank of America. Bank of America pays the check. Because Ivan's indorsement in the name of Newt Gingrich is effective, Local Grocer and Wells Bank are persons entitled to enforce the instrument. Neither Local Grocer nor Wells Bank breach their presentment warranty to Bank of America that they are persons entitled to enforce the check. Likewise, being persons entitled to enforce the check, their taking of the check is not conversion. On its payment to Wells Bank, Bank of America may charge the drawer's account.

i. Good faith required: A payor or taker who does not act in good faith may not assert that the indorsement is effective. U.C.C. §3-404(b)(2).

ii. Comparative negligence: When the taker or payor is negligent, the loss is allocated under comparative negligence principles between the drawer and the negligent party. U.C.C. §3-404(d); U.C.C. §3-404, Official Comment 3.

Example: Assume that Ivan Impostor had deposited the check in an account under the name of Newt Gingrich that Ivan had opened at Wells Bank. If Wells Bank had allowed Ivan to establish a bank account in the name of Newt Gingrich without asking for any identification, Wells Bank's negligence would have contributed to Ivan Impostor's ability to accomplish his mischief. As a result, Drawer has a cause of action against Wells Bank to recover a portion of the loss. U.C.C. §3-404, Official Comment 3.

2. **Fictitious payee rule:** A ***fictitious payee*** is a person who is either not intended to have any interest in the instrument or is nonexistent. U.C.C. §3-404(b). When a drawer or maker issues an instrument payable to a fictitious payee, the maker or drawer will usually suffer any resulting loss.

   a. **What is a fictitious payee:** A payee is regarded as a fictitious payee in three distinct situations. In all these situations, the person signing as or on behalf of the drawer or the maker, intended that the payee have no interest in the instrument:

      i. **Nonexistent payee:** The person identified as the payee does not in fact exist. U.C.C. §3-404(b)(ii).

      Example: A check payable to Donald Duck does not designate any person who could possibly indorse the instrument.

      Rationale: The drawer is in the best position to determine whether the named payee exists.

      ii. **Payee intended to have no interest:** The maker or drawer issues an instrument intending that the named payee have no interest in the instrument. U.C.C. §3-404(b)(i).

      iii. **Employee signing instrument intends payee to have no interest:** When an agent, employee, or officer signs on behalf of the drawer or maker intending the payee to have no interest in the instrument, the actual signer is usually trying to defraud her employer. The agent, employee, or officer may attempt to hide her activity by padding the payroll or altering the records to show a debt owed to the named payee, or she may make no attempt at all to conceal her activity.

b. Relevant intent is of party making signature: In determining whether a payee is a fictitious payee, it is necessary to look at the intent of the "person whose intent determines to whom an instrument is payable" as determined under U.C.C. §3-110(a) and (b). The intent of the signer of the instrument controls the identification of the person to whom the instrument is payable. It does not matter that the signer is acting on behalf of the maker or drawer or whether or not the person was authorized to make the instrument payable to the person identified by the signer. U.C.C. §3-110(a) and Official Comment 1. Where more than one person signs the instrument as maker or drawer and each signer intends by its designation to indicate a different person as the payee, the instrument is payable to any person intended by any one of the signers. U.C.C. §3-110(a).

c. Form of required indorsement: The same rules as to the need for an indorsement in the case of impostors also apply to fictitious payees except in one particular situation. In the case of a fictitious payee, because no person was the intended payee, any person in possession of the instrument is its holder. U.C.C. §3-404(b)(1).

Example: When Ivan Impostor pretends to be Newt Gingrich and asks the drawer to give him a check for his upcoming Congressional campaign, until an indorsement is made in the name "Newt Gingrich," no person, other than Newt Gingrich, can be its holder. U.C.C. §3-404(a).

d. Who may assert that the indorsement is effective: The same rule applies as in the case of impostors.

e. Double forgeries: When a person who forges the drawer's name also intends that the payee have no interest in the check, the payee is a fictitious payee. U.C.C. §3-404, Official Comment 2, Case No. 4. As a result, the payor bank, rather than the depositary bank, suffers the loss when there is both a forged drawer's signature and a forged indorsement.

Analysis: Because any indorsement in the name of the payee is effective to negotiate the instrument, the depositary bank is a person entitled to enforce the instrument. Therefore, the depositary bank does not breach its presentment warranty to that effect. The payor bank suffers the loss because the check is treated as bearing only a forged drawer's signature.

Example: Thief steals Drawer's checkbook and forges Drawer's signature on a check that Thief makes payable to his sister Agnes. Thief intends that Agnes have no interest in the check. Thus, any indorsement in Agnes's name is effective to negotiate the check. Thief, after signing Agnes's name, deposits the check in his bank account at Wells Bank. Bank of America pays the check. Because Drawer's signature is forged, Bank of America may not debit Drawer's account, nor may it recover from Wells Bank for breach of a presentment warranty. Bank of America therefore suffers the loss.

3. **Employer's responsibility for fraudulent indorsement by employee:** When an employer hires an employee and gives the employee responsibility regarding instruments, the employer is liable when the employee makes a fraudulent indorsement. A ***fraudulent indorsement*** is either (1) an indorsement made in the name of the employer on an instrument payable to the employer or (2) an indorsement in the name of the payee on an instrument issued by the employer. U.C.C. §3-405(a)(2).

Example: Sandra, bookkeeper for Diamonds-R-Forever, makes a fraudulent indorsement both when she forges Diamonds-R-Forever's indorsement on a check payable to Diamonds-R-Forever and when she takes a check issued by Diamonds-R-Forever, intended for Sapphire Gem Company, and indorses the check in the name of Sapphire Gem Company. Compare Mount

Vernon Properties, LLC v. Branch Banking and Trust Co., 170 Md. App. 457 (Md. App. 2006) (question as to whether person who forged payee's indorsement on check was an employee of drawer of check, whether such person's authority was more than just having access to instruments being transported so as to make applicable the employer's responsibility for a fraudulent indorsement by its employee) with Schrier Brothers v. Golub, 123 Fed. Appx. 484 (3rd Cir. N.J. 2005) (wholesaler's former salesperson had “responsibility” for checks collected from his customers so as to make applicable the employer's responsibility for a fraudulent indorsement by its employee).

a. **Rule:** An indorsement in the name of the payee is effective in favor of any person who, in good faith, pays an instrument or takes it for value or for collection whenever an employer entrusts an employee with responsibility with respect to the instrument, and the employee or a person acting in concert with him, makes a fraudulent indorsement. U.C.C. §3-405(b).

Rationale: The loss is imposed on the employer for two reasons. First, she has a duty to prevent the loss by exercising care in hiring and supervising her employees. Second, even if the employer is not at fault in any manner, she is still in the best position to prevent the loss by purchasing a fidelity bond governing misappropriations by employees.

b. **Need for indorsement:** The requirements are the same as in the case of impostors. U.C.C. §3-405(b), (c).

c. **Contributory negligence:** If the person paying or taking the instrument fails to exercise ordinary care and the failure substantially contributes to the loss, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent that her failure contributed to the loss. U.C.C. §3-405(b) and Official Comments 2 and 4.

d. **Employee must have responsibility with respect to instruments:** For an indorsement to be effective under this rule, the employer must entrust the employee with responsibility with respect to instruments. U.C.C. §3-405(a)(1); U.C.C. §3-405(b).

i. **Employee:**“Employee” is broadly defined to include actual employees, independent contractors, and employees of an independent contractor retained by the employer.

ii. **Responsibility:**“Responsibility” means authority (1) to sign or indorse instruments on behalf of the employer; (2) to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition; (3) to prepare or process instruments to be issued in the name of the employer; (4) to supply information for determining the names or addresses of payees; (5) to control the disposition of instruments issued in the name of the employer; or (6) to act otherwise with respect to instruments in a responsible capacity. U.C.C. §3-405(a)(3).

Note: An employee does not have responsibility with respect to an instrument just because he has access to instruments, or to blank or incomplete forms, as part of incoming or outgoing mail or otherwise. U.C.C. §3-405(3). Therefore, an indorsement by a mail room attendant in the name of the payee is not effective when he steals the check from the mailroom. U.C.C. §3-405, Official Comment 3, Case No. 1.

Example: A bookkeeper whose duties include the authority to process checks received by the employer for bookkeeping purposes has been entrusted with responsibility as to checks. U.C.C. §3-405(a)(3)(ii). Thus, when the bookkeeper deposits one of the checks into her personal bank account, the check is deemed to have been properly indorsed by the employer. U.C.C. §3-405, Official Comment 3, Case No. 3.

Example: An employee whose duties include entering addresses of suppliers into a computer has responsibility with regard to checks because she has responsibility to supply information determining the names or addresses of payees. U.C.C. §3-405(a)(3)(iv). When the employee adds a fraudulent address for a real supplier, her indorsement of the check in the name of the supplier is effective.

Example: Because Sandra, as treasurer, has authority to sign instruments on behalf of Diamonds-R-Forever, Sandra's indorsement in the name of Sapphire Gem Company, the payee, is effective even though she developed the intention to steal the check only after the check was issued to pay a bona fide debt owed to Sapphire Gem Company. U.C.C. §3-405(a)(3)(i); U.C.C. §3-405, Official Comment 2, Case No. 6.

F. **Customer's duty to review bank statement:** A customer has a duty to review its bank statement to determine whether any forgery of its own signature or any alteration has occurred. U.C.C. §4-406(c). U.C.C. §4-406 does not cover forged indorsements.

1. **Applies to items:** Because the preclusion is found in Article 4, U.C.C. §4-406 applies to all items and not just to “instruments.” However, it has been held that payee bank's encoding error was not encompassed within the 60-day limitations period in customer's account agreement in which to notify bank of alterations, forgeries, or “any other errors.” *See* Douglas Companies, Inc. v. Commercial Nat. Bank of Texarkana, 419 F.3d 812 (8th Cir. Ark. 2005).

2. **No duty of bank to send statement of account to customer:** Whether or not the bank has a duty to supply its customer with a statement of account or to return items to the customer depends solely on its agreement with its customer. U.C.C. §4-406, Revised Official Comment 1. In fact, most banks do send such statements. If items are not returned to the customer, the bank has the duty, for 7 years after receipt of the items, to retain either the items or legible copies thereof. U.C.C. §4-406(b).

3. **If bank sends statement of account:** A bank that sends or makes available to a customer a statement of account showing payment of items on his account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer to reasonably identify the items paid. U.C.C. §4-406(a).

a. **Check retention:** In an attempt to decrease costs, banks have begun to institute the cost-saving practice of check retention. Under a check retention plan, the payor bank retains the check or other item instead of returning it to the customer along with the statement of account. U.C.C. §4-406, Revised Official Comment 3.

b. **Sufficient information:** When neither the item nor its image is returned, the bank fulfills its duty to provide sufficient information if it gives to the customer the number of the item, its amount, and the date of payment. U.C.C. §4-406(a) and Revised Official Comment 1. This information is the information contained on the MICR-encoded line and thus is easily retrievable by the computer paying the item. U.C.C. §4-406, Revised Official Comment 1.

4. **Customer's duty to examine bank statement:** Once the bank sends or makes available a statement of account or the items, the customer has the duty to exercise reasonable promptness in examining the statement or the items to determine whether any payment was unauthorized due to an alteration or because a purported signature, by or on behalf of the customer, was unauthorized. U.C.C. §4-406(c).

a. **Duty to notify bank:** If the customer should reasonably have discovered the unauthorized payment from the statement or items provided, the customer must promptly notify the bank of the relevant facts. U.C.C. §4-406(c); U.C.C. §4-406, Revised Official Comment 1.

b. **Reasonable promptness:** Courts have upheld bank/customer agreements giving the customer a period as short as 14 days to examine his bank statement and report his own unauthorized signature or alteration. In the absence of an agreement to the contrary and absent extenuating circumstances, however, it is unlikely that a delay of more than 30 days would be found to be reasonable.

5. **Duty of bank to prove loss:** Even when a customer fails to reasonably discover or report a forgery or an alteration, the

customer is only precluded from asserting its unauthorized signature or alteration if the bank proves that it suffered a loss by reason of the failure. U.C.C. §4-406(d)(1); U.C.C. §4-406, Revised Official Comment 2.

a. **Difficulty of proof when single forgery or alteration involved:** When a wrongdoer forges or alters only one check, he typically immediately withdraws the funds and either vanishes, becomes insolvent, or goes to jail by the time the statement is returned to the customer. As a result, the bank would suffer the loss whether or not the customer had promptly discovered and reported the forgery or alteration.

6. **Forgery or alteration by same wrongdoer:** The customer is also precluded from asserting an unauthorized signature or alteration by the same wrongdoer on any other item paid in good faith by the bank before it received notice from the customer of the unauthorized signature or alteration and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item or statement of account and notify the bank. U.C.C. §4-406(d)(2); U.C.C. §4-406, Revised Official Comment 2.

Note: The customer is not entitled to prove that a delay of more than 30 days was reasonable under the circumstances. U.C.C. §4-406, Revised Official Comment 2. If a customer fails to report the first forged item within 30 days, he is precluded from recovering for that transaction and for any additional items forged by the same wrongdoer. Spacemakers of America, Inc. v. SunTrust Bank, 271 Ga. App. 335 (Ga. App. 2005).

7. **Good faith and comparative negligence:** If the customer proves that the bank failed to act in good faith in paying an item, the loss falls completely on the bank. U.C.C. §4-406(e); U.C.C. §4-406, Revised Official Comment 2. Even if the bank acts in good faith, the customer may prove that the bank failed to exercise ordinary care in paying the item and that the failure substantially contributed to the loss. When the customer meets this burden, the loss is allocated between the customer and the bank according to the

extent to which the customer failed to comply with his duties and the extent of the bank's failure to exercise ordinary care. U.C.C. §4-406(e); U.C.C. §4-406, Revised Official Comment 2.

8. **1-year preclusion:** A customer must discover and report the customer's unauthorized signature or any alteration on an item within 1 year after the statement or item is made available to the customer. The failure to so report precludes the customer from asserting the alteration or unauthorized signature against the bank whether or not the bank exercised ordinary care. U.C.C. §4-406(f).

   Note: Although the 1-year period does not cover forged indorsements, the general statute of limitations contained in Article 4 precludes a customer from having his account recredited for a debit resulting from the payment of an item bearing a forged indorsement if he delays more than 3 years after payment in filing the action. U.C.C. §4-111.

9. **Duty of payor bank to raise defense:** When a payor bank has the right to debit its customer's account because the customer is precluded under U.C.C. §4-406(c), (d), and (f), or U.C.C. §3-406 (customer's negligence substantially contributing to a forgery or an alteration) from asserting an unauthorized signature or alteration, the payor bank is not allowed to shift the loss from its customer to the presenting or depositary bank by recrediting the customer's account and recovering from the presenting bank for breach of its presentment warranty. U.C.C. §4-406(f); U.C.C. §4-406, Official Comment 5; U.C.C. §4-208(c); U.C.C. §4-406, Revised Official Comment 5.

IV. RESTRICTIVE INDORSEMENTS

A. **Definition: :** A ***restrictive indorsement*** is an indorsement written by or on behalf of the holder that limits negotiation of the instrument to a specific use.

B. **Types of restrictive indorsements:** There are two types of restrictive indorsements.

1. **For deposit:** An indorsement that signifies a purpose of deposit or collection is a restrictive indorsement. U.C.C. §3-206(c). A ***for deposit*** indorsement indicates that the proceeds of the instrument can only be credited to the indorser's bank account. A blank ***for collection*** indorsement or a “for collection” indorsement that specifically designates a bank, e.g., “To Bank of America, for collection, (s) James” also similarly indicates an intention that the proceeds be deposited into the indorser's bank account. ***Pay any bank*** is a blank indorsement that limits holder status to banks. U.C.C. §4-201(b). When an instrument is indorsed “Pay any bank,” only a bank may acquire the rights of a holder until (1) the item is returned to the customer initiating collection or (2) the bank specially indorses the check to a nonbank. U.C.C. §4-201(b).

   Example: When James receives his paycheck, he may indorse it “for deposit only (signed) James.” James indorses the check in this manner to ensure that the check's proceeds are deposited in his bank account.

2. **Trust indorsement:** An indorsement that states that payment is to be made to the indorsee as agent, trustee, or other fiduciary for the benefit of the indorser or another person (***trust indorsement***) is a restrictive indorsement. U.C.C. §3-206(d).

   Example: If Jim wants to negotiate a check for use by the estate of John Jones, Jim may indorse the check to Don, the executor of the estate, by stating “Don in trust for the estate of John Jones.” By so doing, Jim indicates that Don is to use the funds only for the benefit of the estate of John Jones.

C. **Does not limit right to negotiate:** A restrictive indorsement deprives an indorsee neither of holder status nor of the right to further negotiate or transfer the instrument. U.C.C. §3-206(a).

   Example: Even if James, in the above example, loses his paycheck, Finder becomes the holder of the check because the check is payable in blank (James had not listed anyone as the special indorsee). Finder may further negotiate the check to Auto Loan Co. in payment of his own debt in violation of the restrictive indorsement. Auto Loan Co. by virtue of the indorsement becomes the holder of the check. It cannot, however, become a holder in due course of the check because it did not apply the value consistently with the indorsement.

D. Effect of "for deposit only" indorsement: A "for deposit only" indorsement limits the rights of the depositary bank and nonbank purchasers or payors, but not the rights of the payor bank or intermediary banks.

1. **Payor and intermediary banks exempted:** Any bank in the bank collection process, except a depositary bank, may disregard a "for deposit" or similar indorsement. U.C.C. §3-206(c)(4).

   Exception: A payor bank that is also the depositary bank may not ignore a restrictive indorsement.

   Rationale: Because intermediary banks and the payor bank can ignore the restriction, they can efficiently process in bulk the vast number of checks they receive. Because the depositary bank is still bound by the restriction, at least one bank in the collection process is always bound by the restriction.

2. **Depositary bank liable for conversion:** The depositary bank, whether it purchases the instrument or takes it for collection, converts the instrument unless it pays the indorser or applies the proceeds consistently with the indorsement by applying it to the indorser's account. U.C.C. §3-206(c)(2). The depositary bank can become a holder in due course only to the extent that it applies the funds for the indorser's benefit. U.C.C. §3-206(e).

   Note: This also applies to a depositary bank that is also the payor bank. When a check is presented for immediate payment over the counter, the payor bank is liable for conversion unless the funds are received by the indorser. To be consistent with the terms of a "for deposit" indorsement, the depositary bank must credit the bank account designated by the indorser.

   Example: If James indorses the check "For deposit in account number 1234, (signed) James," Wells Bank must credit account number 1234. If the indorsement does not specify a particular account, e.g., "for deposit, (signed) James," Wells Bank can deposit the proceeds into any of James's bank accounts. Bank of America (the payor bank) can also pay cash over the counter for the check as long as James receives the funds.

3. **Nonbank:** Any person, other than a bank, who purchases an instrument restrictively indorsed for collection or deposit is treated just like the depositary bank and is deemed to have converted the instrument unless the amount paid for the instrument is received by the indorser or applied consistently with the indorsement. U.C.C. §3-206(c)(1); U.C.C. §3-206, Official Comment 3. Such a purchaser can become a holder in due course only to the extent that it applies the funds properly. U.C.C. §3-206(c)(1); U.C.C. §3-206(e).

   Example: In our earlier example, Auto Loan Co. cannot become a holder in due course because it applied the value inconsistently with the indorsement. Similarly, the payor bank has the right to refuse to pay Auto Loan Co. because such payment is inconsistent with the indorsement's effect. U.C.C. §3-206(f).

E. **Effect of trust indorsement:** The effect of a trust indorsement differs depending on whether the person deals directly with the fiduciary when he makes payment, takes the instrument for collection, or purchases the instrument.

1. **When taker deals directly with fiduciary:** When the taker or payor deals directly with the fiduciary, unless the taker has ***notice*** of the fiduciary's breach of fiduciary duty, the payor can pay, or the taker can apply its value, without regard to whether the fiduciary is violating a fiduciary duty to the indorser. U.C.C. §3-206(d)(1).

   Example: Let us return to our original example of Jim indorsing a check "payable to Don, in trust for the estate of John Jones." Don goes to Check Cashing Service and asks that it cash the check. Don uses the cash to buy himself a car. Unless Check Cashing Service has notice of Don's breach of fiduciary duty, Check Cashing Service, in purchasing the check from Don, can apply its value without regard to whether Don violated a fiduciary duty to Jim. Check Cashing Service would have notice of Don's breach of fiduciary duty only if it took the check in payment of, or as security for, a debt known by it to be Don's personal debt or in a transaction it knows to be for the personal benefit of Don. U.C.C. §3-307(b)(2). Unless Check Cashing Service knew that the proceeds would be used by Don personally, Check Cashing Service will qualify as a holder in due course and take free of the claim of ownership of the beneficiary (i.e., Estate of John Jones).

Example: If Don had deposited the check in his own personal bank account at Sunshine Bank, the bank would not be a holder in due course. Sunshine Bank, not being a holder in due course, would then take subject to the claim of ownership of the beneficiary (i.e., Estate of John Jones). U.C.C. §3-306.

2. **When taker does not deal directly with fiduciary:** A person who does not take the instrument directly from the fiduciary is neither given notice, nor otherwise affected, by the restriction contained in the indorsement unless it *knows* that the fiduciary dealt with the instrument or its proceeds in breach of his fiduciary duty. U.C.C. §3-206(d)(2).

Example: From the example above, assume instead that after Check Cashing Service took the check from Don, it deposited the check in its personal account at Moonlight Bank. In this case, Moonlight Bank did not take the check directly from Don (the fiduciary). Therefore, Moonlight Bank is neither given notice, nor otherwise affected by, the restriction contained in the indorsement unless it knows that the fiduciary (Don) dealt with the check or its proceeds in breach of his fiduciary duty. U.C.C. §3-206(d)(2). As a result, Moonlight Bank is a holder in due course and unaffected by the trust indorsement unless it knew that Don had used the funds for his own personal use. In the unlikely case that it had such knowledge, it would be denied holder-in-due-course status and would be subject to the claim of ownership of the beneficiary (Estate of John Jones). U.C.C. §3-206, Official Comment 4.

a. **Liability of payor:** A payor that makes payment of the check in this situation is liable for conversion only if it has actual knowledge that the fiduciary has misused the funds.

b. **Difference between direct and indirect takers or payors:** The difference between these two rules is that the first taker from the fiduciary, Check Cashing Service, is denied holder-in-due-course status if it has *notice* under U.C.C. §3-307 of Don's breach of fiduciary duty. Moonlight Bank, which did not take the check directly from Don, is only denied holder-in-due-course status if it had actual *knowledge* of Don's breach of fiduciary duty.

Quiz Yourself on FORGERY, ALTERATION, AND OTHER FRAUDULENT ACTIVITY

41. Assume that Allen steals May's checkbook and forges May's signature as the drawer of the check.

a. If the check is dishonored by payor bank, is May liable to the holder of the check?__________

b. Similarly, in the event that payor bank pays the check, can payor bank charge May's account?__________

c. Is Allen liable as the drawer of the check?__________

d. What result if May's negligence allowed Allen to commit the forgery?__________

42. Assume that Fred forges Julia's indorsement on a check made payable to Julia. Fred then transfers the check to Raoul.

a. Is Raoul the holder of the check?__________

b. If Payor Bank pays Raoul, is the drawer of the check discharged?__________

43. Assume that Dan drew a check payable to Alice Faye. Carelessly looking up her address in a telephone book, he mails the check to the wrong Alice Faye. The wrong Alice Faye deposits the check in her account at Crocker Bank, which presents the check for payment to

Union Bank. Union Bank pays the check. If Union Bank recredits Dan's account and sues Crocker Bank for breach of its presentment warranty, does Crocker Bank have a defense to the suit?__________

44. Don sells a car to Sally, in payment for which Sally negotiates to Don a check supposedly drawn by Jim. Don presents the check to Bank of America and, immediately on payment, the teller, realizing that Jim's signature was forged, demands the payment back.

a. Can payment be recovered from Don?__________

b. Assume that Don knew that the car he sold to Sally had defective brakes in breach of an express warranty. However, Don did not release the car to Sally until he cashed the check. Is Don protected? __________

45. Assume that Allen forges John's signature as maker of a note made payable to Peter. Peter indorses the note to Sally. John refuses to pay Sally.

a. Will Sally suffer the loss?__________

b. Can Sally recover from Peter?__________

c. Can Sally or Peter recover from Allen?__________

d. If John fails to recognize that his signature on the note is forged and pays Sally, can John recover payment from Sally? __________

46. Assume that Jane, the office manager of The Smoke Shop, having no authority to sign checks for her employer, forges the treasurer's signature on a check payable to David, Jane's husband. David, knowing of the forgery, deposits the check in his bank account at Security Bank, which allows him to withdraw the uncollected funds. Security Bank presents the check to Wells Bank, the payor bank. Wells Bank pays the check.

a. Can Wells Bank debit The Smoke Shop's account?__________

b. Can Wells Bank recover from Security Bank?__________

c. Can Wells Bank recover from David?__________

d. Can Wells Bank recover from Jane?__________

e. If Wells Bank does not pay the check, who could Security Bank recover from?__________

47. Don draws a check payable to Bill in the sum of $1,000. Without Don's fault, the check is stolen in the mail before it reaches Bill. The thief deposits the check in his own account at First Interstate Bank, which obtains payment from the payor bank, Bank of Oxnard. Does Don have any cause of action against First Interstate Bank? Against Bank of Oxnard? Does Bill have a cause of action against either bank?__________

48. Dean draws a check in the sum of $50 payable to Earl. Earl raises the amount of the check to $500 and transfers the check, without indorsement, to Frank for $500 cash. Frank presents the check to the payor bank, which refuses to make payment. To what extent may Frank recover from Dean?__________

49. After stealing Jane's checkbook, Thief forges her name as drawer and, so that no one can trace the check to him, makes the check payable in the name of his girlfriend, Doris. After indorsing the check in Doris's name, Thief cashes the check at Check Cashing Service. Check Cashing Service deposits the check in its account at Wells Bank, which obtains payment of the check from Bank of America. Can Bank of America debit Jane's account? Can Bank of America recover the payment from Wells Bank?__________

50. Emaye indorses her paycheck "For deposit only, /signed/ Emaye" and puts the check together with a deposit slip in an envelope addressed to her bank and places the envelope in her mailbox for the postman to pick up. The check is stolen from her mailbox. Thief deposits the check in his bank account at Crocker Bank, which obtains payment of the check from Far West Bank. Does Emaye have any recourse against either Crocker Bank or Far West Bank? __________

51. James Dean ("Dean") is a young aspiring agent who works in the mailroom of ICM, one of the bigger talent agencies in Los Angeles. Dean also has acquired a serious drug habit. To support his habit, he has devised a scheme to steal checks payable to ICM. He opens up a corporate bank account at Wells Bank in the name of Inter Circle Meditation. He makes friends with a person in ICM's bookkeeping department. He tells this person that his goal is to be a bookkeeper. The person agrees, during lunch breaks, to show Dean how the computerized bookkeeping system works. When alone at the computer, Dean examines the accounts receivables. He notices that MGM periodically makes substantial payments to ICM. While alone in the mailroom, he looks for envelopes bearing MGM's return address. He takes the checks out of the envelope and mails the checks for deposit to Wells Bank. He indorses the checks "ICM, Inter Circle Meditation." Wells Bank obtains payment of these checks from Bank of America, MGM's bank. Dean makes a bookkeeping entry in the ICM computer system crediting MGM's account for the payments. During the annual audit, the auditors discover the discrepancy between the amounts deposited in ICM's account and the amounts recorded on ICM's books. Dean confesses and goes to prison. Can ICM recover the money from Wells Bank?__________

52. Assume that David's car is damaged in an accident. David has the car towed to Ripoff Repair Shop. Loss Insurance Company, without telling David, issues a check for the repairs payable jointly to Ripoff Repair Shop and David. Ripoff Repair Shop forges David's indorsement on the check but never finishes the repairs. Can Loss Insurance Company be found negligent?__________

53. Assume that Steve, secretary for Alice, forges Alice's signature as drawer on a check. The forged signature bears no resemblance to Alice's true signature. Bank of America pays the check. Bank of America refuses Alice's demand to recredit her account on the grounds that Alice was negligent in supervising Steve. Alice raises comparative negligence as a defense. She contends that because the forgery was so obvious, Bank of America was negligent in not recognizing that her signature was a forgery. Bank of America claims that it did not notice the forgery because it never visually examines any checks under $5,000. Does the fact that Bank of America did not visually examine the check conclusively prove that Bank of America was negligent?__________

54. Assume that Fredda, representing herself to be an employee of Water Company, induces the drawer to issue a check payable to Water Company. Fredda indorses the check in the name of Water Company and deposits the check into her bank account.

a. Is Fredda's indorsement effective to make the depositary bank a holder of the check?__________

b. Who would suffer the loss?__________

55. Music Publishers submits a bill to Tune Corporation. Tommy Treasurer draws a check on behalf of Tune Corporation payable to Music Publishers intending to cash the check himself.

a. Is Music Publishers a fictitious payee?__________

b. Is Music Publishers a fictitious payee if Tommy Treasurer developed the intent to steal the instrument after he signed the instrument?__________

56. Assume that both Sally, the President, and Sandra, the Treasurer, must sign any corporate check. Sally draws up a check payable to Sapphire Gem Company intending to cash the check herself. Although Sandra intends that Sapphire Gem Company receive the proceeds, Sally does not.

a. To whom is the check payable?__________

b. Is Sapphire Gem Company a fictitious payee?__________

57. Sandra, treasurer of Diamonds-R-Forever, forges Sally's name, the president of the company, as drawer of checks payable to phony suppliers. Sandra forges $20,000 of these checks in February, cashes the checks, and spends the money on drugs. Although the statement from the bank containing the checks forged in February arrives on March 10, Diamonds-R-Forever does not examine the statement. The statement is finally examined on April 21 by Sally, who immediately notifies Bank of America of the forgeries.

a. Assuming that Sandra has no reachable assets, can Bank of America prove that it could have prevented the loss if it had been promptly notified of the forgery?__________

b. Assume that between March 10 and March 31, Sandra forges $40,000 more in checks. Between April 11 and April 15, Sandra forges $50,000 more in checks. On April 16, Sandra leaves the country. Diamonds-R-Forever receives its bank statement on March 10. To what extent is Diamonds-R-Forever precluded from asserting the forgeries?__________

c. Assume that, in our example above, all the checks forged by Sandra were returned by Bank of America to Diamonds-R-Forever on March 10. If Diamonds-R-Forever does not report the forgeries by March 10 of the next year, will Diamonds-R-Forever be precluded from asserting the forgeries even if Bank of America had failed to exercise ordinary care in paying the checks?__________

58. After indorsing a check in blank, Paul loses the check. The finder of the check cashes the check at his brother's bank by forging his brother's indorsement. What effect does the forged indorsement have? __________

59. Automobile Dealer, in a plan to defraud Finance Company, submits to Finance Company loan applications and supporting loan agreements supposedly from prospective car buyers. Finance Company, without verifying any of the information on the loan applications, makes the loans and sends the checks to Automobile Dealer. Automobile Dealer forges the payees' indorsements on these checks. To what extent, if any, is Finance Company liable?__________

60. Tax Defrauder, in a scheme to defraud the IRS by claiming phony charitable deductions, sets up a bank account in the name of “ACS,” makes checks payable to American Cancer Society and deposits the checks in the bank account that he set up. During one trip to the bank, Tax Defrauder loses one of these checks. Freddy Finder finds the check, forges the indorsement of American Cancer Society, and cashes the check at Check Cashing Service. Is Check Cashing Service the holder of the check?__________

Answers

41.a. **No.** Unless there is a grounds for preclusion, May is not liable on the check because her signature does not appear on the check.

b. **No.** Payor bank cannot charge May's account because May did not authorize payor bank to pay the check.

c. **Yes.** When Allen signed May's name, it was as if Allen had signed the check in his own name. Allen is liable as the drawer of the check, and Payor Bank may recover from Allen.

d. **May may be precluded from denying that the signature on the check was her signature.** In this event, if Payor Bank had refused to pay the check, the holder could recover from May on her drawer's obligation. If Payor Bank paid the check, Payor Bank could debit May's account just as if May's signature was authorized.

42.a. **No.** Raoul is not the holder of the check. Because only a holder can indorse an instrument for purposes of its negotiation, an unauthorized indorsement does not negotiate the check. U.C.C.§3-201(b). Until Julia indorses the check, no one, other than she, can become its holder.

b. **No.** The drawer is still liable to Julia. Payor bank may not debit Drawer's account. U.C.C. §4-401(a).

43. **Crocker Bank may defend the suit by proving that Dan's negligence caused the loss.**

44.a. **No.** Because Don took the check in good faith and for value, the payment may not be recovered from him U.C.C. §3-418(c).

b. **Yes.** Don is protected because he has changed position in good-faith reliance on the payment even though, because he knew of Sally's defense, he did not take the check in good faith. U.C.C. §3-418(c). However, if Don uses the money to pay his mortgage payment or gas bill, he would not be found to have changed position in reliance on the payment because he would have been required to have made these payments even if Bank of America had not paid the check.

45.a. **Maybe.** Sally will suffer the loss unless she can recover from Allen or Peter.

b. **Yes.** Sally can recover from Peter for breach of his transfer warranty that all signatures on the instrument were authentic and authorized, U.C.C. §3-416(a)(2), and also on his indorser's contract. U.C.C. §3-415(a).

c. **Yes.** Peter and Sally may recover from Allen because his unauthorized signature makes him liable as maker of the note. U.C.C. §3-403(a).

d. **Depends.** John's chances of recovery depend on whether Sally is a protected person under U.C.C. §3-418. If Sally is a good-faith purchaser for value or has relied in good faith on the payment, Sally is protected from John's action in restitution, and, therefore, John suffers the loss. In the unlikely event that Allen is solvent and available for process, John can recover from him.

46.a. **No.** Wells Bank cannot debit The Smoke Shop's account because The Smoke Shop did not sign the check. U.C.C. §4-401(a).

b. **Maybe.** Wells Bank may recover the proceeds from Security Bank if Security Bank is not a protected person.

c. **Yes.** Wells Bank can recover from David not only because he is not a protected person under U.C.C. §3-418 and had knowledge of the forgery, but also because he has breached the presentment warranty of lack of knowledge that the drawer's signature is unauthorized.

d. **Yes.** Wells Bank can recover from Jane because she was the actual forger. Remember, though, that if Jane and David are insolvent, Wells Bank ultimately suffers the loss.

e. **David and Jim.** Security Bank can recover from David for breach of his transfer warranty that all signatures are authentic and authorized. If David had transferred by indorsement the check to Jim, who deposited the check in his checking account at Security Bank, Security Bank could recover from both David and Jim on their transfer warranty. Because the instrument was dishonored, the holder can also recover from any prior indorser on his indorser's contract. U.C.C. §3-415(a). The holder may also recover from Jane as drawer of the check because her unauthorized signing of the treasurer's name makes her liable in the capacity in which she signs.

U.C.C. §3-403(a).

47. **Don can sue the depositary bank (First Interstate Bank) neither for conversion, U.C.C. §3-420 (a)(i), nor for breach of the presentment warranties.** U.C.C. §3-417, Official Comment 2. Don's recourse is to have Bank of Oxnard recredit his account. Bill, the payee, has no right to recover from either bank for conversion because the instrument was not delivered to him. U.C.C. §3-420(a).

48. **$50.** Because Earl fraudulently altered the check, Dean is discharged from liability. U.C.C. §3-407(b). However, because Frank took the check for value and in good faith and without notice of the alteration, he may enforce the check against Dean for its original amount of $50. U.C.C. §3-407(b).

49. **No.** Bank of America may not debit Jane's account because, bearing her forged drawer's signature, the check was not properly payable. Bank of America, likewise, cannot recover from Wells Bank. Because Thief did not intend for Doris to have an interest in the check, Doris is a fictitious payee. U.C.C. §3-404(b). Being a fictitious payee, Thief's indorsement in Doris's name is effective as against any person who in good faith pays the instrument or takes it for value or collection. Because Wells Bank qualifies as a good-faith taker for collection, the indorsement is effective. As a result, Wells Bank does not breach its presentment warranty that it is a person entitled to enforce the instrument. As in any case of payment over a forged drawer's signature, the loss falls on the payor bank unless it can recover the payment under U.C.C. §3-418. However, if Wells Bank has allowed Check Cashing Service to withdraw the funds, Bank of America would have no right to recover the payment from Wells Bank. U.C.C. §3-418(c).

50. **Yes.** Crocker Bank, being the depositary bank, is liable for conversion unless the proceeds are deposited in the indorser's bank account or paid to the indorser. Because the check was deposited in Thief's bank account, Crocker Bank is liable to Emaye for conversion. U.C.C. §3-206(c)(2). However, Emaye has no action against the payor bank. U.C.C. §3-206(c)(4).

51. **Maybe.** Wells Bank, being the depositary bank, is liable to ICM, the

owner of the checks, for conversion unless ICM is precluded from claiming that the indorsement is unauthorized. U.C.C. §3-420(c). There are two possible grounds for preclusion. First, it can be argued that the indorsement is effective under U.C.C. §3-405 because Dean was an employee of ICM. However, ICM is not precluded because Dean is not a person who was entrusted with responsibility as to the instrument. U.C.C. §3-405. Second, it can be argued that ICM was negligent in the manner in which it handled its business such as to allow Dean access to the bookkeeping system. This is a question of fact. Even if ICM is precluded under one of these two theories, Wells Bank was probably negligent in allowing Dean to open a corporate bank account without requiring proper corporate resolutions. If this is the case, Wells Bank and ICM would share the loss under the principle of comparative negligence.

52. **Yes.** Loss Insurance Company may be found to be negligent in giving the check directly to Ripoff Repair Shop without telling David. In contrast, if Loss Insurance Company had dealt with Ripoff Repair Shop on many occasions in the past without any incidents, Loss Insurance Company may be found not to have been negligent.

53. **No.** However, as long as Bank of America's procedure is reasonable and commonly followed by other comparable banks in the area, failure to visually examine will not be conclusive proof of negligence. U.C.C. §4-406, Revised Official Comment 4. Because few banks visually inspect checks for forgeries or alterations, it is doubtful that Alice could successfully prove that Bank of America's failure to visually inspect the check was unreasonable and therefore negligent.

54.a. **Yes.** Fredda's indorsement is effective to make the depositary bank a holder of the check because, by falsely representing herself to be the agent of the named payee, Fredda is an impostor. U.C.C. §3-404(a). Being an impostor, an indorsement by any person is effective as to any person who takes the instrument for collection. U.C.C. §3-404(b)(2).

b. **The depositary bank and the drawer.** The loss would probably be split between the depositary bank and the drawer because the depositary bank probably failed to exercise ordinary care when it permitted Fredda to deposit the check into her own personal bank account. U.C.C. §3-404(d).

55.a. **Yes.** Even though the debt is actually owed to Music Publishers, the fact that Tommy Treasurer, the person signing the check on behalf of Tune Corporation, intends that Music Publishers not receive the proceeds makes Music Publishers a fictitious payee. U.C.C. §3-404(b)(i), (ii).

b. **No.** U.C.C. §3-405, Official Comment 2, Case No. 2. However, Tommy Treasurer's indorsement would be effective because Tune Corporation had entrusted him with responsibility as to instruments.

56.a. **To either Sapphire Gem Company or to Sally.** The check is payable to Sapphire Gem Company because Sandra intended that the check be payable to them, or to Sally personally, because Sally intended the check be payable to herself.

b. **Yes.** Because one of the signers for the drawer does not intend that Sapphire Gem Company be the person to whom the check is payable, Sapphire Gem Company is a fictitious payee. U.C.C. §3-404, Official Comment 2, Case No. 3.

57.a. **No.** Because the checks had already been cashed before the customer could have known of the forgeries, the bank could prove a loss only if it could prove that had it been promptly notified, it could have recovered the loss from Sandra. Because Sandra had no reachable assets, the bank is unable to prove a loss.

b. When Diamonds-R-Forever received its bank statement on March 10, it had a reasonable time, not exceeding 30 days, to examine the statement. The 30-day period expired on April 10. A court could find that less than 30 days was the extent of a reasonable time to examine the statement. If a court finds that 14 days was the extent of a reasonable time to examine the statement and report the forgeries, it will prohibit Diamonds-R-Forever from asserting the forgery of checks paid after March 24. Under any circumstances, Diamonds-R-Forever would be unable to assert the forgery on any check paid more than 30 days after it received the statement. The court must reach this result because any delay in excess of 30 days is deemed to be an unreasonable time for the customer to examine the statement of account and report any forgery or alteration. U.C.C. §4-406, Revised Official Comment 2.

c. **Yes.** U.C.C. §4-406(f) precludes the assertion of any forgery that is not reported within 1 year after the bank statement containing the item or its description, is made available to the customer whether or not the bank failed to exercise ordinary care in paying the item.

58. **No.** Because his brother's indorsement was not necessary to negotiate the check to the depositary bank, the depositary bank qualifies as a holder despite the forged indorsement.

59. **Yes.** Finance Company was negligent in failing to verify the applications' authenticity. U.C.C. §3-406. This was negligence in that Finance Company failed to observe the reasonable commercial standards in their business. U.C.C. §3-103(a)(9).

60. **Yes.** American Cancer Society is a fictitious payee because Tax Defrauder intended that American Cancer Society have no interest in the instrument. As a result, under U.C.C. §3-404(b)(1), any person in possession of the check is its holder.

Exam Tips on *FORGERY, ALTERATION, AND OTHER FRAUDULENT ACTIVITY*

- **Diagram forgery questions:** When analyzing a question involving a forgery, it is essential that you diagram the transaction and carefully label each of the parties. Once you know the capacity of each party, the rules allocating the loss are simple.
  - For example, assume that the issue is whether a check that has been paid over a forged indorsement has been converted.
    - First ask whether the instrument was delivered to the payee. If not, no conversion action lies. The drawer has no right to sue the depositary bank or the payor bank for conversion.
    - The drawer's remedy is to demand that the payor bank

recredit his account.

- If the instrument had been delivered to the payee prior to the forged indorsement, the payee may sue the depositary and payor banks for conversion.
- The payee may not, however, sue an intermediary collecting bank.

- By properly labeling the parties, you need only to mechanically apply the allocation of loss rules.

CHAPTER 5
PAYOR BANK/CUSTOMER RELATIONSHIP

ChapterScope

This chapter covers the relationship between a payor bank and its customer. It examines when a payor bank may debit its customer's account, the enforceability of bank/customer agreements, a bank's liability for wrongful dishonor, a customer's right to stop payment, and the customer's right to availability of deposited funds under Regulation CC. The key points in this chapter are:

- **Properly payable items:** A bank may debit a customer's account when it pays any item that is properly payable.
- **Bank's right of set-off:** A bank has the right to set off against the customer's account any matured debts owed by the customer to the bank.
- **Variation by agreement:** An agreement between a customer and its bank may vary the provisions of Article 4 unless it attempts to disclaim the bank's obligation of good faith or duty to exercise reasonable care or is unconscionable.
- **Wrongful dishonor:** A bank is liable to its customer for any damages proximately caused when it wrongfully dishonors an item.
- **Bank's liability for payment over stop order payment:** A bank is liable to its customer only for the loss actually suffered by its customer when it pays an item in violation of a valid stop payment order.
- **Funds availability under Regulation CC:** Regulation CC requires a depositary bank to allow its customers use of the deposited funds according to a fairly strict Mandatory Availability Schedule.

I. WHEN ITEM PROPERLY PAYABLE

A. Introduction: A payor bank may charge against its customer's account only items that are properly payable. An item is properly payable if it is both authorized by the customer and complies with the bank/customer agreement. U.C.C. §4-401(a); U.C.C. §4-401, Official Comment 1. An instrument is not properly payable from a bank customer's account if it contains a forged drawer's signature or forged indorsement. *See* Lor-Mar/Toto, Inc. v. 1st Constitution Bank, 376 N.J. Super. 520 (N.J. Super. A.D. 2005).

> **Example:** If a corporate account requires that any check drawn by the corporation be signed by two officers, a check signed by only one officer is not properly payable because the payment does not comply with the bank/customer agreement.
>
> **Example:** If a necessary indorsement has been forged, the check is not properly payable because the customer did not authorize the bank to pay the person presenting the check for payment.

B. Items creating overdrafts: The bank may charge its customer's account for an item, even though it creates an overdraft, as long as the item is otherwise properly payable. U.C.C. §4-401(a); U.C.C. §4-401, Official Comment 1. Although having the right, the bank has no duty to pay an item that creates an overdraft, absent an agreement to the contrary. U.C.C. §4-402(a).

Rationale: By drawing an item in an amount greater than the balance in his bank account, a customer impliedly requests that the bank advance him funds by paying the item.

C. Postdated checks: A payor bank may charge against its customer's account a check that is otherwise properly payable, even though payment was made before the date of the check. U.C.C. §4-401(c).

Rationale: Most banks process checks by sending the check through a computer, which by reading the MICR-encoded line on the check determines whether to pay the check. Because the MICR-encoded line does not include the date of a check, the computer has no way of determining whether the check is postdated. U.C.C. §4-401, Official Comment 3. If banks were not permitted to debit their customer's account on a check paid before its date, banks would have to visually examine each check before paying it. The cost of this visual examination would be staggering.

Exception: The payor bank may not properly pay a postdated check prior to its date if the customer has given notice to the bank of the postdating. U.C.C. §4-401(c).

1. **Same procedure as stop payment order:** The procedure for giving notice of postdating is the same as for the placing of a stop payment order on an item. The postdating notice must describe the check with reasonable certainty and be given in enough time to allow the bank a reasonable opportunity to act on the notice before the check has been processed for payment or certified. U.C.C. §4-401(c).

2. **Same damages as for payment over stop payment order:** If, after proper notice of postdating has been given, the bank charges the check against the customer's account prior to the date of the check, the bank is liable for all damages resulting from the payment, including those damages resulting from the wrongful dishonor of subsequent items. U.C.C. §4-401(c). In the event of the bank's payment of a postdated check in violation of a properly given notice, the bank has the same subrogation rights as it does when it pays an item in violation of an effective stop payment order. *See* Siegel v. New England Merchants Natl. Bank, 386 Mass. 672, 437 N.E.2d 218 (1982).

    Example: Your bank paid a check you gave to Autos-R-Us as a deposit for the purchase of a new car, even though it was postdated and not supposed to be cashed for another two weeks. Autos-R-Us has never delivered the car and refuses to refund your deposit. The bank may debit your account because you did not give the bank proper notice of postdating.

D. **Bank not obligated to pay stale checks:** A bank is under no obligation to its customer to pay a check presented more than 6 months after its date (a stale check). U.C.C. §4-404.

Example: A payor bank does not wrongfully dishonor a check if it refuses to pay a check dated January 1 that is presented for payment on July 2.

Rationale: Because the staleness of a check may indicate that a problem exists, a bank is given discretion as to whether to pay a stale check. U.C.C. §4-404, Official Comment.

1. **Bank has option to pay:** If acting in good faith, a bank may pay a stale check and charge its customer's account for the amount of the check. U.C.C. §4-404. This gives the bank an option as to whether to pay a stale check. U.C.C. §4-404, Official Comment. The bank needs this discretion because, at times, it may know that the drawer wants the check to be paid. U.C.C. §4-404, Official Comment.

2. **Drawer remains liable:** Notwithstanding the bank's dishonor of a stale check, the drawer remains liable to the person entitled to enforce the check. The drawer's liability is terminated only when the statute of limitations has run. U.C.C. §3-118.

E. **Bank's right of set-off:** The bank has the right to set off against its customer's account any matured debt the customer owes to the bank.

1. **Account must belong to customer:** Subject to a few exceptions, the bank may set off a debt owed to it by its customer only against an account belonging to the customer himself.

   a. **Bank must not have knowledge or reason to know that the account belongs to another:** A bank may not exercise its right of set-off if the bank has actual knowledge, or reason to know, that the funds in an account belong to a person other than the customer or that the funds are held in trust by the customer for another. *See* Universal C.I.T. Credit Corp. v. Farmers Bank of Portageville, 358 F. Supp. 317 (E.D. Mo. 1973) (bank had enough facts to put it on inquiry as to the third party's interest).

   b. **No right when account shows third-party interest:** A bank has no right to make a set-off against an account when the designation of the account indicates that a third party has an interest in the account. *See* Energetics, Inc. v. Allied Bank, 784 F.2d 1300 (5th Cir. 1986) (bank not permitted to set off a debt of its customer Republic Drilling against an account entitled "Well Account—Energetics," which contained prepayments by Energetics of drilling expenses).

c. **Equitable rule:** Some courts adopt the "equitable rule" that when a third party has an interest in an account (e.g., a secured party claiming proceeds in an account), a bank, even without notice of the third party's interest, cannot exercise its right of set-off unless the bank has changed its position in reliance on the reasonable belief that the account belongs solely to its depositor. *See* National Indem. Co. v. Spring Branch State Bank, 162 Tex. 521, 348 S.W.2d 528 (1961) (even though the bank had no notice that funds in an insurance agent's account were premiums he received in trust for his employer, the set-off was improper because the bank had not changed its position).

d. **Joint accounts:** Authority is split as to whether a bank can set off a debt of one account holder against an account jointly held. Some courts permit the bank to set off the debt against the entire account regardless of the respective interests of the account holders. *See* Burgess v. First Natl. Bank, 31 Colo. App. 67, 497 P.2d 1035 (1972). Other courts hold that the set-off may be exercised only to the extent of the respective interests of the account holders. *See* Peoples Bank v. Turner, 169 Md. 430, 182 A. 314 (1936).

2. **Debts must be matured:** Set-off is available only if both the debt the customer owes the bank and the debt the bank owes the customer have matured. *See* Bottrell v. American Bank, 773 P.2d 694 (Mont. 1989) (set-off not available where debt not matured).

Example: You have borrowed money from your bank to purchase a car. You have agreed to make monthly payments of $400 payable on the first of every month. You send your landlord a check on the first of the month. The bank sets off the car payment against your account on the second of the month. The landlord presents the check to the bank on the third of the month. After the set-off, your account contained insufficient funds to pay your rent check. Because your car payment was due on the first, the debt had matured, and the bank could set it off against your account. If the car payment was not due until the fifth of the month, the set-off would have been improper.

3. **Notice not required:** The bank is not required to give notice within any specified time before, or after, the set-off absent a statutory requirement.

   Example: California requires that a consumer depositor be given notice no later than the day following the set-off so that the consumer can claim an exemption or that the debt is not due. Cal. Fin. Code §864(c).

4. **Limitations on consumer debts:** Both state and federal law limit to some extent a bank's right of set-off as to debts arising out of a consumer credit transaction.

   Example: Under §169 of the Fair Credit Billing Act of 1974, 15 U.S.C. §1666h, a bank credit card issuer (absent consent in writing) may not set off a debt arising from the use of the credit card against a deposit account of the credit card holder.

F. **Death or incompetence of customer:** Under traditional agency law, the death or incompetence of the principal terminates the agent's authority. Application of this rule to the payment of checks would be disastrous to the banking system because a bank, when paying or collecting a check, has no way of knowing whether one of its customers is incompetent or has died. As a result, the Code gives banks the right to pay or collect items even after a customer's death or incompetency.

1. **Effect of incompetence:** A customer's incompetence does not revoke the bank's authority to pay or collect an item or account for proceeds of its collection until the bank knows of the adjudication of incompetence and has a reasonable opportunity to act on it. U.C.C. §4-405(a). Even after the bank knows that its customer is incompetent, the bank remains authorized to act on behalf of the customer in the collection or payment of an item until the judicial appointment or qualification of a personal representative for the customer.

2. **Effect of death:** Until the bank knows of the customer's death and has had a reasonable opportunity to act on the knowledge, the bank has the right to pay, collect, account, accept, or certify an item. U.C.C. §4-405(a).

   a. **May pay checks for 10 days:** Even after the bank learns of its customer's death, the bank may, for 10 days after the date of death, pay a check, unless the bank is ordered to stop payment by a person claiming an interest in the account. U.C.C. §4-405(b).

      Rationale: The bank is allowed to pay checks (but not other items) presented in the 10-day period after the date of death because most of these checks represent bona fide debts. Many of the checks are in payment of ordinary bills. Rather than making these creditors file a claim against the estate, it is simpler for the bank to pay the checks and have the executor or administrator of the estate recover any improper payment. U.C.C. §4-405, Official Comment 2.

   b. **No duty to pay:** Although a bank can pay a check after the customer's death, the bank has no duty to pay the check. The bank is not liable for wrongful dishonor if it refuses to pay a check after its customer has died. *See* Bank Leumi Trust Co. v. Bally's Park Place, Inc., 528 F. Supp. 349 (S.D.N.Y. 1981).

   c. **Right to stop payment:** To ensure that the drawer has not been pressured shortly before his death to write checks, a bank may not pay a check with knowledge of its customer's death if ordered to stop payment by any person claiming an interest in the account. U.C.C. §4-405(b). The stop payment order has the same requirements and effects as an ordinary stop payment order except that any surviving relative, creditor, or other person who claims an interest in the account may order the bank not to pay the check. The bank is not required to determine whether the person's claim to the account has merit. U.C.C. §4-405, Official Comment 3.

II. VARIATION BY AGREEMENT

A. **Introduction:** Because Article 4 is not a regulatory statute, it neither regulates the terms of the bank/customer agreement nor prescribes consumer protection constraints on bank/customer agreements. Article 4 leaves the protection of bank customers to the individual state legislatures to enact legislation and to the courts to regulate abuse through normal contract doctrines such as unconscionability, public policy, and contracts of adhesion. U.C.C. §4-101, Official Comment 3.

B. **Limitations on agreements:** Article 4 does place two limitations on any agreement that varies the provisions of Article 4: (a) such an agreement may not disclaim a bank's liability for its own lack of good faith or failure to exercise ordinary care, nor (b) may it limit the measure of damages resulting from its lack of good faith or failure to exercise ordinary care. U.C.C. §4-103(a).

C. **Contracts of adhesion:** Even when an agreement does not violate either of the two limitations imposed by Article 4, bank/customer agreements are virtually always contracts of adhesion. Consequently, courts carefully scrutinize a bank's attempt to limit its customer's rights or disclaim the bank's own duties. Courts often refuse to enforce provisions found in a bank/customer agreement or on a deposit slip that cause hardship to the customer or result in unfair surprise.

> **Example:** Courts have refused to enforce a requirement found on a stop payment order form that the bank is obligated to stop payment of a check only if all of the information is accurate, including the amount to the penny. *See* Staff Serv. Assocs. v. Midatlantic Natl. Bank, 207 N.J. Super. 327, 504 A.2d 148 (1985).

1. **Customer's actual knowledge relevant:** The extent to which the customer has actual knowledge, or had a clear opportunity to acquire knowledge, is instrumental in the court's decision as to whether it will enforce the provision. *See* Rapp v. Dime Savings Bank of New York, 164 A.D.2d 964, 408 N.Y.S.2d 540 (1978), *aff'd*, 48 N.Y.2d 658, 421 N.Y.S.2d 347, 396 N.E.2d 740 (1979) (court enforced an agreement giving the bank the right to place a

reasonable hold on uncollected funds when the agreement was printed on the reverse side of the deposit slip, posted in all branch offices, and explained to individual checking account customers on the opening of their accounts).

2. **Against public policy:** A court may refuse to enforce a provision of a bank/customer agreement that it finds to be in violation of public policy. One ground of public policy may be Article 4 itself. Article 4 establishes certain basic rights that bank customers assume are guaranteed them when they open their checking account.

   Example: A court probably would not permit a bank to completely eliminate any of the basic rights that Article 4 has granted to bank customers: the right to stop payment, the right to sue for wrongful dishonor, or the right to object to the payment of items not properly payable.

3. **Agreements may limit customers' rights:** Courts often enforce bank/customer agreements that greatly limit the time within which a customer may claim that a signature or alteration is unauthorized. *See* Simcoe & Erie Gen. Ins. Co. v. Chemical Bank, 770 F. Supp. 149 (S.D.N.Y. 1991) (14 days).

III. WRONGFUL DISHONOR

A. Introduction: Subject to one exception, a payor bank is liable to its customer for wrongful dishonor if it dishonors an item that is properly payable. U.C.C. §4-402(a). A payor bank has no duty to pay an item that, although properly payable, would create an overdraft. U.C.C. §4-402(a).

   Example: The definition of "properly payable" was not intended to require that the bank pay items drawn on insufficient funds. If the drawer draws a check for $1,000,000 on an account containing only $5, the bank cannot be liable for wrongful dishonor if it refuses to pay the check. The bank would be liable only if it breaches an agreement with its customer to honor overdrafts, e.g., a ready reserve agreement or check overdraft protection.

B. **Pivotal issue is whether sufficient funds in account:** In determining whether an item has been wrongfully dishonored, the pivotal question is whether the customer's account has adequate funds to cover payment of the dishonored item. This almost always depends on whether a prior debit or credit by the bank was proper.

1. **Bank may pay checks in any order:** The payor bank has the right to pay checks drawn on its customer's account in any order that it desires. U.C.C. §4-303(b). This discretion allows banks to process checks by computer without concern that a subsequently dated check had been paid while an earlier dated check was dishonored.

2. **Time for determining whether sufficient funds exist:** A bank need only examine a customer's account once when deciding whether to dishonor an item for insufficient funds. This examination may be made at any time during the period between the time when the bank received the item and when it returned the item. U.C.C. §4-402(c).

C. **Duty owed only to customer:** A bank is liable only to its customer for wrongful dishonor of an item. U.C.C. §4-402(b). Customer is defined as "any person either having an account with the bank or for whom the bank has agreed to collect the item." U.C.C. §4-104(a)(5). Person includes both individuals and organizations. [Rev] U.C.C. §1-201(b)(27).

1. **Payee and other holders:** A payee or other holder of the item has no cause of action against the bank for wrongful dishonor of an item. Thus, your landlord has no cause of action against your bank for wrongful dishonor. The bank's duty was owed only to you.

2. **Corporate officers or partners not customers:** Because "customer" is defined to include organizations, when a check drawn on a corporate, trust, or partnership account is dishonored, the person having the right to sue for the wrongful dishonor is the corporation, trust, or partnership and not the corporate officer, trustee, or partner who signed the check. However, nothing in Article 4 displaces any common law cause of action the officer,

trustee, or partner may have against the bank. U.C.C. §4-402, Official Comment 5. *See* Agostino v. Monticello Greenhouses, Inc., 166 A.D.2d 471, 560 N.Y.S.2d 690 (1990) (although corporate officer may not maintain cause of action for wrongful dishonor where checks drawn on corporate account, he may bring a negligence action against the bank under U.C.C. §1-103 if the dishonor causes his arrest).

D. Damages: A payor bank that wrongfully dishonors an item is liable to its customer for all damages proximately caused by the wrongful dishonor. U.C.C. §4-402(b). The test for determining the liability of a payor bank for damages caused by a wrongful dishonor is the tort test of proximate causation.

1. **Loss of profits:** If a transaction fails to go through because the check was wrongfully dishonored, damages may include any resultant loss of profits. *See* Murdaugh Volkswagen, Inc. v. First Natl. Bank, 801 F.2d 719 (4th Cir. 1986) (damages may include injury to credit of corporation including the value of assets when bankruptcy caused by loss of credit); Skov v. Chase Manhattan Bank, 407 F.2d 1318 (3d Cir. 1969) (awarded three years of lost profits when supplier stopped doing business with customer); Twin City Bank v. Isaacs, 283 Ark. 127, 672 S.W.2d 651 (1984) (damages included losses from inability to purchase house when deposit check wrongfully dishonored).

2. **Damage to reputation:** If the customer's reputation was harmed because checks sent in payment of its bills were wrongfully dishonored, the customer can recover damages for the loss to her reputation. *See* Morse v. Mutual Fed. Sav. & Loan Assn., 536 F. Supp. 1271 (D. Mass. 1982) (loss of reputation damages available).

3. **Emotional distress damages:** Although one clearly foreseeable consequence of a wrongful dishonor is the embarrassment, emotional distress, and mental anguish that a customer suffers as a result of the dishonor, courts are reluctant to award a customer damages for these injuries because of the ease of fabricating such injuries. Many courts require that the bank's behavior be reckless or outrageous before such damages are awarded. *See* Morse v. Mutual

Fed. Sav. & Loan Assn., 536 F. Supp. 1271 (D. Mass. 1987) (mental suffering and loss of reputation damages available); Twin City v. Isaacs, 283 Ark. 127, 672 S.W.2d 651 (1984) (damages for mental anguish available on intentional dishonor).

4. **Punitive damages:** Whether a bank is liable for punitive or other noncompensatory damages is left to the court's determination under [Rev.] U.C.C. §1-103(b) or [Rev] U.C.C. §1-305(a). U.C.C. §4-402, Official Comment 1. However, when the dishonor is willful and wanton, courts have allowed punitive damages for wrongful dishonor. *See* In re Brandywine Assocs., 30 U.C.C. Rep. Serv. 1369 (Bankr. E.D. Pa. 1980) (available only when malicious, oppressive, or reckless); Alaska State Bank v. Fairco, 674 P.2d 288, 37 U.C.C. Rep. Serv. 1782 (Alaska 1983) (punitive damages available when willful and wanton).

IV. CUSTOMER'S RIGHT TO STOP PAYMENT

A. **Introduction:** A customer has the right to stop payment of any item drawn on its account. U.C.C. §4-403(a).

B. **Closed accounts:** The same basic rules apply when a check is paid after the customer has closed her account as apply when the customer stops payment of an item. U.C.C. §4-403(a).

C. **More than one customer:** When there are two or more persons, each of whom is individually entitled to write items on an account, any of these persons may order payment stopped even if she is not the person who signed the item. U.C.C. §4-403, Official Comment 5.

Example: If you and your spouse have a joint checking account, your spouse may stop payment on a check written by you.

D. **Payable from customer's account:** A customer may stop payment only on an item payable from its account. A payee or an indorsee has no right to stop payment on a check or other item. U.C.C. §4-403, Official Comment 2.

Example: You cannot stop payment on a cashier's check you purchased from your bank because it is not payable from your account. U.C.C. §4-403, Official Comment 4. Because it is your bank's credit that is at stake and not yours, you should not have the right to impugn the bank's credit by stopping payment on one of its obligations.

E. Effect of stop payment order: The only effect of a stop payment order is to prevent the holder from immediately obtaining possession of the funds represented by the item. Stop payment orders do not change who ultimately gets the funds. This is because issuance of a stop payment order has no effect on a party's liability as drawer of the item. U.C.C. §4-403, Official Comment 7.

Example: After you stop payment on a check given in payment for a defective television set, you will be sued by the holder. U.C.C. §3-414(b). You will be obligated to pay the check unless you have a defense or claim in recoupment that is assertible against the holder. U.C.C. §3-305(a), (b).

F. Requirements for stop payment order: To be effective, a stop payment order describing the item with reasonable certainty must be received at a time and in a manner that affords the bank a reasonable opportunity to act on the order before the bank has completed any of the actions with respect to the item described in U.C.C. §4-303 and discussed in subsection G, *infra* U.C.C. §4-403(a).

1. Adequate description of item: A check or other item is identified with reasonable certainty when the bank is given sufficient information to enable it to identify the item on which payment is to be stopped. U.C.C. §4-403(a), Official Comment 5.

a. Technological capabilities: The information that a bank may require a customer to supply is the information that the bank must have, under current technology, to identify the item with reasonable certainty. U.C.C. §4-403, Official Comment 5.

b. Precise information: Most banks require that the customer supply either the precise amount of the instrument or the number of the check.

Rationale: The state of current technology is such that the computers that banks find economically feasible can be programmed to read only the information contained on the MICR-encoded line. The only information encoded on the MICR line that would enable the computer to identify an individual check is either the check number or the amount payable. Because most current computers used for processing checks can be programmed to identify checks only by either the precise amount payable or the precise check number, a mistake in one digit results in the computer failing to stop payment of the item.

Example: If you indicated on the stop payment order that your check to Target was in the amount of $1,001 instead of its actual amount of $1,000, your stop payment order would not be effective.

2. **Oral or written:** A stop payment order may be either written or oral. U.C.C. §4-403(b). A written stop payment order is effective for 6 months from the date that it is given, whereas an oral stop payment order lapses after 14 calendar days. U.C.C. §4-403(b). If a written confirmation of the oral order is given within the 14-day period, the oral order is effective for 6 months beginning at the time the oral order was given. U.C.C. §4-403(b); U.C.C. §4-403, Official Comment 6.

   a. **Renewal:** Stop payment orders may be renewed as often as desired for the same respective periods.

   b. **Effect of expiration:** When a stop payment order expires, it is as if the order had never been given, and the payor bank may, in good faith, pay the item (even though the item had at one time been subject to the stop payment order). U.C.C. §4-403, Official Comment 6.

   Example: Assume that you originally issued a stop payment order on January 2 and that you attempted to renew the order on August 1. Because the renewal was not within the 6-month period, it is effective only from August 1, the date the renewal is received. Your stop payment order would have been ineffective between July 2 and July 31. If the bank had paid the item any time between July 2 and July 31, the bank's payment would have been proper.

2002 amendments: The 2002 amendments substitute the term “record” for “writing.” A “record” is “information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.” [Rev] U.C.C. §3-103(a)(14).

G. Timeliness of stop payment order, legal process, notice, and set-off: An important question arises as to when a stop payment order is in time to require the payor bank to refuse to pay the item. This same question arises as to other events (called the legals) that contend for priority as to the funds in the customer's account. These other legals are (a) legal process, such as writs of garnishment or execution; (b) the payor bank learning that the drawer has filed a petition in bankruptcy, died, or become incompetent; or (c) the bank's right to set off against the customer's account a debt owed to it by the customer. Needless to say, the customer's self-interest differs when the issue involves stop payment orders as contrasted with the other legals. In the case of a stop payment order, the customer wants the order to be effective to prevent the bank from paying the check. In the case of the other legals, the issue cannot arise if the customer has sufficient funds in her account to pay the check and the bank or her other creditors. When the issue does arise, the customer will almost always prefer that the check be paid out of her account rather than have the money go to her bank or other creditors.

1. Test for determining when stop payment order or other legals come too late: Under U.C.C. §4-303(a), a stop payment order or other legal arrives too late to terminate the bank's right or duty to pay an item if it comes after any of the following events.

a. Bank certifies item: When the bank accepts or certifies an item, the bank becomes liable to the holder. At this point, the item is effectively paid and the stop payment order or other legal is too late. U.C.C. §4-303(a)(1).

b. Pays or becomes accountable for the item: When the bank has already paid the item, the funds are gone and, therefore, there is no payment to be stopped or funds to be garnished or set off against. Payment can be in cash or occur where the bank settles for the item without having a right to revoke the settlement under statute, clearinghouse rule, or agreement. Likewise, when a bank becomes accountable for the amount of the item under U.C.C. §4-302, the bank has in effect made payment. U.C.C. §4-303(a)(2), (3), (4). The issue as to when and under what circumstances a bank pays, or becomes accountable for, an item is discussed in Chapter 6.

c. **Arrives after cut-off hour:** When, with respect to checks only, the stop payment order or other legal arrives after a cut-off hour established by the bank or, if no cut-off hour has been established, after the close of the next banking day after the banking day on which the bank receives the check, the stop payment order or other legal is too late. A bank may not establish a cut-off hour earlier than one hour after the opening of the next banking day following the banking day on which the bank received the item. U.C.C. §4-303(a)(5).

Example: Assume that the bank had a cut-off hour of 10:00 a.m. The check is presented on Tuesday. A stop payment order or other legal is too late if it arrives after 10:00 a.m. on Wednesday.

Rationale: Although the bank is not yet liable for the item by the time the stop payment order or other legal is deemed to be too late, the bank needs to know at what point in time it can safely pay an item without worrying about a subsequent stop payment order or other legal. Because a bank needs time to process stop payment orders and other legals (except for set-offs), the stop payment order or other legal must arrive early enough to give the bank a reasonable time to act on it prior to the time that the bank has done any of the specified events. U.C.C. §4-303(a). Considering the pervasive presence of computers, "reasonable time" is probably a relatively short period. U.C.C. §4-303, Official Comment 6; *see* Chute v. Bank One, N.A., 10 Ohio App. 3d 122, 460 N.E.2d 720 (1983) (bank can place stop payment order in computer within very short time).

Note: Because each branch of a bank is considered, for most purposes, to be a separate bank, a stop payment order or other legal given to a branch other than the one at which the drawer keeps her account is not effective. U.C.C. §4-107, Official Comment 2. However, because the branch to which notice is given is part of the same organization as the payor bank, it has a duty to forward the stop payment order or other legal to the payor branch. [Rev] U.C.C. §1-202(f); U.C.C. §4-107, Official Comment 4. The stop payment order or other legal will be effective when it is (or should have been) received by the payor branch. [Rev] U.C.C. §1-202(f); U.C.C. §4-107, Official Comment 4.

2. **Effect of stop payment order or other legal arriving on time:** If the stop payment order or other legal arrives prior to any of the specified events, the payor bank has neither the right to pay the check nor a duty to its customer to pay the check. Thus, when a stop payment order comes in time to terminate the bank's right and duty to pay the check, the bank is liable to the drawer if, in spite of the timely stop payment order, it pays the check. When a writ of attachment, a garnishment, an execution, or the like comes in time, the bank no longer has a duty to the customer to pay the check. As a result, if it refuses to pay the check, the bank is not liable to its customer for wrongful dishonor. Similarly, when a set-off is exercised by the bank in time, the bank has no duty to the customer to pay the check and, thus, may properly debit the customer's account.

Note: U.C.C. §4-303 does not answer the question as to whether the bank is liable to the creditor if it pays the check despite the fact that the legal is timely. Whether the payor bank is liable to the creditor is answered, not by Article 4, but by the debtor-creditor law of the particular state. *See, e.g.*, Wilton Enter., Inc. v. Cook's Pantry, Inc., 230 N.J. Super. 126, 552 A.2d 1031 (1988) (bank liable to creditor because levy came in time).

3. **Effect of stop payment order or other legal arriving too late:** If

a stop payment order comes too late, the payor bank has the right to pay the check or other item and incurs no liability to the drawer if it does so. However, the payor bank does not have to pay the check in that it may waive that right. Although it has a duty to the drawer to pay the check, by issuing the stop payment order the drawer has, in effect, waived the bank's duty to pay the item. As a result, the bank is not liable to the drawer if it honors the stop payment order. The payor bank thus has the option as to whether to honor the stop payment order up until the point at which it would be liable to the holder if it fails to pay the check. The bank is liable to the holder when it has made final payment under U.C.C. §4-215 or is accountable for the item under U.C.C. §4-302(a). The payor bank is liable to the drawer if it refuses to pay an item when the attachment, garnishment, or set-off occurs or knowledge of bankruptcy is obtained after one of the same events applicable in the case of a stop payment order. The reason for this different treatment is that, unlike in the case of a stop payment order, the customer will not have waived the duty the bank owes to the customer to pay the item.

Example: Assume that your bank has established a cut-off hour of 10:00 a.m. Your check to Target arrived at the bank on Tuesday. You call your bank at noon on Wednesday and ask that it stop payment on the check. If the bank has not already incurred liability to Target, the bank may agree to stop payment of the check.

Note: If the bank, prior to obtaining knowledge of the drawer's bankruptcy, pays the check, the bank is not liable to the trustee in bankruptcy. Although at the moment that the petition is filed all assets belong to the bankruptcy estate, the Bankruptcy Reform Act of 1978 is consistent with Article 4 in providing that the bank is not liable to the trustee for paying an item after the bankruptcy petition is filed as long as the bank does not have actual knowledge of the bankruptcy. 11 U.S.C. §542(c).

H. Damages for payment in violation of stop payment order: A payor bank is liable to its customer for any damages suffered by the customer when it pays an item over a valid stop payment order. The burden of proving the amount of loss resulting from payment contrary to the stop payment order is placed on the customer. U.C.C. §4-403(c).

1. **Measure of damages:** The measure of damages is the difference between the amount paid by the bank and the amount that the customer would have been obligated to pay on the check had payment been stopped. When a bank pays an item in violation of a valid stop payment order, the customer may contend that damages should be in the full amount of the item. The customer's argument is, “But for the bank not honoring my stop payment order, I would have had the amount of the item back in my account.” However, this argument ignores the fact that the customer would have been sued on the item or on the underlying obligation had payment been stopped. As a result, ultimately she may have to pay some or all of the amount of the item to the holder or to the original obligee. For this reason, the measure of damages is the actual loss the customer suffered, taking into account any liability she avoided by having the check paid.

   Example: Ralph writes a check in the amount of $1,000 to Target for the purchase of a television set. The television set had a defective screen that cost $400 to repair. The payor bank pays the check over Ralph's stop payment order. Ralph's loss depends on whether the check is still retained by Target or whether it was acquired by a holder in due course. If Target still retains the check, had payment been stopped Target could have recovered $600 from Ralph ($1,000 contract price less $400 breach of warranty damages). Therefore, Ralph's damages arising from the bank's failure to stop payment of the check is the $400 that Ralph could have avoided paying Target had payment been stopped. If Target, however, negotiated the check to a holder in due course, the holder in due course would have taken the check free of Ralph's breach of warranty claim in recoupment and, therefore, could have recovered the entire $1,000 from Ralph. As a result, Ralph suffered no loss by virtue of the bank's failure to honor the stop payment order.

   Example: Drawer did not show a “loss” from its bank's failure to honor a stop payment request on check to payee in that drawer's alleged loss from contracting for other delivery services arose from payee's breach of delivery and logistics agreement rather than from bank's act in honoring the check. NCS Healthcare, Inc. v. Fifth Third Bank, 2005 WL 1484025 (Ohio App. 8 Dist. 2005).

2. **Damages also include wrongful dishonor of subsequent items:** Losses from the payment of an item contrary to a stop payment order may also include damages for the wrongful dishonor of subsequent items. U.C.C. §4-403(c).

I. **Payor bank's right of subrogation on improper payment:** When a payor bank makes a payment for which it cannot debit its customer's account, some party will be unjustly enriched by the payment. This party will be either the customer, who has received a benefit for which it has not paid, or the person with whom the customer dealt, who has received full payment despite being subject to the customer's defense or claim in recoupment. To protect the payor bank against unfairly being saddled with this loss, the payor bank is subrogated to the rights of any person who has been unjustly enriched by the payment.

1. **What constitutes improper payment:** The bank's subrogation rights arise not only when a payor bank has paid a check over a valid stop payment order but also in any situation in which the payor bank cannot charge its customer's account for the payment. These situations include, among others, a bank that makes an early payment of a postdated check in violation of a proper notice of the postdating issued by the drawer, U.C.C. §4-401(c), and a bank that, with knowledge of its customer's death, pays a check more than 10 days after the death. U.C.C. §4-405(b).

2. **Payor bank subrogated to other parties' rights against drawer:** To prevent the drawer from being unjustly enriched, the payor bank is subrogated to the rights of (1) any holder in due course of the item against the drawer or maker and (2) the payee or any other holder of the item against the drawer or maker either on the item or from the transaction out of which the item arose. U.C.C. §4-407(1),

(2).

> **Example:** When the payor bank paid the Target check over Ralph's valid stop payment order, the bank lost its right to charge the payment to Ralph's account. However, denying the bank the right to charge Ralph's account will result in Ralph being unjustly enriched. If the bank had to recredit Ralph's account for the entire $1,000, he will have received a free television set worth $600. As a result, assuming that the bank paid Target, the bank is subrogated to Target's rights against Ralph on the check and on the underlying obligation. Because Target could recover $600 ($1,000 purchase price minus the $400 breach of warranty damages) from Ralph, so can the bank. The bank needs to recredit Ralph's account only for the $400 difference between the amount of the item and the amount to which it is subrogated to Target's rights against Ralph. If Target had negotiated the check to a holder in due course, because the holder in due course could recover the entire $1,000 from Ralph on the check, so can the payor bank. As a result, it has no obligation to recredit Ralph's account at all.

3. **Payor bank subrogated to drawer's rights:** To prevent the payee or other holder from being unjustly enriched, the payor bank is subrogated to the drawer's rights against the payee or any other holder of the item with respect to the transaction out of which the item arose. U.C.C. §4-407(3).

> **Example:** Even if the bank has to recredit Ralph's account for $400 only, it still is out of pocket that amount. Target has the entire $1,000 even though Ralph had a breach of warranty action against it for $400. To prevent Target from being unjustly enriched, the payor bank is subrogated to Ralph's rights as drawer against Target with respect to the transaction out of which the item arose. Because Ralph had a $400 breach of warranty action against Target, so does the payor bank.

The payor bank usually has the right to recover only from the payee. Because subsequent holders are not liable to the drawer for the payee's breach of contract, there will probably be no rights under which the payor bank is subrogated against these subsequent parties.

The payor bank's subrogation rights ensure that the loss resulting from the improper payment is imposed on the party ultimately responsible for the loss. Assuming Target is solvent, the same party suffers the loss whether or not the bank honored the stop payment order. However, if Target is insolvent, whether Ralph or the payor bank suffers the loss depends on whether the check has been acquired by a holder in due course. Ralph suffers the loss only if he would have suffered the loss had payment been properly stopped. If payment had been stopped and Target sued Ralph, Ralph could have asserted his claim in recoupment. Because the payor bank's failure to honor the stop payment order denied Ralph the ability to recover from the insolvent Target, the payor bank must suffer the resultant loss. However, if the check had been acquired by a holder in due course, even if the payor bank honored the stop payment order, the holder in due course would have recovered the entire amount from Ralph. Ralph would have been left with a worthless claim in recoupment action against the insolvent Target. Because the payor bank's failure to stop payment of the check did not cause Ralph's loss, Ralph must suffer the loss occasioned thereby.

V. FUNDS AVAILABILITY UNDER REGULATION CC

A. Introduction: Prior to the promulgation of Regulation CC, when a customer deposited a check, banks would place a substantial hold on the funds represented by the check to protect themselves from their customer using the funds on a check that is subsequently returned unpaid. However, the hold not only protected the bank against loss from returned checks but also gave the bank a windfall whenever the check was, in fact, paid prior to the expiration of the hold period. In these cases, the bank had the interest-free use of the customer's money (called float). In most cases, the holds, being far longer than the time it actually took to collect the funds, resulted in the creation of an exorbitant amount of float. The extent of the float generated thereby created such a serious problem that Congress enacted the Expedited

Funds Availability Act (EFAA), 12 U.S.C. §4001.

B. Regulation CC: Regulation CC was promulgated by the Federal Reserve Board pursuant to the authority delegated to it by Congress in the EFAA. Regulation CC has two substantive subparts. Subpart B provides mandatory availability schedules under which depositary banks must permit their depositors use of deposited funds within certain expedited deadlines. In addition, depositary banks are required to pay interest on interest-bearing accounts no later than the business day on which the bank receives credit for the funds from its transferee bank. 12 C.F.R. §229.14(a). To protect depositary banks from potential losses that would be caused by being required to allow their customers use of the funds prior to the time that they would normally receive notice that the check is being returned unpaid, subpart C provides rules that impose on payor banks the duty to expedite the check return process so that depositary banks quickly learn of a check's dishonor.

1. Mandatory funds availability schedule: The mandatory availability schedules provide reasonable time periods within which a customer must be allowed use of the funds represented by a deposit corresponding with the likely time within which the bank would obtain notice of the item's nonpayment. The mandatory availability schedules are written into the EFAA itself and fleshed out in Regulation CC, subpart B. Banks must disclose their availability policy to their customers in a clear and conspicuous manner. 12 C.F.R. §229.16.

a. Provide maximum time only: The mandatory availability schedule provides only the maximum time within which funds must be made available to the customer. A depositary bank may allow its customer immediate use of funds deposited even though it has the right to delay availability of the funds under the mandatory availability schedule. 12 C.F.R. §229.19(c), Commentary 1.

b. Subject to chargeback: The depositary bank's obligation to make funds available to its customer is subject to its right to charge back the customer's account in the event that the check is returned unpaid.

2. **Next-day availability:** Some types of deposits are so likely to be paid that the depositary bank is required to allow the depositor next-day availability of the funds, which means that the funds must be made available at the start of business on the business day after the banking day on which the deposit was made. 12 C.F.R. §229.10.

   a. **Definitions:** A business day is any day other than a Saturday, Sunday, or holiday. 12 C.F.R. §229.2(g). A banking day is any *business day* on which an office of a bank is open to the public for substantially all of its banking functions. 12 C.F.R. §229.2(f).

      Example: Funds deposited on Tuesday must be made available on Wednesday (the next business day). Wednesday need not be a banking day for the depositary bank as long as it is a business day.

   b. **Funds subject to next-day availability:** The following types of deposits must be given next-day availability: (a) cash deposits made directly to a teller; (b) deposits by electronic payment; (c) deposit of a United States government check, e.g., Federal Reserve Bank or U.S. Treasury check; (d) deposit of a state or local government check; (e) deposit of a cashier's check, certified check, or tellers' check in person; (f) deposit of an on-us check; and (g) $100 of the aggregate amount of all checks deposited (not counting those that are otherwise entitled to next-day availability) in any one banking day. 12 C.F.R. §229.10.

      Example: When there is a $1,000 deposit of a cashier's check and a $500 deposit of ordinary checks, the bank must make $1,100 available on the next business day. 12 C.F.R. §229.10, Commentary 5b.

3. **Second-day and fifth-day availability:** When a check is not entitled to next-day availability, it is entitled to availability either on the second or fifth business day after its deposit depending on whether the check is a local or nonlocal check.

   a. **Definitions:** A local check is a check drawn on or payable through or at a local paying bank. 12 C.F.R. §229.2(r). A local paying bank is a paying bank that is located in the same Federal Reserve Bank check processing region as the depositary bank. 12 C.F.R. §229.2(s). A nonlocal check is a check drawn on or payable through or at a bank not located in the same check processing region as the depositary bank. 12 C.F.R. §229.2(v).

b. **Local checks:** Funds from a deposit of a local check must be made available on the second business day following the banking day of deposit. 12 C.F.R. §229.12(b)(1).

Example: Assume that Wells Bank and Bank of America are both located in the same check processing region because both banks are in the Southern California area. If you deposit your paycheck in your account at Bank of America on Thursday, Bank of America must make the funds available to you at the beginning of business on the following Monday. 12 C.F.R. §229.12(b), Commentary 1.

c. **Nonlocal checks:** Funds from a deposit of a nonlocal check must be made available on the fifth business day after the banking day of deposit. 12 C.F.R. §229.12(c)(1)(i).

Example: If Wells Bank was located in Portland and Bank of America was located in Los Angeles, your paycheck would be a nonlocal check. If you deposited your paycheck on Tuesday, Bank of America would have to make the funds available for withdrawal on the following Tuesday. 12 C.F.R. §229.12(c), Commentary.

4. **Extensions of mandatory availability schedule:** The mandatory availability schedule can be extended when a substantially increased risk of loss would be imposed on the depositary bank if it were required to honor the mandatory availability schedule. Generally, the depositary bank must give notice to its depositor when it invokes one of these exceptions. 12 C.F.R. §229.13(g). When a bank uses one of these exceptions to extend the time for withdrawal, the time may only be extended for a reasonable period, which is presumed to be 5 business days for local checks and 6 business days for nonlocal checks. 12 C.F.R. §229.13(h).

a. **Extension for cash withdrawal:** The time within which funds must be made available may be extended for one business day for funds represented by deposited checks if the depositor attempts to withdraw the funds in cash or by similar means. 12 C.F.R. §229.12(d). Thus, the depositor may write a check on the funds on the day of availability but not withdraw the funds in cash.

b. **New account exception:** The time within which funds must be made available can be extended when the funds are deposited in a new account. An account is new during its first 30 days if the customer did not have another account at the bank for at least 30 days prior to the opening of the account. 12 C.F.R. §229.13(a).

c. **Large deposit exception:** A bank may extend the hold for local and nonlocal checks to the extent that the aggregate deposit on any banking day is more than $5,000. The mandatory availability schedule still applies to the first $5,000 of deposits on that day. 12 C.F.R. §229.13(b).

d. **Returned and redeposited check exception:** There is an exception for previously returned and redeposited checks because when a check has been dishonored once, the chance is good that it will be dishonored again. 12 C.F.R. §229.13(c).

e. **Repeatedly overdrawn exception:** This exception applies whenever any account or combination of accounts of a single customer has been repeatedly overdrawn. 12 C.F.R. §229.13(d).

f. **Reasonable cause to doubt collectability exception:** This exception applies when the bank has reasonable cause to doubt collectability of a check. 12 C.F.R. §229.13(e). Examples of reasonable cause may be if the depositary bank receives notice from the paying bank that the check is being returned or if the check is more than 6 months old.

g. **Emergency condition exception:** This exception is applicable in emergency conditions in which there is an interruption of communications or computer or other equipment facilities, suspension of payments by another bank, war, or other emergency conditions beyond the control of the depositary bank. 12 C.F.R. §229.13(f).

h. **ATMs:** Deposits of cash in a night depositary or at an ATM owned or controlled by the depositary bank are entitled to second-day availability. Deposits of cash or checks deposited in an automated teller machine not owned or controlled by the depositary bank are entitled to fifth-day availability. 12 C.F.R. §229.12(f).

C. **Availability under Article 4:** Article 4 or other state availability laws govern to the extent that they allow quicker availability of funds than allowed under Regulation CC. 12 C.F.R. §229.20(a). In most cases, Regulation CC allows as quick or quicker availability than does Article 4. For example, under U.C.C. §4-215(e)(1), a depositary bank does not have to allow use of funds represented by a deposited item until it has had a reasonable time to receive return of the item. Because of the vagueness of this standard, banks were able to impose holds far longer than now allowed under Regulation CC.

Exception: Under U.C.C. §4-214(f), a deposit of cash becomes available at the opening of the bank's next banking day after receipt. Because Regulation CC provides that a state law allowing earlier availability of funds than allowed under Regulation CC governs, U.C.C. §4-214(f) prevails over Regulation CC as to cash deposited by mail, in a night depositary, or in an ATM owned by the depositary bank.

Quiz Yourself on
PAYOR BANK/CUSTOMER RELATIONSHIP

61. The day after you deposit your paycheck, you write a check to your landlord. Without the funds represented by your paycheck, you do not have sufficient funds in your account to cover your rent check. The landlord goes to your bank and presents the check for payment over the counter. Your bank refuses to pay the check. Has your bank wrongfully dishonored the rent check?_________

62. Assume that a check you wrote to the American Red Cross was issued after your rent check. You did this deliberately to ensure that your account would have adequate funds to pay the rent check. You were not concerned with whether the American Red Cross check was paid as it was a charitable donation. However, the bank processed and paid the American Red Cross check first. This left insufficient funds to pay your rent check. Had the American Red Cross check not been paid, there would have been sufficient funds to pay your rent check. Was the bank justified in dishonoring your rent check?__________

63. Assume that your rent check was received by your bank at 9:00 A.M. Your bank examines your account at 10:00 A.M. and determines that there are insufficient funds to cover the check. At 11:00 A.M., the bank credits your account with the amount of your paycheck.

a. If you needed your paycheck credited to your account to cover your rent check, could the bank have properly dishonored your rent check?__________

b. If, instead, the bank examined your account at noon, at which time there were adequate funds, would the bank be liable if it dishonored the check?__________

64. If your landlord has you arrested and prosecuted for writing a check on insufficient funds, when there were, in fact, sufficient funds in your account to cover the check, what are your remedies against the bank?__________

65. To make sure that the car is delivered before he is obligated to make payment, Vlade postdates the check he gives in payment for a new Hornet he is purchasing from Kobe. Kobe cashes the check before its stated date and never delivers the car. Can the payor bank debit Vlade's account on payment of the check?__________

66. In addition to having a checking account at Utah State Bank, Carol has also taken out a business loan in the amount of $50,000 from the bank due on March 1. On February 28, Carol writes a $30,000 check to her major business supplier. At the time, Carol's bank account contained $70,000. On March 2, the check is presented for payment. Instead of paying the check, Utah State Bank sets off her $50,000 loan against her checking account and dishonors the check. Is Utah State Bank liable to Carol for wrongful dishonor?_________

67. Assume that the set-off was exercised at 11:30 A.M. on March 2. Utah State Bank had established a cut-off hour of 10:00 A.M. Because of the dishonor, the supplier stops doing business with Carol, who, unable to find another supplier, goes out of business. Has Utah State Bank now wrongfully dishonored the check? If so, to what damages would Carol be entitled?_________

68. Nick issues a check in the amount of $2,000 to Van Exel Sounds for the purchase of a stereo system. Immediately upon taking the system home, Nick discovers that the system does not work. It would cost $500 to repair the system. Nick calls up Payor Bank, telling it the amount of the check and the check number, and orders payment stopped. On presentment the next day by Van Exel Sounds, Payor Bank pays the check. Was the stop payment order effective? If so, to what extent, if any, must Payor Bank recredit Nick's account? If it recredits Nick's account, can it recover from Van Exel Sounds? _________

69. On Monday, Alainis deposits in her Los Angeles bank account a $10,000 royalty check she receives from her recording company drawn on a New York bank. When is her bank required under Regulation CC to make the funds available to her?_________

70. Assume that you are the president of a small family-owned corporation. You are the only person authorized to sign checks for the corporation. Furthermore, everyone that does business with your corporation does so because of their faith in you personally. A check that you write to your major supplier is dishonored because of the bank's mistake. However, before the bank recognizes the mistake, the supplier has filed a criminal complaint against you for writing a check on insufficient funds. You are arrested. The members of your country club no longer talk to you and you are banished from the Rotary Club. Do you have a cause of action against the bank for wrongful dishonor?_______

Answers

61. **No.** The issue is at what point in time did your bank have to allow you to draw upon the funds represented by your paycheck. Under Regulation CC, because your check was a local check, the bank need only make the funds available on the second day following the banking day of deposit. 12 C.F.R. §229.12(b)(1). Under U.C.C. §4-215(e)(1), your bank has no obligation to allow you use of the funds represented by your paycheck until it has had a reasonable time to receive return of the paycheck in the event that it is dishonored. Under no circumstances would this result in your having use of the funds in time to cover your rent check.

62. **Yes.** The bank was justified in dishonoring your rent check and is not liable for wrongful dishonor. A bank has the right to pay checks in any order. U.C.C. §4-303(b). Your belief that the rent check would be paid before the American Red Cross check does not negate the fact that there were insufficient funds in your account when the rent check was to be paid.

63.a. **Yes.** Any credits added to the customer's account after the bank has examined the account are not considered in determining whether the account contains sufficient funds. U.C.C. §4-402, Official Comment 4.

b. **Yes.** The balance at the time of that later examination is used to determine whether there were adequate funds to pay the rent check, regardless of the fact that adequate funds did not exist in the account until three hours after the rent check was actually presented for payment. U.C.C. §4-402, Official Comment 4. Because there were sufficient funds to cover the rent check at the time the bank examined the account, the bank would be liable for wrongful dishonor if it dishonored the check.

64. **You can recover from your bank any damages suffered on account of the arrest and prosecution.** These damages may include your costs of defense and any harm done to your reputation. If you are evicted because of the dishonor, you could recover any damages resulting from the eviction. U.C.C. §4-402(b); U.C.C. §4-402, Official Comment 3.

65. **Yes.** A check is properly payable and may be charged against a

customer's account even though payment is made before its date unless the customer gives the bank proper notice of postdating. U.C.C. §4-401(c).

66. **No.** The bank has a right to set off against Carol's checking account any matured debt. Because the debt was due on March 1, the debt was matured on March 2. No notice is required before a set-off can be exercised. Because the set-off was exercised before any of the events listed in U.C.C. §4-303(a), the set-off had priority over the check. U.C.C. §4-303(a).

67. **Because the set-off was not exercised until after the cut-off hour of the next banking day after the banking day on which Utah State Bank received the check, the set-off was too late.** U.C.C. §4-303(a)(5). As a result, it is liable to Carol for wrongful dishonor. She is entitled to any damages proximately caused by the dishonor, including loss of profits resulting from the termination of her business.

68. **Yes.** The stop payment order was timely and contained sufficient information to allow Payor Bank to identify the check. U.C.C. §4-403(a). Nick has the burden of proving a loss. Had payment been stopped, Van Exel Sounds could have recovered $1,500 from Nick: $2,000 (purchase price) minus $500 (breach of warranty damages). As a result, Nick's loss caused by the bank's failure to honor the stop payment order was $500. When Nick demands that the bank recredit his account, Payor Bank will claim that it is subrogated to Van Exel Sounds's right to recover the $1,500 from Nick. U.C.C. §4-407(2). Payor Bank can use its right to be subrogated to Nick's rights to recover the remaining $500 from Van Exel Sounds. U.C.C. §4-407(3).

69. Generally, a depositary bank must make funds available on a nonlocal check on the fifth business day after the banking day of deposit. 12 C.F.R. §229.12(c)(1)(i). This would mean that the funds have to be made available to her on the following Monday. **However, because this is a deposit of over $5,000, the bank may extend the hold on the amount exceeding $5,000 for a reasonable period not exceeding 6 days. 12 C.F.R. §229.13(h).**

70. **No.** Not being the bank's customer, you have no cause of action against the bank for wrongful dishonor. U.C.C. §4-402, Official Comment 5. Because “customer” is defined to include organizations, when a check drawn on a corporate, trust, or partnership account is dishonored, the person having the right to sue for the wrongful dishonor is the corporation, trust, or partnership and not the corporate officer, trustee, or partner who signed the check.

Exam Tips on
PAYOR BANK/CUSTOMER RELATIONSHIP

- **Determining the extent of a bank's liability:** Remember that a bank that fails to honor a proper stop payment order is not necessarily liable to its customer for the amount of the check.
  - To determine to what damages the payor bank is liable, you must ask how much the drawer would have had to pay the holder had payment been stopped.
  - If the check has been acquired by a holder in due course, the drawer would have had to pay the full amount of the check and therefore appears to have suffered no damages on account of the bank's failure to honor his stop payment order.
  - However, beware that even in this event, the drawer may have suffered a loss if a subsequent check is wrongfully dishonored because payment had not been properly stopped on the earlier check.

CHAPTER 6
THE BANK COLLECTION PROCESS

ChapterScope

This chapter covers the process by which a check or other item deposited by a customer is ultimately paid by the payor bank. It examines the types of banks involved in the process, the law governing the bank collection process, the ability of banks to agree among themselves to vary the provisions of Article 4 and Regulation CC, and the duties of payor and collecting banks under both Article 4 and Regulation CC. The key points in this chapter are:

- **Effect of Regulation CC:** The bank collection aspects of Article 4 have been preempted to a large extent by Regulation CC.
- **Payor bank's accountability on presented items:** A payor bank that does not settle for a demand item or return the item on the day of presentment is liable for the amount of the item. Even if the payor bank settles for the item on the day of presentment, it is liable for the item if it does not pay or return the item by its midnight deadline.
- **Payor bank's duties under Regulation CC:** A payor bank has a duty under Regulation CC to expeditiously return a check and to give prompt notice of the nonpayment of any check in excess of $2,500.
- **Role of collecting bank:** A collecting bank is the customer's agent in collecting an item. Its agency status terminates when the item is paid. As agent, it has a duty of ordinary care in all of its actions.
- **Collecting bank's right of chargeback:** In the event that a collecting bank does not, for any reason, obtain payment of an item, it may charge back its customer's account for the amount of the item.

I. INTRODUCTION TO THE CHECK COLLECTION PROCESS

A. Introduction: When a check is given in payment of an obligation, the holder of the check needs to convert the check into cash. To do so, the holder can either present the check himself to the bank on which the check is drawn or he can deposit the check into his own bank account. His bank, acting as his agent, will then, either directly or through one or more other banks, present the check to and obtain payment from the bank on which the check is drawn. This process is called the ***check collection process.***

B. Bank: A bank is "any person engaged in the business of banking." This includes, among others, commercial banks, savings banks, savings and loan associations, credit unions, and trust companies. U.C.C. §4-105(1).

C. Branch banking: Branches or separate offices of banks are treated as separate banks for most purposes including for computing the time within which an action must be taken, in determining where an action may be taken or directed, or where notices or orders must be given. U.C.C. §4-107. For example, presentment to the Beverly Hills branch of Wells Bank would not be proper if the check was drawn on the Santa Monica branch of Wells Bank. U.C.C. §4-107, Official Comment 2.

D. Types of banks under Article 4: Article 4 classifies banks into five categories.

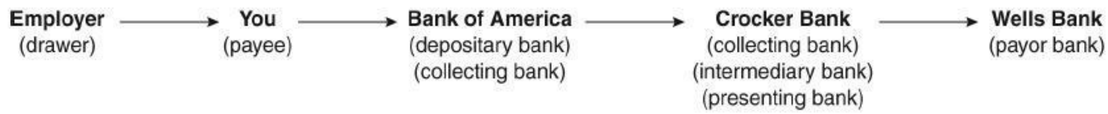
1. **Payor bank:** A ***payor bank*** is "a bank that is a drawee of a draft." U.C.C. §4-105(3).

   Example: Assume that your employer drew your paycheck on Wells Bank. You deposited the check in your account at Bank of America, which sent the check to Crocker Bank for collection. Crocker Bank then presented the check to Wells Bank for payment. Because your employer drew the check on Wells Bank, Wells Bank is the drawee of the draft. Because it is also a bank, it is the payor bank. See Figure 6-1.

2. **Depositary bank:** A ***depositary bank*** is "the first bank to take an item even though it is also the payor bank unless the item is presented for immediate payment over the counter." U.C.C. §4-

105(2).

Figure 6-1



Example: Bank of America is the depositary bank. When you deposit the check into your bank account at Bank of America, Bank of America becomes the depositary bank. Bank of America would still be the depositary bank had the check also been drawn on Bank of America, making it also the payor bank. U.C.C. §4-105(2); U.C.C. §4-105, Official Comment 3. However, Bank of America would be the payor bank only (and not a depositary bank) if you demanded payment for the check from Bank of America by presenting the check for immediate payment over the counter.

3. **Collecting bank:** A ***collecting bank*** is "any bank handling an item for collection except the payor bank." U.C.C. §4-105(5). A depositary bank, as long as it is not also the payor bank, is a collecting bank.

Example: When Bank of America, the depositary bank, sends your paycheck to Crocker Bank for presentment to Wells Bank, both Bank of America and Crocker Bank are collecting banks.

Note: One of the most common ways of collecting checks is through the ***Federal Reserve System***, which is the central bank of the United States. The Federal Reserve System is a network of 12 Federal Reserve District Banks spread throughout the country and 25 additional branches of these banks.

4. **Intermediary bank:** An ***intermediary bank*** is "any bank to which an item is transferred in the course of collection except the depositary or payor bank." U.C.C. §4-105(4).

Example: Only Crocker Bank is an intermediary bank. Wells Bank, being the payor bank, is not an intermediary bank. As the depositary bank, Bank of America is also not an intermediary bank.

5. **Presenting bank:** A ***presenting bank*** is "any bank presenting an item except a payor bank." U.C.C. §4-105(6).

   Example: Because Crocker Bank is the bank that presented the check to Wells Bank, Crocker Bank is the presenting bank.

E. Types of banks under Regulation CC: Regulation CC has created two classifications of banks.

1. **Paying bank:** Under Regulation CC, paying banks have duties above and beyond those imposed on payor banks under Article 4. ***Paying bank*** is a broader concept than "payor bank." The definition of a paying bank includes the bank whose routing number appears on a check even if it is not the true drawee bank. In addition, for bank collection functions, a bank through which a check is payable is a paying bank, even if the check is drawn on another bank. 12 C.F.R. §229.2(z).

2. **Returning bank:** A ***returning bank*** is any bank other than the paying or depositary bank that handles the item on its return. 12 C.F.R. §229.2(cc).

   Example: If Wells Bank decides not to pay your paycheck, it must return the paycheck to Bank of America, the depositary bank. Wells Bank may decide to return the check, not through Crocker Bank (the bank that presented the check), but rather through Interstate Bank. Interstate Bank would be a returning bank. Had Wells Bank returned the check through Crocker Bank, Crocker Bank would likewise be a returning bank. 12 C.F.R. §229.31.

F. Clearinghouses: A common method of collecting checks when the check is deposited in a bank in the same city or county as the bank on which the check is drawn is through a clearinghouse. A ***clearinghouse*** is an association of banks or nonbank payors such as express companies or governmental agencies regularly clearing items. U.C.C. §4-104(a)(4).

Example: First Bank of Arkansas and Little Rock State Bank are both members of the Little Rock Clearing House. Every morning at 10:00 A.M., on the premises of the clearinghouse, First Bank of Arkansas will present to Little Rock State Bank all the checks drawn on that bank. At the same time, Little Rock State Bank will present to First Bank of Arkansas all the checks drawn on that bank. On this particular day, First Bank of Arkansas presents four checks to Little Rock State Bank in the sum total of $1,500. Little Rock State Bank presents eight checks to First Bank of Arkansas in the sum total of $2,000. The banks will settle their mutual obligations on a net basis, which means that First Bank of Arkansas will pay Little Rock State Bank the $500 difference between the total amount of the checks presented to each other.

II. LAW GOVERNING THE CHECK COLLECTION PROCESS

A. Introduction: Although Article 4 is the basic law governing the bank collection process, federal statutory and regulatory law preempts any conflicting provisions of Article 4. The bank collection aspects of Article 4 have been preempted by Congress's enactment of the Expedited Funds Availability Act, 12 U.S.C. §4001, and by the Federal Reserve Board's promulgation of Regulation CC thereunder. Regulation CC governs the collection of checks through any banking channel. To a lesser degree, Article 4 is preempted by Regulation J, which was promulgated under the authority granted to the Board of Governors of the Federal Reserve System by the Federal Reserve Act. 12 U.S.C. §221. Regulation J, which governs the collection of items through the Federal Reserve System, binds any bank that sends an item for collection through a Federal Reserve Bank. 12 C.F.R. §210.3. Regulation J's rules largely resemble Article 4's rules.

Note: When a check is sent for collection through a Federal Reserve Bank, both Regulations J and CC apply. When a check is not collected through a Federal Reserve Bank, only Regulation CC applies. When an item, other than a check, is collected through a Federal Reserve Bank, only Regulation J applies. When an item, other than a check, is not collected through a Federal Reserve Bank, neither Regulation J nor CC applies.

III. VARIATION BY AGREEMENT

A. **Introduction:** The rules set out in Article 4 and in Regulation CC regulating the bank collection process can be varied by agreement between the affected parties. U.C.C. §4-103(a); 12 C.F.R. §229.37.

B. **Limitations:** Parties can agree to vary the provisions of Article 4 or Regulation CC subject to two limitations: (a) such an agreement may not disclaim a bank's liability for its own lack of good faith or failure to exercise ordinary care, nor (b) may it limit the measure of damages resulting from its lack of good faith or failure to exercise ordinary care. U.C.C. §4-103(a); 12 C.F.R. §229.37. The parties may, however, determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable. U.C.C. §4-103(a).

> **Example:** An agreement between a depositary bank and a payor bank may reduce the time that the payor bank has to determine whether it will pay or dishonor a check.

C. **Binding on customer:** With rare exception, as long as the agreement is with respect to the item being handled, the bank's customer (usually the owner of the item) is bound by any agreement that is made by the bank in the process of collecting the item for him even though he is not a party to the agreement. U.C.C. §4-103, Official Comment 3.

D. **Clearinghouse rules:** ***Clearinghouse rules*** have the effect of agreements varying the rules of Article 4 for items collected through the clearinghouse, whether or not specifically assented to by all parties interested in the items handled. U.C.C. §4-103(b); U.C.C. §4-103, Official Comment 3.

IV. DUTIES OF PAYOR BANK

A. **Introduction:** Article 4 and Regulation CC impose certain duties and time restrictions on a payor bank when an item is presented for payment.

B. **Duty to pay or settle on day of presentment:** When a check is presented for payment, the payor bank has a choice. One choice is to either pay or return the check on the day of presentment. The second choice is to ***defer posting*** of the check. When a payor bank defers posting of a check, the bank waits until the next banking day to decide whether to pay or return the check. This second choice is at a cost. To defer posting a check, the payor bank must settle with the presenting bank before midnight of the banking day of receipt or before any earlier time established by Regulations CC or J. This settlement can be revoked if the payor bank decides the next day to return the check. U.C.C. §4-301(a).

> **Example:** Crocker Bank presents your paycheck to Wells Bank on Friday morning. If Wells Bank wants to defer posting of your paycheck, it must settle with Crocker Bank for the amount of the check by midnight on Friday. It will settle by crediting Crocker Bank's account either with Wells Bank or with a Federal Reserve Bank. If Wells Bank decides to return the check unpaid the next day, it will revoke the settlement by either debiting the credit it gave Crocker Bank or instructing the Federal Reserve Bank to debit Crocker Bank's account and credit Wells Bank's account.

1. **Exception for immediate payment over the counter:** When a demand item is presented for immediate payment over the counter, a payor bank has no right to defer its decision as to whether to pay the item. U.C.C. §4-301(a); U.C.C. §4-301, Official Comment 2.

> **Example:** If you go to the branch of Wells Bank on which the check was drawn and demand that it make payment of the check, Wells Bank would have to either pay the check or dishonor it on the day of presentment. U.C.C. §3-502(b)(2).

2. **Exception for on-us checks:** A payor bank does not need to provisionally settle for an "on-us" check on the day of receipt to have the right to defer the decision as to whether to pay or return the on-us item until the next banking day. An ***on-us*** is an item on

which the payor bank and depositary bank are the same bank. U.C.C. §4-301(b); U.C.C. §4-301, Official Comment 4.

Example: If both you and your employer bank with Wells Bank, the deposit of your paycheck in Wells Bank makes your paycheck an on-us item. Wells Bank does not need to provisionally settle with you on the day of receipt to have the right to defer the decision as to whether to pay or return the paycheck until the next banking day. Unlike when one bank settles with another bank, the payor bank has no assurance that you will have the capacity to repay the funds in the event that the check is returned to you the next day.

3. **Failure to settle for demand item on day of receipt:** If the payor bank neither settles for the item, nor returns the item, by midnight of the banking day of receipt, the payor bank is penalized by being ***accountable*** (liable) for the amount of the item. U.C.C. §4-302(a)(1). *See* NBT Bank, Nat. Ass'n v. First Nat. Community Bank, 393 F.3d 404 (3rd Cir. Pa. 2004) (U.C.C. §4-302 imposes strict accountability on a payor bank that fails to revoke its provisional settlement on a dishonored check prior to the midnight deadline).

Extension: The midnight deadline for payor bank to return a check to depositary bank after maker stopped payment was extended by placing the check in possession of a courier for transport to the Federal Reserve Bank; the courier was a highly expeditious means of delivery that would ordinarily result in delivery of the check to the Federal Reserve Bank on the next banking day. *See* U.S. Bank Nat. Ass'n v. HMA, L.C., 169 P.3d 433 (Utah 2007).

4. **Means of dishonoring item:** If the payor bank, after properly settling for the item on the day of its receipt, decides that it will not pay the item, it may revoke and recover the settlement if it returns the item (1) before it has finally paid the item and (2) before its midnight deadline. U.C.C. §4-301(a)(1), (2). [[Rev] U.C.C. §4-301(a)(1),(3).] The ***midnight deadline*** is midnight on the bank's next banking day following the banking day on which the item was received. U.C.C. §4-104(a)(10).

Example: Your paycheck was received by Wells Bank on

Friday. Because Saturday and Sunday are not banking days, the next banking day is Monday. Thus, Wells Bank has to return the check by midnight on Monday.

a. **Cut-off hour:** A bank may fix an afternoon hour of 2:00 P.M. or later as a ***cut-off hour*** for the handling of money and items and the making of entries on its books. The bank may treat any item received after the cut-off hour as having been received on the next banking day. U.C.C. §4-108(a), (b).

Example: Wells Bank has established a cut-off hour of 2:00 P.M. If the check arrives after that hour on Friday, it will be deemed to have been received on Monday, the next banking day. In this event, the midnight deadline would be midnight on Tuesday.

b. **Extensions of midnight deadline for emergencies:** A payor bank may be excused from failing to meet the midnight deadline when an unanticipated emergency prevents it from doing so if certain conditions are met. U.C.C. §4-109(b); 12 C.F.R. §229.38(e).

i. **Circumstances beyond bank's control:** The delay must be caused by circumstances beyond the bank's control.

Example: A blackout of electricity may prevent the bank from using its computer for processing checks.

ii. **Could not have been prevented:** The bank must prove that those circumstances not only caused the delay, but that the circumstances could not be prevented by the bank through the exercise of reasonable care.

Example: If a computer broke down because the bank failed to regularly service the computer, the delay is not excused because the breakdown was within the bank's control.

iii. **Diligence before and after circumstance:** The bank must also prove that it exercised such reasonable diligence as the circumstances required in both anticipating the effects of any foreseeable events and in dealing with the circumstance once it arose.

Example: If a bank has reason to know that computers occasionally break down, the bank should have access to a backup computer or other processing equipment in the event of a computer breakdown. If it does not have such access, the delay is not excused. *Compare* Port City State Bank v. American State Natl. Bank, 486 F.2d 196 (10th Cir. 1973) (bank's delay excused because of computer failure) *with* Blake v. Woodford Bank & Trust Co., 555 S.W.2d 589 (Ky. App. 1977) (court refused to excuse the bank's failure to return the checks by its midnight deadline because the responsible employees had left the bank prior to midnight without leaving any instructions for the bookkeepers and because the checks could have been returned on time had the employees placed the checks in the mail).

c. Special extensions under Regulation CC: Regulation CC specifically provides for extensions of the midnight deadline in returning a check in two situations.

i. Rapid means of return: The midnight deadline is extended by one day if the paying bank uses a means of delivery that would ordinarily result in the check being received by the bank to which it is sent on or before the next banking day following the midnight deadline. 12 C.F.R. §229.30(c)(1).

Example: If instead of mailing a check before the midnight deadline, the payor bank sends the check by a courier who picks up the check at 3:00 A.M. (3 hours after the midnight deadline), the midnight deadline is extended one day if the check would normally be delivered by the courier on the next banking day.

ii. Highly expeditious means: The midnight deadline is extended further if a paying bank uses a highly expeditious means of transportation, even if this means of transportation would ordinarily result in delivery after the receiving bank's next banking day. 12 C.F.R. §229.30(c)(1).

Example: If a paying bank in Los Angeles ships a returned check by air courier directly to the New York depositary bank, the midnight deadline is extended even if the check would normally be received by the New York depositary bank after its next banking day following the Los Angeles bank's midnight deadline. 12 C.F.R. §229.30(c)(1), App. E. Commentary. This is because shipment by air courier would result in the depositary bank receiving the returned check sooner than had the check been mailed before the midnight deadline.

5. **Manner of payment:** Because the payor bank has already settled for the item on the day of its receipt, the bank has nothing more to do if it decides to pay the item. Once the midnight deadline (or any earlier deadline set by agreement, clearinghouse rule, Federal Reserve regulation, or circular) has passed, the check is deemed to be paid. U.C.C. §4-215(a)(3). At this point, the payor bank is precluded from revoking its settlement. U.C.C. §4-301(a).

6. **Failure to settle or timely return of item:** If the payor bank fails to settle for a demand item on the day of receipt or fails to pay or return the item by its midnight deadline, the bank becomes accountable for the item. U.C.C. §4-302(a)(1). This means that the bank is liable for the face amount of the item. U.C.C. §4-302, Official Comment 3.

Rationale: The bank is penalized for its untimely actions by being liable in the face amount of the item whether or not the holder suffers any loss.

a. **Liable whether or not properly payable:** Because accountability is a punishment for the payor bank's tardiness, the payor bank is accountable for the item whether or not the item is properly payable. U.C.C. §4-302(a)(1).

Example: Even if the account does not contain sufficient funds or the item bears a forged drawer's signature, the bank nonetheless is liable for the amount of the item.

b. **Payor bank's defenses against accountability:** The payor bank may defend against its accountability for an item under the same conditions that it could recover a payment made by mistake under U.C.C. §3-418(d). In addition, the payor bank may defend by proving that the presenter breached one of the presentment warranties or by proving that the presenter presented or transferred the check intending to defraud the payor bank. U.C.C. §4-302(b); U.C.C. §4-302, Official Comment 3.

Example: Assume that Wells Bank is accountable for your paycheck because it did not give a settlement on the day it received the paycheck. Wells Bank may defend against its duty to account by showing that the item contained a forged indorsement or has been altered or that the check was presented by you pursuant to a scheme to defraud it.

c. **2002 amendments:** A new [Rev] U.C.C. §4-301(a)(2) has been added to encourage the electronic processing of checks. Under this new subsection, an image of the item, rather than the item itself, may be returned if the party to which the item is to be returned has entered into an agreement under which it will accept an image as return of the item and the image is returned in accordance with the agreement. As a result, the holder may not claim that because the item itself was not returned, the payor bank has missed its midnight deadline, thereby making the payment final as to all parties. [Rev] U.C.C. §4-301, Official Comment 8. Original [Rev] U.C.C. §4-301(a)(2) has been renumbered as (a)(3). In addition, the payor bank may, instead of sending a "written notice" of dishonor or nonpayment sends a "record."

Note: The 2002 amendments define record in [Rev] U.C.C. §3-103(a)(14) as "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form."

7. **Payor bank's liability on documentary drafts and items not payable on demand:** A payor bank is accountable for the amount of a documentary draft (whether payable on demand or at a stated time) or other item not payable on demand only if (1) the item is

properly payable and (2) the payor bank does not pay or accept the item or return it and any accompanying documents within the time limits allowed. U.C.C. §4-302(a)(2).

a. **Must be properly payable:** Unlike demand items, the payor bank is liable for these types of items only if they are properly payable.

b. **Time within which bank must act:** Article 4 does not determine the time within which a bank must act to avoid accountability for these items. This is left to U.C.C. §3-502.

i. **Documentary drafts:** A bank has until the close of business on the third business day following presentment to determine whether to pay a documentary draft. U.C.C. §3-502 (c).

Example: If a documentary draft presented to the bank is payable on February 1, the bank has until the close of business on February 4 to pay or return the draft. If the draft is properly payable, the bank is accountable for the draft if it does not return it by that time. However, if there are insufficient funds to cover the draft, the bank is not liable despite its delay.

ii. **Drafts payable on stated date:** When a draft is payable on a stated date, a payor bank must make payment on the day of presentment or on the stated date, whichever is later. U.C.C. §3-502(b)(3).

8. **Final payment:** When the payor bank finally pays an item, the payment process has been completed. The payor bank may no longer revoke its settlement. In addition, the depositary bank becomes accountable to its customer for the amount of the item. U.C.C. §4-215(d). At this point the drawer and indorsers are discharged from liability. U.C.C. §4-215, Comment 8. The payor bank finally pays an item when it has done any one of the following three acts. U.C.C. §4-215(a).

a. **Pays in cash:** A payor bank finally pays an item when it makes payment in cash. An item is paid in cash when, on presentment over the counter to a teller, the teller pays cash for the item.

Example: When you take your paycheck to Wells Bank and demand that the teller give you cash for the check, the teller's act of handing you the cash is final payment of the check. However, when both the customer and the drawer of the check have an account at the same bank, whether payment is made when the teller gives cash to the customer depends on whether and how the customer fills out the deposit slip and whether there is a provision in the bank/depositor contract that provides otherwise.

- **Less cash:** When the customer fills out a deposit slip listing first the check and then listing some amount in the column reading "less cash," the bank has not finally paid the check. Rather, the customer has deposited the check into its bank account and the bank, in its role as depositary bank, has advanced funds against the check.
- **No deposit slip:** Even if no deposit slip is filled out, the handing over of cash to the depositor is not final payment if the depositor's contract provides otherwise.

b. Settles for item without reserving right to revoke: A payor bank finally pays an item when the bank settles for the item without reserving a right to revoke the settlement under statute, clearinghouse rule, or agreement. U.C.C. §4-215(a)(2); U.C.C. §4-215, Official Comment 4. The reservation must be specifically authorized by statute, clearinghouse rule, or other agreement. However, Article 4 gives a payor bank an automatic right to revoke a settlement it has made if it meets the requirements specified in U.C.C. §4-301. U.C.C. §4-215, Official Comment 4. This does not apply to checks presented for payment over the counter.

Example: When the presenting bank presents an item to the payor bank, the payor bank's settlement on the day of presentment does not constitute payment of the item because U.C.C. §4-301 specifically allows the payor bank to revoke the settlement if it meets the conditions contained in the section.

c. **Fails to revoke provisional settlement by midnight deadline:** The payor bank finally pays an item when the bank has made a provisional settlement for the item and fails to revoke the settlement by the midnight deadline, or an earlier time established by clearinghouse rule or agreement. U.C.C. §4-215(a)(3). The payor bank must provisionally settle for an item. If the payor bank fails to make a provisional settlement, the bank has not finally paid the item although the bank is accountable for the item. By not having finally paid the item, the drawer and indorser are still liable thereon.

Example: Assume that Wells Bank not only fails to settle for your paycheck on the day of presentment but also fails to return or pay your paycheck by its midnight deadline. Wells Bank is accountable to you for the amount of your paycheck. U.C.C. §4-302(a)(1). However, because you do not yet have the funds represented by the paycheck, payment of the check is not final. As a result, your employer, being the drawer, is still liable to you on the check.

9. **Duties of paying banks under Regulation CC in returning unpaid items:** To protect depositary banks that are required to make funds represented by deposited items available according to the expedited Mandatory Availability Schedule under Regulation CC, Regulation CC imposes two duties on the paying bank to ensure that the depositary bank quickly learns of a check's dishonor: (1) the duty to expeditiously return unpaid items and (2) the duty to give prompt notice of nonpayment of any item in the amount of $2,500 or greater.

Note: The paying bank's duties to expeditiously return unpaid items and to give prompt notice of nonpayment do not affect whether the bank has paid or dishonored the check under Article 4. A breach of either of these duties does not result in the bank having paid the check. The check is still dishonored. However, the paying bank is liable for any damages caused by its breach.

a. **Duty of expeditious return:** A paying bank has a duty to expeditiously return unpaid items. A paying bank may meet either of two tests to satisfy its duty of expeditious return: the ***2-day/4-day test*** or the ***forward collection test.*** 12 C.F.R. §229.30(a).

i. **2-day/4-day test:** The 2-day/4-day test requires that the paying bank return an item in a manner such that it will normally be received by the depositary bank within certain time limits. 12 C.F.R. §229.30(a)(1).

- **Local checks:** The time limit for the depositary bank to receive the return of a local check is no later than 4:00 P.M. on the second business day after the check was presented to the paying bank. 12 C.F.R. §229.30(a)(1)(i).

  Example: Assume that your local paycheck was presented to Wells Bank on Friday. Wells Bank must return the check to Bank of America so that it would normally be received by Bank of America by 4:00 P.M. on Tuesday. (Saturday and Sunday are not business days and therefore are not included in the calculation.) Wells Bank may mail the check to Bank of America if, under normal circumstances, the check would be received by Bank of America no later than Tuesday at 4:00 P.M.

- **Nonlocal checks:** The time limit for the depositary bank to receive the return of a nonlocal check is no later than 4:00 P.M. on the fourth business day after presentment. 12 C.F.R. §229.30(a)(1)(ii).

  Example: In the case of a nonlocal check that is received by Wells Bank on Friday, it must be sent in a manner as to be received by Bank of America by 4:00 P.M. on Thursday of the following week.

ii. **The forward collection test:** The forward collection test provides that a paying bank returns a check in an expeditious manner if it does so in a manner that a similarly situated bank would normally handle a check drawn on the depositary bank and deposited for forward collection in that bank by noon on the banking day following the banking day on which the check was presented to the paying bank. 12 C.F.R. §229.30(a)(2)(iii). The payor bank has to act as though the check had been deposited for collection. This means that the payor bank must act as though its customer deposited the check by noon on the next banking day following the banking day that the check was in fact presented to the payor bank. The forward collection test rests on the assumption that in sending a check for collection, a depositary bank has an incentive to use a means of collection that is reasonably prompt so that it will have use of the funds represented by the check. 12 C.F.R. §229.30(a)(2). If the payor bank uses similar means, it acts expeditiously.

Example: If your paycheck was presented for payment on Friday, Wells Bank must treat the paycheck as if it were a check drawn by you on Bank of America and deposited by your employer in its account at Wells Bank by noon on Monday. The issue would thus be whether Wells Bank handled the check in the same way in which it would have handled a check for collection deposited in your employer's account by noon on Monday.

The standard is based on how similarly situated banks would collect such a check. Thus, if similarly situated banks would use an intermediary collecting bank or a Federal Reserve Bank to present the check to the payor bank, the paying bank must use an intermediary collecting bank or a Federal Reserve Bank to return the check. 12 C.F.R. §229.30(a), Commentary, Examples b, (iii), (iv).

Example: A midnight deadline for the payor bank to return a check to the depositary bank after maker stopped payment was extended by placing the check in possession of a courier for transport to the Federal Reserve Bank; the courier was a highly expeditious means of delivery that would ordinarily result in delivery of the check to the Federal Reserve Bank on the next banking day. *See* U.S. Bank Nat. Ass'n v. HMA, L.C., 169 P.3d 433 (Utah 2007).

b. Duty to send notice of nonpayment: The paying bank has a duty to send notice of the nonpayment of any check in the amount of $2,500 or greater directly to the depositary bank. 12 C.F.R. §229.33(a). This ensures that the depositary bank quickly learns of the dishonor of any large items in time enough to prevent having to allow its customer use of the funds under Regulation CC. The notice may be communicated in any way, as long as it is received by the depositary bank by 4:00 P.M. on the second business day following the banking day on which the check was presented to the paying bank. 12 C.F.R. §229.33(a).

Example: If the check was presented on Wednesday to Wells Bank, the notice must be received by Bank of America by 4:00 P.M. on Friday.

Warranty: To protect depositary banks from erroneous notices, a paying bank that sends a notice of nonpayment warrants to its transferee bank, any subsequent transferee bank, the depositary bank, and the owner of the item that it was authorized to send notice of nonpayment. 12 C.F.R. §229.34(b)(2). The paying bank does not warrant that the notice of nonpayment is accurate and timely. 12 C.F.R. §229.34(b), Commentary.

Note: Depositary banks receive little protection from the warranty of notice of nonpayment because damages are limited to the consideration received. Therefore, the paying bank is not liable for any liability incurred by the depositary bank to its customer for wrongful dishonor of subsequent items.

c. Liability for violation of paying bank's duties of expeditious return and notice of nonpayment: A bank is liable for damages for breach of its duties of expeditious return or of transmitting notice of nonpayment only if the bank fails to exercise ordinary care or to act in good faith. 12 C.F.R. §229.38(a). A paying bank that violates its duty of ordinary care is liable to the injured party for the amount of the check less the amount of loss that would have been incurred had ordinary care been used. 12 C.F.R. §229.38(a). The bank's failure to act in good faith gives rise to liability for all damages proximately caused. 12 C.F.R.

§229.38(a). The bank is not liable for costs or attorneys' fees incurred by the injured party.

d. **Warranties given by paying bank on return of item:** Under Regulation CC, the payor bank warrants to the returning bank, the depositary bank, and the owner of the check that (a) it returned the check by its midnight deadline (or any earlier time required by Article 4, Regulation J, or Regulation CC), (b) it is authorized to return the check, (c) the check has not been materially altered, and (d) in the case of a notice in lieu of return, the original check has not and will not be returned. 12 C.F.R. §229.34(a).

Note: Although the payor bank is already accountable for the amount of the check under Article 4 because the bank was late in returning the check, U.C.C. §4-302(a), the depositary bank may choose to recover for breach of the warranty on returned checks because the damages available to it under Regulation CC may include finance charges, attorneys' fees, and other expenses related to the returned check. 12 C.F.R. §229.34(d).

V. DUTIES OF COLLECTING BANKS

A. **Introduction:** Collecting banks—including depositary, intermediary, and presenting banks— have certain duties in the bank collection process.

B. **Collecting bank's status as agent:** When a customer deposits an item into her bank account, the depositary bank automatically becomes the customer's agent for the purpose of collecting the item. U.C.C. §4-201(a).

Example: When you, as the holder of your paycheck, deposit the paycheck in your bank account, you are asking your bank to undertake the job of collecting the check from the payor bank.

1. **Intermediary and presenting banks:** Subsequent collecting banks, including any intermediary and presenting banks, become the subagent for the customer.

Example: When Bank of America sends the check for collection to Crocker Bank, a subsequent collecting bank, Crocker Bank, as a collecting bank, becomes your subagent. U.C.C. §4-201(a). Crocker Bank is responsible directly to you. Despite the fact that Crocker Bank was chosen by Bank of America, it is not the agent of Bank of America. U.C.C. §4-201(a).

2. **Termination of agency status:** The agency status of the depositary bank and other collecting banks terminates when they finally settle for the item. U.C.C. §4-201(a); U.C.C. §4-214(a); U.C.C. §4-214, Official Comment 3. Final settlement occurs in most situations when the payor bank has made final payment. At this point, the depositary bank becomes indebted to the customer in the amount of the item, and the customer's relationship with the depositary bank is transformed from principal and agent to creditor and debtor. U.C.C. §4-201, Official Comment 4.

C. **Right of chargeback:** A depositary bank will provisionally credit its customer's account on deposit of an item. However, subject to funds availability rules, the customer has no right to use the funds until the item is paid by the payor bank. The depositary bank may charge back its customer's account or obtain a refund for the amount of any provisional settlement given to the customer if, for any reason, the item is not finally paid by the payor bank. U.C.C. §4-214(a). *See* Call v. Ellenville National Bank, 5 A.D.3d 521 (N.Y.A.D. 2 Dept. 2004) (When final settlement was not made on check by payor bank due to discovery that check was counterfeit, collecting bank was entitled to revoke provisional settlement made on check and charge back customer's account or obtain refund from him for funds drawn on the check even though the bank represented to the customer that check had cleared.).

Example: Whether your paycheck was dishonored because your employer had insufficient funds in its account, because it stopped payment on the check, or because the payor bank may have gone insolvent, Bank of America may charge back your account for the full amount of the check.

1. **Right to refund:** The depositary bank retains its right of chargeback (or can obtain a refund) when it allows its customer to draw on the uncollected funds or was required to do so under Regulation CC. U.C.C. §4-214(d)(1); U.C.C. §4-201(a); 12 C.F.R. §229.32(b), Commentary b.

2. **Even if collecting bank negligent:** Even if the depositary bank's failure to exercise ordinary care in sending the item for collection caused the dishonor, it may charge back its customer's account. U.C.C. §4-214, Official Comment 5. Of course, the bank remains liable to the customer for any damages caused by its failure to exercise ordinary care in collecting the deposited item. U.C.C. §4-214(d)(2); U.C.C. §4-214, Official Comment 6.

3. **Requirements for chargeback:** To exercise its right of chargeback or refund, the depositary bank must, by its midnight deadline (or within a longer reasonable time after it learns the facts), either (a) return the item or (b) send notification of the facts if the item is not available for return. U.C.C. §4-214(a).

   Note: If the bank is both the depositary bank and the payor bank, it must act by its midnight deadline. U.C.C. §4-214(c); U.C.C. §4-301(a), (b).

4. **Consequences of failing to meet requirements:** Even if the depositary bank fails to act within the required time, it may still revoke its settlement, charge back its customer's account, or obtain a refund. The only consequence of the untimely act is that it is liable for any loss to the customer resulting from the delay. U.C.C. §4-214(a); U.C.C. §4-214, Official Comment 3.

   Note: It may be very difficult for the customer to prove a loss. Unless the drawer and all indorsers become insolvent or leave the jurisdiction in the period between the time the item should have been returned and the time the item was in fact returned, the customer will be unable to prove a loss.

D. **Duty of collecting bank to use ordinary care in collecting and returning items:** Collecting banks owe a duty of ordinary care to their customer when performing their collection and return duties.

U.C.C. §4-202(a). These duties include, among others, presenting or sending an item for presentment, choosing a route to forward an item for collection, sending notice of dishonor or nonpayment, returning the item, or settling for an item. U.C.C. §4-202(a).

1. **Acting reasonably:** Part of a collecting bank's duty to exercise ordinary care is to act reasonably. A collecting bank must take proper action before its midnight deadline following receipt of the item, notice, or settlement. Taking action within a longer time may be considered reasonable, but the burden of establishing the timeliness of the action is on the collecting bank. U.C.C. §4-202(b); U.C.C. §4-202, Official Comment 3.

   Example: If you deposit a check on Monday, Bank of America must send the check for collection by midnight on Tuesday. If the check was mutilated, and, therefore, Bank of America's computer could not read the MICR-encoded line, the fact that it was required to hand-process the check may justify it in missing the midnight deadline in sending the check for collection.

2. **Delay excused:** As in the case of a payor bank, a collecting bank is allowed additional time in the case of emergencies. U.C.C. §4-109(b).

   Example: If a blackout of electricity in its area prevented Bank of America from processing the check by computer, Bank of America's delay in forwarding the check for collection may be excused.

3. **Liable only for own negligence:** A collecting bank is liable only for its own failure to exercise ordinary care. It is not liable for the actions of another bank unless it failed to exercise ordinary care in choosing that bank. U.C.C. §4-202(c).

4. **Measure of damages for failure to exercise ordinary care:** The measure of damages for a collecting bank's failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount that could not have been realized by the use of ordinary care. Upon a showing of bad faith, damages may include any other damages the party has suffered as a proximate

consequence. U.C.C. §4-103(e).

It may be hard for the customer to prove a loss. If the drawer withdrew the funds after a reasonable time for presentment had expired but prior to the time that the check was ultimately presented, the customer will be able to prove a loss. Had the collecting bank presented the check within a reasonable time, the check would have been paid. The customer may also successfully establish a loss if he proves that he has parted with money or property after the time that notice of dishonor should have been received. In contrast, if the funds were withdrawn during the reasonable time allowed for the bank to present the check, the customer cannot prove that he suffered any loss by virtue of the delay.

> **Example:** Assume that Customer agreed to sell to Buyer a diamond ring. Although Buyer pays by check, Customer and Buyer agree that Customer does not have to deliver the diamond ring until the check clears. After 2 weeks Customer, noticing that his bank had taken the hold off his account for the amount of the check (and thus assuming that the check had been paid), sends the diamond ring to Buyer. In reality, his bank had misplaced the check and did not forward the check for collection for 3 weeks. On presentment, the check was dishonored. Buyer has vanished. Customer has suffered a loss in the amount of the diamond ring's value because of his bank's negligence in collecting the check.

5. **Electronic presentment:** A new way of presenting checks or other items is through electronic presentment. ***Electronic presentment (or check truncation)*** involves the transfer of the content of the item through the information contained on the MICR-encoded line rather than transfer of the item itself. In development now is a second means of electronic presentment called ***imaging technology*** that will allow the check's image to be electronically transmitted to the payor bank. U.C.C. §4-110, Official Comment 1. When an item is presented electronically, a presentment notice is sent in the place of the item itself. U.C.C. §4-110(a). The item is deemed presented when the presentment notice is received. U.C.C. §4-110(b).

E. Encoding warranties: To be processed by computer, the depositary bank will encode the face amount of the check on the MICR line. The depositary bank may make a mistake in its encoding. It may encode the check in a greater amount than it is actually payable (***overencoding***) or encode the check in a lesser amount than actually payable (***underencoding***). To protect the payor bank and subsequent collecting banks from losses from the misencoding, any person who encodes information on an item warrants to any subsequent collecting bank and to the payor bank or other payor that the information is correctly encoded. U.C.C. §4-209(a). Under Regulation CC, any bank that handles a check or a returned check warrants that the encoded information is correct. 12 C.F.R. §229.34(c)(3).

1. **Liability for misencoding:** A person misencoding an item is liable to any person taking the item in good faith for the loss suffered, plus expenses and loss of interest incurred. U.C.C. §4-209(c); 12 C.F.R. §229.34(d).

Overencoding example: Your paycheck, drawn in the amount of $1,000, is wrongly encoded by the depositary bank in the amount of $10,000. When the check reaches the payor bank, the payor bank's computer automatically treats the check as being drawn in the overencoded amount of $10,000. The payor bank pays the check. The payor bank, however, can debit your employer's account for only $1,000, the amount for which the check was drawn. The payor bank can recover the difference from the depositary bank that made the encoding mistake. If the item was dishonored because it was overencoded, the depositary bank is liable to the payor bank for any damages for which the payor bank is liable to its customer for wrongful dishonor.

Underencoding example: Conversely, your paycheck may have been underencoded in the amount of $100. The payor bank's computer will debit the drawer's account for $100 and order payment to the depositary bank in that amount. Because the check was in reality payable in the amount of $1,000, the payor bank, having failed to return the check by its midnight deadline, is accountable for the full amount of the check under U.C.C. §4-302(a). As a result, the presenting bank can recover the remaining

$900 from the payor bank. Because your employer wrote the check for $1,000, the payor bank may debit its account for the remaining $900. U.C.C. §4-209, Official Comment 2. However, if your employer's account does not contain sufficient funds, the payor bank will suffer a loss because of the erroneous underencoding of the check. The depositary bank will be liable to the payor bank for this loss.

Quiz Yourself on
THE BANK COLLECTION PROCESS

71. On Thursday, Joey writes a check to Lucky for $50,000. Joey has $50,000 in his bank account. Lucky deposits the check in his bank account at Roma Savings and Loan. At noon on Friday, Roma Savings and Loan presents the check to Sicily Bank. Because of its size, the check is given to the bank manager for processing. The bank manager notices that Joey has a $30,000 loan that is due on Tuesday, May 4. Realizing that paying the check may make it unlikely that the bank will obtain repayment for the loan, the manager decides to hold the check until Tuesday. At 9:00 A.M. on Tuesday, the manager sets off, against the account, the money that Joey owes the bank. Because Joey's account now contains only $20,000, the bank dishonors the check. Is Sicily Bank liable to Lucky? If so, for what damages? __________

72. Assume in the preceding example that Sicily Bank did not settle for the check with Roma Savings and Loan on the day of presentment. If Sicily Bank becomes insolvent, may Lucky recover from Joey? __________

73. Assume that Presenting Bank presents a $3,000 nonlocal check to Payor Bank on Tuesday and that Payor Bank decides on Wednesday to dishonor the check. What are Payor Bank's duties under Regulation CC and by what deadlines must it act to fulfill these duties? __________

74. Sally deposits a check in her account at Wells Bank on March 1. Wells Bank credits Sally's account for the amount of the check. Sally withdraws the funds. Wells Bank misplaces the check. It finds the check on March 20. The check is dishonored on presentment to the payor bank. Wells Bank gets notice of the nonpayment on March 22. Wells Bank returns the check to Sally on March 29. May Wells Bank charge back Sally's account for the amount of the check?_________

Answers

71. **Yes.** Sicily is liable to Lucky for the face amount of the check because it did not pay or return the check or send notice of dishonor until after its midnight deadline. U.C.C. §4-302. The check was presented on Friday and therefore Monday at midnight is the midnight deadline.

72. **Yes.** Because Sicily Bank did not settle for the check on the day of receipt, payment does not become final merely by the passage of time. U.C.C. §4-215(a)(3). Although Sicily Bank has become accountable for the check, Joey is not discharged until Sicily Bank pays the check. As a result, Lucky can still recover from Joey.

73. **Payor Bank has both the duty to expeditiously return the check and to give notice of nonpayment.** There are two ways in which it can meet the duty of expeditious return. First, it can comply with the ***2-day/4-day test***. Under this test, it must return the check by a means such that Depositary Bank would receive the check by 4:00 P.M. on the following Monday (the fourth business day after presentment). 12 C.F.R. §229.30(a)(1). Second, it can meet the ***forward collection test***, which just requires that it return the check in a manner similar to that which it would send a check for collection. 12 C.F.R. §229.30(a)(2). It meets its duty to give notice of nonpayment if the notice is received by Depositary Bank by Thursday at 4:00 P.M. (the second business day following the banking day on which the check was presented to the paying bank). 12 C.F.R. §229.33(a).

74. **Yes.** Although Wells Bank was required to give notice of the chargeback by its midnight deadline or a longer reasonable time after it learns that the check will be returned, U.C.C. §4-214(a), it still retains the right to charge back Sally's account. The only consequence of its delay is that it is liable to Sally for any loss caused by the delay. In addition, it may charge back her account even if its failure to exercise ordinary care caused the loss and even if Sally has drawn on the funds. U.C.C. §4-214(d).

Exam Tips on *THE BANK COLLECTION PROCESS*

- **Keep separate the duties under Article 4 and Regulation CC:** Be careful not to confuse the consequences of a payor bank failing to meet its duties under Article 4 and its duties under Regulation CC.
  - If, for example, a payor bank meets the midnight deadline imposed by U.C.C. §4-302 in returning a check presented for payment, the payor bank is not accountable for the check.
  - This is true even though the bank has failed to expeditiously return the check or give proper notice of nonpayment under Regulation CC.
  - The paying bank is only liable for violation of its Regulation CC duties if it has failed to exercise ordinary care.
  - Even if it is in violation of Regulation CC, a paying bank is liable only for the amount of the check less the amount of the loss that would have been incurred had ordinary care been exercised.
- **Consequences of each branch being a separate bank:** Remember that each branch of a bank is a separate bank. As a result, an attempted presentment of a check to a branch other than the payor branch does not commence the running of the time within which the payor bank must act.
  - Similarly, the giving of a stop payment order to the nonpayor branch is not effective until that branch has had a reasonable time to forward the stop payment order to the payor branch.

CHAPTER 7
WHOLESALE FUNDS TRANSFERS

ChapterScope

This chapter examines the different aspects of a funds transfer including the respective parties and their payment obligations, the duties of the different banks, cancellation of a funds transfer, liability for unauthorized transfers, erroneous payment orders, and misdescriptions. The key points in this chapter are:

- **Definition of funds transfer:** A funds transfer is a transfer of funds (often communicated electronically) between two banks.
- **Sender's obligation to pay:** A sender of a funds transfer is obligated to pay the payment order only if the funds reach the beneficiary's bank, in which event the sender's obligation on the underlying transaction is discharged.
- **Sender's obligation to reimburse:** The sender is obligated to reimburse the receiving bank only according to the terms of its payment order. If the receiving bank issues an order in a greater amount than the payment order or to the wrong beneficiary, the receiving bank must recover the payment from the recipient.
- **Sender's liability for unauthorized orders:** Subject to certain qualifications, a sender is liable for unauthorized orders if the order has been verified according to a commercially reasonable security procedure.
- **Sender's liability for mistakes in a payment order:** A sender is liable for any mistake it makes in a payment order unless the sender sent the order in compliance with a security procedure and the error would have been detected if the receiving bank had complied with the security procedure.

I. WHAT IS A FUNDS TRANSFER?

A. Definition of funds transfer: A ***funds transfer*** (also sometimes known as a ***wire transfer*** or a ***wholesale wire transfer***) is a transfer of funds (often transmitted electronically) between two banks. With certain exceptions, funds transfers are governed by Article 4A of the Uniform Commercial Code. U.C.C. §4A-102.

> **Example:** General Motors (GM) agrees to purchase computers from International Business Machines (IBM) for a price of $5 million. GM instructs its bank, Bank of America, by telephone, to pay $5 million to IBM's account at Chase Manhattan Bank. Bank of America debits GM's account and wires instructions to IBM's bank, Chase Manhattan Bank, to credit IBM's account in that amount. Chase Manhattan Bank credits IBM's account and, as a means of obtaining payment, debits the account that Bank of America maintains with it. U.C.C. §4A-104, Official Comment 1, Case #2. See Figure 7-1.

B. Terminology of funds transfers:

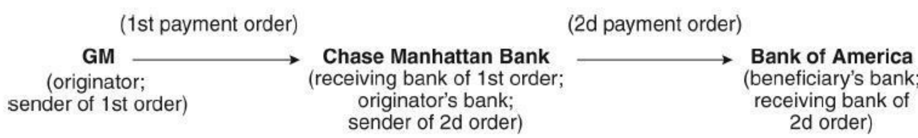
1. **Sender:** A ***sender*** is the person giving the instruction to the receiving bank. U.C.C. §4A-103(a)(5). GM, in our example above, is the sender.
2. **Customer:** A ***customer*** is a person (including a bank) having an account with a bank or from whom a bank has agreed to receive payment orders. U.C.C. §4A-105(a)(3). GM is the customer of Bank of America. If Bank of America issues a payment order to Bank of Missouri, Bank of America is the customer of Bank of Missouri.
3. **Receiving bank:** A ***receiving bank*** is the bank to which the sender's instruction is addressed. U.C.C. §4A-103(a)(4). Bank of America is a receiving bank because GM has instructed Bank of America to pay IBM.
4. **Beneficiary:** A ***beneficiary*** is the person to be paid by the beneficiary's bank. U.C.C. §4A-103(a)(2). IBM is a beneficiary

because GM has instructed Bank of America to cause Chase Manhattan Bank to pay IBM.

5. **Beneficiary's bank:** A ***beneficiary's bank*** is the bank identified in a payment order to make payment to the beneficiary. U.C.C. §4A-103(a)(3). Chase Manhattan Bank is the beneficiary's bank because GM's payment order instructed Chase Manhattan Bank to credit IBM's account.

6. **Payment order:** A ***payment order*** is defined, in part, as "an instruction of a sender to a receiving bank, transmitted orally, electronically, or in writing, to pay, or to cause another bank to pay, a fixed or determinable amount of money to a beneficiary." U.C.C. §4A-103(a)(1).

Figure 7-1



Example: The instruction from GM to Bank of America is a payment order. GM (the sender) gave an instruction orally, by telephone, to Bank of America (the receiving bank) to cause Chase Manhattan Bank to pay a fixed amount, $5 million, to IBM (the beneficiary). Bank of America's wire to Chase Manhattan Bank is also a payment order in that Bank of America (the sender) instructs Chase Manhattan Bank (the receiving bank) to pay IBM (the beneficiary).

7. **Originator:** The sender of the first payment order is the ***originator*** of the funds transfer. U.C.C. §4A-104(c). GM is the originator.

8. **Originator's bank:** The ***originator's bank*** is the receiving bank to which the payment order of the originator is issued if the originator is not a bank. U.C.C. §4A-104(d). Bank of America is the originator's bank.

C. **What is a funds transfer:** A ***funds transfer*** is "the series of transactions, beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order." U.C.C. §4A-104(a).

Example: In our example, a series of transactions—the two payment orders—began with GM's (the originator) payment order, which was made for the purpose of making payment to IBM (the beneficiary).

1. **Includes all payment orders:** The term "funds transfer" includes all payment orders issued for the purpose of carrying out the originator's payment order. U.C.C. §4A-104(a).

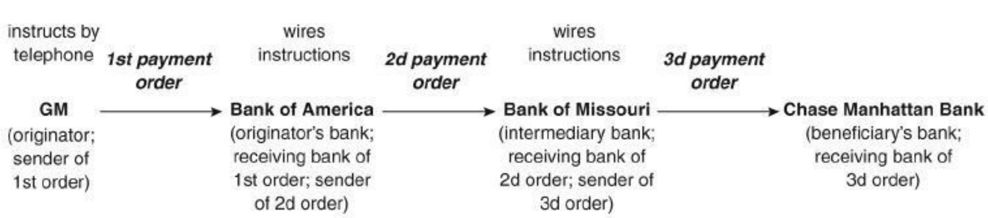
   Example: Bank of America's wire and Chase Manhattan Bank's subsequent payment to IBM are part of the funds transfer originated by GM.

2. **One-bank funds transfer:** The same bank can be both the sending bank and the receiving bank. This type of transaction is called a ***book transfer*** because the payment is accomplished by the receiving bank both crediting the account of the beneficiary and debiting the account of the sender. U.C.C. §4A-104, Official Comment 1, Case #1.

   Example: If both IBM and GM have an account with Bank of America, GM could instruct Bank of America to credit IBM's account. In this instance, Bank of America would be both the receiving bank and the beneficiary's bank.

3. **Intermediary bank:** If the sending bank does not have an account with the receiving bank, the order may be sent through a third bank that has an account with both the sending and the receiving bank. This bank is called an ***intermediary bank.***

Figure 7-2



Example: Bank of America may instruct Bank of Missouri, with which it has an account and which has an account with Chase Manhattan Bank, to pay $5 million to IBM's account at Chase Manhattan Bank. Bank of Missouri will debit Bank of America's account and then send a payment order to Chase Manhattan Bank, which then will credit IBM's account and debit the account of Bank of Missouri. U.C.C. §4A-104, Official Comment 1, Case #3. This funds transfer has three payment orders: one from GM to Bank of America, a second from Bank of America to Bank of Missouri, and a third from Bank of Missouri to Chase Manhattan Bank. See Figure 7-2.

D. **Funds transfers must be between banks:** A ***funds transfer*** is limited to payments made through the banking system. A transfer of funds by an entity other than a bank is excluded. U.C.C. §4A-104, Official Comment 2. Because the definition of "payment order" requires that the instruction must be sent to a receiving bank requesting it to pay or to cause another bank to pay money to the beneficiary, only an interbank transfer can be a funds transfer. Transfers of funds through Western Union or similar companies, therefore, are not covered by Article 4A.

E. **Requirements for a payment order:** To be a payment order, an instruction must meet the following three requirements.

1. **Unconditional:** The instruction cannot state a condition to the obligation to pay the beneficiary other than as to the time of payment. U.C.C. §4A-103(a)(1)(i).

   Example: An instruction that states that Chase Manhattan Bank is to pay IBM only on delivery of bills of lading covering 400 IBM PC computers is not a payment order.

2. **Reimbursed by sender:** The receiving bank must be paid or reimbursed by the sender. U.C.C. §4A-103(a)(1)(ii). In other words, the instruction must be sent by the person who is going to make the payment.

   Example: When GM orders Bank of America to pay IBM, GM is both the sender and the person who will make payment to Bank of America. Therefore, the order is a payment order. If, on the other hand, GM has a preexisting arrangement with its California distributor giving the distributor the right to order Bank of America to transfer funds from GM's account to the distributor's account in payment for expenses incurred by the distributor, the distributor's order to Bank of America would not be a payment order. This is because the distributor would be the sender, but it is GM's account which is to be debited.

3. **Transmitted directly to receiving bank:** The instruction must be transmitted by the sender directly to the receiving bank. U.C.C. §4-103(a)(1)(iii). This requirement eliminates credit cards and checks from coverage under Article 4A. U.C.C. §4A-104, Official Comment 5.

   Example: If GM sends a check to IBM, IBM presents the check for payment to Bank of America. This is not a payment order because GM does not send the check directly to Bank of America. U.C.C. §4A-104, Official Comment 5.

F. **Consumer transactions excluded:** The Electronic Fund Transfer Act of 1978 (EFTA) covers most consumer funds transfers. Article 4A does not apply to any transaction if any part of the transaction is covered by EFTA. U.C.C. §4A-108. This means that most consumer transfers are excluded from coverage under Article 4A.

II. PAYMENT OBLIGATIONS IN CHAIN OF TITLE

A. **Introduction:** Acceptance of a payment order by a receiving bank, other than the beneficiary's bank, obligates the sender to pay the bank the amount of the sender's order. U.C.C. §4A-402(c). The obligation of the sender is excused if the funds transfer is not completed because, for any reason, the beneficiary's bank does not accept the payment order. U.C.C. §4A-402(c). This is called a ***money-back guarantee***. U.C.C. §4A-402, Official Comment 2. When a payment order is issued to the beneficiary's bank, acceptance of the order by the beneficiary's bank obligates the sender to pay the beneficiary's bank the amount of the order. U.C.C. §4A-402(b); U.C.C. §4A-402, Official Comment 1. On acceptance by the beneficiary's bank, the obligation of the originator to pay the beneficiary on the underlying obligation is discharged and the obligation of the beneficiary's bank to pay the beneficiary is substituted for it.

> **Example:** GM issues a payment order to Bank of America, which then issues a payment order to an intermediary bank, Bank of Missouri, which in turn issues a payment order to Chase Manhattan Bank, the beneficiary's (IBM) bank. On acceptance by Bank of America, GM becomes obligated to pay Bank of America the amount of the order. Similarly, on acceptance of the payment order it sent to Bank of Missouri, Bank of America becomes obligated to pay Bank of Missouri the amount of the order. Bank of Missouri, which sent the order, is obligated to pay Chase Manhattan Bank on Chase Manhattan Bank's acceptance of the order. On acceptance by Chase Manhattan Bank, the obligation of GM to pay IBM for the computers is discharged and the obligation of Chase Manhattan Bank to pay IBM is substituted for it.

III. DUTIES AND LIABILITIES OF RECEIVING BANK

A. Introduction: A receiving bank is not obligated to accept a payment order. U.C.C. §4A-209, Official Comment 1. A receiving bank has no duties until it accepts the order. U.C.C. §4A-212. The receiving bank (unless it is also the beneficiary's bank) accepts a payment order only when it executes the order. U.C.C. §4A-209(a).

B. Rejection: Because a receiving bank accepts the order only by executing it, notice of rejection is not necessary to avoid acceptance. The receiving bank, however, may decide to give notice of rejection so as to allow the sender to correct the order or seek other means of payment. U.C.C. §4A-210, Official Comment 1. A receiving bank can reject the payment order by giving notice of rejection to the sender orally, electronically, or in writing. U.C.C. §4A-210(a).

C. Execution of order: By executing the order, the receiving bank promises to issue a payment order complying with the sender's order. U.C.C. §4A-302(a)(1). Execution occurs when the receiving bank issues a payment order intending to carry out the sender's order. U.C.C. §4A-301(a).

1. **Execution date:** The receiving bank is obligated to issue the payment order on the execution date. ***Execution date*** is the day on which the receiving bank may properly issue a payment order executing the sender's order. U.C.C. §4A-301(b). The execution date refers to the day that the payment order should be executed rather than the day that it is actually executed. U.C.C. §4A-301, Official Comment 2. The sender may, in its instructions, set the execution date. U.C.C. §4A-301(b). Where only a payment date is stated, the execution date is the payment date if the order can be transmitted by a means allowing payment on the same date. *Id*. If not, the execution date is an earlier date on which execution is reasonably necessary to allow payment to the beneficiary on the payment date. *Id*.

2. **Payment date:** The ***payment date*** is the day on which the amount of the order is payable to the beneficiary by the beneficiary's bank. U.C.C. §4A-401. In other words, the payment date indicates the day the beneficiary is to receive payment. U.C.C. §4A-401, Official Comment. The originator in its order usually indicates a payment date rather than an execution date because the originator is more concerned as to when the beneficiary receives the payment than when the originator's bank sends the payment order.

3. **Duty to issue payment order:** A receiving bank, on the acceptance of a payment order, must issue a payment order on the execution date complying with the sender's order. U.C.C. §4A-302(a)(1). If the sender's instruction states a payment date, the receiving bank is obligated to transmit the order at a time and by a means reasonably necessary to allow payment to the beneficiary on the payment date or as soon thereafter as is feasible. U.C.C. §4A-302(a)(2). If the sender's instructions specify the means by which the payment order is to be transmitted, the receiving bank must use those means. U.C.C. §4A-302(a)(1).

4. **Time when payment order can be accepted:** To protect the originator against early execution of its payment order, the

originator's bank cannot accept the originator's payment order until the execution date. U.C.C. §4A-209(d). If the receiving bank is also the beneficiary's bank, it could not accept the order until the payment date. U.C.C. §4A-209(d).

Example: Assume that on April 1, GM instructs Bank of America to make a payment on April 15 to IBM's account at Chase Manhattan Bank. Bank of America's payment order to Chase Manhattan Bank mistakenly provides for immediate payment. Chase Manhattan Bank immediately releases the funds to IBM. Because Chase Manhattan Bank complied with Bank of America's order, Bank of America is required to pay Chase Manhattan Bank on Chase Manhattan Bank's acceptance of the order. However, GM is not obligated to pay Bank of America until Bank of America has itself accepted the order. Bank of America cannot accept the order until the execution date, which is deemed to be the date prior to the payment date on which execution must take place to enable the order to be received by Chase Manhattan Bank in time for it to make payment on the payment date. Therefore, no acceptance can occur by Bank of America until shortly before April 15. Early payment has not injured GM because it is not required to pay Bank of America until the execution date.

5. **Damages for breach of duty by receiving bank:** If the receiving bank breaches its duty by, for example, breaching an express agreement to execute an order, failing to complete an order it has accepted, or issuing an order that does not comply with the terms of sender's payment order, the receiving bank is liable for the sender's expenses in the funds transfer and for incidental expenses and interest lost as a result of its failure to properly execute the order. U.C.C. §4A-305(b). Absent an express written agreement to the contrary, consequential damages are not available to the sender. U.C.C. §4A-305(a), (b), (d).

Rationale: Exposing a receiving bank to the possibility of consequential damages is inconsistent with the low cost and high speed of wire transfers. U.C.C. §4A-305, Official Comment 2.

D. Erroneous execution of payment order: An erroneous execution of a payment order refers to mistakes made by the receiving bank in its execution of the sender's order.

1. **Duplicative order, order in greater amount than authorized, or to wrong beneficiary:** When the receiving bank executes a payment order in an amount greater than the amount of sender's order, issues a duplicate order to the beneficiary, or issues an order to the wrong beneficiary, the sender, not having authorized these erroneous orders, is only obligated to reimburse the receiving bank for whatever payment was to be made according to the sender's original order. U.C.C. §4A-303(a), (c); U.C.C. §4A-402(c).

    Example: If GM issues an order to pay IBM $5 million but Bank of America issues an order in the amount of $7 million, GM is liable to Bank of America for $5 million only. U.C.C. §4A-303, Official Comment 2. Bank of America must seek the remaining $2 million from IBM. If Bank of America issues a payment order to Xerox as the beneficiary instead of properly issuing an order to IBM, GM is not obliged to pay Bank of America on the payment order. U.C.C. §4A-303(c).

    a. **Recovery from recipient:** Whether the receiving bank can recover the excess payment from the beneficiary or the improper payment from the recipient depends on the common law governing mistake and restitution. U.C.C. §4A-303(a). A court may apply either of two rules in determining whether the receiving bank may recover from the beneficiary.

        i. **Mistake of fact rule:** Under the ***mistake of fact rule***, the receiving bank may recover from the beneficiary unless the beneficiary has detrimentally relied on the payment.

            Example: Because GM's payment was in excess of the amount owed under the contract, IBM may have shipped additional computers under a subsequent order. However, unless IBM relied on the payment, Bank of America can recover the mistaken payment.

        ii. **Discharge for value rule:** Under the ***discharge for value rule***, the beneficiary (or recipient) is entitled to retain the funds as long as it had given value to the sender (whether from this or some other transaction), had made no misrepresentations to the receiving bank, and had no notice of the bank's mistake. *See* Banque Worms v. Bank America International, 13 U.C.C. Rep. Serv. 2d 657 (N.Y. 1991); In re Calumet Farm, Inc.**,** 398 F.3d 555 (6th Cir. Ky. 2005); *In re* Calumet Farm, Inc., 398 F. 3d 555 (6th Cir. 2005).

Example: Assume that GM had owed IBM other debts totaling $2 million. IBM could retain the payment even though IBM did not change position in reliance on the payment.

b. Right of subrogation: If, under the law of restitution, the beneficiary or recipient can retain the excess payment, the receiving bank becomes subrogated to any rights that the beneficiary had against the sender. U.C.C. §4A-303, Official Comment 2.

Example: Bank of America could recover from GM on the debts it owed to IBM, which were discharged by the mistaken payment.

2. Payment in a lesser amount: If the receiving bank issues a payment order in a lesser amount than authorized, it is entitled to payment from the sender in the lesser amount only unless the receiving bank issues an additional payment order for the remaining difference. U.C.C. §4A-303(b).

Example: Bank of America issues a payment order in the amount of $3 million, but GM's payment order to it was in the amount of $5 million. In this event, Bank of America is entitled to payment from GM for only $3 million unless Bank of America issues an additional payment order for the remaining $2 million difference. U.C.C. §4A-303(b). Bank of America would also be liable to GM for failing to properly execute the payment order.

3. Duty of sender on receipt of notification of error: On receipt of notice of the order as executed or of the debiting of its account, the sender has the duty to exercise ordinary care to determine, on the basis of the information available to it, whether the order was erroneously executed and, if so, to notify the receiving bank of the relevant facts within a reasonable time not exceeding 90 days after the notification is received by the sender (GM in our example). U.C.C. §4A-304. The only penalty for the sender's failure to perform this duty is that the receiving bank is not obligated to pay interest on any amount refundable to the sender for the period prior to the time the bank learns of the execution error. U.C.C. §4A-304. However, the sender may be precluded from objecting to the receiving bank's retention of its payment for the order if the sender does not notify the receiving bank of its objection within 1 year after the sender received a notification reasonably identifying the order. U.C.C. §4A-505; U.C.C. §4A-505, Official Comment. *See* Regatos v. North Fork Bank, 5 N.Y.3d 395 (N.Y. 2005) (Both the one-year period of repose in U.C.C. §4-A-505, governing a bank customer's time in which to notify the bank of an unauthorized transfer of funds, and the “reasonable time” referred to in U.C.C. §4-A-204 (1), which determines the customer's ability to recover interest on the misallocated money, begin to run when the customer receives actual notice of the improper transfer.).

IV. DUTIES OF BENEFICIARY'S BANK

A. Overview: A funds transfer is complete once the beneficiary's bank accepts the originator's bank's payment order. U.C.C. §4A-104(a); U.C.C. §4A-406(a). On its acceptance of the payment order, the beneficiary's bank becomes indebted to the beneficiary in the amount of the order on the payment date. U.C.C. §4A-404(a). Once this occurs, the originator's debt to the beneficiary on the underlying contract is discharged.

B. Manner in which beneficiary's bank accepts payment order: Acceptance of a payment order by the beneficiary's bank occurs when the first of any of the following acts occurs. However, acceptance cannot take place before the payment date. U.C.C. §4A-209(d).

1. Payment: The beneficiary's bank accepts the payment order when it pays the beneficiary. U.C.C. §4A-209(b)(1)(i). The beneficiary's bank will usually make payment by crediting the beneficiary's account. In this event, payment occurs when the beneficiary's bank has either (1) notified the beneficiary of its right to withdraw the credit, (2) properly applied the credit to a debt owed to it by the beneficiary, or (3) otherwise made the funds available to the beneficiary. U.C.C. §4A-405(a).

2. **Acceptance by notification:** The beneficiary's bank accepts the payment order when it notifies the beneficiary of the receipt of the order or that its account has been credited for the order. U.C.C. §4A-209(b)(1)(ii). However, notification does not operate as acceptance if the notice informs the beneficiary that the beneficiary's bank is rejecting the order or that funds with respect to the order may not be withdrawn or used until receipt of payment from the sender of the order. U.C.C. §4A-209(b)(1)(ii).

3. **Acceptance by receipt of payment:** Acceptance of the payment order occurs when the beneficiary's bank receives payment of the entire amount of the order. U.C.C. §4A-209(b)(2).

4. **By inaction:** The beneficiary's bank may accept a payment order by its inaction. U.C.C. §4A-209(b)(3). Unless the beneficiary's bank rejects the order, acceptance occurs automatically on the opening of the beneficiary's bank's next funds-transfer business day following the payment date of the order if either the amount of the order is covered by sufficient funds in an authorized account that the sender maintains with the beneficiary's bank or the beneficiary's bank has otherwise received full payment from the sender. U.C.C. §4A-209(b)(3). A ***funds-transfer business day*** is that part of a day during which the bank is open for the receipt, processing, and transmittal of payment orders and cancellations and amendments of payment orders. U.C.C. §4A-105(a)(4).

C. **Rejection of payment order:** Acceptance can be prevented from occurring by the beneficiary's bank's inaction if the beneficiary's bank gives timely notice of its rejection of the order. U.C.C. §4A-209, Official Comment 8.

1. **Time within which rejection must occur:** Rejection must occur

within 1 hour after the opening of the beneficiary's bank's next funds-transfer business day after the payment date. U.C.C. §4A-209(b)(3).

> **Example:** If the payment date is Friday, assuming that its funds-transfer business day begins at 9:00 A.M., Chase Manhattan Bank must give notice of rejection before 10:00 A.M. on Monday.

2. **No rejection after acceptance:** Once the beneficiary's bank accepts the payment order, it may not later reject the order. U.C.C. §4A-210(d).

D. Liability for failure to make prompt payment: If the beneficiary's bank refuses to pay the beneficiary after proper demand by the beneficiary and receipt of notice of the particular circumstances giving rise to such damages, the beneficiary may recover consequential damages. If the damages are extraordinary, the beneficiary also must give notice of this fact. U.C.C. §4A-404, Official Comment 2. *See* Evra Corp. v. Swiss Bank Corp., 673 F.2d 951 (7th Cir. 1982) (the failure of the beneficiary's bank to complete a wire transfer for $27,000 caused the beneficiary to lose a valuable ship charter with resultant damages in the amount of $2 million; the court held that such damages were not foreseeable and therefore could not be recovered).

> **Example:** Assume that IBM needs $5 million to exercise an option to purchase land to build a new factory. If Chase Manhattan Bank fails to make timely payment to IBM, Chase Manhattan Bank is liable for the damages that IBM will suffer in not being able to exercise the option only if IBM not only demands payment from Chase Manhattan Bank but also gives notice, at the time of demand, of the general type or nature of the damages that it will suffer. U.C.C. §4A-404, Official Comment 2. If IBM's inability to exercise the option will cause it to lose $100 million due to the rapid rate of appreciation of real estate, IBM must inform Chase Manhattan Bank of this fact. Because Chase Manhattan Bank normally would not be aware that a $100 million loss would result from a $5 million

transfer, IBM is not permitted to recover these extraordinary damages unless it informs Chase Manhattan Bank that the damages may be of such a magnitude. U.C.C. §4A-404(a); U.C.C. §4A-404, Official Comment 2.

Exception: The beneficiary's bank is not liable for consequential damages if it proves that it did not pay because of a reasonable doubt concerning the right of the beneficiary to the payment. U.C.C. §4A-404(a). The beneficiary's bank could avoid liability by, for example, proving that it did not know whether it, in fact, had received the payment and, therefore, whether acceptance had really occurred or that it questioned whether the person demanding payment was authorized to act for the beneficiary. U.C.C. §4A-404, Official Comment 3.

E. **Duty to notify beneficiary:** The beneficiary's bank has the duty, under certain circumstances, to notify the beneficiary of receipt of the order. If the beneficiary's bank accepts a payment order that requires *payment to an account* of the beneficiary, it must give notice to the beneficiary of the receipt of the order before midnight of the next funds-transfer business day following the payment date. U.C.C. §4A-404(b). Without this notice, the beneficiary may be unaware that the funds have been received.

Exception: If the order does not instruct payment to an account of the beneficiary, however, the beneficiary's bank is required to notify the beneficiary only if the order requires notification. U.C.C. §4A-404(b). For example, when the order is to pay IBM rather than to credit one of its accounts, Chase Manhattan Bank's act of payment by itself gives IBM notice that the funds have been received.

V. EFFECT OF ACCEPTANCE ON UNDERLYING OBLIGATION

A. **When payment is accomplished:** Payment by the originator to the beneficiary occurs when the order is accepted by the beneficiary's bank. U.C.C. §4A-406(a). Payment is accomplished by substituting the obligation of the beneficiary's bank for that of the originator.

U.C.C. §4A-406, Official Comments 1, 2.

> **Example:** When GM makes payment by a funds transfer to IBM, its obligation to IBM on the underlying contract is discharged not when Bank of America sends the payment order to Chase Manhattan Bank but only when Chase Manhattan Bank accepts the payment order. Once Chase Manhattan Bank accepts Bank of America's payment order, the obligation of GM to IBM is discharged.

Exception: Payment by a funds transfer does not discharge the underlying obligation if all of the following conditions are met: (1) the means of payment was prohibited under the contract governing the underlying obligation; (2) within a reasonable time after receiving notice of the order, the beneficiary notified the originator of its refusal to accept the means of payment; (3) the funds were neither withdrawn by the beneficiary nor applied to its debt; and (4) the beneficiary would suffer a loss that could have reasonably been avoided if payment had been made in a way that complied with the contract. U.C.C. §4A-406(b).

> **Example:** Assume that GM promised to pay IBM by a cashier's check drawn on Bank of America. Instead, GM issued a payment order to Bank of America, which in turn issued a payment order that was accepted by Chase Manhattan Bank. Before IBM withdraws the credit, Chase Manhattan Bank becomes insolvent. IBM has the right to refuse the payment, thereby denying GM a discharge. GM cannot shift the risk of Chase Manhattan Bank's insolvency to IBM when the required means of payment did not provide for such an allocation of risk. If the contract between GM and IBM does not prohibit the use of a funds transfer as a means of payment, GM would be discharged when the transfer is completed. U.C.C. §4A-406, Official Comment 2.

VI. CANCELLATION (STOPPING PAYMENT) OF PAYMENT ORDER

A. **Introduction:** The sender may want to stop payment of a payment order. In our example, GM (the sender) may have a defense arising out of the underlying transaction with IBM, or the order may be unauthorized, in a greater amount than intended, a duplicate of an earlier order, or sent to Xerox instead of IBM. U.C.C. §4A-211, Official Comment 1. Under Article 4A, stop payment is called cancellation.

B. **Effect of cancellation:** A cancelled payment order cannot be accepted. When an accepted order has been cancelled, the acceptance is nullified, and no person has any right or obligation based on the acceptance. U.C.C. §4A-211(e).

> **Example:** If GM issues a cancellation to Bank of America that is timely and proper, it is as if GM never issued the original payment order. If GM's attempt at cancellation is not effective, it is liable on its payment order as if there had been no attempt at cancellation.

C. **Right to cancel unaccepted orders:** Before the receiving bank has accepted the order, the sender has the absolute right to cancel the order if the sender gives timely notice of cancellation. U.C.C. §4A-211(b).

Rationale: The receiving bank is not hurt because, by not yet accepting the order, it incurred no obligation to make payment. U.C.C. §4A-211, Official Comment 3.

1. **Manner of cancellation:** The sender may cancel its order orally, electronically, or in writing. U.C.C. §4A-211(a). Unless the receiving bank agrees otherwise, when there is a security procedure in effect between the sender and the receiving bank, the cancellation is not effective unless it is verified pursuant to the security procedure. U.C.C. §4A-211(a). Notice of cancellation must be given at a time and in a manner that affords the receiving bank a reasonable opportunity to act on the communication before acceptance of the payment order. U.C.C. §4A-211(b). Because execution of an order is acceptance of the order, the cancellation must be received in sufficient time to ensure that the appropriate bank employee can prevent execution of the order. U.C.C. §4A-

211, Official Comment 3.

2. **Cancellation by operation of law:** An unaccepted payment order is cancelled by operation of law at the close of the fifth funds-transfer business day of the receiving bank after the execution date or payment date of the order. U.C.C.§4A-211(d).

Example: If GM, in its payment order, instructed that payment be made to IBM on Monday, February 4, the order, if not yet accepted by Chase Manhattan Bank, is cancelled by operation of law at the close of business on Monday, February 11.

Rationale: When the payment order is not executed within a few days of its execution date or accepted within a few days of its payment date, the order probably has a problem. Although the sender probably regards the unaccepted payment order as dead, he may have neglected to cancel the order. This rule protects the sender from an unexpected delayed acceptance. U.C.C. §4A-211, Official Comment 7.

D. **Cancellation of order accepted by receiving bank:** A receiving bank has no obligation to cancel an accepted order. U.C.C. §4A-211(c). Even if it chooses to do so, the cancellation is not effective unless the receiving bank cancels the payment order it sent in execution of the sender's order. U.C.C. §4A-211(c)(1); U.C.C. §4A-211, Official Comment 3.

Example: Bank of America becomes liable to Bank of Missouri (the intermediary bank) once Bank of Missouri accepts the order. If Bank of America is unable to cancel its order to Bank of Missouri, it will be obligated to reimburse Bank of Missouri. GM has no right to cancel its order if Bank of America cannot cancel its order to Bank of Missouri. U.C.C. §4A-211, Official Comment 3.

E. **Cancellation of order after acceptance by beneficiary's bank:** Once the beneficiary's bank accepts the order, the funds transfer is complete. The beneficiary has been paid and the originator's debt to the beneficiary discharged. As a result, cancellation of an order accepted by the beneficiary's bank can occur only in rare situations.

Once the beneficiary's bank has accepted an order, it has no obligation to agree to cancel the order. Although having no duty to agree to a cancellation, the beneficiary's bank may agree to a cancellation in four situations:

- if the payment order is unauthorized;
- if the payment order is duplicative of a payment order previously sent;
- if the payment order is mistakenly sent to a beneficiary who is not entitled to payment from the originator; or
- if a payment order is issued by mistake in an amount greater than the beneficiary is entitled to receive from the originator. U.C.C. §4A-211(c)(2).

> **Example:** An unauthorized employee of GM sends a payment order to Bank of America payable to IBM. Being unauthorized, Chase Manhattan Bank, the beneficiary's bank, exercises its right to agree to the cancellation. Bank of America then may cancel its order to Bank of Missouri, which in turn may cancel its order to Chase Manhattan Bank. On cancellation, the acceptance is nullified and Chase Manhattan Bank is entitled to recover the payment from IBM to the extent permitted by the law of mistake and restitution. U.C.C. §4A-211, Official Comment 4, Case #1. *See* Khawaja v. J.P. Morgan Chase Bank, 10 Misc. 3d 862 (N.Y. City Civ. Ct. 2005) (Senders of transfer advices, whereby one bank customer transferred funds to the account of another customer of same bank, had the right to cancel the transfers with the bank's consent where the advices constituted unauthorized payment orders. Upon cancellation, the bank was entitled to recover from beneficiary any amount that it initially credited his account to extent allowed by law governing mistake and restitution.

VII. LIABILITY FOR AUTHORIZED PAYMENT ORDERS

A. **Introduction:** The sender has the duty to reimburse the receiving bank for the amount of any authorized payment order. U.C.C. §4A-203, Official Comment 1. A payment order is authorized if the sender either actually or apparently authorized the order or is otherwise bound by the order under the law of agency. U.C.C. §4A-202(a).

VIII. LIABILITY FOR UNAUTHORIZED PAYMENT ORDERS

A. **Introduction:** A sender is liable for an unauthorized order if it qualifies as a ***verified order***. An order that passes on being properly tested according to a security procedure is called a ***verified payment order***. U.C.C. §4A-202(b).

Rationale: Because most payment orders are transmitted through electronic means, the receiving bank has no way to determine the identity or authority of the person sending the message unless it has established some type of security procedure that can be employed to determine whether the order is authorized and accurate. If the receiving bank establishes such a security procedure and verifies the order pursuant to that procedure, it must be able to rely on the order and know that it will get reimbursed once it executes the order. Thus, the sender is liable for any order, whether authorized or not, that is verified according to a proper security procedure.

B. **Security procedure:** A security procedure is a procedure by which the bank may test the authenticity and/or accuracy of an order. A ***security procedure*** is defined as "a procedure established by agreement of a customer and a receiving bank for the purpose of (i) verifying that a payment order or communication amending or canceling a payment order is that of the customer, or (ii) detecting error in the transmission or content of the order, amendment or cancellation." U.C.C. §4A-201. A security procedure may take any number of forms, including a code or an algorithm, identifying words or numbers, encryption, or callback procedures. U.C.C. §4A-201. However, because of the ease of forging a signature, the comparison of a signature on a payment order (or other communication) with an authorized specimen is not, by itself, a security procedure. U.C.C. §4A-201.

C. **Requirements for sender's liability for verified payment orders:** Determining whether the customer is liable to the receiving bank for an unauthorized but verified payment order is a two-step process.

1. **First step:** The receiving bank must prove that the order is a verified payment order. The bank proves that it is a verified payment order by proving the following:

   a. **Agreement with customer:** The bank had an agreement with its customer providing that orders would be verified pursuant to a security procedure.

   b. **Commercially reasonable procedure:** The security procedure is a commercially reasonable method of providing security against unauthorized payment orders.

   c. **Bank complied with procedure:** The bank accepted the payment order in good faith and in compliance with the security procedure and any written agreement or instruction of the customer. U.C.C. §4A-202(b).

   Rationale: The loss is thrust on the customer because it is the customer's burden to supervise its own employees and to ensure that confidential information and access to transmitting facilities are kept secure. Once the bank proves that the order is a verified order, it is likely that the leak came from the customer's side. U.C.C. §4A-203, Official Comment 3.

   Note: The burden of making a commercially reasonable security procedure available is on the bank because it knows what procedures are possible and how well they will work. If the bank fails to offer a commercially reasonable security procedure or fails to comply with the security procedure adopted, the bank suffers the loss. U.C.C. §4A-203, Official Comments 2, 3.

2. **Second step:** If the bank proves that the order was a verified order, the order is effective as the order of the customer whether or not it was authorized by the customer. The customer is therefore liable to the receiving bank for the amount of the order. U.C.C. §4A-202(b).

However, the customer can avoid liability by proving (indirectly) that the security breach was the responsibility of the bank. The customer does so by proving that the breach of security was not in any way attributable to the customer itself. To do so, the customer must prove a negative. It must prove that the order was not caused, directly or indirectly, by a person who falls into one of two categories.

a. **Entrusted with duties as to payment orders:** The first category includes any person who was entrusted at any time with duties to act for the customer with respect to payment orders or to the security procedure. U.C.C. §4A-203(a)(2)(i).

b. **Access to source or facilities:** The second category comprises any person who (a) obtained access to the customer's transmitting facilities or (b) obtained, from a source controlled by the customer and without authority of the receiving bank, information facilitating breach of the security procedure, regardless of how the information was obtained or whether the customer was at fault. Information includes any access device, computer software, or the like. U.C.C. §4A-203(a)(2).

   Note: It would be extremely difficult for a customer to bear this burden of proof unless the customer can affirmatively show that the leak came from a source controlled by the bank.

D. **Summary of when loss falls on bank:** There are, thus, four situations in which the loss caused by an unauthorized payment order falls on the bank and not on the customer:

- no commercially reasonable procedure was in effect;
- the bank did not comply with the security procedure in place;
- the customer can prove that the wrongdoer did not obtain the information from it; or
- the bank agreed to assume all or part of the loss. U.C.C. §4A-204, Official Comment 1.

E. **Contrary agreement prohibited:** The customer cannot agree to take more of the loss than provided for in Article 4A. U.C.C. §4A-202(f).

F. Duty of customer on receipt of notification of error: On being notified of the relevant facts, the customer has the duty to exercise ordinary care to determine whether the order was unauthorized and, if so, to notify the receiving bank of the relevant facts within a reasonable time not exceeding 90 days after the notification is received by the sender that her account was debited or the order accepted. U.C.C. §4A-204(a). The only penalty for the sender's failure to perform this duty is that the receiving bank is not obligated to pay interest on any amount refundable to the sender. However, the sender may be precluded from objecting to the receiving bank's retention of its payment for the order if the sender does not notify the receiving bank of its objection within 1 year after the sender received a notification reasonably identifying the order. U.C.C. §4A-505; U.C.C. §4A-505, Official Comment.

IX. ERRONEOUS PAYMENT ORDERS

A. Introduction: An erroneous payment occurs when the sender makes a mistake in the payment order it sends and the receiving bank accepts the order without noticing the error. The mistake may be in the amount of the order or in the identity of the beneficiary. Whether the sender or the receiving bank suffers the loss depends, to a large extent, on whether a security procedure was in place to detect such errors.

> **Example:** GM may have mistakenly instructed that payment be made to Xerox, instead of to IBM, or GM may have sent an order duplicative of an order previously sent to IBM or in an amount greater than it had intended.

B. Allocation of loss when no security procedure in place: The sender suffers the loss in the event that there is no established security procedure to determine the accuracy of the order. U.C.C. §4A-205, Official Comment 1.

Rationale: Without an established security procedure, the receiving bank has no way of determining that an error has been made. Because only GM could have prevented the error, the loss falls on GM. GM's remedy is to recover from Xerox, in the first case, and from IBM in the last two cases. U.C.C. §4A-205, Official Comment 1.

C. **Allocation of loss when security procedure in place:** When an established security procedure is in place to detect such errors, the loss shifts to the receiving bank if the sender proves that it had complied with the security procedure and that the error would have been detected if the receiving bank had also complied with the security procedure. U.C.C. §4A-205(a)(1).

Example: If GM had intended to send an order for $5 million but had erroneously sent an order for $7 million, GM would be obligated to pay Bank of America only $5 million if GM proves that it complied with the security procedure and that the error would have been detected if Bank of America also complied with the security procedure. Bank of America could recover the remaining $2 million from IBM (the beneficiary of the order) to the extent allowed by the law governing mistake and restitution. U.C.C. §4A-205(a)(3); U.C.C. §4A-205, Official Comment 1.

D. **Sender's duty on receipt of notice of acceptance:** Once the sender receives notification from the receiving bank that the order has been accepted by the bank or that the sender's account has been debited in the amount of the order, the sender has a duty of ordinary care to discover (on the basis of the information that it has) any error concerning the order and to advise the receiving bank of the relevant facts within a reasonable time (not exceeding 90 days) after notification is received by the sender. U.C.C. §4A-205(b); U.C.C. §4A-205, Official Comment 2. If the receiving bank proves that the sender failed to perform this duty, the sender is liable to the receiving bank for any loss, not exceeding the amount of the order, that the receiving bank proves it incurred as a result of the failure. U.C.C. §4A-205(b); U.C.C. §4A-205, Official Comment 2.

X. MISDESCRIPTIONS

A. **Introduction:** In different situations, the originator (or other sender) may have improperly described the beneficiary. In these situations, the question arises as to whether the originator (or other sender), the originator's bank, an intermediary bank, or the beneficiary's bank suffers any loss caused by the misdescription.

B. **Nonexistent or unidentifiable person or account:** If the name, bank account number, or other identification of the beneficiary refers to a nonexistent or unidentifiable person or account, no person has rights as the beneficiary of the order. U.C.C. §4A-207(a). As a result, the beneficiary's bank cannot accept the order and the funds transfer cannot be completed. U.C.C. §4A-207; U.C.C. §4A-207, Official Comment 1. Each sender in the funds transfer is relieved of liability and is entitled to a refund to the extent of any payment. U.C.C. §4A-207, Official Comment 1.

> **Example:** Assume that one of GM's creditors is Ace Welding Company. In sending a payment order to Bank of America, GM misdescribes the beneficiary as “Acme Welding Company.” Unfortunately, accounts exist at Chase Manhattan Bank not only under the name of “Ace Welding Company” but also under the name of “Acme Hardware Company.” Chase Manhattan Bank must reject the order. Bank of America has no obligation to pay its payment order and GM has no obligation to pay Bank of America. U.C.C. §4A-402(c).

C. **When beneficiary identified by both name and number:** When the beneficiary is identified by both a name and an identifying or bank account number and the name and number identify different persons, the beneficiary's bank may rely on the number as the proper identification of the beneficiary and credit the account number. U.C.C. §4A-207(b)(1). The loss will generally then fall on the bank sending the order. The customer is not obligated to pay the order unless the receiving bank proves that before acceptance of the customer's order, the customer received notice from the receiving bank that payment might be made on the basis of the identifying number or bank account number even if it identifies a different person. U.C.C. §4A-207(c)(2).

> **Example:** Assume that GM's order identified the supplier as “Ace Welding Company, Acct. No. 1234.” Chase Manhattan

Bank credits the order to account number 1234. Although GM has properly identified the beneficiary by name, the account number is the number of Avis Rent-a-Car. As a result, the money is paid to Avis and not to Ace. Chase Manhattan Bank is nonetheless entitled to payment from Bank of America. However, Bank of America is not entitled to payment from GM unless it supplied GM with notice that payment may be made by identifying number rather than by name. U.C.C. §4A-207(c)(1).

Rationale: Payment orders received by beneficiary's banks from other banks are processed by an automated device that processes the order by reading the identifying number or the bank account number and not the name of the beneficiary. As a result, the beneficiary's bank will not generally even notice the name of the intended beneficiary. U.C.C. §4A-207, Official Comment 2. However, when the beneficiary's bank either pays the person identified by name or knows that the name and the number identify different persons, the beneficiary's bank assumes the risk that it has failed to pay the person intended by the sender. If it pays the proper person, the beneficiary's bank is entitled to payment. If it does not, no acceptance can occur and the originator's bank has no obligation to pay the beneficiary's bank. U.C.C. §4A-207(b)(2).

D. **Misdescription of intermediary bank or beneficiary's bank:** Similar problems arise when the intermediary or beneficiary's bank is improperly described.

1. **Identification by number only:** When a payment order identifies an intermediary bank or the beneficiary's bank by an identifying number only and that number is wrong, the bank sending the order will suffer any loss caused by the order being accepted by the wrong bank. U.C.C. §4A-208(a)(1).

   Example: Assume that GM issues a payment order to Bank of America identifying the beneficiary's bank as Chase Manhattan Bank. Bank of America issues a payment order to Bank of Missouri (the intermediary bank) describing the beneficiary's bank as “Bank No. 156234.” However, the number actually describes Bank of Connecticut. Bank of Missouri sends the order to Bank of Connecticut, which accepts the order. Bank of Missouri is entitled to reimbursement from Bank of America. U.C.C. §4A-208, Official Comment 1, Case #1. Not only is Bank of America not entitled to reimbursement from GM, but it is liable for damages to GM as provided for under U.C.C. §4A-305(b). U.C.C. §4A-208, Official Comment 1, Case #1. However, if the originator (GM) supplied only the number and not the name of the beneficiary's bank, the originator would be obligated to reimburse the originator's bank. U.C.C. §4A-208(a)(2).

2. **Conflict between name and number:** When there is a conflict between the name of the beneficiary's bank (or intermediary bank) and the identifying number, the receiving bank may rely on the number as the proper identification of the beneficiary's bank (or intermediary bank) if it does not know at the time it executes the order that the name and number identify different persons. U.C.C. §4A-208(b). In this event, the sending bank suffers the loss and may not recover from its customer. *See* TME Enterprises, Inc. v. Norwest Corp., 124 Cal. App. 4th 1021 (Cal. App. 2 Dist. 2004) (The fact that a bank accepted an incoming wire transfer of funds that specified both an account number and a named beneficiary did not mean that it had actual knowledge that the holder of the account number specified and the name designated as the beneficiary were inconsistent. As a result, the bank did not violate Federal Reserve Board's Regulation J when it accepted the transfer.).

Example: Assume that Bank of America, in its order to Bank of Missouri, describes the beneficiary's bank as "Chase Manhattan Bank, No. 156234." Unfortunately, No. 156234 describes Bank of Connecticut. The loss falls on Bank of America.

Exceptions: If a nonbank sender had included the conflicting description of the beneficiary's bank in its order to the sending bank, it would be obligated to reimburse the sending bank for any losses or expenses incurred in executing or attempting to execute the order if the sender received notice that the sending bank might rely on the identifying number only in accepting the order. U.C.C. §4A-208(b)(2).

If the receiving bank knows that the name and the number identify different banks, reliance on either the name or the number, if incorrect, is a breach of its duties in executing the sender's payment order. U.C.C. §4A-208(b)(4).

XI. INJUNCTION

A. Generally: A creditor can obtain an injunction preventing the originator from issuing a payment order initiating a funds transfer to the beneficiary, the originator's bank from executing the originator's payment order, the beneficiary's bank from releasing funds to the beneficiary, or the beneficiary from withdrawing the funds. U.C.C. §4A-503. However, no intermediary bank can be enjoined from executing a payment order or a receiving bank from accepting the order or receiving payment from the sender. U.C.C. §4A-503, Official Comment.

Quiz Yourself on WHOLESALE FUNDS TRANSFERS

75. Assume that Xerox instructs Bank of California to transfer funds to Ford Motor Company's account at Detroit State Bank. Assuming that Bank of California will send a payment order directly to Detroit State Bank, how many payment orders are involved in the transaction and what are the capacities in which each of the parties act?__________

76. True or False: A receiving bank is liable for wrongful dishonor if it fails to accept a payment order when the sender has sufficient funds in its account to cover the payment order.__________

77. True or False: A receiving bank must send notice of rejection if it does not want to accept an order. __________

78. True or False: If a receiving bank accepts a payment order prior to the execution date, it may debit the sender's account even though it remains liable for any losses caused by the early execution.__________

79. True or False: A receiving bank is not liable for consequential damages when it fails to execute an order even if those damages are foreseeable.__________

80. True or False: Assuming that the contract does not forbid payment by funds transfer, once the beneficiary's bank accepts the payment order sent by the originator's bank, the originator is discharged from liability on the underlying transaction even if the beneficiary's bank becomes insolvent.__________

81. True or False: As long as the beneficiary's bank has not yet accepted the payment order, the originator has an absolute right to cancel its payment order.__________

82. An order is sent to Bank of California allegedly from Xerox instructing the bank to transfer $1 million to Laundered Money, Inc. at Swiss Bank. Bank of California tests the payment order against the security procedure that Bank of California and Xerox have agreed should be used to test orders of this type. The payment order passes. Xerox proves that no authorized person sent the order. Can Bank of California charge Xerox's account for the amount of the order? __________

Answers

75. There are two payment orders: the order from Xerox to Bank of California and the order from Bank of California to Detroit State Bank. Xerox is the sender of first payment order, U.C.C. §4A-103(a)(5), the originator, U.C.C. §4A-104(c), and the customer of Bank of California, U.C.C. §4A-105(a)(3). Bank of California is the receiving bank on the first payment order, U.C.C. §4A-103(a)(4), the originator's bank, U.C.C. §4A-104(d), the sender of the second payment order, U.C.C. §4A-103(a)(5), and the customer of Detroit State Bank, U.C.C. §4A-105(a)(3). Detroit State Bank is the receiving bank of the second payment order, U.C.C. §4A-103(a)(4), and the beneficiary's bank, U.C.C. §4A-103(a)(3). Ford Motor Company is the beneficiary, U.C.C. §4A-103(a)(2).

76. **False.** A receiving bank has no duty to accept a payment order.

U.C.C. §4A-209, Official Comment 1.

77. **False.** Until it accepts the order, it has no duties regarding the order. U.C.C. §4A-212.

78. **False.** A payment order cannot be accepted before its execution date. U.C.C. §4A-209(d). Consequently, the sender has no obligation to reimburse the receiving bank for the payment order.

79. **True.** Absent an express written agreement to the contrary, a receiving bank is not liable to the sender for consequential damages. U.C.C. §4A-305(a)-(c).

80. **True.** The originator's obligation to the beneficiary is discharged the moment that the beneficiary's bank accepts the payment order. U.C.C. §4A-406(a).

81. **False.** Once the originator's bank accepts the payment order, the originator has no right to cancel the order unless the originator's bank not only consents to the cancellation but also is able to cancel the payment order it sent pursuant to the originator's instructions. U.C.C. §4A-211(c).

82. **Yes.** A sender is liable for an unauthorized order if it qualifies as a verified order. Because the order passed on being properly tested according to a security procedure, it is a verified order. U.C.C. §4A-202(b). Xerox can avoid liability only by proving that the order was not caused, directly or indirectly, by a person entrusted with duties as to payment orders or a person who had access to Xerox's transmitting facilities or from information facilitating breach of the security procedure obtained from a source controlled by Xerox. U.C.C. §4A-203(a).

Exam Tips on *WHOLESALE FUNDS TRANSFERS*

- **A customer's liability and burden of proof:** Remember that, as a general matter, the customer and not the receiving bank is liable for a verified payment order even though it is unauthorized.

- Once the receiving bank proves that the order is a verified payment order, the customer has the substantial burden of proving that the breach of the security procedure was not its fault.
- Note that it is almost impossible for the customer to prove that no unauthorized person had access to its transmitting facilities or to information as to the security procedure.
- The customer can avoid liability only by affirmatively proving that it was the receiving bank's fault that the security procedure was breached.

CHAPTER 8
CONSUMER ELECTRONIC FUND TRANSFERS

ChapterScope

This chapter examines what constitutes an electronic fund transfer governed by Regulation E, a consumer's liability for an unauthorized fund transfer, stopping payment of a fund transfer, special rules for preauthorized transfers, documentation requirements, error resolution procedures, and a financial institution's liability for failing to make a correct fund transfer. The key points in this chapter are:

- **Electronic fund transfers covered by Regulation E:** An electronic fund transfer covered by Regulation E is a transfer of funds that is initiated through an electronic terminal, a telephone, or computer or magnetic tape for the purpose of instructing a financial institution to debit or credit a consumer asset account.
- **Types of electronic fund transfers:** Typical electronic fund transfers include point-of-sale transactions and automated teller machine transactions.
- **Consumer liability:** A consumer is liable only up to $50 for an unauthorized transfer from his account. However, this liability can be increased if the consumer either fails to report the loss of his access device or to report unauthorized transfers appearing on a periodic statement.
- **Stop payment:** A consumer, although having no right to stop payment on an ordinary electronic fund transfer, may stop payment on a preauthorized fund transfer from his account.
- **Notification of error:** A financial institution must follow established procedures once the consumer notifies it of an error.

I. LAW GOVERNING CONSUMER ELECTRONIC FUND TRANSFERS

A. Introduction: Consumer electronic fund transfers are governed, for the most part, by the Electronic Fund Transfer Act (EFTA), 15 U.S.C. §1693, and Regulation E promulgated thereunder. The EFTA preempts state law to the extent that the state law is inconsistent with the EFTA. State laws that provide greater protection for consumers than the protection afforded by the EFTA are not preempted. 15 U.S.C. §1693q; 12 C.F.R. §205.12(b).

II. WHAT IS AN ELECTRONIC FUND TRANSFER?

A. Introduction: An electronic fund transfer is any transfer of funds that is initiated through an electronic terminal, a telephone, a computer, or magnetic tape for the purpose of instructing a financial institution to debit or credit a consumer asset account. 15 U.S.C. §1693a(6); 12 C.F.R. §205.3(b). A ***consumer asset account*** is one that contains a consumer's assets. 15 U.S.C. §1693a(2); 12 C.F.R. §205.2(b)(1). Electronic fund transfers resulting in an extension of credit on a credit line are not covered by the EFTA.

> **Example:** Article 4 did not apply to a cause of action against a bank, for approval of unauthorized electronic fund transfers with an automatic teller machine card. Rather, EFTA applied Hospicomm, Inc. v. Fleet Bank, N.A., 338 F. Supp. 2d 578 (E.D. Pa. 2004).

> **Example:** Bank's transfer of funds from account holders' checking account to debt collector was not an electronic fund transfer subject to requirements of the EFTA where the debt collector personally presented a paper draft on the holders' account to a teller at its bank. Vigneri v. U.S. Bank Nat'l Assn., 437 F. Supp. 2d 1063 (D. Neb. 2006).

B. Typical electronic fund transfers: The most common types of electronic fund transfers are:

- **Point-of-sale transfers:** Point-of-sale transfers (***POS transfers***) use a debit card at a terminal located at the merchant's business location that, through a computer linkup, determines whether the consumer's bank account contains sufficient funds and, if it does, immediately debits the consumer's bank account and credits the merchant's bank account.
- **Automated teller machine (*ATM*) transfers**
- **Direct deposits or automatic payments**

C. How initiated: The transfer must be initiated through an electronic terminal, a telephone, or computer or magnetic tape.

> **Example:** When a consumer preauthorizes a creditor to initiate a debit to the consumer's account, the transaction is governed by the EFTA if the bank debits the consumer's account according to information provided to the bank by the creditor on computer or magnetic tape. 12 C.F.R. §205.3(b)(1), Official Staff Commentary.

> **Example:** Transfers through POS terminals, ATMs, and cash dispensing machines are covered because these are electronic terminals. 12 C.F.R. §205.2(f). The EFTA also covers home banking services in which a consumer initiates transfers to, or from, an account (a) by a computer or a television set linked to the financial institution's computer system or (b) under a pay-by-phone plan by which the consumer telephonically instructs her financial institution to make a payment to a creditor. 12 C.F.R. §205.2(f)(1), Official Staff Commentary.

Exception: A transfer from a consumer account initiated through use of a debit card is covered even though the transaction does not involve an electronic terminal, magnetic tape, or computer. 12 C.F.R. §205.3(b)(5). A ***debit card*** is an access device that has the capability to transfer funds by debiting the consumer's bank account.

> **Example:** A consumer may be able to use a debit card almost like a check to purchase goods or services. In this type of transaction, the merchant makes a copy of the information contained on the card and asks the consumer to sign the debit

slip. The debit slip is then forwarded for payment through the merchant's bank to the consumer's bank.

Rationale: Although no electronic terminal is used, the transaction is nonetheless governed by the EFTA to protect consumers who may naturally assume that because the transaction is initiated by a debit card, they have the same protections whether the merchant makes a copy of the debit card or has the consumer run the debit card through an electronic terminal.

III. CONSUMER'S LIABILITY FOR UNAUTHORIZED TRANSFERS

A. **Introduction:** A consumer has only limited liability for unauthorized transfers out of his account.

B. **What is an unauthorized fund transfer?** An electronic fund transfer is unauthorized if the transfer is initiated by a person without actual authority to initiate the transfer and the consumer did not receive a benefit from the transfer. 15 U.S.C. §1693a(11); 12 C.F.R. §205.2(k).

Exception: An electronic fund transfer is not unauthorized if the consumer gave to the person initiating the transfer an access device unless the consumer has notified the financial institution involved that transfers by that person are no longer authorized. 15 U.S.C. §1693a(11); 12 C.F.R. §205.2(k)(1). An ***access device*** is a “card, code, or other means of access to a consumer's account, or any combination thereof, that may be used by the consumer for the purpose of initiating electronic fund transfers.” 12 C.F.R. §205.2(a)(1).

1. **No longer authorized after notification:** Any transfer becomes an unauthorized transfer once the cardholder notifies the card issuer that the person having the card is no longer authorized to use the access device. After being notified, the card issuer can prevent any further transfers by blocking the ability of the device to access the account.

2. **Obtained through robbery or fraud:** Any transfer is an unauthorized electronic fund transfer if it is made with an access device that was obtained either through robbery or through fraudulent inducement. 12 C.F.R. §205.2(k)(3), Official Staff Commentary.

> **Example:** Assume that Grandfather's wallet, which contained his ATM card, is stolen. A subsequent transfer initiated by the thief's use of the card would be unauthorized. The same would be true if Nurse, without Grandfather's consent, took the card out of his wallet. If Grandfather was forced at gunpoint to withdraw funds from an ATM, his withdrawal also would be treated as an unauthorized transfer. 12 C.F.R. §205.2(k)(4), Official Staff Commentary.

C. **Conditions to consumer's liability for unauthorized fund transfers:** Before a consumer is liable for an unauthorized fund transfer, three conditions must be met. 15 U.S.C. §1693g(a); 12 C.F.R. §205.6(a).

1. **Transfer through accepted access device:** The unauthorized transfer must have been made by an accepted access device. An access is ***accepted*** (1) on receipt of the device if the consumer requested the financial institution to issue the device to her; (2) if the consumer did not request that the access device be issued to her, when the consumer signs the access device, uses, or authorizes another person to use the device for the purpose of transferring funds or obtaining money, property, or services; (3) when the consumer requests validation of the device; or (4) if it is issued in substitution for, or in renewal of, a previously accepted access device. 12 C.F.R. §205.2(a)(2)(ii). ***Validation*** occurs when the financial institution has taken all steps necessary to enable the consumer to use the access device to initiate an electronic fund transfer. 12 C.F.R. §205.5(b)(4).

2. **Means to identify consumer:** The financial institution must have provided some means by which the consumer can be identified when she uses the device. 12 C.F.R. §205.6(a). The means will often be a PIN, but it may also be a signature, photograph, or

fingerprint.

3. **Disclosures:** The financial institution must have provided the consumer with certain written disclosures as to her liability for unauthorized transfers. 12 C.F.R. §205.6(a).

D. **Limitation of consumer liability:** If these conditions are met, the consumer is liable for the lesser of (a) the amount of any unauthorized fund transfers or (b) $50. 15 U.S.C. §1693g(a); 12 C.F.R. §205.6(b). The consumer is not liable for any unauthorized fund transfers that occur after the consumer has given notice to the financial institution that an unauthorized electronic fund transfer involving her account has been or may be made. 15 U.S.C. §1693g(a); 12 C.F.R. §205.6(b). The limitations on liability apply whether or not the consumer is negligent. 12 C.F.R. §205.6(b)-2, Official Staff Commentary.

> **Example:** On March 1, Jane loses her ATM card. She had written her PIN on the card. On March 10, the finder withdraws $400 in cash from her account. On March 15, she realizes that the card is gone. On March 19, she notifies the bank of the loss. The finder withdraws another $600 on March 20. Jane owes $50. Jane's liability is not increased because she wrote her PIN on the card thus enabling the thief to have access to her account.

E. **Failure to report loss of device:** If the consumer does not notify its financial institution of the loss or theft of the access device within 2 business days after learning of the loss or theft, the consumer's liability increases to the lesser of (a) $500 or (b) the sum of (i) $50 or the amount of unauthorized electronic fund transfers that occur before the close of the 2 business days, whichever is less, and (ii) the amount of unauthorized electronic fund transfers that the financial institution establishes would not have occurred but for the consumer's failure to notify the institution within 2 business days after it learns of the loss or theft of the access device, and that occur after the close of the 2 business days and before notice to the financial institution. 12 C.F.R. §205.6(b)(2).

> **Example:** On March 1, Jane loses her ATM card. On March 10, the finder withdraws $400 in cash from her account. On March 15, she realizes that the card is gone. The finder withdraws

another $600 on March 19. On March 20, she notifies the bank of the loss. Under the second alternative in (b)(i), the amount of loss that occurred *before* 2 days after she learned of the loss is $400. Because that amount is larger than $50, she is liable under (b)(i) for only $50 of the original $400 loss. The $600 withdrawal, however, occurred *more* than 2 days after she learned of the loss of her ATM card. Her failure to notify the bank caused the entire $600 loss because the bank would have deactivated the card had she notified the bank of the loss. Therefore, her total liability under (b)(i) and (b)(ii) is $650. However, under (a), her liability is only $500. Because she is liable only for the lesser of (a) and (b), her liability is in the amount of $500.

F. **Failure to report unauthorized transfers on periodic statement:** In the event that the consumer fails to report within 60 days of a statement's transmittal any unauthorized electronic fund transfer that appears on the periodic statement, the consumer is liable to the financial institution for (a) up to $50 of any unauthorized transfer or transfers that appear on the statement, plus (b) the full amount of any unauthorized transfers that occur after the close of the 60 days after transmittal of the statement and before the consumer gives notice to the financial institution. 12 C.F.R. §205.6(b)(3).

Example: In Kruser v. Bank of America, 230 Cal. App. 3d 741, 281 Cal. Rptr. 463 (1991), a consumer's failure to report a $20 unauthorized transfer shown on his periodic statement made the consumer liable for $9,020 of unauthorized transfers occurring 9 months later, even though he promptly reported these later transfers.

G. **Combination of failure to report lost device and failure to report unauthorized transfers:** When there is a combination of a failure to report a lost or stolen access device and a failure to report the loss after the receipt of a periodic statement, the provisions that impose liability for the failure to report the lost or stolen access device govern the amount of liability for transfers that appear on the periodic statement and before the close of 60 days after the consumer first received a periodic statement showing an unauthorized transfer. The provisions imposing liability for the failure to report the losses that appear on a periodic statement govern thereafter. 12 C.F.R. §205.6(b)(3).

> **Example:** Assume, in our original example, that Jane did not notice and, therefore, did not report to her bank the unauthorized transfers occurring in March and appearing on the periodic statement arriving on April 1. In April, $2,000 in additional unauthorized transfers took place. In May, $3,000 in additional unauthorized transfers took place. In June $4,000 in additional unauthorized transfers took place. She finally notifies her bank of these unauthorized transfers on July 1. The provisions governing the failure to report a lost or stolen access device determine her liability for unauthorized transfers up to June 1, which is 60 days after transmittal of the statement showing an unauthorized transfer. Her liability is limited to $500 for the transfers up until June 1 even though the total of these unauthorized transfers was $6,000. However, there is no such limit to her liability for unauthorized transfers occurring between June 1 and the time she notified her bank. She is therefore liable for the entire $4,000 of unauthorized transfers occurring during that period. Her total liability is therefore $4,500 ($500 up to June 1 and $4,000 thereafter).

IV. STOPPING PAYMENT OF ELECTRONIC FUND TRANSFERS

A. Introduction: Whether an electronic fund transfer can be stopped depends on whether it is an ordinary electronic fund transfer or a preauthorized electronic fund transfer.

B. No right to reverse ordinary fund transfer: An electronic fund transfer such as a POS transaction takes place instantaneously. As a result, there is no way to stop payment on the fund transfer in the event that the consumer decides afterward that he is dissatisfied with the purchase. A separate question is whether the consumer has a right to reverse a previously made transfer.

1. **EFTA:** Congress, in enacting the EFTA, determined that a consumer should have no right to reverse an electronic fund transfer (other than a preauthorized electronic fund transfer).

   Note: Payment by electronic fund transfer should be the equivalent of payment in cash. If a consumer wants to retain the ability to prevent a merchant from receiving payment for the goods, the consumer can pay by check or credit card. Once the electronic fund transfer is completed, the consumer's only recourse is to recover the payment from the merchant.

2. **State law:** A few states do allow an electronic fund transfer initiated by a consumer to be reversed under certain conditions. Under Michigan law, for example, a consumer may reverse a fund transfer if the following conditions are met: (1) the consumer makes a good-faith effort to seek redress from the merchant and return the goods or services, (2) the transaction is for more than $50, and (3) the request for reversal is made within 4 calendar days of the transaction. Mich. Comp. Laws §488.16.

C. **Stopping payment on preauthorized electronic fund transfers:** There is a right to stop payment of any preauthorized electronic fund transfer from the consumer's account. A ***preauthorized electronic fund transfer*** is any transfer that is authorized in advance and that recurs at substantially regular intervals. 15 U.S.C. §1693a(9); 12 C.F.R. §205.2(i). A consumer can stop payment of a preauthorized electronic fund transfer by giving oral or written notice to its financial institution at any time up to 3 business days before the scheduled date of the transfer. 12 C.F.R. §205.10(c).

> **Example:** If the preauthorized transfer is scheduled to take place on Monday, February 1, the consumer can stop payment of the transfer by giving notice any time up to Wednesday, January 27. (Saturday and Sunday do not count because they are not business days.)

Rationale: Preauthorized electronic fund transfers serve a very different purpose than do POS or other similar transfers. The primary purpose of a POS transfer is as a substitute for payment in cash. Allowing reversibility would defeat this purpose. In contrast, the primary purpose of a preauthorized electronic fund transfer is to eliminate the expense and inconvenience of paying by check. The consumer is relieved of the burden and expense of writing out and mailing checks. The creditor is saved the time and expense of opening the mail containing the checks and of depositing the checks into its account. Allowing the consumer the right to stop payment of a preauthorized debit does not undercut the advantages either party obtains through the arrangement.

1. **Manner of stopping payment:** A preauthorized transfer may be stopped orally or in writing. If the notice is oral, the financial institution may require that written confirmation of the stop payment order be given within 14 days of the oral notification. 12 C.F.R. §205.10(c). Reconfirmation in writing is a practical necessity. If, on request, the consumer fails to confirm the stop payment order in writing, the oral stop payment order ceases to be binding 14 days after it has been made. 12 C.F.R. §205.10(c). When the creditor resubmits the bill after the 14-day period, it will be paid.

2. **Damages for failing to stop preauthorized fund transfer:** A financial institution is liable to its customer for damages if, once a proper stop payment order is given, the institution fails to stop payment of a preauthorized fund transfer. 15 U.S.C. §1693h(a)(3).

   Example: You stop payment on a preauthorized electronic fund transfer to your cable television supplier because you are not satisfied with the service. Your bank ignores your stop payment order. You are required to file a lawsuit to recover the funds. Absent a defense, your bank would be liable to you for failing to stop payment of your preauthorized fund transfer to your cable television supplier.

   a. **Damages if failure unintentional:** Neither the EFTA nor Regulation E spell out clearly what type of damages may be available if the financial institution fails to stop a preauthorized transfer. It is likely that when the bank's failure was not intentional, a court would adopt the measure of recovery found in Article 4 governing the failure of a bank to honor a stop payment order on a check.

b. Damages if failure intentional: If the bank's failure was intentional, the bank may be obligated to pay as consequential damages the consumer's legal expenses in recovering the payment from the recipient together with interest for the loss of the use of the funds.

V. CONSUMER LIABILITY TO THIRD PARTIES IN THE EVENT OF SYSTEM MALFUNCTION

A. Introduction: If there is a malfunction in the fund transfer system that prevents a preauthorized payment from being made, the consumer's obligation to make the payment is suspended until the system malfunction is corrected and the electronic fund transfer may be completed. 15 U.S.C. §1693j. The consumer must pay the bill if, at any time before the malfunction is corrected, the creditor demands in writing that payment be made by means other than an electronic fund transfer. 15 U.S.C. §1693j.

Example: The mortgagee could not foreclose on the mortgagor when the failure to make payment by an electronic fund transfer resulted from a "system malfunction" or technical problem in the payment process. *See* Household Finance Realty Corp. of New York v. Dunlap, 15 Misc. 3d 659 (N.Y. Sup. 2007).

VI. RESTRICTIONS ON ISSUANCE OF ACCESS DEVICES

A. Introduction: An access device not requested by the consumer may be issued only if it is not validated. 15 U.S.C. §1693i(b); 12 C.F.R. §205.5(b)(1). Issuance by the financial institution of an unrequested access device must be accompanied by a complete disclosure (1) as to the consumer's rights and liabilities once the device is validated, (2) clearly explaining that the access device is not validated, and (3) instructing the consumer on how to dispose of the device in the event that the consumer does not wish to use the device. 12 C.F.R.

§205.5(b).

Rationale: To protect consumers against unexpected liabilities, the EFTA places restrictions on the ability of financial institutions to issue access devices to consumers who have not requested the device. 15 U.S.C. §1693i(a); 12 C.F.R. §205.5(b).

> **Example:** Because a debit card cannot access a consumer's account without a PIN, an access device is not validated unless a PIN has been assigned to it. Thus, a financial institution cannot send an unsolicited debit card to a consumer if a PIN has been assigned to the card.

VII. SPECIAL RULES FOR PREAUTHORIZED TRANSFERS

A. Introduction: Because preauthorized fund transfers serve different purposes than do ordinary fund transfers, e.g., POS or ATM transactions, special rules apply to preauthorized fund transfers.

B. Transfers to consumer's account: If the consumer's account is to be credited by a preauthorized electronic fund transfer from the same payor at least once every 60 days, the bank must give notice of the deposit by one of the following.

1. **Notice that transfer made:** Oral or written notice within 2 business days after the transfer that the transfer has occurred.
2. **Notice that transfer not made:** Notice within 2 business days after a scheduled fund transfer that the transfer has *not* occurred.
3. **Readily available telephone line:** The bank may provide a readily available telephone line that the consumer may call to ascertain whether or not the preauthorized transfer occurred. 12 C.F.R. §205.10(a).

C. Transfers from consumer's account: When the debit is in the same amount each month, no notification is required. Because the consumer knows that the debit will occur, any notification would be superfluous. If debits are in a varying amount, the consumer has the right to receive notice if a transfer varies in amount from the previous transfer or from the preauthorized amount. 12 C.F.R. §205.10(d). Notice must be given either by the bank or by the payee at least 10 days before the scheduled transfer date so as to enable the consumer not only to verify whether the amount is correct but also to deposit funds in the account to cover any deficit. 12 C.F.R. §205.10(d).

VIII. DOCUMENTATION REQUIREMENTS

A. Introduction: One of the disadvantages of making payment or withdrawing funds by electronic fund transfer, rather than by check, is the absence of a returned check to evidence the payment or the withdrawal. To remedy this deficiency, the EFTA and Regulation E contain various documentation requirements for electronic fund transfers.

B. Receipts at electronic terminals: When the consumer initiates an electronic fund transfer at an electronic terminal, the financial institution itself, or through another party (for example, the merchant at a POS terminal), the consumer must be provided with a written receipt containing certain basic information as to the transaction.

C. Periodic statements: The financial institution must provide periodic statements to the consumer providing certain basic information for each transfer occurring during the period covered for each account to, or from which, electronic fund transfers can be made. 15 U.S.C. §1693d(e); 12 C.F.R. §205.9(b).

IX. ERROR RESOLUTION PROCEDURES

A. Introduction: To protect consumers, the financial institution must follow an established procedure in the event that the consumer claims an error has occurred.

B. What is an "error"? ***Errors*** include unauthorized and incorrect electronic fund transfers, omissions from a periodic statement, computational or bookkeeping errors, receipt of an incorrect amount of money from an electronic terminal, improper identification of an electronic fund transfer, and a consumer's request for any documentation required by Regulation E or for additional information or clarification regarding an electronic fund transfer. 15 U.S.C. §1693f(f); 12 C.F.R. §205.11(a)(1). *See* Gale v. Hyde Park Bank, 384 F.3d 451 (7th Cir. Ill. 2004) (Checking account holder stated a claim against its bank under the EFTA for the bank's failure to comply with error resolution requirements when he alleged that he did not receive a timely report of the results of his complaint that a debit card transaction did not post to his account until four months after the transaction and that he did not receive information about the bank's error-resolution procedures.

C. **Notice of error:** The consumer must give oral or written notice of error to the financial institution no later than 60 days after the bank provided the consumer with the periodic statement indicating the error. 15 U.S.C. §1693f(a); 12 C.F.R. §205.11(b)(1)(i). If the consumer fails to give notice within the 60-day period, the consumer has no right to require that the bank go through the error resolution procedure. However, the consumer may still bring an action against the bank to recredit its account because of the error.

D. **Bank's duty to investigate:** On receipt of the notice of error, the financial institution has the duty to promptly investigate and determine whether an error has occurred. 15 U.S.C. §1693f(a); 12 C.F.R. §205.11(c). How long it has to make a determination depends on whether it has recredited the consumer's account.

1. **Does not recredit:** If the financial institution does not provisionally recredit the consumer's account during the investigation, it must transmit the result of its investigation to the consumer within 10 business days. 15 U.S.C. §1693f(a); 12 C.F.R. §205.11(c)(1).

2. **Recredits:** If the bank provisionally recredits the account in the amount of the alleged error (including any applicable interest) within 10 business days after receipt of the notice of error, the financial institution may, as long as it acts promptly, take up to 45 calendar days to transmit the results of its investigation to the consumer. 15 U.S.C. §1693f(c); 12 C.F.R. §205.11(c)(2).

E. **After the bank makes its determination:** If the bank determines that an error has occurred, it must promptly, and no later than 1 business day after this determination, correct the error and, whether or not the bank determines that an error has occurred, mail or deliver to the consumer a written explanation of its findings within 3 business days after concluding its investigation. 15 U.S.C. §1693f(b), (d); 12 C.F.R. §205.11(c)(2)(iii), (iv).

X. LIABILITY FOR FAILING TO MAKE CORRECT FUND TRANSFER

A. **Introduction:** A financial institution is liable to its customer if it fails to make a fund transfer in the correct amount and in a timely manner.

Note: If the bank's failure was unintentional and occurred despite reasonable precautions established by the institution to guard against such failures, damages are limited to actual damages proved. This does not include consequential damages. 15 U.S.C. §1693h(c).

XI. CIVIL LIABILITY

A. **Enforcement actions provided by EFTA:** The provisions of the EFTA may be enforced by administrative action. Besides administrative enforcement, the EFTA also provides for civil actions by consumers. 15 U.S.C. §1693m-n.

B. **Individual consumers:** An institution that fails to comply with the provisions of the EFTA is liable to the injured consumer for any actual damage sustained by the consumer because of the noncompliance, together with an amount not less than $100 nor greater than $1,000, plus the costs of a successful action to enforce the liability, including reasonable attorneys' fees. 15 U.S.C. §1693m(a).

Example: Borrower was not entitled to recover damages as result of mortgage lender's violation of the EFTA where there were no unauthorized or erroneous electronic transfers as the failure was a result of a technical malfunction of which the borrower was unaware. *See* Household Finance Realty Corp. of New York v. Dunlap**,** 15 Misc. 3d 659 (N.Y. Sup. 2007).

C. Class actions: In the event of a class action, instead of the $100 and $1,000 limitations, the total recovery for the class arising out of the same failure to comply is limited to the lesser of $500,000 or 1 percent of the net worth of the defendant plus actual damages, costs, and reasonable attorneys' fees. 15 U.S.C. §1693m(a)(2)(B).

D. Treble damages: Damages may be trebled where: (a) the noncompliance is a failure to comply with the error resolution rules, or (b) the financial institution knowingly and willfully concluded that the consumer's account was not in error when such a conclusion could not reasonably have been drawn from the evidence available to the financial institution at the time of its investigation. 15 U.S.C. §1693f(e).

E. Defenses to liability: A financial institution is not liable if its noncompliance resulted in an error that was properly resolved pursuant to the EFTA error resolution procedures. 15 U.S.C. §1693m(a). For example, if your bank improperly charged your account for an electronic fund transfer that did not take place, your bank is not liable to you if it, in a timely manner, investigated your claim and recredited your account.

1. **Bona fide error:** A financial institution is also not liable if it proves, by a preponderance of the evidence, that the noncompliance was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid such noncompliance. 15 U.S.C. §1693m(c).

2. **Offers to pay damages:** A financial institution is likewise not liable if it both notifies the consumer of the noncompliance prior to the consumer bringing an action and pays to the consumer his actual damages. 15 U.S.C. §1693m(e).

Quiz Yourself on

CONSUMER ELECTRONIC FUND TRANSFERS

83. On February 1, while hiking in the Sierra Mountains, Gerry loses his wallet containing his ATM card. Gerry does not notice that his wallet is gone until February 3, when he stops for gas on his return trip home. On his arrival home on February 4, he telephones his bank to inform it of the loss of his card. Five hundred dollars were withdrawn from his account on February 3. For how much of the $500 is Gerry liable?__________

84. Assume that Gerry did not report the loss of the card until February 9 and that an additional $1,000 was withdrawn from his account between February 6 and 9. How much of the total $1,500 will Gerry be liable for?__________

85. True or False: Under the EFTA, a consumer has 3 days to order her bank to reverse any point-of-sale transfer from her account.__________

86. True or False: A financial institution may issue a validated access device if it is requested by the consumer.__________

87. Although Grandfather has authorized Nurse to write checks on his account, he has not authorized her to initiate electronic fund transfers. However, because of the frequency with which she has been writing checks, Grandfather's bank reasonably believes that she has full authority to conduct financial transactions for him. Although Nurse may have apparent authority to initiate electronic fund transfers, are transfers initiated by her authorized?__________

88. What if Nurse secretly learns Grandfather's ***personal identification number (PIN)*** and makes his mortgage payment by an electronic fund transfer. Is the transfer unauthorized?__________

89. If Grandfather gave his ATM card and his PIN to Nurse, and told her not to use the card until he authorized her to do so, are her withdrawals unauthorized if she makes them before Grandfather gives her permission?__________

90. You just purchased a television set from Radio Shack. You paid for the set by an electronic fund transfer through the POS terminal located at the store. You took the television set home and discovered that the set did not work. Radio Shack refuses to take the set back. What options for recourse do you have? What rights does your bank have?_________

91. You instruct your bank to transfer funds by August 1 to the seller of the house you want to purchase. The bank fails to do so. Because of the bank's failure, you lose the right to purchase the house. The house appreciates in value. Is your bank liable?_________

92. In the preceding example, if the bank's failure to transfer the funds was unintentional, what would you be allowed to recover?_________

Answers

83. **$50.** A consumer is liable for the lesser of the actual unauthorized transfers or $50. 15 U.S.C. §1693(g)(a); 12 C.F.R. §205.6(b).

84. **$500.** By not notifying the bank within 2 business days after learning of the loss, Gerry is liable for the lesser of (1) $500 or (2) $50 or any lesser amount charged between February 3 and February 5 plus the amount charged between February 6 and 9 that the bank can prove would not have occurred but for Gerry's failure to notify the bank of the loss. Because if Gerry had notified the bank of the loss within 2 days, none of the $1,000 loss would have occurred, the total amount under (2) is $1,050. As $500 is less, Gerry's liability is limited to $500. 12 C.F.R. §205.6(b)(2).

85. **False.** A consumer has no right under the EFTA to stop or reverse any electronic fund transfer except a preauthorized electronic fund transfer.

86. **True.** A financial institution is prevented from issuing a validated device unless it is requested by the consumer. 15 U.S.C. §1693(i)(b); 12 C.F.R. §205.5(b)(1).

87. **No.** Regardless of her apparent authority, any transfer initiated by Nurse is unauthorized because she has no actual authority to do so.

88. **No.** The transfer is not unauthorized because Grandfather received a benefit from it.

89. **No.** Nurse's withdrawal of funds through the use of the card is not regarded as unauthorized even though Nurse used the card before Grandfather authorized her to do so. By giving Nurse his ATM card and his PIN, Grandfather gave Nurse the means to make the transfer without the financial institution or a merchant (if the transfer is at a POS terminal) knowing that her use was unauthorized.

90. **None.** You can neither prevent your bank from paying Radio Shack nor order your bank to reverse the transfer. Likewise, your bank has no right to demand the payment back from Radio Shack or its bank.

91. **Yes.** Absent a defense, your bank would be liable to you for failing to make the funds transfer to the seller of the house by August 1.

92. **You would be limited to your costs in making the transfer and any loss of interest.** You would not be allowed to recover your lost profits on the purchase of the house if your bank's failure was unintentional and your bank employed reasonable precautions to avoid such a failure. If your bank's failure was intentional or your bank did not employ reasonable precautions, you would then be entitled to your lost profits.

Exam Tips on *CONSUMER ELECTRONIC FUND TRANSFERS*

- **Consumer liability for fund transfers:** Remember that a consumer is liable for a transfer **only if** she either actually authorized the person to make the transfer or benefited from the transfer.
  - The only time that a consumer is liable for an unauthorized transfer is if she gave the access device and the PIN to the unauthorized user.
  - A consumer is not liable for an unauthorized transfer simply because she was negligent.
  - However, always remember that a consumer's exposure to liability increases if she fails to report a lost or stolen access

device or an unauthorized transfer on a periodic statement.

CHAPTER 9
LENDER CREDIT CARDS

ChapterScope

This chapter examines the law governing credit card transactions, a consumer's liability for the unauthorized use of a credit card, the right to refuse payment of a credit card charge, and error resolution procedures. The key points in this chapter are:

- **Truth in Lending Act and Regulation Z:** Consumer use of credit cards is governed by the Truth in Lending Act and Regulation Z. Business credit cards are subject only to the rules governing unauthorized use and the issuance of unrequested cards.
- **Liability for unauthorized use of credit card:** A cardholder is liable for only up to $50 of charges from the unauthorized use of her card. However, use of a card by a person to whom the cardholder has given possession is not unauthorized despite any instructions to the contrary.
- **Cardholder's right to refuse payment:** A cardholder has the right to assert against the card issuer any defense or claim arising from the underlying transaction as long as the cardholder has attempted to settle the dispute with the merchant and the transaction meets certain geographical limitations.
- **Billing error procedure:** The card issuer must comply with a fairly strict billing error procedure when a cardholder gives notice that a billing error has occurred.

I. TERMINOLOGY IN CREDIT CARD TRANSACTIONS

A. Introduction: If a person purchases a television set from Radio

Shack by use of a Mastercard, that person is called the ***cardholder***. Bank of America, which issued the card to the cardholder, is called the ***issuing bank*** or the ***card issuer***. Radio Shack is called the ***merchant***. Wells Bank, the bank at which Radio Shack maintains its account, is called the ***merchant bank***.

II. LAW GOVERNING CREDIT CARD TRANSACTIONS

A. Introduction: Credit cards are not governed by a comprehensive set of statutes or regulations. Rather, they are governed by an assortment of diverse federal and state consumer protection laws.

B. Federal law: The basic law governing credit cards is federal law and can be found in the Truth in Lending Act, 15 U.S.C. §1601, as amended by the Fair Credit and Charge Card Disclosure Act, the Fair Credit Billing Act, and Regulation Z, 12 C.F.R. part 226, promulgated pursuant to the Truth in Lending Act. These statutes and regulations cover only the relationship between the card issuer and the cardholder. Even as to this relationship, it covers only certain issues: disclosure requirements, error resolution, the right of a cardholder to raise defenses, and the liability of a cardholder for unauthorized transactions.

1. **Primarily consumer protection:** With two exceptions, these statutes and regulations cover only consumer use of credit cards. Business credit cards are also subject to the rules governing liability for unauthorized use and the right of the card issuer to issue unrequested cards. Business credit cards are governed, in all other respects, by the agreement entered into between the business and the card issuer.

2. **Other law:** Although some state consumer protection laws govern credit cards, much of the cardholder/card issuer relationship is left to the cardholder agreement. The remaining relationships (i.e., merchant/merchant bank and card issuer/merchant bank) are governed by the agreements establishing their respective relationships. The law governing the agreements between the various parties to a credit card transaction is ordinary contract law.

III. LIABILITY FOR UNAUTHORIZED USE

A. Introduction: A cardholder has very limited liability for an unauthorized use of her card. A cardholder is liable only for the lesser of (1) $50 or (2) the amount of money, property, labor, or services obtained by the unauthorized use. There is no liability for any unauthorized charges incurred after the consumer gives notice to the bank of the unauthorized use. 15 U.S.C. §1643(a)(1); 12 C.F.R. §226.12(b). It has been held that a commercial bank has a duty to verify the authenticity and accuracy of a credit account application before issuing a credit card. *See* Wolfe v. MBNA America Bank, 485 F. Supp. 2d 874 (W.D. Tenn. 2007).

> **Example:** On March 1, Jane loses her Mastercard. She does not notice that the Mastercard is gone until April 10 when she gets her Mastercard bill showing charges in the amount of $5,000. She immediately notifies the card issuer. Jane is liable for $50.

Exception: With one exception, the rules governing liability for unauthorized use of a credit card apply to credit cards used for business purposes as well as for consumer purposes. 15 U.S.C. §1645. The one exception involves issuance by a card issuer of 10 or more credit cards for use by the employees of an organization. In this situation, the card issuer and the organization may contractually set liability for unauthorized use at an amount greater than otherwise permitted by law. However, an employee of the organization has the same limited liability as does a consumer as to both his employer and the card issuer. 15 U.S.C. §1645; 12 C.F.R. §226.12(b)(5).

B. Conditions to liability: A cardholder has no liability whatsoever for an unauthorized use of her card unless three conditions are met.

1. **Accepted card:** The card must be an accepted credit card. 12 C.F.R. §226.12(b)(2)(i). An ***accepted credit card*** is any credit card that a cardholder has (1) requested or applied for and received, (2) signed, or (3) used or authorized another person to use to obtain credit. Any credit card issued as a renewal or substitute becomes an accepted credit card when received by the cardholder. 12 C.F.R. §226.12(a)(2), n.21.

2. **Disclosures:** The card issuer must have provided the cardholder with adequate notice of its maximum potential liability and of the means by which it can notify the card issuer of the loss or theft of its card. 12 C.F.R. §226.12(b)(2)(ii).

3. **Merchant identification:** The card issuer must have provided a means by which the merchant could have identified the cardholder as the authorized user of the card. Two of the more common ways for a card issuer to provide a means of identification are by (1) including tape on the back of the credit card where the cardholder may provide a sample of his signature and (2) including a photograph of the cardholder on the face of the credit card. 12 C.F.R. §226.12(b)(2)(iii) and Official Staff Commentary.

C. Unauthorized use: *Unauthorized use*

is defined as the use of a credit card by a person other than the cardholder, who does not have actual, implied, or apparent authority for such use, and from which the cardholder receives no benefit. 12 C.F.R. §226.12(b), n.22. The card issuer has the burden of proving that use of a card was authorized. 15 U.S.C. §1643(b).

D. Authorized use: A use is ***authorized*** when the user has either actual or apparent authority to use the card.

1. **Actual authority:** The user has actual authority to use a credit card when the cardholder either expressly or by implication gives the user authority to use the card.

   Example: Assume that your brother asks you for money to fill his car with gas. Without saying a word, you hand him your credit card. You have impliedly authorized him to use the card to purchase gas. (Had you told your brother that he could use your card to purchase gas, he would have express actual authority.) However, you did not give him actual authority to use the card to purchase a television set when you loaned him the card to buy gas.

   Example: Debtor had no defense in the debtor's action to collect the outstanding balance of the account credit card debt from unauthorized purchases made by the debtor's housemate when the unauthorized purchases were possible through debtor's intentional, careless, or negligent conduct as provided in the Truth in Lending Act. *See* New Century Financial Services, Inc. v. Dennegar, 394 N.J. Super. 595 (N.J. Super. A.D. 2007).

2. **Apparent authority:** A user has apparent authority when the cardholder gives the impression to third parties that the user is authorized to use the card.

Example: From the example above, assume that the gas station owner called to ask you whether your brother was authorized to use your card and you told him that your brother could charge the purchase of gas. You, however, forget to get the card back from your brother. The next week, your brother charges another purchase of gas on your credit card. Your telephone confirmation of your brother's authority to use your card gave the gas station owner the impression that your brother was authorized to use the card. Even though your brother was not, in fact, authorized to make the second purchase of gas, your brother had apparent authority to do so. Therefore, his use of the card was authorized and you are liable for the second purchase as well as for the first.

Example: A corporate credit cardholder's failure to inspect its monthly billing statements sacrificed any Truth in Lending Act protections from liability for unauthorized use by repeatedly paying without protest all of the employee's charges on the account after receiving notice of them from card issuer. DBI Architects, P.C. v. American Express Travel-Related Services Co., Inc., 388 F.3d 886 (D.C. Cir. 2004).

a. **Knowingly giving card to user:** The specific characteristics of a credit card transaction have encouraged courts to adopt a very expansive definition of what constitutes apparent authority. Some courts find that if the cardholder voluntarily and knowingly gives the card to another person, the person to whom the card is given has apparent authority to use the card.

Example: If your brother went to Radio Shack and purchased a television set, the fact that you gave him the card to purchase gas gives him apparent authority to purchase the television set even though you made no representations to Radio Shack that led it to believe that your brother was authorized to use your card. *See* Martin v. American Express, 361 So. 2d 597 (Ala. Civ. App. 1978) (cardholder gave his business associate his American Express Card with express authority to charge up to $500. The cardholder instructed American Express not to allow the total charges on his American Express Card to exceed $1,000. The business associate charged $5,300 on the card. The court found that the business associate had apparent authority to charge the entire $5,300 on the card and, therefore, held that the cardholder was liable for the entire amount).

b. **Informs card issuer:** Courts are split as to whether the cardholder is liable for purchases made by the user after the cardholder informs the card issuer that the user no longer has actual authority to use the card. *Compare* Standard Oil Co. v. Steele, 489 N.E.2d 842 (Ohio Mun. Ct. 1985) (not liable) *with* Walker Bank & Trust v. Jones, 672 P.2d 73 (Utah, 1983) (use of a credit card by a spouse continues to be apparently authorized until the card is returned to the card issuer even though the cardholder had notified the card issuer that the spouse's use of the card was no longer authorized).

IV. RIGHT TO REFUSE PAYMENT

A. **Introduction:** If a consumer fails to satisfactorily resolve a dispute as to a product purchased with his credit card, the consumer can assert against the card issuer all claims (other than tort claims) and defenses arising out of the transaction and relating to the failure to resolve the dispute. 15 U.S.C. §1666i; 12 C.F.R. §226.12(c)(1).

Example: Jane purchases a television set from Radio Shack on her Mastercard. It turns out that the set is defective. Jane goes back to Radio Shack and demands that it either fix the television set or give back her money. Radio Shack refuses to do either.

Jane may have a right to raise her breach of warranty claim against Radio Shack as a defense to her obligation to pay Mastercard for the amount charged for the television set. If Bank of America recredits her account, Bank of America would pass the loss back down the line to Wells Bank (the merchant's bank) and Wells Bank would charge back Radio Shack's account. If Radio Shack believes that her claim is not well founded, it would then have to attempt to recover the payment from her.

B. **Conditions to right to withhold payment:** There are three conditions to a consumer's right to withhold payment of her credit card bill for a purchase.

1. **Good-faith attempt to resolve dispute:** The consumer must make a good-faith attempt to resolve the dispute with the merchant. 12 C.F.R. §226.12(c)(3)(i).

   Example: The fact that Jane went to Radio Shack and asked it to fix the set or return her money is probably sufficient to constitute a good-faith attempt to resolve the dispute. 12 C.F.R. §226.12, Official Staff Commentary, Comment 12(c)(3)(i).

   Example: The fact that the transaction for which the issuing bank was attempting to collect charges was for a business or commercial purpose did not preclude the cardholder from asserting the nondelivery defense under the Truth in Lending Act, in issuing bank's action to collect charges on credit card for merchandise that was never delivered. *See* Citibank (South Dakota), N.A. v. Mincks, 135 S.W.3d 545 (Mo. App. S.D. 2004).

2. **More than $50:** The charge for the purchase must be more than $50. 12 C.F.R. §226.12(c)(3)(ii).

3. **Purchase within same state or within 100 miles:** The purchase must have occurred in the same state as the consumer's current designated address or, if not within the same state, within 100 miles of that address. 12 C.F.R. §226.12(c)(3)(ii).

Note: By issuing a credit card to the cardholder, the card issuer undertakes the obligation of monitoring merchants in the cardholder's area but not in an area outside her state or more than 100 miles from her residence. If no geographical limitation were placed on the cardholder's right to refuse payment, merchants distant from the cardholder's residence would be leery of allowing her to pay by credit card. This is because if the cardholder refuses to pay the credit card charge, the merchant would have to undertake the costly task of attempting to recover from her in her state of residence.

Regulation Z: Regulation Z does not determine where a transaction takes place. The Official Staff Commentary to Regulation Z simply states that "[T]he question of where a transaction occurs (as in the case of mail or telephone orders, for example) is to be determined under state or other applicable law." 12 C.F.R. §226.12, Official Staff Commentary, Comment 12(c)(3)(ii)(1). There is no helpful case law on the question of where a purchase takes place when the merchant is in one state and the consumer is in another state.

C. Exceptions: The geographical and monetary limitations do not apply when the merchant (a) and the card issuer are the same person, (b) is directly or indirectly controlled by, or controls, the card issuer, (c) is a franchised dealer of the card issuer's products or services, or (d) has obtained the order for the disputed transaction through a mail solicitation made, or participated in, by the card issuer. 12 C.F.R. §226.12(c)(3), n.26.

D. Limited to amount of credit outstanding: The amount of the claim or defense that may be asserted cannot exceed the amount of credit outstanding for the disputed transaction at the time the cardholder first notifies the card issuer or the merchant of the existence of the claim or defense. 12 C.F.R. §226.12(c)(1); 12 C.F.R. §226.12(c)(1), n.25.

V. ERROR RESOLUTION PROCEDURES

A. Introduction: Cardholders are given substantial protections in the event that they claim the card issuer has made a billing error. ***Billing errors*** are basically mistakes found in the credit card statement that the card issuer sends to the cardholder. Among others, billing errors include (1) billing for an extension of credit that was not made to the cardholder, (2) billing for property or services that were neither accepted nor delivered to the cardholder, (3) improper identification of an extension of credit, (4) failing to properly credit a payment or other credit, or (5) making a computational or accounting error. 12 C.F.R. §226.13(a).

> **Example:** When Jane receives her credit card statement, she notices that she was charged not only for the television set that she purchased from Radio Shack but also for a VCR that she looked at but did not purchase. The charge for the VCR is a billing error because it was a billing for an extension of credit that was not made to Jane.

B. What cardholder must do on noticing billing error: If the cardholder wants to activate the error resolution procedure, the cardholder must send written notice of the billing error so that it is received by the card issuer no later than 60 days after the card issuer transmitted the statement that reflected the billing error. 12 C.F.R. §226.13(b)(1). Although failing to do so results in the cardholder losing the protections accorded to her under the error resolution procedure, her failure does not prevent her from bringing a breach of contract, or other action, against the card issuer for recrediting of her account.

> **Example:** If the statement reflecting Radio Shack's erroneous billing of the VCR to Jane's account was sent to Jane on March 1, Bank of America would have to receive her billing error notice by May 1.

C. What the card issuer must do on receipt of billing error notice: Within 30 days after receiving the billing error notice, the card issuer must either (a) mail or deliver to the cardholder a written acknowledgment of receipt of the notice or (b) comply with the appropriate resolution procedures. 12 C.F.R. §226.13(c)(1).

1. If error is found: If the card issuer determines that the billing error mentioned in the notice has occurred, the card issuer must, within two complete billing cycles (but in no event later than 90 days) after receiving the billing error notice, correct the billing error and credit the cardholder's account with any disputed amount and related finance or other charges, if any. The card issuer must also, during this period, mail or deliver to the cardholder a correction notice. 12 C.F.R. §226.13(e)(1), (2).

2. **If no error found:** Before the card issuer may determine that no billing error has occurred, it must conduct a reasonable investigation. 12 C.F.R. §226.13(f). If, after conducting a reasonable investigation, the card issuer determines that no billing error occurred, it must, within two complete billing cycles (but in no event later than 90 days) after receiving the billing error notice, mail or deliver to the cardholder an explanation that sets forth the reasons for its belief that the alleged billing error is incorrect in whole or in part. 12 C.F.R. §226.13(f)(1). It must also promptly notify the cardholder in writing of the time when payment is due and the portion of the disputed amount and related finance or other charges that is owed. 12 C.F.R. §226.13(g)(1). The cardholder has the same grace period within which to pay the amount due without incurring additional finance or other charges that it would have had had it just received the periodic statement showing the charge. 12 C.F.R. §226.13(g)(2).

   Example: Assume that Bank of America allows a 21-day grace period to make payment without incurring a finance charge. If on March 1 Bank of America notifies Jane that she owes the charge for the VCR, she has until March 22 to pay, without a finance charge, the amount found not to be in error.

D. **Remedy:** Failure to comply with the requirements of the billing error resolution procedure results in the card issuer forfeiting the right to collect from the cardholder the amount of the alleged error together with any finance charges on that amount. The amount of the forfeiture, however, cannot exceed $50. 15 U.S.C. §1666(e).

Quiz Yourself on
LENDER CREDIT CARDS

93. Although Rene realizes that she has lost her Visa card, she does not inform the card issuer for 2 weeks. In these 2 weeks, $1,000 is charged on the card. For how much of this amount is Rene liable? __________

94. Assume that Rene orders take-out food from a local restaurant. Rene asks her neighbor, Don, who is going to pick up the order for her, to charge the order on her Visa card. On the way to the restaurant, Don stops off at Target Department Store and charges, on Rene's card, the purchase of a television set for $600. To what extent is Rene liable for the purchase?__________

95. Simone, who lives in Los Angeles, purchases an expensive watch while on vacation in New York. She charges the purchase on her American Express card. When the watch turns out to be a phony, she demands that the merchant give her money back. The merchant refuses. Can Simone refuse to pay the portion of her American Express bill that represents the purchase price of the watch? __________

96. If Bank of America issues to IBM 1,000 cards to be used by its employees, what are IBM's and the employee cardholders' limitations on liability?__________

97. Assume that in the preceding example, Bank of America and IBM agree that IBM is liable for up to $1,000 of any unauthorized charges. Is the employee cardholder also liable for up to $1,000?__________

98. Adam gives his daughter his credit card, instructing her to buy groceries for dinner that night. The manager at the grocery store calls Adam and asks whether his daughter was authorized to use his card. Adam responds affirmatively. He forgets, though, to get the card back from his daughter. The next week, his daughter charges another purchase of groceries on Adam's credit card. Was this second use of the card authorized?__________

99. Jane lives in New York City, and purchased a new couch in Newark, New Jersey (which is within 100 miles of New York City). If the couch was severely damaged during the store's guaranteed-safe delivery, can she withhold payment?__________

100. Assume the same facts as above, except that Jane bought her couch in Los Angeles, California. Can she refuse payment on the charge? __________

Answers

93. **$50.** A cardholder is liable for a maximum of $50 of any unauthorized charges. 15 U.S.C. §1643(a)(1); 12 C.F.R. §226.12(b). Rene's liability is not increased even though, had she notified the card issuer, the loss may have been prevented.

94. **Possibly $600.** Use of a credit card is not unauthorized if the user has apparent authority. 12 C.F.R. §226.12(b), n.22. Some courts hold that if the cardholder voluntarily gives the card to a third person, that person has apparent authority to use the card. If the court finds that Rene's giving of the card to Don gave him apparent authority, Rene would be liable for the entire purchase.

95. **No.** A cardholder may only refuse to pay for a purchase that was made within the same state as the consumer's designated address or within 100 miles of that address. 12 C.F.R. §226.12(c)(3)(ii). Because Simone's purchase meets neither of these conditions, she must pay her full American Express bill.

96. **Same as for consumers.** The limitations on liability applicable to consumers are also applicable to IBM's and its employees' liability on the credit cards, absent an agreement to the contrary.

97. **No.** Regardless of the agreement between IBM and the bank, the employee cardholder is not liable to either Bank of America or IBM beyond the $50 limit imposed by the Truth in Lending Act.

98. **Yes.** Adam's telephone confirmation of his daughter's authority to use his card gave the grocery store manager the impression that his daughter was authorized to use the card. Even though the daughter was not, in fact, authorized to make the second purchase of groceries, the daughter had apparent authority to do so. Therefore, her use of the card was authorized and Adam is liable for the second purchase as well as for the first.

99. **Yes.** Jane may withhold payment on a purchase made in any location in the state of New York as well as on any purchase made within 100 miles of her residence. She can, therefore, refuse to pay the charge for the couch bought in Newark, New Jersey, to the extent that the couch was damaged.

100. **No.** She may not refuse payment on a charge made in Los Angeles because Los Angeles is outside of the 100-mile range of her residence in New York City.

EXAMPLES & EXPLANATIONS

Payment Systems

Fifth Edition

James Brook

Wolters Kluwer
Law & Business

Payment Systems

PART I

The Basic Law of Negotiable Instruments

CHAPTER 1

What Is a Negotiable Instrument?

INTRODUCTION TO PAYMENT SYSTEMS

I would be among the last to suggest that wealth heads or even ranks particularly high on the list when it comes to what really matters the most in life. As far as the study of payment systems is concerned, however, there's no way around the fact that wealth *is* what it's all about. Payment systems, as a topic falling within the wider classification of commercial law, does not deal with how individuals and organizations accumulate and hold onto their share of the aggregate wealth generated within the society, although for those with an acquisitive nature a good understanding of the topic certainly doesn't hurt. The field of payment systems is concerned with how wealth can be and is *moved around* from place to place and from person to person: What means will shift some specific amount of money from one person's or organization's stash of wealth—from that legal entity's pocket, so to speak—into that of another?

To narrow the focus considerably, we observe that payment systems deal only with how wealth gets moved around, shifted from one owner to another, when the transfer is made in terms of an amount of cash. Wealth is transferred, of course, any time an individual deeds or gives some measure of legal rights in an identified parcel of real estate to another or hands over and gives good title to a particular piece of personal property. Such transactions in themselves are covered in other parts of the legal curriculum. The area of payment systems, however, deals exclusively with promises to pay or payments that are actually made by one party to another of *an amount of money*.

Although what has become in recent years the conventional designation for this area of commercial law—*payment systems*—does feature the word *payment*, not all transfers of money with which we deal in our lives or which we will see in this volume necessarily involve a party's attempt to "pay" for something that he or she has received, some property transferred, or some services rendered. Such transactions are no doubt the background for a great majority of payments made through the means that we will study, but they do not cover the entire field. Each of us probably, at some time, has been moved to make a gift of cash to a friend or relative on some special occasion or to write out a check to a favored charity, such as (of course) an alma mater's alumni fund. Whatever the underlying reason, what we were attempting to do was move some of our money into the hands of another. We were participating in the wonderful world of payment systems.

Undoubtedly, the earliest form of payment mechanism, and that which is still used most frequently, is straightforward payment by cash. You may have paid cash for this book. You most likely have paid cash to a merchant over the past few days to buy pens or pencils with which to take notes, or a sandwich to eat or a soda with which to wash it down. Simply in terms of the number of transactions that occur each day, payment by cash still ranks as, by far, the most common type of payment transaction. As we will see later, however, in terms of the aggregate value of money that moves from one place to another in the course of a given day, the direct delivery of cash accounts for a small—though not insignificant—amount of the payments being carried out. However often it may be proclaimed that we are heading toward a "cashless society," people still tend to feel comfortable making payment by cash, at least for smaller amounts, and are apparently in no great hurry to drop the practice.

Once larger sums have to be transferred, however, payment by cash turns out to be a much less attractive option. It is easy to understand the reasons behind this. Few of us feel at ease carrying around large amounts of cash, because of the risk of theft or loss, which we quite understandably want to avoid. If the question is how to make a payment, a gift, or a donation to a party in some far-off location, and the answer seems to be that we will have to send it via the mail or some similar carrier, it would be a rare individual who would eagerly stuff a large amount of cash into an envelope and blithely send it on its way. We search for other ways of getting the cash into the hands of the distant party without actually having to travel the distance ourselves with a large quantity of cash on our person or sending that same amount of cash out into the world on its own, trusting (or perhaps we have to say hoping) that it will make its way to the intended recipient untouched.

In just the past few decades, mechanisms have been devised for transferring cash over great distances using modern means of electronic telecommunications. In Parts VI and VII of this book, we will deal with the systems now in place for the electronic transfer of funds, both in the consumer context, where someone like you or me has a paycheck automatically deposited in a specified bank account or pays a bill by computer; and in the world of high finance, where major commercial entities are increasingly turning to the use of computerized mechanisms for *wire transfer*s of incredibly large sums back and forth around the country and the world. We start, however, and spend the majority of our time with the modern version of a distinctly low-tech system for making payment by means other than cash. This system, which has a long and venerable history, relies on private parties creating, issuing, passing from hand to hand, and in the process taking on obligations and securing rights under some very distinctive pieces of paper with some unique properties. These special pieces of paper, which under modern parlance and the law of the Uniform Commercial Code (the "U.C.C.") now go by the name of *negotiable instruments*, are more than just contractual promises to pay that have been reduced to writing, like a simple I.O.U. scratched out on a paper napkin. To say that a given piece of paper qualifies as a negotiable instrument under the U.C.C. is to say quite a lot about it: How it should properly be passed from one party to the next, what rights are conveyed to the one taking such an instrument, what defenses are available against anyone asserting rights based on the instrument, and so much more. Ultimately, of course, we are interested in how reliance upon such negotiable instruments can serve as a payment mechanism substituting for payment in cash, as well as how payment in this manner is similar to and different from the paradigm of payment by cash. Our first order of business is therefore, quite naturally, to understand what exactly a negotiable instrument is. For this we turn first to the following section and then to the Examples and Explanations with which the chapter concludes.

THE DEFINITION OF A NEGOTIABLE INSTRUMENT

Let's start at the very beginning. Section 3-101 of the U.C.C. states that, "This Article may be cited as Uniform Commercial Code—Negotiable Instruments." Nothing terribly exciting there, but at least it assures us that we've come to the right place if what we are interested in is the law relating to negotiable instruments. This is confirmed by the first sentence of §3-102(a): "This Article applies to negotiable instruments." The rest of §3-102 deals with possible overlaps or conflicts between Article 3 and other articles of the U.C.C., as well as with Regulations and other pronouncements of the Federal Reserve System, but nothing here need concern us for the moment.

Section 3-103 is, as you can see, a fairly lengthy compendium of definitions, some of which are given in subsection (a) and others of which appear in other sections of Articles 3 and 4 (with which we'll be dealing later) as indexed in subsections (b) and (c). Subsection (d) further reminds us that Article 1 of the U.C.C. contains still other definitions, as well as principles of construction that are applicable to all issues arising under any article of the Code. There is certainly no reason now to linger over any of these definitions. As a particular definition becomes relevant to the topic or issue we are considering at the moment (and some will become crucial within just a page or two), I will point you back to the definition or definitions you will need. Just observing the length and detail of §3-103, however, should serve as notice that the study of the law of negotiable instruments is replete with a whole set of special terms—a distinct lingo all its own. If, as you go through this material, you ever find yourself stymied by a question that doesn't seem to make any sense or seems harder than it should be, the first thing to do is read the question and any relevant Code sections over again, paying particular attention to the exact wording used. Now is the time to commit yourself to being as precise and meticulous in the use of the special terminology relating to negotiable instruments you will be learning as you will find the drafters of the Code were in their crafting of Article 3 and its compatriot Article 4.

Moving on in our tour of Article 3, we finally hit the Code provision directly relevant to the question we have first to address: What exactly *is* a negotiable instrument? This is answered in subsection (a) of §3-104. Stripped of a lot of language around the edges, which we will consider later on, the core language of §3-104(a) is as follows:

> "[N]egotiable instrument" means an unconditional promise or order to pay a fixed amount of money.

Note also that in subsection (b) we are instructed that whenever the Code uses the single word *instrument*, it is referring to a negotiable instrument as that term is defined in subsection (a).

We can now make use, for the first time, of a couple of crucial definitions from §3-103(a). Look at this section's definition of *promise*:

> "Promise" means a written undertaking to pay money signed by the party undertaking to pay. An acknowledgment of an obligation by the obligor is not a promise unless the obligor also undertakes to pay the obligation.

Check out the definition of *order* as well:

> "Order" means a written instruction to pay money signed by the person giving the instruction.… An authorization to pay is not an order unless the person authorized to pay is also instructed to pay.

So a promise is a promise and an order is an order. The first thing you notice in these two definitions is that for a promise to be a "promise" and for an order to be an "order" for Article 3 purposes, the given promise or order must be *in writing.* A *writing* is defined for purposes of the U.C.C., in §1-201(46) of the original Article 1 (which I'll cite as "§1-201(46)") or §1-201(b)(43) of the revised version of that article ("§1R-201(b)(43)"), as including not only verbiage rendered by hand but also "printing, typewriting or any other intentional reduction to tangible form." Thus, a negotiable instrument, whether it be based on a promise or an order, is first and foremost a tangible thing: A piece of paper. But then, of course, it's not just any old piece of paper, but only one that meets the §3-104(a) definition as we are exploring it.*

A second important point that comes out of the definitions of *payment* and *order* is that for a writing to qualify as a negotiable instrument, it must be *signed* either by the party making the promise or the one issuing the order. See *Cashen v. Integrated Portfolio Management, Inc.*, 2008 U.S. Dist. LEXIS 95415, 67 U.C.C.2d 848 (N.D. Ill. 2008). For the Code's definition of *signed,* look to §1-201(39) or §1R-201(b)(37). Signing includes "using any symbol executed or adopted by a party with present intention to adopt or accept a writing." What this means, among other things, is that if a particular person chooses to sign his or her name to a writing of this type with what seems to us a perfectly indecipherable scrawl, or with a simple "X" if that is his or her choice, that mark can be sufficient to meet the signature requirement—as long as that scrawl or that X is being adopted by the party in question "with present intention to adopt or accept" the writing.

The first three examples of this chapter ask you to examine some simple pieces of paper that may or may not be negotiable instruments according to the definition as we've discussed it so far, and furthermore to identify what subspecies of negotiable instrument that paper would be. (See Figures A-C.) Negotiable instruments come in two main varieties, the *note* and the *draft*, on which see §3-104(e). You will certainly want to know a *check* when you see one. See §3-104(f). These initial examples will also help you to identify some principal characters in the negotiable instruments game, the parties as they are identified by role either as *maker*, *drawer*, or *drawee*. You'll find these terms defined as you need them in §3-103(a).

The following examples then explore the criteria, in addition to those we've already mentioned, that must be satisfied if a particular piece of paper is to qualify as a negotiable instrument. When we first looked at the crucial definition of that term in §3-104(a), we set aside for the moment a lot of the language around the edges to focus on the fact that a negotiable instrument must be, at its core, a written and signed promise or order to pay a sum of money. Beginning with Example 4, we look at the several other criteria laid out in §3-104(a). In particular we explore the requirements that

• the purported negotiable instrument must be based on an "unconditional" promise or order,

• the promise or order must be "to pay a fixed amount of money, with or without interest or other charges described in the promise or order,"

he purported negotiable instrument must be payable "to bearer or to order" at the time it is issued or first comes into the possession of a holder,

he instrument must be payable on demand or at a definite time, and he instrument must not also state “any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money,” with only a narrow set of exceptions.

The concluding examples deal with some other definitions that we’ll be needing soon enough—that of *certified check*, *cashier’s check*, and *teller’s check*—and also with the particular issues that arise when we are dealing with what is termed an *incomplete instrument* under Article 3. There is plenty to look forward to in this first set of Examples and Explanations. They set the stage for all that is to come. Right now there is nothing for it but to set in on the first of them.

Examples

Examine the writing pictured in Figure A.
Does this qualify as a negotiable instrument under §3-104(a)? If so, what type of negotiable instrument is it?
Is its status as a negotiable instrument jeopardized by the fact that it does not indicate the date on which Horace Rivers created or purported to create the writing? See §3-113 and in particular subsection (b).
What term does Article 3 use to describe Horace Rivers?

Figure A

> I promise to pay \$2,000 to the order of Jennifer Lake on January 15, 2015.
>
> *Horace Rivers*
> Horace Rivers

Figure B

> TO: Arnold Moneybucks January 12, 2013
>
> Pay to the order of Sarah Student \$1,000 on February 15, 2013.
>
> *James Brook*
> Prof. James Brook

Figure C

> First National Bank
> 123 Main Street
> Brookville, New York *January 12, 2013*
>
> Pay to the order of *Stewart Student* *\$1,000*
> *One Thousand and 00/100* Dollars
>
> *James Brook*

The party in Jennifer Lake's position is conventionally referred to as the "payee" of the instrument, but as a matter of fact Article 3 never defines that term. An interesting question remains, however. We have to assume that there are some number of people out there with the name Jennifer Lake. To what person, to *which* Jennifer Lake, does this promise run? See the first sentence of §3-110(a).

Professor Brook owes Sarah Student $1,000 for work she did in helping him to prepare the manuscript of a book he is writing. Brook tells Sarah that he does not have the cash at the moment to pay her, but that he has arranged for her to get the money the next month from one Arnold Moneybucks, a prominent (and wealthy) local businessperson. On January 12, Brook prepares and signs the writing pictured in Figure B and hands it over to Sarah.

Does this qualify as a negotiable instrument under §3-104(a)? If so, what type of negotiable instrument is it?

What terms does Article 3 use to identify Brook and Arnold Moneybucks as of January 12?

Professor Brook also owes another research assistant, one Stewart Student, the sum of $1,000. He decides to pay Stewart in a more conventional manner, out of a checking account he maintains at the First National Bank in his hometown. He takes out a blank check and fills it out as pictured in Figure C.

Does this qualify as a negotiable instrument under §3-104(a)? If so, what type of negotiable instrument is it?

What terms does Article 3 use to describe each of Brook and First National Bank as of January 12?

Suppose that Brook, prior to handing the writing over to Stewart, had struck out the preprinted phrase "Pay to the order of" preceding the space on which he inserted Stewart's name, or that the company that had printed up the forms had through some oversight failed to include these words on the preprinted check form? Does this change your analysis of the situation at all? See §3-104(c).

Jason Jones signs a writing dated August 4, 2012, stating that, "I promise to pay to the order of Roberta Rogers $12,450 if she conveys to me title to her 2009 Aspen Exemplar automobile one week from this date."

Is this writing a negotiable instrument? See §3-106(a).

What if the writing signed by Jones had read, "In consideration of her agreement to convey to me title to her 2009 Aspen Exemplar automobile, I, Jason Jones, promise to pay to the order of Roberta Rogers $12,450 one week from this date"? Would this writing be a negotiable instrument?

Suppose that the writing had initially stated only that Jones "promises to pay to the order of Roberta Rogers" the sum on the date set. It also contains a sentence, however, stating that, "This note and any rights or obligations arising hereunder are subject to a Contract of Purchase and Sale entered into between Jason Jones and Roberta Rogers on the same date as the date hereof." Would this writing qualify as a negotiable instrument?

Finally, consider the following possibility. The writing Jones signs reads, "In accordance with a Contract of Purchase and Sale entered into between myself and Roberta Rogers on this date, I promise to pay to the order of the said Roberta Rogers $12,450 one week from the date hereof." Is this a negotiable instrument?

Lili McCue signs a dated writing stating, "I promise to pay to the order of Colin Danforth that which I owe him by delivering to his place of address a ruby of at least one carat three months from the date hereof."

s this a negotiable instrument?

Even if this writing does not qualify as a negotiable instrument under Article 3, does that mean it has no legal significance?

Isabelle Inkster is able to obtain a small business loan from the First Federal Bank of New York. The note she signs in 2011 states that she must repay, on a specified schedule, "to the order of the First Federal Bank of New York" the principal amount, along with interest to be calculated as "three percent (3%) over the Prime Rate charged by First Federal Bank of New York, to be adjusted monthly." First Federal's prime rate of interest is regularly reported in the financial press. Assuming that all the other criteria of §3-104(a) are met, does this writing qualify as a negotiable instrument under Article 3? See §3-112(b).

Consider in each of the following, using as your guide §3-109(a) and (b), whether the language in what purports to be a note or a draft satisfies the requirement of §3-104(a)(1) that at the time of its creation the writing be "payable to bearer or to order." In each case, if the writing does qualify as a negotiable instrument at the time of issuance, is it an instrument initially payable to bearer or to order?

I promise to pay to Rachelle Roe …"

'I promise to pay to bearer …"

\ check directing the drawer's bank to "Pay to the Order of Rachelle Roe."

\ check made out "Pay to the Order of Cash."

A check, otherwise complete, that is made out "Pay to the Order of …" with no name filled in on the line where the payee's name usually goes.

Consider, using as your guide §3-108, whether each of the following would satisfy the requirement of §3-104(a)(2) that the writing be "payable on

demand or at a definite time."
"Pay to the order of Rachelle Roe on demand."
"Pay to the order of Rachelle Roe on sight."
"Pay to the order of Rachelle Roe" but with no date given.
"Pay to the order of Rachelle Roe on December 15, 2015."
"Pay to the order of Rachelle Roe thirty (30) days following sight."
"I, Allan Adare, promise to pay to the order of Rachelle Roe $40,000 within six months following the death of my Uncle, Adrian Adare."

A writing, dated February 3, 2013, reads "I, Otto Olson, promise to pay to the order of Manuel Marquez the sum of $16,000 and also to deliver him title to the estate known as Whiteacre one month from the date hereof." Does this qualify as a negotiable instrument?

Joseph Byers of Boston and Suzanne Sellers of Seattle both collect antique porcelains. Byers has for several months been negotiating over the telephone with Sellers for the purchase of a particular piece she owns, which he very much wants to add to his collection. It is finally agreed that she will sell him the piece for $12,000, delivery to be made in exchange for that price when the two meet the next week at a porcelain collectors' convention in Chicago. Byers obviously does not want to have to carry that much cash with him on his journey from Boston to Chicago, so he tells Sellers he will pay her by check. Sellers has completed her study of payment systems and hence is aware, as you will be soon enough, of the problems she might encounter if she were to take a simple personal check from Byers in a situation such as this, such as that the check might bounce for insufficient funds or that Byers might stop payment on the check before she gets to cash it. Therefore, Sellers tells Byers that she wants him to pay the purchase price to her by some other, more secure (for her) means.

Byers has a checking account with the Bay State Bank in Boston. He writes out a check payable to the order of Sellers for $12,000. He then takes this check into his branch of Bay State Bank, where he gets a representative of the bank to apply to the back of the check a stamp bearing the name of Bay State Bank and to place her initials by the mark she has made with the stamp. What term would you now use to characterize this check? See §3-409(d).

Suppose instead that Byers had gone into Bay State and arranged for the withdrawal of the $12,000 from his account. Instead of taking this amount in cash, he requests that the bank prepare a check of the following type: Bay State Bank directs itself, Bay State Bank, to "pay to the order of Suzanne

Sellers" the sum of $12,000 on demand. What term does Article 3 use for such a check? See §3-104(g). Notice that Byers is neither the drawer nor the drawee of this check. What term characterizes Byers in this situation? See §3-103(a)(11).

As a third possibility, suppose that Bay State Bank itself has a checking account with Seaside Bank of Seattle, in which it keeps a sizeable balance. Byers uses the $12,000 he withdraws from his account at Bay State to purchase a check drawn by Bay State on its account with Seaside Bank "to the order of Suzanne Sellers" for the right amount. What term does Article 3 use for such a check? See §3-104(h).

Coincidentally, Byers has also come upon another piece of antique porcelain that he wants to buy, this one in a small antique shop in Boston not far from his home. The owner of the shop, which is called "The Antique Attic," is a woman named China White. The last time Byers looked in the store, the piece in which he is interested was marked with a tag giving its price as $3,500.

Byers takes a blank check from his checkbook and fills in the name of the payee as "The Antique Attic" and the amount as $3,500. He does not sign the check, but puts it in his wallet as he heads out the door on his way to the shop. As it now sits in his wallet, is this paper an "incomplete instrument" as that term is used in §3-115?

Assume instead that Byers has in fact signed the check, along with filling in the amount. However, because he is not sure in what name Ms. White will want the check to be made out, he leaves the payee space blank. He gives the check to his assistant, Murphy, instructing Murphy to purchase the item from the store and fill in the name of the payee as whatever Ms. White requests. Would the paper now in Murphy's possession be an incomplete instrument? Would it be a negotiable instrument under §3-104(a)? To carry on with the story, when Murphy gets to the shop, Ms. White is more than happy to take the check in exchange for the item, and asks that he fill in the name of the payee as "China White Antiques, Incorporated," which is the legal name under which she carries on the business. Murphy does so and hands the check over to her. What is its status now?

As a third alternative, suppose that Byers is well aware, from prior dealings, of the correct name to put on the check. He fills in the payee as "China White Antiques, Incorporated" and signs it. He does not fill in the amount of the check, however, thinking that through Murphy he may have some chance to cut a deal at a lower price with Ms. White. He gives the paper filled out in this fashion to Murphy. Is it at this point an incomplete instrument? Is it a negotiable instrument under §3-104(a)? As it turns out, the valued assistant Murphy is able to get Ms. White to accept $3,000 for the piece, so he completes the check form by filling in this amount and hands it over to her. What is the status of the paper now?

Explanations

Yes. This is a negotiable instrument under §3-104(a). You should verify that it meets all the criteria of that definition. It expresses a promise to pay, is in writing, and is signed by the person making the promise, Rivers. There is not a hint of a condition on this promise. It is a promise to pay a fixed amount of money, $2,000. As we will later see in more detail, it is "payable to order" in that the promise is stated as an obligation to "pay to the order of" an identified person. It is payable in this case not on demand, but at a definite time, January 15, 2015. Finally, there is simply nothing in this uncomplicated writing that states an "undertaking" by Rivers to do any act in addition to the payment of money. It is a negotiable instrument all right, and because the core language is that of promise it is the type of negotiable instrument we call a *note*. See §3-104(e).

No. There is no requirement that a writing include or exhibit a date in order for it to be a negotiable instrument. Under §3-113(b), should the issue ever arise, the "date" of this instrument would be "the date of its issue [a concept we will get into in the Chapter 2], or in the case of an unissued instrument [ditto], the date it first comes into the possession of a holder [ditto again]."

Horace Rivers is to be referred to as the maker of the note (§3-103(a)).

Under §3-110(a) the particular Jennifer Lake to whom this note is initially payable is determined by the intent of Horace Rivers when he put that name, "Jennifer Lake," into his promise. The Jennifer Lake to whom this money is initially promised is the Jennifer Lake that Horace had in mind when he wrote out the promise. No other Jennifer Lakes need apply.

Yes. This is a negotiable instrument under §3-104(a), as you can confirm for yourself. Because the language is that of an order, this is a draft (§3-104(e)).

Professor Brook is the drawer of the draft and Arnold Moneybucks is the drawee (§3-103(a)). Note that the creation of a valid draft does not require the participation, the approval, or even the knowledge of the drawee. In Chapter

3, we will pick up on this example, and see what happens when Sarah tries to get Moneybucks to follow the order that Brook has written out and addressed to him. For the moment, it is enough to see that Moneybucks, the drawee, plays no part in the drawing of the draft. His part in the story comes later.

The paper that Brook has handed over to Stewart is indeed a negotiable instrument. It is a draft. Furthermore, as you can confirm by a reading of §3-104(f), it is, unsurprisingly, what we and, more to the point Article 3, call a *check*. "'Check' means (i) a draft … payable on demand and drawn on a bank." As to what constitutes a "bank" for these purposes, see §4-105(1), a definition made applicable to Article 3 via §3-103(c).

Professor Brook is the drawer of the check and the Main Street branch of First National Bank is the drawee. Again, as in Example 2's case of the draft Brook made payable to Sarah Student, the drawee—in this case the bank—is not involved in the creation of the draft.

Under §3-104(c), this is still a check, even though it fails to display what we will soon discover to be the crucial words of negotiability ("to the order of" or "to bearer"), which are in all other cases absolutely essential for the creation of a negotiable instrument. The reasons why the drafters of the 1990 Revised Version of Article 3 thought it appropriate to put in this subsection (c) are given at the end of the first paragraph of Comment 2 to §3-104.

No. This is not a negotiable instrument. Under §3-106(a), the promise made is not unconditional for purposes of the basic definition of §3-104(a), because it states "an express condition to payment," that condition being Rogers's conveyance of title to her car by August 11. See, for example, *Reid v. Pyle*, 51 P.3d 1064, 48 U.C.C.2d 1066 (Colo. App. 2002), where what professed to be a note was correctly held not to be a negotiable instrument as the promise to pay was expressly conditioned on "the sale or transference" of a particular piece of real estate. Note also that language in a document will not constitute a promise for purposes of Article 3, and hence cannot be the basis for a note if by its terms it only "acknowledges" the existence of an obligation but does not convey any promise by the signer to pay the obligation. See *Jacob v. Harrison*, 2002 Del. Super. LEXIS 514, 49 U.C.C.2d 554.

Yes. This is a negotiable instrument. Jason Jones has expressed no condition on his obligation to pay Roberta Rogers the set sum on the given date. The introductory phrase, "In consideration of …" is read as explaining, if you will, the genesis of the promise—it is a bit of background information—but it does not express a condition on Jones's promise as he has made it. See the first paragraph of Comment 1 to §3-106.

No. Here the promise is deemed, under §3-106(a), other than an unconditional one because it is "subject to or governed by another writing."

Yes. The last sentence of §3-106(a) tells us that, "A reference to another writing does not of itself make the promise or order conditional." Here there is reference to the Contract of Purchase and Sale that Jones and Rogers have entered into, but nothing in the language of the note suggests either that the promise is "subject to or governed by" that contract document nor that "rights and obligations with respect to the promise" are stated in it. See the second paragraph of Comment 1. Note the rationale for the distinction between this example and something like what we saw in 4c: "[T]he holder of a negotiable instrument should not be required to examine another document to determine rights with respect to payment."

The slight differences in language that we are exploring in this example may not seem like much, but just such distinctions can be crucial to the determination of whatever rights the parties are trying to assert, or any defenses they are or may be subject to, on a particular written promise or order. For an example, see *TeleRecovery of Louisiana, Inc. v. Gaulon*, 738 So. 2d 662, 38 U.C.C.2d 853 (La. Ct. App. 1999). In that case the Court of Appeals of Louisiana concluded that the presence of the language "I agree to payment according to the terms of the Credit Payment Agreement previously executed by the undersigned" found on the writing under dispute (a so-called casino marker for gambling debts in the amount of $10,000) did not render the writing, which otherwise met all the requirements for being a check, nonnegotiable. The court wrote:

> Examining the language at issue in this case, we conclude it does not destroy negotiability of the marker. Its location on the last line of the instrument as well as its use of "according to" simply references another document but does not make payment conditional.

Another interesting example is *Sheppard v. Stanich*, 749 N.E.2d 609, 46 U.C.C.2d 773 (Ind. App. 2001). There the parties entered into an agreement in April 1993 under which Sheppard was to purchase all of Stanich's stock in a company called 21st Century Holdings. In accordance with that agreement Sheppard executed what was presumably intended by both to be a note in which he promised to pay the amount of $38,000 plus interest on or before April 15, 1994. Following Sheppard's signature there appeared on the paper a handwritten sentence: "If value exceeds 6 percent interest Jon agrees to split profits." The court took this last sentence to be a reference to an aspect of the underlying Agreement of Purchase under which the seller would split the profits of the business in a defined way based on a valuation that was to be made of the stock being sold. The addition of this sentence was held by the court to render the “note” nonnegotiable “because it was not an unconditional promise of one party to pay the other, but a bilateral agreement.… The Note [that is, the piece of paper that purported to be a note] was evidence of Sheppard’s promise to pay the purchase price and contained an additional term of the agreement [Stanich’s promise to take less than the $38,000 under some condition laid out in the Agreement of Purchase].”

Here we confront for the first time what will become the principal notion lurking behind all the subsidiary rules to be applied when we must answer the question of whether a specific piece of paper is a negotiable instrument. Whether a writing constitutes a negotiable instrument should be determinable by the person we will end up referring to as the *holder*—or by anyone else examining it for that matter—by what is to be found *within the four corners* of the writing itself. Whether a writing satisfies the requirements to be a negotiable instrument for Article 3 purposes, and if so what type of instrument it is; who is promising or ordering whom to pay how much and when; and (as we have yet to see) whether the drawee of a draft has accepted—all this information should be available from taking a good look at the writing itself. Should we conclude, after examining the writing itself, that we would have to consult another document to answer any of these questions, or would have to question a party for crucial information or to discern that party’s or a set of parties’ “intention” (heaven forfend!), we are dealing with something that isn’t a negotiable instrument to begin with. Any negotiable instrument is a special type of document that carries all the pertinent information about it right on its face or, as we will begin to see, on its flip side. The negotiable instrument is a very tangible thing; it is a piece of paper. Its importance, however, is that the instrument and the information it carries are, at least metaphorically speaking, one and the same.

This is not a negotiable instrument. Under §3-104(a), the promise or order must be one “to pay a fixed amount of money.…” Look at the definition found in §1-201(24) or §1R-201(b)(24), the heart of which is the statement that: “‘Money’ means a medium of exchange authorized or adopted by a domestic or foreign government.…” That a note or a draft may be payable in foreign currency is confirmed by §3-107, as you can check, but a promise to deliver a ruby, even a fairly pricey one, will not do.

Even though this piece of paper turns out not to be a negotiable instrument, that certainly does not mean that it has no legal significance. McCue apparently is indebted to Danforth for some amount and has promised to pay him, not in cash, but by the delivery of a gem of a certain type and by a given date. McCue will presumably be obligated to do as she has promised; her legal obligation arises under the common law of contracts and is governed by its principles. This paper is a contract document and may turn out to be very important to Danforth if McCue fails to carry out her promise or tries to deny that she ever made such a promise. It just doesn't happen to be a negotiable instrument.

By the test of §3-112(b), the way the interest term is expressed in the note Inkster signs—as a variable rate of interest keyed to First Federal Bank of New York's Prime Rate, when that rate is readily available by consulting generally available sources of information, even though these are extrinsic to the instrument—does not render the note nonnegotiable. Note from Comment 1 to §3-112 that the same would of course not be true if the *principal* amount were not given as a "fixed amount."

> You should be aware that the answer to this question is as easy as it is because the note was signed by Inkster in 2005 and hence is governed by the 1990 Version of Article 3 and its very helpful §3-112(b). The prior version of Article 3, adopted by the states in the 1960s, had no section comparable to what we now see in §3-112(b). This was no huge oversight on the part of the drafters; at the time, the so-called variable-interest-rate note was virtually unknown. Notes were almost without exception written in terms calling for a fixed rate of interest. Only in the following decades did the idea of the variable-interest-rate note come into general use, to the point where today such notes probably account for a majority of all notes signed by borrowers.
>
> The earlier version of Article 3 not only lacked a section specifically providing for the negotiable status of this type of variable-interest-rate note (such as we now have in §3-112(b)), but in fact was so written as to lead most courts to hold that any note providing for interest calculated in this manner was definitely *not* a negotiable instrument. The original version of §3-104 required that, for a writing to be a negotiable instrument, the writing had to contain a promise or order to pay "a sum certain"—but the Article did not go on to define this term. In fact, a

comment to the old §3-106, which dealt with (even if it never actually defined) *sum certain*, stated that, “The computation [of how much is promised or ordered] must be one which can be made from the instrument itself and without reference to any outside source.” Even though faced with such language in the then-effective version of Article 3, some courts did find their way to a reading of the Code that allowed variable-interest-rate notes to be true negotiable instruments. However, the majority of courts, as I have indicated, did not. See, for example, *Taylor v. Roeder*, 234 Va. 99, 360 S.E.2d 191, 4 U.C.C.2d 652 (1987). The note in question called for interest to be charged at “[t]hree percent (3.00%) over Chase Manhattan Prime to be adjusted monthly.” The Supreme Court of Virginia concluded that this was not a negotiable instrument under the then-applicable version of Article 3:

> We conclude that the drafters of the Uniform Commercial Code adopted criteria for negotiability intended to exclude an instrument which requires reference to any source outside the instrument itself in order to ascertain the amount due, subject only to those exceptions specifically provided for in the U.C.C.
>
> … Although the rate may be readily ascertained from published sources, it cannot be found within the “four corners” of the note.

In a number of jurisdictions in which the variable-interest-rate note was held not to be a negotiable instrument subject to the old Article 3, the legislatures quickly stepped in and adopted a nonuniform amendment to cover the situation. In others, the legislatures did nothing and the situation remained as the courts of those jurisdictions had held: The variable-interest-rate note, however much it might be used and accepted in day-to-day business affairs and treated just as a note conventionally would be, was not a true negotiable instrument—a conclusion that might later come as an unpleasant surprise to some party down the line if things got dicey and litigation ensued.

Thus, the situation prior to the 1990s was anything but uniform. In some jurisdictions the variable-interest-rate note was simply nonnegotiable. In others it was negotiable under that state’s courts’ reading of the original Article 3. In others it was negotiable due to legislative initiatives amending Article 3. I would like to say that the whole controversy has been rendered moot by the promulgation and near-uniform passage by the states of the 1990 Version of Article 3, but unfortunately that isn’t entirely the case. Notes are typically term instruments and in some instances the terms are quite long. Plenty of notes still out there were entered into prior to the adoption of the 1990 revisions, and hence they are still subject to the rules, whatever they may be for the particular state, of the original Article 3. See, e.g., *Barnsley v. Empire Mortgage Ltd. Partnership V*, 142 N.H. 721, 720 A.2d 63, 37 U.C.C.2d 1069 (1998), and *Amberboy v. Société de Banque Privée*, 831 S.W.2d 793, 35 Tex. Sup. J. 621, 17 U.C.C.2d 145 (1992).

For notes entered into today, of course, we have the rule of §3-112(b) to consult and to make our lives a lot easier. This subsection doesn't make any purported note a negotiable instrument no matter how weirdly or in what complex fashion the interest terms are stated, but it does give a clear criterion by which this question is to be addressed.

This writing, because it is not payable to bearer under any of the possibilities given in §3-109(a) nor to order under (b), is not a negotiable instrument. Your initial reaction might be that Article 3 is being unnecessarily finicky (or downright silly) in requiring that either the exact six-letter word "bearer" or the five-letter word "order" appear in just the right way on the writing in order to make the writing a negotiable instrument. What magic do these words, sometimes referred to as the *language of negotiability*, work on a simple piece of paper? But that is exactly the point. These words serve as neat, and one might say, elegant markers of negotiability, placed right there on the document itself. Recall the fundamental notion that whether or not a writing constitutes a negotiable instrument should be determinable from the face of the writing itself, from within its "four corners." What better way to do this than to make at least one criterion the presence of at least one of these two distinctive words? If the language of negotiability is not on a writing, then it can't be a negotiable instrument (with that one odd but necessary exception dealing with preprinted checks of §3-104(c)). The fact that certain words, and these two in particular, set off a negotiable instrument from all the other writings that people sign is (as I have a feeling you've already surmised) not a recent innovation of the U.C.C. Just as the notion and nature of negotiable instruments has a long and distinguished history, the use of these particular words as the touchstone language of negotiability are a central part of that history. And you can be sure that the courts take this seemingly "technical" requirement seriously. See, for example, the decision of the Supreme Court of Idaho in *Sirius, LC v. Erickson*, 144 Idaho 38, 156 P.3d 539, 62 U.C.C.2d 411 (2007) or that of the Supreme Court of Mississippi in *Whitaker v. Limeco Corp.*, 32 So.3d 429, 2010 Miss. LEXIS

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Don’t be misled. The fact that any particular promise to pay, stated *without* the language of negotiability, appears in a writing doesn’t make the promise illegal, immoral, or anything like that. More to the point, it certainly doesn’t render the promise unenforceable. The result is only that any enforcement of the promise will be enforcement under the traditional common law of contract, unless some other regime of legal rules can be successfully invoked. What the enforcing party cannot do is enforce the promise as an obligation *on a negotiable instrument*; as I have promised before and will promise again, what differences exactly that makes will be apparent soon enough.

This promise will make the writing a negotiable instrument under §3-109(a)(1). Not surprisingly, this writing has been created as what we would term a *bearer instrument*.

This check is a negotiable instrument payable to order under §3-109(b), because it is written as payable to the order of an identified person. It is classed as an *order instrument*.

This is a bearer instrument under §3-109(a)(3).

This is a bearer instrument under §3-109(a)(2). It is also what we will discuss as an “incomplete instrument” in Example 9. There is some language in the middle of Comment 2 accompanying §3-109 that confirms this result, if you aren’t willing to take my word for it.

This is (obviously) payable on demand.

An instrument using this language is also payable on demand (§3-108(a)(i)).

This is also payable on demand (§3-108(a)(ii)). See *Nordin v. Retzlaff*, 786 N.W.2d 880, 72 U.C.C.2d 837 (Minn. App. 2010).

This is payable at a definite time under §3-108(b) because it is payable at a fixed date.

This is also considered to be payable at a definite time under §3-108(b), because it is “payable on elapse of a definite period of time after sight.”

This promise could not be the basis of a negotiable instrument, as it is neither payable on demand nor payable at a definite time. Who could tell from a good look within the four corners of the instrument, or even the most careful look at Uncle Adrian himself and his medical records, when the promised payment will become due? I doubt you will find it surprising that the Court of Appeals of Ohio recently determined that a paper denoted a “note” was not in fact a negotiable instrument when by its language it called upon the signer to make payment "when you can." *Smith v. Vaughn*, 174 Ohio App. 3d 473, 882 N.E.2d 941, 64 U.C.C.2d 757 (2007).

No. Under §3-104(a)(3), a negotiable instrument must "not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money," with some limited exceptions not relevant here. Olson's promise to convey Whiteacre in addition to paying the money renders the entire writing a nonnegotiable one.

> You should read through the listing of exceptions to this general rule that concludes §3-104(a)(3). You'll see that they certainly don't cover a promise to convey a piece of real estate, and, in effect, don't really deal with any type of undertaking or order to take any action in addition to or independent of the core obligation to pay money, which is what the note or draft is all about. Any promise to give or maintain collateral to support a monetary obligation, for example, doesn't have an independent life, so to speak, other than as it relates to the promise to pay the money. Similarly, an authorization or power given to the holder of the instrument to confess judgment or to take other acts to enforce the monetary obligation can't be thought of as anything distinct from or in addition to the monetary obligation itself. There is no reason to worry, unless an actual case comes your way in which the matter arises, about this latter part of §3-104(a)(3). The fundamental principle is what we are after here: A negotiable instrument is a promise or order to pay a sum of money and the maker or the drawer cannot, if his or her creation is to retain its negotiable status, tack on any additional promises or instructions unrelated to that fundamental monetary obligation.

This check is now a *certified check* under §3-409(d). Byers was from the outset the drawer of the check, and he remains so. Bay State Bank was the drawee, and when an authorized representative of the bank stamps its name on the check the bank becomes what we will term the acceptor as well.

This is a *cashier's check* under §3-104(g). Bay State Bank is *both* the drawer and the drawee of the check. Byers is the *remitter* in this situation (§3-103(a)), as he was the person who purchased the instrument from its issuer, Bay State Bank, when the instrument was payable to an identified person other than himself, that person being Suzanne Sellers.

This instrument is a *teller's check* under §3-104(h). Bay State Bank is the drawer and Seaside Bank of Seattle is the drawee. Byers is once again the remitter.

No. Under §3-115(a), an incomplete instrument must be a signed writing. We can stop right there. The check now in Byers's wallet has not been signed. It is not an *incomplete instrument* as that term is used in Article 3.

Under this set of facts, the check in Murphy's possession *is* an incomplete instrument as he makes his way to the antique shop. It is signed and its contents indicate "that it is incomplete but that the signer intended it to be completed by the addition of words or numbers." The more interesting question is whether this incomplete instrument is in its present state a negotiable instrument under §3-104(a) criteria—and the answer is yes. Recall that a draft is payable to bearer if it states that it is payable "to the order of …" but then has no name appearing in the space provided for naming (if one chooses to) a specific person as payee (§3-109(a)(2)). Murphy carries to the shop a check payable to bearer for $3,500. Once Murphy fills in the correct name of the payee as Ms. White gives it to him, and then hands the paper over to her, she has in her possession an order instrument, a check payable to the order of a corporate entity named China White Antiques, Incorporated.

Once again, the check Murphy is holding onto as he makes his way to the antique shop is an incomplete instrument, but in this case it is not a negotiable instrument. The price is left blank. It does not include an order to Byers's bank to pay "a fixed amount of money," and so it fails to meet that criterion of negotiability of §3-104(a). Once the figure of $3,000 is filled in, the paper does become a negotiable instrument. See the second sentence of §3-115(b). When the check is handed over to Ms. White, she is in possession of a check payable to the order of her corporation for $3,000.

Revision Proposals

The basic definitions with which we have been working in this chapter have been moved around a bit in the 2002 Revisions to Article 3, but the definitions themselves have not been changed, not even by a word. And the singularly important definition of what is a *negotiable instrument* in §3-104(a) remains the same. In fact that entire section has not been tampered with at all by the Revision drafters.

In all the chapters that follow, you may assume that this latest Revision of Articles 3 and 4 has not proposed any change, or at least not any change of substance, in what we have studied unless I indicate otherwise by a box such as this setting out the relevant Revision Proposals at the end of the chapter.

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*As a matter of fact, and as you may have noticed, nothing in the Code says that this particular type of writing must actually be written on a piece of paper, although that clearly is the convention and one we can happily live with. Within the world of commercial law, there are any number of stories, some of them probably true and others no doubt apocryphal, of some wiseacre (for what must have seemed like a good reason at the time) writing a negotiable instrument not on a sheet of paper but on some other tangible medium: something like a check written on the side of a watermelon, or on a tamale, or welded onto a sheet of heavy metal. For our purposes it seems perfectly legitimate, and will make our lives that much easier, if we assume that all the negotiable instruments with which we deal are pieces of paper with the right kind of writing on them. We'll assume that a "writing" is a writing on paper, and leave the watermelons and the tamales to the commercial folklore.

CHAPTER 2

Principles of Negotiation and Becoming a Holder

THE LIFE STORY OF A NEGOTIABLE INSTRUMENT

A negotiable instrument, once it is created by the maker of the note or the drawer of the draft, doesn't just sit there. If it is going to play out whatever function the maker or the drawer intended for it, it must start moving from hand to hand. The life of a negotiable instrument, at least metaphorically and in most cases quite literally, is a life on the move. The tale of any particular negotiable instrument unfolds as a series of events. The first of these events is termed *issuance* of the instrument. As §3-105(a) tells it,

> "Issue" means the first delivery of an instrument by the maker or the drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person.

We'll deal with the nature of issuance in the first example of this chapter.

The life cycle of the instrument typically ends with its *presentment* by some party seeking to enforce the promise or order it contains back to the party who in the normal course of events is expected to pay it: the maker in the case of a note or the drawee in the case of a draft. Presentment is defined in §3-501(a), and is something we will look at more closely in Chapter 3.

Presentment gets the instrument to the party who is supposed to pay up on the promise or order, and in the vast majority of cases (even the most cynical would have to admit) the demand that payment be made is honored. The presentment results in the instrument turning into the correct amount of cash. The role of the negotiable instrument in moving wealth in the form of money from one party to another has been played out just as it was intended.

It is perfectly possible that the person to whom the instrument is initially issued will himself or herself directly present it for payment. In many instances, however, there are some intervening steps—often quite a few—and additional parties involved between the issuance of the instrument and its presentment. Any such intervening step is referred to as a *transfer* of the instrument. Notice that by the definition of *transfer* found in §3-203(a), issuance of an instrument is not a transfer.

> An instrument is transferred when it is delivered by a person *other than its issuer* for the purpose of giving the person receiving delivery the right to enforce the instrument.

Also, as you can see, presentment is not a transfer because the instrument is not being delivered to the maker or drawee "for the purpose of giving the person receiving delivery the right to enforce the instrument." The maker or the drawee does not enforce the instrument; the whole idea of the instrument is that it is to be enforced *against*, not *by*, the maker or drawee.

There you have, in broad outline, the life cycle of the negotiable instrument, at least as it runs if all goes according to plan. The instrument is issued; it may be transferred anywhere from zero to some significant number of times; and all is wrapped up when the final transferee (or the party to whom it was issued if there have been no transfers subsequent to issue) makes a presentment to the maker or drawee. Of course, as you would expect, the real world being what it is, in some small but still meaningful number of cases everything doesn't go just as it should. Parties don't do what they are supposed to; ambiguities arise that need clearing up; or people who should have nothing to do with the instrument (such as the thieves and forgers we will eventually meet) try and often succeed in getting their hands on money that by no stretch of the imagination is meant for them. The legal rules for sorting all of this out are what give Article 3 (and Article 4, which we will later add to the mix) and the large middle portion of this book their heft.

THE PROCESS OF NEGOTIATION

The primary topic of this chapter, after an initial look at issuance of the instrument, is transfer of a negotiable instrument: how it is to be done and what effect it will have. Of prime importance is that some transfers qualify to be distinguished by a special term and confer specific rights on the transferee. We call such a transfer a *negotiation* of the instrument. Negotiation is defined in §3-201(a) as

> a transfer of possession, whether voluntary or involuntary, of an instrument by a person other than the issuer to a person who thereby becomes a holder.

Which reasonably leads us to inquire: Who or what is a *holder*? For that we have to look at §1-201(20) (or its equivalent in the revised Article 1, §1R-201(b)(21)(A)):

> "Holder" with respect to a negotiable instrument, means a person in possession of the instrument if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in possession.

This is not as gracefully written as it might be, but its meaning has never been in question. First and foremost, to be a holder of a particular instrument one must be in actual physical possession of that instrument. If at the moment the instrument is in "bearer" form—either because it was initially issued as a bearer instrument or it has become so through the rules of negotiation, which we will explore in the examples—then possession is *all* that is required to make the possessor the holder of the instrument. If, however, the instrument is at the time in question an "order" instrument, that is, payable to the order of an identified person, then that person and that person only will be the holder *if* he or she is in possession of the instrument.*

It is important to make clear at the outset that the conclusion that a person qualifies as a holder of an instrument is not necessarily to say that the person is a rightful holder or the lawful owner of the instrument. As we will see in the examples, a thief of an instrument may, under the right circumstances (for the thief), be the holder of that instrument even if he or she clearly has no legal right to that which he or she has stolen. Who is the rightful owner of the instrument, and the problems that person will encounter in trying to avoid the loss due to the theft, are issues that make up a large part of what is to come. For our present purposes, it is sufficient to recognize the importance of being able to determine who is and who isn't the holder of a given instrument, whether rightfully so or otherwise.

The term *negotiation* is defined in §3-201(a) by its result. A transfer is a negotiation if the transferee thereby becomes a holder. This still leaves the question of *how* exactly a negotiation is carried out. For that we look to subsection (b). Putting aside the special case of negotiation by a remitter,

> if an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument and its indorsement by the holder. If an instrument is payable to bearer, it may be negotiated by transfer of possession alone.

Now we need only identify a few other key sections and the terms they contain before we put all these pieces together in the examples that follow. The term *indorsement* is defined in §3-204(a). Notice that indorsement requires the signature of the indorser on the instrument itself and that this signature must be done for one of a set of purposes—and indeed is assumed to have been done for such a purpose—which include negotiating the instrument. You should also look over the definition of the terms *special indorsement* in §3-205(a) and *blank indorsement* in §3-205(b). Finally, look back to §3-109. We previously looked at subsections (a) and (b) of this section to determine whether a writing purporting to be a negotiable instrument was "payable to bearer or to order" at the time of its creation. Now look at subsection (c):

> An instrument payable to bearer may become payable to an identified person if it is specially indorsed pursuant to Section 3-205(a). An instrument payable to an identified person may become payable to bearer if it is indorsed in blank pursuant to §3-205(b).

So an instrument as it passes from hand to hand on its journey through life may, if certain conditions are met, be not merely transferred but also negotiated by one party to the next. As it is negotiated, it may change character from a bearer instrument to an order instrument or the other way around. All very interesting for a relatively simple piece of paper. And all worthy of study through the following examples and explanations.

Examples

Ms. Boss runs a small business with about a dozen employees. At the end of the year she decides to give each employee a bonus, and on the day before the Christmas holiday is to begin she writes up a set of checks. Included in this set is one payable “to the order of Louie Lacky,” Lacky being one of her oldest and most trusted employees. She puts this check along with the others in a pile on the top of her desk.

As of this moment, has Boss issued the check?

Boss puts out the word around the shop that each of the employees should stop by her office before the end of the day “for a pleasant surprise.” When one of them, Terry Toady, comes into Boss’s office, he is given his bonus check and thanks Boss profusely. Toady happens to comment that Lacky is not at work that day but is home sick. In fact, Toady is planning on dropping by Lacky’s home after work to see how his friend is doing. Boss hands to Toady the bonus check made out to Lacky, instructing Toady to give it to Lacky and commenting, “Maybe this will make him feel better.” Toady takes this check out of Boss’s office. As of this point, has the check been issued? Is Toady the holder of the check?

Suppose instead that Lacky has come into work that day. He comes into Boss’s office, but before she has a chance to thank him for all the work he has done over the year and give him his bonus check, he launches into a tirade about how much he hates “this stinking job” and also how little (to put it mildly) he thinks of Boss and her operation. Boss tells Lacky that if that’s how he feels, he is fired on the spot—then she storms out of the room. When Boss later returns to her office, Lacky is gone. Also gone is the bonus check made out to Lacky, which he must have spotted on the desk and taken with him as he left. In this situation, is it correct to say that the check has been issued? Is Lacky a holder as he walks out of the office and out of Boss’s place of business with the check in his pocket?

Able draws a check “to the order of Baker,” which he hands over to Baker.

Is Baker the holder of the check?

Baker then gives the check to Charlene in exchange for a rare set of old law books that he has been craving, but he does not place his signature anywhere on the check. Is Charlene now the holder of the check? If not, what can

Charlene do about the situation? See §3-203(c).

Dora draws a check “to the order of Ervin,” which she gives to Ervin. Ervin signs the back of the check under the legend “Pay to Felice.” Ervin puts the check in his pocket.

As of this moment, is Ervin the holder of the check? Is Felice?

Later in the day, Ervin runs into Felice and hands her the check. Is Felice now the holder of the check?

Would Felice’s ability to negotiate this check later to another party have been diminished in any way had Ervin written not simply “Pay to Felice” over his signature but instead either “Pay only to Felice” or “Pay to Felice only upon her completion of certain construction work now being done for me under contract”? See §3-206(a) and (b).

Greg writes a check on his account for $400 payable to “Cash.” He loses this check, which is found by one Hannah.

At this stage, is Hannah a holder?

This check is stolen from Hannah by Thad the thief. Was the transfer of the check in this way a negotiation from Hannah to Thad? Is Thad now the holder of the check?

Thad transfers this check to Isaac, of Isaac’s Liquor Store, in return for $360 in cash. Is Isaac a holder?

Jason writes a check on his account for $300 payable “to the order of Katherine.” He gives this check to Katherine. Before she can do anything with it, it is stolen from her by Thelma, another thief. Thelma then takes it to Isaac’s Liquor Store, where she writes “Pay to Isaac” on the back of the check and signs “Katherine” underneath. She hands it over in return for $270 in cash. Is Isaac a holder of this instrument?

Leroy writes a check “to the order of Maria” and gives it to Maria. Maria signs her name on the back of the check. The next thing she knows, the check is missing. It has either been stolen or lost.

Is the thief or finder a holder of the check?

What if Maria had signed her name on the back of the check under the legend “Pay to Natalie” before the check went missing? Would any thief or finder of this check be a holder?

Oscar writes a check “to the order of Patricia” and gives it to her. Patricia signs just her name on the back of the check and hands it over to Quincy. Quincy writes “Pay to Quincy” above Patricia’s signature on the back of the check. What effect, if any, does this have on the status of the check? See §3-

205(c).

Ralph signs a note (identified on the note as #SBT12345) for $10,000 payable "to the order of State Bank and Trust" on December 31, 2014. Soon after taking the note, an authorized representative of State Bank writes "Pay to Tremont Financial Services" on the note and signs below this legend on behalf of State Bank. She delivers the note to Tremont.

s Tremont now the holder of the note?

Assume instead that the representative of State Bank delivered the note to Tremont together with a separate document, signed on behalf of the Bank, containing the statement, "State Bank and Trust hereby transfers and negotiates to Tremont Financial Services a note for $10,000 (#SBT12345) made by Ralph and stated to be payable to the order of State Bank and Trust on December 31, 2014." Would Tremont become a holder through this procedure? What if this document prepared by State Bank had been securely attached to the note itself, either at its bottom or on its reverse, by the use of a hefty application of glue?

Uma owes money to Victor Verdun for some work Victor did for her. Never terribly good at names, Uma makes out a check for the correct amount payable "to the order of Victor Verdone" and mails it to Victor at his correct address. Is Victor the holder of this check? When he goes to negotiate it to another, or to sign it for deposit in his bank account, how may or must he sign his name in order for it to be all nice and legal? See §3-204(d).

Walter writes a check "to the order of Xavier or Yolanda Zendel."

Who will have to sign this check to make for a valid indorsement? See §3-110(d).

What if the check had been made out "to the order of Xavier and Yolanda Zendel"?

What if the check had been made out "to the order of Xavier Zendel/Yolanda Zendel"?

Explanations

No. Ms. Boss is here the drawer of the check and it is pretty clear that she has not "delivered" it to anyone for any purpose whatsoever. Under §3-105(a), the instrument has not been issued.

Yes, the check has been issued. No, Toady is not a holder of the check. It is an order instrument payable to Lacky as the specified person, so although

Toady is in possession of it he cannot be a holder. Of course, as of this moment Lacky is not the holder of the instrument either, because he is not in possession of it. As long as Toady retains the check, there is no holder of it. Still, this does not preclude our determining that the check has been issued by Boss. Subsection 3-105(a) defines *issuance* as including delivery (on which see §1-201(14) or §1R-201(b)(15)) "to a holder or nonholder" as long as the delivery is carried out "for the purpose of giving rights on the instrument to any person." As of Boss's delivery to Toady, it's fair to say that Boss intended Lacky to have rights in the instrument—in particular the right to have it handed over to him by his friend Toady.

> Perhaps a more typical example of an instrument being initially issued by deliverance into the hands of a nonholder is suggested by Comment 1 to §3-105. A remitter purchases a cashier's or teller's check payable to someone else from an issuing bank. The remitter would not be a holder any more than Toady is a holder of Lacky's bonus check, but we would still say the check has been issued when it has been sold and delivered to the remitter.

No, the check was never issued because Boss never "delivered" it to anyone. Lacky, however, is by definition a holder of the check, as he has the check made out to his order in his possession. Where does that leave us? Well, notice in §3-105(b) the statement that "nonissuance is a defense." This means that if Lacky or anyone else to whom he has negotiated the check tried to present it for payment or were to bring an action against Boss when the presentment for payment did not succeed, Boss would have a defense based on the fact that the instrument was never issued in the first place. Would this defense on Boss's part succeed? The answer—as we will see when we get into Part II of this volume and the important principles surrounding the central figure of what is termed the holder in due course—is that the defense will sometimes be good against the claimant and sometimes not. Don't worry about this for the time being; just be sure you see why, in the situation as I have presented it here, we are bound to the conclusions that the instrument was never issued and yet Lacky is truly a holder of it.

Yes. Baker is the holder of the check because he is in possession of an order instrument that is, as of the moment, payable to the order of him as the "identified [on the check itself] person."

No. Charlene is not the holder. She is in possession of the instrument, but it is still an order instrument running to the order of Baker. And she's not Baker.

The holder's signature on the instrument is no mere technicality, but absolutely essential for a proper negotiation of an order instrument; see *Town of Freeport v. Ring*, 1999 Me. 48, 727 A.2d 901, 38 U.C.C.2d 1225 (1999). As a matter of fact, although Charlene is not now a holder of the instrument, she will have the rights of a holder under what is referred to as the *shelter principle* of §3-203(b): "Transfer of an instrument, whether or not a negotiation, vests in the transferee [here Charlene] all and any right of the transferor [here Baker] to enforce the instrument.…" Therefore, because Baker was a holder and had the rights of a holder, Charlene here has acquired the *rights* of a holder, those rights which Baker her transferor had, even though the transfer to her was not a negotiation.

> As a practical matter, it would be wise for Charlene to become the check's actual holder and not have to worry about relying on the shelter principle if she is planning to cash the check any time in the future. Under §3-203(c), because the check was transferred for value (remember those rare and presumably valuable old law books?), "the transferee has a specifically enforceable right to the unqualified indorsement of the transferor, but negotiation of the instrument does not occur until the indorsement is made." So Charlene is going to have to find a way of actually putting into practice this "specifically enforceable right" against Baker and getting his unqualified indorsement on the check. Then she can rest comfortably as a full-fledged holder of the instrument.

As the check sits in Ervin's wallet, after his having specially indorsed it over to Felice, Ervin is no longer the holder of the check. He is in possession of it, but as it stands it is payable to the order of Felice, not him. Note, by the way, that the special indorsement under §3-205(a) required only that Ervin, as the then holder, sign below his identification of "a person [in this case Felice] to whom it [the act of specially indorsing] makes the instrument payable." Thus, it was enough that he wrote "Pay to Felice" above his signature. It was not necessary for him to use a special word of negotiability, as, for instance, by writing "Pay to the order of Felice" over his signature. Once the writing is created as a negotiable instrument by having met the criterion (among others) that it bear the crucial words of negotiability at the time of its origination, there is no need for the words to be used again in any subsequent negotiation, as long as the negotiation otherwise meets the requirements of §§3-201, 3-204, and 3-205.

But what about Felice? Is she the holder of the check now payable to her order as of this moment? Of course not. She is not in possession of it, and that is enough to defeat any argument that she is the holder.

Yes. Once Felice comes into possession of the check—which we are assuming has been specially indorsed by the previous holder Ervin in the proper way—she becomes the holder of it.

Any such attempt by Ervin to restrict what Felice is able to do with the check, and particularly to prevent her from freely negotiating it to another or presenting it for immediate payment, by this type of restrictive endorsement is ineffective. That's the clear message of the first two subsections of §3-206 and of Comment 2 to this section. The type of *restrictive indorsement* with which you are probably more familiar, where the holder writes "For Deposit Only" on the check and identifies a particular account of his or hers into which the funds are to be credited, is dealt with in subsection (c) and Comment 3. We don't go into it here, because it requires some familiarity with the check collection system, which is a subject yet to come. Suffice it to say, however, that this type of restrictive indorsement does have the effect you would hope. The check can now not be effectively indorsed to any nonbank party, and the bank to which the check is first delivered in an attempt to get it paid must, in the words of the Comment, "act consistently with the indorsement."

Yes. The check is a bearer instrument and Hannah is in possession of it. That's enough to make her a holder.

Yes and yes. Because this is still bearer paper, the transfer from Hannah to Thad was a negotiation and Thad is now the holder of the check. Refer back to §3-201(a), which says that negotiation is "a transfer of possession, *whether voluntary or involuntary*, by a person other than the issuer to a person who thereby becomes a holder." Thad, however he came by the instrument, is in possession of it and, because it is in bearer form, is the holder of it. If you have any questions or qualms about this result, see the concluding part of Comment 1 to §3-201.

Yes, Isaac is a holder, and this would be true whether Thad just handed over the check to him (keeping it as bearer paper) or specially indorsed it with the words "Pay to Isaac" over Thad's signature (converting it to a piece of order paper payable to Isaac). In either case, as long as Isaac remains in possession, he remains the holder.

The principal lesson of this example is an important one: Even if the person in possession of an instrument happens to be so totally by accident (as with Hannah) or has stolen it (like the ignominious Thad)—or if the instrument has passed through the hands of a finder or thief somewhere up the line before it ends up in the hands of someone who gives true value for it (Isaac)—the possessor of the instrument can qualify as a holder for Article 3 purposes, *if* the paper was in bearer form when it was lost or stolen. (We will compare this result to what happens when a forgery is involved; see the next example.) Thad was never what we would want to call the rightful owner of the instrument. Nor was Hannah, for that matter, unless you want to call on some primitive notion of "finders-keepers." The check was rightfully the property of Greg from the start. But Greg has learned a simple truth about carrying around bearer paper: If you lose it or if it is stolen from you, you stand a good chance of never seeing it again. Furthermore, it may end up in the hands of a total innocent, such as Isaac, who will be able to cash the check and keep the money. Carrying around bearer paper is like carrying around cash. Don't carry more than you can afford to lose.

No. Isaac does not qualify as a holder of the check. He could become a holder only if the check were negotiated to him by the previous holder. When Thelma steals the check from Katherine, she does not become a holder, because she has stolen an instrument payable to Katherine. Thelma is in possession of the check, but the check is payable to "an identified person" and that person is someone other than her. Isaac, we will assume, is innocent and maybe nonnegligent, as he has no sure way of checking if the "Katherine" who indorsed on the back is who she purports to be (given that the kind of people inclined to steal checks are also not necessarily averse to getting their hands on some fake ID when the need arises). Notwithstanding his innocence, Isaac stands in possession of the check but is not its holder.

Contrast this result with what we saw in the previous example: When a thief makes off with an order instrument, he or she does not become its holder. If the thief tries to pass it on to someone else, he or she is necessarily going to have to forge the true owner's signature, and the person who takes thereby does not become a holder. Once a negotiable instrument bears a forged indorsement of someone to whose order the instrument had been specifically made payable (either because it was initially issued as an order instrument or had later been specially indorsed), no one who subsequently gains possession of the instrument can ever qualify as a holder. See the discussion in *Romano's Carryout*, *Inc. v. P.F. Chang's China Bistro, Inc.*, 196 Ohio App. 3d 648, 964 N.E.2d 1102, 75 U.C.C.2d 610 (Ohio App. 2011).

Maria, by placing her signature and nothing else on the back of the check, has converted it into a check payable to bearer. When it is either lost or stolen, the finder or the thief comes into possession of bearer paper and hence becomes its holder. What words of advice would you have for Maria?

By specially indorsing the check over to Natalie as she has, Maria has converted it into an order instrument payable to the order of Natalie and Natalie only. Maria, by so doing, is no longer herself a holder, even though she is in possession, but at least when the check goes missing she can be sure that the thief or finder could not be a holder either. (That is, of course, unless the thief or finder just happens to be the Natalie in question.)

Patricia has indorsed in blank before handing the check over to Quincy, so Quincy becomes the holder of a bearer item. Quincy, who may have been talking to our friend Greg of Example 4, does not like the idea of carrying around a bearer item that could be lost or stolen. His actions, under the rule of §3-205(c), convert Patricia's blank indorsement into a special indorsement identifying him, Quincy, as the person to whom the instrument is now payable. Quincy is now in possession of an order instrument running to his order. He is still its holder, but now it is in order form and he can rest more comfortably knowing that should it ever slip out of his possession, the person who "finds" it would have to forge Quincy's signature to do anything with it, and neither that person nor anyone who took from that person could become a holder of this particular check.

Yes. This is just a reminder that notes can be—and in fact must be—indorsed and negotiated according to the same rules we have been applying in the earlier examples to checks. By State Bank's special indorsement of the note to Tremont and its delivery to that firm, Tremont becomes the holder of the note.

If the indorsement was written up and signed on a completely separate piece of paper that was not attached to the note in any way, it would not be effective. Note in the first sentence of §3-204(a) the requirement that an indorsement be a signature made "on an instrument."

If this separate document containing the authorized signature of State Bank had been glued to the note itself, then it would be effective as an indorsement and the transfer to Tremont would be a proper negotiation. Note the last sentence in §3-204(a): "For the purpose of determining whether a signature is made on an instrument, a paper affixed to the instrument is a part of the instrument." A piece of paper so affixed to a negotiable instrument as to become "a part of" it, and hence worthy of bearing indorsements, is referred to historically and to the present day as an *allonge* (apparently from the French for "extension" or "to elongate"). See the last short paragraph of Comment 1 to §3-204. Whether a purported indorsement is on a separate piece of paper or on what qualifies as an effective allonge may seem a meaningless distinction to you, but it has since the beginning of the modern law of negotiable instruments been taken perfectly seriously by the courts. This is no less true today as both commercial and consumer notes—for example, mortgage notes—are passed on from one party to the next and then the next, often in large bundles. See *Ruggia v. Washington Mutual,* 719 F.Supp.2d 642, 72 U.C.C.2d 471 (E.D.Va. 2010), *aff'd.* 442 Fed.Appx. 816 (4th Cir. 2011), and *US Bank National Association v. Gregory*, 2009 Conn. Super. LEXIS 927, 68 U.C.C.2d 883.

Victor is the holder of the instrument. Recall the rule of §3-110(a) that the person to whom an instrument, in this case the check, is initially payable is determined by the intent of the issuer. The second sentence of that section explicitly states, "The instrument is payable to the person intended by the signer even if that person is identified in the instrument by a name or other identification that is not that of the intended person." There is no question here that Uma intended Victor to be the payee of the check, so it is initially created as a check payable to his order. Being in possession of it, Victor is the holder of the check. As to how Victor should sign the back of the check properly to indorse, see §3-204(d). His indorsement may be made "in the name stated in the instrument or in the holder's name or both, but signature in both names may be required by a person paying or taking the instrument for value or collection." So he can sign as Victor Verdun or Victor Verdone or both. In some instances, he may be asked and will be required to sign as both, which he should have no qualms about doing. This situation is covered in Comment 3 to §3-204.

Under §3-110(d), because the check is payable to the two Zendels in the alternative, it is payable to either of them individually and may be negotiated by either without the signature of the other.

When the check is written in this way, it is payable to them "not alternatively" and hence is payable to both of them. An effective negotiation would require the signatures of both.

Checks or other negotiable instruments that name the payees in this fashion or something similar had, prior to the effectiveness of the 1990 Revisions to Article 3, caused some problem for the courts. Should this check be treated like that in subpart (a) or subpart (b) of this Explanation? The court in *Danco, Inc. v. Commerce Bank/Shore, N.A.*, 290 N.J. Super. 211, 675 A.2d 663, 29 U.C.C.2d 513 (1996), for example, concluded that what is called a *virgule* ("/") was equivalent to the word "or" when placed between two names and unambiguously indicated that signature in the alternative was called for. The court did go on to suggest that it would have reached the same result even if the use of the virgule had been "deemed to have resulted in ambiguity." Note that new §3-110(d) now contains an express rule as to the result when the multiple payees of an instrument are named in such a way that it is "ambiguous as to whether it is payable to the persons alternatively." The result is that the ambiguity is resolved in favor of the named persons alternatively. So either Xavier or Yolanda may negotiate this check by his or her signature alone. See Comment 4.

What if, instead, the check had been made payable to "Xavier Zendel-Yolanda Zendel," with their names being separated by a hyphen? At least one case held that this would require the signature of only one of the Zendels, not both—but it took a trip to the supreme court of the state to get to this result. In *J.R. Simplot, Inc. v. Knight*, 139 Wash. 2d 534, 988 P.2d 955, 40 U.C.C.2d 57 (1999), the trial court had concluded that a hyphen between two payees' names created an ambiguous situation, and that therefore the check could be cashed with the signature of only one. The court of appeals reversed, stating that,

> [a] hyphen is an indicator that words are to be read as a compound or together. Unlike the virgule which separates, a hyphen joins. We hold that a hyphen between the names of two payees on a check unambiguously means "and" so that the check is payable to all of them and may be negotiated only by all of them.

The Supreme Court of Washington granted a petition for review and reversed the court of appeals, reinstating the trial court's determination. Following a lengthy section of its opinion entitled "Interpreting the Hyphen," the Supreme Court of Washington came to the conclusion that "the use of a hyphen to separate multiple payees on a negotiable instrument is patently ambiguous"; this being so, the check was, under the rule of §3-110(d), payable in the alternative.

In a number of recent cases, courts have had to decide who could effectively indorse an instrument on which a set of dual or multiple payees were listed with *no* grammatical connectors whatsoever separating their names, the situation of so-called stacked payees. The payees may be stacked either vertically, as in:

Pay to the order of:
Xavier Zendel
Yolanda Zendel

Or horizontally:

Pay to the order of Xavier Zendel Yolanda Zendel.

The cases have pretty uniformly concluded that such an instrument is ambiguous under §3-110(d) and as a result could effectively be indorsed by any one of the named payees individually. See, for example, *In re Ames Dept. Stores, Inc.*, 322 Bankr. 238, 56 U.C.C.2d 417 (Bankr. S.D.N.Y. 2005) or *Socar, Inc. v. Regions Bank (Inc.) (Alabama)*, 2006 U.S. Dist. LEXIS 44989, 59 U.C.C.2d 1218 (N.D. Ga. 2006).

In the world of negotiable instruments, as you are no doubt coming to appreciate, little things (or the absence thereof) mean a lot.

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* This is as good a place as any to point out that, under §1-201(30) or §1R-201(b)(27), as used in the U.C.C. the word *person* "includes an individual or an organization." You may have questions at this point about how an organization can give its signature, the act that we have already seen is crucial to the creation of a negotiable instrument and which we will explore in this chapter as ofttimes essential for a valid negotiation. We will deal with such problems in Chapter 4.

CHAPTER 3

Liability on the Negotiable Instrument

INTRODUCTION

At the core of any negotiable instrument lies a promise or order to pay a sum of money. In a great majority of cases, the promise made by the maker of a note is kept, or the order to a draft's drawee is followed, as a matter of course. The person entitled to payment on the instrument gets that payment and is thereby satisfied, just as we would hope and expect to be true. The note or draft has served its purpose, and that's the end of that.

There are instances, however, when not everything goes so smoothly. For one reason or another, rightly or wrongly, the maker of the note does not keep the promise he or she has signed, or the drawee of the draft does not accept and pay as he or she has been commanded. In such cases someone is left holding the instrument, literally, and left holding the bag, figuratively, when the money expected is not forthcoming. What is this person to do? It will not surprise you to discover that Article 3 sets out, in some detail, the ways in which the party with the right to payment under the instrument, but who has been frustrated in getting that payment as due, may enforce his or her rights to get the amount owed. Enforcement may in some circumstances end up calling for suit by the aggrieved party. Other times a satisfactory result can be achieved just by calling to the attention of the relevant obligor his or her responsibility as set out by the Uniform Commercial Code

(U.C.C.). In this chapter we are concerned not with the procedural niceties of any potential suit but with the underlying rules of liability. To whom does the obligation represented by the negotiable instrument run, and what party or parties must meet that obligation? As we will see, the present version of Article 3 is written in terms of "the obligation" on the instrument of any person who has become, in one role or another, a party to the instrument. Traditional usage invokes the same notion when we speak of a party's "contract liability" on the instrument itself.*

THE PERSON ENTITLED TO ENFORCE

The first question to address is to whom is this obligation or contractual liability—liability on the instrument—owed? For that we look at §3-301 and its delineation of just who is a *person entitled to enforce* an instrument. For most situations it is enough to look at part (i) of the definition and use as a working rule the idea that the person entitled to enforce at any given moment is the holder of the instrument at that moment. The slight expansion of this term in subparts (ii) and (iii) to cover some possible, if uncommon, situations need not detain us here. One thing seems clear: At the very minimum a person seeking to enforce an instrument must have actual physical possession of it and be able to produce it in court. See *In re Sheskey*, 263 Bankr. 264, 46 U.C.C.2d 475 (N.D. Iowa 2001).†

It is therefore very much worth pausing to reflect on the dilemma of a person seeking to enforce who would in all rights be the holder of the instrument but for the fact that the instrument has been lost, destroyed, or stolen. Can a person who has been deprived of physical possession of an instrument by such misfortune simply assert the facts of the loss as he or she knows them to be and then proceed to enforce the instrument as if the piece of paper itself were still on hand? Far from it. Read §3-309(a). The unfortunate soul who has lost an instrument, seen it destroyed, or from whom it has been stolen must satisfy a set of fairly strict criteria before he or she can go forward with enforcement of the instrument. Beyond that, as you read in §3-309(b), he or she will have to *prove* "the terms of the instrument and [his or her] right to enforce" to a court before being allowed to proceed. A court entering a judgment under this section in favor of a party seeking to enforce an instrument, who does not have physical possession of it but can meet the requirements of §3-309(a), may not enter judgment allowing the suit to proceed unless the court "finds that the person required to pay the instrument is adequately protected against loss that may occur by reason of a claim by another person to enforce the instrument."

Return now to §3-301 and read its last sentence:

> A person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument.

In a variety of situations we will encounter in later chapters, we will have to remind ourselves of this distinction and come to terms with its consequences. The person entitled to enforce under the definition of §3-301 is most typically a holder, and whether or not someone qualifies as a holder is, as we saw in Chapter 2, a matter requiring careful evaluation of his or her position under the definition of *holder* in §1-201(20) or §1R-201(b)(21) and the rules of negotiation set forth in Article 3. In a given situation, a person may be a holder even if he or she is not the true owner of the instrument or in rightful possession; for example, if he or she is a thief of bearer paper or has taken from such a thief. At the same time, a person who should rightfully be considered the owner of the instrument but is not the holder of it, because he or she is not in possession or an indorsement critical to a negotiation is missing, will not be a person entitled to enforce.

ENFORCEMENT AGAINST WHOM?

Once we have established that a given person qualifies as a person entitled to enforce a particular instrument, *against whom* may he or she enforce it? What requirements must he or she satisfy to set out a valid prima facie case for enforcement against the party in question?* The first point to be made in addressing this issue is the prime directive laid out in §3-401(a):

> A person is not liable on an instrument unless (i) the person signed the instrument, or (ii) the person is represented by an agent who signed the instrument and the signature is binding on the represented person under §3-402.

We will deal with the problems pertaining to signature through a representative agent in Chapter 4. For the moment, the all-important point is that no person (natural or corporate) can be held to obligation on an instrument unless that person's signature appears on the instrument itself. The signature can be made by the person himself or herself, or through an authorized agent, but it must be physically present on the piece of paper. As Comment 1 to §3-401 states, "Obligation on an instrument depends on a signature that is binding on the obligor." Obligation of the type we are concerned with here is in the nature of contractual obligation of the most classic sort, and a party cannot and will not be bound to such contractual obligation unless and until that party has exhibited his or her assent to be bound. In the law of negotiable instruments, such assent is manifested in one and only one way: by the party's placing of his or her signature on the instrument itself. On the nature of the signature required for these purposes, see §3-401(b) and Comment 2.

Once it is established that a party may be obligated on an instrument, because his, her, or its signature appears thereon, the key to all that follows is to recognize that the U.C.C. authority for any such obligation (and the place we look to determine the extent of, any exceptions to, or preconditions on such obligation) depends upon the role in which that party affixed its signature to the instrument in question. Any signature appearing on an instrument must of necessity be the signature of either a maker of a note, a drawer or an acceptor of a draft, or an indorser of either type of instrument. There are simply no other alternatives. Furthermore, the obligation of the signatory depends upon the capacity in which the signature was made.

The one character in this list whom we haven't met before is the *acceptor* of a draft. Look at §3-409(a):

> "Acceptance" means the drawee's signed agreement to pay a draft as presented. It must be written on the draft and may consist of the drawee's signature alone. Acceptance may be made at any time and becomes effective when notification pursuant to instructions is given or the accepted draft is delivered for the purpose of giving rights on the acceptance to any person.

We have already seen that the creation and issuance of a draft does not require the cooperation or even the knowledge of the drawee of that draft. As we will see in this chapter, the drawee has no liability on the instrument simply because he or she is named thereon as drawee. If, however, the draft is presented to the drawee who then accepts the draft, the drawee will by that act become the acceptor of the draft and will have committed himself, herself, or itself to liability on the draft. As to what constitutes *presentment*, look at subsection (a) of §3-501.

You should now take an introductory look at the following sections, which set out the rules in each of the possible situations:

ligation of Issuer [Maker] of a Note or [Drawer of a] Cashier’s Check
ligation of Acceptor [of a Draft]
ligation of Drawer [of a Draft]
ligation of Indorser

In each of the following examples, the first order of business will be to determine the capacity in which the party whose obligation or lack thereof is being questioned signed the instrument. That should lead you to the correct U.C.C. section of those set forth in the preceding list and to the explanation you are seeking.

Examples

Andrea borrows $5,000 from Bart in 2011. In return for the loan she gives Bart a note promising to pay “to the order of Bart” on June 1, 2014, the amount of $5,600. When June of 2014 comes around, Bart still has the note in his possession. He has not, however, been paid any money by Andrea.

Does Article 3 create a legal obligation to Bart on Andrea’s part? For how much?

Suppose instead that sometime in 2013 Bart negotiated the note over to Carol in exchange for, say, $5,300 in cash. It is now June 2014 and Carol remains in possession of the note. To whom, if anyone, does Andrea owe an obligation on the note, given these facts?

Professor Brook owes Sarah Student $1,000 for work she did in helping him to prepare the manuscript of a book he has written. Brook tells Sarah that he does not have the cash at the moment to pay her, but that he has arranged for her to get the money the next month from one Arnold Moneybucks, a prominent (and wealthy) local businessperson. On January 12, Brook prepares and signs a draft ordering Moneybucks to “pay to the order of Sarah student $1,000 on February 15, 2013.” He hands this draft over to Sarah.

Would it be proper to say that as of January 12 Moneybucks is the acceptor of the instrument?

On January 13, Sarah heads over to the offices of Arnold Moneybucks in the impressive Moneybucks Tower building. With persistence, she is able to make her way into the office suite of Mr. Moneybucks himself. She tells the secretary guarding the door, "I come bearing an order from Professor Brook." The secretary understandably looks puzzled, but upon speaking with Moneybucks on the intercom, is told to usher Sarah directly into the great man's office. Sarah hands the writing over to Moneybucks. He examines it and then says, "If Brook wants me to pay you $1,000 on February 15, that is certainly what I'll do. We go back a long way and I owe him a lot. Any order from him like this is one I'm more than willing to follow." Moneybucks signs his name to the writing and hands it back to Sarah, telling her to come back on February 15 for her money. As of this point, would it be correct to characterize Moneybucks as the acceptor of the instrument? What would your answer be if Moneybucks showed every willingness to follow the order and committed himself orally to do so, but never actually signed the paper?

Suppose instead that, even though Sarah is able to make her way into Moneybucks's inner sanctum and present him with the writing, his reaction is quite different. He bellows, "Who the heck is this James Brook, and why does he think he can order me to do anything, much less pay out some of my hard-earned money? This is all very amusing, but take your silly piece of paper and get out of here!" He hands the writing back to Sarah, who quickly leaves the office and the Moneybucks Tower. How would you characterize the situation as of this point?

Professor Brook owes one of his research assistants, Stewart Student, the sum of $1,000. Stewart agrees to take payment by a personal check for this amount, which Brook draws payable "to the order of Stewart Student" on Brook's checking account at the First National Bank in Brook's hometown. Stewart decides that the quickest way to get his money is to go directly to the branch of First National Bank where Brook has his account. He hands the check to a teller and demands that he be given $1,000. The teller looks the check over, makes some inquiries of the bank's computerized accounting system, and then hands the check back to Stewart, telling him, "Sorry, I can't cash this for you."

Can Stewart make the argument that the bank is under a legal obligation to him for its refusal to take the check and exchange it for cash? See §3-408.

Stewart still has the check but not the cash. To whom do you suggest he look for legal satisfaction, citing which section of Article 3?

Seymour Sellers agrees to sell a quantity of high-quality widgets to Bertha Byers, who uses such widgets in her manufacturing operations, for the price of $12,000. On March 1 Sellers delivers the widgets to Byers. He does not ask for cash payment immediately, but does ask Byers to sign a draft that Sellers has drawn up. The operative language of the draft states that Sellers orders Byers to pay "to the order of Seymour Sellers" the amount of $12,000 "sixty days from sight" of the draft. In exchange for getting her hands on the much-needed widgets, Byers signs the draft.

By signing as she does, has Byers taken on any obligation on the instrument? To whom does the obligation run? What is the extent of the obligation?

Assume that soon after getting Byers's signature on this draft, Sellers sells the draft to the firm of Friendly Factors. He does so by negotiating the draft over to Friendly Factors in exchange for $11,300 cash in hand. To whom does Byers's obligation now run? If by the end of the 60-day period Byers has not paid the $12,000 to Friendly Factors, does that firm have a cause of action against Byers?

Let us return to the situation presented in Example 1b. In 2011 Andrea delivers to Bart a note promising to pay "to the order of Bart" on June 1, 2014, the amount of $5,600. In 2013 Bart negotiates this note over to Carol in exchange for $5,300. It is now June 2014. Carol remains in possession of the note and has not received any payment on it.

Would Carol be within her rights immediately to sue Bart, as an indorser of the instrument for the amount due?

Suppose that Carol does first make a presentment for payment to Andrea for the amount due, but that Andrea is unable or unwilling to meet her obligation as set forth in the note. She refuses to pay. Carol immediately notifies Bart of what has happened. Would Carol now be within her rights to hold Bart responsible for paying the amount due on the note?

Suppose that Carol had not immediately informed Bart of Andrea's failure to pay on the instrument when called upon to do so, but had instead waited something like two months to let Bart know what had happened. Would your answer to the previous question be any different?

If Bart is legally obligated to Carol for the amount due on the note and is made to pay up, is there anyone against whom Bart may then proceed to recover what he has been forced to pay Carol?

Richard writes a check payable to “Cash” and delivers it to Stella. Stella deposits this check into her own checking account with the Depot National Bank. When doing so, the teller insists that Stella sign the back of the check with her own name. Under her banking agreement with Depot, and because she is such a good customer, the bank allows Stella immediately to withdraw the amount of money represented by the check. The check itself is then forwarded to Richard’s bank for collection, but is returned to the Depot Bank unpaid, as Richard does not have enough money in his own checking account to cover the check. Depot Bank notifies Stella immediately that the check has been returned.

Is Stella obligated to Depot for the amount of the check under her contract of indorsement?

Would your answer be any different if the bank had waited three days to inform Stella that this check had been returned dishonored by Richard’s bank?

In return for some work done for him, Damon draws a check payable to Fred First and delivers it to First. First negotiates the check over to Suzanne Second in exchange for cash. Second then takes the check to the Third Avenue Liquor Store where she in turn cashes it, negotiating it over to the store. The store deposits the check in its account with Depot National Bank. When the check is sent to Damon’s bank for collection, it is returned to Depot unpaid because Damon does not have enough in his account with his bank to cover the check. Depot immediately notifies the liquor store of the bounced check and physically returns it to the store. Third Avenue Liquor is now in possession of a bounced check and is out the money that it gave to Second.

Against whom does the store have a right of action on the check to obtain relief?

Assume that Third Avenue is able to find Second and get her to pay the amount of the check. Third Avenue then surrenders the check back to Second. Against whom may *she* then proceed to make herself whole?

Would it make any difference to your analysis if any of the indorsers (First, Second, or the Third Avenue Liquor Store) had added the words “without recourse” to his, her, or its signature at the time of indorsement?

What if Damon, the drawer of the check, had added the words “without recourse” to his signature at the time he initially issued the check? See §3-414(e).

Garson draws a check payable to Harry and delivers it to him on February 1. On February 2, Harry indorses the check over to Isadora. Isadora puts the check on a pile of papers accumulating on her desk and does not get around to depositing it in her checking account until March 30. The check is returned unpaid to her bank, which immediately returns the check to Isadora along with a notice that the amount represented by the check has not been added to her account balance. Does Isadora have the right to go against Harry on his contract of indorsement? See §3-415(e).

Bertha Byers is in need of a particular type of widget connector, which is a critical component of her manufacturing operation. She finds a firm, Critical Connections, that is willing to deliver her the parts in question, but on a "cash only" basis. This means that the seller will hand over the merchandise only in exchange for cash or its equivalent. Byers draws a check, for the purchase price called for in the sales contract, payable to Critical Connections, on the checking account she has with Commerce Bank and Trust. She then takes the check to that bank, where she has it certified. She turns this check over to Critical Connections in exchange for the widget connectors. If for some reason this certified check is not paid when presented to Commerce Bank and Trust, does Critical Connections have the right to sue Byers as drawer of the dishonored instrument? See §3-414(c).

Explanations

Andrea's obligation to pay the amount due on the note, $5,600, is found in §3-412, which reads in relevant part, "The issuer of a note … is obliged to pay the instrument (i) according to its terms at the time it was issued." This a perfectly straightforward example of the primary obligation of the maker of a note—who has, after all, signed a promise to pay a certain amount of money on specified terms—to keep that promise. Notice, as the final sentence to this section makes absolutely clear, that this obligation "is owed to a person entitled to enforce the instrument." Bart is the current holder of the note, and hence under §3-301 a person entitled to enforce it.

As you see when you read through the full text of §3-412, the drafters included language to deal with those instances when a note somehow comes into the hands of a holder even if it was never technically issued, as that term is defined in §3-105, or when the note was initially issued as a so-called incomplete instrument under §3-115.

Neither of these more unusual circumstances is before us at present, so there is no need to look further at the precise way in which the section deals with them. It is worth remembering, however, that §3-412 gives clear guidance on the question of a maker's obligation on an unissued instrument or an instrument initially issued but as an incomplete instrument. For the moment, we are dealing with the most common case. The maker of a note has not kept the promise embodied in the note. Section 3-412 is clear and to the point: The maker has an obligation to keep the promise.

Again there is nothing tricky or ambiguous about the question. Andrea owes the obligation to pay the instrument according to its terms—that is, to pay $5,600 on June 1, 2014—only now the person to whom this obligation runs is not Bart (who is no longer the holder of the note and hence not a person entitled to enforce) but instead the current holder, Carol.

No. As of January 12, Moneybucks is the drawee named on the draft, but he has not accepted it.

Once Moneybucks, for whatever reason, signs his name to the instrument, he has accepted, and as of the moment he hands the draft back to Sarah he is the acceptor of this particular draft. What Sarah has done in her determined way is to present the draft to Moneybucks. In this case, because the money is not yet due, this would be referred to as *presentment for acceptance,* as opposed to a presentment for immediate payment. Moneybucks has responded to the presentment by signing his name to the draft, which is all that is required for an acceptance under the second sentence of §3-409(a). Having accepted as of January 13, Moneybucks is now obligated to carry out the order conveyed to him by Brook through the means of the draft. Sarah will have to return to Moneybucks Tower on or after February 15 with the draft and present it once again to Mr. Moneybucks himself, this time making a *presentment for payment* under the language of subpart (i) of §3-501(a). Moneybucks will then be obligated to pay the draft according to its terms under §3-413(a), and Sarah will finally have her money. Notice that Moneybucks will be legally responsible for paying this amount, but not because of Brook's writing out a draft with Moneybucks's name as drawee. The drawer by his or her will alone cannot obligate the drawee to do anything. In this scenario, Moneybucks becomes obliged to pay the stated amount on February 15 because *he* willingly took on this obligation by his voluntary act of accepting on January 13. It is the drawee's acceptance, if acceptance there be, that obligates him on the draft, not the creation of the draft itself or his being named therein as drawee.

If Moneybucks did indicate to Sarah his willingness to follow the order put before him but never signed the paper, he would not have accepted (see again the definition of *acceptance* in §3-409) and would not be committed in any way to do anything for Sarah, now or in the future.

The situation is very easy to characterize, if not one about which Sarah will necessarily feel very happy. Moneybucks has been presented with the draft but has refused to accept it. There is nothing Sarah can do, legally or practically, to make him accept. She sensibly leaves the building, knowing there's no more she can do there, with an unaccepted draft drawn by Brook still in her possession. The question for Sarah then becomes what she can do now, other than curse the day she agreed to work for Brook or to accept payment in this strange fashion. She still has the right to the money, but she's going to have to get it from someone other than Moneybucks. She will have to go against Brook himself. Note that he will be liable as the drawer on an unaccepted draft under §3-414(b). As we will see in Chapter 6, Sarah could also decide to ignore the draft entirely and sue Brook directly on the contract for services that she initially entered into with him.

First National has been presented, as drawee, with a demand draft and has made the decision not to accept (or, as we tend to say in the banking context, not honor) the check. The reality is that in the vast majority of cases the standard personal check (especially one written by Professor Brook) is honored as a matter of course. The money flows to the person entitled to enforce the instrument, either directly, as cash paid over the counter; or by an addition to his or her own checking account into which the check has been deposited once the check has cleared. There are instances, of course, even if their number be relatively small, when a check is dishonored. The drawee bank decides, for one reason or another, not to honor the check, but to return it dishonored.

The question here is whether Stewart has any rights *against First National* for its dishonor of the check, and the answer is clearly no. As §3-408 makes clear:

A check or other draft does not of itself operate as an assignment of funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until the drawee accepts it.

First National has, for whatever reason, refused to accept the check. Its signature appears nowhere on the check. First National cannot and does not have any obligation on the instrument itself as a drawee who refuses to accept. Stewart has no way of enforcing the instrument against First National. He has no rights against that bank whatsoever. The holder of a draft presents the draft to the drawee (in this case First National) in the hope and expectation that the drawee will accept and then pay the draft as it has been ordered to do, but the holder has no right to *insist* that the drawee accept. And if it hasn't accepted it can't be made to pay.

Two cases, which you might want to take a look at, serve as powerful reminders (at least they should have to the losing parties) of the importance of this result. *Outdoor Technologies, Inc. v. Allfirst Financial, Inc.*, 2001 Del. Super. LEXIS 166, 44 U.C.C.2d 801, reads in the words of one of the judges who had to deal with it "like a payment systems hypothetical written by a law school professor." Like at least some law school hypotheticals, however, the answer turns out to be perfectly straightforward: "Article 3," the court notes, "does not provide a basis for relief when the drawee bank has not accepted the negotiable instrument." In *Harrington v. MacNab*, 163 F. Supp. 2d 583, 45 U.C.C.2d 698 (D. Md. 2001), the one to learn this lesson was someone whom the court described as "an experienced real estate attorney" who found himself "bamboozled" by a couple of real estate buyers who convinced him to take a personal check that later bounced instead of the conventional certified check as part of a real estate closing. The plaintiff's argument that the drawee bank had in effect orally accepted the check in the course of a phone call made during the course of the closing was to no avail. "Acceptance requires," the court reminded him, "as it has since Lord Mansfield's day [which would have been the middle of the eighteenth century], the formality of the drawee's signature on the check."

You may naturally wonder why a bank, such as First National in our hypothetical, would decide to dishonor a check written on an account held at the bank. There are, as you may expect, plenty of perfectly good reasons why it might do so: Brook may no longer have an active account at the bank; he may not have enough in his account to cover the check; or by the time Stewart makes it to the bank, Brook may have issued a stop-payment order on the check. Note that even if the bank has made a mistake in dishonoring this particular check written by Brook on his account with First National—if it dishonored the check when it had no legitimate reason to do so—its failure (what we will end up discussing in

Chapter 14 as *wrongful dishonor* by the bank) is a wrong against Brook as the bank's customer, not against Stewart as a holder of the check. Brook has entered into a contract with the bank (much more about which in Part IV of this volume) under which the bank has agreed to honor his checks unless certain defined reasons not to do so are present. A bank's wrongful dishonor of a check written by its customer (that is, its failure to abide by the terms of the agreement it entered into when the customer opened the account) can create a cause of action *for the customer* against the bank. All of this creates no rights for the holder of the check, in our case Stewart, however. For whatever reason, rightly or wrongly, the bank has decided not to honor the check and there is nothing Stewart can do about it vis-à-vis the bank. He is going to have to look elsewhere for relief.

This is where §3-414(b) swings into play. The check has been dishonored. Therefore, under this subsection, "[t]he drawer [Brook] is obliged to pay the draft … according to its terms at the time it was issued." This obligation is owed to "a person entitled to enforce the draft," which definitely means Stewart in our case. So, given that the check has been duly presented to the drawee bank and has been dishonored, Stewart now is in the position of demanding that Brook as drawer pay on the instrument itself. He also has the option, as did Sarah in the final part of Example 2, of bringing suit against Brook, not on the instrument but on the underlying contract for services into which he and the good professor had at one time entered.

This example is meant to give you a look at a typical use of the noncheck draft in the commercial context, one that you are frankly much more likely to encounter in the real world than the situation we examined in Example 2. By signing the draft addressed to her as drawee by Sellers as drawer, Byers has become an acceptor of the draft. Byers is now obligated, not merely on the contract to pay for the widgets, but also on the draft that Sellers has made her sign, to pay Sellers $12,000 within 60 days of the date on which Byers accepted the draft by her signing of it.

After the sale and negotiation of the accepted draft over to Friendly Factors, that firm becomes the holder of the instrument and hence a person entitled to enforce it. So Byers's obligation under §3-413 runs from that point forward to Friendly Factors. If the amount due on the accepted draft is not paid as and when due, Friendly Factors can invoke this section in bringing a suit against Byers for her failure to meet her Article 3 obligation to act as an acceptor is supposed to act—that is, to follow the order which, by accepting, she has committed herself to obey.

The obligation of an indorser to pay on an instrument is governed by §3-415. Carol does not have the right immediately to sue for payment from Bart as an indorser. At least two things have to be checked out. For one, the indorser's obligation under subsection (a) is predicated on the instrument's having been dishonored. Has this note been dishonored merely because the date for payment has passed and Andrea has not made payment? Look at §3-502(a), comparing parts (2) and (3). The answer would depend on whether the note in question "requires presentment." If presentment is required, then Carol would first have to formally present the note to Andrea and demand payment. Only if payment is then not forthcoming would Carol be able to proceed against Bart as indorser. As Comment 2 to §3-502 points out, in most cases the note will be written so as to waive any requirement of formal presentment or demand for payment upon the maker. "If payment is not made when due, the holder usually makes a demand for payment, but in the normal case in which presentment is waived, demand is irrelevant and the holder can proceed against indorsers when payment is not received." Still Carol, who after all has the note in her possession, will want to inspect its language carefully to determine whether the terms of the particular note in question require presentment to establish a dishonor under §3-502(a)(2).

Even if no formal presentment to Andrea is required of Carol, however, this does not mean she may proceed directly against Bart as indorser without question. Bart's obligation under §3-415(a) is specifically made subject to a series of other subsections, of which (c) is of present concern:

> If notice of dishonor of an instrument is required by Section 3-503 and notice of dishonor complying with that section is not given to an indorser, the liability of the indorser under subsection (a) is discharged.

Needless to say, we now want to look at §3-503. Subsection (a) states that:

> The obligation of an indorser stated in Section 3-415(a)… may not be enforced unless (i) the indorser … is given notice of dishonor of the instrument complying with this section, or (ii) notice of dishonor is excused under Section 3-504(b).

You can look at §3-504(b) to find out about the unusual instances in which notice of dishonor is excused. If not excused, then it will be necessary for Carol to give notice to Bart of Andrea's dishonor. The manner of giving such notice is laid out in §3-503(b). As you can see, notice of dishonor will be deemed effective if given by any person and "by any commercially reasonable means." It need not even necessarily be in writing. As to the amount of time the holder of a dishonored instrument has to give an indorser of the instrument notice of the dishonor, so as not to jeopardize the case for holding the indorser liable on the instrument, see subsection (c), which we will apply in the next two parts of this example.

Carol has made a presentment for payment to the maker of the note, whether or not that presentment was technically called for by the provisions of the Code. The maker has dishonored. Carol's right to hold Bart liable as an indorser is, under §3-415(c), subject to her complying with her responsibility to give effective notice of dishonor to Bart under §3-503. We can assume that the manner of notice complies with the criteria of §3-503(b). Was the notice timely under §3-503(c)? The first lengthy sentence of this subsection applies only to instruments "taken for collection by a collecting bank," which is not the case here. The Andrea, Bart, and Carol situation is governed by the final, shorter sentence of (c): "With respect to any other instrument, notice of dishonor must be given within 30 days following the day on which the dishonor occurs." Given that we are told in this part of the example that Carol immediately notified Bart, Carol has apparently met all of the preconditions for holding Bart "obliged to pay the amount due on the instrument … according to the terms of the instrument at the time it was indorsed," under §3-415.

If Carol waits two months to give Bart notice of dishonor, then under the last sentence of §3-503(c) she has failed to give timely notice. Thus, unless the late notice of dishonor can for some reason be excused under §3-504(b), the notice is ineffective, and under §§3-415(c) and 3-503(a) Carol would not be able to enforce any obligation against Bart as an indorser of the note.

Bart may sue Andrea as the maker of the note, who still has not paid what she promised to. Look again at §3-412, the section in which we found the responsibility of the maker of a note to meet the obligation undertaken by the making of the note. "The obligation," the last sentence of this section reads, "is owed to a person entitled to enforce the instrument *or* to an indorser who paid the instrument under §3-415." This last phrase covers Bart's case if he is made to pay Carol on the contract of indorsement. It gives him the right to sue Andrea on the contract of the maker.

Yes. When Stella signed the back of the check, her signature was an indorsement. Look again at §3-204(a). You see that *indorsement* means any signature on an instrument other than that of a maker, drawer, or acceptor (none of which Stella is) that, alone or accompanied by other words, is made for the purpose, among others, of "(iii) incurring indorser's liability on the instrument." Because what Stella was depositing was a bearer instrument, her signature was not necessary for a valid negotiation of the check over to the bank, but the bank asked for her signature anyway, and now you can appreciate why. Here Depot National Bank insisted on this indorsement, not just because it likes to collect signatures of those with whom it deals, but because the indorsement allows the bank to enforce the contract of indorsement against Stella should events take an unfortunate turn and such enforcement become necessary to protect the bank's interests. Remember, had her signature not been placed on the check itself, Stella would never have incurred any contractual obligation under the instrument.

As an indorser, and again looking to §3-415(a), Stella is obligated to pay the amount of the instrument according to its terms at the time of her indorsement provided first of all that the instrument has been dishonored —which we know is true here because Richard's bank has been presented with the check and has refused to accept it—and that the bank has given Stella as an indorser proper notice of this dishonor, as called for in §§3-415(c) and 3-503. To see whether notice of dishonor by the bank to Stella was timely, we look to §3-503(c), but this time to the first sentence, as the situation involves an instrument (the check) taken (by Depot National Bank) for collection. Unless the time for notice of dishonor is extended by one of the excuses for delay set out in §3-504(c), notice of dishonor must be given by the bank "before midnight of the next banking day following the banking day on which the bank receives notice of dishonor of the instrument." We are told in this portion of the example that Depot immediately notified Stella of this check's dishonor, so the bank should be able to hold Stella to the contract of indorsement.

If Depot National Bank had instead waited three days to let Stella know of the check's dishonor, you can see that under §3-503(c) it would have failed to give timely notice to Stella, and any liability it might hope to impose on her as an indorser will be discharged for failure to give prompt and proper notice under §3-503.

Third Avenue Liquor would have the right under §3-414(b) to go against

Damon, as the drawer of a dishonored check; or against any of the two prior indorsers, Fred First or Suzanne Second, on their contracts of indorsement of that same dishonored instrument, via §3-415(a). Third Avenue would be a person entitled to enforce the instrument. Its only problem being that, in order to make sure that the obligation of either of the indorsers is not discharged, it must give proper notice of dishonor according to the rules of §3-503 to either or both of the prior indorsers whom it might contemplate later going against on the contract of indorsement. Looking again at §3-503(c), we can see that Third Avenue would be well advised to give notice of dishonor to First or Second (or preferably both) within 30 days following the day on which it receives notice from the Depot National Bank that the check has been returned dishonored.

If Third Avenue is able to enforce the contract of indorsement against Suzanne Second, that leaves her holding the bag. She could then try to enforce the drawer's contract against Damon, or she could choose instead to go against First, whose indorsement was prior to hers. Notice that in §3-415(a), last sentence, the obligation of the indorser is owed not only to "a person entitled to enforce the instrument," but also "to a subsequent indorser who paid the instrument under this section." So Second, as a subsequent indorser who has been made to pay the instrument, may sue on the contract of indorsement anyone who indorsed the instrument *prior to* her in the temporal chain of indorsements. So, just as Third was entitled to sue either of the prior indorsers, First or Second, on the contract of indorsement once it had been left holding the bag (provided, of course, it had given proper and timely notice of dishonor), Second—once the loss has been shifted to her—can herself sue not only the drawer but also any previous indorsers. If she brings a successful action against First, then First is left only with the possibility of a suit against Damon on Damon's obligation as the drawer of the dishonored draft. If all goes well, First should be able to make Damon pay up, which is only right when you think of it. The genesis of the check in the first place was the fact that First did some work for Damon and was to be paid for it. First initially got his money not by presenting the check directly to Damon's bank, but by negotiating it over for cash to Second. Second, having paid First cash for the check, was able to come out even by selling the check to Third Avenue. Third Avenue then deposited the check in its account with Depot National Bank. Had the check been good—had it not been dishonored by Damon's bank—then Third would have come out even, as the amount in its account at the Depot bank would have been increased by the amount of the check. Simultaneously, the amount in Damon's own checking account would have been decreased by the amount of the check. Thus, by what is admittedly a fairly circuitous route, Damon would have paid First for the work done. The amount of the check would have been deducted from Damon's store of wealth in his checking account and First would have had the money he agreed to take for the work done.

> The trouble comes in an example like this one when the check is not accepted for payment by the drawee bank but is instead dishonored. The game for the parties involved then becomes one of attempting to pass the check back, retracing the steps it took in reverse order to parties who had signed, and thereby taken on the role either of drawer or indorser, prior to themselves. The holder who tries to collect by presentment but is rebuffed through dishonor of the check is able to sue either the drawer or anyone who indorsed the instrument on its way to the current holder. If the holder is able to get paid by one of these parties—either because the earlier party voluntarily agrees to abide by the obligation it took on by signing the instrument or through a suit enforcing the obligation—then that party in turn can look up the chain of signatures to determine against whom to proceed. Eventually, if all goes as it should in an ideal world, the ultimate responsibility to pay the amount of the check comes to rest on the drawer, Damon, as indeed it should. (Of course, were this an ideal world, the check would not have been dishonored in the first place, and none of this analysis, talk of obligation, and threatened lawsuits would be necessary.)
>
> If at the end of it all the check does not clear *and* Damon cannot otherwise be made to pay the amount, the ultimate outcome is that Damon will have received something of value (here services from Fred First) and will not have paid a penny for them. Some innocent party will be left to absorb the loss.

If any of the indorsers had signed "without recourse," then they could not be liable under the contract of indorsement. You see this in §3-415(b). This provision allows the holder of an instrument to sign the instrument as necessary to make for an effective negotiation over to another party, but to avoid binding himself or herself to the contract of indorsement to the party to whom the instrument is negotiated or to anyone who later takes it.

> In our particular example, if all three of the indorsers (First, Second, and Third Avenue) had signed without recourse, then Depot Bank, once

the check was returned to it unaccepted, would have recourse only against Damon as drawer.

Under §3-414(e), although the drawers of certain other types of drafts may sign “without recourse” and thus avoid taking on the obligation of the drawer of a dishonored draft, this opportunity does not extend to the drawer of a check. “A disclaimer of the liability stated in subsection (b) is not effective if the draft is a check.” This makes sense. When a person takes a personal check in payment, it is expected that the check will turn into actual cash money in one way or the other. In the vast majority of cases, the check is honored by the bank on which it is drawn and that’s the end of the story. If the check is dishonored (if it bounces, as we say), it is only natural that the payee will look to the drawer to make good and pay up what is still owed. For someone to draw a check and at the same time, by adding a few words to his or her signature, disavow any responsibility for that check being any good or for paying up in some other fashion if it is not would undermine the whole check payment system. It is this system that makes people willing to take personal checks in payment with some confidence. As Comment 5 to §3-414 states, “There is no legitimate purpose served by issuing a check on which nobody is liable.”

No. Under §3-415(e):

> If an indorser of a check is liable under subsection (a) and the check is not presented for payment, or given to a depositary bank for collection, within 30 days after the indorsement was made, the liability of the indorser under subsection (a) is discharged.

In this case the indorsement was made on February 2. Isadora does not deposit the check into her bank for collection until March 30, more than 30 days later. Harry can no longer be held to his contract of indorsement.

No. Under §3-414(c), once a check is accepted by a bank—and recall that under §3-409(d) a *certified check* is one that has been accepted by the bank on which it is drawn, as is true here—the drawer is discharged from any potential liability under §3-414. Critical Connections, the seller here, has specifically refused to take a personal check in payment for the valuable widget connectors it is handing over. It has insisted upon and has received a bank check. As a party taking a bank check, it will have only the bank to look to for payment. Of course, this should not cause it any grief. The main feature of a bank check, be it a certified check, a cashier’s check, or a teller’s check, is that there should be absolutely no trouble turning it into cash. The bank has accepted this check already and hence it is bound by the unconditional contract of an acceptor from the very beginning. We will deal in later materials with the exceptionally rare situation in which a bank that has either certified a check or issued its own cashier's or teller's check argues that it has the right to refuse payment on such an item. The relevant point here is that such instances will be exceedingly uncommon; rarer still will be those when the bank is ultimately successful in avoiding its liability on such a bank check. The party who takes a bank check is relying, and not unreasonably, on the fact that the bank will as a matter of course be ready, willing, and able to pay on that check. For that reason Byers, as the drawer of the check that she has had accepted by the bank prior to handing it over to her supplier, is let off the hook by §3-414(c). She has already done her part in making sure that the seller will be paid.

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* As the Supreme Court of Texas has recently concluded, obligation on a negotiable instrument of the type we will be discussing in this chapter is in the nature of a "contract" obligation, although of course not under the common law of contracts. The obligation arises, as we will see, by virtue of a the statutory scheme of the state's Article 3. *1/2 Price Checks Cashed, v. United Automobile Insurance Co.*, 344 S.W.3d 378, 54 Tex. Sup. J. 1264 (Texas 2011).

† While not addressed in the examples of this chapter, a recent spate of cases involving the issue of whether a party is "entitled to enforce" a note deserves mention. These cases arise from the increasing occurrence of foreclosures of real estate mortgages, a phenomenon which we are all too aware of in the past few years. The law covering real estate mortgages and foreclosures is, of course, not part of Article 3, or any other part of the Code for that matter. Under the law of some states, however, and in specified circumstances, a lender attempting to foreclose has to demonstrate that it is entitled to enforce the *mortgage note* that is secured by the mortgage. At one time, this would not have been terribly difficult; the bank which loaned the money held the note and, unless it was terribly sloppy in its handling of important papers, it could produce the note when the need arose. Under current practices, however, it has become common for the note-mortgage package to be passed from one party to another and then another—often as only one of many such packages in connection with a securitization scheme—with what might be ungenerously characterized as wild abandon. When a particular mortgagor falls behind on his or her payments and a foreclosure is attempted, it has in many instances been difficult for the foreclosing party to actually produce the note or even to be sure with any certainty where the note, the crucial piece of paper, is. If you are interested in delving more deeply into this topic, you might want to have a look at the article by Allan M. White, *Losing the Paper—Mortgage Assignments, Note Transfers, and Consumer Protection*, 24 Loy. Consumer L. Rev. 468 (2012).

* Our concern in this chapter is how and when a prima facie case of liability on the instrument is established. As you may imagine, even when all the elements of a prima facie case are present, the defendant may under certain circumstances assert affirmative defenses that, if effective, will relieve it from obligation on the instrument. We deal with the types of defenses available to a party who is being charged to meet its obligation on the instrument—and when and whether such defenses will be valid under the particular circumstances of the case—in Chapters 8 and 9. For the moment, we are interested only in the basic criteria of the prima facie case for obligation on the instrument.

CHAPTER 4

Issues of Agency

SIGNATURE BY A REPRESENTATIVE

As we already have seen, contractual liability of a party to a negotiable instrument necessarily requires that the party in question has signed the instrument in one capacity or another. The signature is the key to obligation on an instrument. It's worth the effort to look at §3-401(a) again, now reading it in its entirety and giving special attention to the language of subpart (ii).

> A person is not liable on an instrument unless (i) the person signed the instrument, or (ii) the person is represented by an agent or representative who signed the instrument and the signature is binding on the represented person under Section 3-402.

As subsection 3-401(b) assures us, a document may be signed in a variety of ways (look to §1-201(39) or §1R-201(b)(37) for a definition of *signed*). As the concluding language of subsection (a) reminds us, however, the actual act of signing for a party, whether a manual signature is used or some other "device or machine," in the language of subsection (b), is employed, is not always done by the party himself, herself, or itself. People and organizations, in the course of going about their business, in many instances rely upon the actions of their employees or other agents to get things taken care of for them. A given individual burdened with running a complex business operation, for instance, may delegate to underlings the right to take specified actions—such as entering into a contract or signing crucial documents—on behalf of that individual. These actions will affect the delegating person's legal rights and responsibilities just as if he or she had taken that action or done that act himself or herself.

Once we get to something like a corporation or a trust, however, the use of a representative to sign an instrument—or to do any other act, for that matter—becomes more than a matter of convenience. Such a legal entity is able to bind itself to even the most complex of legal obligations, but among the perfectly mundane activities that it can't do for itself is the simple act of signing something. A signature can be made only through action taken by an individual, a real live human being. A corporation, General Motors for example, for all its power and prestige, cannot *itself* physically sign the simplest document. It must necessarily work through others, authorized representatives who are actual he's and she's, who sign on its behalf. Subsection 3-402(a) acknowledges this reality by providing that a *person*—which under the definition of §1-201(30) or §1R-201(b)(27) includes an individual or an organization—can become bound himself, herself, or itself through the signature of an agent or representative, signing on that person's behalf.

This chapter deals with two significant issues that can arise when a signature on an instrument is made by someone acting, or purporting to act, in a representative capacity. The first thing to notice is that the drafters of Article 3 have chosen to use the terms *represented person* and *representative* for the two main players in this story. You may be more familiar (indeed, you most definitely should be familiar by the time you've finished your legal studies) with the more conventional common law terms *principal* and *agent*. The terms you find in Article 3 may be meant to connote slightly different concepts, but if so the differences are very slight and certainly not something that we need worry about. Indeed, as you will see, the comments to the two sections with which we'll be concerned in this chapter, §§3-402 and 3-403, immediately slip into the language of principal and agent without any apology or explanation.

WHEN DOES THE REPRESENTATIVE BIND THE

REPRESENTED PARTY?

The first issue that presents itself when a signature is made on a negotiable instrument by some person who purports to be acting, as a legitimate representative or agent, for another, the represented person or principal, is whether the signature (in the words of §3-401(a)(ii)) "is binding on the represented person." It will come as no surprise to you that in many instances a person will claim to be acting for another but have no legal authority to do so. The reason may be a simple mistake on the purported agent's part or something much more sinister. For Article 3 purposes, the crucial language pertaining to this issue is found in §3-402(a):

> If a person acting, or purporting to act, as a representative signs an instrument by signing either the name of the represented person or the name of the signer, the represented person is bound by the signature to the same extent the represented person would be bound if the signature were on a simple contract.

As the second sentence to Comment 1 makes clear, the intention of this language is to defer to the law of agency, which will presumably be common law of the state governing the transaction, for determination of when the purported agent's signature binds the principal.

The law of agency is a whole area of study unto itself. A large part of any systematic review of agency law deals with just the kind of question we have here: When does the act of the purported agent bind the principal? This covers a lot of territory, and its importance is definitely not confined to the effect of signatures on negotiable instruments. It is not my intention here to review all of the intricacies of the general law of agency, nor even the subset of rules devoted to the all-important question of when the act of the agent serves legally to bind the principal. A few words on the subject, however, are not out of order.

We say that the act or acts of one person, the *agent*, are effective legally to bind another, the *principal*, in whatever way the principal would be bound if he or she personally took those acts if and only if the act or acts in question are authorized by the principal. *Authority*, as the word is used in agency law, comes in a variety of forms depending on the circumstances involved. The first and easiest to deal with is the case of what we refer to as *actual* *authority*, or sometimes, to be even more precise, *actual express authority*. This type of authority is present when the principal expresses—using whatever words and through whatever means are appropriate to the situation—to the agent directly that the agent has the legal power and right to do such-and-such a thing on the principal's behalf. Actual authority arises out of direct communication between the principal and the agent. The principal informs the agent that the agent has the authority to take some action on the principal's behalf and that the agent is thereby empowered and authorized to do so. For a recent case in which the Iowa Supreme Court discusses the notion of actual express authority and finds it to have been present, thus binding the principal to a note signed by its agent, see *Soults Farm, Inc. v. Schafer*, 797 N.W.2d 92, 74 U.C.C.2d 619 (Iowa 2011). Notice that the agent's express authority necessarily extends only to those acts and only so far as the principal has, by its communication to the agent, given the agent reasonably to believe. If the principal, for instance, tells an employee that he or she has the authority to sign checks on the principal's account for the purpose of buying supplies and only if the checks do not exceed $2,000, then the agent has no actual authority to sign checks for any other purpose nor in any greater amount.

A second type of authority recognized by the traditional law of agency is termed *implied authority*. Implied authority, like actual express authority, arises out of communication or an understanding between the principal and the agent, but here the agent's reasonable understanding of what he or she may do on the principal's behalf arises not out of any direct unequivocal statement by the principal to the agent. Implied authority can be vested in the agent when statements or other manifestations by the principal, even if not directed expressly to the precise act that the agent ends up taking, have led the agent reasonably to understand that such an act would be within the scope of the agent's duties and conform to his or her principal's desires as to what can be done to bind the principal legally. The principal who expressly authorized an employee to issue checks to pay for supplies would also, it seems fairly clear, have impliedly authorized the same employee to issue a stop-payment order on any such check when the situation so warranted and the employee could reasonably conclude that the principal would want this action to be taken.

The third source of authority which I'll mention in this terribly brief abstract of agency principles is the notion of *apparent authority*.* Apparent authority is grounded not on any dealings or communication between principal and agent, but rather on manifestations the principal has made to the third party who is dealing with the agent. If the third party is led by such manifestations to the reasonable belief that a given person is in fact empowered to act in such-and-such a way as an authorized agent for the principal, then that given person (the person whom the principal has led the third party to believe is acting as the principal's agent) has the apparent authority to take the action and consequently to bind the principal even if he or she was never actually or impliedly (by manifestations made to this agent) authorized by the principal to do so. A reasonable belief in the mind of the third party that the agent is in fact an agent of the principal authorized to take certain action—if that reasonable belief is created by the doings of the principal—creates apparent authority. A person with the apparent authority to take action on behalf of another is able to bind the other just as if he or she had the actual or implied authority to do so. The principal is bound by the act of this other, not because of any intention to authorize the agent to act, but because the third party has been led by the principal reasonably to believe that the agent has in fact been authorized to act on the principal's behalf in the way that he or she does.

So, for example, suppose that Ted, a seller of business supplies and equipment, pays a call on a store owned and operated by one Paula. As he is beginning his sales pitch, Paula cuts him short by telling him, "Talk to my assistant Adam. He takes care of all those decisions for me." Paula points Ted in the direction of Adam's office. Ted is eventually able to convince Adam to purchase a piece of equipment for use in Paula's enterprise. Adam signs a contract committing Paula to purchase the equipment in question for a purchase price of $3,418 and writes Ted a check out of Paula's business account for this amount. Assuming that it is reasonable for Ted to believe that Adam has the power to enter into such a deal and to write a check in this amount for the purpose of acquiring equipment to be used in the business, then both the acts of signing the contract of sale and writing the check on Paula's behalf would, under the rubric of apparent authority, be binding on Paula as principal. This would be true even if in fact Paula had expressly told Adam that he was not authorized to enter into any deals for equipment or supplies or to write checks covering such expenses when the amount being spent was over $2,000 without first checking the deal out with Paula and getting her specific approval for the contract in question. Ted's success in holding Paula bound, both to the contract of sale and to the obligation of a drawer on the check, all depends on his being able to establish that he was reasonable in believing, based on what he had been told by Paula and given all the other circumstances surrounding the transaction, that Adam had been authorized by Paula to commit her to such a purchase and to write such a check. If we imagine that Ted and Adam had gotten along so well that their conversation ended with an agreement that Ted would purchase Paula's whole business—lock, stock, and barrel—for a sum in the hundreds of thousands, Adam might eventually sign all kinds of documents purporting to commit Paula to the scheme, but it is doubtful, to say the least, that Adam's signature on even the most finely drawn papers would bind Paula in any way. Ted would be hard-pressed to prove that he was reasonable in believing that Paula had authorized Adam to conduct any transaction of this type or on such a scale on Paula's behalf.

As I'm sure you can imagine, in many situations the facts are such that an agent's power to bind the principal could be established under any or all of the notions of express authority, implied authority, and apparent authority. These three variants or types of authority—express, implied, and apparent—will in the simpler situations overlap to a great degree. In a trickier setting, the third party who hopes to hold the principal accountable based on the acts of another may have a tough time showing that even one of these concepts can rightfully be brought to bear. To narrow our focus considerably, and to return to the issue with which we are concerned in this chapter, the important point to remember in the negotiable instruments context is that the question of whether the signature of a representative (returning now to the language of Article 3) is effective to bind the represented person is, by virtue of §3-402(a), to be answered by reference to this general law of agency, not by resort to any distinct rules treating the signature of negotiable instruments differently from any other acts that an agent may purport to do on behalf of another. This treatment is confirmed by looking at the definition in §1-201(43) or §1R-201(b)(41) which, appearing as it does in the set of Article 1 definitions, applies wherever the defined term appears in the Code.

> "Unauthorized" signature means a signature made without actual, implied, or apparent authority. The term includes a forgery.

Some special rules pertaining to the consequences of application of an unauthorized signature to a negotiable instrument are covered by §3-403, to which you will have to refer (along with §3-402) in considering some of the examples of this chapter.*

WHEN MAY THE REPRESENTATIVE BE PERSONALLY BOUND BY HIS OR HER SIGNATURE?

The second distinct issue we have to address when a signature is made on a negotiable instrument by someone acting in a representative capacity is whether that person can himself or herself be held *personally* obligated on the instrument. The presence of one's signature on an instrument in whatever role—maker, drawer, acceptor, or indorser—is, after all, the key to obligation on the instrument under §3-401(a). The representative has himself or herself signed the instrument. Will the representative ever be obligated on the instrument through the act of signing? If so, when?

This question is, as you can imagine, of more than academic interest. The representative, if he or she intends to bind the represented party but to do no more, will want to be sure that his or her form of signature cannot later be argued by someone entitled to enforce the instrument to have given rise to personal liability on the representative's part. At the same time, in some circumstances the person who is taking the instrument or asking for and relying upon the signature of the representative is perfectly reasonable in wanting to ensure that *both* parties (the represented party and the representative himself or herself) can be held to the effect of the signature should something go wrong and suit (or at least arguments of legal liability) be necessary. Neither outcome—obligation of the represented party only or personal obligation of the representative as well—is necessarily right or wrong. It depends on what is called for in the situation; what obligation, if any, the representative is willing to take on; and what the party asking for the signature is willing to accept. In the ideal situation, the signer and the party relying on the signature should have no doubt about whether, if at all (and if so, when) the representative could be held liable on the instrument by virtue of his or her signature on it. To the extent there is doubt as to the ramifications of the representative's signature in this regard, §3-402(b) and (c) present rules under which such doubt is to be resolved. If you read the beginning of Comment 2 to this section, you'll see that the original version of Article 3 took an approach which the drafters of the 1990 revision found "unsatisfactory." Hence, the rules under the revised §3-402 differ in style and in some instances in result from what was previously to be found in the prerevision §3-403.* The rules of the revised §3-402(b) and (c) are meant to be easier to apply and to lead to more certain and consistent results. Whether this is so we will test in the following examples.

As you can see under paragraph (1) of §3-402(b):

> If the form of the signature shows unambiguously that the signature is made on behalf of the represented person who is identified in the instrument, the representative is not liable on the instrument.

Note the two criteria here that must be satisfied for the representative to avoid liability on the instrument. The form of the representative's signature must show *unambiguously* that the signature has been made on behalf of another, the represented person. Furthermore, that represented person must be *identified* in the instrument itself.

If either of these criteria fails to appear from a reading of the instrument, the representative may still avoid personal liability, but the situation becomes much more problematic. We have to consult paragraph (2) of §3-402(b). The rule then is that

> the representative *is* liable on the instrument to a holder in due course who took the instrument without notice that the representative was not intended to be liable on the instrument. With respect to any other person [than a holder in due course], the representative *is* liable on the instrument unless the representative proves that the original parties did not intend the representative to be liable on the instrument.

You no doubt noticed that in application of §3-402(b)(2) the question may turn on whether the person seeking to enforce personal liability on the part of the representative is that special breed of holder referred to in Article 3 as a "holder in due course." We will have much to say in later chapters about who does and who does not qualify for this impressive title and the special status of the holder in due course of any particular instrument. For me to attempt, at this juncture, even the crudest nutshell version of just who qualifies as a holder in due course and what exactly the consequences of this may be seems unwarranted and unwise. For the purposes of this chapter, I beg your indulgence and your trust. If I say that someone does not qualify as a holder in due course, take my word for it. The party may be a holder and a person entitled to enforce the instrument, but he or she is not a holder in due course. If I say that someone will in fact be able to establish that he or she holds that special status, take my word for that as well. Once we have dealt in the proper fashion with who or what is a holder in due course, you will able to review this chapter and §3-402(b)(2) to appreciate with even greater sophistication and respect the rules as we find them there.

Examples

Xavier and Yolanda Zendel are a happily married couple. When a large tax refund check, made out "to the order of Xavier Zendel and Yolanda Zendel," arrives at their house, Yolanda is out of town on an extended business trip. Xavier would like to deposit the check in their joint checking account as soon as possible. When they speak by telephone that night, Yolanda tells Xavier that, yes, he should indorse the check on her behalf and deposit it in that account. The next day Xavier takes the check to the bank. On the back of the check he signs his own name and under it signs "Xavier Zendel, as Agent for Yolanda Zendel."

Has the check been effectively indorsed?

Would the result be any different if under his own signature Xavier had signed "Yolanda Zendel" in his own script?

What if, instead, Xavier never tells Yolanda that the refund check has arrived. He takes it to a bank where he has an account in his name only. In depositing it he signs his own name and also Yolanda's. Has the check been properly indorsed under this set of facts?

Minisoft Corporation is a thriving and well-known enterprise with its main headquarters located in Washington state. Someone introducing herself as Willa Bates, the President of Minisoft, rushes into a branch of Empire State Bank located in New York City and is quickly ushered into an office of one of Empire's senior loan officers. Willa hands this officer a copy of her business card, which bears all the markings of a card of the type a representative of Minisoft would be expected to have and identifying her as

"Willa Bates, President." Willa tells the officer that she is in town on other matters but has just been presented with the possibility of acquiring some property in New York that she thinks would be particularly good for her corporation. The seller is in a rush, however, and is demanding a $20,000 deposit in the form of a bank check by the end of the day. Willa would like to arrange to borrow this money on behalf of Minisoft from Empire State. The loan officer is more than eager to comply. He has a cashier's check in the form Willa requests drawn up. He gives this to Willa, asking only that she sign a standard form note naming Minisoft Corporation as the borrower. Willa signs this note, promising to repay the $20,000 at a stated rate of interest, as "Willa Bates, President, Minisoft Corporation." The bank soon becomes aware, but not before the cashier's check it has issued has been paid, that the person who presented herself as Willa Bates, President of Minisoft, is not who she claimed to be. She is, instead, an up-and-coming and until now little-known con artist named Connie. The business card that Connie presented to the bank was not issued by Minisoft, but had been cleverly printed up by Connie herself to appear to be a Minisoft business card.

Can Empire State Bank hold the Minisoft Corporation obligated on the note signed, as it turns out, by Connie?

s anyone obligated to pay the money due on the note? See §3-403(a).

Paula Pratt owns and operates a large business that relies heavily on the most advanced, state-of-the art computerized equipment. Paula gives one of her employees, Adam Archer, the title of Purchasing Director and tells him that he is authorized to acquire any new piece of such equipment that he deems appropriate for the use of the business, paying either in cash or on reasonable credit terms, as long as the price of the equipment does not exceed $50,000. Archer arranges for Pratt to buy a particular piece of equipment from the Zippy Computer Company, the cost of which is $30,000. Zippy agrees to take payment in the form of a note payable in a series of 36 monthly installments over a period of 3 years, with the monthly payments being calculated on the basis of the purchase price and a reasonable market rate of interest. The form of the note states that "Paula Pratt, as purchaser, agrees to pay to the order of Zippy Computer Company" the monthly payments. At the bottom of the note, on a line labeled "Purchaser/Borrower," Archer signs by writing "Adam Archer, as agent for Paula Pratt."

s Pratt obligated on the note? Is Archer?

Suppose instead that Archer had signed by writing simply "Adam Archer, Purchasing Director." Does this change either of your answers to the questions asked in (a)?

Finally, suppose that Archer has written only "Paula Pratt" in script on the line designated for the borrower. Would Paula be bound by this signature? Could Archer be personally held liable on the note?

The basic situation is as in the previous example. Paula Pratt is running a business and Adam Archer is her purchasing director. Archer decides to buy another piece of equipment on Pratt's behalf, this time from the Xeroff Copier Company for $15,000. A note presented to Archer for signature to complete the deal states only that "the undersigned Borrower(s) agrees to pay to the order of the Xeroff Copier Company" the sum of $15,000 within 60 days from its date. Archer signs with his own name, Adam Archer, only. Sixty days go by and Xeroff has not been paid on the instrument, which is still is in its possession.

Assuming that Xeroff would not qualify under the circumstances as a holder in due course, would Archer be personally bound to pay the note that he signed?

Would your answer be any different if Archer had signed, "Adam Archer, as agent?"

What if Archer had filled in the signature line on the note by writing "Paula Pratt" and signed below in his own name, Adam Archer?

In each of the three preceding cases, would your answer be any different if by the time the 60 days had passed the note in question had been sold and duly negotiated to a firm, Friendly Factors, for the price of $13,750? You should assume that, by this negotiation, not only did Friendly Factors become the holder of the note, but also that it met the criteria for being considered a holder in due course of the instrument.

We have one more situation to consider in which the industrious Paula Pratt obtains some equipment through the activity of her purchasing director, Adam Archer. In the deal for this final piece of equipment, a super-sophisticated computer printer from the firm of Izod Printers Incorporated, the note presented to Archer for signature reads, "Paula Pratt as purchaser and borrower promises to pay to the order of Izod Printers Incorporated" a set sum of money at a definite time. Archer signs with his own name only.

May Archer be personally liable on the note if Izod itself (which you should assume would not be a holder in due course) tries to enforce the note against him?

How would your answer change if the party trying to hold Archer to personal responsibility on the note was some party other than Izod, one that would rightly be considered a holder in due course?

Cosmo Graphics starts a small enterprise that he incorporates (with himself as president, naturally) and runs under the name of Graphics Surprise, Incorporated. Cosmo arranges with a local bank, Main Street Bank and Trust, to borrow an amount of money that he needs to begin operations. One of the documents that the bank prepares and presents to him to finalize the loan is a note, the text of which gives the name of its maker as "Graphics Surprise, Incorporated." The note is signed by Cosmo under a line that has been filled in with the language, "Graphics Surprise, Inc. by Cosmo Graphics, President."

Can Cosmo Graphics be held personally responsible on this note?

Graphics has signed not only as above, but in addition has been asked by the bank's representative to add his signature devoid of any other identification below this on the instrument. Graphics does so sign a second time. Does this affect his potential personal liability on the note? Why might the bank in a situation such as this want, and indeed insist upon, this second signature?

Carlos Martinez has been appointed director of the accounts payable department of the Minisoft Corporation. It is his job, once all appropriate internal corporate accounting procedures have been observed and the proper authorization forms reach his desk, to issue and dispatch checks drawn on that corporation's account with the First Bank of Washington State. The preprinted check forms used by Carlos clearly identify the checks as being drawn on Minisoft's checking account and coming from that corporation. Before sending off any such check, Carlos personally signs his name on the line provided on the check form for the drawer's signature. Nowhere on the check does he indicate that he is signing in a given capacity or "as agent" for the corporation. Can Carlos be held personally liable on any of the Minisoft checks he signs with his name alone? Refer to §3-402(c).

Explanations

Yes. We know from our previous look at §3-110(d), in which we last met up with the Zendels, that when an instrument is payable to two parties in this fashion it may be properly negotiated only by both of them. Thus, a valid signature of each, Xavier and Yolanda, is necessary. Here we have both.

Xavier has signed for himself, and in addition has been given express authority by Yolanda to sign the check on her behalf and to deposit it in their joint account as he has done. Under §3-402(a) Yolanda is the represented person, bound by the signature of Xavier as her representative.

The result would be the same if Xavier, in addition to signing his own name, signs for Yolanda in this fashion. Section 3-402(a) says that the effect of a signature by a representative is the same whether the representative, or one purporting to be an authorized representative, "signs an instrument by signing either the name of the represented person or the name of the signer." In the prior example, Xavier signed for Yolanda using his own name. Here he signs by signing the name of Yolanda, the represented person. The issue is still the same: Did Xavier have the authority to sign on Yolanda's behalf and thereby bind her to the same extent as if she had personally signed the instrument? In this example there is no doubt; Yolanda expressly authorized Xavier to act as her representative for the purpose of indorsing the check and depositing it into their joint account. Xavier has not forged Yolanda's name. He has signed on her behalf as an authorized representative.

It is doubtful that anyone later trying to rely on this indorsement would be able to establish its validity. The issue, of course, is whether there is any basis to argue that under the facts Xavier was authorized in any way to sign Yolanda's name as he did and then to deposit the check, not into the couple's joint account, but into his own individual account. Xavier has certainly not been given any express authority to do so by his wife. Xavier could argue that he had the implied authority to do as he did, but that would require him to establish that he was reasonable in assuming (perhaps based on how the couple dealt with similar tax refund checks in previous years), that Yolanda would want him both to sign her name to the check and to deposit it in his personal account. This would seem to be a hard case to make, but it would ultimately have to be resolved by the particular facts, not just about how the couple acted here but also about their past practices and communications.

It would similarly seem a hard case to make that Xavier had the apparent authority to sign as he did. Yolanda was not even aware of the receipt of this particular check, and so she certainly could not have made any direct manifestations to any third parties that could lead them reasonably to believe that Xavier was authorized to do as he did, diverting their joint tax refund into an account under his exclusive control. Again it would all be in the facts. Under the common law of agency, to which §3-

> 402(a) defers on such points, issues of whether someone purporting to act for another has the authority to bind the purported principal, and if so to what particular acts the authority extends, depend to a great degree on the particulars of the situation and the present and past dealings of the parties involved. This is especially true when the argument being advanced is that the agent acted not with express authority but rather with implied or apparent authority. In the particular example before us—with Xavier signing Yolanda's name to a check made payable to them jointly and depositing it into his personal account, all without informing her—I think it highly unlikely that this would be found to be an effective indorsement by Yolanda and hence an effective negotiation made, as it would have to be, by the two of them.

There is no basis to argue that Minisoft has signed the note in question, and hence it cannot be held obligated on the note. The facts here at least are not in dispute, and the conclusion is unavoidable (for the bank) that this person Connie was not authorized in any manner to sign for the Minisoft Corporation. She had never been given any authority, either express or implied, by that company, which does not even know of her and certainly wouldn't be happy with what she's up to. Whatever indicia the loan officer was relying upon that allowed him to come to the conclusion that the person before him was in fact Willa Bates, president of Minisoft—and what's more, that she had the authority to sign a note on the corporation's behalf promising to pay $20,000—all emanated from the supposed Willa herself. Connie was the one who said she was the famous Willa Bates. Connie was responsible for printing up the (phony) business cards. There were no actions at all that could be traced back to the Minisoft Corporation itself, which contributed to the loan officer's belief that Connie was who she claimed to be. That being so, there is no way that it could be argued that Connie had the apparent authority to act on behalf of Minisoft in any way whatsoever. The signature purporting to be that of Minisoft is an unauthorized signature, pure and simple. Minisoft is in no way bound to any obligation on the note by what Connie did here.

Connie herself is obligated as a maker of the note promising to pay Empire State Bank the $20,000 on the terms and conditions set forth in that note. At first this might seem strange. We know that any obligation on an instrument must be based on a person's signature appearing thereon, and we don't seem to have Connie's signature anywhere on the note. Under §3-403(a), however, an unauthorized signature such as we have here, though ineffective to bind

Minisoft in any way, *is* effective "as the signature of the unauthorized signer [Connie] in favor of a person who in good faith pays the instrument or takes it for value." Empire State Bank has indeed taken the instrument for value; it has given a cashier's check for $20,000 in exchange for the note. The bank may have been, at least as we view it in retrospect, awfully gullible here and not terribly prudent in how it handled its affairs, but there is nothing to indicate that it was lacking in good faith (as that term is defined in §3-103(a)(4), a definition we will concentrate on in greater detail in later material) in taking the note for value as it did. By signing the note with the words "Willa Bates, President" as she did, when she knew for certain that she was not authorized to do so, Connie in effect signed the note herself. Because her signature appears on the note in the place where the maker's signature is to be found, Connie is bound to pay as the maker when called upon to do so. The prospects of Empire State actually getting repaid by Connie are, of course, pretty dim at best. Con artists like Connie, if they are any good at what they do, tend to disappear into the woodwork fairly quickly once a con has been pulled off. They don't, as a rule, hang around to follow up on their legal obligations to make whole those parties they have defrauded. Good luck to the bank in its efforts to find Connie and make her pay up. The Code at least is on the bank's side, if not the laws of human nature.

This example obviously brings to the fore the much larger question of how someone getting the signature of a representative on an instrument can be sure, or at least maximize the likelihood, that the person with whom he is dealing is in fact who she claims to be. Beyond that, although we did not even have to reach the issue in this example, how can the party relying on the signature reach a desired level of confidence that the person, even if she is without doubt who she says she is and not an impostor or phony, is *authorized* to sign and commit the represented party in the way and to the extent that she is doing? Even if a bank's loan officer were dealing with someone who was in fact the real Willa Bates, President of Minisoft, and there was no doubt about it, if Willa said she was authorized to sign a note for $10 million on behalf of that corporation, would you suggest the loan officer simply take her word for it? I have not tried to incorporate into this chapter all the issues dealing with when and whether an agent has the requisite authority to act for the principal as he or she maintains that he or she has. This is rightly the stuff of a large part of the study of agency law as that law applies to all sorts of activities and transactions, not just dealings in negotiable instruments. There is, obviously, no way we could cover all, or even any large measure, of that material here and come close to doing it justice. I trust that you will at some time get a chance to treat such issues in agency, and particularly the significant issue of when a purported agent is empowered to bind the principal by his or her deeds, more generally at some time in your legal studies.

Pratt is obligated on the note. She has authorized Archer to act as he has, entering into the contract to buy the equipment and signing a note to serve as payment under that contract. His signature binds Pratt under the basic principle of §3-402(a) and the common law of agency. The more interesting issue here is whether Archer has in any way obligated himself to pay on the instrument. After all, he has appended his signature to the note. We consult §3-402(b). First we note that the precondition stated at the beginning of §3-402(b) has been met: Archer as representative has signed his own name to an instrument and that signature is an authorized signature of Paula Pratt as the represented person.

The question then becomes whether the case we are looking at falls within the rule of paragraph (1) or (2) of this subsection. As you should confirm, we are here safely within the bounds of subsection (b)(1). Here the form of the signature, "Adam Archer, as agent for Paula Pratt," does show unambiguously that Archer is signing on behalf of Pratt; furthermore, Pratt is "identified" in the instrument, here both in the body of the instrument and in the form of signature as well. Archer cannot be held personally liable on the instrument.

You may want to look at the case of *Suttles v. Thomas Bearden Co.*, 152 S.W.3d 607, 2004 Tex. App. LEXIS 6613, as an example of §3-402(b)(1) in action. In that case the individual signing as president of a corporation, which was the general partner of a limited partnership which was the actual borrower, was held not to have incurred any personal liability given that the identity of the actual borrower as well as the signer's representative capacity were both sufficiently clear from the note's "signature block," even though the name of the borrower did not appear in the body of the note itself.

If Archer signs in this manner, the result should be the same as it was in Example 3a. Pratt is obligated by the authorized signature of her representative, Archer. Archer would be able to argue that the form of signature, “Adam Archer, Purchasing Director,” shows unambiguously that he is not signing for himself but for another, and furthermore that the other (the represented person) is identified within the instrument—if not at the bottom where the signature is placed, more importantly in the body of the note itself. The critical text of the note reads that Pratt and only Pratt is the party agreeing to pay and hence is the maker of the instrument. In this context it seems unambiguous that Archer’s signature, followed as it is by his title, indicates that he is signing in a representative capacity only.

Assuming as we are that Archer is authorized to sign this note for Pratt, his signature of her name will be effective to bind Pratt just as if she had herself signed, under the introductory language of §3-402(a), whether he carries through on his authority by signing in his name or in hers. So Pratt is bound to the obligation of the maker on the note. Is Archer bound? No. Notice that he himself never signed the note. His scrawling of “Paula Pratt” on the line designated for the borrower was his act of signing *her* signature, as he was authorized to do. Neither his name nor his signature appears anywhere on the note, so there is no way he could ever be liable on it. Note also that the rule of §3-403(a), which we looked at in Example 2b, does not come into play here: It applies when an *unauthorized* signature is placed on the instrument. In this case Archer was authorized to sign for Pratt as he did. If for some reason Archer were not so authorized and his signing of “Paula Pratt” to the note were deemed to be an unauthorized signature, then and only then would his actions amount to his own signature, even though not literally in his own name, of the instrument, creating possible obligation for him on the instrument itself.

This example differs from the previous one in that the form of signature does not “show[] unambiguously that the signature [was] made on behalf of the represented person,” nor is the represented person, Pratt, “identified in the instrument” itself. Neither of these conditions being present, Archer cannot rely on §3-402(b)(1) to relieve him of any potential liability on the instrument. The case then comes within the rule of paragraph (b)(2) to this same section. We are to assume that the person trying to enforce obligation on the instrument is not a holder in due course. That being so, the operative rule is that “the representative is liable on the instrument unless the representative proves that the original parties did not intend the representative to be liable on the instrument.”

In the particular case, it may not be too difficult for Archer to meet his burden of proving that the intention of the parties was to bind his employer Pratt to the instrument (via §3-402(a)) and Pratt only. After all, the note was signed to pay for a Xeroff copier machine, which machine presumably was delivered to Pratt's place of business and is being used by her. The Xeroff representative dealt with Archer not because she believed him to be the kind of person who would buy an expensive copier in his own right, but because he was the purchasing director for the enterprising Paula Pratt. Of course, it does not necessarily follow just because Xeroff, in taking the note, wanted Pratt to be obligated on it, that it did not also want to have Archer as a second person liable to pay the note. There are certainly instances, as we will soon see, in which the party relying upon a signature by a representative will most definitely want to see that the represented party and the representative are *both* obligated on the instrument. That does not seem to be the case here, however. Xeroff, in agreeing to sell to Pratt on credit, was presumably making some determination about her creditworthiness and what degree of risk it was willing to take in allowing her some time to pay. It's doubtful that the possibility of having Paula's director of purchasing personally liable as well was something that Xeroff even considered.

It seems likely here that Archer would be able to prove that the original parties to this instrument did not intend him to be liable on it. Still, the lesson, at least as far as Archer the agent is concerned, should not be overlooked. Had he been careful and made sure both that the note he was signing on Pratt's behalf identified her and that the form of his signature left no room for doubt that he was signing in a representative capacity only, he would then have been able to rely on §3-402(b)(1), where the rule is simple and straightforward. He would not have been liable on the instrument and he would have needed no proof beyond what was on the face of the instrument itself to assure himself of this result. Having signed this note written out as it was, and with his simple signature devoid of any clear indication of his signing as a representative only, the result is that he is prima facie liable on the instrument unless he can prove through facts extrinsic to the instrument itself that there was no intention on the part of the original parties that he be bound. Even if he is eventually able to satisfy his burden of proof in this regard and thereby escape personal liability should some problem develop and litigation ensue, he'll no doubt be struck by (and probably cursing himself with) the realization that the necessity of his taking on and meeting this burden could all have been avoided had he been a little more careful about looking over and insisting on a more clearly worded form of note at the time of signing, and then signing unambiguously in his representative capacity only.

The applicable rule is the same as in 4a. We and Archer are still going to have to look to subsection (b)(2) of §3-402. Subsection (b)(1) is reserved for instances where both the form of signature is unambiguously that of someone signing in a representative capacity *and* the represented person is identified in the instrument. In this case Archer has met the first criterion: The form of his signature shows unambiguously that he was signing in a representative capacity. However, the represented person, Paula Pratt, is still not identified in the instrument. Recall that the body of the note refers only to "the undersigned Borrower(s)." Archer will be able to avoid personal liability on the note, as against a person other than a holder in due course, only by taking on and meeting the burden of proving that the original parties to the instrument (that would be Pratt and Xeroff) did not intend him to be liable on it.

The situation remains the same. Archer is still stuck as far as §3-402(b)(2) is concerned. Here the represented person *is* identified in the instrument, but Archer's representative capacity is not unambiguously shown by the way he signed. Again, he will be prima facie liable to someone not a holder in due course unless he can prove that the original parties to the instrument did not intend him to be personally obligated on it.

Once the party trying to hold the representative liable qualifies as a holder in due course, the rule changes, and it will become that much harder for Archer to avoid liability. Subsection (b)(2) states that a representative in Archer's situation—where either his representative status does not unambiguously appear from the form of his signature *or* the represented party is not identified in the instrument—is liable to a holder in due course "that took the instrument without notice that the representative was not intended to be liable on the instrument." There is no requirement that the type of notice that would bar the holder in due course from holding the representative personally liable be found on the instrument itself, or even that it be in writing—but note the language at the end of the first long paragraph of Comment 2 to §3-402 to the effect that "[a] holder in due course should be able to resolve any ambiguity against" the representative. (I know John Doe and Adam Archer may not be one and the same person, but it may not have escaped your notice that the three examples I have used in 4a, 4b, and 4c just happen to parallel Cases #1, #2, and #3 of this Comment.)

In our Example 4a, but now assuming that the note is in the hands of Friendly Factors, a holder in due course, Archer would probably have a very hard time escaping personal liability. Note that at the time Factors bought the note and took as a holder in due course, all that appeared on the face of the note was the promise that "the undersigned Borrower(s)" would pay the promised amount; Adam Archer's signature appears, devoid of any hint of representative capacity, at the bottom of the note. It is going to be very hard for Archer to prove that, at the time it took the note, Factors had notice that Archer was not "intended to be liable on the instrument." We have to assume that Factors would not have paid all it did for the note unless it thought *someone* was committed to paying it, and no name other than Archer's even appears on the note. Perhaps Archer would be able to come up with compelling proof that, at the time it took the note, Factors had the requisite notice that the note had been signed on behalf of Pratt, with no intention that Archer be bound on it, but this may not be easy and it is most assuredly not something that Archer can count on when he signs the note in this fashion. Remember that a negotiable instrument such as this may have passed through the hands of several parties before it ended up in the possession of Friendly Factors. How is Archer to prove what notice Factors had when it took the note? Also, as a practical matter, a firm like Friendly Factors will often pay for and take negotiation of notes such as this from a merchant not on an individual basis but in large quantities. Factors may have purchased this note directly from Xeroff, but perhaps as one of a group of dozens or even hundreds. If this were the case, Factors would have examined the notes to make sure each looked satisfactory within its four corners and asked for some general information from Xeroff, but it is highly doubtful that a person from Factors would have sat around chatting with someone from Xeroff to learn about the nature of each note and the underlying transaction that gave rise to it. Xeroff would have no way of knowing that someone like Adam Archer could not possibly have been buying a Xeroff copier for himself, much less that he was doing so only on behalf of one Paula Pratt. I wouldn't count on Archer's being able to escape personal liability on the note once it is in the hands of a holder in due course like

Friendly Factors, no matter how Friendly that firm may be.

The situation in Example 4b, where Pratt is not identified in the instrument but Archer has signed "as agent," is a little more hopeful for Archer, but it still is unclear that he could escape personal liability. True, the addition of these words definitely suggests that Archer was acting in a representative capacity for someone when he signed the note, but nowhere on the note does it identify *who* that someone is. It may be hard for Archer to establish that Factors had, at the time it took the note, notice that he "was not intended [by whom?] to be liable on the instrument." If it had such notice, whom did it think would be liable as maker of the note? Perhaps if Factors had been more careful it would not have taken this instrument until this matter had been cleared up. But then Archer could have avoided the whole problem simply by signing, "as agent for Paula Pratt," identifying his principal. This kind of messy situation, which comes up all too often, could have been avoided with a little more care and attention to detail by the representative who has no intention of taking on personal responsibility, looking out for his or her own interests as well as those of the principal.

The situation in Example 4c would probably find Archer liable to Friendly Factors as a co-maker along with Pratt of the note. There are two signatures on the note, that of Pratt (made by Archer acting as her agent) and that of Archer himself. Nothing distinguishes one as the mark of a principal and the other as that of an agent or representative. There is, of course, the possibility of Archer's proving that Friendly Factors, at the time it took the instrument, had notice of who was whom and of what exactly was going on here in more detail, but it will be a hard burden for Archer to meet.

This case also comes within (b)(2) of §3-402—here not because the represented party is not identified in the instrument, which she clearly is, but because Archer the representative has not signed with a form of signature unambiguously showing that his signature was made in a representative capacity only. If Izod tries to enforce the note against Archer, he will be put to the test of proving that Pratt and Izod are to be considered the "original parties" to the instrument and furthermore that they did not intend Archer to be liable on it. Fortunately for Archer, the way Pratt is identified in the instrument, along with other facts he will be able to bring into the picture, may well allow him to meet this burden. But again, think of how much easier life would be for Archer (at least on this one particular matter) had he signed, “Adam Archer, as agent,” or “Adam Archer, Purchasing Director for Paula Pratt.” Had he done so, the situation would be governed by (b)(1), not (b)(2), of §3-402, and Arthur would have been, by the language of the Code itself, “not liable on the instrument” without having to make any additional showing.

Should Archer be confronted with a holder of the note who qualifies as a holder in due course, he would (again under (b)(2)) be liable unless he can establish that the holder took the instrument with notice that there was no intention that Archer be bound. The case here doesn’t look as bleak for Archer as some we have been considering, even if the party seeking enforcement is a holder in due course, because the text of the note itself refers to Pratt as the “purchaser” of the printing equipment and “borrower” of the money to pay for it. Still, should Pratt not pay on the instrument, and especially if her financial condition makes it unlikely that she will ever be able to pay, the holder in due course may find it has no choice but to go against Archer, and the result will depend on who can prove what about what the holder had notice of at the time it took the instrument. That holder could properly point out that just because one person, Pratt, had clearly taken on obligation on the instrument, it does not follow that another signer, in this case Archer, had not also taken on responsibility. In plenty of situations, two or more parties will jointly take on the obligation to pay a note when due. Archer may eventually win this one, but he can’t just walk away from any such suit or the argument that the original intention was that he, in addition to Pratt, was to be obligated on the instrument.

No. This situation fits within §3-402(b)(1). Cosmo has clearly signed in a representative capacity, as the president of the corporation, and the represented party, the corporation itself, is clearly identified in the instrument.

If Cosmo signs a second time using his name only, it seems appropriate to interpret this as his signing as a co-maker (and, as we will see in Chapter 5, being considered an “accommodation party,” with all that implies) of the instrument. Two parties are obligated to pay as promised: the corporation as a distinct legal entity and Cosmo as an individual. A court should, and most courts have, found this to be the legal effect of the second personal signature in a situation such as this, but if you represented the bank you could do a bit more to make this outcome crystal clear and beyond doubt. You could create the note to read so that the corporation and Cosmo were both unequivocally identified as makers, each jointly and severally liable. On the bottom of the note you would be sure there were two distinct lines labeled “Borrower.” On one you would fill in the name “Graphics Surprise, Inc.” and have Cosmo sign under this in his representative capacity, “by Cosmo Graphics, President.” On the second borrower line you would have Cosmo sign his name alone. This would make evident beyond any question the intention that both the corporation, signing through its representative, and Cosmo personally were to be liable on the instrument.

It is not difficult to see why, in a situation such as this, a lender such as Main Street Bank and Trust would not merely hope for, but also (if it knew its business) insist upon, the personal obligation of Cosmo, the president of this small closely held corporation, in addition to the obligation of the corporation. It is lending to the corporation, and if all goes well the corporate business will thrive and Graphics Surprise, Incorporated, will have no trouble keeping up with any loan payments it has agreed to make. The bank, however, has to be aware that not all businesses flourish, and that there is some nonnegligible chance that the corporation will run into trouble and not be able to meet its obligations. The corporation may even be forced to declare bankruptcy and dissolve. Where does that leave the bank? When lending to a small business entity, especially a newly formed one, the bank will necessarily want to have the ability to go against the people who put that business together, those we sometimes refer to as the *principals of the business*. One way of doing that is to make sure that those people can be held personally obligated on any notes signed on behalf of the business. Someone like Cosmo Graphics here, who may be incorporating his business for perfectly valid and noble reasons, still has to recognize that others will be concerned that, should the corporation run into difficulty, Cosmo will not automatically be liable for its debts just because he is the president or even the sole shareholder of the corporation. In fact, the general rule, as you should know, is just the opposite. Those such as Main Street Bank and Trust, in our example, who deal with a corporation—the form of which legally limits liability to the entity itself and insulates its owners and officers from responsibility for the corporation’s obligations—have to take reasonable precautions. A lender such as the bank will do so by making sure that the form of any note it takes from the corporation and the way that note is signed makes it possible for the corporate principal or principals to be held personally liable if the corporation goes belly-up.

Carlos is free from any worry that he could be held personally liable on the checks, even though he has signed them and even though he may not have signed with any clear indication that he did so in a representative capacity. The 1990 revisions to Article 3 added the provision we find in §3-402(c):

If a representative signs the name of the representative as drawer of a check without indication of the representative status and the check is payable from an account of the represented person who is identified on the check, the signer is not liable on the check if the signature is an authorized signature of the representative.

As you can read in Comment 3 to this section, the prerevision version of Article 3 contained no such provision, and some courts had found the person signing, as Carlos is doing here, to be personally obligated on the instrument for lack of any showing of a representative capacity. The revision drafters meant to and did address what they obviously thought to be an incorrect and unfortunate outcome with the new §3-402(c), for which Carlos can be thankful.

Carlos is, of course, a fictional character. For a recent case showing how the new §3-402(c) worked to the benefit of one Janet V. Andrew—the real life secretary treasurer of Storage Solutions, Inc., a Connecticut corporation—who signed checks on behalf of the corporation but was found not to have incurred any contractual liability on the checks, and hence never to have "transacted business" in Massachusetts so as to be subject to personal jurisdiction in that state, see *Raid, Inc. v. Andrew*, 2002 Conn. Super. LEXIS 492, 47 U.C.C.2d 633. Two other recent examples of §3-402(c) in action are *Packaging Materials & Supply Co., Inc. v. Prater*, 882 So. 2d 861, 52 U.C.C.2d 465 (Ala. Civ. App. 2003) and *Squire Industries, Inc. v Hryb*, 2008 Conn. Super. LEXIS 21, 68 U.C.C.2d 883.

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* Those who have already studied the basics of agency law in some other context, even if not in a separate course in agency law (which I'd urge you to take as a general matter if such a course is available to you), will no doubt already have observed how superficially I am skimming the surface here of concepts that are nowhere near as easy, neat, and straightforward as this text might suggest. A full discussion of this topic would probably also include, beyond what I am outlining here, the notions of inherent agency power, ostensible authority, and even agency by estoppel. For our purposes in this chapter, however, I hope that the introduction offered in the text will suffice—or at least give you a elementary understanding of the deeper issues, and often quite difficult complicated analyses, that lie just below the surface. Given that §3-402(a) directs us to the law of agency of the jurisdiction involved, much of the substance of a full-blown agency course comes into play. I can only present the highlights

here.

* It is interesting and important to note that the term *unauthorized signature* includes but is not limited to a forgery. We will see, in chapters to come, any numbers of situations of forgery, where someone signs the name of another to the instrument with the intention that it be taken as the actual signature of that party, and it can be tempting to conclude that the only type of unauthorized signature is the forgery. But look at the first sentence of Comment 1 to §3-403. An unauthorized signature includes not only a forgery but also a signature made by one exceeding his or her actual (which would mean either express or implied) or apparent authority. In the example used earlier, for example, should Adam sign his name to a check from Paula's account for $1 million, this is not a forgery. Adam signs Adam's name, and there is no attempt to pass it off as a signature of anyone else. It would, however, be an unauthorized signature if Adam had never been authorized (expressly or impliedly) to write a check for such an amount out of Paula's account nor could any apparent authority be shown on his part to do so.

* If you were ever confronted with this issue as it pertains to a signature made on an instrument prior to the effective date of the revised Article 3 in the governing jurisdiction, you would of course turn to the old §3-403 and to cases decided under it for guidance. Be aware that there are still plenty of notes of older vintage outstanding, and for those notes the question here presented would have to be dealt with by reference to that former §3-403, because the newer version of Article 3 is generally held not to be retroactive in effect.

CHAPTER 5

Accommodation Parties

INTRODUCTION

A creditor is typically someone like a lender, who has exchanged money lent in the present for a promise of repayment in the future, or a seller of goods who has taken as payment not cold hard cash but a promise of payment at some later date. The creditor is necessarily living at risk. To some greater or lesser degree, the possibility always exists that, when time comes for the loan to be repaid or the goods paid for, the promise upon which the creditor has been relying will not be kept and the money that is due the creditor won't be forthcoming. A creditor can try to reduce, if never totally eliminate, this risk in a variety of ways. One possibility is for the creditor to insist that the debtor, in addition to making his or her promise of payment, put up some collateral—some property of the debtor's—to secure the amount of credit that has been extended. If the property put up as collateral is real property, the situation is that of the traditional real estate mortgage, and the law governing this aspect of the transaction is the common law governing mortgages as it has developed over time in each of the several states. If the collateral that backs up the debtor's promise of payment is in the form of personal property, the creditor and debtor will have entered the world of the secured transaction, now governed not by common law principles but by Article 9 of the Uniform Commercial Code (U.C.C.) as adopted in each of the several states.

Putting up some property (collateral) is only one way in which a debtor may "back up" the promise made to the creditor and ease the creditor's anxiety about whether it will be paid in the future. Another possibility is for the debtor to bring in another party, someone who agrees to stand behind the promise made to the creditor and become legally committed to making payment if the debtor does not do so. This third party is commonly referred to as a *guarantor* or a *surety* of the debtor's obligation. The surety stands behind the debtor's obligation to the creditor. In general, the rules governing the relationship between the creditor, the debtor (now referred to as the *principal debtor*), and the surety constitute a special body of common law—and a particularly intricate and oft-times perplexing body of law it is—referred to as the law of *suretyship*. The basic framework of suretyship—this tripartite arrangement involving the creditor, the principal debtor, and the surety—and the issues that may arise in its application are not limited to deals in which negotiable instruments play a part. The possibility of a third party being brought into a deal to act as surety for one of the more active players exists in a wide variety of situations. We limit our examination in this chapter to those special cases in which the surety takes on that role by affixing his or her signature to a negotiable instrument for the purpose of giving assurance that some other party to the instrument (someone who has already signed as either a maker, a drawer, an indorser, or an acceptor) will fulfill the obligation assigned to that role under the rules of Article 3 (which have already been examined in Chapter 3).

Although Article 3's treatment of suretyship does not differ radically from the general common law of suretyship as you would study it elsewhere, the drafters chose not to simply refer to that law and incorporate it by reference. Instead, they set forth the operative rules with regard to the role of the surety, in the context of negotiable instruments law, in detail (often, it has to be admitted, in what initially reads as excruciating detail) in the text of the Code itself. These rules are to be found principally in two sections, §3-419 and §3-605, on which we will focus in this chapter.*

WHO OR WHAT IS AN ACCOMMODATION PARTY?

The first thing we have to be aware of when looking at this topic through the lens of the law of negotiable instruments is that Article 3 adopts a vocabulary entirely distinct from that of the common law of suretyship. To see this, look at §3-419(a):

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

So Article 3 refers to the surety who has become a party to the instrument as an *accommodation party*. The party we have been referring to as the debtor or the principal debtor is the *accommodated party*. The third party in the picture, the creditor with whose concerns we started out this whole discussion, does not appear in subsection (a), but he, she, or it will be, in Article 3 lingo, the "person entitled to enforce" the instrument in question, a character whom we have already met.

Notice that under §3-419(a) no one can become an accommodation party to an instrument unless he or she has actually signed the instrument. The general rule remains true: A person cannot become a party to an instrument—accommodation party or otherwise—unless he or she has signed on the paper itself. See *Belden v. Thorkildsen*, 2008 WY 145, 197 P.3d 148, 67 U.C.C.2d 549 (2008).

Further, as the second paragraph to Comment 3 makes clear:

> An accommodation party is always a surety. A surety who is not a party to the instrument, however, is not an accommodation party. For example, if M [for maker] issues a note payable to the order of P [for payee], and S [surety] signs a separate contract in which S agrees to pay P the amount of the instrument if it is dishonored, S is a surety but is not an accommodation party. In such a case, S's rights and duties are determined under the general [common] law of suretyship [and not under the provisions of Article 3].

In this chapter we will be dealing with accommodation parties only, and not even attempting to cover the law of suretyship in general. And whether a person is an accommodation party is first and foremost to be determined by whether that person's signature appears on the instrument. The circumstances of how and why that person's signature came to be affixed to the instrument will determine whether he or she is an accommodation party instead of a regular nonaccommodation party, but the fact of that party's signature appearing on the instrument is an absolute prerequisite to accommodation party status.

The fact that a party signs as an accommodation party does not alter another of the basic principles with which you should already be familiar: Anyone signing an instrument does so in a particular capacity. Once again, there are only four possibilities. Anyone whose signature appears on an instrument must have signed either as a maker of a note, the drawer or acceptor of a draft, or an indorser. This is no less true for an accommodation party. Any accommodation party will necessarily be either an accommodation maker, an accommodation drawer, an accommodation acceptor, or an accommodation indorser.

As Comment 1 to §3-419 points out, and as we will explore in the earlier examples, by far the most common situations (and the only two we will consider here) are those of the accommodation co-maker of a note and the accommodation indorser of either type of instrument. The comment actually refers to the second situation as that of the *anomalous indorser*, for which we need to turn back for a moment to §3-205(d):

> "Anomalous indorsement" means an indorsement by a person who is not the holder of the instrument. An anomalous indorsement does not affect the manner in which the instrument may be negotiated.

In the material we have already covered (particularly in Chapter 2), we saw that the purpose of an indorsement on an instrument was to fulfill a requirement so that instrument could be effectively negotiated. The holder was required, if the note was as held payable to the holder as an identified person, to sign the instrument either with a blank or a special indorsement in order to negotiate it to the next person down the chain of title by the act of transfer of possession.

You should be able to convince yourself that any signature on an instrument that isn't clearly the signature of a maker, drawer, or acceptor, and is furthermore not an indorsement made by a holder for the purposes of negotiating the instrument to the next person in the chain of title, is necessarily and simply by process of elimination an anomalous indorsement. As Comment 3 to §3-205 states:

> The only effect of an "anomalous indorsement" … is to make the signer liable on the instrument as an indorser. Such an indorsement is normally made by an accommodation party. Section 3-419.

All this still leaves us with the ultimate question: On what basis do we determine whether a party to an instrument can correctly be characterized as an accommodation party in whatever role that party signed the instrument? As we will see as we work through the examples, in most instances there should be no trouble making this determination. In some instances, however, a party may claim accommodation status, for reasons we have yet to see, and the party seeking to enforce the instrument against that party will contest the claim. Should the question of whether a party qualifies as an accommodation party arise, the ultimate test is as stated in §3-419(a): Did the party "sign the instrument for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument?" In some situations, as you can imagine and as we will examine in the examples and explanations to follow, the distinction between a direct and an indirect benefit can be a difficult line to draw.

THE CONSEQUENCES OF ACCOMMODATION STATUS

It is all well and good to consider in the abstract who is and who is not an accommodation party to an instrument, but the answer to this question must be of more than theoretical interest. What difference does it make if a party to an instrument can successfully maintain that he or she is not simply a party to the instrument, but is rightfully to be considered an accommodation party? The first thing that has to be pointed out is one way—and a very significant way at that—in which an accommodation party is no different from any other party to an instrument. Any person signing an instrument as an accommodation party, remember, signs as either a maker, drawer, acceptor, or indorser. We have already seen that any party to an instrument, whatever that party's role, takes on the obligation to pay what is due on the instrument under certain well-defined rules supplied in §§3-412 through 3-415. The accommodation party is no different in this crucial regard. Recall that part of the definition of *accommodation party* in §3-419(a) is that the accommodation party "signs the instrument for the purpose of incurring liability" on it. Subsection (b) of §3-419 could not be clearer:

> An accommodation party may sign the instrument as maker, drawer, acceptor, or indorser and, subject to subsection (d) [a special and very limited case, that we'll look at in Example 3c], is obliged to pay the instrument in the capacity in which the accommodation party signs.

Whatever else may be true of the person who can establish signature of the instrument as an accommodation party, the basic rules controlling when the signatory must pay a person entitled to enforce the instrument remain the same. The accommodation party who tries to escape liability on the instrument by arguing that he or she signed "only" in an accommodation capacity, and received no benefit or value in exchange for his or her signature, will get nowhere with this argument. The accommodation party signs the instrument in one capacity or another—either as a drawer or acceptor or, more typically, as a maker or indorser—and is obliged as any nonaccommodation party would be to pay on the instrument if the conditions, and the rules of Article 3, call for payment by a party signing in that capacity.

Other consequences of accommodation status, however, do confer special benefits on the accommodation party. First, we note that if an accommodation party does have to come up with the cash to pay the instrument, he or she will be doing so because some other person, the accommodated party, has failed to meet its own obligation. The accommodation party has agreed to stand as surety for the accommodated party and to pay if and when the accommodated party fails to pay as it is expected to do. The accommodation party has committed itself to "backing up" the accommodated party's obligation, but it is clear that the ultimate obligation to pay rests on the accommodated party. The accommodation party certainly never agreed to pay whatever is due by the accommodated party and leave it at that. The accommodation party that has been forced to pay on the instrument because of the accommodated party's failure to do so will have what is referred to in the law of suretyship as a *right of recourse* against the accommodated party; that is, the right to payment by the accommodated party of what the accommodation party has paid on the other's behalf. Section 3-419 incorporates this general principle in subsection (e): "An accommodation party who pays the instrument is entitled to reimbursement from the accommodated party and is entitled to enforce the instrument against the accommodated party."

A second significant way in which a party that can establish signature in an accommodation status only may gain some benefit involves a series of distinct defenses to liability, which are traditionally referred to as the *suretyship defenses*. These special defenses, available only to a surety, and only when the most exacting of criteria have been established, traditionally go by the names of *discharge, material modification* (which Article 3 treats as two separate situations, extension of the due date and all other material modifications), and *impairment of the collateral*. The specifics and exact contours of each of these defenses, both as they have evolved in the common law of suretyship and as they are incorporated into Article 3 via §3-605, are (to put it mildly) complex and dense with detail. In the examples I will not even attempt to get into all of the subtleties, but I do think it important and entirely possible for you to get some basic understanding of what the suretyship defenses involve and how they work, at least in broad relief.*

At the outset we can recognize the type of problem that the suretyship defenses are intended to address. When a party agrees in whatever manner to act as a surety, such as when a party agrees to sign a negotiable instrument as an accommodation party, that party is agreeing to lend not just its name but also its credit to a particular situation. It is agreeing (one would hope only after due deliberation) to act as surety for a defined obligation or set of obligations that the principal debtor has to the creditor as of the particular time when the suretyship obligation is assumed. In the cases with which we are concerned, the accommodation party agrees to meet certain obligations of the accommodated party—should the accommodated party fail to do so—to the extent and under the conditions as they exist as of the time when the accommodation party signs the instrument. Suppose that at some later date the principal debtor and the creditor agree between themselves, without either informing or getting the agreement of the surety, to make some change from their original agreement. Suppose further that the surety is later called upon to come up with money to pay the creditor off when the principal debtor is unable to do so and that because of the debtor's financial position there is no chance that the surety will be made whole by the debtor through the right of recourse. If the surety can establish that it would not have been placed in this position—having to pay the principal debtor's obligation and being unable to get reimbursed for doing so—had the principal debtor and the creditor not made this readjustment to the terms and conditions of the principal debtor's obligation *after* the surety signed on and without getting the surety's agreement to the newly configured deal, then the surety should certainly have the right to argue that it should not be held to its initial agreement to back up the principal debtor's obligation, because that obligation has changed from what the surety originally agreed to support. The surety agreed to stand behind and guarantee the debtor's obligations as they were known to the surety at the time of the initial agreement. If the subsequent change in circumstances, agreed to by the creditor and the debtor but not the surety, can be shown to have placed a greater risk on the surety than it originally agreed to accept, the surety in all fairness should have some argument that its suretyship obligation can no longer be enforced against it, or at least that its potential liability on its agreement to stand as surety should be limited in some fashion to reflect the terms and conditions on which it did originally agree to take the responsibility and risks of suretyship.

Trying to make sense of the suretyship defenses in the abstract is, as you may be feeling at this point, a difficult proposition. This is just the type of problem with which a concrete example or two or three should help enormously. The final examples in this chapter are not intended to address every detail or variation on the theme, but if you work through them carefully you should be able to pick up the fundamentals of how the suretyship defenses may affect the potential liability of an accommodation party to a negotiable instrument. The availability of these defenses under the right circumstances is a significant consequence of accommodation status.

Examples

Cosmo Graphics starts a small enterprise that he incorporates under the name of Graphics Surprise, Incorporated, with himself as sole shareholder and president. Graphics arranges with a local bank, Main Street Bank and Trust, to borrow on behalf of the corporation an amount of money that Cosmo needs to begin operations. One of the documents that the bank prepares and presents to him in order to finalize the loan is a note, the text of which gives the name of its maker as "Graphics Surprise, Incorporated." The note is signed by Graphics under a line that has been filled in with the language: "Graphics Surprise, Inc. by Cosmo Graphics, President." The bank also insists, because the corporation is a new enterprise with few assets of its own, that Graphics add his signature, devoid of any other identification, a second time to the bottom of the instrument. Has the notion of accommodation signing of an instrument been invoked here? If so, who or what is the accommodation party? Who or what is the accommodated party?

Upon her graduation from college, Lisa desires to buy a car. She finds just the kind she is looking for at Wiggum's Autorama. Wiggum is willing to sell the car to Lisa on credit, but since she has not had the opportunity to build up any kind of positive credit history, he says that he will do so only if Lisa finds someone to co-sign the note, which is of the type he asks all credit buyers to sign. Lisa's father, Homer, is more than willing to act as co-signer. The note is prepared, saying that "Lisa, as purchaser and borrower, promises to pay to the order of Wiggum's Autorama" specified monthly payments over the next three years. Lisa signs at the bottom of the note. Homer also signs at the bottom. Lisa takes delivery of the car and registers it in her own name.

Who is the accommodation party here? Who is the accommodated party?

What if the text of the note had read only that "the undersigned Borrower(s)" promise to make payment on the note? Both Lisa and Homer each sign at the bottom of the note with no other language indicating status. Does this change the situation?

What if the note refers in its text only to "the undersigned Borrower(s)," but Homer adds the words "as Guarantor" after his signature?

Finally, what if Lisa signs on the bottom of the note and Homer signs his name only on the reverse? How would you characterize this situation?

Bart also wants to buy a car from Wiggum's Autorama, but because of his poor credit rating is told by Wiggum that he will be able to do so only if he gets a co-signer for the note he will be asked to sign. Bart convinces his mother, Marge, to act as co-signer. She does so by signing at the bottom of the note with her signature only. Bart takes delivery of the car and registers it in his name. From the beginning Bart falls behind on the monthly payments called for in the note, and eventually he stops paying altogether.

May Wiggum go directly against Marge for failure to pay on the instrument as due, or is he obligated first to try to collect from Bart?

If Wiggum does bring an action against Marge on the note, can she use as a defense the fact that she personally never received anything of value for her agreement to sign the note?

Suppose Marge had signed with her name followed by the legend "Collection

Guaranteed." Would this change the analysis? See §3-419(d).

If Marge does have to make good to Wiggum on the payments not made by Bart, has she any course open to her other than to bear the loss and curse the day she ever agreed to help Bart buy the car on credit? See §3-419(e).

Selma and Patty are sisters. Selma loves boating and contracts to buy a small but far from inexpensive yacht from The Skipper's Marina. The Skipper agrees to the sale only on the condition that Selma get a co-signer for the note she will be giving to him. Patty agrees to and does co-sign the note. Selma takes possession of the boat and registers it in her name. She arranges for it to be docked at a nearby yacht club that she has joined and regularly pays for the boat's fuel and other maintenance expenses. Patty, as it happens, doesn't like boating at all. She consistently turns down Selma's invitations that she "come out for the day" on the yacht.

s Patty an accommodation party under this set of facts?

What if Patty were as enthusiastic about boating as is Selma? Patty joins Selma on the boat often and agrees to share the expenses of paying for, docking, and maintaining the craft. Patty also feels free to, and does on occasion, take the yacht out on her own. Can Patty still claim to be an accommodation party under these facts?

What if the facts are somewhere in between those given in (a) and (b)? Patty doesn't avoid the yacht entirely, but goes out on it only occasionally and then only when Selma is at the helm. Should the issue arise, can Patty be classified as an accommodation party and take advantage of any special rights she may have deriving from that status?

Seller agrees to deliver a quantity of goods to Buyer on credit. Buyer is required to sign a note promising to pay the purchase price within a year from the date of delivery. Seller also insists, as part of the arrangement, that Buyer have some independent party, Guarantor, sign the note as an accommodation party. Buyer and Guarantor both sign the note. When the goods are delivered, it turns out that they are totally substandard and without question fail to meet the requirements of what Seller was bound to deliver under the contract of sale. Buyer returns the goods to Seller. A year goes by and the note is still in the hands of Seller. You may assume that if Seller attempted to sue Buyer on its obligation as a maker of the note, Buyer would have a complete defense based on the quality of the merchandise delivered.

If instead Seller were to sue Guarantor under its contractual obligation on the note, would Guarantor be able to rely upon the same defense based on the poor quality of the goods? See §3-305(d).

What if instead the goods as delivered were just what was ordered? Buyer keeps the goods, but when the time comes for it to pay on the note, it has undergone such financial problems that it has been forced to declare bankruptcy and thus will be able to avoid payment on the note. Will Guarantor be off the hook as well in this situation?

In April 2012, Homer arranges to borrow $45,000 from the Springfield National Bank, to set him up in a small business that he is sure will make him a ton of money. To get the loan from the bank, Homer has to ask his friend and neighbor Flanders to co-sign the note given to the bank. Flanders agrees to do so. The note that both of them sign calls for payment of the $45,000 plus interest on April 15, 2014. By early 2013, it has become apparent that Homer's get-rich-quick scheme is going nowhere and is steadily losing money. Homer contacts the bank, which agrees that if he will pay it $30,000 immediately it will release him from any further obligation on the note. Homer scrapes up this amount of cash and takes it to the bank, which gives him in exchange a signed writing renouncing all further rights against Homer on the note.

Can the bank later reverse its decision and sue Homer for the remainder due on the note when it comes due in April 2014? See §3-604.

s the bank barred from suing Flanders on the note for what is due on April 15, 2014, minus the $30,000 previously paid on the obligation by Homer? See §3-605(b).

The basic situation remains the same: Homer signs a note agreeing to pay Springfield Bank and Trust the sum of $45,000 plus interest on April 15, 2014, and Flanders signs the note as an accommodation to Homer. When Homer approaches the bank in early 2013, telling it of his financial troubles, it agrees not to release him from his obligation on the note but rather to extend the time he has to pay on it. Homer is now given until April 15, 2016, to come up with the $45,000 plus interest, which will continue to accumulate at the same rate as it has previously. Flanders is not informed of this renegotiation by Homer and the bank. By the time April 2016 comes around, Homer is flat broke. He is unable to pay the bank, or anyone else for that matter, a penny. The bank brings suit against Flanders as a co-maker for the full amount due on the note.

Vhat argument does Flanders have that he may not be held fully liable for the amount due on the note? By what measure may his potential liability be reduced? See §3-605(c).

Would your analysis of the situation be any different if it were shown instead that Flanders had in fact been informed at the time the extension was granted by the bank to Homer and that Flanders made no objection to the bank's decision to grant Homer more time to repay the loan? See §3-605(i).

Suppose that there was language in the note, signed by both Homer and Flanders in the year 2012, to the effect that "any party hereto waives any defenses based on that party's status as surety for the obligation of another on this instrument." How, if at all, does this affect the situation?

Moe owns a tavern. He approaches the Springfield National Bank, wanting to borrow $70,000 for the purpose of making improvements to his establishment. The bank agrees to make the loan only on two conditions: (1) Moe must put up as collateral all of the equipment of his business, and (2) he must get a co-signer on the note he will be giving the bank. Moe enters into an agreement granting to the bank a security interest in "all of his equipment, now held or hereafter acquired," to secure repayment of the loan; he also signs all other papers requested of him by the bank in connection with this security agreement. In addition, he gets his friend Barney to co-sign the $70,000 note that he gives to the bank. Before the note comes due, Moe's business has taken a nose dive and he is forced to declare bankruptcy. The bank, it turns out, has through its own carelessness failed to file an Article 9 financing statement covering the collateral. As a result of this oversight, the bank is not able to establish a perfected interest giving it any special right in the equipment at the time of the bankruptcy. The bank is reduced to the position of a general (rather than a secured) creditor and as a result gets none of the $70,000 it is owed by Moe at the distribution of the bankruptcy estate.

The bank goes against Barney as the accommodation party on the note. Assuming that the value of Moe's equipment was around $38,000, how much is the bank entitled to collect from Barney?

What would the bank be able to collect from Barney if the value of the equipment at the time of the bankruptcy was nearer the $100,000 mark?

Explanations

This is most definitely an example of an accommodation signature. The first time Graphics signs, he signs as president of the corporation and binds the corporation as the principal debtor on the note. The second time he signs with his name only, and his signature binds him personally as an accommodation party, in this case an accommodation co-maker. The accommodated party is the corporation, Graphics Surprise, Incorporated.

You might have been tempted to say that Graphics could not be an accommodation party, as he will personally benefit from the loan "his" corporation has been able to obtain, and indeed in various ways he will benefit. He is, after all, the president of the corporation, and what's more important its sole shareholder and probably an employee as well. The key, however, is that all of this would be classified, at least in the minds of the U.C.C. drafters (as we will soon confirm) as indirect rather than direct benefit to Graphics personally. A signer can be an accommodation party under §3-419(a) as long as he is not "a *direct* beneficiary of the value given for the instrument." As Comment 1 to this section explains,

> Subsection (a) distinguishes between direct and indirect benefit. For example, if X cosigns a note of Corporation that is given for a loan to Corporation, X is an accommodation party as long as no part of the loan was paid to X or for X's direct benefit. This is true even though X may receive indirect benefit from the loan because X is employed by Corporation or is a stockholder of Corporation, or even if X is the sole stockholder so long as Corporation and X are recognized as separate entities.

For a decision that follows the lead of this language in the commentary, see *Plein v. Lackey*, 149 Wash. 2d 214, 67 P.3d 1061, 50 U.C.C.2d 234 (2003), a case otherwise most instructive because the plaintiff did not think of invoking Article 3 and §3-419 in particular until the final stage of a lengthy litigation in his petition for review before the Supreme Court of Washington. The plaintiff eventually won, but how much more smoothly things would have gone had he or his counsel picked up earlier on the obvious fact that Article 3 governed—and easily resolved—the situation, we can only guess.

In our example, as long as Graphics makes sure that all the loan proceeds go directly into the corporate treasury, are used for legitimate corporate purposes, and are not carelessly commingled with his own personal funds, he should be able to characterize himself as an accommodation co-maker should the need ever arise in the future for him to do so.

The basic scheme we see in this example—of one and sometimes several of the principals of a small corporation acting as surety, and in this case as an Article 3 accommodation party, for an obligation taken on by the corporation directly—is a very common one in business. Can you appreciate why a lender would not be comfortable getting the assurances of the corporate borrower alone that the loan will be repaid?

Homer is the accommodation party. Although Homer might want to argue, if for some reason it would make a difference, that his signature was an indorsement and not that of a maker, he would almost assuredly lose on this point. It is technically true that under Article 3 there is no requirement of *where* an indorsement must be placed on an instrument. However, the courts have generally ruled that someone signing at the bottom of the front of a note is signing in just the space conventionally reserved for the signatures of makers and will, unless there is very clear language to the contrary, be so classified. Homer is an accommodation co-maker. Lisa is the accommodated party.

This should not change the situation. As long as all of the direct benefit of the loan is going to Lisa, and Homer is receiving only indirect benefit from his signature (such as the pleasure he gets from being of assistance to his daughter, not having to drive her wherever she has to go, and perhaps just getting her out of the house), he is still signing as an accommodation party. The fact that his accommodation status is not clearly evident from a full reading and examination of the instrument alone is not decisive. As Comment 3 begins: "As stated in Comment 1 [where exactly?], whether a person is an accommodation party is a question of fact." Here the facts all point to Homer's being an accommodation party only. A separate question—and one that is important only in limited circumstances of the type we get into when we later touch on the suretyship defenses and §3-605—is whether any particular holder of the instrument would have notice that Homer signed for accommodation only. In our situation Wiggum would certainly have notice. He was the one who told Lisa that for her personally to obtain the loan and get the car, she'd have to get a co-signer to back up her signature. Should Wiggum sell the note to another party, that party would not necessarily have any way of knowing, at least not from the face of the instrument itself, that Homer's signature was intended to make him an accommodation co-maker only. Homer might still be able to establish himself as an accommodation party, but the burden would be on him to show that this person who took from Wiggum had either actual knowledge or reason to know that Homer had signed without receiving a direct benefit.

It's skipping ahead a bit, but take a look at §3-605(h). On the question of notice, this section refers us to §3-419(c). The important language in that section for our purposes is its first sentence:

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

> If Homer just signs his name below that of Lisa on a note that speaks only of "the undersigned Borrower(s)," as he has done here, he may later be able to establish that he was signing as an accommodation party only, and furthermore that whoever is trying to enforce the instrument against him had notice of his accommodation status, but he won't be able to take advantage of the exceptionally helpful presumption of §3-419(c) working in his favor to make his case.

Homer has done better to sign in this fashion. Should the issue ever arise of whether he was signing for accommodation only, he has the presumption of §3-419(c) to lean on. Here his signature is not an anomalous indorsement; however, it is "accompanied by words indicating that the signer [Homer] is acting as surety or guarantor with respect to the obligation of another party to the instrument [Lisa]." Assuming, as we have been, that all the direct benefit of the loan proceeds have gone to Lisa, Homer is an accommodation party and should have little trouble establishing that anyone who might later come into possession of the note had notice of the status in which he signed.

A signature on the reverse of an instrument is conventionally assumed to be an indorsement, and there is nothing to suggest that this intention was not present here. Homer is once again an accommodation party, but now an accommodation indorser. Lisa is, as always, the accommodated party.

Marge has signed as an accommodation co-maker. Bart is the accommodated party. Wiggum as the holder and person entitled to enforce the instrument is perfectly within his rights to go against Marge directly as one of the two makers of the instrument, without trying first to collect from Bart. Recall the general rule of §3-419 that the accommodation party "is obliged to pay the instrument in the capacity in which the accommodation party signs." Marge signed as one of two makers, and as such her obligation to pay on the instrument is as set forth in §3-412.

Marge has no defense that she signed merely as an accommodation party, that she received no direct benefit from the value given (that is what an accommodation party is all about, after all), nor that she received nothing in exchange from Bart or anyone else for her agreement to act as an accommodation party to help Bart out. See the very last part of §3-419(b):

"The obligation of the accommodation party may be enforced … whether or not the accommodation party receives any consideration for the accommodation." She may very well have agreed to co-sign the note only out of the kindness of her heart, to help Bart out. Even so, that in no way lessens her obligation on the negotiable instrument she signed.

Yes, the situation is different if the accommodation party signs in a way indicating that her signature is "guaranteeing collection rather than payment of the obligation of another party to the instrument." For an accommodation party to fall within the special rule of §3-419(d), the signature must truly and "unambiguously" (as the subsection makes clear) show that only collection and not payment was guaranteed. An accommodation party who signs simply as "Guarantor" or with the words "Payment Guaranteed" would clearly not be unambiguously guaranteeing collection only.

> In this part of our example, Marge was very careful and signed with the legend "Collection Guaranteed." This being the case, under subsection (d) Wiggum will have to go against Bart first. Marge can be called upon to meet her obligation on the instrument only after Wiggum has obtained a judgment against Bart and attempted to enforce it. If (i) the execution of judgment against Bart has been returned unsatisfied, (ii) Bart is insolvent or in insolvency proceedings, (iii) Bart cannot be served with process, or (iv) it is otherwise apparent that payment cannot be obtained from Bart, then and only then can Wiggum go against Marge. This obviously puts Marge much less at risk of having to pay on the instrument, or at the very least delays considerably the time when she conceivably might have to pay. In contrast, a "Collection Guaranteed" accommodation such as this is of much less value to the lender, who was willing to proceed only on the condition that Bart get someone to "stand behind" his obligation and co-sign his note. It is fairly unlikely that someone in Wiggum's position, at least if he knows what is good for him, will accept a guarantee of collection only and not a full guarantee of payment as a suitable co-signature allowing Bart to buy the car on credit. In other, more complex financial arrangements, of course, the guarantee of collection only by someone other than the principal debtor may be perfectly appropriate and all that the lender wants, or can expect to obtain, in order for the deal to go through.

If Marge does have to fork over the money due to Wiggum, she is entitled under §3-419(e) "to reimbursement from the accommodated party and is entitled to enforce the instrument against the accommodated party." This last language, allowing her "to enforce the instrument" against Bart, is not just a duplication of the right to reimbursement (also provided for). Reimbursement would entail Marge's getting from Bart (if she can find him) just the amount she had to pay out of her pocket to Wiggum. Often a straightforward reimbursement will be enough to satisfy the accommodation party who has been made to pay on the instrument—and indeed, in many cases the accommodation party will feel lucky if she can get just this. The provision permitting the accommodation party who has had to make payment to "enforce the instrument," however, allows for more than mere reimbursement. The accommodation party who pays the instrument then, in effect, takes up the instrument and can assert any of the rights that the initial obligee (here Wiggum) had on the instrument against the accommodated party (Bart). So, for instance, if the terms of the note allowed the holder to accelerate the amount due upon a default, or to charge some reasonable penalty against the defaulting borrower, or to recover its attorney's fees involved in collection, Marge would succeed to those rights once she has paid Wiggum. Also, assume that Wiggum had initially, in addition to insisting that Bart get a co-signer to back up his obligation on the note, taken a security interest in the car he was selling to Bart as collateral to further ensure the payment of Bart's debt. Marge, once she has paid off Wiggum, would step into his shoes, obtaining such rights as he had against Bart; this would include the rights to consider the car (if she can find it) as collateral supporting Bart's obligation to pay her what he owes on the note. See Comment 5 and the *Plein v. Lackey* case cited earlier.

> The situations in this and the previous example—where a parent agrees to act as surety for his or her child for whom credit is understandably hard to obtain—are typical of a whole other group of transactions in which the nature of accommodating another on a note is employed. All kinds of circumstances are possible, of course. For a rarer case in which a high-school-age son signed a note to accommodate his mother without reading it (because he had come into the house "tired from work"), see *Ruane v. Jancsics*, 2001 Mass. App. Div. 103, 45 U.C.C.2d 1121. What school he was in or what job he was working when he was held liable as an accommodating party the court does not tell us.

Yes. Patty, whatever her motives for agreeing to sign the note, receives no "direct benefit," as that term is used in §3-419(a), from the value given for the instrument, the boat. As this example is meant to explore, it is not necessarily crystal clear in all cases whether someone claiming to be an accommodation party has in fact received what would amount to a direct benefit for the purposes of this subsection, and hence would not meet the test for being an accommodation party. The Code nowhere provides a definition of the term nor a standard for distinguishing a direct benefit from an indirect one. In this part of the example, however, Patty—who chooses to have nothing to do with the boat in question or boating in general—clearly has gotten no direct benefit, however that term should be understood, from Selma's acquisition and will qualify as an accommodation party.

Patty can still claim to be an accommodation party, but under this set of facts it is far less clear that she should or would be so characterized. Even though the boat may be registered in Selma's name only, so that she is technically the owner, Patty seems to be getting the same benefit from its acquisition as is Selma. Patty could try to argue that she is only receiving the "indirect benefit" of having a sister who owns a yacht and is generous about inviting her aboard and letting her use it on occasion, but the picture here seems to show that Patty is a direct beneficiary of the purchase of the boat in the same way that Selma is, if not exactly to the same degree. Whether or not a person is an accommodation party is always a question of fact, and the facts here could make it hard for Patty to prove that she had accommodation status.

Notice that the result would not necessarily be different even if Patty had signed with the notation "as Guarantor" under Selma's unqualified signature. True, under §3-419(c) Patty's signing in this manner would create the presumption that she is an accommodation party, but this is only a presumption and is subject to rebuttal. The first paragraph of Comment 3 to §3-419 reminds us of the basic proposition that whether a person qualifies as an accommodation party is always a question of fact. Subsection (c) creates the presumption of accommodation status in certain circumstances, but it is a presumption only and can be overcome by the right evidence. This paragraph of the comment concludes, "A party challenging accommodation party status would have to rebut this presumption by producing evidence that the signer was in fact a direct beneficiary of the value given for the instrument." If Patty is truly using the boat as if she were a co-owner, as the facts here suggest, anyone later trying to hold her liable on the instrument might well be able to rebut any presumption that she is an accommodation party, no matter how she signed the instrument.

The facts are now somewhere in between those of parts (a) and (b), and it will not surprise you that being confident of the correct answer is just that much harder. Patty is deriving *some* benefit from Selma's purchase of the boat, but does it rise to the level of a direct benefit, or is it merely, as Patty will argue, an incidental and indirect benefit? Perhaps further investigation of the facts would clarify the matter, but even with all the facts at hand the issue can be a close call and there is simply no bright-line test that will resolve it. The cases that have had to address situations such as this (under the prerevision version of Article 3, which employed slightly different language to define an accommodation party but did not seem to be aiming for a different analysis) have done the best they could in sorting out direct from indirect benefit, but, as we would expect for such a fact-specific issue, the results have not been noted for any great consistency.

Yes. We have not yet had the opportunity to explore the defenses that a party to an instrument will be able to assert, and then with what success, when that party is sued on the obligation it undertook by signing the instrument in one capacity or another. The rules, as we will see, depend on the nature of the defense and furthermore on who is seeking enforcement. I trust, however, that you didn't find it hard to accept what I asked you to assume for the purposes of this question. If the note is still in the hands of Seller, and Seller tries to enforce it against Buyer, Buyer's defense here—what would amount to a total failure of consideration—would be good against Seller. The relevant point for our present purposes is, as you saw in §3-305(d), that Guarantor as surety would be able to assert this same defense against Seller if Guarantor, rather than Buyer, were being sued on the note. With certain limited exceptions of which we will soon take note, any defense that the accommodated party would be able to assert is also available to the accommodation party being sued on the instrument.

What we are seeing here is not an example of the so-called suretyship defenses. We come to those in the next example. Those are defenses available only to an accommodation party and then only under very distinct circumstances. Here the defense of failure of consideration, which Buyer would be able to assert if it were being sued by Seller, is available to Guarantor as a *derivative defense*. Guarantor has agreed, by becoming an accommodation party, to stand behind and act as surety for whatever obligation the accommodated party may legitimately owe.

> Buyer does not owe Seller anything—not on the underlying contract for sale and not on the instrument given as payment—for the goods that were not up to the contract specifications and that in fact were returned to Seller. The accommodated party having no obligation to Seller under the circumstances, Guarantor has every right to assert and prove this to be so and that therefore it has no duty to pay what the accommodated party does not itself owe.

No, Guarantor will not be able to use as a defense the accommodated party's bankruptcy. As you saw when you read §3-305(d), the accommodation party may assert against the party seeking enforcement any defense that the accommodated party would be able to assert "*except* the defenses of discharge in insolvency proceedings, infancy, and lack of legal capacity." This makes sense. These three defenses might well be available to the accommodated party in some situations, but they do not arise because that party has no obligation to pay what he or she has promised. Rather, they cover situations in which, because of special rules of law, the obligation of the accommodated party cannot be enforced against it, even though it truly does owe some amount of money. It is just these situations that potential creditors find most worrisome—that the principal debtor may owe money that it cannot be made to pay (because of a discharge in bankruptcy, for example)—and exactly the reason why such a creditor is apt to ask for a personal guarantee from some other party. In case the principal debtor, the accommodated party in our story, does go bankrupt, the creditor wants to have some other solvent party against whom it can proceed to collect on the debt. If the surety—or as we say in the negotiable instrument context, the accommodation party—were to be able to avoid obligation when the accommodated party goes bankrupt, it would greatly undermine the very assurance with which the creditor is seeking to provide itself by insisting that someone sign in accommodation for the principal debtor. From the creditor's point of view, what's the value of getting someone else to back up the debtor's obligation if the back-up is immune from suit in just those eventualities about which the creditor is most concerned, and in which being able to proceed against the surety will be most necessary?

No. Under §3-604(a), the bank as the person entitled to enforce the instrument may, as it has done here, "discharge the obligation of a party [Homer] to pay the instrument." The bank in this instance has done so by a signed writing renouncing any rights against Homer. In return it has received consideration of $30,000 cash from Homer, but as you can see in §3-604(a), a person entitled to enforce can discharge a party to an instrument by its voluntary act even if no consideration is given. Homer has no further obligations on the note.

No. Under §3-605(b), discharge of Homer *does not* discharge the obligation of Flanders, an accommodation party having a right of recourse against Homer, the discharged party. The bank can hold Flanders responsible for what is still due, above and beyond the $30,000 it earlier received from Homer, on the instrument. Once Flanders pays this amount, he has of course a right of recourse against Homer, the accommodated party, for reimbursement, but if Homer is unable to pay Flanders will have to bear the loss. That's the kind of thing that can happen when you agree to serve as an accommodation party on an instrument. Flanders can take comfort in the fact that he has acted as a good friend and neighbor, but in doing so he took on a risk that came back to haunt him.

At first it might strike you as strange that the holder of the instrument and the accommodated party, here the bank and Homer, can agree between themselves to release the accommodated party from any further liability on the instrument and at the same time allow the holder to retain all of its rights against the accommodation party, Flanders. Note that this result does not depend on the bank and Homer getting Flanders's agreement to the discharge transaction; Flanders need not even be made aware of it. What is to keep the bank and Homer from agreeing to a discharge of Homer for little or nominal consideration, comfortable in the fact that the bank can then collect the full value of the note from the friendly and solvent Flanders when the time comes for payment? One response to this question is that, like all other actions under any article of the Code, the discharge transaction is subject to the general obligation of good faith found in §1-203 or §1R-304. We will need to consider the notion of good faith in various topics yet to come, but do look at the definition of *good faith* as it appears in §3-103(a)(4) or now in §1R-201(b)(20): "'Good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing." Were the bank to discharge Homer from any further responsibility on the note for no good reason other than to put Flanders in the hot seat by shifting the obligation to pay onto him, Flanders would doubtless have a strong argument that the bank had not acted in good faith in so doing.

Although the legal obligation of good faith offers Flanders protection against some type of collusive effort on the part of the bank and Homer to shift the principal responsibility for paying on the note onto him, it is unlikely that the issue of good faith would ever even arise. As a practical matter, Flanders's real protection against the bank's too cavalierly discharging Homer from future liability on the note is the simple fact that creditors just don't do that sort of thing. We have to assume, unless the bank is unlike any lender we have run into in the past, that it is not going to release *anybody* from *any* obligation owed to it without a very good reason. In agreeing to release Homer from any further obligation in return for an immediate payment of $30,000 in early 2013, the bank must have made a calculated business determination that Homer's financial situation would simply deteriorate further and the prospects for the bank's getting even this much from him in the future would only diminish as time went on. By taking the $30,000 from Homer when it did, the bank was making a cold-hearted decision that this was the most it would ever be able to get from Homer on the note, and that it would be better to take what it could at the time rather than risk further loss in the future. We have to assume as well that the figure of $30,000 was not picked out of thin air, but was the result of a negotiation in which the bank aimed at squeezing as much out of Homer as it possibly could at the time. Just as the prudent and professional lender is not about to release any party without what it deems at the time to be a good reason, it is not going to do so for any less in return than it can possibly get that party to come up with. Of course Homer has the sense to agree to pay $30,000 prior to when it is due only in exchange for being released from any further obligation on the note, but that is only to be expected.

Flanders, as we know, remains liable as an accommodation party for the remainder of what the bank is due. He of course has a right of reimbursement from Homer, but if the bank's prognosis of Homer's financial future is correct, it is unlikely that Flanders will have much success in getting reimbursement from Homer of what Flanders is eventually made to pay to the bank. The point to be made, however, is that if the bank was taking care of its own business properly, it was at the same time really acting in a way compatible with and not contrary to Flanders's interests. True, Flanders is almost assuredly going to lose some money, but had the bank not made the earlier settlement with

Homer, the amount due from Homer on April 15, 2014, would have been the full $45,000 plus interest, and the possibility that Homer could have been made to pay even $30,000 toward this amount would have been all the more remote. Remember that the reason the bank agreed to release Homer earlier for less that the full sum due was not just to be nice; it had made a pragmatic determination that Homer's get-rich-quick scheme was not working out as planned, that his financial situation was worsening, and that his ability to pay anything on the note would only lessen over time. Homer might have been flat broke by the time April 15, 2014, rolled around. Flanders would have had to pay the full amount due on the note with little hope of getting anything in the way of reimbursement from the now-penniless Homer. So Flanders has to take some comfort in the fact that had the bank not entered into the discharge agreement with Homer earlier, he would in all probability have been required to pay even more on account of his having agreed to act as an accommodation party than the liability he now faces. The first paragraph of Comment 3 to §3-605 calls upon this same line of thinking to justify the rule of §3-605(b). As the penultimate sentence in that paragraph concludes, "Settlement [between the creditor and the principal debtor] is in the interest of sureties as well as the creditor."

Flanders would invoke §3-605(c), asserting the suretyship defense available to him because of the bank's agreement with Homer to extend the due date on Homer's obligation. As that subsection states, when the due date has been extended in this way by agreement between the person holding the instrument and the accommodated party,

> the extension discharges an … accommodation party having a right of recourse against the party whose obligation is extended to the extent the … accommodation party proves that the extension caused loss to the … accommodation party with respect to the right of recourse.

Flanders would first have to establish that he signed the note as an accommodation party only, but that should not be hard in this instance. He would then bear the burden of proving the extent, if any, to which the extension caused a loss to him "with respect to the right of recourse" against Homer. What might such proof entail? Suppose that Flanders could prove that although Homer was in dire financial straits at the time of the initial due date, he could somehow have come up with the full measure due (the $45,000 plus interest) to pay off the note had the bank not extended the time for him to pay. If this were true, then but for the extension Flanders would have had to pay nothing as an accommodation party. Even if the bank, rather than fight Homer tooth and nail, had agreed to take, say, $40,000 flat from Homer in exchange for releasing him from obligation on the note as of April 15, 2014, and had then gone against Flanders for the remainder at that time (as we saw it could under §3-605(b) in the previous example), Flanders would have been able to assert his right of recourse against Homer for what Flanders would have had to pay the bank and would have come out whole. As it turned out, however, by its agreement to extend the time for Homer to pay, all the bank did was allow the situation to degenerate to the point where Homer could not pay a thing. The bank will collect the full amount due on the note from Flanders, but Flanders's right to reimbursement from Homer has been rendered valueless by the passage of the extra time until April 2016. Suppose that Flanders could prove the facts to be as we've just assumed them: That, in effect, the bank's agreement to extend the due date of the instrument turned the situation from one in which Flanders would not have had to lose anything as an accommodation party (if the original due date had not been tampered with and Homer had been made to pay in 2014) to one in which Flanders was made to pay the entire amount due in 2016, with no hope of reimbursement from a now-destitute Homer. You can see how Flanders could argue that the extension caused him a loss in the full amount of what the bank is demanding he pay in 2016 in his accommodation role on the instrument. Had the bank not agreed to the extension, Homer would have scraped up the money to pay in 2014 and Flanders would have been off the hook entirely. With the bank having agreed to the extension, and Homer's financial condition further deteriorated, Flanders now stands potentially liable for the full debt with no chance of reimbursement from Homer. In the face of such proof by Flanders, the general law of suretyship and §3-605(c) discharges the surety or accommodation party to the extent that the extension of time granted by the creditor (the bank in this instance) actually caused loss to the surety. If the facts are as we have been assuming them to be, Flanders would be fully discharged, in light of the extension, from having to pay anything on the note.

Assume the facts to be otherwise. In particular, assume that Homer was already out of money by 2014. Had the bank not agreed to the extension, it would have attempted to collect from Homer but gotten nowhere. It would then have collected the full amount due from Flanders as the accommodation party. Flanders would, of course, have sought reimbursement from Homer, but if Homer doesn't have the money in 2014 to pay the bank then he's not going to have it to pay to Flanders. Under this assumption, Flanders would have ended up paying the full amount due on the note with no reasonable prospect for reimbursement in 2014. The extension of the due date on the note to 2016 doesn't really cause him any further loss. He can be made to pay the full amount because of his agreement to accommodate Homer on his neighbor's obligation to the bank, but he would have had to do so and pay just as much even if the extension had not been granted by the bank. The extension does not cause any additional loss to Flanders. By the end of the term initially agreed to (April 15, 2014) his fate was sealed. Under this scenario, Flanders cannot prove any loss to him caused by the extension. (If anything, there was at least the possibility, even if it didn't pan out here, that if Homer had been given some more time to come up with the money, he might have been able to pay all or at least a portion of what was due on the note by 2016, thereby decreasing the amount Flanders would have to pay on his accommodation contract.) Because Flanders would be unable to prove, under this set of facts, that the extension caused him any loss with respect to his right of recourse, he would not be discharged at all from what he now will be obligated to pay the bank in 2016.

Of course, all kinds of situations can arise where the facts are not as all-or-nothing as I have presented them in the two previous paragraphs. The principle remains the same. Assume that Flanders can prove that, had the extension not been granted by the bank, Homer would have been forced to pay, either to the bank or by way of reimbursement to Flanders, some amount X, perhaps less than all he owed but a significant sum nonetheless. As it turns out, the extension is granted and the most that can be gotten out of Homer in 2016, either by the bank or by Flanders, is some other sum Y. If X is less than Y, Flanders has not suffered any loss as a result of the extension, and he will have no right to any discharge under §3-605(c). If, however, X is greater than Y, Flanders is discharged from the amount he will have to pay the bank in 2016, to the extent of X minus Y. In practice, of course, the trick—or rather, the subject of what may turn out to be extensive litigation—is to determine the true value in dollars and cents of the Xs and Ys of the situation.

I did not think it advisable to lengthen this chapter still further by giving you an example on point, but you should be aware that §3-605 deals, in subsection (d), with a different but related set of circumstances. That subsection sets forth the rule when the creditor and the accommodated party agree "to a material modification of the obligation of [the accommodated] party other than an extension of the due date." So, for example, the bank and Homer could agree to keep the due date on the note as is but to increase the principal or to raise the rate of interest, either of which could obviously end up having some detrimental effect on Flanders's position as an accommodation party. The way subsection (d) deals with such situations is basically the same as what subsection (c) does when the alteration is only that of an extension of the due date on the instrument: The accommodation party is discharged from obligation on the instrument to the extent the material modification causes it actual loss. The one significant difference between (c) and (d), however, and the reason the drafters chose to cover the different situations in two distinct subsections, has to do with burden of proof. In subsection (c), which is concerned with modifications the only effect of which is to extend the accommodated party time for payment, the burden of proof is on the accommodation party to show loss caused to it by this modification, and its obligation is discharged only to the extent of the loss it can prove. In subsection (d), which deals with modifications other than extensions of time, the presumption is that such a modification effects a loss to the accommodation party, and the rule is that there is a full discharge "unless the person enforcing the instrument proves that no loss was caused by the modification or that the loss caused by the modification was an amount less than the amount of the right of recourse." The reason for the drafters' decision to treat the two cases differently in this respect is given in Comment 5:

> The rationale for having different rules with respect to loss for extensions of the due date and other modifications is that extensions are likely to be beneficial to the surety and they are often made. Other modifications are less common and they may very well be detrimental to the surety. Modification of the obligation of the principal debtor without permission of the surety is unreasonable unless the modification is benign. Subsection (d) puts the burden on the person seeking enforcement of the instrument to prove the extent to which loss was not caused by the modification.

If Flanders had been made aware of the extension entered into between Homer and the bank and had not objected, he would be barred from later asserting any suretyship defense otherwise available to him under §3-605.

The bank could point to §3-605(i) and show that Flanders's failure to object to a modification of which he was aware constituted consent to the modification.

Such a clause in the note, or in any other writing signed by Flanders at the time he took on the obligation of an accommodation party, would deprive him of the right to assert any of the suretyship defenses of §3-605 should the need or the hope of doing so ever arise. Under §3-605(i), a party may not be discharged under §3-605 if "the instrument or a separate agreement of the party provides for waiver of discharge under this section either specifically or by general language indicating that the parties waive defenses based on suretyship or impairment of collateral" (the situation we deal with in the last example). As a matter of fact, such clauses generally and prospectively waiving any and all suretyship defenses are quite common. As Comment 2 notes,

> The importance of the suretyship defenses is greatly diminished by the fact that they can be waived. The waiver is usually made by a provision in the note or other writing that represents the obligation of the principal debtor. It is standard practice to include a waiver of suretyship defenses in notes given to financial institutions or other commercial creditors. Section 3-605(i) allows waiver. Thus Section 3-605 applies to the occasional case in which the creditor did not include a waiver clause in the instrument or in which the creditor did not obtain the permission of the surety to take the action that triggers the suretyship defense.

See, for example, *Decatur County Bank v. Smith*, 1999 Tenn. App. LEXIS 864, 40 U.C.C.2d 1236.

Springfield National Bank should be able to collect $32,000 from Barney but no more. The bank could sue Barney for the full $70,000, but Barney should know enough to assert the suretyship defense of so-called impairment of the collateral, provided for in §3-605(e). (This all assumes, of course, that at the time of the initial transaction Barney did not sign anything waiving for all time his right to assert such a defense under §3-605(i).) Under subsection (g), impairing the value of an interest in collateral includes "failure to obtain or maintain perfection or recordation of the interest in collateral," and that is exactly what the bank did here. Under Article 9 of the U.C.C., the bank's failure to file with the proper public records office a financing statement covering the collateral in question rendered its security interest unperfected. Had it done what it was supposed to and filed, it would have had a perfected interest in this equipment, and upon Moe's bankruptcy would have been able to turn this interest into $38,000, which it would then have applied against the debt. Instead, it got nothing of value from its security interest, because of its own failure to protect its interest as it should have, and as Barney could reasonably have expected it to have done.

Under §3-605(e), this impairment of the collateral by the bank discharges the obligation of the accommodated party "to the extent of the impairment." The language of the subsection on how to measure the extent of the discharge to which the accommodated party is entitled in such a situation is fairly dense and not the easiest to read, but the basic principle is not that hard to follow, and it will do for our purposes. In the situation we have before us, had the impairment of the collateral not occurred the bank could have gotten $38,000 of what it was owed from enforcing its rights in that collateral. That would have left it unpaid to the tune of $32,000, and it would have gone against Barney for only that much. Barney would have had to pay the $32,000 to the bank on his accommodation contract. He would of course have a right of recourse against Moe for this amount, but as Moe is bankrupt it is highly unlikely that Barney will ever see a penny from him. The bank, having impaired the value of the collateral right down to zero dollars, can sue Barney for the $70,000, but Barney will be able to argue that he has been discharged to the extent of $38,000 of this obligation, due to the bank's impairment of the collateral.

If the collateral that the bank, through its own failure, let slip through its hands was worth something like $100,000, or anything over $70,000 for that matter, then Barney would be able to argue total discharge of his obligation based on the accommodation signature. Had it not impaired the value of the collateral, the bank would have been able to walk away from the bankruptcy fully satisfied, thanks to its judicious decision to take a security interest in collateral to protect its position and the fortunate fact that when the time came for it to rely on that interest the value of the collateral exceeded the obligation it was owed by Moe. The bank would have had no reason to come against Barney for anything; even if it had, and Barney had been made to pay $70,000 to the bank, Barney would then have a right of recourse against Moe. And Barney's right of recourse would then automatically have been secured by the security interest initially taken by the bank. See Comment 5 to §3-419:

> Since the accommodation party that pays the instrument is entitled to enforce the instrument against the accommodated party, the accommodation party also obtains rights to any security interest or other collateral that secures payment of the instrument.

Barney, now owed $70,000 by Moe under §3-419(e), would himself be able to go against the collateral. Because it is worth more than what he is owed by Moe, Barney will be made whole that way. This all depends, of course, on the rights in the collateral not having been impaired. Once the bank impairs the value of the collateral, neither the bank nor Barney (if he is made first to pay the bank and then later look to Moe for reimbursement) can get any value out of the equipment to lessen the amount due from Moe. Moe is not able to pay anybody anything. So the bank's failure to protect both itself and the surety, Barney, by properly taking, perfecting, and maintaining perfection of a security interest on equipment that would be of some value in the bankruptcy proceeding, has by its impairment of the collateral discharged Barney in this case from having to pay anything on his contract as an accommodation party. For a case of this type, when an accommodation party alleged, but had offered no evidence to prove (thus denying her the right to summary judgment in her favor), impairment of the collateral by the lender, see *J.B. Allen, Inc. v. Pearson*, 31 S.W.2d 526, 43 U.C.C.2d 360 (Mo. App. 2000).

See Revision Proposals on the following page.

Revision Proposals

Revised §3R-419 now contains a subsection explicitly stating what we have been assuming all along, that a person signing an instrument "accompanied by words indicating that the party guarantees payment or the signer signs the instrument as an accommodation party in some other manner that does not unambiguously indicate an intention to guarantee collection rather than payment, … is obliged to pay the amount due on the instrument … in the same circumstances as the accommodated party would be obliged, without prior resort to the accommodated party by the party entitled to enforce the instrument." Nothing terribly novel here.

In contrast, §3R-605 has been totally rewritten, right down to all the accompanying comments. This major overhaul is intended, as the drafters inform us in the Prefatory Note to the Amendments to Article 3 and 4 constituting the 2002 revision, to conform this provision to the language and rules of the recently issued (in 1995) and well-received (if they do say so themselves) *Restatement of Suretyship and Guaranty*. The amendment to this one section alone, in fact, makes up something like one-half of the length of the entire set of amendments. With all this rewriting, no doubt there are substantive changes here and there, but this is certainly not the place to go into them in all their gory detail. Should a question arise that needs to be addressed by §3R-605, you should find help in the new commentary, even more copious than what it replaces, which has already been described by some as a “mini-treatise,” not just on the workings of this section but on suretyship law in general.

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* This is one situation where I do not suggest that you immediately try to read through the entire text of these two sections, much less the rather voluminous Official Commentary with which the drafters have provided us, on your own at the outset. The twists and turns in this area of law, whether as a general matter of common law or as the drafters of Article 3 have attempted to pin them down, are many. Our goal in this chapter is not to go through all of the minutiae of this material or these sections in all their agonizing (or mesmerizing, depending on how you look at these things) detail. It will be enough for you to get a good grasp of the basics and an appreciation of what kinds of further problems might have to be addressed and where to look for guidance when reference to the finer technicalities becomes necessary.

* You need not worry about the separate reference to the indorser in the caption to or other parts of §3-605, which we will cover. In some instances an indorser acts as a surety even though it does not technically fit within the definition of an accommodation party under §3-419(a). The drafters did their best to cover all the bases and capture each and every detail in their careful rendition of §3-605 and the comments thereto. Even after all that work was done, they were called upon to reexamine some 11 distinct issues related to the general matter of suretyship under the new Article 3, in a Commentary No. 11 issued in 1994 by the Permanent Editorial Board for the Uniform Commercial Code. This Commentary in turn revised some of the Official Comments. The degree of embellishment and complexity here can be truly daunting. Fortunately, it is not our goal here to master the field in all of its sophisticated variations. We are interested in getting a general appreciation of the main lines and contours of what §3-605 and the accompanying commentary cover in such loving detail. For our purposes, it will be more than sufficient to deal with only the simple situations and leave the seemingly endless variations on the principal themes to another day.

CHAPTER 6

Effect on the Underlying Obligation

INTRODUCTION

Negotiable instruments are, as you are by now no doubt more than ready to concede, distinct and utterly fascinating pieces of paper. Their importance, of course, lies not in the pure beauty of the form, nor in the intricate rules by which they are distinguished from other types of writings, nor in the specialized mechanics governing how they may be passed from hand to hand, nor even in how the rules pertaining to them both create and simultaneously record a special breed of legal obligations as these fascinating bits of paper move from party to party. Negotiable instruments take on their true importance because of the function they serve in the real world of commerce.

It is perfectly possible, of course, for a negotiable instrument to be issued with the issuer having no business purpose in mind; we have already noted that one may draw a check, for example, for the purpose of making a gift to a friend or a donation to a charitable institution. In the vast majority of cases, though, the reason a negotiable instrument has been called into being is that the issuer can use it to pay for something. The genesis of the typical negotiable instrument, if you will, is some duty arising under some other area of law—the duty to pay under contract law for goods or services received, the duty to repay a loan, the duty to pay a judgment rendered against the issuer, or any other duty that can be and has been reduced to the obligation to pay a sum of money—which duty the obligor is intending to fulfill by handing over to the obligee not a pile of cash, but some negotiable instrument to serve in its stead. It is customary to refer to this background debt or other duty to pay as the *underlying obligation* explaining why the instrument was issued in the first place. The issuer's intention in creating and handing over the negotiable instrument to another is to satisfy the underlying obligation. When and how this objective is met, and what the consequences are when it is not (if, for example, the instrument is dishonored), are our concerns in this chapter. Fortunately, Article 3 covers the issues involved directly in a single section, §3-310, which you should read over carefully before you proceed to the examples.

Examples

Boris enters into an agreement to buy an expensive antique porcelain figurine from Sonya. As agreed, she hands the valuable object over to him in exchange for a cashier's check for $25,000, which he has obtained from the Independent Republic Bank. By the time Sonya gets around to depositing the check, this bank is experiencing financial difficulty and may not be able to pay on the cashier's checks it has outstanding.

f Sonya runs into trouble trying to collect on the cashier's check, may she sue Boris for what she will argue is $25,000 due her on the original contract of sale?

How, if at all, would the situation be different if, in addition to obtaining physical possession of the cashier's check at the time of the transaction, Sonya had gotten Boris to sign the back of the check before he turned it over to her?

Bert buys a used stereo system from Sarah. As agreed, he takes delivery of the stereo and promises to send her a personal check for $200. He makes out a check for this amount to Sarah's order and mails it to her. It is apparently lost in the mail and never arrives at Sarah's address. Can Sarah bring an action on the check against Bert? Can she sue Bert for breach of the original sales contract for his failure to pay the purchase price?

Bert also agrees to buy a large collection of used compact discs from one Stuart. Stuart delivers the box of CDs to Bert's house and receives in return a personal check made out by Bert to Stuart's order for the agreed purchase price.

Assume that Stuart immediately deposits this check in his own checking account. Within a few days he is able to confirm that Bert's bank has honored the check and that the amount of the check has been permanently credited to Stuart's own account with his bank. What is the situation now? Does Bert have any further obligation to Stuart, either on the underlying contract of sale or on the check?

Assume instead that a few days after Stuart deposits the check in his own account, he is informed by his bank that the check has been returned by Bert's bank unpaid and marked "NSF" (for Not Sufficient Funds, meaning that Bert didn't have enough in his account to cover the check). The dishonored check is returned to Stuart. Does he have a right to bring an action against Bert based on the contract of sale? On the obligation of Bert as drawer of this dishonored check?

Bert further enters into an agreement to buy a valuable collection of vintage long-playing records from Stella. Stella is willing to take payment for this pricey set of LPs by Bert's delivery to her of a check made payable to Stella, issued not by Bert himself but by a friend of his, Carlos. Stella deposits this check in her bank account, and her bank sends it on for collection from the bank on which it has been drawn by Carlos.

Assume the check is honored and paid by Carlos's bank. What is the result?

Assume instead that the check is dishonored and returned unpaid. Does Stella have a cause of action against either or both of Bert and Carlos, and if so on what basis?

Bertha is indebted to a local store, Smallville Office Supplies, for the sum of $1,435. She writes out a check for this amount payable to the store and mails it to the address indicated on the most recent invoice she has received. This check is received by Smallville Office Supplies, but before the store has a chance to deposit the check in its own bank for collection, the check is apparently stolen or mislaid. No one at the store can find the check or figure out what has happened to it. A month goes by and this particular check has never been presented to Bertha's bank for payment.

Can the store simply ignore the fact that it has received the check and sue Bertha for the amount of supplies she purchased, under the original contract of sale?

Can the store insist that Bertha issue it another check for the same amount?

Tenant, a freelance artist, lives in a rented loft. According to his lease, he is obligated to pay rent of $1,000 on the first of every month. When his commission work is slow at the beginning of the year, he is concerned that he will not be able to pay the rent. He gets Landlord to agree to take a promissory note for $4,500, payable on April 1, to substitute for the rental payments due on the first of January, February, March, and April of the year.

By the middle of February, Landlord is beginning to doubt the wisdom of her having taken this note and desires to evict Tenant. Assuming that the laws of the jurisdiction allow eviction of a tenant who has not paid rent for two months in a row, can Landlord evict this Tenant?

Assume that Landlord does not try to evict Tenant. Instead, she sells the note in question to a local lender, Financial Services, in the middle of February, negotiating the note over to that firm in exchange for $3,700 cash. Tenant is informed of this transaction. When April 1 comes around, Tenant does not pay the $4,500 due on the note to Financial Services. He writes to Landlord indicating that he has every intention of beginning to pay the monthly $1,000 rental again starting with the rent due at the beginning of May. Does Landlord now have any right to insist on payment for the first four months of the year? Does Financial Services have any rights against Tenant?

Explanations

No. Boris's contractual obligation to pay $25,000 for the pricey piece of bric-a-brac is totally discharged once Sonya takes the cashier's check in payment. As §3-310(a) makes clear, unless otherwise agreed (of which there is no evidence in this example), if a bank check is taken for an obligation, "the obligation is discharged to the same extent discharge would result if an amount of money equal to the amount of the instrument were taken in payment of the obligation." See *Crawford v. J.P. Morgan Chase Bank, NA.*, 2009 U.S. Dist. LEXIS 55375, 70 U.C.C.2d 96 (E.D. Mich. 2009).

Notice that Sonya does not have any cause of action against Boris on the instrument either; this was a cashier's check and Boris's signature does not appear anywhere on the check. The bank is both drawer and drawee. Boris has his figurine and has paid for it, presumably by coughing up $25,000 in cash to purchase the cashier's check from the bank. Sonya sought to ensure that she would be paid for the item she was giving up in sale by insisting on payment by a bank check. In the overwhelming majority of situations, such checks really are "the equivalent of cash" or "as good as cash," as we tend to say, from the seller's perspective and the taker will have absolutely no trouble collecting on the item. In the exceptionally rare case such as I have posited here, where the issuing bank itself runs into financial difficulty and is failing to meet its obligations, the holder of the bank's check (such as Sonya) will be left holding the bag.

Notice too that the outcome would be no different if Boris had paid with a certified or a teller's check, as opposed to the cashier's check he used. Under §3-310(a), his obligation on the underlying contract of sale would have been totally discharged by Sonya's taking of a certified check in payment. She might hope that she could hold Boris obligated on the instrument itself, as the drawer of a dishonored draft under §3-414. Recall, however, subsection (c) of that section. As we saw in Chapter 3, once a draft is accepted by a bank—as would be true when Boris got his check certified—the drawer is discharged from any obligation on the instrument. So once again Boris has been discharged from his underlying contractual obligation to pay for what he has purchased and has been discharged as well from any Article 3 obligation he might have had on the instrument given in payment. Boris is off the hook (or should I say both hooks?) when a certified check is taken for the amount he owed under the contract of sale.

Sonya's one hope of getting the money due her under this scenario is to go against Independent Republic Bank for the amount due on the cashier's check it issued. Even if the bank is experiencing difficulty in meeting its obligations, Sonya would be considered a customer of the bank protected by Federal Deposit Insurance Corporation (FDIC) insurance if the bank is FDIC-insured. If the bank cannot make the $25,000 payment, the FDIC would be obligated to do so.

If Boris had signed his name to the cashier's check prior to turning it over to Sonya, he would have become an indorser of the instrument. See the last sentence of §3-310(a): "Discharge of the [underlying] obligation does not affect any liability that the obligor [Boris] may have as an indorser of the instrument." Sonya cannot sue Boris on the underlying contract for purchase and sale. She has no right against him as drawer of the dishonored draft, because, this being a cashier's check, he is not in fact the drawer. She will, however, in this instance be able to go against him as an indorser of the dishonored draft.

Sarah cannot bring an action against Bert on the check because the check never came into her possession. We don't know where the check ends up, but we do know that Sarah is not now a person entitled to enforce the instrument. Sarah can, and presumably will, sue Bert for breach of the underlying contract of sale, unless he quickly issues her another check that does come into her possession or in some other way pays up. Section 3-310 never comes into play. That section delineates the effect of an instrument when that instrument is "taken" by the obligee in payment. Nowhere in the Code is the word *taken* defined, but it seems clear that at the very least a person, Sarah in this instance, would not be held to have "taken" a check that never even arrived at her address. See, for example, the recent case of *Barrett Business Services, Inc. v. Workers' Compensation Appeals Board*, 204 Cal.App. 4th 597, 139 Cal.Rptr. 3d 109 (Cal. App. 2012). As far as Sarah and the Uniform Commercial Code are concerned, Bert has never paid for the stereo system, and his obligation to do so has been neither discharged nor suspended by his putting a check in the mail when that check never makes it into Sarah's possession. Bert had better pay up or Sarah can sue him on his obligation undertaken in the sales contract.

Other situations can arise in which the question of whether an instrument has been "taken" for an obligation is somewhat trickier. Suppose, for example, that a contract of sale calls for the buyer to pay with a cashier's check. The buyer sends a personal check to the seller. The seller does receive it, but, wishing to insist on its rights under the sales contract, immediately returns the personal check to the buyer. It seems fair to say that the seller has not taken the check in payment. In contrast, if the seller immediately deposits and tries to collect on the personal check, even if it would have been perfectly within its rights to return the check, the seller would presumably be held to have taken the check in payment for the buyer's obligation, triggering the rules laid out in §3-310. What if the seller neither returned the personal check nor immediately deposited it? The seller just holds onto the check for a time, either because it feels it gains some advantage (but what?) by doing so, or more likely because it just is lackadaisical or downright sloppy in handling its accounts. Would it be right to say that, after a certain period of time has passed, the seller has taken the check in payment of the buyer's obligation, even if perhaps unintentionally so? There is no easy or obvious answer to this question, but it highlights the important point that only when an instrument is "taken" for an obligation may it possibly have an effect on the underlying obligation under the principles laid out in §3-310.

The result here is as you would expect. Bert has paid Stuart for the CDs and there ends the story. When Stuart took Bert's personal check in payment of Bert's payment obligation, this resulted (under §3-310(b)(1)) not in the discharge of the underlying obligation, but in its *suspension* "to the same extent the obligation would be discharged if an amount of money equal to the amount of the instrument were taken." From that point forward until the suspension is lifted, one way or another, Stuart would have no right to go against Bert on the underlying obligation. At the same time, it is not as if the underlying obligation has been finally discharged. The final discharge of Bert's obligation to pay for what he has bought comes only when the check is paid. Under (b)(1):

> In the case of an uncertified check, suspension of the obligation continues until dishonor of the check or until it is paid or certified. Payment or certification of the check results in discharge of the obligation to the extent of the amount of the check.

In the case we have before us, the check is paid. Bert has no further obligation to Stuart on the instrument itself. Nor is Bert under any further obligation on the underlying contract, as you see in the last sentence of subsection (b)(1) just quoted. Payment of the check transforms the suspension of Bert's obligation for which the check was taken into a discharge of that obligation. The transaction is wrapped up neatly, just as we expect both Bert and Stuart intended it to be. Bert has his CDs, free and clear from any further obligation to pay for them. Stuart has his money, the purchase price, in the bank. End of story.

If the check is not paid, as here, the story has not come to an end. The suspension of Bert's obligation on the underlying contract of sale—which came into effect with Stuart's taking of the personal, uncertified check in payment—is lifted once the check is dishonored. Because his obligation was not discharged by payment of the check, Bert is once again under a contractual obligation to pay the purchase price. At the same time Bert is now also the drawer of a check that has been dishonored, the check that has been returned to Stuart. Stuart could enforce Bert's obligation on the instrument arising under §3-414(b). So, once a personal check is dishonored and the suspension is lifted, the person who took the check as payment of an underlying obligation (Stuart in our example) has two ways to go: He can either proceed against the obligor on the original contractual obligation as if no payment had ever even been offered, or he can go against the obligor on that party's obligation on the dishonored instrument itself. Quoting from Comment 3:

> If the check or note is dishonored, the seller may sue on either the dishonored instrument or the contract of sale if the seller has possession of the instrument and is the person entitled to enforce it.

We have to assume that Stuart, like any reasonable person, would want to avoid the hassle of litigation if he can. So his first effort would be to contact Bert, inform him that the check has bounced, and do what he can to convince Bert to pay what is owed as quickly as possible. Only if this appeal to Bert's conscience—and of course Bert's own natural desire to avoid being hit with a lawsuit, which would mean having to deal with lawyers and their own peculiar (and usually expensive) ways of settling such disputes—fails would Stuart resort to litigation. If he is forced by the circumstances to sue, as we've seen, he has two ways to proceed: He can sue via basic contract law on the buyer's obligation to pay for goods, or he can sue under Article 3 to enforce Bert's obligation on the dishonored check. Which route Stuart (or more realistically Stuart's expensive lawyer) chooses to take may not make that much difference, but in some situations the basis on which the suit is brought can be significant and some thought will have to be given on how to proceed. (That's why Stuart's lawyer charges the quite reasonable fees that she does.)

In most instances a suit on the instrument will be the more direct and easier way to go. If Stuart were to sue on the contract of sale, he would have to allege and prove the existence of the contract, its terms, the fact of Bert's breach, the measure of his damages, and so on. It may not be hard for Stuart to establish each of these elements, but then, even what appears at first blush to be the simplest suit on a contract can have its nasty twists and turns, as no doubt you remember from your contracts course. Suit on an obligation arising under a negotiable instrument has some special features that can make it an easier operation. Many states have special streamlined procedures designed especially for enforcement of obligations owed on instruments; the person entitled to enforce need only produce a copy of the instrument itself and allege nonpayment to make out a prima facie case for relief.

Note also the special rules on pleading and proof of §3-308, which essentially give to the person enforcing an obligation on an instrument the benefit of a presumption of "the authenticity of, and authority to make, each signature on the instrument." In more complicated situations, when the terms of the contract are laid out in a complex document and the instrument is other than a simple check, comparison of the terms of the underlying contract and of the instrument is in order. A successful suit on the contract, for instance, may entitle the disgruntled seller to recovery of its attorney's fees when suit on the instrument would not. In other circumstances, the contract would not allow the seller to recover its cost of collection, but the instrument might. Such considerations will, naturally, weigh heavily in the decision of whether to proceed on the initial underlying obligation or the rights created by the dishonor of the instrument given in payment.

The result here is that Bert's obligation to pay for the LPs, created by the contract of sale, was suspended when Stella took the uncertified check, even if it was a check written by Carlos rather than Bert, in payment (§3-310(b)). This suspension of the obligation continued until the moment when the check was paid, as happily it was here, at which time Bert was discharged from his obligation to pay on the contract (§3-310(b)(1)). Bert has paid for the records, and that's that.

If the check is dishonored, two things are true. First of all, the suspension of Bert's obligation under the contract of sale to make payment for the LPs is lifted, because, under §3-310(b)(1), the check has been dishonored. Stella could sue Bert on the contract of sale. Could Stella sue Bert on the dishonored check? No. Nothing in the fact pattern suggests that Bert has signed the instrument, and so he has no obligation on it whatsoever. (This should suggest to you why Stella would have been wise to insist that Bert sign the back of the check issued by Carlos, thereby becoming an indorser against whom Stella could proceed on the instrument if all else fails. Unfortunately for Stella, there is no indication here that she took that precaution.) Secondly, Stella could bring suit against Carlos on the instrument, as the drawer of a dishonored check. She could not, of course, sue Carlos on the obligation to pay for the LPs created by the contract of purchase and sale. Carlos was not a party to that contract and never took upon himself the responsibility to pay the purchase price.

This example just highlights the fact that the two sources of potential legal liability—the obligation on the underlying contract and the obligation or obligations arising under the instrument—remain distinct even if they are temporarily "merged," as you will sometimes hear said, by the taking of the instrument in satisfaction of the contractual obligation. Once this “merger doctrine” comes into play, the underlying obligation is not just merged metaphorically into the instrument, but is suspended as a legal obligation pending the obligee’s attempt to obtain payment on the instrument. If payment on the instrument is forthcoming, both the underlying obligation and of course any obligations on the instrument are discharged. If the instrument is dishonored, both sources of legal liability revive. Whatever obligation there was on the underlying obligation, whatever its source (which need not necessarily be a contract of sale such as we’ve seen in our examples) and whoever was so obligated, comes back into existence. At the same time, any obligation or obligations on a dishonored instrument, of the type we investigated in Chapter 3, come into being by virtue of the dishonor.

No. Once the store took the check for the obligation owed to it by Bertha, that obligation (to pay for what she bought from the store) is suspended under §3-310(b)(1); because this was an uncertified check, the suspension continues “until dishonor of the check or until it is paid or certified.” None of these events has occurred. The check has not even been presented for payment, so it certainly can’t be said that it has been dishonored. Nor has it been paid or certified. See *Fidelity and Deposit Company of Maryland v. Gladwynne Construction Company*, 184 Md. App. 229, 964 A.2d 726, 68 U.C.C.2d 261 (Md. App. 2009).

An interesting recent case that tests the limit of a check being “taken” by a creditor is *Fifth Third Bank v. Jones*, 168 P.3d 1, 64 U.C.C.2d 187 (Colo. App. 2007). The defendant, Monay Jones, had signed a note for more than $280,000 payable to the bank and secured by a mortgage on her property. When she fell behind in her loan payments, the bank attempted to foreclose on the mortgage. Ms. Jones contested the foreclosure, claiming that the entire amount of the loan had been paid off by the bank’s “taking” of a check—a check for the full amount owed on the note and sent to the bank by a third party. A representative of the bank testified that the check had been received by the bank and its receipt noted in the bank’s records. The check was then forwarded to the bank’s payoff department but it appears to have been lost before it made it to that department. “The bank,” we are told by the appellate court, “notified the debtor of the loss, and both parties searched, without success, for a copy of the lost check or evidence of the identity of its maker, drawee bank, or amount.” (Ms. Jones asserted, but apparently had no evidence to substantiate her claim, that the check had been issued by an Arkansas bank at the request of her since-deceased aunt.) The trial court found by a preponderance of the evidence that the check had indeed been taken by the bank, and the appellate court upheld this determination. Moreover, the trial court found that, more likely than not, this had been a certified or cashier's check for the entire payout amount of Ms. Jones's obligation on the note. Again, the appellate court found that the evidence at trial was sufficient to support this determination. Therefore, the bank having been found to have taken a certified or cashier's check in the amount owed on the note, Ms. Jones had no further obligation on the note under the rule of §3-310(a), as we saw in the first Example of this chapter.

No. The store has no right to another check from Bertha. Look at the final paragraph of Comment 4:

> If a creditor takes a check of the debtor in payment of an obligation, the obligation is suspended under the introductory paragraph of subsection (b). If the creditor then loses the check, what are the creditor's rights? The creditor can request the debtor to issue a new check and in many cases the debtor will issue a replacement check after stopping payment on the lost check. In that case both the debtor and the creditor are protected. But the debtor is not obliged to issue a new check.

You can understand why Bertha should be under no obligation to issue a new check just because the store asks her to. Should she do so and not issue a stop-payment order on the original check, she would just be asking for trouble. That first check could later turn up, perhaps in the hands of a thief, and be presented to and paid by her bank. Bertha would have paid the same bill twice. As we will see in material to come, she would presumably have rights to recover for the wrongful payment on the first check, but, as we will also see, these rights are not always easy to assert, nor are they foolproof or cost-free. At the very least, Bertha would want to issue a stop-payment order on the first check and make sure that the stop-payment mechanism is effectively in place before she even considers issuing the store—not as a matter of right, but just to be helpful and to keep up good business relations—a second check. She might also want the store to absorb whatever fee she'll have to pay to put the stop-payment on the first check in place.

The more interesting question is why an obligor such as Bertha should not be *obliged* to respond to a reasonable request by the store that she go through this routine of stopping payment on the first check and issuing a replacement. Our first response to this is the simplest: The store's current problem is all of its own making. It has either mislaid the check or allowed it to be stolen from the store's offices. Bertha has done nothing to cause the store's present predicament. If she had dropped by the store and paid the $1,435 she owed for supplies in cash, she would not be responsible (nor terribly sympathetic) if the store later misplaced the cash. Nevertheless, if the store offers to pay whatever it might cost Bertha to put a stop payment on this check, why should she not be required to go along with what seems like a perfectly reasonable request and then issue a second check? The reality of the matter, however, is that the proper issuance of a stop-payment order, and the oversight to ensure that the order is actually observed and effective to stop payment on a check, is not always as easy as one might initially imagine. If Bertha issues two checks to pay for the same stuff, even if she has attempted to stop payment on one, she could be at some nontrivial risk, at least initially, of paying for the same stuff twice. True, she might eventually be able to sort everything out, and if the rules of Article 3 work just as they are supposed to, she should be able to get back what has been deducted from her account because both checks were paid. But meanwhile, during the course of all the investigation and possible litigation, her bank account balance will be lower than it should be—all thanks to the store's failure adequately to take care of its own affairs. It is even possible that, whatever the carefully crafted rules of Article 3 might say about the situation in the abstract, practical difficulties and mounting costs of litigation could stand between Bertha and what is technically due her.

In the majority of cases, a debtor in Bertha's position will probably do what she can to help out the creditor, and will issue a second check under the right circumstances even if it is not legally obligated to do so. If not, however, what is the creditor to do? We return to the conclusion of Comment 4 to this section:

> If the debtor refuses to issue a replacement check, the last sentence of subsection (b)(4) applies. The creditor may not enforce the obligation of debtor for which the check was taken. The creditor may assert rights only on the [lost or stolen] check. The creditor can proceed under Section 3-309 to enforce the obligation of the debtor, as drawer, to pay the check.

Section 3-309 does give the creditor the possibility of proving itself a "person entitled to enforce the instrument," but, as you can see, subsection (a) places on the creditor a set of criteria for reaching this status. Note also that under (b),

> The court may not enter a judgment in favor of the person seeking enforcement unless it finds that the person required to pay the instrument is adequately protected against loss that might occur by

reason of a claim by another person to the instrument. Adequate protection may be provided by any reasonable means.

So Article 3 places upon the creditor who finds itself without the instrument in hand the cost and bother of undertaking legal proceedings to get what it feels is owed to it. Even then, the court must be sure that the party who could potentially be subjected to a loss due to the creditor's problem be given "adequate assurance" that it will be protected from such a loss. Once the creditor, Smallville Office Supplies in our example, has obtained a court order under §3-309 entitling it to enforce the check, its obligation physically to present the (still lost) check for payment will be excused under §3-504(a)(i). The store can then treat the check as dishonored and, as Comment 4 to §3-310 has told us, "enforce the obligation of the debtor [Bertha], as drawer, to pay the check."

No. Landlord's taking of the note in substitution for Tenant's obligation to make those particular four monthly rental payments results, under §3-310(b), in the suspension of Tenant's obligation to make those payments. Under (b)(2), this suspension of Tenant's underlying obligation under the lease continues "until dishonor of the note or until it is paid." As of the middle of February, the note has been neither dishonored nor paid, so the suspension is still in place. Landlord cannot assert any legal default on the lease (at least with respect to Tenant's obligation to pay the monthly rent) and so has no grounds for eviction.

Although I can nowhere find it spelled out as clearly in the statutory text of §3-310 as the drafters of this provision seem to think they have done, the intended result is this: because the note is now in the hands of a holder who is other than the original obligee (the Landlord), the only remaining possible action is by that holder, Friendly Finance, on the note. We find this in the language at the end of the first paragraph of Comment 3. Following its statement to the effect that when an instrument other than a bank check is taken for an obligation and then dishonored, the seller (or whoever is the original obligee) may sue "on either the dishonored instrument or the contract of sale if the seller has possession of the instrument and is the person entitled to enforce it." This case we have already seen in Example 3b. This paragraph concludes, however,

If the right to enforce the instrument is held by somebody other than the seller, the seller can't enforce the right to payment of the price under the sales contract because that right is represented by the instrument which is enforceable by someone else. Thus, if the seller sold the note or the check to a holder and has not reacquired it after dishonor, the only right that survives is the right to enforce the instrument.

> If this Comment is correct—and there seems every reason it should be, despite the fact that the result is never laid out as clearly in the text of §3-310(b) as the Official Commentators seem to think it is—then once Landlord sold the note to Financial Services for $3,700 cash, she lost forever any right to sue Tenant for the rent due for those months. This seems only fair, as she has actually received $3,700 in cash. The only right that continues thereafter is the right of Financial Services as purchaser and now holder of the note to enforce it. If Tenant fails to meet his obligation on the note, his only legal obligation (not to diminish its importance) is under §3-412 to Financial Services as the person now entitled to enforce the instrument.

PART II

The Holder in Due Course

CHAPTER 7

Who Qualifies as a Holder in Due Course?

INTRODUCTION

The holder in due course is an especially important character in the law of negotiable instruments. Whether a particular party attempting to enforce an instrument qualifies not merely as a holder of the instrument but as that special and particularly favored type we identify as a holder in due course can and will have far-reaching consequences. This chapter makes no attempt to cover exactly what those consequences are. That will come in Chapter 8. For the moment, let me just suggest in broad outline the paramount and often highly significant effect of a party's being able to establish itself as a holder in due course of an instrument. One suing on an instrument who can legitimately assert holder in due course status is immune from many of the most common defenses that the party being sued would otherwise be able to assert to lessen or totally eliminate his or her obligation on the instrument if he or she were being sued by someone who does not qualify as a holder in due course. The possibility of a potential plaintiff's being insulated from a whole set of defenses that might otherwise stand in the way of recovery on an instrument is, to put it mildly, no small matter and should be enough to pique your interest in the fundamental question to be explored in this chapter: Who qualifies as a holder in due course under Article 3?

The basic definition of *holder in due course* is found in §3-302(a). Note first of all that one can be a holder in due course only if what one is holding is an "instrument" under Article 3, which we know from §3-104(b) means a "negotiable instrument" as that term is defined in (a) of the same section. We dealt with what pieces of paper meet the standards for being negotiable instruments in Chapter 1. As it turns out, a large number of cases have had to deal with a controversy about whether some paper that does not clearly and unambiguously fall within the definition of §3-104(a) may still be classified as an Article 3 negotiable instrument. These courts are confronted with the issue precisely because some party is claiming not merely the right to enforce the promise or order the paper articulates, but also the right to enforce the obligation as a holder in due course of a negotiable instrument, free and clear of certain pesky defenses the obligor may want to put in his or her way. A party cannot expect to get any special recognition as a holder in due course, or any special benefit from being so classified, unless a negotiable instrument is the basis of that party's suit.

A second basic prerequisite for any party's being able to establish holder in due course status is that the party be a holder of the instrument. As we saw in Chapter 2, whether a party qualifies as a holder of the instrument (assuming that it is a negotiable instrument under Article 3) depends on a complex series of rules and definitions. Again, much of the litigation involving the problem of who is and who is not a holder has as its background the desire of a plaintiff to prove holder status, so that plaintiff can then go on and claim to be a holder in due course, with all the advantages that will bring. There is no need for us to recapitulate here all of what we dealt with in Chapter 2. It is enough to highlight the fact that for a party to become a holder in due course of an instrument, it is essential that the party first establish that it qualifies as a holder of the instrument under the rules we have already studied.

Beyond the need to prove that a negotiable instrument is involved, and that he or she is a holder of that instrument, anyone claiming holder in due course status must prove that the conditions laid out in both (1) and (2) of §3-302(a) are met. (There is no need for us to concern ourselves at the moment with the exceptions of either §3-302(c) or §3-106(d).) It is worth pointing out from the very beginning that the burden of establishing holder in due course status is on the party making the claim to be such. Under §3-308(b),

> If a defense or claim in recoupment [a concept explored in Chapter 8] is proved [by the party

> being sued on the instrument], the right to payment of the plaintiff is subject to the defense or claim, except to the extent *the plaintiff proves* that the plaintiff has rights of a holder in due course which are not subject to the defense or claim.

So, what exactly must a party prove to establish itself a holder in due course, beyond the fact that it is the holder of the negotiable instrument? Under subpart (1), the holder must show that the instrument, when issued or negotiated to the holder, did not "bear such apparent evidence of forgery or alteration or [was] not otherwise so irregular or incomplete as to call into question [the instrument's] authenticity." This criterion did not appear in the initial version of Article 3, although, as Comment 1 explains, it did have a precursor in the Negotiable Instrument Law, which was in effect even earlier, prior to the adoption of the original Uniform Commercial Code (U.C.C.) in the 1960s. As a result, we have no modern cases interpreting the language of this first criterion. As a practical matter, though, it probably covers only the grossest circumstances, in which no one would have thought a holder could successfully claim to be a holder in due course no matter what the exact language of the definition. In the examples to follow, we will first look at a couple of situations in which this first criterion could be invoked, at least to deal with some simple cases easily and effectively.

The criterion now articulated in part (2) of §3-302(a) was, until the 1990 revision of Article 3, the sole standard by which the question of who was and who was not a holder in due course was to be determined. Even today it must be consulted when the more interesting and subtle cases emerge, so we will have to put more time into it. This language is what lawyers, judges, and teachers of negotiable instruments law had become used to as the sole test for settling questions of holder in due course status under the original version of Article 3, which served so well for so many years. Thus, there is some tendency for a party hoping to disprove another's claim of holder in due course status to rely on §3-302(a)(2) even if (1) is now available and might be appropriately applied to the instance at hand. Whatever the case, criterion (2) is of such importance and raises sufficient questions that we cannot—nor would we want to—avoid going into it in depth.

To set the stage, observe that what is stated in §3-302(a)(2) really lists a series of conditions, each of which must be met if the party trying to prove itself a holder in due course is to satisfy its burden. To meet the test for being a holder in due course, the holder must (in addition to satisfying the rather straightforward test stated in subsection(a)(1)) have

aken the instrument for “value” (on which see §3-303),
aken it in “good faith” (as that term is defined in §3-103(a)(4) or now in §1R-201(b)(20)),
taken it without notice of its being overdue (on which see §3-304) or having already been dishonored,
aken it without notice that it contained an unauthorized signature or had been altered,
• taken it without any notice of a claim to the instrument by another (as provided for in §3-306), and
aken it without any notice that any party has a defense or claim in recoupment of the type described in §3-305(a).

With respect to what constitutes a legitimate claim by another to an instrument of the type recognized by §3-306, I must beg your indulgence for a while. Similarly for the nature of any defense or claim in recoupment provided for under §3-305(a). We will look at the contents of these sections in their full glory in Chapter 8. For the examples of this chapter, it will be necessary for me to make use of some simple examples of the type of thing we will explore in more detail soon enough, and ask you to accept as given what I say about any particular claim or defense falling within the scope of these important provisions.

ON THE GOOD FAITH REQUIREMENT

The concept of *good faith* plays a large part in determining whether a holder can qualify as a holder in due course. Historically, the question of what exactly was required for a holder to establish his or her good faith has always been troubling for the law of negotiable instruments. Prior to the adoption of the 1990 revisions to Article 3, there was no definition of the phrase *good faith* in the text of Article 3 itself. This meant that the general definition of the term in §1-201(19) was, by default, to be applied whenever the term was used in Article 3; in particular, it was crucial to the definition of *holder in due course*. Under §1-201(19), good faith was defined to mean “honesty in fact in the conduct or transaction concerned.” Thus, under the prerevision version of

Article 3, the presence or absence of good faith was to be determined under what we generally term a purely subjective standard. Did the party whose conduct was being scrutinized act dishonestly in doing what it did under the circumstances? The standard makes no reference to what others in the position of the party in question might have done, nor to what it would have been "reasonable" to do under the circumstances. This standard came to be referred to by many as the "pure heart and empty head" standard or test. If the party could not be shown to have behaved dishonestly in the light of some fact or facts that it actually *knew* at the time of the transaction, its failure to inquire into why it was able to obtain the particular instrument on what might seem incredibly favorable terms would not in and of itself have meant that the party lacked good faith.

Given this situation, the courts were often urged to temper the purely subjective definition of *good faith* supplied by the Code with judicial incorporation of an objective component to the concept of good faith, to be applied in some or all situations. With only some exceptions, the courts refused to do so, and the subjective standard stood alone. In some particularly egregious cases, a court would allow a determination of whether a party had acted dishonestly, and thus failed to meet the subjective standard of good faith, if the facts already known to that party permitted the inference that it must have been suspicious to some degree of what was going on and that its failure to inquire further was evidence of a deliberate desire to avoid gaining further information that it must have feared would damage its position. The result under the prerevision Article 3, even taking these cases into account, was summarized as follows:

> "Good faith" is defined as "honesty in fact in the conduct or transaction concerned." The good faith standard does not require the holder of an instrument, regular on its face, to inquire as to possible defenses unless facts known to the holder are such that failure to inquire discloses a desire to evade knowledge for fear that it would reveal a defense to the instrument.

Dalton & Marberry, P.C. v. Nationsbank, N.A., 34 U.C.C.2d 748 (Mo. App. Ct. 1998).

One of the more significant changes wrought by the 1990 revisions to Article 3 was the incorporation into that article itself of a distinct definition of *good faith*. Look at the definition in §3-103(a):

> “Good faith” means honesty in fact and the observance of reasonable commercial standards of fair dealing.

Under our present version of Article 3, then, the purely subjective standard of good faith has been jettisoned and an objective standard has taken its place. (The objective standard has also recently worked its way into the revision of Article 1. See §1R-201(b)(20).) Note, first of all, the importance placed by the drafters of this new, expanded definition of good faith on the distinction that should be carefully observed between conduct that may be negligent or even reckless and the type of misconduct that is to be seen as evidencing a lack of good faith. See Comment 5 to §3-103. As Judge Easterbrook of the Seventh Circuit has recently commented, “Avoidance of advantage-taking, which [the expanded ‘objective’ definition of good faith] is getting at, differs from [failure to exercise] due care.” *State Bank of the Lakes v. Kansas Banker Surety Co.*, 328 F.3d 906 (7th Cir. 2003).

The first attempt at a fuller explication of the revised definition of good faith was undertaken by the Supreme Court of Maine, observing initially that the inclusion of this new definition in Article 3

> signals a significant change in the definition of a holder in due course. While there has been little time for the development of a body of law interpreting the new objective requirement, there can be no mistaking the fact that a holder may no longer act with a pure heart and an empty head and still obtain holder in due course status. The pure heart of the holder must now be accompanied by reasoning that assures conduct comporting with reasonable commercial standards of fair dealing.

Maine Family Federal Credit Union v. Sun Life Assurance Co., 1999 Me. 43, 727 A.2d 335, 37 U.C.C.2d 875. As the court in this case was quick to point out, the determination of whether a party has observed “reasonable commercial standards of fair dealing” will not always be easy to make. If nothing else, as the court observed,

> The most obvious question arising from the use of the term “fair” is: fairness to whom? Transactions involving negotiable instruments have traditionally required the detailed level of control and definitions of roles set out in the U.C.C. precisely because there are so many parties who may be involved in a single transaction. If a holder is required to act “fairly,” regarding all of the parties, it must engage in an almost impossible balancing act of rights and interests. Accordingly the drafters [of the 1990 revision] limited the requirement of fair dealing to conduct that is reasonable in the commercial context of the transaction at issue.

The Maine Supreme Court concluded that application of this new objective standard of fair dealing required a two-step analysis.

> The factfinder must therefore determine, first, whether the conduct of the holder comported with industry or “commercial” standards applicable to the transaction and, second, whether those standards were reasonable standards intended to result in fair dealing.

I have spent so much time on the *Maine Family* case not because I think it is the last word on the question of how the new objective test of good faith, now part of Article 3 via §3-103(a)(4) introduced in 1990, is to be applied. In fact, as the Maine Supreme Court itself was aware, the case is better understood as something like the first word on the subject, the first major case to have put some thought into exactly how the changes brought about by the introduction of the objective standard into the definition of *holder in due course* work out in practice.

A noteworthy case that adopted and applied the *Maine Family* approach to the objective standard of good faith is *Any Kind Checks Cashed, Inc. v. Talcott*, 830 So. 2d 160, 48 U.C.C.2d 800 (Fla. App. 2002). The court there upheld a trial court’s findings that, on the facts presented, the check-cashing firm had *not* acted in good faith in cashing a check for $10,000 but *had* been in good faith in later cashing another for $5,700. Both the checks were issued by Talcott, a 93-year-old Massachusetts resident, and made payable to one Salvatore Guarino on the advice of Talcott’s “financial advisor,” D. J. Rivera. Rivera was soon discovered to be, in the words of Guarino, “a cheat and a thief,” but meanwhile he had made off with cash received from Any Kind for each of the checks, and that firm naturally enough wanted to recover the sum from the check’s drawer. Talcott ended up responsible for the $5,700 even though the check had been clearly obtained from him by fraud, but not for the $10,000. What made the difference between the two checks? In the case of the check for $5,700, a manager at the check-cashing company, whose authorization was required for the cashing of any check over $2,000, had actually called Talcott and gotten his oral approval for cashing the check. The check for $10,000, on the other hand, had been cashed earlier (minus a fee, of course) by the company, the manager apparently relying on her “instinct and judgment” even though she had not been able to reach Talcott by phone to get his approval. The Florida District Court of Appeals upheld a finding by the trial court that in so doing the check-cashing firm had not acted in good faith.

> There was no evidence at trial concerning the check cashing industry's commercial standards. Even assuming that Any Kind's procedures for checks over $2,000 met the industry's gold standard, we hold that in this case the procedures followed were not reasonably related to achieve fair dealing with respect to the $10,000 check, taking into consideration all of the participants in the transaction, Talcott, Guarino, and Any Kind.

Any Kind had argued that this result would put too great a burden upon itself and other check-cashing operations, but the court manifested little sympathy under the circumstances:

> Against this [factual] backdrop, we cannot say that the trial court erred in finding that the $10,000 check was a red flag. The $10,000 personal check was not the typical check cashed at a check cashing outlet. The size of the check, in the context of the check cashing business, was a proper factor to consider under the objective standard of good faith in deciding whether Any Kind was a holder in due course. [Citing *Maine Family*]

Subsequently, the Court of Appeals of Ohio in *Buckeye Check Cashing, Inc. v. Camp*, 159 Ohio App. 3d 784, 825 N.E.2d 644, 56 U.C.C.2d 484 (2005), held that a check-cashing establishment had failed to meet the objective measure of good faith—thus preventing it from attaining holder in due course status—when it cashed, under the particular circumstances presented in the case, a postdated check. For an interesting recent case in which the Court of Appeals of Maryland considered both the *Any Kind Checks Cashed* and the *Buckeye Check Cashing* cases in coming to the conclusion that a check cashing business *did in fact* qualify as a holder in due course of a check for $18,000, even though it took that check from someone impersonating the named payee who in addition forged the signature of that payee right in front of the check-cashing establishment's employees, see *State Security Check Cashing, Inc. v. American General Financial Services*, 409 Md. 81, 972 A.2d 882, 69 U.C.C. Rep. Serv. 2d 683 (Md. App. 2009).

It will be interesting to see, as time goes on, what further explication of the objective good faith standard we will be given by the courts. What no one would doubt is that the move in the 1990 revision of Article 3 from a purely subjective to an objective test for good faith was meant to work a significant change in how that term was understood and applied wherever it appears in Article 3—and in the definition of *holder in due course* most particularly.

ON NOTICE

A second concept that is extremely important to the definition of *holder in due course* is that of a holder's having or not having notice of this or that being true. It is worth taking time now to become acquainted with the definition of *notice* as first defined in §1-201(25):

A person has "notice" of a fact when

he has actual knowledge of it; or

he has received a notice or notification of it [on which see subsections (26) and (27)]; or

from all of the facts and circumstances known to him at the time in question he has reason to know that it exists.

In the revised Article 1 you'll find the same ideas in §1R-202. Having duly taken notice of what "notice" is, we may now move on to some examples to explore more fully just who is and who is not a holder in due course of a negotiable instrument.

Examples

Paul approaches Jennifer and shows her a check for $400 made out to him, drawn by one Darren on Darren's account with the Payson National Bank. The numeral "4" in the space where the amount of the check has been written has a funny look to it and appears to be written in two different inks. Also, the word "Four" on the line where the amount is set forth in words is written over a very discernible smudge and also happens to be written in an ink darker than all of the other writing on the check, such as Darren's signature. Paul convinces Jennifer to cash this check for him. He indorses the check over to her in exchange for $400.

Does Jennifer qualify as a holder in due course of the check?

What if there were no such glaring irregularities on the face of the check, but it is apparent that it had once been ripped or cut in half and then taped back together? If she takes the check from Paul by way of negotiation, could Jennifer successfully claim to be a holder in due course under this set of facts?

Andrew issues a check for $1,000 to Belinda. Belinda negotiates this check over to Carlos, taking and asking for nothing in return. Belinda is making a gift to her friend Carlos.

Can Carlos qualify as a holder in due course of the check?

What if Belinda negotiated the check to Carlos in exchange for a used car, the title of which Carlos then transferred to Belinda?

What if the reason Belinda negotiates the check to Carlos is to pay him for some services Carlos has already performed for her?

What if Carlos is given the check in exchange for his promise to perform certain services in the future for Belinda, but which he has not yet performed?

Darla issues a note to Ernest in 2013 in exchange for a valuable painting that Ernest is selling to her. The note calls for Ernest to be paid the amount of $10,000 on a date in 2016. In need of some ready cash, as soon as he gets the note Ernest takes the note to Friendly Finance. That firm agrees to buy the note from him for $3,000 payable immediately and another $5,000 to be paid on the due date in 2016. Ernest accepts these terms and negotiates the note over to Friendly Finance, which gives him the initial payment of $3,000. By the time 2016 rolls around, Friendly Finance has become aware, as it had not been initially, that the painting Ernest sold Darla in the transaction giving rise to the note was a fake and not an original as Darla had been led to believe. Can Friendly Finance claim and benefit from holder in due course status when it tries to collect, in 2016, the $10,000 payable by Darla on the note it is holding? See §3-302(d).

Grant issues a note to Helena payable on March 1, 2014. On April 1, 2014, Helena negotiates this note over to Irwin in exchange for cash. Can Irwin qualify as a holder in due course of the instrument?

Janice writes a check to Kirk dated January 5, 2013. On June 1 of that same year, Kirk negotiates the check to Lena. Can Lena qualify as a holder in due course of the check?

Manny, a college student, shows his friend Naomi a check for $18,000, written to Manny and drawn on an account of the Microtough Corporation, a large public company. The check is written on an official preprinted check of the corporation and the signature at the bottom is that of Manny himself. Naomi knows that her friend has been working as a summer intern in the bookkeeping department of Microtough. Without asking any questions, Naomi takes this check in exchange for a used car that she has been trying to get off her hands. Can Naomi qualify as a holder in due course of the check?

Oscar is strolling along the street one day when he happens to spy a piece of paper lying on the ground. He picks it up. It turns out to be a check, written by one Boss Industries and payable to a Louie Lackey, and the back of it bears what appears to be the signature of Louie himself. Is Oscar a holder of this instrument? Is he a holder in due course? You may assume that Louie Lackey, the unlucky loser of the check, would have a valid claim to it as his property under §3-306.

Quincy contracts to buy what he believes to be a valuable antique vase from Roberta. In payment for the vase, Quincy writes Roberta a check for $12,500. Roberta negotiates this check over to her friend Steve as partial payment of a larger debt that Roberta owes to Steve. Steve, being a friend of Roberta's, is well aware that the vase she has sold to Quincy is not an original, but rather a reproduction worth nowhere near the amount Quincy paid for it. Roberta has often complained to Steve about how she herself was initially fooled by the vase, but there is no doubt it's a reproduction only. You may assume that the sale of the vase as an original when it is known by the seller to be a modern reproduction would provide Quincy with a defense under §3-305(a) to payment of the instrument, should he become aware of the fact before the check is paid.

Does Steve qualify as a holder in due course of the check?

Would your answer be the same if Steve had no knowledge or any reason to believe that the vase was other than original? Roberta was aware that it was a reproduction, but she kept this information to herself and did not share it with anyone, even her friend Steve.

Thomas is invited to invest in what he is assured by its promoter, Horace Underwater, is going to be a fast-growing and highly profitable real estate venture, Underwater Estates. In 2014 Thomas acquires an interest in this company by giving a note to Underwater Estates for $50,000, payable five years from the date of signing. On behalf of the venture, Horace immediately sells this note to one of the major banks in the community, Little Rock Bank and Trust. Little Rock pays $40,000 for the note, an amount reflecting a customary discount for purchase of this type of note, given the underlying nature of the enterprise, the time the bank will have to wait for payment, and so forth. You may assume that the bank has no knowledge or reason to know of any defenses that the maker, Thomas, might be able to assert when the time comes to pay the note. It knows that the maker is investing in a real estate deal and that such deals always involve some degree of risk, but it has no reason to believe that the Underwater Estates project is any more risky or suspect than it now appears to be.

Does the Little Rock bank qualify as a holder in due course of the note?

Would your answer be the same if Horace had agreed to sell the note to the bank for $22,000? The officials at the bank were surprised that the price they were being asked to pay was so low, but decided not to look a gift horse in the mouth. They eagerly took up the $50,000 note for $22,000 in cash.

This example starts with the same situation as in Example 9a. Thomas makes a note promising to pay $50,000 to Underwater Estates in five years. This note is immediately sold at a reasonable discount to Little Rock Bank and Trust, which has no notice of any irregularities in the transaction between Thomas and Underwater that gave rise to the note. About a year later, it is discovered that Horace Underwater had been convincing people, including Thomas, to invest in this project by knowingly giving them false information and projections as to its future profitability. You may assume that this kind of fraud in the transaction would give rise to a defense on Thomas's part, should he ever be sued on the note, of the type described in §3-305(a). After all the facts of Horace's skullduggery become widely known, the Little Rock bank negotiates the note to the Instrument Enforcement Corporation (IEC) for $35,000.

When the due date of the note arrives, can IEC, in suing for the full $50,000 due on the note from Thomas, prove itself to be a holder in due course of the instrument?

Even if IEC cannot itself claim to be a holder in due course under the circumstances, can it assert *the rights of a holder in due course,* including the right to enforce Thomas's obligation on the instrument free and clear of any defense Thomas might have if the note were still held by the deceitful Horace? Give careful attention to §3-203(b).

Explanations

No. This appears to be a particularly clumsy job on Paul's part of attempting to change a check for $100 into one for $400. This is an alteration of the instrument (see §3-407(a)). We don't have to look any further than §3-302(a)(1) to find that Jennifer will not qualify as a holder in due course. At the time the check was negotiated to her, it certainly did bear "such apparent evidence of forgery or alteration … as to call into question its authenticity."

I think not. Again, under (a)(1), although there was no apparent evidence of a forgery or alteration made to the instrument, it was in my opinion at the time of negotiation to Jennifer "so irregular or incomplete as to call into question its authenticity." That would be enough to prevent Jennifer from acquiring holder in due course status. The drafters of the revision of Article 3 did not include a definition of the word *authenticity* that they use here, but note the following language from Comment 1:

> The term "authenticity" is used to make it clear that the irregularity or incompleteness must indicate that the instrument may not be what it purports to be. Persons who purchase or pay such instruments should do so at their own risk.

It is important to point out that in this and the previous example the conclusion is not that Jennifer isn't a holder of the instrument. She is, and may enforce it for all it is worth—whatever, if anything, that may turn out to be. The conclusion is only that she would not qualify for the special status as holder in due course of the check, which could very likely affect her ability to enforce it for the full $400 she has supposed it to be worth when the time comes to turn this piece of paper into cash.

No. Carlos has no trouble meeting the criterion of §3-302(a)(1), but he must also fulfill the requirements of (a)(2). The first of these, and the one which we explore in this example, is that for a person to qualify as a holder in due course, that person must have taken the instrument "for value." Section 3-303(a) is used to determine whether an instrument is issued or transferred for value. This case is easy. The check was transferred to Carlos as a gift. Carlos becomes the holder of the check, but he does not become a holder in due course of it. He has not given value for it.

Someone who simply finds a negotiable instrument, even one in bearer form, will have no more success in claiming he or she gave value for the instrument. Take, for example, the case of *Griffith v. Mellon Bank, N.A.*, 328 F. Supp. 2d 536, 54 U.C.C.2d 373 (E.D. Pa. 2004), *aff'd*. 173 Fed. Appx. 131, 59 U.C.C.2d 135 (3d Cir. 2005). In January 2001 Mr. Kim Griffith found, while cleaning out his self-storage locker, a piece of paper that purported to be a certificate of deposit issued by Mellon Bank, N.A. of Pittsburgh on July 3, 1975, in the amount of $530,000, to accumulate interest at 5.75 percent annually, and made payable "To Bearer." The paper apparently came floating out of one of a quantity of old books, which Griffith had bought from some unnamed person, as Griffith and his wife were "shaking out" all the books in the locker. On its face the certificate bore no evidence that it had ever been paid. Griffith, as holder of the instrument, demanded payment from the bank of nearly $2.5 million, based on the amount of principal and interest that would be due after the more than 27 years from when the certificate was purportedly issued. The United States District Court allowed the bank to assert the defense that the certificate had been paid based on a common law rule established by a long line of Pennsylvania cases that after the lapse of 20 years, all debts "are presumed to have been paid." The court first held that Griffith had not offered sufficient evidence to overcome this presumption of payment. To Griffith's argument that he was a holder in due course of the instrument and, as a result, not subject to this defense, the court replied,

> Although Griffith claims to have bought the book in which he found the certificate of deposit, he admits that he did not know the certificate was in the book when he made the transaction. Therefore, although Griffith may have paid for the book inside which the certificate of deposit was found, Griffith did not pay any value in return *for the certificate of deposit itself*. For that reason Griffith is not entitled to holder in due course status under [§3-302]. (Emphasis in original)

If Carlos gave Belinda a used car in exchange for the check, then he has given value and, assuming that he meets all the other criteria of (a)(2), he takes the check as a holder in due course. It's interesting (and frustrating) that the drafters didn't provide any clear language covering this simplest of situations in §3-303(a), although there is no doubt that we are meant to find Carlos to have given value in such a case. Subparts (2) through (5) of §3-303(a) relate to specific situations, none of which is involved here. Probably the best way to look at this case is to consider it under (a)(1) and conceive of it as follows: Belinda transferred the check to Carlos in exchange for a promise by him to transfer the car to her and he has performed his promise. Thus, Carlos has given value for the instrument and has met this qualification for obtaining holder in due course status.

Carlos took the instrument for value and could be a holder in due course. You can support this conclusion with §3-303(a)(1), reasoning that Carlos had presumably at some time made a promise to Belinda that he would perform these services, and he has given value to the extent the promise has been performed, which in this case is to the full extent of the promise.

Carlos would be a holder of the instrument, but not a holder in due course. Look once again at §3-303(a)(1). An instrument is taken for value if it is taken in exchange "for a promise of performance, *to the extent that* the promise has been performed." Here Carlos's promise to furnish service in the future has not been performed at all, and as a consequence—under the definition found in §3-303(a), which we must apply to §3-302(a)(2)—he has not yet given any value for the instrument. He cannot qualify as a holder in due course of it.

For a case that hinges on just this distinction between a promise already performed and one that has not yet been performed, see *Carter & Grimsley v. Omni Trading, Inc.*, 306 Ill. App. 3d 1127, 716 N.E.2d 320, 39 U.C.C.2d 484 (1999). Omni Trading Company issued a couple of checks to Country Grain Elevators, Inc., for grain it had purchased. Country Grain soon thereafter negotiated these checks over to the law firm of Carter & Grimsley as a retainer for future legal services. The law firm deposited the checks, but by the time it did so Omni Trading had stopped payment on them and the checks were returned unpaid. Carter & Grimsley later brought suit against Omni on the checks, asserting that it held each of them as a holder in due course. The firm produced no evidence that it had performed any legal services for Country Grain Elevators prior to its receiving the checks. The checks represented a retainer for future services; such future services, the court held, could not constitute value given by the law firm so as to allow it to benefit from holder in due course status.

This retainer was a contract for future legal services. Under section 3-303(a)(1), it was a "promise of performance," not yet performed. Thus, no value was received, and [the law firm] is not a holder in due course.

Friendly Finance is of course a holder of the note to its full extent. Under the special rule of §3-302(d), however, it will be able to rely on the rights of a holder in due course with respect to only 3/8 of the value of the note, or $3,750. At the time it gave the initial $3,000 of the total $8,000 it agreed to pay for the note, it had no notice of any defense that would be good against its transferor, Ernest, of the type described in §3-305(a). Thus, as of that point and forevermore, Friendly Finance may "assert rights of a holder in due course of the instrument to the fraction of the amount payable under the instrument [$10,000] equal to the value of the partial performance [$3,000] divided by the value of the promised performance [$8,000]." As to the other 5/8 or $6,250, its rights will be those of a holder but not those of a holder in due course. If it had later made the other promised payment to Ernest (and let's hope for its sake it did not), that would not increase the extent to which Friendly Finance held the note as a holder in due course. Although more value would have been given, this additional value beyond the $3,000 would have been given by Friendly Finance under circumstances that prevent it from acquiring any further holder in due course rights; it would have had notice, at the time of the giving of this additional value, that the party Darla "had a defense … described in Section 3-305(a)." A similar example to the one I've given here can be found as Case #5 in Comment 6 to §3-302.

No. At the time Irwin took the instrument, he had notice that it was overdue. Hence he does not meet all of the requirements of §3-302(a)(2), in particular the criterion stated under (iii) thereof. We know that the note was overdue because §3-304(b)(2) decrees, "With respect to an instrument payable at a definite time … [i]f the principal is not payable in installments and the due date has not been accelerated, the instrument becomes overdue on the day after the due date." Irwin certainly had notice that the note was overdue. The due date was written right on the instrument, so he had all the opportunity in the world to know that the particular note was overdue as of March 2, 2014. He knew he was taking it on April 1, 2014. Look again at the definition of *notice* in §1-201(25) or §1R-202. Can there be any question that "from all the facts and circumstances known" to Irwin, he had plenty of reason to know that he was taking an overdue instrument?

> Remember, although we have just concluded that Irwin will not obtain the rights of a holder in due course in the instrument, this does not mean he is not a holder and is not entitled to enforce the instrument. Everything may turn out just fine for him. If, however, Grant interposes certain defenses to payment when Irwin attempts to enforce it, Irwin as a holder but not a holder in due course may be subject to those defenses in a way he would not have been had he taken as a holder in due course. Irwin, by taking the instrument with knowledge that he would hold it not as a holder in due course, was taking a greater risk that he would never be paid all that was supposedly due on the instrument. So Irwin, if he knows what he's doing, is not necessarily acting foolishly or unwisely here, at least if the amount of cash he gave Helena for the overdue instrument was low enough to reflect the increased risk that he was knowingly incurring by purchasing this instrument under this set of circumstances.

No, Lena cannot qualify as a holder in due course of the check. Under §3-304(a)(2), a check becomes overdue 90 days after its date. Lena took the check with notice that it was overdue. Don't fall into the trap of concluding that the check Lena took from Kirk was "no good" or anything like that. There would be nothing unusual here if Lena deposited the check in her account and it cleared with no problem. If, however, it doesn't clear and she later has to sue Janice on Janice's obligation as the drawer of a dishonored check, Janice may be able to successfully interpose defenses against Lena that she could not if Lena were a holder in due course. There is nothing wrong, in and of itself, with taking a check that was written some time ago, but as Lena may learn to her dismay, it is an inherently riskier proposition than is taking a check that was issued only a few days ago. Most checks are, naturally enough, cashed or deposited for collection soon after they are issued. The fact that a check has been hanging around for some time without its being cashed or deposited doesn't necessarily mean that there will be any difficulty collecting on it, but it does suggest a greater likelihood of some trouble lurking, some messiness surrounding the transaction that gave rise to the check or the route it has taken since that point that would account for its still being outstanding some 90 days after issuance. Any person taking it in such a situation should be aware of the greater riskiness associated with this particular item. Article 3 reflects this simple reality by providing that someone who takes a check more than 90 days old may not become a holder in due course of it.

Naomi will qualify as a holder in due course only if she can show that she took the check "without notice that the instrument contained an unauthorized signature" pursuant to §3-302(a)(2)(iv). Refer again to the definition of *notice* that we have to work with. Do you think it likely that Naomi could satisfy her burden of proving that she had no "reason to know" that Manny was not authorized to sign a check for $18,000 payable to himself from his temporary employer, the Microtough Corporation, "given all the facts and circumstances" known to Naomi? Even if she didn't know for certain that Manny had taken advantage of his position in the bookkeeping department to write up this check payable to himself, despite his having no authority to do so, what do you make of the fact that she took this highly dubious item without asking a single question about how Manny came to have it?

> As you can see, the determination of when and whether the person taking an instrument has "notice" of a particular infirmity of the type that would, under (a)(2), disqualify the taker from becoming a holder in due course is not always free from dispute. There have been and will presumably continue to be plenty of cases in which a judge or jury has to decide who did or did not have notice of one thing or another at the time that person took an instrument. Each case has to be decided on its facts, of course. As to the case before us, my guess would be that Naomi will

have a good deal of trouble meeting her burden of proof that she was without notice of the unauthorized signature of Manny on a check of the Microtough Corporation. Interns in the bookkeeping department aren't usually, at least in my experience, given the authority to sign checks for the employer, especially not checks made out for large amounts and payable to themselves. Naomi may not have "knowledge" of the improper signature, but it's important to note that the definition of *notice* goes beyond this to encompass facts that a person should have "reason to know" under the circumstances. I wouldn't bet on Naomi's being able to establish holder in due course status under the facts as we have them here.

If the signature is truly that of Louie, then Oscar qualifies as a holder of the instrument. Louie, by making a blank indorsement on the back of the check payable to him, has turned it into a bearer instrument. Oscar, in physical possession of a bearer instrument, is a holder of it. Oscar, however, would not qualify as a holder in due course. He has notice that another, Louie, would have a claim to the instrument of the type described in §3-306. Under §3-302(a)(2)(v), this prevents Oscar from becoming a holder in due course.

No, Steve is not a holder in due course under this set of facts. He is a holder. Furthermore, he has given value for the instrument; under §3-303(a)(3), an instrument is transferred (here from Roberta to Steve) for value if it is transferred "as payment of … an antecedent claim against any person." Steve fails to qualify as a holder in due course, however, because at the time he took transfer of the instrument he had notice that Quincy had a defense against payment of the instrument of a type described in §3-305(a). Hence, Steve does not meet the criterion of §3-302(a)(2)(vi).

You might have been tempted by this example also to consider the question of whether Steve, knowing what he did about how Roberta acquired the check, could appropriately be considered to have acted in "good faith" in taking it as he did. After all, there is a distinct requirement under §3-302(a)(2)(ii) for someone claiming holder in due course status to prove that he took the instrument in good faith. Here Steve did not himself actively participate in the con job that Roberta pulled on Quincy, but he seems more than willing to turn a blind eye to what Roberta did and in an indirect way to profit by it. If Roberta was able to get $12,500 for a vase worth nowhere near that much and then use the money to pay off part of her debt to Steve, then he benefits from the initial purchase and sale transaction and the fraud that Roberta has committed against Quincy.

Can Steve, fully aware that this is the source of the check written in this amount, be said to have taken it in good faith?

There is, as you might expect, no easy answer to this question. We will look at the good faith requirement of §3-302(a)(2)(ii) in more detail in the following example, where we will see how difficult it often is to know just when that requirement has been met. For the moment, the point to observe is that in many situations the issue of whether the holder took the instrument in good faith for purposes of (a)(2)(ii) will be difficult, if not downright impossible, to distinguish from the "without notice" requirements listed in (a)(2)(iii) through (vi). The issue of good faith rarely, if ever, comes up in a vacuum, and so it naturally tends to overlap or become intertwined with more specific questions of whether the person taking the instrument had notice of a particular reason to question the enforceability of the instrument. Some courts go to great trouble to deal with the two separate criteria set forth in §3-302(a)(2)—good faith and lack of notice—distinctly and independently. Sometimes they seem successful in doing so. You will, however, come across other cases where it seems as if the court has not been able (or has simply not bothered) to keep distinct the two different notions as they apply to the facts at hand. You may wonder if this is because the court failed to keep each part of the puzzle distinctly in view (we are all human, and as we've already noted, the pieces of the puzzle do overlap to a considerable extent, if not totally blur one into the other) or whether the court consciously concluded that the two criteria do not need separate consideration, given the circumstances and given that they both are intended to address the same ultimate concern. A good deal of this, of course, depends on how the good faith requirement of (a)(2)(ii) is to be applied. As we will explore soon enough, this itself is no easy matter.

If Steve had no knowledge or any reason to believe that Roberta had acquired the check from Quincy by selling him a phony antique, then Steve could legitimately claim that he had no notice that Quincy had a defense against his obligation to pay on the instrument. Steve would be a holder in due course of the check.

Yes. The Little Rock bank has taken the instrument for value and with no notice of any defenses available to any party or claims of another to the instrument. The note is not overdue, nor does it contain any unauthorized signature or alteration. The remaining question is whether there is any reason to doubt the good faith of the bank in taking the note under the circumstances set out here. I can't see why we would. The bank has taken the note for a discount, but the discount, we are told, is within the range of what this bank or another similarly situated would expect to get for a note on these terms and reflecting this type of venture. Little Rock qualifies as a holder in due course.

The issue here is whether Little Rock has acted in good faith in taking the note for this more deeply discounted price. If this question were to be addressed under the historical subjective test of good faith discussed in the introduction, would the Little Rock bank be found lacking in good faith? Remember that the note it purchased was "regular on its face" and the only other fact it knew was that Horace Underwater was willing to sell the bank the note at a very appreciable discount. Couldn't the bank honestly take advantage of the situation without being in bad faith? Would these facts and nothing more allow the purity of its heart to be called into question?

Given that the note in question was created in 2014 and negotiated to the bank soon after its issuance, however, we confront the issue of good faith not under the prerevision Article 3 and the subjective standard, but as dealt with under the 1990 revisions and the objective standard of good faith. With this standard now applying to Little Rock Bank and Trust's conduct in taking the note for $22,000, how would you answer the question of whether it had acted in good faith? At least we are given some guidance by the *Maine Family Federal Credit Union* case (discussed in the introduction) on where to start looking. What can we determine about what industry standards are with regard to such transactions? What would other, similarly situated banks be expected to do when confronted with a note of this kind offered to them on these terms? Would they as a matter of course inquire further into the background of Horace Underwater and into the details of the Underwater Estates real estate venture? Even if they would not make a full investigation into all aspects of the Underwater Estates plan, wouldn't they ask some fairly pointed questions, given the otherwise inexplicably low price at which they are being offered the note?

You have to consider as well the second prong of the test as the Maine court enunciated it. If other banks would as a matter of industry practice make further inquiries of the type that Little Rock did not, it does not seem difficult to conclude that this customary commercial behavior could be considered to constitute "reasonable standards intended to result in fair dealing." True, these other banks would not be making the further inquiry because they feel themselves obligated to police every deal with which they become even tangentially involved; the Maine court did not mean to suggest that any bank that purchases a note from someone like Horace Underwater must necessarily ensure the "fairness" of its transferor's conduct in every particular and with respect to every other party with whom he may have dealt. If other banks in Little Rock's position would make such further investigation, however, it must be traceable in some degree to their concern about not getting caught in the middle of a fraudulent or unduly risky scheme. This would be enough, I think, to conclude that their standard of conduct would qualify as what the court referred to as "reasonable standards intended to result in fair dealing."

A more interesting question comes up if we conclude, upon investigation, that other banks would *not* have acted differently from Little Rock had the same opportunity been presented to them by Horace. They would, just as eagerly, have bought up the note obligating Thomas to pay $50,000 five years hence for the remarkably low price of $22,000, with no questions asked. In other words, what if Little Rock could show that its actions had in fact "comported with industry or 'commercial' standards applicable to the transaction" at hand? Under the two-step analysis supplied by the Maine court, we would still be allowed to conclude that Little Rock had not acted in good faith, because, even if it acted in accordance with industry standards, those standards were so lax that they could not be considered "reasonably intended to result in fair dealing." If an entire industry were to adopt practices of dealing that fail to take into account some reasonable measure of "fair dealing," however exactly (or vaguely) this phrase comes to be understood, no one member of the industry could show itself to have been acting in good faith merely because it acted according to this industry's practices—if the industry-wide practices don't measure up.

No. IEC could never qualify as a holder in due course. Even though it gave value and (we may assume) acted in good faith, at the time it took transfer of the note it had notice that a party, here Thomas the maker, had a defense to payment on the instrument. That defense is, as we have postulated, one of those "described in Section 3-305(a)." IEC fails to meet requirement (vi) of §3-302(a) and is not a holder in due course.

Although IEC cannot itself claim to be a holder in due course, it took the instrument from a party who was, the Little Rock Bank and Trust. (Recall that at the time Little Rock took the instrument, it had no notice that Thomas had any defense on the instrument.) This being so, IEC can assert the rights of a holder in due course under the so-called *shelter doctrine* of §3-203(b):

Transfer of an instrument, whether or not the transfer is a negotiation, vests in the transferee any right of the transferor to enforce the instrument, *including any right of a holder in due course*.…

So, although IEC is not a holder in due course, at the time of transfer it acquired the rights of a holder in due course from its transferor, the Little Rock Bank. Whatever the rights of a holder in due course are—and it is this we will get into in more detail in Chapter 8—IEC has them, even if IEC itself does not qualify to be considered a holder in due course because of the circumstances known to IEC at the time it took the note.

At first this result, and the whole shelter doctrine principle, may seem like little more than a play on words. IEC is not a holder in due course, but it does have all the rights of a holder in due course. The concept is an important one, however, and one you should be sure to appreciate. It serves an important function in the actual practice of dealing with negotiable instruments. Look at the beginning of the second paragraph of Comment 2 to §3-203.

Under subsection (b) a holder in due course that transfers an instrument transfers those rights as a holder in due course to the purchaser. The policy is to assure the holder in due course a free market for the instrument.

To appreciate the policy justification for the doctrine to which this comment refers, consider the situation from the point of view of Little Rock Bank and Trust. In 2014, it purchases a note from Underwater due in five years' time. In doing so it becomes a holder in due course. Some time later it becomes apparent that Underwater may well have engaged in fraud in procuring the note from the investor Thomas. This does not change Little Rock's position. It is still a holder in due course of the note, and if it held onto the note until the due date in 2019 would be entitled to payment of the full $50,000 from Thomas. Any defense to payment of the note that Thomas might hope to use would turn out to be unavailing against Little Rock, because that bank would still qualify as a holder in due course. Whatever Underwater may have done to procure the investment, and whatever trouble he may be in from other quarters because of what he's done, Thomas's note remains due for the full amount to the Little Rock bank when the due date comes up in 2016.

So Little Rock is holding a valuable asset, a note of Thomas's payable to it for $50,000 in 2019. But what if the bank, for one reason or another, wants to sell that asset? It stands to reason that it should be able to get in return cash or its equivalent, in an amount reasonably related to the value of the note as it now stands in the bank's possession. The value of the note to the bank, even after all the details about Underwater's disgraceful behavior become generally known, is its value as a note enforceable by a holder in due course. Any party to whom the bank now tries to sell the note could not, as we have seen, itself qualify to be a holder in due course. If any potential buyer were to consider taking the note, knowing it would then hold the note without the rights of a holder in due course, that buyer would justifiably figure the note to be far less valuable to it than the bank's appraisal of the note's worth. The bank would be holding an asset that it rightfully considers to be worth so much to it, but as a practical matter it would not be able to find a buyer for the asset who would be willing to pay anything like the value the asset has in the hands of the bank. The bank would be stuck having to hold onto the note until 2019, for it would be the only holder that could get the maximum amount due on the note when the due date arrives.

There is no good reason to prevent the bank from transferring the note into the hands of another party. Thomas, when he signed a note on these terms in 2014, had to be aware that the note could come into the hands of a holder in due course, as indeed it has, and that he would have to pay the $50,000 due in 2019 to whomever is holding the note at the time, irrespective of whatever he may later discover about the Underwater Estates venture. Remember that he signed the note payable to Underwater Estates. He did not have anything to do with picking out the party, in this case Little Rock Bank and Trust, to whom it was then negotiated. Nor could he assert any reason to suppose that it might not then be negotiated one or several more times. When you issue a negotiable instrument and send it out into the world, you have to expect that it may pass from hand to hand any number of times; the issuer's consent to, or even his awareness of, all subsequent transfers is most definitely not required. And so it can't really be said that Thomas has anything to complain about if the party to whom he is obligated to make the $50,000 payment in 2019 is the Little Rock bank or some other party entirely, as long as that party is one legitimately "entitled to enforce" the instrument at the time it becomes due.

Therefore, if Little Rock Bank and Trust is going to be able to sell off the note to some other party (such as IEC) in exchange for the value that the Little Rock bank reasonably puts on the note, the bank has to be allowed to sell the note *along with* the bank's rights to enforce the note as a holder in due course would be able to do. Otherwise it just wouldn't be able to find a buyer willing to pay the appropriate price. The shelter doctrine of §3-203(b) is what allows such a transaction to take place. In the words of the comment, it "assures the holder in due course [Little Rock in our example] a free market for the instrument."

Let me give you one other example of how the shelter doctrine could work in practice. Imagine that *A* makes a note payable to *B* in one year. *B* immediately negotiates the note over to one *C*, who takes it as a holder in due course. Suppose that when the year is up, *A* fails to make payment to *C*. *C* could of course go through the process of trying to collect from *A* what is due on the note, up to and including bringing suit on it. But it may be that *C* is not in the best position, for one reason or another, to go through all that this entails. Or perhaps it simply doesn't find it worthwhile to act as its own collection agent in this way. After a few modest attempts to get payment out of *A*, *C* would like to sell the note to *D*, a firm that is more than willing to take on the collection responsibilities. *D*, however, cannot by acquiring the note become a holder in due course, as the note is already overdue (§3-302(a)(2)(iii)). *D* can, however, under the shelter principle of §3-203(b), take the note and in so doing acquire from its transferor *C* any rights to enforce it as a holder in due course. The sale of the overdue note from *C* to *D* can take place at an appropriate price.

For two fairly recent examples of the shelter doctrine in operation, see *Tiffin v. Cigna Insurance Co*., 297 N.J. Super. 199, 687 A.2d 1045, 31 U.C.C.2d 1040 (1997), and *Tiffin v. Somerset Valley Bank*, 343 N.J. Super. 73, 777 A.2d 993, 44 U.C.C.2d 1200 (2001), even if the court in the latter case makes the mistake of phrasing its conclusion—as by now you would know not to do—as a finding that the plaintiff had "the status" of a holder in due course. What it meant to say, undoubtedly, was that the plaintiff, while not having such status had "the rights" of a holder in due course nevertheless.

Finally, note that the drafters of §3-203(b) were careful to close one potential loophole that the shelter doctrine would otherwise make possible, and that would only lead to mischief or worse. Reread this subsection, but now focus on the concluding language:

> … but the transferee cannot acquire rights of a holder in due course by a transfer, directly or indirectly, from a holder in due course if the transferee engaged in fraud or illegality affecting the instrument.

Take the hypothetical we have been working with. Imagine that Underwater had engaged in fraud to procure the note from Thomas. He takes the note and negotiates it to the Little Rock bank, which takes the note as a holder in due course. Suppose that Underwater were then to repurchase the note from Little Rock. Could he then claim to have obtained, through this transfer, the rights of a holder in due course, despite his own fraudulent behavior, thanks to the shelter doctrine and the fact that its transferor was a holder in due course? Of course not! As Comment 2 to §3-203 remarks:

> There is one exception to [the shelter doctrine] rule stated in the concluding clause of subsection (b). A person who is party to fraud or illegality affecting an instrument is not permitted to wash the instrument clean by passing it into the hands of a holder in due course and then repurchasing it.

The shelter doctrine is an important tool enhancing the free transferability of negotiable instruments, but it is a tool that cannot be allowed to fall into the wrong hands.

Revision Proposals

The crucial definition of the term *good faith* may be found in the revised version of Article 3 at §3R-103(a)(6). But then again it may not. If on looking at §3R-103(a)(6) you find that subpart with no definition but simply marked "Reserved," it is because the particular jurisdiction has adopted the Revised Version of Article 1 promulgated in 2001 and this, the so-called objective, definition of good faith can now be found in its §1R-201(b)(20). The definition thus automatically applies to any use of the term in Article 3, and a separate definition of it in that article would be redundant.

CHAPTER 8

Defenses, Claims of Others, and the Holder in Due Course

INTRODUCTION

We have already considered, in Chapter 3, how any party signing an instrument takes on the obligation to pay the instrument under certain well-defined circumstances. The obligation of a maker to pay on a note is set forth in §3-412, the obligation of an acceptor to pay on a draft in §3-413, and so forth. In each instance, as we know, the obligation is owed to a "person entitled to enforce the instrument" as defined in §3-301. Should a person entitled to enforce find himself or herself in the unenviable position of having to bring (or at least threaten) suit in order to compel performance of the obligation of a maker, a drawer, an acceptor, or an indorser, the defendant may raise as a defense any argument that the plaintiff is not in fact a person entitled to enforce the instrument. The defendant may also question whether all the elements of the plaintiff's prima facie case asserting obligation have been met; that is, whether the facts bring the case within the rules laid out in §§3-412 through 3-415, whichever the plaintiff is relying upon to advance his or her claim of the defendant's obligation to pay on the instrument.

In addition to any efforts the defendant will make to undercut the plaintiff's prima facie case, he or she may also wish to assert certain affirmative defenses arising out of the circumstances under which his or her signature on the instrument was obtained. In this chapter we explore the nature of these affirmative defenses, as well as the related concept of what Article 3 refers to as a "claim in recoupment," which the defendant may use to lessen, if not totally do away with, its obligation to pay what is due on the instrument. We will also consider instances when the person holding an instrument has to contend with someone else's claim that the instrument is rightfully that other person's property and should be returned to him or her.

In examining such situations—the assertion of affirmative defenses and the related claims in recoupment by a party whose obligation to pay on an obligation is the matter in dispute, or the claim of a property interest in an instrument presently held by another—the full import of the question of who is a holder in due course comes to the fore. By the very nature of negotiable instruments, the answer to when and whether a particular defense will be available against a holder claiming the right to be paid on the instrument, or the right to consider the instrument his or hers free from the claims of others, frequently depends on whether the holder has acquired the status of a holder in due course. The concepts and rules with which we will be dealing in this chapter predate the Uniform Commercial Code (U.C.C.) by a century or more. We find them carried through to the present day for our use in a couple of crucial sections of the present version of Article 3, §§3-305 and 3-306.

Look first at §3-305(a). It says that, "except as stated in subsection (b) [an exception of no small importance, which we'll visit in a moment], the right to enforce the obligation of a party to pay an instrument is subject to" three distinct types of defensive claims. The first set of defenses, those listed in subsection (a)(1), are what have traditionally been referred to as the *real defenses*. Although the list may seem long, as a practical matter the instances in which one of the real defenses is available to a defendant turn out to be relatively few. Each of the real defenses, as we will see in the examples to follow, is very limited in scope.

Subsection (a)(2) defines what are conventionally referred to as the *personal defenses*. Under this part, the right to enforce the obligation of a party to pay an instrument is subject to

> a defense of the obligor stated in another section of this Article or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract.

Though stated in relatively simple terms, the personal defenses cover a lot of territory. The type of standard, common law contract defenses that will constitute personal defenses for the purposes of negotiable instruments law include such old favorites (from your study of contracts) as failure or want of consideration, mistake, and knowing misrepresentation rising to the level of fraud that induced a party to enter into a contract from which he or she might otherwise have steered clear.

Subsection (a)(3) deals with what the current version of Article 3 has dubbed *claims in recoupment*. A claim in recoupment is not, strictly speaking, a defense; even if available to the defendant, it does not totally do away with his or her obligation to pay what is due on the instrument. What is meant by a claim in recoupment is a legally recognized argument that the amount owed by the obligor should be reduced by some amount because of an offsetting claim the obligor can assert "if the claim [of the obligor for a reduction] arose from the transaction that gave rise to the instrument." Some illustrations of what will or what will not constitute a claim in recoupment appear in Examples 4 and 5.

We now turn to the all-important subsection (b) of §3-305:

> The right of a holder in due course to enforce the obligation of a party to pay the instrument is subject to the defenses of the obligor stated in subsection (a)(1), *but is not subject to* defenses of the obligor stated in subsection (a)(2) or claims in recoupment stated in subsection (a)(3) against a person other than the holder.

The emphasis has, of course, been added by me, but I could not resist. A party that qualifies as a holder in due course (or that can rely on the rights of a holder in due course thanks to the shelter doctrine of §3-203(b)) when enforcing the instrument is subject to the real defenses. The holder in due course, however, is immune from any personal defense that the defendant would otherwise have available and from any claims in recoupment that the obligor would have against a party other than the plaintiff himself or herself.

If you had been wondering about why we spent as much effort as we did in Chapter 7 looking at the question of how a party can establish its status not merely as a holder or a person entitled to enforce, but as a holder in due course, your curiosity should now be more than satisfied. Once a negotiable instrument has come into the hands of someone who qualifies as a holder in due course, the personal defenses and most claims in recoupment are cut off once and for all; anyone who has taken on the obligation to pay the instrument by signing it in one capacity or another is forevermore barred from asserting any personal defense to avoid payment or claim in recoupment to offset what he or she will be made to pay on the instrument.

To conclude this introduction, I ask that you turn to §3-306.

> A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including the right to rescind a negotiation and to recover the instrument or its proceeds. *A person having rights of a holder in due course takes free of the claim to the instrument.*

Again the emphasis is mine. The claims that are the subject of this section are to be distinguished from any possible claims in recoupment. What the section lumps together as *claims to an instrument* are claims by some party that he or she has a "property or possessory right in the instrument" that gives him or her greater right to the instrument than that of the present holder. The simplest example is the situation in which a thief has made off with a piece of bearer paper. Recall that the thief does qualify as a holder. He or she would not, however, be the legitimate owner of the instrument. The person from whom the instrument was stolen clearly has an argument for its return, based on a property right, and should be able to assert such a claim against whatever party is currently in possession of the instrument. Whether such a claim will be successful depends, as we will examine in Example 10, on whether the party now holding the instrument can successfully claim holder in due course status. Holder in due course status not only cuts off the personal defenses and claims in recoupment, but also protects the holder from such property-based claims of others.

Examples

Ms. Boss, who runs a small business, decides to give a Christmas bonus to each of her employees. She writes up a set of checks, including one payable "to the order of Louie Lacky." When Lacky comes into Boss's office to pick up his check, the two of them get into an argument and Boss decides not to give Lackey his bonus. The check written out to him remains on her desk. When Boss leaves the room, Lacky spies the check and quietly slips it into his pocket. By the time Lacky deposits the check in his own checking account, Boss has become aware of its absence and has put a stop-payment order on the check. The check, having been dishonored, is returned to Lacky by his bank.

If Lacky brings an action against Boss, based on her obligation under §3-414(b) to pay on the dishonored check of which she is the drawer, should Lacky's suit succeed? Recall §3-105.

What if, instead of directly depositing the check, Lacky had taken it to the Midtown Liquor store where he cashed the check for its full amount? Assume that there is no reason why Midtown, in taking the check, would not become a holder in due course. Midtown deposits the check, which is not paid because of Boss's stop-payment order and is returned to Midtown dishonored. If Midtown brings suit on the check against Boss, will its suit be successful?

In 2014 Thomas is invited to make an investment in Underwater Estates, which he is assured by its promoter, Horace Underwater, is going to be a fast-growing and highly profitable real estate venture. Thomas acquires an interest in this company by giving a note payable to Underwater Estates for $50,000, payable five years from the date of signing. By the time 2019 rolls around, it has been discovered that Horace Underwater had been convincing people (including Thomas) to invest in this project by knowingly giving them false information and projections as to its future profitability.

Assume that in 2019, when the note becomes due, it is still being held by Underwater, who brings suit to enforce it asserting Thomas's obligation under §3-412 to pay on the note according to its terms. Will Thomas have to pay the $50,000 due on the note?

Assume instead that Underwater had sold the note, soon after obtaining it, to one of the major banks in the community, Little Rock Bank and Trust. The Little Rock bank qualifies as a holder in due course at the time it takes transfer of the note. In 2019 it is still holding onto the note, and when Thomas does not pay the $50,000 when due, it brings suit against Thomas. Is Little Rock Bank and Trust entitled to collect this amount from Thomas?

In March of 2013, Seymour Sellers agrees to sell a quantity of high-quality widgets to Bertha Byers, who uses such widgets in her manufacturing operations, for the price of $12,000, delivery of the widgets to be made no later than April 1. Sellers does not ask for cash payment at the time the contract of sale is signed, but does get from Byers a note payable "to the order of Seymour Sellers" for the amount of $12,000 and due on May 1,

2013. Sellers never delivers the widgets to Byers. Byers never pays on the note.

Assume the note is still being held by Sellers. After May 1 he brings a suit on the note against Byers. Should Sellers's suit succeed in getting him the $12,000?

Assume instead that soon after he took possession of the note, Sellers sold it to the First National Bank for $11,000, and that the bank in taking the note qualifies as a holder in due course. When Byers does not pay the $12,000 due on the note on May 1, the bank brings an action against her for this amount. Will the bank's suit be successful?

This example starts out as does the preceding one: Seymour Sellers contracts to sell some widgets to Bertha Byers for the price of $12,000, with delivery of the widgets to be made no later than April 1. Sellers receives in March, at the time of the signing of the contract of sale, a note signed by Byers payable "to the order of Seymour Sellers" for the amount of $12,000 and due on May 1, 2013. This time, however, the widgets are delivered as promised before April 1. Unfortunately, Byers soon discovers some flaws in the widgets. They do not meet the specifications of the contract of sale entered into between Sellers and Byers. Byers determines that she will not return the widgets. She is able to fix the flaws so that the widgets end up meeting the contract specifications, but to do so she has to spend $1,400 of her own money.

Assume the note is still held by Sellers. Under the circumstances, is Byers still obligated to pay Sellers the full $12,000 on the note by May 1?

Assume instead that soon after he took possession of the note, Sellers sold it to the First National Bank for $11,000, and that the bank in taking the note qualifies as a holder in due course. When Byers does not pay the $12,000 due on the note on May 1, the bank brings an action against her for this amount. Will the bank's suit be successful and for what amount?

Now assume that Sellers and Byers enter into two separate contracts of purchase and sale. Under the first, Sellers will deliver the widgets by April 1. Sellers takes a note from Byers for $12,000, payable on May 1, in payment for the widgets. Under a second contract, Sellers agrees to supply Byers with a quantity of gaskets for $5,000, which Byers pays up front and in cash. Both the widgets and gaskets arrive on time. The widgets are as ordered; there is nothing wrong with them. The gaskets are, however, a different story. Byers is forced to spend $740 of her own money to repair the many that arrived broken or bent. When the note becomes due on May 1, it is still in Sellers's possession. Sellers insists on being paid the full $12,000 promised in the instrument. Byers argues that she has the right to deduct the $740 that she had to spend to bring the gaskets up to the quality promised her by Sellers from the amount due on the note. Which party has the better argument?

To expand his fledgling Internet company, Younger buys an assortment of computer equipment from Carl's Computer City. In exchange for the merchandise, he gives Carl a note calling for Younger to make monthly payments of a stated amount over the next three years. Carl immediately sells this note to Merchants Credit Association, which takes the instrument as a holder in due course. Soon thereafter, Younger comes back to Carl's. He wishes to return everything he purchased and "cancel" the note that he signed. It turns out that Younger is 17 years old. Carl tells him that even if he wanted to do as Younger asks, he no longer holds the note, as he has transferred it to Merchants Credit. Younger stops making his monthly payments on the note. Can Merchants Credit successfully bring suit against Younger on the note?

Mrs. Hodge entered into an agreement with Fred Fentress under which Fentress would do certain plumbing work for Hodge. Hodge gave Fentress a check for $500, and Fentress promised to return the next day with the necessary equipment to do the work. Fentress never returned. He did, however, cash the check at the Kedzie & 103rd Street Currency Exchange, which in taking the check qualified as a holder in due course. By the time the Currency Exchange itself tried to obtain payment on the check, Hodge had placed a stop-payment order on it. The check was returned unpaid to the Currency Exchange, which then sued Hodge on her obligation as the drawer of a dishonored check. Hodge asserted as a defense the fact that Fentress was not a licensed plumber. The state's plumbing licensing law requires that all plumbing, including just the type of work that Fentress initially contracted to do for Hodge, be performed only by plumbers licensed under the licensing law. Hodge argues that because Fentress was in violation of this law, the transaction giving rise to the check was illegal. Does this give her an effective defense to the collection suit brought by the Currency Exchange?

To get the capital he needs to expand a small business he operates, Cosmo Graphics arranges to borrow $80,000 from the firm of Ventura Capital. In exchange for the money, he gives a note the text of which reads that "the undersigned Borrower(s) agree to pay to the order of Ventura Capital" interest and principal on a schedule set out within the note. Graphics signs on the bottom on a line marked for "Borrower." Graphics has been told by Ventura Capital that he will need a co-signer on the note. He goes up to Dimmer, one of his senior employees, and asks if Dimmer would just please sign this piece of paper (the note) on the bottom next to his signature. "It's just a formality," he assures her, "and nothing for you to worry about." Dimmer signs as requested.

s Dimmer obligated on the note?

) Would it make any difference to your answer if Ventura Capital had transferred the note over to another firm, Centura Capital, which in taking the note would qualify as a holder in due course?

On February 1, 2014, Annie Able borrows $12,000 from Bennie Baker. She gives Baker a note payable to his order for $12,000 plus interest payable on December 1, 2014.

On November 24, Able pays Baker the amount due on the note, which is still held by Baker. Does Able have any further obligation on the note? See §§3-601 and 3-602(a).

Suppose that when Able makes her payment to Baker, he is no longer holding the note. He transferred it in March to Carla Charles. What is the result?

Finally, suppose that Baker was still holding the note when Able made her payment in November. Baker, however, does not return the note to Able, nor does he cancel the note by doing anything like ripping it in half or stamping it with a "Paid" stamp. (See §3-604.) On November 28, Baker negotiates the note to one Helen Chang, who qualifies as a holder in due course and has no knowledge or reason to know that Able made payment to Baker earlier in the month. Chang is expecting payment from Able of the full amount due on the note on December 1. When she doesn't receive this payment, she brings suit against Able for the amount of the note that she now holds. Is Chang entitled to payment?

Ms. Boss makes out and delivers a paycheck to one of her employees, Terry Toady. Toady immediately signs the back of the check with his name and puts the check in his jacket pocket, intending to deposit it in his bank on his way home. Before he leaves work for the day, however, another employee, Sally Sly, takes the check from Toady's pocket. Fortunately for Toady, someone sees Sly taking the check and the next day informs Toady of what has happened.

Assuming the check is still in Sly's possession, does Toady have the legal right to get it back from her?

Assume instead that by the time Toady catches up with the check, Sly has cashed it at a local grocery store, Ralph's Market. Assume further that Ralph's Market qualifies as a holder in due course of the check, which now sits in Ralph's cash register waiting to be deposited by Ralph along with other checks he has taken during the week. Does Toady have the right to regain possession of his check from Ralph?

Explanations

Lacky's suit to enforce Boss's obligation on the check should fail. Under §3-105(a), this check was never issued, and subsection (b) of this same section states that "nonissuance is a defense." For the sake of completeness, we should note that this defense would come under §3-305(a)(2) as "a defense of the obligor stated in another section of this Article." Boss has an effective defense against Lacky, who stands as holder of the instrument but not a holder in due course.

If, as we are assuming, Midtown qualifies as a holder in due course, then Boss's defense of nonissuance could not be successfully invoked against Midtown. Under §3-305(b), the rights of a holder in due course are not subject to the defenses of the obligor, here Boss, stated in subsection (a)(2). For confirmation, look at Comment 2 to §3-105:

> Subsection (b) [of §3-105] continues the rule that nonissuance … is a defense of the maker or drawer of an instrument. Thus, the defense can be asserted against a person other than a holder in due course.

When Thomas is sued on the note by Underwater, he will have available the personal defense of good old garden-variety *fraudulent inducement*. Thomas's agreement to take on the obligation represented by the note was induced by Underwater's fraudulent representations made to Thomas at the time of his signing concerning the underlying transaction. This is just the kind of conventional contract defense covered by subsection (a)(2) of §3-305.

If Little Rock Bank and Trust qualifies as a holder in due course of the note, then it is entitled to collect the full amount of Thomas's obligation on the note when due, and it is not subject to the defense of fraudulent inducement that Thomas would want to interpose. Fraud of this type is a personal defense and will be of no avail against a holder in due course.

> You might have been tempted, in answering this question, to try on Thomas's behalf to squeeze the defense upon which he seeks to rely into the real defenses of §3-305(a)(1)(iii), and thereby make it a defense that is

not cut off even if the party enforcing the instrument is a holder in due course. As we will see in Example 8, however, the type of fraud to which (a)(1)(iii) refers is a very different situation from what we have here. Fraudulent statements relating to the underlying transaction made to induce another to sign an instrument, such as Underwater has at least allegedly engaged in, clearly fall within the scope of the personal and not the real defenses. Hence, even if Underwater's fraud of this type could be easily proved by Thomas, it would not relieve Thomas of the obligation to pay the instrument now that it is in the hands of a holder in due course.

Byers should be able to defend herself successfully by invoking the standard contract defense traditionally referred to as *failure of consideration*. (In more modern contract lingo, we might speak of this as being the absence of a condition precedent, the delivery of the goods, to the existence of Byers's obligation to pay for them. But it amounts to the same thing.) Byers gave her promise to pay the money in the future in exchange for a promise on Sellers's part to deliver some high-quality widgets, and Sellers has totally failed to live up to his part of the bargain. As a matter of fact, this particular defense is incorporated directly into Article 3 in §3-303(b): "If an instrument is issued for a promise of performance, the issuer has a defense to the extent the performance of the promise is due and the promise has not been performed." Either way of looking at it, this is a personal defense under §3-305(a)(2) and as such is available to Byers when she is being sued on the note by a person who does not qualify as a holder in due course.

The bank, being a holder in due course, will be able to enforce the note and collect the $12,000 from Byers. As a holder in due course, it is not subject to the personal defenses such as she would try to assert here. Where does that leave Byers? Well, she will have to pay First National on the note and then pursue Sellers by other means. She can bring an action against him under Article 2 (see §§2-712 and 2-713) for any damage caused to her by his failure to deliver the goods contracted for. This remains a matter between Byers and Sellers, however. As far as the bank is concerned, being as it is a holder in due course of the note, it can enforce the note against Byers free and clear of any personal defenses she would have at her disposal if she were being sued by Sellers himself or any other holder that could not prove itself to have taken as a holder in due course.

No. Under §3-305(a)(3), Byers would be able to assert a claim in recoupment for $1,400 against Sellers in his suit against her. Sellers would be entitled to payment of $10,600 ($12,000 minus $1,400) on the note, but no more. This is what Article 3 considers a claim in recoupment, because it is a claim—in this case for breach of warranty (see §2-714)—that arises from the same transaction that gave rise to the instrument.

Because First National Bank stands as a holder in due course, it will be able to enforce the instrument without being subject to any claim in recoupment that Byers may have. Notice that §3-305(b) states that the holder in due course is not subject to "claims in recoupment stated in subsection (a)(3) against a person other than the holder." Whatever claim in recoupment Byers may have is a claim against Sellers, not against First National Bank, which is now the holder. Sellers's failure to make widgets that were up to par may not be used to reduce the amount owed to First National on the note that it holds as a holder in due course.

Sellers wins this argument. He is owed the full $12,000 due on the note exchanged for the widgets. Byers does have a claim for breach of warranty, because of the broken and bent gaskets, amounting to some $740, but this does not qualify as a claim in recoupment that can be asserted against Sellers to diminish the right he has to receive the $12,000 due on the note. A claim in recoupment under §3-305(a)(3) must be a claim arising "from the same transaction that gave rise to the instrument." See *Zener v. Velde*, 135 Idaho 352, 17 P.3d 296, 42 U.C.C.2d 1073 (Id. App. 2000). Byers's claim for breach of warranty arose from a different transaction than the one that gave rise to the $12,000 note. Hence, Sellers's right to enforce Byers's obligation as the maker of the note is not "subject to" her breach of warranty claim arising under this other transaction. Byers does, of course, have the right to collect $740 from Sellers for the damages he has caused her by his failure to deliver the gaskets as warranted, but she will have to pursue him separately for this amount. She cannot simply offset it against the amount due on the note. Observe that this result does not depend on whether the person holding the instrument and to whom obligation is due is a holder in due course. Rather, it is the result of what "claim in recoupment" means in the Article 3 context.

When Merchants Credit attempts to collect from Younger on the note, Younger may try to use as a defense the fact that he signed the note when he was still a minor. Among the real defenses of §3-305(a)(1) to which even a holder in due course is subject is "infancy of the obligor to the extent it is a defense to a simple contract." As Comment 1 states, No attempt is made [in this section] to state when infancy is available as a defense or the conditions under which it may be asserted. In some jurisdictions it is held that an infant cannot rescind the transaction or set up the defense unless the holder is restored to the position held before the instrument was taken which, in the case of a holder in due course, is normally impossible. In other states an infant who has misrepresented age may be estopped to assert infancy. Such questions are left to other law, as an integral part of the policy of each state as to the protection of infants.

So the answer to this question will depend on exactly how the common law of contracts in the jurisdiction in which this story is being played out treats the defense of infancy.

This example is based on the well-known case of *Kedzie & 103rd Currency Exchange v. Hodge*, 156 Ill.2d 112, 619 N.E.2d 732, 21 U.C.C.2d 682 (1993). The question is whether Mrs. Hodge can assert, against the holder in due course, the defense of illegality under §3-305(a)(ii). Again, as in the case of the infancy defense, the question has to be answered by reference to the common law of the jurisdiction, but the test of whether the defense is available is different. The defense of "illegality of the transaction" is, under (a)(ii), available against a holder in due course only if, under the law of the jurisdiction, it "nullifies the obligation of the obligor." This test—which applies as well to the defenses of duress and lack of legal capacity—requires a showing that, under the applicable law of the jurisdiction, the defense renders the obligation not merely voidable at the election of the obligor, but entirely null and void from the outset.

No single test has been adopted by all the states to determine when illegality of a transaction renders all obligations under that transaction null and void, as opposed to merely voidable at the election of one of the parties. In the *Kedzie* case, the Illinois Supreme Court held that the defense was not available against the check-cashing agency suing as a holder in due course. The defense of illegality nullifies the transaction under Illinois law only when "the instrument arising from the contract or transaction is, itself, made void by statute." The Illinois plumbing license law made it illegal to do plumbing without a license; it did not specifically make it illegal to issue an instrument in payment for plumbing to be done by someone without the requisite license.

Although the *Kedzie* case was decided under the prerevision version of Article 3, there is no reason to think it would come out any differently today. In both versions, the test of whether illegality of the transaction rises to the level of a real defense, available even against a holder in due course, depends on the "other law" of the jurisdiction, and there is no reason to think that the law of Illinois as to when illegality renders a transaction void rather than merely voidable would have changed with the adoption of the new Article 3. Two cases that follow the Illinois Supreme Court's approach in *Kedzie* are *State Street Bank & Trust Co. v. Strawser*, 908 F. Supp. 249, 30 U.C.C.2d 477 (M.D. Pa. 1995) (applying Pennsylvania law), and *Hand v. Manufacturers & Traders Trust Co.*, 405 Md. 375, 952 A.2d 240, 66 U.C.C.2d 957 (2008).

Not all states draw the line exactly where Illinois does, requiring a specific declaration by the state's legislature that any instrument issued under the circumstances is void as a matter of law. Some would find illegality in the underlying transaction (at least if it were not a mere technical violation of law but a particular heinous encroachment on what is deemed to be a particularly significant state interest) enough to render void any instrument issued as part of the transaction, even if the state legislature had not addressed the matter directly. In any event, the defense of illegality as it stands in (a)(1)(ii) has to be thought of as a narrow one. As a matter of fact, the illegality defense seems to arise most often not in the situation of unlicensed plumbing and the like, but when the instrument in question was issued to pay a gambling debt or to borrow money with which to gamble. Some states, even those that allow legalized gambling, have specific statutes rendering void any instrument issued to pay a gambling debt or to obtain funds on credit with which to gamble, in which case even the holder in due course of such an instrument would be unable to enforce it. Other states, though not having statutory pronouncements directly on point, may reach the same result. On this defense, as well as the defenses of incapacity and duress, which are grouped in (a)(1)(ii) with illegality as defenses available only when the result is to "nullify" the obligation of the defendant, see the third and fourth paragraphs of Comment 1 to §3-305.

Dimmer will almost assuredly be held obligated on the note as a co-maker. She may try to assert the defense, provided for in §3-305(a)(1)(iii), of "fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms," but she would have a hard time making the case that this applies to her situation. First, note that fraud of the type being talked about here is not of the same type as we dealt with in Example 2. That was the essentially different—and doubtless far more common—fraudulent inducement, and it fell within the grab bag of personal defenses of (a)(2). The subject of (a)(1)(iii) is what has historically been referred to as *fraud in the factum*. It consists of fraudulent behavior designed to get someone's signature on a document without the signer's knowing or having a reasonable opportunity to discover just what the paper he or she is signing is all about. As the fifth paragraph to Comment 1 explains,

> The common illustration is that of the maker who is tricked into signing a note in the belief that it is merely a receipt or some other document. The theory of the defense is that the signature on the instrument is ineffective because the signer did not intend to sign such an instrument at all.

Fraud of this type is, as you might expect, exceptionally difficult to prove. As the comment continues,

> The test of the defense is that of an excusable ignorance of the contents of the writing signed. The party must not have only been in ignorance, but also must have had no reasonable opportunity to obtain knowledge. In determining what is a reasonable opportunity all relevant factors are to be taken into account, including the intelligence, education, business experience, and ability to read or understand English of the signer. Also relevant is the nature of the representations that were made, whether the signer had good reason to rely on the representations or to have confidence in the person making them, the presence or absence of any third person who might read or explain the instrument to the signer, or any other possibility of independent information, and the apparent necessity, or lack of it, for acting without delay.

Applying this test to Dimmer's case, it is hard to imagine that she will be able to prove the kind of excusable ignorance of what she was signing that would allow her to rely on this defense. Dimmer may have acted pretty dimly in signing this note as she did, but there is no indication, at least from the information I've given you, that she is generally lacking in intelligence, education, or the like, nor that she had, in the words of the section, no "reasonable opportunity to learn of [the note's] character or its essential terms." As you may imagine, the defense of fraud in the factum is available in only a very limited number of situations. For an interesting case considering the difference between fraud in the factum (the real defense we are discussing in this example) and the distinct notion of fraudulent inducement (the personal defense we encountered in Example 2) that also demonstrates how exceedingly difficult it is for a party to successfully invoke the notion of fraud in the factum, see *Brown v. Carlson*, 25 Mass. L. Rep. 61, 70 U.C.C.2d (Sup. Ct. Mass. 2009). The circumstances under which Dimmer, of our example, signed would not seem to fit within this defense.

If (and as we have just seen it is a very big *if*) Dimmer were successfully able to assert the fraud in the factum defense, then she would be able to use it against Centura Capital, even if that firm did qualify as a holder in due course. The defense arising from this species of fraud, limited as it is in practice, is a real defense. As such, once proven, it would be available against a holder in due course.

No. Able's paying Baker has discharged her from any further obligation on the note. Under §3-601(a), "The obligation of a party to pay the instrument is discharged as stated in this Article," and according to §3-602(a), subject to some exceptions none of which are relevant here,

> an instrument is paid to the extent payment is made (i) by or on behalf of the person obliged to pay the instrument, and (ii) to a person entitled to enforce the instrument. To the extent of the payment, the obligation of the party obliged to pay the instrument is discharged.…

In this instance, Able was the person obliged to pay on the note and Baker was a person entitled to enforce the instrument. The payment by Able to Baker discharged Able from any further obligation to pay on the note.

Discharge of this type is not, as you can check, listed among the defenses to obligation in §3-305. That section recites the affirmative defenses that a person charged with an obligation on an instrument may seek to assert. Discharge by payment is not an affirmative defense. If you are discharged from an obligation, for whatever reason, your defense is simply that you are no longer subject to the obligation being asserted against you. Anyone trying to enforce the instrument will fail to make out a prima facie case against you. You don't need to bring up any affirmative defenses. The effect of payment and potential discharge is, however, sufficiently important that we cannot let it go unaccounted for, and the present chapter seemed as good a place as any to deal with it.

Able is not discharged by her payment to Baker if he no longer holds the instrument. Under §3-602(a), an instrument is paid to the extent that payment is made to a person entitled to enforce the instrument. As of the moment Able pays Baker in this hypothetical, Baker is no longer a person entitled to enforce the note. That would now be Charles. Charles can, and we have to assume will, insist that Able make full payment to her as and when the note becomes due, and Able will not be able to argue against Charles that the note has been paid off. It has not.

So, the first rule of thumb in paying off an instrument is to be sure that the person to whom you are making payment is at the time truly in possession of the instrument and entitled to enforce it. Don't just assume. Ask to see the instrument and accept no substitutes.

Chang is entitled to payment from Able even though Able paid off the note when it was still in the hands of Baker. See §3-601(b): "Discharge of an obligation of a party is not effective against a person acquiring rights of a holder in due course without notice of this discharge." Chang, we are assuming, is not only a holder in due course but also had no notice of the discharge. Thus, she could sue Able for the full amount of the note without having to recognize any previous discharge that occurred when Able paid Baker.

So, the second rule of thumb in paying off an instrument is to make sure that you take back physical possession of the instrument (if it is being fully paid off) or see it destroyed or fully canceled before your eyes. This assures that it can never later fall into the hands of someone qualifying as a holder in due course. If you are paying off only a portion of what is due on the instrument, make sure that this partial payment is duly noted *on the instrument itself*. That way no one later taking the instrument, even if he or she qualifies as a holder in due course, can claim lack of notice of the discharge.

Yes. Notice that Sly is in fact a holder of the check. She has possession of a bearer instrument. Sly is not, however, a holder in due course. Among other things, she didn't give value for it—not to mention her lack of good faith. In any event, under §3-306, "[a] person taking an instrument other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds including a claim … to recover the instrument or its proceeds." Toady has such a claim to the check as his property and will be able to enforce this claim against Sly.

No. Section 3-306 concludes with the statement that "[a] person having rights of a holder in due course takes free of the claim to the instrument." Ralph is, we are assuming, a holder in due course of the check and took it free from any claim to the check that Toady would have. Once again, and for the last time (at least in this chapter), we see the awesome power that holder in due course status confers upon a party. The holder in due course takes the instrument free of all but the limited "real" defenses and free from the claims of others to the instrument itself. Holder in due course status is far from being just a matter of prestige or bragging rights. It figures mightily into the bottom line.

Revision Proposals

The 2002 Revision of Article 3 adds some language to §3-602 that may be of some help to parties in the position of our friend Able confronted in Example 9b. Recall that she made payment to the original payee of a note of which she was the maker, but that the payee had previously transferred the note to another party. Her obligation on the note was not discharged under current §3-602(a). How could she have made such a bush-league error? The same outcome might still be true under §3R-602(a), but note the following that has been added to a new subsection (b):

> … [A] note is paid to the extent payment is made … to a person that was formerly entitled to enforce the note only if at the time of the payment the party obliged to pay has not received adequate notification that the note has been transferred and that payment has been made to the transferee.

The subsection goes on to prescribe what is required for adequate notice of the transfer, and further states:

> Upon request, a transferee shall seasonably furnish reasonable proof that the note has been transferred. Unless the transferee complies with the request, a payment made to the person that formerly was entitled to enforce the note is effective [for purposes of discharge] even if the party obliged to pay the note has received a notification under this paragraph.

The reason given in an accompanying comment by the revision drafters for this amendment is that, "Unlike the earlier version of Section 3-602, this rule is consistent with Section 9-406(a), Restatement of Mortgages §5.5, and Restatement of Contracts §338(1)."

So, in our Example 9b, under this revision, Able *might* be discharged of any obligation on the note upon her payment to Baker *if* either Baker failed to give her adequate notice of the transfer to Charles or if Charles fails to comply with Able's perfectly reasonable request that Charles prove that he still holds the note transferred to him. The rule of thumb stated in the second paragraph of my explanation to that example in the text—it hardly need be stated—still goes.

CHAPTER 9

The Consumer Context

INTRODUCTION

Traditionally, the holder in due course doctrine has been thought of as one of the most significant features—indeed, probably the principal feature—distinguishing the negotiable instrument from the nonnegotiable contractual promise to pay, even when that promise to pay is memorialized in a writing of some detail and sophistication. Negotiability makes a big difference. It is, of course, perfectly possible for people to buy and sell rights arising under a contract. Your study of the common law of contracts presumably included at least an introduction to the law governing the assignment of contract rights. As a practical matter, however, the assignment of a contract right in exchange for cash or anything else of present value carries a great deal of risk for the buyer, which consequently severely limits the market for such rights. The purchaser of a nonnegotiable contract right will, under the fundamental principles of contract law, take the right subject to all defenses the obligor would have against the initial obligee. In contrast, the purchaser of a negotiable instrument who can assert the rights of a holder in due course will, as we have seen, take the instrument and the promise of payment it represents free of the most common defenses that the obligor may later try to interpose. The holder in due course doctrine cuts off these defenses and thus greatly reduces the risk that the purchaser of the instrument takes in giving present value in exchange for the instrument and its promise of payment in the future. In so doing, the holder in due course doctrine greatly facilitates the marketability of negotiable instruments.

A party signing a negotiable instrument should be aware that in doing so, he or she faces the very real possibility that the instrument will end up in the hands of someone who qualifies as a holder in due course, and that consequently the defenses available when the obligation on the instrument comes due will be greatly limited. There is nothing inherently unfair or unreasonable about this result. A signature on a negotiable instrument in connection with a loan, the sale of goods or services, or any other transaction, should result in the signer's being able to obtain credit at a lower rate of interest than if he or she were attempting to obtain credit without being willing to assume obligation on an instrument. The creditor can extend these more favorable terms to the borrower precisely because it has the possibility of selling off the instrument to another, who could thereby qualify as a holder in due course. The party purchasing the instrument as a holder in due course is willing to pay more for it because that holder in due course status cuts off the most common defenses to later enforcement of the instrument, thus reducing the note purchaser's risk. Holder in due course status allows the purchaser to value the instrument without having to take into account any of the personal defenses the obligor might later try to assert based on irregularities, or even outright fraud, in the original transaction giving rise to the instrument.

The holder in due course doctrine as a core feature of negotiable instrument law has a long history, and as we have seen, it carries through to the most recent version of Article 3. By the middle of the last century, however, attention was increasingly being drawn to the argument that the doctrine could and did work a particular hardship on consumer borrowers. Sophisticated businesspersons who signed instruments could be expected to know and appreciate (even if sometimes we wonder whether they really did) the consequences of taking on obligation by signing a negotiable instrument. In contrast, it is feared that all too often the consumer creditor will sign just about any paper put in front of him or her without question and without a full understanding of all the consequences that may flow from that signature.

The basic problem as it relates to the consumer transaction can be related fairly easily. Consider the following transaction:

The consumer buys some expensive item, say a car, from the retailer. The buyer may pay some of the price as a cash down payment, but the bulk of the buyer's obligation to pay for the car will be evidenced by a note that he or she signs, calling for monthly installment payments over a period of a few years. The seller then sells off the note for cash to a local bank or other financial institution. There is, of course, nothing wrong with or suspicious about this. Most consumer purchasers are not in a position to buy big-ticket items such as automobiles other than on credit. The seller will insist on the buyer's signing a note, rather than just contractually obligating itself to pay over time under a simple common law contract, so that the seller can sell off (or, as we sometimes say "discount") the note. The bank is willing to buy the note because it is in negotiable form and the bank can take it as a holder in due course.

The trouble—at least from the buyer's point of view—comes when something goes wrong with the car or if the buyer later becomes aware that he or she was induced into purchasing the car on the basis of fraudulent misrepresentations by the seller. Under such circumstances the buyer may legitimately argue that he or she has the right, under the basic law relating to the purchase and sale of goods, to return the car and get his or her money back. Or perhaps he or she will want to keep the car but subtract from what he or she owes on it the amount of damages caused by the car's failure to be as warranted by the seller. The problem is that any such arguments, although they will be good against the seller, will have no effect on the consumer's obligation to keep paying the monthly installments on the note, which is now in the hands of the bank. The bank, if it can properly claim holder in due course status, has every right to insist that the consumer continue to meet its obligation as maker of the note. Any personal defenses or claims in recoupment that the injured buyer might want to assert are cut off and not available to him or her now that the note has found its way into the possession of a holder in due course. The car buyer is relegated to seeking whatever remedy he or she can against the breaching or defrauding seller; what he or she *cannot* do is stop paying the bank on the note. The monthly car payments, as the buyer will naturally think of them, are still due regardless of the car's condition or what the buyer has later learned about the seller's tactics that led to the sale. The bank's position, simply put, will be, "Keep paying us on the note. We had nothing to do with the sale of the car. Whatever problems you have with it, you will have to take up with the dealer." What we may well think of as a particular unfairness to the consumer in such a situation can be compounded if we consider that whatever rights the buyer may retain against the seller may be of little value if, by the time the buyer becomes aware of what has happened, the seller has become insolvent or is otherwise unavailable for suit.

A COMMON LAW RESPONSE

Should the law concerning negotiable instruments do away with the holder in due course rule, either entirely or at least in the case of consumer transactions? Around the 1960s this question became a subject of considerable debate by academics and other commentators. On one side were those who argued that the fundamental inequity imposed upon consumers in such situations—where they typically had no way of being aware, at the time of signing a note, of all the implications of the obligation they were undertaking—called for some type of relief. Those who argued against either doing away with or significantly cutting into the holder in due course doctrine, even in the consumer context, argued that to do so would only make it that much harder for consumers to obtain credit with which to make large purchases, or would greatly increase the cost of whatever forms of credit remained available to them.

Meanwhile, as the academic debate raged, consumer advocates began to find some success in the states, through both court decisions and legislative enactments. For one thing, the courts began to recognize that the party claiming holder in due course status was not in all instances a truly independent third party that had purchased the note from the seller in an arm's-length transaction. Certainly, if the bank had with any regularity been purchasing notes taken by the retailer in exchange for its wares, and had some reason to be aware that the retailer was selling shoddy merchandise or engaging in deceptive practices, it could be held not to be a holder in due course because of its failure to act in good faith in taking the instrument, even if it had no notice of a defect in the particular goods sold. Beyond this, several decisions looked beyond the paperwork of the transaction and determined that the party presenting itself as a holder in due course was not in fact as divorced or isolated from the initial transaction giving rise to the note as we would commonly expect a true holder in due course to be. In some instances the seller and the financial institution taking the note, supposedly as holder in due course, were in actuality just two parts of the same business enterprise, organized to appear as distinct entities but in fact operated and controlled by the same people. Even if the seller and the institution to which it sold the note were not really just two divisions of the same operation, there might be such a regular and mutually beneficial relationship between the two (say, between a car dealership and the one major bank in town to which it steered all customers interested in obtaining car loans) that the court might find it inappropriate for the bank later to claim holder in due course status. This led, in many jurisdictions, to judicial adoption of the so-called *close-connectedness doctrine*, under which the court would refuse to recognize the right of a holder in due course to avoid the personal defenses or claims in recoupment that would have been available against the "closely connected" entity from which it purchased the note had the note still been in that party's possession. In the oft-cited case of *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405, 4 U.C.C. 542 (1967), the Supreme Court of New Jersey reasoned:

> The basic philosophy of the holder in due course status is to encourage the free negotiability of commercial paper by removing certain anxieties of one who takes the paper as an innocent purchaser knowing no reason why the paper is not as sound as its face would indicate. It would seem to follow, therefore, that the more the holder knows about the underlying transaction, and the more it controls or participates or becomes involved in it, the less he fits the role of the good faith purchaser for value; the closer his relationship to the underlying agreement which is the source of the note, the less need there is for giving him the tension-free rights considered necessary in a fast-moving, credit-extending commercial world.

The court concluded by articulating a test that other courts were later to follow for determining when and whether the relationship between the retailer and the financial institution to which it sells its consumer paper is sufficiently close to conclude that the institution's right to enforce the instrument is not freed of the personal defenses or claims in recoupment.

> [W]hen it appears from the totality of the arrangements between the [retailer] and financier that the financier has had a substantial voice in setting standards for the underlying transaction, or has approved the standards established by the [retailer], and has agreed to take all or a predetermined or substantial quantity of the negotiable paper which is backed by such standards, the financier

> should be considered a participant in the original transaction and therefore not entitled to holder in due course status.

Over the ensuing years, the close-connectedness doctrine has been applied almost exclusively in cases in which the maker of a note has been a consumer buying for his or her own personal use. Nevertheless, a handful of cases extend the notion to the protection of the small business borrower. See, for instance, *St. James v. Diversified Commercial Finance Corp.*, 102 Nev. 23, 714 P.2d 179, 1 U.C.C.2d 121 (1986).

LEGISLATIVE AND REGULATORY RESPONSES

While the courts in many states were adopting and refining the close-connectedness doctrine to give the consumer purchaser a measure of relief, a number of state legislatures were enacting statutes intended to confront the same problem. Such legislation was not adopted in all states, nor is the legislation necessarily the same from state to state in the jurisdictions where the legislature did take action. Although such state statutes operate in various ways, the principal intent of each is to provide that if a party takes a note from a consumer in violation of whatever provisions are set forth in the statute (such as having to put the legend "Consumer Note" on the paper itself), and then sells the note to a third party, that third party will not be able to take advantage of holder in due course status. This result is often limited by the requirement that the third party must have been aware of the violation.

The state responses to the problem of consumer protection, as it arises in connection with the law of negotiable instruments and the time-honored holder in due course doctrine, have tended to fade into the background in more recent years, because of the promulgation in the mid-1970s of the Federal Trade Commission Holder-In-Due-Course Regulations (16 C.F.R. Part 433).* We will explore in more detail exactly how these regulations work in the examples and explanations of this chapter, but the basic idea is simple enough. The regulations make it an *unfair or deceptive act or practice* under Section 5 of the Federal Trade Commission (FTC) Act (15 U.S.C. §45) for any seller to take from a consumer a note that does not bear, in at least 10-point bold type, a legend reading:

NOTICE

> **ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.**

The following examples explore when such a legend is required to be placed on a consumer note, what its effect is when it does appear, and what consequences follow if it does not. As we will see, not every note, and indeed not every note signed by a consumer, has to bear such a legend. The legend quoted here is required in some instances when the note signed by a consumer is issued to the seller, either directly or indirectly. In other instances, credit will be obtained not from the seller directly but from some other lender, and a slightly different legend *may* be required. See 16 C.F.R. §433.2(b). Key to determining whether a note issued to a lender other than the seller requires this legend is the concept of the *purchase money loan* as defined in 16 C.F.R. §433.1(d) to be:

> A cash advance which is received by a consumer in return for a "Finance Charge" within the meaning of the Truth in Lending Act and Regulation Z [which you need not worry about here], which is applied, in whole or substantial part, to a purchase of goods or services from a seller who (1) refers customers to the creditor or (2) is affiliated with the creditor by common control, contract, or business arrangement.

Examples

Stan and Dan are neighbors. Stan agrees to buy a used car from Dan (who happens to be a podiatrist), in return for which he gives Dan a note for the purchase price, made payable to Dan one year hence. The note contains no special legend of the type called for by the FTC Holder-In-Due-Course Regulations. Is Dan as seller in violation of §433.2 of those regulations? See 16 C.F.R. §433.1(b) and (j).

Stewart Student decides to buy a house. He arranges with Hometown National Bank to borrow the money to buy the house, signing a so-called mortgage note indicating that the note is secured by a mortgage that the bank will hold on the property. Does this note have to carry an FTC holder in due course legend?

Able, of Able's World of Wheels, is an authorized dealer in automobiles manufactured by the Zephyr Motors Manufacturing Corporation. He sells one such vehicle to Christine, who plans to use the car for her everyday personal use. Christine gives Able a down payment representing 10 percent of the price and also signs a note promising to pay Able the rest of the price in monthly installments (reflecting, of course, an agreed rate of interest) over the next four years.

Is the note that Christine signs required to carry, in the appropriate size bold type, the legend found in §433.2(a) of the FTC regulations?

Does the inclusion of this provision in the note prevent the note from being a negotiable instrument under Article 3? See §3-106(d) and Comment 3 to that section.

Assume that the note signed by Christine does bear the required FTC legend. Soon after acquiring the note, Able sells it off to Downtown Federal Bank. Can Downtown Federal qualify as a holder in due course of the note? See §3-302(g) and Comment 7 to that section.

Beatrice owns and operates another authorized Zephyr dealership. When Ralph decides to buy a car from her on credit, she does not extend the credit to him directly. What she does is suggest that he speak to a particular loan officer at Uptown Bank and Trust, who should be able to arrange for that bank to give Ralph an auto purchase loan, the proceeds of which he can then use to pay Beatrice for the car. Ralph does obtain a loan from Uptown. In connection with the loan agreement, Ralph is asked to sign a note under which he is to make monthly payments to repay the bank for what it loaned. Uptown forwards the loan proceeds to Beatrice, who then completes the sale of the car to Ralph.

If the parties involved want to be sure that the FTC Holder-In-Due-Course Regulations are not violated, what must be true of the note signed by Ralph and made payable to Uptown Bank and Trust? See 16 C.F.R. §433.2(b).

Suppose that, instead of sending potential credit buyers like Ralph to Uptown Bank and Trust, Beatrice has an arrangement with Zephyr Motors Acceptance Corporation (ZMAC), a subdivision of the Zephyr Corporation (a separate subdivision of which is Zephyr Motors Manufacturing). ZMAC specializes in making auto loans to people interested in buying autos from Zephyr dealerships. Beatrice gives Ralph all the appropriate papers to sign to apply for a loan from ZMAC and forwards these to a special agent at ZMAC who is accustomed to working with Beatrice and her customers. ZMAC approves the loan. When he picks up his new car, Ralph is required to sign a note made payable to ZMAC. What must be true of this note if Beatrice is to steer clear of any violation of the FTC regulations?

Charlie operates yet another Zephyr dealership. He sells a car to one Lenni for a price of $20,000. Lenni gives Charlie a $2,000 down payment and also signs a note payable to him, under which the remainder of the price will be paid off in monthly installments of $480. The note that Lenni signs bears, in the correct form, the legend called for in the FTC regulations. Charlie immediately sells this note off to the Midtown Bank for Savings. After Lenni has made the first two monthly installment payments, a significant defect in the car's emergency brake (which you may assume was present at the time of the sale by Charlie but had not previously been discovered or discoverable by Lenni) allows the car, while parked on a steep incline, to roll backward and off a cliff. Fortunately, no one is injured, but the car is a total loss. Also lost in the accident is more than $4,000 worth of computer equipment that Lenni had stored in the trunk at the time of the accident.

Can Lenni stop making payments on the note, which is now in the hands of the Midtown Bank?

Is Lenni entitled to recover from the Midtown Bank the $2,960 she has already paid on the car, as well as the $4,000 in consequential damages she suffered because of the car's defective condition?

Dexter, of Dexter's Auto and Truck Emporium, is the last of the Zephyr dealers whom it is our destiny to meet. He sells a used Zephyr auto to one Johanna, who plans to use the car for purely personal purposes, for only $500 down. For the remainder of the price he takes an installment note made out to his firm. This note does not bear any legend as called for by the FTC regulations. Dexter sells this note to the Eastside Bank. Soon after the sale, Johanna becomes aware that the odometer of the car has been tampered with and that the car has been driven many more miles than she had been led to believe by Dexter at the time she bought it. Johanna drives the car back to Dexter's dealership, fully intent on returning the car and demanding her money back. It turns out that Dexter has closed up shop. The building that housed the dealership is boarded up and deserted. Dexter is nowhere to be found. Meanwhile, Johanna has been given notice by the Eastside Bank that it holds the note signed by her and that it fully expects her to make the monthly payments called for by the note. Is she under an obligation to do so?

Explanations

No. The operative language of 16 C.F.R. §433.2 makes it an unfair or deceptive trade practice for a seller to take either a note or the proceeds of a note in exchange for goods or services if the note in question fails to bear an appropriate legend whenever a sale is made to a consumer. Unless Stan is buying the used car for some business purpose of which we are not aware, he comes within the definition of a *consumer* under 16 C.F.R. §433.1(b): "A natural person who seeks or acquires goods or services for personal, family or household use." Dan, however, does not fall within the restricted definition of *seller* in 16 C.F.R. §433.1(j): "A person who, in the ordinary course of business, sells or leases goods or services to consumers." This transaction does not fall within the scope of the FTC regulations.

No. The note was signed to obtain money not to acquire goods or services but to purchase real estate. Again, as in Example 2, such mortgage notes are very often sold off by the bank that originally took them and can easily fall into the hands of a holder in due course.

Yes. Able is a seller of the type to whom the FTC regulations are directed per 16 C.F.R. §433.1(j) and Christine is a consumer buyer under §433.1(b). Under §433.2(a), it would be an "unfair or deceptive act or practice within the meaning of Section 5 of [the Federal Trade Commission Act]" for Able as a seller, directly or indirectly, to "take or receive a consumer credit contract" that fails to carry, in the appropriate size and bold type, the notice set out in §433.2(a). The term *consumer credit contract* is defined in §433.1(i) and includes a "financed sale" as defined in §433.1(e), which is what we have here between Christine as the buyer and Able as the financing seller. Able would be in violation of the FTC Act if the note that he gets Christine to sign did not include the required notice.

No. Section 3-106(d) was included in the revision to Article 3 to address just this point. The inclusion of the FTC notice does not make the promise embodied in the note conditional for the purposes of §3-104(a) and hence the note is still a negotiable instrument within the meaning and covered by the terms of Article 3 of the Uniform Commercial Code.

No. As you will have noticed in the concluding language to §3-106(d), there cannot be a holder in due course of an instrument bearing a notice of the type required by the FTC regulations. Subsection §3-302(g) repeats this message: “This section [defining the holder in due course] is subject to any law limiting status as a holder in due course in particular classes of transactions.”

The transaction here comes within the definition of *purchase money loan* under 16 C.F.R. §433.1(d). Ralph has received a cash advance (which we can assume was received by him in return for a *finance charge* as that term is defined in another set of FTC regulations), which he applies to the purchase of the car from Beatrice as seller. Furthermore, she refers customers to this particular bank, the creditor. This being true, under §433.2(b) Beatrice would be in violation of the FTC regulation if she were to take, as full or partial payment for the sale to Ralph, the proceeds of the purchase money loan unless the note signed by Ralph at the bank bore the form of notice set forth in part (b) of §433.2.

Note that although I asked the question in terms of what “the parties involved” would have to do to ensure that the FTC regulations were complied with, it is really only the seller, Beatrice in this case, who has anything to fear if the FTC legend is either intentionally or inadvertently left off the note Ralph signs at the bank. As you will have noticed by now, the FTC Holder-In-Due-Course Regulations speak only to the *seller’s* behavior and how it may be in violation of the FTC Act if the seller should fail to act as those regulations require. Neither the consumer buyer nor any third-party financer, which either takes up a note originally written to the seller as payee or makes a purchase money loan with which the consumer buyer can make cash payment to the seller, can be in violation of the FTC regulations. So, in this case, it is for Beatrice to be concerned that the note Ralph signs payable to Uptown Bank and Trust bears the correct legend. Otherwise, her taking the proceeds of the loan as partial payment for the car subjects *her*—not Ralph or the bank—to proceedings for violation of the FTC Act. Therefore, Beatrice has to make sure that the form of note the bank asks Ralph to sign carries the correct notice, even though she is not even a party to the note. Beatrice should not, as a practical matter, have trouble making sure that the note is as it should be. Remember, the reason the FTC regulations apply to this particular purchase and sale transaction, to which Beatrice is most definitely a party, is because the loan by the bank qualifies as a purchase money loan under §433.1(d) as a result of Beatrice’s practice of “refer[ring] customers to the creditor” Uptown Bank and Trust.

This note must also bear the notice required under 16 C.F.R. §433.2(b). This is a purchase money loan as defined in §433.1(d) because the seller, Beatrice, "is affiliated with the creditor [ZMAC] by common control, contract, or business arrangement." This final term, *business arrangement*, may seem fairly open-ended, and a reading of §433.1(g) where it is defined will only confirm this impression. Clearly, however, the intent is to cover the kind of relationship that Beatrice, a Zephyr auto dealer, has with Zephyr Motors Acceptance Corporation.

Yes. Because the note that Midtown holds bears a correct FTC notice, that bank cannot qualify as and does not have the rights of a holder in due course. Under the law of sales, Lenni should be able to revoke her acceptance of the automobile under §2-608 of the U.C.C. Under §2-711, the justifiably revoking buyer may then "cancel," which would allow her to stop making payments to the seller. Midtown's entitlement to enforce the instrument is subject to any personal defenses or claims in recoupment that Lenni would have against Charlie (the seller and original payee of the note), so Lenni would be within her rights to stop making payments to Midtown.

Under U.C.C. §2-711, the revoking buyer is entitled to "recover so much of the price as has been paid." Lenni should also be able to recover consequential damages to the tune of $4,000, under §2-715(b). All of this would amount to a claim in recoupment, which she would have against Charlie, her seller, and hence against Midtown Bank for Savings, which has taken the note but which does not qualify as a holder in due course. Lenni will not, however, be entitled to recover all of this from Midtown Bank for Savings. Look to the last sentence of either version of the FTC notice: "Recovery hereunder by the Debtor shall not exceed amounts paid by the Debtor hereunder." Lenni may recover from Midtown only up to what she has paid that bank on the note, which in this case is $960. For return of the down payment of $2,000 and payment of the consequential damages of $4,000, she will have to look to Charlie directly.

Whether or not Johanna has to keep paying Eastside Bank on the note is not clear. Dexter as seller was clearly in violation of the FTC regulations and hence guilty of an "unfair or deceptive act or practice" as defined in Section 5 of the FTC Act. Should he ever be found, he will be subject to the type of civil proceedings that the FTC Act empowers the FTC to bring in such cases. He could be subject to a cease-and-desist order issued by that agency or to civil penalties.

The problem for Johanna is that neither the FTC Act nor the Holder-In-Due-Course Regulations provide any private right of action on the part of the individual consumer who has been subjected to the unfair or deceptive act or practice that constitutes the violation of the FTC Act. Dexter's failure to include the proper notice on the note puts him in the wrong, but the absence of the notice may make it possible for Eastside Bank to argue that, whatever wrong Dexter may have done, it still can and does qualify as a holder in due course. Eastside has done no wrong, at least as far as the FTC regulations are concerned, and it has taken a note that bears no forbidding notice or other indication that would bar the bank from claiming holder in due course status. As one court has recently observed,

> A plain reading of the regulation shows that, although it is unlawful to handle a consumer credit contract that fails to include the required Notice, the regulation itself does not automatically insert the required language into those contracts. Indeed, it would be *impossible* to violate the regulation if the required Notice were automatically read into every consumer credit contract.

Whittington v. Patriot Homes, Inc., 2008 U.S. Dist. LEXIS 29760, 65 U.C.C.2d 488 (W.D. La. 2008).

All hope is not lost for Johanna on this issue, however. Many states have adopted separate consumer protection legislation which, either explicitly or by judicial interpretation, provides that when a note is issued and fails to carry the FTC notice when that notice is called for by the federal regulations, no subsequent holder may assert the rights of a holder in due course. In other states, courts have held to the same effect despite the lack of legislation directly on point. This result is not, however, a foregone conclusion. See *Crisomia v. Parkway Mortgage, Inc.*, 2001 Bankr. LEXIS 1469 (E.D. Pa. 2001), and *Morales v. Walker Motor Sales, Inc.*, 162 F. Supp. 2d 786 (S.D. Ohio 2000). So Johanna will have to do some digging into her state's legislative and common law to see if she can find any relief there.

Another argument Johanna may advance is that under Article 3 of the U.C.C., as adopted in all of the states, a sophisticated lender such as Eastside Bank cannot qualify as a holder in due course under §3-302(a), as it could not have been acting in "good faith" in purchasing a consumer note that failed to display the expected FTC notice. After all, the bank would know of the FTC regulations and should realize that any note signed by a consumer made payable to an auto dealership should, in order to comply with those regulations, bear the required legend. This note did not. Especially now, in light of the new expanded definition of *good faith* in §3-103(a)(4) introduced by the 1990 revision of Article 3, this argument has a lot going for it.

Revision Proposals

A significant consumer protection part of the 2002 Amendments to Article 3 comes into play in situations such as the one Johanna of our last example found herself confronting. Recall that she signed a note that was supposed to have the FTC Notice printed on it but did not, and the note came into the hands of a party that would like to take advantage of holder in due course status. Under the current version of Article 3 there is no obvious relief for her. The revised version, first of all, would add a definition of *consumer transaction* in §3R-301(a)(3). Secondly, language would be tacked on to §3-305, in §3R-305(d), providing that in a consumer transaction if an instrument is issued that under other law *ought* to contain a statement such as the FTC Notice but *does not* contain the statement, then the instrument is in effect treated—now under Article 3 authority—as if it did bear the statement anyway. That is, "the instrument has the same effect as if the instrument included such a statement," and in particular no one can assert the special rights of a holder in due course of the instrument. Another addition, §3R-305(f), states explicitly that, "This section is subject to law other than this article that establishes a different rule for consumer transactions."

* I assume, if you are studying this topic in your course, that the full text of these regulations will be available to you as part of whatever hefty volume of "Selected Commercial Statutes and Other Materials" you have obtained to furnish you with your own personal copy of the Uniform Commercial Code. If for some reason you don't have the FTC regulations in your course materials, you could, needless to say, find them yourself in the Code of Federal Regulations under the citation given.

PART III

The Check Collection System

CHAPTER 10

The Traditional Method of Check Collection

INTRODUCTION TO CHECK COLLECTION

It all starts when someone writes a check. It is perfectly possible, of course, for any of us to write a check on any bank. All it takes, according to Article 3, is a pen, a piece of paper, and the minimal effort it takes to write on the paper something that qualifies as a check under the definition of §3-104(f). The whole exercise doesn't make much sense, however, unless the drawer has an active checking account with the bank in question. As background to the writing of any check of significance, we have to posit that the drawer has opened a checking account with the bank named as drawee on the check and that the account is still active. We will look at the relationship between the bank and its checking account customer in more detail in Part IV, but a brief introduction at this point will set the stage for the topic on which we now embark, the check collection process.

The relationship between a bank and its checking account customer is that of debtor and creditor. The customer deposits some funds in an account with the bank. The bank, by accepting the funds pursuant to the agreement setting up the account, takes on an obligation to the customer equal in amount to what the customer has available in his or her account. The bank owes this amount back to the individual customer and hence stands as a debtor. The customer is owed this amount by the bank and takes on the role of creditor. The customer has advanced funds to the bank, which he or she has the right to get back or use as he or she sees fit.

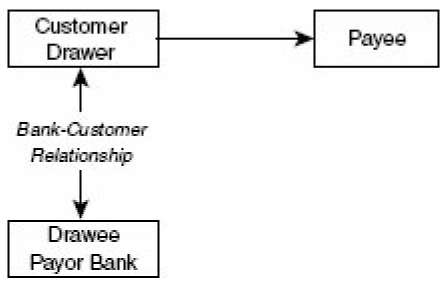
What makes a checking account—as opposed to, say, a savings account—particularly useful to a customer is that one particular way the customer can make use of his or her money "in the bank" is by having a portion of the funds on deposit paid out by the bank *to another*, to some third party, at the customer's direction. The customer need only *order* the bank to pay a certain amount of money to another, and the bank will become obligated (assuming various conditions are met, of the type we will be meeting in this and chapters to follow) to comply with the customer's order. The initially curious aspect of all this is that the customer does not directly order the bank to pay someone else with funds available from the customer's account. With the typical checking account, the customer cannot just call up the bank and tell it to dispense some amount to any particular person. The order to the bank is made in a very indirect fashion. That, of course, is where the check comes in. The customer initiates the order by issuing a check naming the bank as drawee. The check may then be transferred any number of times, physically passing from hand to hand. Eventually, if the check is to turn into actual funds for someone in possession of it, the check must be presented to the drawee bank. The bank, having received an order to pay in this roundabout fashion, will in the normal course of things (again assuming that a variety of conditions are met) respond to its customer's order by releasing funds equal in amount to what is written on the check to whatever party presented the check to the bank. The bank obeys the orders of its checking account customer, which come to it in the form of pieces of paper—checks—presented to it. Our concern in this chapter is how the check written by the customer eventually makes its way to the drawee bank. In Chapter 12 we will pick up the story to see how the check is dealt with once it arrives at and is thus "presented to" the drawee bank. In the great majority of cases, the drawee bank responds by honoring the check which, as we will see, it typically does by retaining physical possession of it (rather than returning, or as we say, "bouncing" the item). There the accepted check sits, at the drawee bank, until it is most often returned to the customer—now as a canceled check—along with the customer's bank account statement. The check has taken a complex and multi-staged journey only to land right back where it started, in the customer's hands.

You will have noticed that I titled this chapter to emphasize that we will first look at what I have chosen to call the "traditional method" of check collection. By that I mean, first, that the customer has chosen to disburse money from his or her account by creating and issuing a *piece of paper* that qualifies as a check under the definition we have been using from the very first chapter of this book. The traditional method of collection then continues with this piece of paper physically *making every step* of the collection journey, being passed from one player in the collection process to the next, literally and not just symbolically or metaphorically. Modern automated means may be used to facilitate this movement of the check from place to place—just as the check may make it across the country on a modern jet plane instead of by something equivalent to a horse and buggy—but the check itself, that piece of paper, is always on the move. Put this in the context of the modern economy where, since early in the last century, tens of billions of checks have been channeled through the traditional check collection process each year, and you have a staggering number of pieces of paper, each with its own unique travel itinerary, making their way through the system each year.

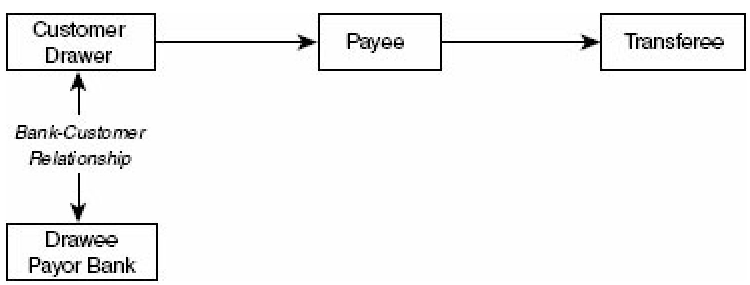
As you are no doubt aware, in recent years a variety of methods have been introduced attempting to streamline this process. Some use more advanced electronic means to speed the check—or at least the core information carried on the check—from one place to another. Some do away with the paper check altogether! In Chapter 11 I give an overview of these newer techniques that have appeared on the check collection scene, most only in the last few decades. In this chapter, however, we will stick with the traditional scheme of collection as it evolved over the early and well into the later part of the twentieth century.

It is important for you to appreciate that, while I have decided to term this the "traditional" method of collection, it shouldn't be thought of as some kind of archaic or old-fashioned process of primarily historical interest. For one thing, a significant number of checks, both commercial and consumer, are still collected in just the way we'll be looking at in this chapter or still make a substantial part of their collection journey in conventional paper form.* For another, you wouldn't be able to understand, much less appreciate, the newer variations on the theme to be considered in the next chapter without a good understanding of this traditional method of collection of the traditional paper check. The newfangled approaches we'll explore in the next chapter will necessarily be, as we will see, attempts to either work within or, in some cases, work their way around, what we will be studying in this chapter.

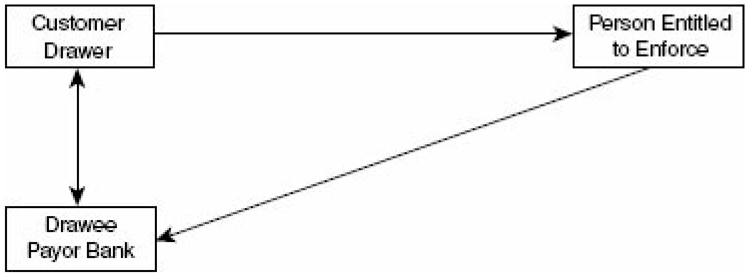
With this general background in mind, we return to where we began: It all starts when someone who has established a checking account with a bank writes a check on that account. The check is then issued and presumably finds its way into the hands of the named payee.† So we begin with a situation that can be diagrammed like this:



You will have noticed that I chose in the diagram to refer to the drawee bank as the *Payor Bank*. This term, which we will be using more and more in what is to come, is not my invention. See §4-105(3). The payee who is now in possession of the check may choose to collect on it himself or herself, but as we know he or she may instead transfer the check to another, either by negotiation or otherwise.



There may in fact be several transfers of the check before it eventually comes into the hands of someone who wants to do more with it than just pass it on to another. This party wants to collect the funds that the check represents. If each of the transfers has been a valid negotiation (and, as we are assuming in this chapter, no nasty business such as theft or forgery has been involved), then this person should qualify as a "person entitled to enforce" the instrument under §3-301. We know that the holder of a draft such as a check must first try to enforce the instrument and get the money that it represents by presenting it to the drawee. In this case, that means presenting the check to the bank on which it is written, the *payor bank*.



If the person attempting to collect on the check is in a hurry, or if he or she just happens to be in the neighborhood where the payor bank is located, he or she can make a direct presentment by going to the bank and handing the check to a teller there, *over the counter* as we say. The rule governing presentment over the counter is found in §3-502(b)(2). Recall that upon presentment of any draft—and that includes a check—to the drawee, the drawee will be confronted with the decision of whether to accept the draft as written. If the drawee does not accept the draft, declining to comply with the order given in it by the drawer, it will have dishonored the instrument. *Dishonor* of a check presented over the counter occurs when "presentment for payment is duly made to the drawee [the payor bank] and the [check] is not paid on the day of presentment." It is important to note that the payor bank is given some time, until the end of the day on which direct over-the-counter presentment is made, to determine whether to honor the check that it has just been handed. It does not dishonor the check by refusing to pay it immediately. The bank is given this time because it has to be able to determine a number of things in order to decide whether it is obligated to pay this check: The drawer does in fact have an account at the bank, the account is still active, the bank has not received a stop-payment order from its customer telling it not to pay the check in question, and of course the all-important consideration of whether the customer's account has sufficient funds available to cover the check.*

You will also want to remember, from our past work, that if the bank does not honor the check, in this or in one of the more complicated settings to which we will soon turn, and even if this is what we will later term a *wrongful dishonor* (meaning that under the circumstances the bank should have, under its agreement with its customer, honored the check), the wrong committed by the payor bank is committed against the customer, not against the person entitled to enforce the check. (We will deal with the problem of wrongful dishonor in Chapter 14.) The person attempting to enforce a draft never has a right to the drawee's acceptance. If the check is dishonored and returned unpaid, the person left holding the unpaid draft must then proceed against the drawer under §3-414(b) to obtain relief. The person entitled to enforce the check has no right to insist that the bank pay it even if, under the circumstances, there is nothing fishy about the check and the bank should, according to the terms of its agreement with its customer, have paid the item when presented.

DEPOSITING FOR COLLECTION

In many instances, of course, people or institutions holding checks will not want to take the trouble or be in a position to present the checks they have received directly to the payor bank. What they will do instead is deposit the checks in a bank with which they have established their own bank-customer relationship. Their bank will not itself pay the check. What it will do for its customer is itself present, or take steps intended to lead to the eventual presentment of the check, in one way or another, to the payor bank. As we will see in this chapter, the bank, by taking deposit of a check, obligates itself to act in a way reasonably calculated to effect collection of the funds that the check represents. The money, if it is forthcoming, is still to be paid by the payor bank.

By depositing a check for the purpose of collection, the customer has entered into a complex and highly sophisticated system by which collection is made through banking channels. It has also plunged us directly into the world of Article 4 of the U.C.C. Look at §4-101 and the comments to that section. As the first comment indicates, by 1990 something like 50 billion checks made their way through the check collection system each year in the United States. (By the end of the 1990s, the number probably peaked at something close to 70 billion before beginning to drop off because of electronic means of payment, the type we'll touch on in Chapter 11.) Section 4-102(a) deals with the scope of Article 4 in a somewhat cryptic fashion:

> To the extent that items within this Article are also within Articles 3 and 8, they are subject to those Articles. If there is a conflict, this Article governs Article 3, but Article 8 governs this

Article.

Fortunately, we don’t have to worry about Article 8 at all. For that matter, we don’t really have to worry about conflicts between Articles 3 and 4, as we just don’t see any popping up.* As far as what *items* are within the scope of Article 4, look at the definition of that term in §4-104(a)(9). An *item* is “any instrument or a promise or order to pay money handled by a bank for collection or payment.” This includes some types of items with which we will not bother ourselves, but it certainly includes the simple check deposited for collection.

Having deposited a check in its account for the purposes of collection, the customer has singled out this bank as what we can now, using the definition of §4-105(2), refer to as the *depositary bank* with respect to this item. The situation stands like this:

Before it proceeds any further with its handling of the check, the depositary bank will do two things. First of all, it will record the amount of the check as a credit to the depositor’s account, but this will necessarily be a *provisional* credit only. Until the check has been presented to the payor bank and honored, the depositary bank will not consider this an unconditional addition to the amount in the depositor’s account. The check represents a potential for money to come into that account, but until the check is honored and funds are received, directly or indirectly, from the payor bank, the depositary bank will consider it only a provisional addition to the account. As you have no doubt experienced in your own life, the depositary bank will not consider the amount of the check as immediately accessible for withdrawal by the depositor out of his or her account as cash or as funds available to cover any checks the depositor himself or herself has written. As we proceed with the story of check collection, we will see what happens to this *provisional* credit to the depositor’s account in the depositary bank: whether it firms up and turns into a *final* credit, to add to the funds in the depositor’s account actually and without question, or whether it ends up being withdrawn, leaving the depositor with none of the money in his or her account and holding a dishonored check.

The second thing the depositary bank will do upon receipt of the check is encode its amount onto the check itself. If you look along the bottom of any preprinted check form, you will see a series of oddly shaped but still perfectly readable numbers encoded on the check. This is the so-called MICR (for *M*agnetic *I*nk *C*haracter *R*ecognition) line. On the check form as it is made available to the bank's customer, the first set of numbers represents the routing number of the particular bank on which the check is to be drawn (a unique number assigned by the American Bankers Association). The next series of numbers represents the customer's account number at that bank. These in turn are followed by the check number of that particular one of the customer's preprinted checks. Once the check is issued by the drawer and deposited into someone else's account, the depositary bank adds to the end of the line, in MICR characters, the amount of the check. After the check is encoded with its amount by the depositary bank, this is probably the last time it will be individually handled or even looked at by a real live human being. From this time forward, the check can be and is (with only rare exceptions) sorted, handled, moved around, and evaluated by high-speed reading and sorting machines, which are able not only to read but also to react to the information as carried on the MICR line. As Comment 2 to §4-101 makes clear, only because the huge number of checks that run through the check collection system each day can be dealt with through this automated system can the system operate as efficiently and as cheaply as it does.

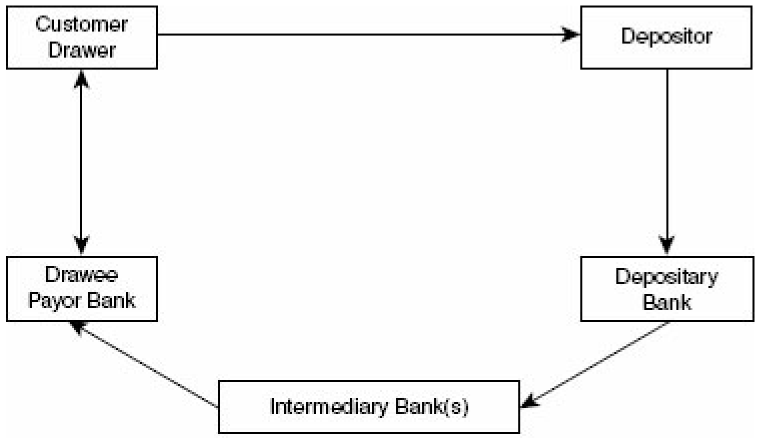
FORWARDING FOR COLLECTION

The depositary bank is now in possession of a fully encoded check and has given a provisional credit to the depositor. What next? As part of its agreement with its customer (the depositor), the depositary bank as the first of the *collecting banks* (per §4-105(5)) is now charged with acting as an agent for the customer in seeing that the check gets sent on its way to the payor bank for presentment. See §4-201(a). In carrying out its role as agent for collection, the depositary bank, as well as any other collecting bank encountered along the way, is charged with exercising reasonable care on behalf of the depositor. See §§4-202(a) and 4-204(a). What constitutes reasonable care, and the exact route the check will take on its way to the payor bank, will necessarily vary depending on the circumstances. The depositary bank will first cull out, through its automated sorting machines, any checks written on itself, so-called *on-us* items. When the depositary bank also happens to be the payor bank, the bank then takes on the responsibility of acting as the payor bank upon presentment; it must examine the item and determine whether to honor it. If it does honor, the provisional credit in the depositor's account is stripped of its provisional status and the amount in the depositor's account is increased by the amount of the check. As a result of the check having been honored, the balance in the drawer's account is decreased by the same amount.

At the same time that the depositary bank is sorting out the checks written on itself, its sorting machines are also separating out other checks, on the basis of where the payor bank is located and other factors that the depositary bank has determined will control how it deals with each of the many checks it has received that day for the purposes of collection. For instance, the depositary bank may have a policy of directly presenting checks to all local banks, or at least certain banks that it can anticipate will regularly account for a large number of the checks it receives for deposit. On such items the depositary bank then takes on the role of the *presenting bank*, as defined in §4-105(6). It is perfectly possible for the depositary bank in such a situation to present a single item by properly delivering it to the payor bank, but this would happen only rarely. More likely is that the depositary bank will bundle together all the items it has received that day written on the payor bank in question. It delivers this packet of items, along with a computer printout that lists the items individually and gives the total of all items in the bundle, directly to the payor bank. It would not be unusual for the payor bank itself to have received, during the same period, a large number of checks written on the depositary bank. The roles now switch, and when Bank *A* directly presents to Bank *B* a bundle of checks written on the latter bank, Bank *B* will take the opportunity (or rather, follow the agreement or practice that the two banks have entered into for dealing with items written on each other) to hand over and hence present any checks deposited at Bank *B* that are written on Bank *A*. The two banks have directly presented those items deposited at one and written on the other.

In many metropolitan areas where there are a number of larger banks, any one of which can expect to receive for deposit a significant number of checks written on each of the others, this process of reciprocal direct presentment has been more formally organized by the establishment of local clearing houses. These are voluntary organizations that have as members the major banks in the locality. Suppose that Bank *A* is a member of the local clearing house in its area, along with five other banks, *B* through *F*. Each day Bank *A* will sort out and bundle the checks it has received for deposit written on each of Banks *B* through *F*. At a given time and place, all as specified in rules promulgated by the clearing house, someone from Bank *A* will bring each of these bundles of checks to the floor of the clearing house. There he or she will deliver to a representative of each of these other member banks the items that Bank *A* has received made payable on those other banks. Bank *A*'s representative will at the same time receive from each of Bank *B*, Bank *C*, and so on, any items written on Bank *A* that each of those banks has received. The clearing house mechanism results in a large number of local checks being directly presented by the depositary bank to the payor banks on which they are written, in a particularly efficient fashion.

Any given bank on any given day may of course receive hundreds, thousands, or tens of thousands of checks written on any number of banks spread wide across the country. For checks that are not on-us items, or for which the depositary bank does not have an established mechanism for making direct presentment to the payor bank, the depositary bank will fulfill its obligation to the depositor by forwarding the check to another bank that stands in a better position to present the check or at least to forward the check to a bank closer geographically and in a better position to act as the presenting bank. This bank may then present the item to the payor bank or, if it is not set up to do so itself, forward the check one more time to another bank that may be able to do so. And so it goes. The check continues to be forwarded through a series of what are termed *intermediary banks* (§4-105(4)) until eventually it comes into the possession of a bank that is in a position to act as the presenting bank, which will then present the check to the payor bank.



Forward Collection Process

For any given check, there is no way of telling with any certainty in advance exactly how many intermediary banks, if any, will be involved in the collection process before the check makes it way to its final destination, the payor bank. In some instances, as we have seen, no intermediary banks are involved at all, as when the depositary bank takes a check written on itself or on a bank to which it can directly present. In other instances, the check may have to go through a number of intermediary banks before it reaches one that can and will act as the presenting bank. Nor is it possible to say that there is only one correct way for any given item to make its way through the maze of banks throughout the country on its way to the payor bank. A given check could make its way from the depositary bank to a distant payor bank through a variety or routes, each of which consists of a series of steps that would be deemed reasonable under the circumstances.

Nevertheless, any bank involved in the process is not allowed to spend as much time as it likes to take the action required of it, nor can it just forward the check to any old bank it wishes. Under §4-105(5), the term *collecting bank* is used to refer to any bank in the collection process other than the payor bank, which therefore includes the depositary bank as well as any intermediary bank or banks involved. This will become important when we later look at the affirmative obligations of a collecting bank as set forth in Article 4, which are designed to make sure that the process of check collection goes forward in a reasonable manner intended to get the check to the payor bank in a timely fashion, if not necessarily by the absolutely quickest means theoretically available.

In considering the use of intermediary banks, special note must be taken of the system of Federal Reserve Banks spread across the country. The country is divided into 12 distinct Federal Reserve Regions, some of which have further subdivided themselves into more than one territory to accomplish their role in the check collection process. Any bank in the United States will lie within the defined territory of a single Federal Reserve Bank. The system of Federal Reserve Banks provides to all banks operating in this country a nicely integrated and convenient network of check clearing centers. Although there is no requirement that these Federal Reserve banks be used as intermediary banks to facilitate the collection process, they often are. A bank in one of the Federal Reserve's check collection regions, in which has been deposited a check written on a bank in another region, may as a matter of course forward that check to the Federal Reserve Bank in its own region, knowing that the check will then be forwarded to the Federal Reserve collection center servicing the area in which the payor bank is located. A depositary bank that receives a large number of checks written on banks across the country may choose to sort the checks it has taken for deposit by the Federal Reserve collection center covering the area in which the drawee bank is located. It can then send these bundles of checks directly to the various remote Federal Reserve collection centers, bypassing its local Federal Reserve. (Remember that this is all possible because the MICR line conveniently carries, in coded form, information about the exact bank on which the check is written. The first four digits of the MICR line, in fact, just happen to denote which Federal Reserve processing center covers the area in which the payor bank is located.) A given depositary bank will determine how to deal with checks written on distant banks based on what is most efficient and most cost-effective given its own individual circumstances.

The influence of the Federal Reserve Banks, and of the numerous local clearing houses, in the overall process of check collection is considerable. Section 4-103(a) allows the provisions of Article 4 to be varied by agreement of the parties involved. Subsection (b) then provides:

> Federal Reserve regulations and operating circulars [issued by the individual Federal Reserve Banks], clearing-house rules, and the like have the effect of agreements under subsection (a), whether or not specifically assented to by all parties interested in the items handled.

Although Comment 3 to this section is somewhat heavy going, and I would not advise you to worry over every detail, it is worth looking over at this point. It reminds us that even though the rules governing check collection (with which we will concern ourselves in the examples to follow) are laid down by Article 4, any bank must be concerned as well with the other regulatory requirements of the Federal Reserve system operating as a whole, the rules of individual Federal Reserve Banks with which it may deal, and the requirements of any clearing house of which it is a member, if it is to do a proper job of check collection and avoid liability for failure to do so.*

As the check is passed from bank to bank in the forward collection process, each transferor bank will expect to receive from its transferee *settlement* for the item at the time of transfer. Under §4-104(a)(11):

> "Settle" means to pay in cash, by clearing-house settlement, in a charge or credit or by remittance, or as otherwise agreed. A settlement may be either provisional or final.

As Comment 10 acknowledges in its final paragraphs, this definition is purposefully broad, to take into account the wide variety of means that banks use to settle for items they receive through the collection process. For our purposes, it is sufficient to know that each bank that takes a check for collection, as well as the payor bank to which the check is eventually presented, will at the time it receives the item "pay" for it by settling for the item in one way or another, making immediately available to its transferor funds equivalent in value to the amount of the check. Such settlements are in almost all cases provisional. Just as the depositary bank has, upon receipt of the check from its customer, *provisionally* credited his or her account with the amount of the check, each bank through whose hands the check then passes will *provisionally settle* with the prior bank in the chain. As we will see in the next section, these provisional settlements will firm up and become final settlements automatically upon final payment of the check by the payor bank. In the unlikely event that the payor bank dishonors the check and does not finally pay it, all provisional settlements are then reversed or charged back by the parties who made them, in effect undoing them and wiping them off the books. Look at Comment 1 to §4-214.

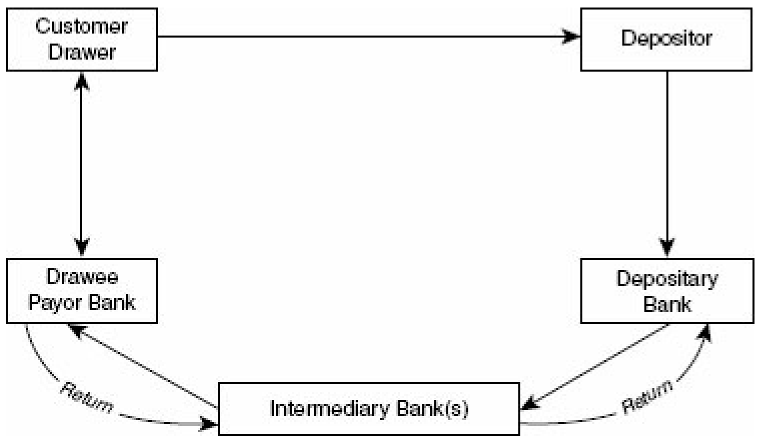
THE CHECK REACHES THE PAYOR BANK

Eventually, if the collection process has gone forward as intended, the payor bank will be presented with the individual check that started off this whole affair. Unless the payor bank is itself also the depositary bank, the payor bank is required to settle for the item with the presenting bank by midnight of the banking day on which it was presented with the item (§4-302(a)(1)). Such settlement is, in almost all instances, provisional only. The payor bank then has one additional day until its *midnight deadline*, as defined in §4-104(a)(10)—"midnight on its next banking day following the banking day on which it receives the relevant item"—to decide whether to accept the check or dishonor it (again, §4-302(a)(1)). It is given this additional time to determine whether the account on which the check is drawn is an active account, whether there are any outstanding stop-payment orders on the particular check, and of course whether the drawer has sufficient funds in his or her account to cover the item. If the payor bank decides to honor the check (or, as we will see in more detail in Chapter 12, it fails to dishonor and return the check by the passing of its midnight deadline), we speak of the check as having been *finally paid*. We will leave all the intricacies of final payment for Chapter 12. For the moment, it is sufficient to note that if a check is finally paid by the payor bank—and more than 99 percent of all checks are—then the check has found, at least for a time, its final resting place. The payor bank will hold onto the check, at least unless and until it returns it as a canceled check to the drawer along with that customer's monthly statement, if that is what it is required to do by its agreement with the customer. Also, at the moment of final payment, all the provisional settlements that have been created in the various intermediary banks the check passed through on its route to the payor bank automatically firm up, as does the previously provisional credit allocated to the depositor's account by the depositary bank (§4-215(c) and (d)). See *Kimberly A. Allen Trust v. FirstBank of Lakewood, N.A.*, 989 P.2d 203, 40 U.C.C.2d 1048 (Colo. App. 1999).

As we have already noted, the vast majority of checks are honored once received by the payor bank. Given the huge number of checks working their way through the system at any given time, however, even if the percentage of checks that are not finally paid by the payor bank is small, the absolute number of them is hardly insignificant. Many checks do bounce, and the system has to provide for what happens in any such instance. Once the payor bank decides, prior to its midnight deadline, not to honor a check, that bank's obligation then is to return the item to the presenting bank (§4-301(a)). That bank will in turn have to transmit the item back to the bank from which it, the presenting bank, received the check. And so it goes. The check is bounced back, retracing the route it originally took on making its way to the payor bank, but now as a so-called *return item*, until it eventually arrives back at the depositary bank.*

As the dishonored check makes its way through the return process, all provisional settlements given by each transferee bank to its transferor are revoked or charged back (§4-214). Notice that any of the collecting banks is subject to the duty of ordinary care while playing its part in this return process, just as it was earlier in forwarding the check for collection (§4-202(a)(2)). The depositary bank will, when it receives the unpaid item, withdraw the provisional credit to the depositor's account and notify the depositor of what has happened. The depositary bank has carried out its role as an agent in attempting to collect on the check, but now it has the sad duty to inform its customer that the collection attempt was unsuccessful.

An extremely important aspect of the process we are examining is that if and when a check is finally paid by the payor bank, none of the banks that have been involved in the collection process—and this includes the depositary bank—will ever expect to receive affirmative notice of the happy event. The payor bank that finally pays an item is not required to, nor does it in the regular course of events, send any message back up the chain of banks through which presentation was made. It does not notify anyone that, yes, the check is good. It simply accepts the check, deducts its amount from its depositor's account, and that is that. Under the system as it operates, a collecting bank is just left to assume that any check that has passed through its hands has in fact been finally paid, from the fact that the bank never hears to the contrary. No news, as far as the intermediary and depositary banks are concerned, is good news. If these banks do not receive any negative information about the check in question within some period of time, they should rightly be able to conclude that the check has been honored, all provisional settlements have become final, and the depositor has this amount of money in his or her account to do with as he or she sees fit. A problem, particularly for the depositary bank, which we now have to acknowledge and about which we will have much more to say in what follows, is that by the nature of the system there is no exact amount of time or number of days, either dictated by statute or regulation or necessarily following from the process of collection, that it will take for bad news to reach the depositary bank. The forward collection process may involve only a single transfer of the instrument or quite a few. If the payor bank dishonors a check, it is required to return that check within a certain amount of time, and the returned item will work its way back along the route it originally took in the forward collection process. Thus, it can take quite some time, the exact extent of which cannot be stated with any certainty, for a dishonored check to make its way back to the depositary bank. No news is good news in the check collection process, but there is no way for the depositary bank to know with certainty by what date bad news would arrive if any were on its way.



Examples

Annie writes a check payable to Patrick on her account with the North Street branch of the First National Bank of Springfield. On Monday morning, Patrick deposits this check in his own checking account, which coincidentally also happens to be with the North Street branch of First National.

What are the obligations of the folks at the North Street branch with respect to this check?

What if Patrick's account with First National is held at the South Street branch of the bank? He deposits the check on Monday morning at this South Street location. What must happen here? See §4-107.

Annie writes another check, to one Pauline. Pauline deposits this check in her account with the Second National Bank of Shelbyville on a Wednesday at 2:45 in the afternoon. That bank does nothing with the check on Wednesday, but groups it with the items it receives on Thursday morning for the purpose of processing. Is the bank within its rights to do so? See §4-108.

The Barker Company, which operates a manufacturing plant in Bakersfield, California, arranges to buy some supplies from the Stanley Corporation, which is located in Salem, Massachusetts. Stanley agrees to sell the supplies to Barker on credit. Once Barker has received the supplies, it draws a check for the price on its checking account with Bakersfield Bank and sends this check to Stanley. When Stanley receives the check, it promptly deposits it, along with others it has received that day, in its account with the Salem State Bank. It makes this deposit on Monday morning. By late on Monday afternoon, the Salem bank has encoded the check and forwarded it, along with a large number of other checks it has received payable by nonlocal banks, to the Federal Reserve Bank of Boston.

Has the Salem bank taken appropriate action with respect to this check? Consult §§4-202 and 4-204(a).

What if the Salem bank had not sent the check to the Boston Fed until Tuesday?

What if it had waited until Wednesday? See §4-103(e).

Assume that the check from Example 3 is in fact sent to the Federal Reserve Bank of Boston on Monday and is received by that bank on Tuesday. The Boston Fed then forwards the check to the Los Angeles Federal Reserve Bank check processing center on Wednesday morning. Assuming that Bakersfield is within the territory covered by the L.A. Federal Reserve check processing center for collection purposes, has the Boston Fed met its obligations with respect to the item?

We continue with the story of this particular check. Assume that it was sent by the Boston Fed to the Los Angeles Fed collection center, which receives it on Thursday morning. What must that collection center do then?

The Los Angeles Fed collection center presents this check to Bakersfield Bank, the bank on which it has been drawn. That bank honors the check. What are the consequences of this final payment by Bakersfield Bank?

Suppose that by the time Bakersfield Bank receives the check from the Los Angeles Fed collection center, it has already received a stop-payment order from its customer, the Barker Company, which on inspection determined that the supplies sent to it by Stanley were substandard and will have to be returned. Bakersfield Bank dishonors the check by returning it to the Los Angeles Fed collection center on the next day.

What is the Los Angeles Fed collection center now supposed to do with the check?

Complete the story of this dishonored check. What route will it take now and where should it end up?

Leno Electronics, a firm located in Burbank, California, also arranges to buy some supplies from the Stanley Corporation of Salem, Massachusetts. Leno's contract with Stanley is unlike that which Barker entered into, in that Stanley refuses to sell to Leno on credit. Stanley agrees to send the merchandise to Leno only after receiving payment for it. Leno writes out a check drawn on its account with the Burbank Bank of Commerce and mails this check to Stanley. Stanley deposits this check into its account with Salem State Bank. This check is properly forwarded for collection via the Boston Fed and the Los Angeles Fed collection center. The Los Angeles Fed collection center presents the check to the Burbank bank, which dishonors it, because Leno Electronics does not have sufficient funds in its account to cover the amount of the check. The Burbank bank promptly returns the check to the Los Angeles Fed collection center, which in turn promptly returns it to the Boston Fed. The Boston Fed then promptly returns the check to the Salem State Bank. This dishonored check arrives at the offices of the Salem State Bank on a Tuesday morning. There it lies for more than a week, until an officer of the bank calls the Stanley Corporation to inform it that the check it has deposited has bounced and that the amount of the check, previously credited to Stanley's account, is being withdrawn. It turns out that just the day before, Stanley shipped out the supplies it had contracted to sell to Leno. Does the Salem State Bank bank have any liability to its customer Stanley?

Explanations

In this instance, the depositary bank, First National Bank of Springfield, happens also to be the payor bank, so there is no need for any forwarding of the item or any provisional settlements between banks. The people at the North Street branch will give Patrick a provisional credit for the amount of the check and then must treat the check as one presented for payment to it as the payor bank on Monday. The bank will be deemed to have finally paid the item if it does not return the item to Patrick by its midnight deadline, which would in this case be midnight on Tuesday. See §4-301(b) and Comment 4 to that section.

Section 4-107 provides that:

> A branch or separate office of a bank is a separate bank for the purpose of computing the time within which and determining the place at or to which action may be taken or notices or orders shall be given under this Article and under Article 3.

As Comment 1 notes, exactly how the situation should be dealt with will depend on the facts of the case. If we assume that the North Street branch and the South Street branch of First National have not so integrated all of their check-handling and payment procedures as to in effect operate as a single entity for check collection purposes, then the North Street branch, after giving a provisional credit to Patrick, will have to forward the check for collection to the South Street branch, within the time limits and exercising the degree of care as it would be required to observe with respect to any other bank. Once the item is received at the South Street branch, that branch will deal with it as with any other item it receives for payment. Notice that §4-107 does not say that the two branches are to be considered separate banks for all purposes. So, for instance, there will be no need for the South Street branch to give a provisional settlement to the North Street branch upon receipt of the item. In this respect the depositary bank and the payor bank should be considered one and the same, the First National Bank of Springfield, and there is no need for a bank to settle with itself.

Under §4-108, the Shelbyville bank will be within its rights to consider this as a check received on Thursday *if* it has previously "fixed an afternoon hour of 2 p.m. or later as a cutoff hour for the handling of money and items and the making of entries on its books." If the Shelbyville bank has set such a cutoff hour, and that time is no earlier than 2 p.m. but no later than the 2:45 when Pauline deposited her check, under §4-108(b) the check "may be treated as being received at the opening of the next business day."

First we note that under §4-202(a) a collecting bank, which by definition (§4-105(5)) includes the depositary bank (Salem State Bank in our case), must exercise ordinary care in its handling of the item, including "presenting an item or sending it for presentment." Under the following subsection (b),

> A collecting bank exercises ordinary care under subsection (a) by taking proper action before its midnight deadline following receipt of an item, notice, or settlement. Taking proper action within a reasonably longer time may constitute the exercise of ordinary care, but the bank has the burden of establishing timeliness.

The Salem bank does not present the item directly, but does send it for presentment to the Federal Reserve Bank of Boston, and it does so on the afternoon of the day on which it received the item. The bank has acted with ordinary care with respect to the timing of its actions.

As Comment 2 to §4-202 states, if the collecting bank does not itself present the item but does forward it to be presented, subsection (a) “requires ordinary care with respect to routing (Section 4-204), and also in the selection of intermediary banks or other agents.” So we look to §4-204. Under subsection (a) of that section,

> A collecting bank shall send items in a reasonably prompt method, taking into consideration relevant instructions, the nature of the item, the number of those items on hand, the cost of collection involved, and the method generally used by it or others to present those items.

Given the circumstances here, and assuming that the Stanley Corporation has not issued contrary instructions to the Salem bank (which would be very unlikely), the Salem bank would undoubtedly be found to have sent the item for eventual presentment via a “reasonably prompt method” by forwarding it to the Federal Reserve Bank of Boston. The Salem bank was not required to send it to the Boston Fed and the Boston Fed only. It was entitled to use any “reasonably prompt method” given the circumstances. For the Salem bank to send a check written on a bank in a distant part of the country to the local Federal Reserve bank for collection through the network of Federal Reserve Banks would be considered, barring some very unusual circumstances, just the kind of thing that a bank in Salem’s position would do. Being a “method generally used by it or others to present those items,” this should constitute a “reasonably prompt method” of doing what the bank is required to do, following its obligation to its depositor to send the check on for collection while exercising ordinary care. Notice that at this point the Salem bank should have received a provisional settlement for the amount of the check from the Boston Fed.

The Salem bank’s actions will still be deemed to have been taken with “reasonable care” for the purposes of §4-202(a). Under subsection (b), the bank had until its midnight deadline, which was midnight on Tuesday, to take proper action.

The Salem bank here would probably be found to have failed to use the requisite reasonable care in sending the check on for presentment. By sending the check to the Boston Fed, the bank still chose a “reasonably prompt method” under §4-204(a) for making collection, but it will be argued that Salem bank failed to take this action with the ordinary care required by §4-202(a), because the bank didn’t act until after the midnight deadline had passed. Under §4-202(b), it would still be possible, of course, for Salem State Bank to argue that its taking the proper action—sending the check on to the Boston Fed—within a “reasonably longer time” than its midnight deadline still constituted the exercise of ordinary care, but it would have the burden of establishing timeliness and this is usually a hard burden for a bank to meet. If the bank had a particularly compelling argument that, although it was aware of its delay in sending the item for collection, the delay was justified by some extraordinary conditions, it might also find some relief in §4-109(b). Barring a serious breakdown in its computer facilities, war, or other emergency conditions, however, it looks like the Salem bank has failed to use the ordinary care required of it by §4-202 in sending the check on for presentment.

The consequences of a bank's failure to use ordinary care in the handling of an item are laid out in §4-103(e).

The measure of damages for failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount that could not have been realized by the exercise of ordinary care. If there is bad faith it includes any other damages the party suffered as a proximate consequence.

This language, at least as far as I am concerned, takes a bit of explaining. Note first of all the important caveat of the final sentence of Comment 6 to §4-103:

Of course, it continues to be necessary under subsection (e) as it has been under common law principles that, before the damage rule of the subsection becomes operative, liability of the bank and some loss to the customer or owner must be established.

So, even if Salem State Bank failed to meet its obligation of ordinary care by taking too long to forward the check for collection, there will be no damages to pay if, as would presumably be true in most cases, the check is paid as a matter of course when it does eventually reach the payor Bakersfield bank. True, the provisional credit to Stanley's account in the Salem bank will firm up somewhat later than it should have, but the money will be there and eventually become a firm credit nevertheless. Under the normal workings of the check collection system, the exact moment when the provisional credit in Stanley's account loses its provisional status is usually not even known either to Salem as the depositary bank or to Stanley as the customer. It just happens at some point when the check is finally paid in California. Also, the time when the funds represented by the check become available to Stanley in its account, for withdrawal or to cover checks that it may write, is not (as we will see in Chapter 16) controlled by when the check is finally paid. In the large majority of cases, then, even if a collecting bank fails to act with ordinary care in forwarding a check for collection, if the only consequence of this failure is a delay in presentation of the check to the payor bank, no harm will be done to the depositor and no damages will be due at all.

Suppose, however, that when the check (which has not been forwarded by the depositary bank in a timely fashion) reaches the payor bank, the account on which the check was written does not include enough to cover the check. The payor bank therefore does not pay the check but returns it for insufficient funds. The provisional credit that was added to the depositor's account balance when he or she deposited the check is charged back, so the amount of the check is never finally added to the balance in the depositor's account. Now §4-103(e) kicks in. The depositor will argue that the damage caused by the depositary bank's failure to use ordinary care is equal to the amount of the check. Had the depositary bank not dawdled, so the argument goes, the check would have arrived at the payor bank earlier, when there was still money in the drawer's account to cover it, and it would have been paid. The depositor's argument relies on the factual assertion that, had the depositary bank acted with ordinary care, the check would have been finally paid by the payor bank and the amount of the check would have ended up as funds available to the depositor in its account. If in fact it is true that the full amount of the check could have been realized by the exercise of ordinary care on the bank's part, then the "amount that could not have been realized by the exercise of ordinary care" is zero. The depositor *could* have realized the full amount of the check had its bank acted with ordinary care in handling the item. The depositor is therefore owed damages by the depositary bank, which failed to exercise ordinary care in forwarding the item—damages equal to the full amount of the check without any reduction.

Now assume instead that the depositary bank could show that even if it *had* exercised ordinary care and forwarded the check for collection in a timely fashion, the check *still* would have been returned unpaid due to insufficient funds in the drawer's account. Then the depositor has not really been hurt by the depositary bank's failure to use ordinary care. Had the bank used ordinary care, the depositor would have ended up with nothing but a bounced check in its hands. As it was, with the depositary bank not having used ordinary care, the result was the same. The damages due to the depositor under §4-103(e) for the depositary bank's failure to exercise ordinary care in this instance is the amount of the check reduced by "an amount that could not have been realized by the exercise of ordinary care"—which in this case turns out to be the full amount of the check. The depositor is owed no damages.

Yes. The Boston Fed, as a collecting bank, is under the same obligations of ordinary care set forth in §§4-202 and 4-204 as is any other collecting bank. Here it seems clearly to have met those obligations. It received the check on Tuesday and forwarded it for collection on Wednesday. It has exercised ordinary care, at least as far as the timing of its actions under §4-202(b), by acting before its midnight deadline, which would have been midnight on Thursday. Its forwarding of the item to the Los Angeles Fed would seem, in the absence of instructions to the contrary or other unusual circumstances, to be a "reasonably prompt method" of dealing with the check for the purposes of sending it on for eventual presentment to a bank located in the Los Angeles Fed's territory.

First of all, the Los Angeles Fed collection center will have to settle with the Boston Fed for the amount of the item. This will be a provisional settlement. The Los Angeles Fed collection center then has until its own midnight deadline, midnight on Friday, to forward the check either directly to Bakersfield Bank for presentment or to another bank to which it might customarily and reasonably forward any checks payable on Bakersfield Bank. The Federal Reserve bank in a given territory is not absolutely required to present directly any checks it receives payable on banks within its territory. In many instances it might well do so, especially if the bank in question is a large one for which the Fed on any given day can expect to receive a large number of items. If the bank is a smaller one, however, the Fed may direct the check to one of the larger local banks that it knows has entered into an agreement to directly present checks to the bank in question. A Federal Reserve Bank is, like any collecting bank in the process, required by §4-204(a) only to use a "reasonably prompt method, taking into consideration relevant instructions, the nature of the item, the number of those items on hand, the cost of collection involved, and the method generally used by it or others to present those items."

As it turns out, the Los Angeles Fed collection center decides to take on the role of presenting bank and thus forwards the check directly to Bakersfield Bank, the payor bank. Bakersfield will, upon receipt, settle provisionally for the amount of the item with the Los Angeles Fed collection center. Then, as the payor bank, it must decide whether to pay the item. We will deal with the situation confronting the payor bank upon presentment of the check, and particularly when that bank will be held to have "finally paid" the item, in more detail in Chapter 12. We assume that final payment has occurred here, as the payor bank has honored the check. What are the consequences? For one thing, Bakersfield Bank will charge against the Barker Company's account the amount of the check. (Whether it has the right to do so is another topic, covered in Chapter 14.) As far as the check collection process is concerned, the important thing to note is that Bakersfield Bank will now just hold onto the check. Depending upon the agreement it has with its customer, the Barker Company, the bank may later send the *canceled check*, as we call it, to Barker along with its monthly statement, or it may record a digital image of the check that will later accompany the monthly statement. In any event, the important thing to note is that the check comes, at least temporarily, to rest once it reaches the payor bank and that bank finally pays on the item.

As of the moment of final payment by the payor bank, all provisional credits generated in the forward collection process between banks are said to "firm up" and become final. See §4-215(c). The provisional credit that Salem State Bank gave to its depositor, the Stanley Corporation, also transmogrifies from a provisional to a nonprovisional addition to Stanley's account. The interesting and important thing to acknowledge about all this is that none of the collecting banks (including the depositary bank), nor the depositing customer himself or herself, has any way of actually knowing exactly when the provisional settlements or credits each has received during the course of the forward collection process firmed up and became final. It all depends on when final payment is deemed to have occurred at the payor bank. None of the prior parties in this process will know the precise moment when this final payment occurs. Nor is the payor bank required to send any notice back up the stream of collection to the effect that final payment has been made. The vast majority of checks are finally paid by the payor bank, and the exact moment when this happens is really irrelevant to the prior banks in the process and to the depositor himself or herself. What is important when a check is honored by the payor bank is that all provisional settlements do eventually (even if we don't know precisely when) become final, and the provisional credit that the depositary bank has made to the depositor's account does the same.

Bakersfield Bank is obligated to follow the stop-payment instruction of its customer and to dishonor the check. To do so it needs to and has returned the item within the proper amount of time to the presenting bank, the Los Angeles Fed collection center. At this point it will have revoked, or as the term is used, *charged back* the provisional settlement it made in favor of the Los Angeles Fed collection center on the previous day. The Los Angeles Fed collection center is obliged to continue the return process by sending the check to the bank from which the Fed originally received it, in this case the Boston Fed. Note that in doing so the Los Angeles Fed collection center is obligated, as will be all banks now involved in the return process, to use ordinary care in "sending a notice of dishonor or nonpayment or returning an item … to the bank's transferor after learning that the item has not been paid" under §4-202(a)(2). The operative rule now becomes that of §4-214(a): The Los Angeles Fed collection center is entitled to charge back the amount it gave its transferor, the Boston Fed, in provisional settlement for the item, "if by its midnight deadline or within a longer reasonable time after it learns the facts it returns the item."

Once it is received by the Boston Fed, the check will then be sent by that bank in turn to the Salem State Bank. The Boston Fed will charge back the provisional settlement it made earlier on the Salem bank in exchange for the item. The Salem bank will then be obligated to return the check or give notice of its dishonor within a timely fashion to its customer, the Stanley Corporation. The Salem bank will, at the same time, withdraw the amount of the check that it had provisionally credited to Stanley's account from that account. The dishonored check should eventually end up in the hands of the Stanley Corporation, which is going to have to decide what to do about the situation of having been paid for some supplies with what turns out to be a bum check.

The Salem State Bank received the facts regarding the dishonor of this check, through return of the check itself, on Tuesday. It is then entitled, under §4-214(a), to "charge back the amount of any credit given for the item to the customer's account, or obtain refund from its customer …, if by its midnight deadline or within a longer reasonable time after it learns the facts it returns the item or sends notification of the facts." Unfortunately for the Salem State Bank, it allowed its midnight deadline to pass without either returning the item to Stanley or sending notice of the check's dishonor to that firm. What are the consequences for a depositary bank that fails to inform its depositor of the return of a check within the time limit provided? Stanley would want to argue that once the depositary bank fails to give notice within the time provided for, it is thereafter foreclosed from revoking the provisional credit recorded in the customer's account, but this is not the rule. Subsection 4-214(a) continues: "If the return or notice is delayed beyond the bank's midnight deadline or a longer reasonable time after it learns the facts, the bank *may* revoke the settlement, charge back the credit, or obtain refund from its customer, *but it is liable for* any loss resulting from the delay." See Comment 3 as well as *Essex Construction Corp. v. Industrial Bank of Washington, Inc.*, 913 F. Supp. 416, 29 U.C.C.2d 281 (D. Md. 1995), and *Liberty Bank & Trust Co. v. Bachrach*, 1996 Okla. 143, 916 P.2d 1377, 30 U.C.C.2d 612 (1996).

In a majority of cases, it is probably fair to say that the bank's depositor will not be able to show that it suffered any actual loss due to the depositary bank's failure to give timely notice of the check's dishonor. Getting a bit of bad news some days later than one is entitled to doesn't usually amount to an actual loss and mere speculation is not enough to make the case. See *U.S. Bank National Ass'n. v. First Security Bank, N.A.*, 2001 U.S. Dist. LEXIS 16714, 44 U.C.C.2d 1088 (D. Utah 2001). The Stanley Corporation has been sent a check by Leno Electronics, which check bounces. Becoming aware of this fact a few days later than it should have, especially considering that there is no definite amount of time knowable in advance within which a returned check will necessarily be received by the depositary bank, would normally not impose any distinct loss on Stanley. In the particular facts as I have posited them, however, there may be liability on the Salem bank's part for failure to give notice of dishonor in a timely fashion. Recall that Stanley as seller set up its transaction with Leno as buyer so that Stanley would not send the merchandise contracted for until it had received payment. Stanley receives a check from Leno, which it duly deposits. It then waits for some period of time to see if the check is good. Not having heard that the check has bounced, it sends off the stuff. As it turns out, had the Salem bank given it notice within the proper time, Stanley would have known that Leno Electronics' check was no good and it would not have shipped out the goods. To the extent that Stanley may now be unable to get payment for what it has delivered, or that it will have to spend a good deal on lawyers' fees and the like eventually to get payment from Leno, this would seem to be a case in which the Salem State Bank's failure to give notice of nonpayment within the proper amount of time could in fact make it "liable for any loss resulting from the delay."

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* Those pundits who in the middle and later part of the last century predicted that by the dawn of the new millennium we would surely be in a "checkless" society have proven no more accurate that those who were sure that by 2001 we would be in a world where cash would be only a memory. It appears that some traditions—especially when it comes to money and the way we think about and deal with it—die hard.

† It is, of course, possible that a check can be issued and never even get to the named payee. It may be given to someone else, somebody *X*, who is instructed to deliver it to the payee but who decides that he or she would rather keep it for himself or herself. What happens then? In Part V, we deal with the knotty and intriguing problems created by the thieves and forgers who unfortunately do inhabit this world. For the most part, in this chapter and those immediately following, we will take a rosier view of the world, assuming that no thievery or forgery intrudes into the life stories of the checks with which we are concerned. As a matter of fact, in the overwhelming majority of cases this is not just a rosy view of the world but an accurate one. The system of check collection that we are about to explore could not really function as it does if this were not so. Theft, forgery, or any other kind of irregularity in the check collection process is the exception, the very rare exception, rather than the rule. Even though we will later spend a good deal of energy examining what happens when theft or forgery rears its ugly head, you should appreciate that by and large the typical check goes through the collection process quite mechanically and with little or no fuss. The vast majority of checks are collected upon simply as a matter of course, with no questions asked or needing to be asked—as I hope you've personally found true with the checks you yourself have written or received.

* Note as well that the bank will not be found to have dishonored a check presented over the counter unless the check was properly presented, and that in particular the person seeking payment in this fashion must not just "exhibit the instrument" but "give reasonable identification" of himself or herself. See §3-501(b)(2). The Court of Appeals of Maryland has ruled that a bank's requirement that a noncustomer presenting a check over the counter place an "inkless" thumbprint or fingerprint on the check itself was a reasonable part of the identification process. *Messing v. Bank of America, N.A.*, 373 Md. 672, 821 A.2d 22, 50 U.C.C.2d 1 (Md. App. 2003). The procedure is, in fact, part of the Thumbprint Signature Program created by the American Bankers Association, working with a number of federal agencies, in response to a rising number of check frauds.

* In 1990, many changes were made to Article 4 to conform it to the major overhaul being done on Article 3. The drafters chose to refer to their efforts as promulgation of amendments to and not an entirely revised version of Article 4. In any event, we will be working with the 1990 version of Article 4, just as we have been doing with Article 3.

* The two principal regulations of the Federal Reserve System that most directly affect the check collection process, and in doing so may supersede the rules as laid down in Article 4, are known as Regulation J and Regulation CC. Regulation J applies to all banks dealing with any Federal Reserve Bank in the check collection process, and as a practical matter does not differ from the standards set forth in Article 4 in any significant (for us) detail. Regulation CC, promulgated to effectuate the federal Expedited Funds Availability Act and applicable to every bank in the country, worked some very major changes in the check collection process. Chapters 13 and 16 deal with the changes wrought by Regulation CC both in the basic workings of the check collection process and in the fundamental bank-depositor relationship. For the purposes of this chapter, however, we will concentrate on the law as laid down by Article 4, even if parts of what we see here have been superseded by the later issuance of Regulation CC. It turns out that the best way to appreciate the significance of the changes brought on

by Regulation CC is first to appreciate what the situation was like before its introduction.

* This description does not take into account the changes introduced into the return process by Regulation CC of the Federal Reserve. We will take a special look at those changes in Chapter 13.

CHAPTER 11

The Checking Account in the Electronic Age

INTRODUCTION

In Chapter 10, we followed the path of a check as it made its way through the forward collection process by what I chose to call, for lack of a better expression, the “traditional method” of check collection. This method of payment is characterized by its being initiated by the customer’s creating and issuing a paper check drawn on a checking account and that check’s eventual deposit in some other account at what is termed the depositary bank. The check, the physical item itself, is then passed hand-to-hand through the bank collection system until it is eventually presented to the drawee-payor bank which, in the vast majority of cases, accepts the check by keeping possession of the check and not returning it. The check then takes the final step in its long journey when it is returned to the customer, now a “canceled” check, along with the customer’s monthly account statement.

By referring to this process as the “traditional” method of doing things, I do not mean to suggest that you should think of it as an antique system or one of only historical importance. Some significant number of checks deposited for collection in United States depositary institutions still follow this route, even if the percentage that are handled as paper items from beginning to end of the process is decreasing rapidly. In recent decades, however, the banking industry has sought to find ways to make use of increasingly sophisticated technology to speed up this process and to make it more efficient (read less costly and cumbersome). In this chapter we will take a quick tour of some of these more recent innovations. But it will have to be a quick tour and nothing more. You will notice that there are no Examples and Explanations in this chapter, which I hope is not too much of a disappointment. Had I chosen to deal with each of the subjects introduced here by giving it the full treatment, this volume would have had to become several chapters longer and get into some pretty arcane material. My purpose here is only to introduce some of the latest additions to the way that money may flow into and be dispersed from the typical consumer checking account in this second decade of the twenty-first century.*

Nor should you conclude that the traditional method is able to function today without any reliance on what we might want to call high-tech or electronic systems. As a matter of fact, through roughly the first half of the last century, check collection did operate at a fairly low level of sophistication; reading, sorting, and routing of checks were done by bank personnel on a check-by-check basis with each individual check actually receiving some distinct personal attention by at least one human being at each bank. By the middle of that century, the number of checks being written by Americans was increasing dramatically and would have undoubtedly overwhelmed the system had it not been for the creation and adoption of automated systems based on the inclusion of the Magnetic Ink Character Recognition (MICR) line on the bottom of each check, a method of encoding checks that allowed for automated reading and sorting of items at vastly greater speeds. See Comment 2 to §4-101 for a good summary of this development. At the time, the MICR line and the reading and sorting machines that could take advantage of it were at the forefront of the then current technology. Times have changed, however, and newer innovations have come along that make the whole "traditional" method of check collection seem, at times, downright dowdy. Quite naturally, the banking industry would like to take advantage, for any number of reasons, of these newer innovations. There is, however, one large sticking point that you should always keep in mind: The MICR technology works today because *all* banks have in place the machinery that allows it to operate as it does. It is easy enough to think up newer, faster, more efficient, and more sophisticated systems now that we have leapt into the electronic, Internet age. But any one newer method could take over the field only if all, or at least virtually all, banks were to convert to the newer system, *and* be able to make the changeover at precisely the same time. A total overhaul of the check collection apparatus of any one bank would be a difficult and, perhaps more to the point, a terribly expensive process. For the banking industry as a whole the costs and difficulties would be particularly daunting. It will not surprise you, then, that most of the newer “non-traditional” means of getting funds into and out of a consumer’s checking account will seem—upon reflection—more like less ambitious means of speeding up or lowering the cost of at least some transactions in at least some situations, rather than any one dramatic innovation that would totally replace and do away with the older, traditional method with its reliance on the MICR line and all that.

CHECK TRUNCATION

The colloquial term *truncation*, when used in connection with the check collection system, really has a quite simple meaning. We say a check—again reminding ourselves that we are speaking by definition of a unique physical piece of paper—is “truncated” at a certain point in its journey when it comes to rest at that point. The check itself stays put at the point of truncation and is held there (at least for some time, after which it may simply be disposed of with or without its image being retained in electronic form) while *the information* encoded on the check’s MICR line, having been read off the check by automated means, continues through the forward collection process by electronic means, freed from that clumsy corporeal piece of paper, which, by this point, seems only to be weighing it down. Since any bank further down the collection chain, and in particular the payor bank, will in the overwhelming number of instances have no interest in dealing with or even seeing the check itself—handling the item presented based on only the information from the MICR line as read by its automated, totally impersonal machinery—there seems no real point for the physical thing itself to tag along any further than is necessary.

The first type of truncation to be introduced, and one with which you may well be familiar from your own experience, is truncation at and by the payor bank. For several decades now individual banks have been trying to get their individual customers to agree to receive their monthly checking account statements unaccompanied by any canceled checks themselves. The statement would list the check as paid, giving the check number, its date of payment, and the amount, but the check itself would not be in the envelope. The Uniform Commercial Code (U.C.C.) does not require return of the actual item, the check, with any periodic statements of account sent by the bank to its customer (as we will see when we look at the bank statement and §4-406 in Chapter 19). This means that there is no need for canceled checks to be returned unless this has been made part of the individual agreement entered into by the customer when he or she opens his or her account. Until fairly recently, banks have not found customers in large numbers particularly willing to agree to this type of truncation. Americans, it seems, more than people in just about every other country, are terribly fond of the idea of paying by paper check and, what is more, getting each and every canceled check back for their own private records. After all—as consumer advocates have argued—if the only information the customer ever gets from his or her bank with respect to any item is the number, amount, and date of payment of a check, he or she won't be as capable of determining if this was a check correctly paid out of his or her account, since the most important bit of information—the payee's name—appears nowhere on the account statement. (This is, as you no doubt realized, because the payee's name is never encoded onto the MICR line of the check, nor could it ever be given the nature of the existing MICR technology.) The banks, which would like to save the bother and expense of having to sort by account and then mail out along with account statements each and every check they receive, argue that anyone who is careful in keeping track of the checks he or she writes and knows how to check his or her own records against the account statement should not need the check itself to spot a problem, but customers are not very receptive to this argument. In addition, there seems to be some kind of general perception, even though it's not exactly based on any legal rule to which anyone can point with assurance, that a customer may need the actual canceled check to prove payment if it is ever disputed. The notion seems to be that if, for example, your landlord claims never to have been paid the June rent, your one and only way to counter this allegation is to have the check with which you did pay the rent, indorsed and deposited by the landlord, and paid by your bank to place before the landlord as conclusive proof of payment.

In recent years, however, payor banks have finally been able to wean almost all of their customers from their insistence on getting back the canceled check itself. This may be due to a change in overall attitude, but more likely results from the fact that payor banks are now often able to offer *images* of the check itself—both front and back—either automatically with the periodic account statement or upon the customer's request for an image of a given item identified by check number, amount, or date of payment alone.

ELECTRONIC PRESENTMENT

Once the technology exists and is put into place, at least at some banks, to "convert" in some sense the check into an electronic version of itself, the question quite naturally arises why truncation of the paper check cannot occur at an earlier stage in the forward collection process. In particular, why not allow the depositary bank to hold onto the piece of paper itself (at least for some time) while it forwards only a digitized version of the check—either just the information on the MICR line or this information supplemented by an image of the check itself? As a matter of fact, this type of earlier, depositary bank truncation and electronic presentment is now a common feature of the banking system.

The 1990 versions of Articles 3 and 4 (now adopted in all states save New York) were written contemplating and allowing for this method of collection. See first §3-501(b)(1). As the Comment to this section notes: "Electronic presentment is authorized." Section 4-110 provides that banks can enter into agreements under which presentment is made by transmission to the payor bank of an image of a check or of sufficient information to qualify as what is termed "presentment notice" rather than by physical delivery of the item itself. As Comment 2 to this section notes, the interbank agreements of the type that are contemplated by this section may be either

> bilateral (Section 4-103(a)), under which two banks that frequently do business with each other may agree to depositary bank check retention, or multilateral (Section 4-104(b)), in which large segments of the banking industry may participate in such a program. In the latter case, federal or other uniform regulatory standards would likely supply the substance of the electronic presentment agreement, the application of which would be triggered by the use of some form of identifier on the item.

The interbank agreements that have been entered into by a large number of banks in this country can and do vary in a number of ways. In some, it is agreed that the depositary bank will forward at one time all of the information on the MICR line along with a digitalized image of the check. Receipt of this packet of information by the payor bank serves as presentment. Under other agreements, the depositary bank first sends the payor bank the MICR line information electronically—giving the payor bank enough information to begin its "deliberation" about whether or not to honor the check, of the type we began to consider at the end of the previous chapter and which we will look into in more detail in the chapter to follow—but the agreement specifically provides that presentment for the purposes of Article 4 occurs only when either a digitalized image, or even the paper check itself, is delivered on a later day.

When a check is treated in the way described in this section, the law governing the collection process is Article 4 as supplemented by the terms of any binding interbank agreement. The process is also subject—as has been all check collection through banks in the United States by whatever means since 1987—to the federal Expedited Funds Availability Act, and to Regulation CC promulgated by the Federal Reserve under that Act. We will delay our look at the fundamentals of Regulation CC, at least as originally set out in 1987, until Chapters 13 and 16.

"CHECK 21"

The possibility of speeding up the forward collection process by the means of electronic presentment is something depositary banks understandably find appealing, and not just because it can cut down on processing costs. The sooner a depositary bank can get the relevant information about a check to the payor bank—that is, the information on which the payor bank's automated systems will make the decision on whether or not to bounce the check—the sooner the depositary institution can withdraw any provisional credit given to the depositor on account of any check that the depositary bank is made aware is to be dishonored. This in turn decreases the likelihood that the depositor can make use of the funds represented by the check, or simply withdraw the amount in cash and then conveniently disappear, before the fact that the check cannot be collected upon is known to the depositary bank.

And, as we have seen, this information is all encoded on the check's MICR line. Electronic presentment is a way of moving the MICR information forward as quickly as possible, with the physical check which it represents following, either in its original form or as a digitalized image, at a more leisurely pace.*

With this in mind, you might expect that there would be significant advantage to the check collection system as a whole if all presentment were required to be in electronic form. The prospect of this happening, or at least happening any time soon, is remote, however, for at least two reasons. For one thing, not all banks have the technology in place to deal with electronic presentment, and the necessary equipment—to create and to send and receive images of checks, both front and back, for example—is not cheap. Second, even those banks that do have such systems in place do not all work on a single uniform computer protocol, but vary from group to group. Thus, to mandate that all checks must be handled using anything more sophisticated than the MICR scanning and sorting technology now uniformly in place would create a significant burden on all parts of a complex system comprising thousands of independent banks across the country, and especially on those smaller banks for whom reconfiguration and upgrade of their automated systems would presumably be most costly and difficult.

By the begining of this century the federal government *had* made a tentative step in the direction of encouraging, while not mandating, the use of electronic messaging to speed up the nation's check collection system, with the passage of the Check Clearing in the 21st Century Act of 2003, codified as 12 U.S.C. §§5001-5018, and usually referred to as simply *Check 21*. The Act became effective as of October 2004. At the same time, the Federal Reserve Board, which was empowered to issue regulations which it considered necessary to implement and "facilitate compliance" with the provisions of the Act, did so by adding a Subpart D to its Regulation CC (which I have previously mentioned, only to then delay the discussion for a later time).

The two core concepts necessary to appreciate what Check 21 allows for in furtherance of its declared goal of "foster[ing] innovation in the check collection system without mandating receipt of checks in electronic form" are *truncation* and the *substitute check* as each is defined in the Act. Notice that we have talked of truncation before, but always as a term of art. We've not before encountered a formal definition. In Check 21, however, the term "truncate" is defined, in §5002(18), as meaning

> to remove an original paper check from the check collection … process and send to a recipient, in lieu of such original paper check, a substitute check or, by agreement, information relating to the original check (including data taken from the MICR line of the original check or an electronic image of the original check), whether with or without subsequent delivery of the original paper check.

The Act obviously anticipates that in most cases the truncating institution will be the depositary bank, but this need not necessarily be so. If the depositary bank does not have the means for forwarding the necessary information (including, as we will see, most importantly an image of both the front and back of the original paper check) electronically, it can if it wishes enter into an arrangement with another nearby bank, which does have the necessary equipment under which the depositary bank will first forward some or all of the checks it has received in deposit to that other bank, which will do the necessary truncation and send the electronic message on its way to the proper party.

The idea of the substitute check is what's really "new" about the Check 21 apparatus. Under §5002(16),

> The term "substitute check" means a paper reproduction of the original check that—

contains an image of the front and back of the original check;
bears an MICR line containing all of the information appearing on the MICR line of the original check …;
conforms in paper stock, dimension, and otherwise with generally applicable industry standards for substitute checks; and
is suitable for automated processing in the same manner as the original check.

If a substitute check is created as part of the forward collection process with respect to any individual "original" paper check that had earlier in the process been truncated and sent on its way in purely electronic form, then it is because some bank has served as what the Act defines as a "reconverting bank" (§5002(15)) with respect to that check—the bank which turns that electronic information back into a good solid piece of paper that meets the standards for being a legitimate substitute check.

The central operative provisions of the Check 21 act, or at least those with which we need trouble ourselves in this brief overview, are perfectly short and straightforward. Section 5003(b) states a simple rule of legal equivalency. That is, a substitute check shall be "the legal equivalent of the original check for all purposes … and for all persons" as long as it accurately represents all of the information on the front and back of the original check and furthermore, for the benefit of the customer, bears the legend, "This is a legal copy of your check. You can use it the same way you would use the original check." Subsection (a) of §5003 provides that a person may "deposit, present, or send for collection," a substitute check "without any agreement of the recipient … with respect to the substitute check."

The Check 21 act does not mandate that any check be truncated at any stage of the collection process or ever turned into its electronic equivalent. Nor does it mandate that any bank be ready, willing, and able to take presentment in electronic form (as indeed many banks do not now have the facility to do so). What it does require is that if a payor bank is presented with a *substitute* check, the bank must process it just as it would the original check for which it is substituting. Note this calls for nothing new or more burdensome on the part of any payor bank. Look again at the definition of the substitute check. It is a piece of paper the size of a check, bearing an MICR line like that of the original check, and "is suitable for automated processing in the same manner as the original check." All banks should be currently set up to process such an item with no more difficulty than they would encounter in processing incoming "original" paper checks.

If a depositary bank knows that the payor bank is one capable—and what is more has entered the type of agreement we dealt with in the previous section—of processing electronic presentment directly, then Check 21 need never come into play. If the payor bank is not ready or willing to accept electronic presentment, then the depositary bank if it wishes can truncate the check and send the necessary electronic message to a bank in the vicinity of the payor bank that has agreed to be a "reconverting bank" for these purposes. That bank will then create a substitute check and physically present it to the payor bank, which has no choice but to take the presentment of the paper just as it would an original check. If the check is paid, then the customer will, of course, not get the original check, nor even an image made by his or her own bank of that check, accompanying his or her periodic bank statement. What the customer will receive is either the substitute check itself—bearing, as you recall, the legend, “This is a legal copy of your check. You can use it the same way you would use the original check.”—or an image of the front and back of the *substitute* check bearing this legend. Yes, we are now beginning to encounter images of images, and there is legitimate concern among some that what the customer will have to review along with his or her statement may become progressively harder to decipher, or at least appreciate in all its detail, because of this process. Check 21 and the regulations promulgated by the Federal Reserve Board under the Act (material that you certainly may study if you wish, but which I’m not getting into here since they seem to be beyond the scope of what most students will encounter in an introductory Payment Systems course) allocate the various new risks encountered when the substitute check mechanism comes into play. Beyond this, the law governing the collection process remains Articles 3 and 4 of the U.C.C. (and Regulation CC as we will later encounter it), just as is true for any other check collection.

Between the introduction of check truncation and conversion of paper items into digital packets of information, the widespread adoption of means for electronic presentment of such digital items, and Check 21, as well as other electronic improvements in the check collection system, the changes in just the past few years in how the process is accomplished have been truly remarkable. In fact, it is estimated that something like 97 percent of all items passing through the forward collection process now do so in electronic form. The number, and consequent bulk, of paper checks that have to be hauled around the country has decreased dramatically. As a measure of this change in the check collection landscape, it should be noted that from 2003 to 2010 the Federal Reserve reduced the number of locations where paper checks are processed from 45 to just 1, the Federal Reserve Bank of Cleveland.

PLASTIC

I would be very surprised if any reader of this book were not familiar with an entirely separate system, not involving the use of those old traditional paper checks at all, by which money can flow into and out of a consumer checking account at the customer’s command. I am referring, of course, to the use of the automated teller machine, or ATM. It may, in fact, surprise the reader to learn that ATMs are a relatively new introduction to the payment systems scene. While the first such machine is reported to have made its appearance in 1972, the widespread presence and use of ATMs is really a phenomenon of the late 1970s and early 1980s. The key to using the ATM is, of course, the ATM card.

A second piece of plastic, the *debit card*, which a consumer may use to pay for goods or services right at the point of purchase, was actually first introduced a year or so before the ATM, although it did not immediately catch on with consumers who were initially caught up with the explosive growth in the availability and ease of use of credit cards. In the past ten years or so, however, debit card use has apparently "taken off," to the point where the number of debit card transactions is now greater than those involving credit cards.

I will not go into the law regarding the use (and possible misuse) of ATM and debit cards here at any length. These forms of plastic get the full, or at least a pretty hefty, treatment in a later chapter devoted to them exclusively, Chapter 21. For the moment, only a few points need to be highlighted. Note, first of all, that either an ATM or debit card only functions as it does because it is associated to a particular checking account held by the user. Funds are deposited into or withdrawn from that particular account by use of the card.* Any single use of an ATM or debit card should be reflected in a notation of that transaction on the customer's periodic account statement.

A second and very important point is that use of such cards is not governed in any way by the U.C.C. No check is ever created, so Article 3 does not apply. It follows that there is no check collection of the kind falling within the scope of Article 4. As we will see in Chapter 21, the law governing the use of such cards is the federal Electronic Funds Transfer Act (EFTA), 15 U.S.C. §1601 *et seq.*, passed by Congress in 1978. In addition, we will have to bring into play the Federal Reserve Board's Regulation E, which was promulgated by the Board in furtherance of its responsibilities mandated by the Act.

AUTOMATED CLEARING HOUSE TRANSACTIONS

An automated clearing house (ACH) consists of a collection of banks that have established procedures for passing amongst themselves electronic messages the purpose of which is to transfer funds either into or out of consumer bank accounts. Any one ACH will have been established under guidelines set forth by a Federal Reserve bank. The number of ACH associations in the country have in turn combined into one integrated system under the auspices of a private not-for-profit group formerly known as the National Automated Clearing House Association, now just NACHA. Each member institution that makes up the resultant nationwide ACH network of participating institutions is thus committed to operating under a set of Operating Rules issued by NACHA.

Up until recently, the principal use of the ACH network would be seen in something like a large employer arranging for electronic credit transfers of a given amount at a predetermined time to each of a large number of employees, what we are familiar with as the *direct deposit* of our "pay checks" even if no check is ever involved. Working the other way, that is through a debit transfer, a mortgage company or car loan provider might initiate the direct transfer out of the consumer borrower's account into its coffers of whatever it is owed on a monthly basis through a preauthorized ACH debit transfer. Key to the entire process, of course, is that the consumer has in fact authorized such periodic electronic deposits and withdrawals and that the company making use of the ACH network is proceeding by the NACHA rules.

Once again, as we saw in the last section regarding ATM and debit card transactions, the individual transaction will be noted on the periodic account statement that the customer receives in connection with his or her checking account. Of course, there will be no canceled check or image of a check in connection with a debit transfer. No paper check is involved at all in the process. And once again, the governing law will not be the U.C.C. but the EFTA and Regulation E, as supplemented here by the set of NACHA rules.

In just the past few years, a new use of the ACH transfer network has come onto the scene. While previously any ACH entry would have to be initiated by a bank, it has now become possible that the payee of a check may tap into the system directly. There are two types of situations where this may happen. In the first, known as a point-of-service (POS) or point-of-purchase (POP) transaction, the customer makes a purchase at a merchant's place of business, handing over a check naming the merchant as payee directly to the merchant as a means of payment. The merchant, rather than keeping the check for later deposit into some bank, then and there swipes the check through a machine reader able to capture the data already encoded on the MICR line of the check and also enters the amount of the check. The merchant hands the check back to the customer, who we presume voids it or otherwise keeps it for his or her records noting how it has been used for payment. At the same time, the automated process directly initiates an ACH debit transfer calling for the movement of the stated amount out of the customer's account and into an account held by the merchant. The individual check has served, in effect, as something like a debit card for the purposes of that transaction only.

A second type of ACH enabled payment that has recently come onto the scene is the use by a creditor to whom a paper check has been mailed to collect directly on it through the ACH system, bypassing the need for any depositary bank and making collection on the check that much quicker. Say, for instance, that I receive a credit card bill and respond to it by sending a check in the envelope conveniently provided to the credit card company. Upon receipt the company can have the check's MICR line read, the amount keyed in, and an ACH debit entry passed on through the ACH network directly to the bank on which I've written the check. My next monthly statement on that checking account will indicate that the given numbered check, written for a certain amount, was collected upon on a specific date. What I won't receive with my statement, of course, is the canceled check itself nor even an image of it.

The Federal Reserve Board has recently amended Regulation E to take into account some issues of particular importance that can surface when such merchant-originated ACH debit entries are involved. One key feature of the regulation is that the customer must have authorized the use of the check to initiate an electronic debit entry as it does in these situations. The regulations do not require, however, that the consumer customer ever give written consent in order for such authorization to be found. The use of the ACH mechanism will be considered authorized by the checking account customer if he or she has been given proper "notice," as the NACHA rules require, that the check will or may be processed in this way. In the POS-style transaction, such notice is presumably present when and where the merchant takes the check in the form of a posted sign of some sort, setting out the consequences of this form of payment. When checks sent to creditors to pay bills are involved, the requisite notice usually comes as a statement on the bill itself, even if not a very prominent one. As I write this I have before me a copy of a recent credit card statement that carries, along with all the other small-type boilerplate on the back of the statement, the following, admittedly in bold if not larger type:

> Sending an eligible check with this payment coupon authorizes us to complete the payment by electronic debit. If we do, the checking account will be debited in the amount of the check, as soon as the day we receive the check, and the check will be destroyed.

So I, at least, have been put on notice by this one creditor.

INTERNET BANKING

The enormous growth in the use of the Internet, and particularly the Web, in recent years has led many banks to make some form of Internet or online banking available to even the smallest customer. By pointing his or her browser at a designated Web site, the consumer can check out his or her balance, transfer money between accounts (at least those held at the same bank) and, most importantly for our purposes, direct payments out of a specified account to a named payee. The particulars of the systems will presumably vary slightly from bank to bank, as each develops or acquires from an outside vendor its own distinct brand of software, but the general procedure seems to be pretty much the same. The communication between the customer and the bank that initiates such a payment is governed by the EFTA, Regulation E, and the language of the agreement the customer entered into with the bank upon signing up for this service.*

When a customer directs that some amount be sent out via this very handy method of payment, what actually happens next will depend on the nature of the payee involved. In most instances the bank will have already been provided with certain information by larger institutional so-called *repeat players*—such as credit card issuers, utility companies, mortgage or car loan providers, and the like—that regularly will be paid by many users of the bank's system. This information will include the routing number of the bank and the number of the account at that bank into which the payee wants such payments directed. The customer's computer screen will display a message something like "Payment to be made electronically," and the customer's bank will use the information provided by the customer to send out an ACH credit entry. All proceeds electronically, and those laws, regulations, and private agreements that we have first encountered in this chapter, if briefly, come into play. Since no paper check is even written, the U.C.C. never has anything to do with it.

Not all online payments proceed this way, however. I know that, at least on the system I use, I am perfectly able to order up a payment to anyone, for delivery to any address. For instance, I may choose to "pay" online a birthday gift to one particular nephew or to a charity just being started up by some friends. Note that in such situations my bank will have no information about at what bank, if any, the recipient has an account. Nor do I have, or really care about, that kind of detail. I simply want to send off the money and be done with it. In such a situation, while I will have ordered up a payment online, the result will be a cashier's check written by my bank and mailed off to the named payee at the address I have entered in filling the appropriate box on the Web page. How the recipient deals with this check, a piece of paper of the old school such as we first met in Chapter 1, is anybody's guess. If the named payee has established a banking account—and we have to remember that not every person or group in the nation does in fact have an account—the check will most likely be deposited into that account. This check may then be collected upon in any one of a number of ways, using the most traditional (as of 1960 or so) means or cutting-edge twenty-first-century technology.

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* Please note that the discussion in this chapter pertains only to transactions involving *consumer* checking accounts. An entirely different system has developed for electronic fund transfers into and out of large *commercial* accounts. We will take up this distinct topic in the final chapters making up Part VII of this book.

* It is, of course, not just depositary banks that appreciate faster means of check collection. Large companies that regularly receive many smaller checks from consumers—such as landlords, utilities, those who make consumer loans which enable the purchase of autos and the like—appreciate quicker collection, as the money flows into their coffers that much sooner. It is only fair to point out that others, most notably consumer advocates concerned about the effect of even the smallest change in the checking system on those they represent, have qualms (to put it mildly) about the various ways we discuss in this chapter for speeding up the collection process. Their concerns, on behalf of the consumer, are basically two. First of all, the quicker the collection is made the sooner the consumer's account will be charged. This shortens the "float," that period of time between when the customer sends out a check and when he or she must actually have the funds available in his or her account to cover the item. Individual consumers may have come to expect, or even to rely upon, having this bit of leeway as a natural outgrowth of the slower "traditional" way of doing things. Increasingly rapid collection calls

upon the customer actually to have the funds in his or her account that much faster if he or she is to avoid bouncing a check. A second concern is that the time that a customer has to issue an effective stop-payment order on that check (as we will explore in Chapter 15) can be greatly reduced or rendered virtually useless. As you can imagine, much of the discussion and haggling over the details of those new statutes and regulations which are mentioned, if not really explored in any detail, in this chapter has had to do with attempts by Congress and the Federal Reserve Board to make what they think is a fair, and politically acceptable, balance between the competing interest of all those with a stake in the outcome.

* As we will see, this is just one distinction between the debit card and the credit card, the use of which we will take on in Chapter 20. Your use of a credit card does not implicate or involve in any way any checking account you may have. Your *payment* of your credit card bill, of course, is another story, if you pay by check or in some other way that moves money out of your checking account and into the hands of the credit card issuer.

* The exact terms of the agreement to which the customer has bound himself or herself will be found either in the packet of written materials given to the customer when the account, including this aspect of it, was opened with the bank. If you first "signed up" online for use of this type of Internet banking service with respect to a previously existing account, as I did, you were presumably presented at one point with a chance to read online the new agreement you were entering into and to click on the "I Agree" link before you could proceed any further. Did you really read and give due consideration to all the language of the screen before you indicated, at least as far as the computer program was concerned, your agreement? Did I? Does anybody?

CHAPTER 12

Final Payment

INTRODUCTION

In Chapter 10 we saw how a check drawn on a particular payor bank makes its way to that bank for the purposes of collection under the traditional method of check collection. In Chapter 11 we reviewed some recent variations on the theme, but also how these variations shared with the traditional model one very important characteristic—the ultimate goal of the exercise. One way or another, the purpose of the forward collection process is to make a *presentment* to the payor bank, either of the physical item itself or of an electronic record incorporating in essence all of the information carried on the check itself. Upon being presented with the individual check or its electronic equivalent, the decision the payor bank must make is no different from that of the drawee of any draft: Is the draft with which it has been presented, a written order directed to it to pay a sum of money, to be accepted or not? Once we are dealing with a check, we tend to use the terminology of the payor bank's decision to *honor* or *dishonor* the item, but the fundamental question with which the payor bank, as drawee of a negotiable instrument, is faced upon presentment of the instrument is in essence that confronted by any drawee of a draft. The payor bank, of course, is not free to make the decision about honoring the check on whim alone. If the drawer has opened a checking account with that bank—which is something the bank should surely be able to establish quickly enough—then the bank's obligations to its customer come into play. We will deal with the full scope of a bank's obligations to its checking account customer in a later part of this book. For the moment, it is enough to point out that central to the bank's responsibilities will be its obligation to honor only those checks that it receives drawn on the customer's account that are, according to the terms of Article 4, *properly payable* items. If the payor bank fails to honor a properly payable item, it will be liable for any harm done to its customer. In contrast, if the bank pays an item that is *not* properly payable, it will not be able to charge the amount against the customer's account and can itself be left holding the bag for the loss that ensues.

We will postpone for a while any further discussion of exactly what makes a check properly payable and what will make it a "not properly payable" item. What is important here is to recognize that the payor bank's decision to honor or dishonor an item is not free from consequence, not by a long shot. At the same time, we will see that the payor bank is not given an unlimited amount of time to make the decision. Under the rules of Article 4 governing check collection, the presentment of an item to a payor bank starts the clock ticking on some very precise and unforgiving deadlines. Look at §4-302(a). It provides that a payor bank will be accountable for any item presented to it in either of two situations: either because it "retains the item beyond midnight of the banking day of receipt without settling for it" (what is sometimes referred to as the *midnight rule*); or because it "does not pay or return the item or send notice of dishonor until after its *midnight deadline*" (for a definition of which see §4-104(a)(10)). If the bank does not take appropriate action with respect to the item before the passage of either of these deadlines, it will be held as a matter of law to have accepted the check and the responsibility of an acceptor of a draft to pay it, whether or not the check was indeed properly payable and whether or not the payor bank will be able to charge its customer's account for the amount of the item.*

ON FINAL PAYMENT

Crucial to all that follows is the notion of *final payment* as set out in Article 4. Under §4-215(a), An item is finally paid by a payor bank when the bank has first done any of the following:

paid the item in cash;
settled for the item without having a right to revoke the settlement made under statute, clearing-house rule, or agreement; or
made a provisional settlement for the item and failed to revoke the settlement in the time and manner permitted by statute, clearing-house rule, or agreement.

The possibility allowed for in the second part—the payor bank's having irrevocably settled for an item—is exceptionally rare and not something that we will give any significant time to. The other two possibilities—payment in cash and failure to revoke in a timely fashion a *provisional* settlement given for an item upon presentment—cover the vast majority of cases and must be explored more fully, as they will be in the following examples.

As we have already seen in Chapter 10, checks written on any single payor bank are deposited at various depositary banks around the country. Each then eventually makes its way to a bank that is in a position to act as a presenting bank with respect to the particular item. That bank will present to the payor bank, which will then *provisionally* settle for the item by the end of the day with the presenting bank. The key questions then become: What must the payor bank do, and how soon must it do it if it wishes to avoid final payment of the particular item under §4-215(a)(3)? Subject to different deadlines or procedures supplied by any clearing-house rules governing presentment of the particular item or to an "other agreement" between the presenting and payor banks, the answers to these questions are to be found in the payor bank's right to revoke a provisional settlement as set forth in §4-301.

Final payment of an item is a watershed event in the check collection process. In the words of Comment 1 to §4-215, final payment is "the 'end of the line' in the collection process and the 'turn around' point commencing the return flow of proceeds." If presentment has been made to the bank through a series of collecting banks, each of which has received provisional settlement for the item, upon final payment all provisional settlements firm up and become final settlements (§4-215(c)). Any provisional credit that the depositary bank allocated to the depositor's account becomes, as of the moment of final payment by the payor bank, a final credit (§4-215(d)). If the payor bank does not make any initial settlement or later final payment by the time it is obligated to do so, but tries to avoid the consequences by later returning the check, it will be considered *accountable for* the amount of the item under §4-302(a). For the payor bank to be accountable under this section means that the person entitled to enforce the check will be able to hold the payor bank strictly liable for the amount of the check.* If you look at the very end of Comment 3 to §4-302, you'll see the following language:

> If a payor bank is accountable for an item it is liable to pay it. If it has made final payment for an item, it is no longer accountable for it.

That is to say, once a payor bank has made final payment, it *has already* paid the item and thus is no longer accountable for it. If it failed to finally pay the item when it should have, it is then accountable for that item and can be made to pay as it should have.

Among the most significant consequences of final payment of a check is that once final payment has occurred, it cannot be undone. Final payment really is meant to be final. Under normal circumstances, the payor bank cannot revoke a settlement that has become final, nor does it have any right under Article 4 to get back any final payment that it made in cash. Under certain limited circumstances, however, a payor bank that has paid an item by mistake may look for relief to §3-418 and the possibility of *restitution* of the amount paid mistakenly. We will look at the operation of §3-418 in the final examples of this chapter.

Examples

David Drake has a checking account at the North Side branch of Payson State Bank. He draws a check for $2,000 on this account payable to Paula Paley. Paley takes this check to the North Side branch of Payson and presents it to a teller, asking for immediate payment of the check in cash. The teller looks at the status of Drake's account and determines that it is within the bank's guidelines for him to accept the item. He hands over $2,000 in cash to Paley.

Has this check been finally paid?

Suppose instead that Paley had asked that she be issued a cashier's check by Payson for $2,000 in exchange for the check she has received from Drake. The teller does issue her such a cashier's check. Has the check issued by Drake to Paley been finally paid by the Payson bank?

Suppose that Paley herself has an account with the same branch of Payson. She deposits Drake's check in her account by indorsing it and handing it over to a teller, along with a deposit slip indicating a deposit of a single check for $2,000. Has this check been finally paid as of this moment?

Finally, suppose that the situation is as in part (c), except that when Paley presents Drake's check to the teller, she says she would like to "deposit it as cash" in her own account. Paley signs the back of the check and hands it over to the teller, along with a deposit slip indicating that she is depositing $2,000 in cash. What is the result?

David Drake draws a second check on his account for $1,500, made payable to Patricia Parsons. Parsons has an account with the Payson bank, but her account is held at the South Side branch of that bank. Parsons deposits this check in her account on Monday morning.

Ias this check been finally paid?

Vhat is the obligation of the South Side bank with respect to this check?

The South Side branch forwards this check to the North Side branch, which receives it on Tuesday morning. What are the North Side branch's obligations with respect to the check? What must it do if it wishes to avoid final payment of the check or becoming accountable for the amount of the check?

Drake draws a third check to pay his Vista credit card bill. He sends this check to the address in a distant city indicated on the bill. Vista deposits this check (along with a load of others it has received) into its account with Depot Bank for Commerce, a bank in the city in which the Vista headquarters are located. The Depot Bank forwards Drake's check for collection through normal banking channels. Eventually the check ends up in the possession of one Prestige Bank, a major bank located in the same city as the smaller Payson State Bank and to which checks written on Payson are routinely routed. On a Tuesday morning, Prestige Bank presents this check for payment to the Payson bank. The Payson bank never makes a settlement, provisional or otherwise, with the Prestige Bank but does, upon finding that Drake's account doesn't include sufficient funds to cover the check, return the check to Prestige by special messenger on Wednesday afternoon.

Has Payson made final payment on this check?

Can Payson be held accountable for the amount of the check to Vista? If so, why?

Drake draws yet a fourth check, this one to pay his Mastercharge bill, and sends the check off to Mastercharge. That company deposits the check in its account with Downtown Federal Bank, which forwards the check for collection through customary banking channels. This check is eventually forwarded to Prestige Bank, which presents it for payment to the Payson bank on a Wednesday morning. Payson does settle with Prestige for this check by the end of Wednesday. On Thursday, having determined that Drake does not have sufficient funds in his account to cover the check, Payson decides not to honor it. The check is put in an envelope and mailed off to Prestige Bank on Thursday afternoon. It is received by Prestige Bank on the following Monday.

Has Payson successfully avoided making final payment on this check?

Suppose instead that Payson does not mail the check to Prestige until Friday morning, but that the returned check still is received by Prestige on the following Monday. Under this set of facts, can Payson claim that it has avoided making final payment on the check? Does Payson have any argument that the result in this situation should be no different from that in part (a), because its failure to act until Friday did not cause any additional delay in the return of the item (in each case it was received by the presenting bank on the following Monday) and its lateness in returning the item could have caused no damage to Mastercharge?

The DotCom Corporation is another customer of the Payson State Bank. DotCom writes a check for $15,000 to Paul Perkins, a consultant who has completed a project for the company. Perkins deposits this check to his account with the New Economy Bank and Trust. This check is forwarded for collection to the Payson bank, which receives it on a Monday morning. By the time Payson gets the check, DotCom has issued a proper stop-payment order covering the check, and this stop-payment order has been received by Payson. Through a foul-up at that bank, though, the fact that payment on the check has been stopped is not recognized by the Payson bank’s computer system, and the check is not returned to the presenting bank by the end of Tuesday.

Has Payson made final payment of this check?

Will Payson be able to charge the amount of the check against the amount in

DotCom’s account?

When Payson becomes aware of what has happened, will it be able to recover the $15,000 from Perkins under the theory of restitution? Look to §3-418.

Assume instead that the check written out and delivered to Perkins was not for work already done for DotCom. Perkins, as a consultant, has a policy of demanding payment in advance for any project he agrees to take on. The bank mistakenly pays the check over a valid stop-payment order it has received from DotCom. By the time Payson contacts Perkins to explain what has happened and demand restitution of the $15,000 now under the control of Perkins, the consultant has not yet begun to do any work on the DotCom project. Under this assumption, can Payson get restitution from Perkins?

DotCom writes a second check out of its account with Payson State Bank, this one to Star Microsystems for $23,500 to pay for some computer equipment that DotCom bought and received from Star. At the time the check is presented to the Payson bank, DotCom does not have sufficient funds in its account to cover the check. In this situation, Payson would as a matter of course dishonor and return the check, but through a mistake it does not. It holds onto the check beyond its midnight deadline. Will Payson be able to get restitution of the $23,500 from Star Microsystems?

Dexter Moneybucks, the wealthy financier, also has an account with Payson State Bank. He draws a check for $45,000 payable to the Uptown Art Gallery to pay for a painting he is adding to his extensive collection of modern art. The check is presented to Payson on Tuesday morning, and that bank settles for the $45,000 with the presenting bank by the end of that day. On Wednesday morning, it is brought to the attention of the account manager responsible for the Moneybucks account that there are not sufficient funds in the account to cover the check. Not wanting to offend an important customer of the bank, she telephones Moneybucks and informs him of the situation. She tells him she will be forced to dishonor the $45,000 check that has just been presented unless that amount is in his account by the end of the day. Moneybucks assures her that this is just a temporary problem and that the bank should soon be receiving a deposit of funds for his account that will more than cover the check to the Uptown Art Gallery. Later in the day, the account manager again investigates the situation and discovers that no new funds have come into Moneybucks’s account. She elects to give this valued customer a bit more time before bouncing one of his checks and then leaves for the day without having taken any action with respect to the check. On

Thursday morning she once again inquires into the status of the Moneybucks account, and things are no better. No new deposits have been made by him. Is it too late for the Payson bank to avoid making final payment on this $45,000 check? Does the bank have any argument, based on the theory of restitution, that it should be able to recover the $45,000 paid to the art gallery under the circumstances?

Explanations

Yes. This is the simplest case going. Under §4-215(a)(1), the payor bank has finally paid an item when it has "paid the item in cash."

The prevailing opinion seems to be, yes. Once the payor bank has issued a cashier's or teller's check in exchange for a check that was presented directly over the counter, the presented check has indeed been finally paid. This follows from the general notion that a cashier's or teller's check is, for all practical purposes, if not literally cash, then at least should be considered a "cash equivalent" for the amount of the check. Hence, final payment has been made by virtue of §4-215(a)(1). Some might want to analyze the situation instead as one in which, under §4-215(a)(2), the payor bank has "settled for the item without having a right to revoke the settlement," but the result remains unchanged. The check written by Drake to Paley has been finally paid by Payson State Bank's giving a cashier's check to Paley in exchange for the item.

> A distinct question, and one that we do not get into here (wait for Chapter 15), is whether Payson State Bank will ever have the right to refuse payment on the cashier's check it has just given to Paley, and if so under what circumstances. Even in the very rare case when Payson may have a right to withhold payment on its cashier's check, this doesn't really affect the answer to the question with which we are at present concerned. The check in question—the one drawn by Drake on his account with Payson State Bank and made payable to Paley—has been finally paid by Payson's acceptance of that check and payment for it by way of a cashier's check of its own.

No. As of this moment, Payson has been presented with the check in question but has not finally paid it. It will be required, by the end of the day, to provisionally credit the amount of the check to Paley's account, but it will then have an additional day to determine whether it wishes to revoke the provisional credit and return the check to the depositor Paley. If it does revoke and return before its midnight deadline, it will avoid final payment of the check and any accountability for that check.

Paley will want to argue that this check has been finally paid by, in effect, the payment of $2,000 to her in cash (making the case like that in Example 1a) which she then deposited in her own account just as she might deposit any other cash she had in her possession. The bank will want to argue that what really occurred is that it took the check for deposit (as in Example 1c), with the understanding that anything later paid on the check would be automatically deposited into Paley's account just as if it were cash. The bank may be able to take advantage of some language that it carefully included in the agreement signed by Paley upon her opening the account, to the effect that any cash given for an on-us item deposited at the bank is to be considered merely an advance of cash to the depositor and may be recovered if the check is not finally paid. Barring such language, and a court's being willing to enforce it under the circumstances, Paley probably has the better argument. For a case on point supporting Paley's position here, see *Kirby v. First & Merchants National Bank*, 210 Va. 88, 168 S.E.2d 273, 6 U.C.C. 694 (1969).

No. It has not been paid in cash and any credit that the South Side branch may add to Parsons's account will be provisional only. Final payment has not been made.

Under §4-107, the answer to this question will depend on how the North Side and the South Side branches of the Payson bank have set up their check collection and check clearing operations. If the two branches use a common facility for handling checks (located somewhere in the middle of town, presumably), then the situation is to be dealt with just as if Parsons had deposited directly in the payor bank. The check will be finally paid if it is not returned to her by the midnight deadline following a Monday-morning presentment. If instead the North Side branch and the South Side branch work through independent check collection centers, each located at the branch in question, then the South Side branch's obligation with respect to this check is that of a collecting bank. It must forward the check to the North Side branch, thereby presenting it, by its midnight deadline. The South Side branch acts as the depositary bank but is not the payor bank. It is not in a position to finally pay on the item.

The North Side branch is under no obligation to settle for the check by the end of Tuesday with the South Side branch. For this purpose at least, the two branches are not considered separate banks between which settlement must be made. The North Side branch must, however, determine whether to honor or dishonor (by return) the check, and it must do so by its midnight deadline —midnight on Wednesday, in this case. To avoid finally paying the check or becoming accountable for it, the North Side branch must under §4-301(a) and (b) "return the item" or "send written notice of dishonor or nonpayment [in the unlikely event] the item is unavailable for return" prior to the passing of its midnight deadline. For what constitutes effective return for the purposes of Article 4, see §4-301(d). Other than cases in which a check has been presented through a clearing house and special clearing-house rules apply, an item is deemed returned "when it is sent or delivered to the bank's customer or [as in this case] transferor or pursuant to instructions." Therefore, to avoid final payment on this particular check, the North Side branch of Payson must send the check back to the South Side branch before midnight on Wednesday.

No. Payson has not taken any action that would constitute final payment under any part of §4-215(a).

Yes, Payson can be held accountable to Vista for the amount of the check because of its failure to settle with Prestige Bank, the presenting bank, by midnight on the day on which it was presented with the item for collection. Reread carefully §4-302(a). In this case Payson has failed to meet its obligation under the midnight rule, which governs the payor bank's obligation initially to settle for any item with which it is presented; hence, it is accountable for the item. This example is based on the noted case of *Hanna v. First National Bank, of Rochester*, 87 N.Y.2d 107, 661 N.E.2d 683, 637 N.Y.S.2d 953, 28 U.C.C.2d 417 (1995), which held that the payor bank was not absolved from its violation of the midnight rule for settlement even though it returned the presented item prior to the expiration of its midnight deadline. The New York Court of Appeals declared:

> The statutory requirement that the payor bank settle for the item on the day of receipt is the first step toward effectuating the overarching purposes of article 4 of the Uniform Commercial Code, to make the transactions it regulates swift and certain. Although timely dishonor may minimize the pecuniary harm to the particular parties involved, forgiveness of the payor bank's untimely conduct would do a significant disservice to the integrity of the complex, ordered, and predictable operation of article 4's rules governing banks.

The *Hanna* case was decided under the prerevision version of Article 4 (the state of New York had not at the time—and as a matter of fact has still not, as of this writing—adopted the 1990 revisions to Articles 3 and

4), but there is no reason to believe that the result would have been any different had the revised version been in effect.

Yes. The Payson bank provisionally settled with the presenting bank on the day of the check's presentment, so it can then avoid making final payment, under §4-215(a)(3), by revoking the settlement "in the time and manner permitted by statute, clearing-house rule, or agreement." The statutory right to revoke the provisional settlement is found in §4-301(a):

> If a payor bank settles for a demand item … presented otherwise than for immediate payment over the counter before midnight of the banking day of receipt, the payor bank may revoke the settlement and recover the settlement if, before it has made final payment and before its midnight deadline, it
>
> returns the item; or
>
> sends written notice of dishonor or nonpayment if the item is unavailable for return.

Subsection 4-301(d)(2) provides that an item other than one presented through a clearing house is returned "when it is sent or delivered to the banks' customer or [as in this case] transferor or pursuant to instructions." As Comment 6 to this section helpfully informs us, the definition of *sent*, as that term is used in this section, is to be found in Article 1, at §1-201(38) or §1R-201(b)(36). Quoting from the original Article 1:

> "Send" in connection with any writing or notice means to deposit in the mail or deliver for transmission by any other usual means of communication with postage or cost of transmission provided for and properly addressed and in the case of an instrument to any address specified thereon or otherwise agreed, or if there be none to any address reasonable under the circumstances.

So, if Payson deposited the envelope containing the dishonored check in the mail before its midnight deadline, it has effectively returned the check prior to its midnight deadline and has not finally paid on the item. This all assumes, of course, that the envelope bore the proper address and sufficient postage.

In *First Bank v. Farm Worker's Check Cashing, Inc.*, 745 So. 2d 994, 39 U.C.C.2d 663 (Fla. Dist. Ct. App. 1999), the payor bank did mail out the checks it sought to dishonor prior to its midnight deadline, but they were sent to the wrong address. The customer check-cashing service had notified the bank of a prospective move of its business office and had filed a change of address notice with the bank, but that notice specified that the change of address was not to be effective until March 31, 1995. The bank sent the returned checks to this new address prior to the specified effective date. As a result, it was held that the bank had not sent the items in return in a proper fashion and that final payment had occurred.

If Payson does not return the check until Friday morning, after its midnight deadline has passed at the end of the day on Thursday, then it has finally paid the item. It has no right to revoke on an item that it has finally paid. Even if the check does work its way back through the return process and what should be now regarded as nonprovisional settlements are somehow revoked, this is of no help to Payson, because under §4-302(a)(1) it would still be accountable for the item for its failure to "pay or return the item or send notice of dishonor until after its midnight deadline." For the payor bank to be "accountable" for an item means that it must pay the full amount of the check to the person entitled to enforce. One way or another, Mastercharge is entitled to the amount of the check. If the check was properly payable, of which there seems to be no doubt in this example, then Drake's account at Payson will be overdrawn due to payment of the check. Payson has the right to expect that Drake will eventually cover the negative balance in his account by the deposit of additional funds, but that is a matter between Payson and Drake, its customer. It need not concern Mastercharge.

It is very important to appreciate that Payson does not have any defense here based on the fact that its failure to act by its midnight deadline does not seem, in this particular instance, to have actually delayed eventual return of the check to the depositary bank at all. The payor bank's obligation to return the check prior to its midnight deadline (as well as its obligation to settle for the check prior to midnight on the day of receipt, as we saw in the previous example) does not depend on the showing of any harm brought about by the delay. Nor does this accountability on the instrument require any showing that the payor bank's failure to meet the specified deadlines set for it in Article 4 was the result of lack of ordinary care or anything like that. Compare this result to the example in Chapter 10, in which a collecting bank failed to act within a timely fashion as a participant in the collection process. For a collecting bank, liability for failure to act as required under Article 4 is determined by the actual damage resulting from its failure to follow the rules. This is not the case for the payor bank; liability after final payment, and accountability should it fail to make available to the depositor the amount of the check as it is obligated to do upon final payment, is not limited to any harm that can be shown to have been caused by the payor bank's delay. Accountability under §4-302 is treated as strict liability. See the discussion in *First National Bank in Harvey v. Colonial Bank*, 898 F.

Supp. 1220, 28 U.C.C.2d 290 (N.D. Ill. 1995).

Yes. Payson, by retaining the check beyond its midnight deadline, has finally paid on the check.

No. Payson is allowed to deduct from its customer's account only the amount of those checks that are properly payable. A check on which the bank has received a valid stop-payment order will not be considered properly payable. Payson cannot charge the amount of this check to DotCom's account.

Under §3-418(a), the payor bank is given a statutory right to restitution if a check was finally paid by mistake in two distinct situations.

> Except as provided in subsection (c), if the drawee of a draft pays … the draft and the drawee acted on the mistaken belief that (i) payment had not been stopped pursuant to Section 4-403 or (ii) the signature of the drawer on the draft was authorized, the drawee may recover the amount of the draft from the person to whom or for whose benefit payment was made.… Rights of the drawee under this subsection are not affected by the failure of the drawee to exercise ordinary care in paying … the draft.

Here Payson as drawee paid under the mistaken belief that there was no stop-payment order covering the check. The catch here, as least as far as Payson is concerned, is in the all-important introductory words to this subsection, "Except as provided in subsection (c)." That subsection states that the remedy provided for in subsection (a), upon which Payson would be hoping to recover, "may not be asserted against a person who took the instrument in good faith and for value or who in good faith changed position in reliance on the payment." Payson should not be able to get restitution from Perkins of the $15,000 mistakenly paid by it. Recall the definition of *value* found in §3-303(a). Perkins will have taken the check "for value" if he took it in exchange for a promise of performance on his part, to the extent the promise has been performed. If we assume, as we have no reason not to, that Perkins acted in good faith in taking the instrument for the work he did, then he has taken the instrument "in good faith and for value" and hence is not vulnerable to any action for restitution that Payson State Bank may attempt to bring under §3-418(a).

Payson will assert its right to restitution under §3-418(a). The question is whether Perkins can establish that he is insulated from Payson's claim based on subsection (c). Based on the facts as we are now assuming them to be, Perkins cannot claim to be a person who took the instrument for value. Recall that under §3-303(a), a promise of performance not yet performed does not constitute value for Article 3 purposes. Perkins may still be able to defeat the restitution claim, but only if he can establish that he "in good faith changed position in reliance" on the mistaken payment of the check. Let us continue to assume that Perkins has been acting in good faith. Perhaps he can demonstrate that once he obtained payment on the check from DotCom, he turned down other jobs, because he can take on only so many consulting projects at one time. This could constitute a change in position in reliance on the payment of the check, which would bar restitutionary recovery by Payson.

Even if he acted in good faith, if Perkins cannot prove that he either gave value for the instrument or acted on reliance on its being paid, then Payson would be entitled to restitution under §3-418(a). Note that even after making restitution Perkins will not be out of pocket any money. He will only be in the same position he would have been in had the Payson bank not made the mistake and observed the stop-payment order it had received from DotCom. Perkins may, of course, have a contractual cause of action against DotCom for a possible repudiation of whatever consulting agreement it entered into with Perkins, but that is between the consultant and the company. Payson has made a mistake, but in this particular situation it can escape from the consequences through the route of restitution. It's a fair guess, however, that this type of situation will be the exception rather than the rule. As Comment 1 to §3-418 concludes,

> The result in the two cases covered by subsection (a) is that the drawee in most cases will not have a remedy against the person paid because there is usually a person who took the check in good faith and for value or who in good faith changed position in reliance on the payment or acceptance.

Just to get to the circumstances posited in this part of the example, we had to assume that Perkins was able to get prospective clients to pay up front for the consulting work he proposes to do for them. In all likelihood, even the most sought-after consultant (even in the red-hot world of Internet commerce, where we have to admit that just about anything seems possible) would not be able to insist on payment on terms such as this.

Payson has made final payment on this check by holding onto it past Payson's midnight deadline. Payson can find no support for recovery in restitution in subsection (a) of §3-418, because the mistake that it made is not of either variety covered there. The bank will have to look instead at subsection (b):

> Except as provided in subsection (c), if an instrument has been paid … by mistake and the case is not covered by subsection (a), the person paying … may, to the extent permitted by the law governing mistake and restitution … recover the payment from the person to whom or for whose benefit payment was made.…

> As Comment 3 to this section makes clear, this subsection, by directing courts to deal with cases not governed by subsection (a) under "the law governing mistake and restitution," is referring the issue in such instances to the common law of restitution, as the courts of the jurisdiction in which the problem is being addressed understand that law to be. In the particular example we have before us—and in most actual instances, as Comment 3 is quick to point out—there is no need to delve into the intricacies of the general common law remedy of restitution. Any right to recover under §3-418(b) is explicitly made subject to subsection (c), just as we earlier saw any cause of action under subsection (a) to be. Here Star Microsystems took the check for $23,500 "in good faith and for value," and hence it is immune from any action in restitution that Payson might be tempted to bring.
>
> If you are interested in delving further into under what circumstances the common law of restitution might come to the aid of a bank mistakenly paying a check, you might want to look at Section 67 of the Restatement Third, Restitution and Unjust Enrichment, the final version of which was issued by the American Law Institute in 2011. The reporter for that restatement, Professor Andrew Krull, has also written a helpful article, *Restitution and Final Payment*, 83 Chi.-Kent L. Rev. 677 (2008).

It is too late for the bank to avoid making final payment on the check. It has already done so by failing to return the check to the presenting bank prior to the passing of its midnight deadline on Wednesday midnight. Nor should Payson be able to assert any kind of right of restitution under the circumstances. Any possibility of restitution, founded as here it would have to be on §3-418(b), takes as its starting point a finding that the check in question had been paid "by mistake." However much the account manager at Payson bank will later regret making the decision she did—not to arrange for return of the check on Wednesday afternoon even if she would have been within her (and her employer's) rights to do so—this was not a mistaken payment in the sense that word is used in the law of restitution. The bank, through its agent, made a conscious decision to act as it did, paying an item by retention beyond the midnight deadline even if it was under no contractual obligation to its customer Moneybucks to do so. It did not "mistakenly" pay the check. It knowingly and willingly allowed the check to be paid even though this created an overdraft in Moneybucks's account. In effect, the bank advanced the money to cover the check to Moneybucks on unsecured credit, and Payson will have to go after Moneybucks if he doesn't quickly bring his account balance into the black. The case of *First National Bank v. Colonial Bank*, cited earlier, though dealing with a much more complex situation than the rather simple one presented here by Moneybucks's efforts to add yet one more expensive artwork to his collection, addresses itself to this issue and concludes (as we have) that no "mistaken payment" is involved when a bank knowingly holds onto a check beyond its midnight deadline on the assurance that the customer will soon be coming up with the funds necessary to cover the check.

See Revision Proposals starting on the following page.

Revision Proposals

The 2002 Revision makes two important amendments to §4-301, both of which are intended, as an additional Comment 8 informs us, to facilitate "electronic check-processing." Recall that in the present version of §4-301(a) a payor bank can avoid being accountable for an item by either physically returning the item or by sending to the presenting bank a "written notice of dishonor or nonpayment if the item is unavailable for return." Revised §4-301(a) gives the payor bank three possibilities; it avoids accountability if it

returns the item;

returns an image of the item, if the party to which the return is made has entered into an agreement to accept an image as return of the item and the image is returned in accordance with that agreement; or

sends a record providing notice of dishonor or nonpayment if the item is unavailable for return.

Notice that in part (2) electronic return of an *image* of the check is not made conditional on the check's not being available for physical return.

Note as well that part (3) refers to the sending of a "record" and not a "written" notice. What's a *record?* This is a new concept that has been making its way into the modern Uniform Commercial Code as various articles have been revised in this new age of electronic communication. You'll find the word defined either in §1R-201(b)(31), if you are working with the 2001 Revision of Article 1, or in §3R-103(a)(14) if you are not. It is "information that is inscribed on a tangible medium or that is stored in an electronic medium and is retrievable in perceivable form." So a writing, as that continues to be defined in Article 1, would be a record, but a record need not necessarily be a writing. For example, consider an e-mail message, here one sent by the payor bank to the presenting bank making clear that it is dishonoring a given check. The message is received by the presenting bank and stored as a "file" on its e-mail system but never printed out to be held in an old fashioned file cabinet. (In fact, it would most likely be forwarded to the bank that had transferred the check to the presenting bank, and so on until it arrives as an e-mail to the depositary bank.) This message is a record even if it is never printed out on paper by anyone. It is enough that it is "retrievable in perceivable form," that it has been preserved and should the need arise *could be* later printed out or simply pulled up on a computer screen for the eye to see. As you should also be able to convince yourself, a phone message, *if* it is recorded *and* the recording is saved in some form from which the message can later be heard, also qualifies as a record even if it is never reduced to writing.

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* You will note that in this chapter—for the purpose of keeping the discussion manageable and focused—I am reverting to the "traditional," all-paper-all-the-time, model of collection, so that what is presented to the payor bank is the original check itself and not a substitute check, an electronic record, or anything of the sort we ran into in Chapter 11. Each of those new means of collection will, naturally, have its own essentially parallel rules on final payment, but with the source of the rule, its exact language, and how it plays out all modified to fit the circumstance.

You should also note that this chapter deals with the payor bank's responsibilities and potential liability under the rules of Article 4. The provisions of Article 4 have now been supplemented and in some limited cases superseded by the promulgation of Regulation CC by the Federal Reserve. We will look at the consequences of Regulation CC in Chapter 13.

* For the purposes of this chapter, we will continue to assume that the person attempting to collect on the check, either by presentment to the payor bank for payment over the counter or by depositing the check in his or her own account, does qualify as a person entitled to enforce the check. A whole separate set of concerns arises, as you can imagine, when the person attempting to collect on the check has no right to do so, as when there has been theft or forgery. We will give such problems all the attention they deserve in Part V.

CHAPTER 13

Expedited Return Under Regulation CC

THE EXPEDITED FUNDS AVAILABILITY ACT

As we have seen in the previous chapters, and as you are most likely aware from your own experience, when a customer deposits a check into his or her account, the money that the check represents is not immediately “available” to the customer. It will be a few days before the depositary bank will allow the customer to withdraw the amount as cash or consider it as funds in the account to be used to cover checks that the customer himself or herself has written and that are presented for payment. This follows from what we know of the check collection process as we have looked at it so far: The deposited check results in only a *provisional* credit to the customer’s account. When a check is deposited, it must then be sent on for collection. Eventually it reaches the payor bank. In the large majority of cases, that bank honors the check, in which case and at which time the provisional credit in the depositor’s account is said to “firm up” and does indeed become the depositing customer’s money in the bank. A small percentage (but still a significant number) of checks presented for payment, however, are not honored by the payor bank. Once dishonored, they are expected to make their way back to the depositary bank, which will, upon receipt of the dishonored item, remove the provisional credit from the customer’s account balance. The check never turns into available funds at the depositor’s disposal.

So, the deposited check creates only a provisional credit in the customer's account, and this provisional credit will either firm up to become available funds *or* be withdrawn entirely if the check in question is dishonored by the payor bank. The real problem here has always been not just that some checks will be returned unpaid, but that there is obviously no way for either the customer or the depositary institution to know, at the time of deposit, which checks those will be. Nor could there be any way to forecast with confidence how many days it will take for a dishonored check to make its way back to the depositary bank and for the sad fact of dishonor to become known. The forward collection process is, thanks to its mechanical and automated nature, fairly quick and efficient. Still, it may take several transfers of any single item, passing from the hands of one bank to another, for a check sent for collection to reach the bank on which it was written, especially if that bank is in a distant part of the country. Each of the collecting banks is then obligated to send the check off to its next destination, so there will be further time in transit. Once the check reaches the payor bank, we know that bank must act by its midnight deadline if it wants to dishonor the item, but even then its only obligation to avoid final payment under Article 4 is that it return the check by sending the item back to the presenting bank. That bank in turn will have a couple of days to figure out how and from whom it received the check and then send the item back to that transferor. And so it goes. The returned check is sent back to the depositary institution retracing in reverse the path it took on forward collection. This return process, historically, has always been slow, as there was no automated procedure for return of dishonored checks. It had to be done on an item-by-item basis and by real live individuals looking over each check and determining what to do with it next. Slow going indeed.

Because of this predicament, it became customary for depositary banks to create their own internal rules for when they would consider the amount represented by any deposited check as fully available funds in the customer's account. Each bank would adopt a policy of placing "blanket holds" of a certain number of days on all deposited checks, usually distinguishing between local and nonlocal checks.* In response to rising consumer ire and critical commentary directed at the lengths of the blanket holds of individual banks and the banking industry in general, the federal government passed the Expedited Funds Availability Act (the "EFAA") in 1987. The general purposes and detailed provisions of the Act have been effectuated through the promulgation of an administrative regulation by the Board of Governors of the Federal Reserve System—Regulation CC: Availability of Funds and Collection of Checks (12 C.F.R. Part 229). In July 2011, a new federal regulatory agency, the Consumer Financial Protection Bureau (CFPB), was created as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The newly created CFPB was granted joint authority, along with the Federal Reserve, to promulgate regulations under the EFFA. As of this writing, it has not proposed or enacted any change to Regulation CC, although it may of course choose to do so in the future.

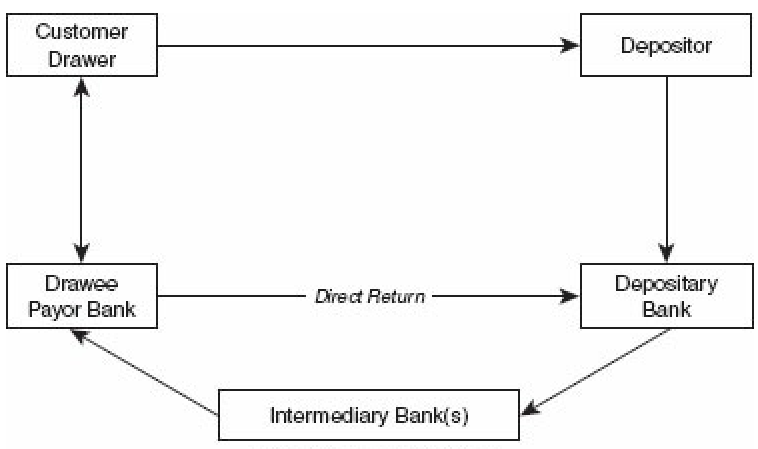
INTRODUCING REGULATION CC

Regulation CC is lengthy, wordy, and complex. It is, after all, a federal regulation.* It applies to all banks (as that term is defined in loving detail in 12 C.F.R. §229.2(e)) in the United States. In broad outline, its effect in implementing the Expedited Funds Availability Act is twofold. One part of Regulation CC (Subpart B, which we will explore in Chapter 16) dictates for all banks a mandatory schedule as to when funds reflecting any deposited check must be made available to the depositor and how the depositor is to be made aware of his or her rights under the system. Individual banks are no longer free to impose whatever hold policies they wish. Regulation CC sets forth the maximum time during which a bank may restrict use of funds represented by any deposit. Not surprisingly, considering that the regulation is meant to carry out what Congress chose to entitle the *Expedited* Funds Availability Act, the availability schedule now mandated by Regulation CC generally allows for quicker use of funds by the customer than was true prior to the adoption of the Act and promulgation of the regulation.

REGULATION CC AND CHECK COLLECTION

By effectively requiring that depositary banks make funds available to their customers based on deposited items on an accelerated basis, the Act was necessarily increasing the risk to the depositary institution that it would part with funds on the basis of what would later turn out to be uncollectible items. In particular, the expedited availability schedules of Subpart B made even easier a not terribly sophisticated, but nevertheless often quite effective, type of check fraud. A customer could deposit a check that he or she knew for a fact or had every reason to believe would not be honored by the bank on which it was drawn. The check would typically be drawn on a distant institution, such that even under the best of circumstances the forward collection, the anticipated dishonor, and then consequent return of the item would take a fairly long time. The customer could then wait out the relatively brief (at least for his or her purposes) time that Subpart B of Regulation CC gave the depositary bank to restrict availability on the item. As soon as that time had run, the customer would withdraw in cash all of the money in his or her account, and then vanish into thin air. By the time the depositary bank got return of the item unpaid, it was too late to do anything and that bank would usually simply have to bear the loss.

In a rough attempt to counterbalance this consequence of what it was doing to benefit the individual customer (most of whom were, of course, not involved in any kind of fraud, and most of whose checks would clear with no difficulty) by shortening the time for availability of funds, Regulation CC also took on a second task. It set forth a new set of rules, again applicable to all banks, designed to get notice of a check's dishonor more quickly to the depositary bank. This aspect of Regulation CC is found in the provisions of its Subpart C, and it is the subject to be covered in this chapter.

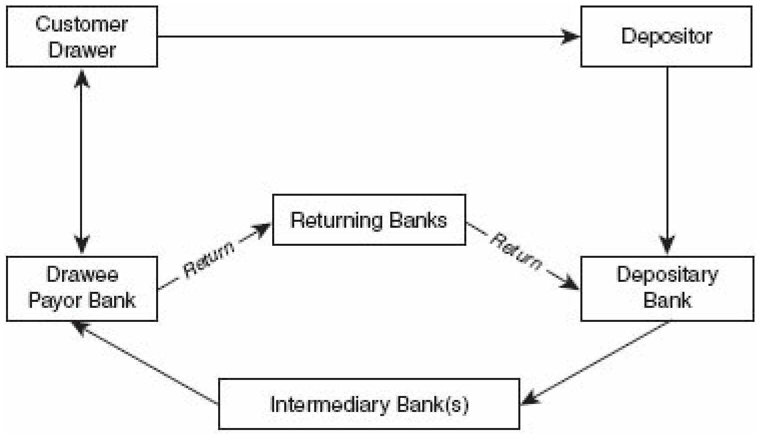


Direct Return Upon Dishonor

The first thing to note is that the traditional rules of Article 4 on check collection and return, as we have seen them in Chapters 10 and 12, are not done away with or preempted by Regulation CC. A payor bank will have to make sure that it meets the standards of *both* Article 4 and Regulation CC in handling any return of items. See *Farm Credit Services of America v. American State Bank*, 212 F. Supp. 2d 1034 (W.D. Iowa 2002) *aff'd*. 339 F.3d 764 (8th Cir. 2003). It is true that, to the extent the rules of Article 4 are inconsistent with those in Regulation CC, it is the regulation that governs. See, for example, Comment 4 to U.C.C. §4-214. Recall that the basic requirement under Article 4 of a payor bank that determines not to make final payment on a check is that the bank return the check to the presenting bank by the payor bank's midnight deadline. The presenting bank is then required to return the check to the bank from which it received it, and so on. Under the traditional way that returned checks were handled and under Article 4 as it is still written, return of an unpaid check anticipates that the check will physically retrace the steps of forward collection, only in reverse. In some, perhaps a majority, of instances, return by this means will also comply with the requirements of Regulation CC. If so, all to the good. But to the extent that this means of return does not satisfy the requirements of expeditious return and notice of dishonor of Regulation CC, the federal regulation governs and the payor bank is under an obligation to comply with its more stringent requirements.

The changes this aspect of Regulation CC have brought to the business of returning unpaid checks are quite significant. For one thing, Regulation CC allows for, although it does not necessarily require, *direct return* of a dishonored item, with the payor bank returning any check that it determines not to honor directly to the depositary institution, with no intermediate stops along the way.

Regulation CC also contemplates that in some situations, the payor bank will return the dishonored check to the depositary bank not directly, but via a route of go-between banks, so-called *returning banks*, different from those through which the check initially passed during the forward collection process.



Return Upon Dishonor Through Returning Banks

The mechanism that the payor bank will employ to make return in this fashion is what Regulation CC refers to as the *qualified return check*. Under §229.2(bb) of Regulation CC, a qualified return check is

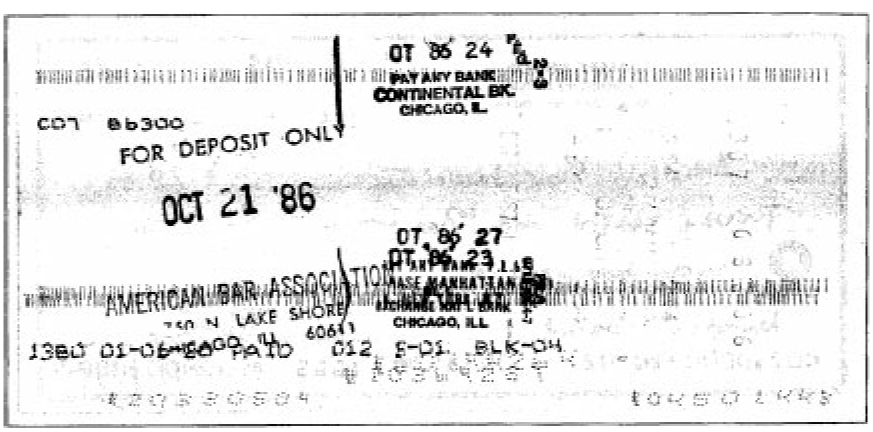
> a returned check that is prepared for automated return to the depositary bank by placing the check in a carrier envelope or placing a strip on the check and encoding the strip or envelope in magnetic ink.

You can find more detail on what is required for a check to be converted into a qualified return check as part of §299.30(a)(2)(iii). Once a check is converted into a qualified return check, with a new MICR line on the bottom or on a carrier envelope into which the check has been placed, it can be processed automatically through the machinery that banks already have on hand to handle the forward collection process. The return process can be accomplished with the speed and efficiency of the forward collection of checks.

CHECKING OUT THE BACK OF A CHECK

Before looking into the various obligations that Regulation CC imposes on a payor bank that decides to dishonor a check, it is interesting to look at one change Regulation CC forced in the way checks are handled; a simple enough matter, but one that makes all that follows possible. Prior to the introduction of Regulation CC, each bank in the collection chain would usually put some stamp, notation, or set of numbers on the back of any check that passed through its system. After the depositor had indorsed the back of the check, the depositary bank would then itself stamp or mark the back in some fashion, as would each succeeding collecting bank in turn. The result was that the back of any individual check, by the time it reached the payor bank, bore a mess—and I mean this quite literally—of colorful, overlapping, smeared-together, and difficult-if-not-impossible-to-read markings. Good perhaps as modern art, but not for administration of the check collection process. Even if at this stage the payor bank had for its own reasons *wanted* to get in touch with the depositary bank, there was no way the people at the payor bank could have told with any certainty just by looking at the check exactly *where* and at which bank it had been deposited. Any marking the depositary bank may have put on the back was by this time more than likely to have been rendered indecipherable by all the markings that had been piled on top of it. Below I reproduce for your consideration the back of one of my returned checks from the pre-Regulation CC era.

Given such a display, all that the payor bank could be sure of was from which bank it had received the item and this only by looking at its own records. Thus, the best it could do by way of return was to send it back to the presenting bank from whence it had come. That bank, once it received the returned item, would have its own difficulty in trying to determine what bank had transferred the check to it. It was certainly not something that could be handled by machine or on other than an item-by-item basis. The back of the check could be consulted, but again it was unlikely that much could be gleaned from that source. Any collecting bank would have to do some digging into other records it had on hand (and now we see why it was given two days for processing by Article 4) to determine to what bank the check should next be returned.



Under §229.35(a) of Regulation CC, each bank that handles a check during forward collection "shall legibly indorse the check in accordance with the indorsement standard set forth in Appendix D to this part." It is doubtful that you will have the said Appendix D easily available to you, and I am not suggesting that you run out and find yourself a copy (unless you just happen to have a thing for the minutiae of the Code of Federal Regulations). What I can relate, however, is that Appendix D sets forth with precision the standards for who should stamp where on the back of any check. A certain portion of the back of the check, roughly the middle third, is intended for the use of the depositary bank and the depositary bank only. The space above is meant for the depositing customer to make his or her indorsement. The space below is where any intermediary bank is allowed to place its mark. In the middle, however, the depositary bank is directed to make its indorsement, which must contain that bank's unique nine-digit routing number set off by arrows pointing toward the number at each end, the bank's name and location, and the indorsement date. All this information is to be placed on the check by the depositary bank in the prescribed location and in dark purple or black ink. Many preprinted checks now come to the customer with the prescribed areas marked off on the back of the check. I know that mine do, even invoking in small print the Federal Reserve Board of Governors Regulation CC, as you can see by looking at the "Before" picture of the back of one of my more recent checks. Look at the example on page 245.

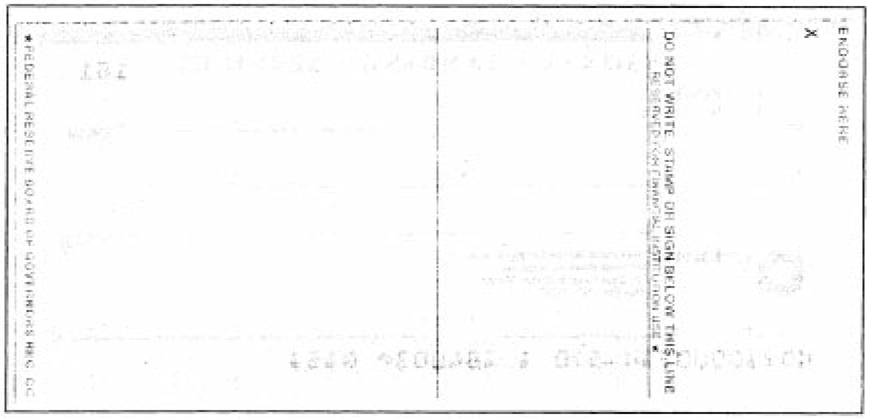
You can see for yourself what happened to this particular check, which I mailed off, presumably in some preaddressed envelope, to pay for my subscription to the *Wall Street Journal*. The *Journal* has in its very personal way indorsed the check for deposit, as you see on the far right. In the middle you can make out that it was deposited at a bank that goes by the name, or at least the initials, of FNBB located at 2 Morrissey Boulevard in Boston. Equally, if not more, important, that bank's routing number is given as ► 011000390◄. The other markings are relevant only in that they do not cover up or render illegible the information that allows us to identify the depositary bank. Had my bank decided to dishonor this check (say, because I had insufficient funds in my account, though I must assure you that it did not have to), my bank would have had available *from the check itself* all the information it needed about the identity and whereabouts of the depositary bank, which would have made it possible for it to follow the various dictates of Regulation CC, Subpart C, to which we now turn.*

EXPEDITIOUS RETURN

Regulation CC made three major changes to the check collection process. The first, the requirement of *expeditious return*, is found in 12 C.F.R. §229.30(a): "If a paying bank [the term used in Regulation CC for what Article 4 terms the *payor bank*] determines not to pay a check, it shall return the check in an expeditious manner as provided in either paragraphs (a)(1) or (a)(2) of this section." As we will see in the following examples, the paying bank will be able to establish that it has met its obligation of expeditious return by demonstrating that its handling of the check for return satisfies either the *two-day/four-day test* of §229.30(a)(1) or the *forward collection test* of §229.30(a)(2).

In many instances, a payor bank's return of a check in a manner that would avoid accountability for the amount of the item under Article 4 will, without anything more, also meet that bank's Regulation CC obligation of expeditious return. This will not always be true, however, and so the payor bank must make sure that it does what it must to meet *both* its Article 4 and its Regulation CC responsibilities. It is important to remember that the rules of Regulation CC supplement, rather than preempt, what we have already learned about how the payor bank must handle a check under Article 4. The significant difference in approach, which you will discern by reading the relevant portions of Regulation CC, is that the rules of Article 4 are written in terms of when the payor bank must *send* the check for return—that is, get the check off the bank's hands and route it on its way so that it will eventually arrive back at the depositary bank; Regulation CC is written in terms of what the payor bank must do to enable the depositary bank actually to *receive* the returned check in as expeditious a manner as possible. When the depositary bank receives the check in return, and is then on notice to withdraw any provisional credit it added to the depositor's account, is of course what really matters as far as that bank is concerned. Regulation CC is written to address this concern directly.

BEFORE



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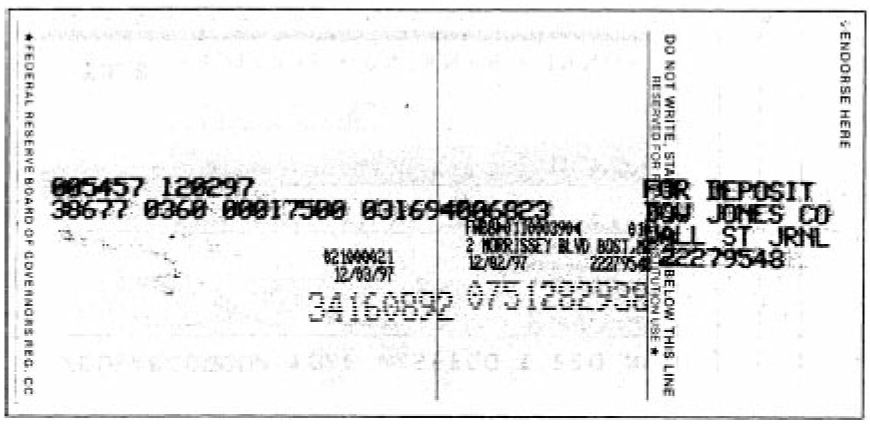

NOTICE OF DISHONOR

The second significant change wrought by Regulation CC on the process of check collection is found in 12 C.F.R. §229.33(a). If a payor bank determines to dishonor a check in the amount of $2,500 or greater, it must not only return the check in compliance with both Article 4’s and Regulation CC’s obligations of expeditious return, but must also send *notice of nonpayment* directly to the depositary bank, by a means and within a timeframe laid out in that subsection. If the payor bank decides to dishonor a larger item, it is under the obligation not only to return it in an expeditious manner but in addition to send the depositary bank advance notice that the check has been dishonored and is on its way back to the depositary bank. Again, Regulation CC is written with the needs of the depositary bank in mind; the quicker it learns that a deposited check is not going to convert to collected funds, the better position it is in to withdraw any provisional credit it has given and prevent the depositor from withdrawing or making use of what will turn out to be uncollectible funds.

POSSIBLE EXTENSION OF THE MIDNIGHT DEADLINE

The third way in which Regulation CC alters the rules of check collection and return is found in 12 C.F.R. §229.30(c). In this one respect, Regulation CC does not merely supplement or give an alternate route for a payor bank that decides to dishonor a check to meet its obligations under Article 4; it may actually override what is perhaps the most basic requirement of Article 4 in some limited situations. Under §229.30(c), the crucial midnight deadline by which the payor bank need act if it is to avoid accountability on an item under Article 4 may be *extended* if the bank uses means of expeditious return that fit the bill under this subsection of Regulation CC. The regulation even provides that the midnight deadline may be "extended further if a paying bank uses a *highly expeditious* means of transportation." What exactly this means in practice is just the kind of thing we will explore in the examples.

Two final points before we turn to the examples. First of all, I want to make clear that it is not my purpose here to explore every possible nook and cranny of Regulation CC, Part C. Each and every detail is more than we need, and probably more than we could bear at this juncture. You should be aware, however, that if a particular term within those parts of the Regulation that we do need is unclear to you, or if you are just plain curious about how exactly it is to be read, §229.2 of Subpart A of Regulation CC provides us with the definitions of key terms as those terms are used in the Regulation. Finally, it is important to note the nature of the liability a bank may face if it fails to meet the requirements placed upon it by Subpart C of Regulation CC. Look at 12 C.F.R. §229.38(a). A bank can be held liable for its failure to exercise ordinary care or act in good faith in carrying out the dictates of Subpart B. The measure of damages for failure to exercise ordinary care is not the full amount of the item, but rather "the amount of the loss incurred, up to the amount of the check, reduced by the amount of the loss that party would have incurred even if the bank had exercised ordinary care.” A bank cannot be held accountable for the full amount of a check simply because it failed to use ordinary care in carrying out its obligations under Subpart B of Regulation CC; it will be held responsible only for the amount of actual loss a party has suffered as a result of that failure.

Examples

Able writes a check to Barker for $45,000, payable on Able’s account with Big Apple Bank of New York City. This check is deposited by Barker in an account she has at a Manhattan branch of Gotham Bank on Monday. Both banks are members of the New York Clearing House Association. Gotham presents the check to Big Apple at a clearing held on Tuesday morning. On Tuesday afternoon, Big Apple determines not to pay the check, because Able has insufficient funds in his account. It returns the check to Gotham, following the clearing-house’s rules, at a clearing held on Wednesday morning.

Has Big Apple avoided making final payment on the item under Article 4?

Has Big Apple complied with its obligation of expeditious return under §229.30(a) of Regulation CC?

Has Big Apple met its notice obligation under §229.33(a) of Regulation CC?

Able writes a second check to Charters for $15,000, payable on his account with Big Apple Bank of New York City. This check is deposited by Charters in an account he has at Greenlawn Bank, a bank located in the suburbs of New York. Greenlawn presents this check directly (along with others it has received written on Big Apple) by courier to Big Apple on a Tuesday morning. On Wednesday, Big Apple determines not to pay the check, again because of insufficient funds in Able’s account. By Wednesday evening, Big Apple has put the check in an envelope correctly addressed to the Greenlawn bank and has deposited this envelope in the mail with correct postage.

Has Big Apple avoided making final payment on the item under Article 4?

Has Big Apple complied with its obligation of expeditious return under §229.30(a) of Regulation CC?

What if, instead, Big Apple had on Wednesday sent this check directly to Greenlawn via an overnight courier service, paying for next-day morning delivery?

Would your answer to part (c) of this example be any different if it turned out that the courier service, through some mix-up on its part, did not actually deliver the check to Greenlawn until Friday, rather than on Thursday morning as it had promised to do?

The third check Able writes on his account with Big Apple is for $12,500. It is made payable to Drennan, who deposits it in the Bakersfield Bank of Bakersfield, California. The check is eventually presented to Big Apple Bank on a Wednesday. Big Apple determines not to honor the check.

Would Big Apple be in compliance with Regulation CC if it simply mailed this check on Thursday evening to the Bakersfield Bank via first-class mail?

What if it sent the check on Thursday evening to Bakersfield via a private delivery service that promised not next-day delivery, but delivery within two days of receipt?

Able's fourth check is written on Big Apple Bank to Earl for $500. Earl deposits this check in the Burbank Bank of Burbank, California. This check is forwarded through customary banking channels and eventually comes into the possession of Gotham Bank of New York City, which presents it for payment to Big Apple on a Monday morning. By the time of its arrival at Big Apple, Able has issued a stop-payment order on the check, so Big Apple decides to dishonor the check. On Tuesday it delivers the check to the New York Fed with instructions that it be returned to the depositary bank in California.

Has Big Apple complied with its obligation of expeditious return under Regulation CC by acting as it has? You may assume that Big Apple would normally handle any check deposited with it and made payable on a California bank such as Burbank by forwarding such a check to the New York Fed for collection.

Suppose that, prior to delivering the check over to the New York Fed for return, Big Apple had converted the check in question into a qualified return check. How would this affect your answer to the previous question?

Able keeps writing checks on his Big Apple account. This one is for $28,000 made payable to Friendly, who deposits it in her bank account at First National Bank of Fresno, in California. The check is presented to Big Apple on a Monday. By Tuesday Big Apple has decided, for whatever reason, not to pay the check. It converts the check into a qualified return check and delivers the check in this form to the New York Fed by Tuesday evening. Has Big Apple done all that is required of it to avoid potential liability for violation of

Regulation CC? What more must it do?

Able writes one final check (at least as far as we need be concerned). It is made payable to Garber and is for $53,600. Garber deposits this check in an account he has at a Manhattan branch of Gotham Bank on a Monday morning. Gotham presents the check in question (as part of a parcel containing a large number of checks) directly to Able's branch of Big Apple on Tuesday. Big Apple does nothing with the check on Wednesday, but on Thursday morning discovers that Able's account is woefully overdrawn. A vice president of Big Apple hops in a taxi and makes her way to Garber's branch of Gotham Bank. There, at 3:58 p.m., she hands the check over to that branch's Director of Check Processing.

Has Big Apple done all that is required of it to avoid any violation of Regulation CC?

Gotham argues that Big Apple can be held accountable for the full amount of the check for failing to dishonor the check prior to its midnight deadline under Article 4. What response does Big Apple have to this assertion? See §229.30(c)(1) of Regulation CC. Is Big Apple's position hurt by the facts that this is the first time it has ever done anything like this (that is, having a vice president return a check directly to the depositary bank by means of a taxicab) and that it ordinarily uses much more conventional methods for return?

Explanations

Yes. Big Apple was presented with the check on Tuesday. Under U.C.C. §4-301(a), it had until its midnight deadline, in this case midnight on Wednesday, to return the item and revoke the provisional settlement it would have given to Gotham on the day of presentment. It returned the check on Wednesday morning. See §4-301(d)(1).

Yes. Big Apple is required by 12 C.F.R. §229.30(a) to "return the check in an expeditious manner as provided in either paragraphs (a)(1) or (a)(2) of this section." Big Apple could demonstrate that it met this responsibility by invoking either of the two tests. Under the two-day/four-day test of (a)(1), it would have to show that it "sen[t] the return check in a manner such that [the check] would normally be received by the depositary bank not later than 4:00 p.m. (local time of the depositary bank) of … the second business day following the banking day on which the check was presented for payment," as this check was deposited in a local bank. (As to what constitutes a *local* bank, see the definition in §229.2(s), followed up by §229.2(m).) In the case before us, because both banks are members of the New York Clearing House, it would seem no problem for Big Apple to assert that having received the check from Gotham on a Tuesday and returning the check to that bank on the following day would "normally" assure that Gotham received it back prior to 4:00 p.m. on Thursday. In fact, if the clearing-house rules allowed, Big Apple could have returned the check at a clearing on Thursday and still have met this test, if the clearing were held prior to 4:00 in the afternoon.

This check is for an amount of $2,500 or more. Big Apple, as a payor bank that has determined not to pay the check, is thus obligated to provide notice of its nonpayment such that the notice is received by 4:00 p.m. (local time) of the second business day following the banking day on which the check was presented. (As to the distinction between a *banking day* and a *business day*, as those terms are used in Regulations CC, consult 12 C.F.R. §229.2(f) and (g).) So Big Apple had to give notice of its nonpayment to Gotham prior to 4:00 p.m. on Thursday.

You will have noticed two differences in the payor bank's notice obligation as opposed to its obligation of expeditious return. First of all, there is no difference in the time limit imposed on the payor bank for giving the requisite notice depending on whether the bank is a local or a nonlocal bank. Notice of the type that Regulation CC requires when larger checks are returned can as easily be made across the country as across town, so the deadline for notice is 4:00 p.m. on the second business day following presentment regardless of where the depositary bank is situated. Secondly, the two different tests relating to the payor bank's actual return of a check it has determined not to pay are written in terms of actions that would result in the returned check's "normally being received" by the depositary bank by such-and-such a time (in the two-day/four-day test), or a manner in which a similarly situated bank would "normally handle" such an item for forward collection (in the forward collection test). The obligation to provide notice of return of a larger check is not set out in terms of what a bank must do that would "normally" get the notice to the depositary bank in a timely fashion. It is an absolute obligation to provide the notice in a timely fashion. Look over §229.33(b) and (c) on what information the notice must contain and on the *depositary bank's* obligation to accept such notice.

The question remains: Has Big Apple given the requisite notice in the situation we have before us? Look to the concluding language of §229.33(a):

> Notice may be provided by any reasonable means, including the returned check, a writing (including a copy of the returned check), telephone, Fedwire [a telecommunications system run by the Federal Reserve System], telex, or other form of telegraph.

Big Apple actually physically returned the check to Gotham prior to 4:00 p.m. on Thursday, so the return also functioned as the proper notice, assuming that the returned check was accompanied by all the information required by §229.33(b).

Yes. Big Apple was presented with the check on Tuesday morning. Under §4-301(d)(2), it returned the check for Article 4 purposes when it "sent" the check back to Greenlawn on Wednesday evening. Because this action was taken prior to its midnight deadline, Big Apple has avoided final payment and any accountability on the item under Article 4.

It is doubtful that Big Apple has accomplished expeditious return by mailing off the check by first-class mail. Big Apple will want to claim that its actions comply with the two-day/four-day test of 12 C.F.R. §229.31(a)(1), but do you think that an envelope deposited in the mail in New York City on a Wednesday night would "normally be received" by an addressee in the suburbs by 4:00 p.m. on Thursday? (I am assuming, of course, that Greenlawn would be a local bank with respect to Big Apple.) I don't want to seem unduly cynical, but I don't think so myself. At least, that has not been my experience with the postal system, whatever other fine things I may have to say about the institution.

Big Apple would also have the opportunity to show that it met its obligation of expeditious return by compliance with the forward collection test of §229.31(a)(2), but again I think it would have difficulty. Would a "similarly situated bank" in New York City *normally* handle a single check for this amount, drawn on a suburban bank, by sending it off by mail to that bank? I don't see that as likely. The forward collection test, as we will see in Example 4b, is meant to and does come into play more when the check is converted into that interesting item, the "qualified return check" and thereafter sent back to the depositary bank through normal banking channels.

By acting as it has, Big Apple does not stand in a good position to successfully claim, should it later become necessary, that it met its obligation of expeditious return under Regulation CC. Remember, however, that this failure will not normally make it liable for the full amount of the check, but only for any actual loss caused by the tardiness of the return. It may well be that no damage was done by the fact that this check was not returned in an expeditious manner. At least Big Apple can hope that this is the case.

Had Big Apple sent the check off on Wednesday evening in this manner, it would have fulfilled its obligation of expeditious return by meeting the two-day/four-day test. The overnight courier service would normally be expected to get the check to Greenlawn by 4:00 p.m. on Thursday. Use by Big Apple of this (admittedly more expensive) method of return has saved the day.

The answer should not change just because in this unusual instance the overnight delivery service didn't function as it is expected to and usually does. Note once again that the language of the two-day/four-day test speaks in terms of the returning bank's use of a means of return such that the check would "normally" be received by the local bank by 4:00 p.m. of the second business day following the banking day on which the check was presented to the payor bank. The fact that in a particular instance the means selected, which would normally suffice, fails in that one instance to get the returned check to the depositary bank by this deadline, does not prevent the returning bank from relying upon its compliance with the two-day/four-day test to establish expeditious return.

First we look at the duty of expeditious return. Now we apply the four-day part of the two-day/four-day test of 12 C.F.R. §229.31(a)(1). Would a first-class letter deposited in the post in New York City on a Thursday evening normally be received by an addressee in Bakersfield, California, no later than 4:00 p.m. on the following Tuesday? (This is assuming that we haven't run into any of the holidays not counted as a business day under §229.2(g).) There is obviously no bright-line answer to this question. My tendency is to say that Big Apple would have met the test, or am I now giving the post office more credit than it is due?

We also have to look at Big Apple's obligation under the notice requirement of §229.33. Unless that bank has taken some action of which we are not aware, it has apparently *not* lived up to the standards imposed upon it by that part of Regulation CC. Because this check is for more than $2,500, Big Apple is required to give the Bakersfield Bank, as the depositary institution, notice of the fact that the check is being dishonored by 4:00 p.m. California time on Friday, the second business day after which Big Apple was presented with the check. So Big Apple appears to be vulnerable on this score.

Big Apple's handing the returned check over on Thursday to the delivery service for two-day delivery would fulfill its obligation of expeditious return, as this would normally result in the check being returned to the depositary bank in California no later than Monday. This would still not, however, put the bank in compliance with the notice requirement of 12 C.F.R. §229.33(a). Big Apple cannot count on return of the check to fulfill the notice requirement, as return would not come by Friday at 4:00 p.m. Big Apple, because of the size of the check, will have to use some other means—such as a telephone call, a telex, or a fax—to give the requisite notice to Bakersfield by 4:00 p.m. on Friday California time.

No. Big Apple will not be able to rely on the two-day/four-day test of 12 C.F.R. §229.31(a)(1) to build a case for expeditious return. It was presented with the check on a Monday morning. It puts this check into the hands of the New York Fed on Tuesday. Would this normally result in the check coming into possession of the California bank by Thursday at 4:00 p.m.? The answer really has to be no. It is going to take the New York Fed at least a day and perhaps two to turn this item around, and then send it across the country. There is no reason to believe that it will then send the check directly to the Bakersfield Bank. More likely, the New York Fed would send it on to a Federal Reserve processing center in the Los Angeles area. That facility will in turn then have to take a day or two to determine where the check should go next, and even if it is in a position to deliver it directly to Bakersfield, by this time the week is almost surely drawing to a close.

The problem here is not that Big Apple Bank started the return by delivering the check to the New York Federal Reserve Bank rather than the exact bank by which it had been presented the check, the Gotham Bank. The real cause of the delay, beyond what might otherwise be accomplished through ordinary banking channels, is that on each step of the return process the check must be handled, sorted, and sent on its way again on an item-by-item basis and with the aid of human intervention rather than by purely automated means. Recall that any check deposited in a bank and then sent on its way in the forward collection process can be sped along from bank to bank because of the MICR line on the bottom of the check, which makes possible the automated reading, sorting, and handling of the item. The ability to handle the item through this technology allows the turnaround time at any of the collecting banks along the way to be kept relatively brief. The MICR line on any check, however, does not—indeed it cannot—contain any information about the bank into which the check is ultimately deposited. Thus, any check that is returned usually has to be dealt with at any given returning bank by real live people, who individually examine the back of the check and the bank's own records to figure out where the check has come from and where it should next be sent so that it will eventually arrive at its proper destination, the depositary bank. This traditional means of return is by all accounts a tedious, expensive (relative to automated handling), and sluggish process. Therefore, a check that is returned in this manner with the goal of getting it across the country and into the hands of the depositary bank is almost assuredly going to take more than four days to make its way to its intended destination.

Can Big Apple rely instead on its compliance with the forward collection test of §229.31? No, not if all it did was send the check to the New York Fed with instructions that it eventually be returned to a particular bank in Bakersfield, California. Although Big Apple or a similarly situated New York City bank might normally handle a check for an amount such as this by delivering it over to the New York Fed for forward collection, there is a big difference here. As we've just noted, any check that it would deliver for forward collection would be encoded with the routing number of the payor bank on the MICR line, and therefore would be presented to the New York Fed all ripe and ready for automated processing. The check that Big Apple delivered to the New York Fed for return in this part of the example is still in its "raw" state. There is no way it can be handled in an automated fashion to get it to the Bakersfield Bank in as little time as possible. It will be much slower going than any check Big Apple sent for forward collection along this route. Big Apple has not met its duty of expeditious return as judged by either the two-day/four-day test or the forward collection test.

Because the check in question has been converted into a qualified return check, it now bears a new MICR line, one that points the check directly to the *depositary* institution. Big Apple can now introduce that check into customary banking channels as it would a check destined for forward collection, here by sending the check to Big Apple's local Federal Reserve

Bank. The check will be handled and sorted automatically and will make its way to the Bakersfield Bank efficiently and quickly. Thus, Big Apple would probably be found to have met its duty of expeditious return.

The concept of the qualified return check was first added to the system by the introduction of Regulation CC in the late 1980s. Prior to that, all returns were done by hand and the extra time that this process entailed was one of the principal justifications given by banks for placing those long blanket holds on all deposits. With the new possibility of converting checks destined for return into qualified return checks, and thus avoiding the laborious and time-consuming hand return procedures, the process of return was dramatically altered. Initially, not all banks had the technology required to do the actual conversion of a check into a qualified return check. Today, most large banks, and probably most banks in general, have the necessary machinery. What if, we can still ask, the payor bank does not have the means available to transform a check it wants to dishonor into a qualified return check? That bank is allowed to deliver the check to another bank that *does* have the necessary technology, on the agreement that the transferee bank will make the conversion and then send the check on its way. Note the language toward the end of §229.31(a), following the description of the qualified return check:

> The time for expeditious return under the forward collection test, and the deadline for return under the UCC and Regulation J [with which you need not be concerned], are extended by one business day if the returning bank converts a returned check to a qualified returned check. This extension does not apply to the two-day/four-day test specified in paragraph (a)(1) of this section or when a returning bank is returning a check directly to the depositary bank.

Big Apple has met its obligation of expeditious return, but it still has to be concerned about its duty to give notice of nonpayment under 12 C.F.R. §229.33(b), as this is a check for an amount greater than $2,500. It must provide that notice to the First National Bank of Fresno such that the notice is received by that bank no later than 4:00 p.m. (Fresno time) on Wednesday. The qualified return check may be speeding its way through a series of returning banks, but it still seems highly unlikely that the check itself will arrive in Fresno in time to satisfy the notice requirement. Big Apple will have to make a phone call, or send off a fax or a telex, to the Fresno bank, with all the information required by §229.33(b).

It seems so. It has made expeditious return of a local check by satisfying the two-day test. True, it doesn't usually return checks by taxi, but that is not the test. Use of the cab on the second day following the day of presentment, at least if the vice president took the cab early enough in the afternoon, certainly seems to be a manner of return "such that the check would normally be received" by 4:00 p.m. on that day. Even in New York City traffic. As this is a check for a large amount, Big Apple also has to worry about whether it has satisfied its obligation of notice for nonpayment. Because it was able to return the actual check to the depositary bank prior to 4:00 p.m. on Thursday—if just barely—it has complied with this aspect of Regulation CC as well.

Gotham's argument is that even if Big Apple has complied with Regulation CC, it is obligated for the full amount of the check for its failure to dishonor the check prior to its midnight deadline, which would have passed at the end of the day on Wednesday. Regulation CC, however, provides in §229.30(c) for an *extension of the midnight deadline* in certain circumstances.

> The deadline for return … under the U.C.C. … is extended to the time of dispatch of such return … where a paying bank uses a means of delivery that would ordinarily result in receipt by the bank to which it is sent (1) On or before the receiving bank's next banking day following the otherwise applicable deadline.…

Were it not for this portion of Regulation CC, Big Apple's deadline for return would indeed have been midnight on Wednesday. But all it would have had to do to satisfy that deadline would have been to *dispatch* the check back to Gotham by that time. Under the just-quoted portion of Regulation CC, this deadline is extended to the time of dispatch, whenever that may be, because Big Apple used "a means of delivery that would ordinarily result" in *receipt* by Gotham no later than the end of the "next banking day following the otherwise applicable deadline"; that is, by the end of Wednesday. Again, whatever may be true of New York City traffic, Big Apple's use of this atypical but effective and expeditious method of getting the returned check actually into the hands of the depositary bank fits within the criteria of 12 C.F.R. §229.30(c)(1). That being so, Regulation CC supersedes or alters the strict midnight deadline rule of Article 4. Big Apple has met its extended midnight deadline obligation and cannot be held accountable for the amount of the item.

Gotham may want to argue that the extension given to a returning bank under §229.30(c)(1) should be available only to a bank that *ordinarily or normally* uses the particular means of expeditious return involved, and not when the extraordinary means are relied upon in only one particular instance. (After all, Big Apple does not usually return local checks via taxi; it did so in this case only to avoid a potential large liability.) This argument was tried and found wanting in *First National Bank of Chicago v. Standard Bank & Trust*, 172 F.3d 472, 38 U.C.C.2d 1 (7th Cir. 1999), the case on which this example is loosely based. On a Friday, First National presented checks, totaling just shy of $4 million, to the bank on which they were drawn, Standard. Standard was still holding the checks on Tuesday morning. That afternoon it attempted to dishonor the checks, following what would otherwise have been the passage of its midnight deadline at the end of Monday. Three of its bank officers "dashed off" to First National's Operations Processing Center and were able to deliver the checks there at 3:58 p.m. First National argued that Standard was accountable for the amount of the checks under Article 4 because it failed to return them by its midnight deadline. Standard claimed that it was entitled to rely on the extension of the Article 4 midnight deadline created by §229.30(c)(1) of Regulation CC. First National argued that the extension did not cover Standard's actions, as the extension was intended by the writers of Regulation CC to apply only to banks that "regularly" use courier services or other exceptionally fast means of delivery to return checks. The Seventh Circuit rejected this argument, holding that a reading of §229.30(c)(1) on its face demonstrates that the extension provided "may apply to one-time single check transactions."

In our example and in the *First National Bank* case, the payor bank was saved from liability under Article 4 by extension of its midnight deadline by only a single day, thanks to the initial language of §233.30(c)(1). If you read further into this paragraph you find that:

> [T]his deadline is extended *further* if a paying bank uses a *highly* expeditious means of transportation, even if this means of transportation would ordinarily result in delivery after the receiving bank's next banking day.

This particular bit of Regulation CC is indeed unclear. Apparently a payor bank could invoke it to avoid accountability under Article 4 even if its attempt to return the check was more than just one day past its midnight deadline. How much "further" could or should the otherwise applicable deadline be extended? What would constitute a "highly expeditious" and not merely an "expeditious" means of transportation for getting the check back into the hands of the depositary bank? As far as I am aware, no court has yet been called upon to tackle these questions.

* A case from 1978 in which the availability schedule of a particular savings bank in New York City was challenged—unsuccessfully—as "illegal" on a number of grounds gives the following information: The typical commercial bank in New York would at the time restrict withdrawals against local checks to 3 business days and imposed longer holds, generally from 5 to 10 days, on nonlocal checks. Savings banks, which by their nature were not able to present directly to the Federal Reserve or through the New York Clearing House Association, imposed even longer holds, typically from 5 to 8 days on a local check and from 8 to 21 (with an average of 15) days on a nonlocal one. *Rapp v. Dime Savings Bank*, 64 A.D.2d 964, 408 N.Y.S.2d 540, 24 U.C.C. 1220 (1978).

* I assume that you have available to you a copy of Regulation CC in the selected commercial statutes volume you are using to consult the various parts of the Uniform Commercial Code. As originally promulgated in 1988, Regulation CC was relevant only to the Expedited Funds Availability Act in its Subpart B, with which we deal in Chapter 16, and Subpart C, the topic of this chapter. (Subpart A consists of general provisions.) In 2004, new material was added as a Subpart D in furtherance of the Federal Reserve's obligation to issue regulations implementing the newly minted Check 21 Act of 2003, introduced in Chapter 11.

* Notice that "a paying bank that is unable to identify the depositary bank with respect to a given item" will be given a special dispensation, under 12 C.F.R. §229.30(b), from the obligation of expeditious return. For a case in which the depositary bank was held partially responsible for a loss that ensued based on its failure to make its mark legibly in the designated place on the back of the check, see *USAA Inv. Mngt. Co. v. Federal Reserve Bank of Boston*, 906 F. Supp. 770, 28 U.C.C.2d 959 (D. Conn. 1995).

PART IV

The Bank-Customer Relationship

CHAPTER 14

The Duty to Pay and Wrongful Dishonor

INTRODUCTION

The relationship between a bank and its checking account customer is that of contract. By the customer's applying to open an account and the bank's accepting the customer's application, the two parties have entered into an agreement. What are the terms of that agreement? They are found in whatever documents passed between the parties at the time of agreement: in this case, the application form, any informational literature the bank gave to the customer, the signature card that the bank asked the customer to sign, and so forth. For most consumer customers, the terms of the contract are usually offered on pretty much a take-it-or-leave-it basis. Larger commercial entities may be in a position actually to negotiate some of the terms of the contract. Section 4-103(a) specifically provides that, subject to certain limitations, "[t]he effect of the provisions of this Article may be varied by agreement."

This agreement between the customer and the bank is governed by the basic principles of contract law. In addition, of course, the rules laid down by Article 4, as well as those arising from clearing-house rules and federal regulations such as Regulation CC (see §4-103(b)), govern the relationship. In this chapter we examine the provisions of Article 4 regarding the bank's obligation to its customer to handle any check written on the account (or at least purportedly written on the account), upon presentment in accordance with the bank's contractual obligations. Look first at §4-401(a):

> A bank may charge against the account of a customer an item that is properly payable from the account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and the bank.

The key here is obviously the term *properly payable*. When a properly payable check is presented to the payor bank, §4-401(a) provides that the bank "may" pay the check. The bank will then be entitled to deduct the amount of the check from the balance in the customer's account. On first reading, this might suggest that it is within the payor bank's discretion whether to pay a check, even when that check is properly payable. Look, however, at §4-402(a):

> Except as otherwise provided in this Article, a payor bank wrongfully dishonors an item if it dishonors an item that is properly payable, but a bank may dishonor an item that would create an overdraft unless it has agreed to pay the overdraft.

So, if an item is properly payable the bank is *required* to honor it. If a bank wrongfully dishonors an item, it can be held liable, under §4-402(b), which we will explore more fully in the examples, for damages proximately caused by the wrongful dishonor.

What if a payor bank is presented with a check that is, for one reason or another, *not* properly payable? Although §4-401(a) does not lay out the consequences as clearly as we might wish, the rule is clear: The bank will then have no right to charge such a payment against the customer's account. Section 4-401(a) gives the bank the right to charge against an account *only* properly payable items. If the bank does pay the check and deducts its amount from the customer's account, it can be made to recredit the account when the fact of its payment of the not-properly-payable item has been established. The payor bank will then be left to bear the loss of its payment on an item that was not properly payable. Whether it will be able to pass that loss on to another party, and if so how, are matters that we will consider in Part V. In this chapter we focus on a set of preliminary questions: When *must* a bank pay a customer's check? In what instances *may* it pay the check and charge the customer's account even if it is not obligated to do so? When is the bank *precluded* from charging against a customer's account a check that it has paid?

Examples

Andrew has a regular checking account with the Paley National Bank. He writes a check for $400 payable to one Bette. Bette signs the back of the check and deposits it in her own bank account. The check is presented to Paley. At the time of presentment, Andrew has more than $1,000 in his account. He has not issued any stop-payment order on the check.

May Paley honor this check? Must it do so?

How would you answer the preceding questions if, at the time Paley is presented with the check, Andrew's account contained only $156 in available funds?

Andrew hires one Thad to do some redecorating in his apartment. When he is left alone in Andrew's den, Thad (who turns out to be not just a decorator but also a thief) finds Andrew's checkbook in a desk drawer. Thad takes one of the checks from the book. He writes out a check to a confederate, Theo, forging Andrew's signature on the drawer line. Theo signs his own name on the back of the check and deposits it in his bank. The check is presented to Paley National Bank. May Paley pay this check and deduct its amount from Andrew's account?

Andrew himself writes a check payable to the order of Clara and delivers it to her. Thelma (another thief) steals Clara's wallet, which contains the check. Thelma forges Clara's signature to the back of the check and deposits the check in Thelma's own bank account. When this check is presented to Paley National Bank, may that bank pay it and deduct its amount from Andrew's account?

The DotCom Corporation also has a checking account with Paley National Bank. As part of its contract with that bank, Paley has agreed that it will not honor any check written on the DotCom account for more than $50,000 unless the check bears the signatures of both the president and the treasurer of the corporation. The president writes out and signs a check for $74,510. She does not get the signature of the company's treasurer on the check, but delivers it directly to the payee. When this check is presented to Paley, may the bank honor it and deduct its amount from the DotCom account?

For many years the married couple of Xavier and Yolanda Zendel have had a joint checking account with Paley National Bank. Either is authorized to sign a check payable from the account on his or her own without the signature of the other. Unfortunately, in the early part of 2014, the couple come to the conclusion that they have irreconcilable differences, and they separate. In March of that year, Yolanda writes a check from the account for $12,000 to pay for a used car for herself. When this check is presented to Paley, the Zendels' account has only $10,500 in it. A decision is made at the bank, given the couple's long history of good relations with the bank, to pay the check even though it will result in an overdraft of $1,500 with respect to the account.

Vas Paley within its rights to honor the check?

) Is Xavier liable to pay toward reducing and eventually eliminating the overdraft? See §4-401(b).

Darla is another of Paley's checking account customers. On March 13, 2013, she writes a check payable to Ethan for $3,500. The date she writes on the check is "September 1, 2013." She hands the check over to Ethan with the understanding that he will not attempt to cash or collect on the check until the September date. Ethan immediately deposits the check in his own account, and it is presented to Paley on March 17, 2013. Paley pays the check and deducts the $3,500 from Darla's account. Was it within its rights to do so? See §4-401(c) and Comment 3 to that section.

Frederick, another of Paley's customers, writes a check out of his account for $2,435. The check is presented to Paley on Monday morning. On Monday evening, Paley determines that Frederick's account contains only $1,500 in available funds, and that hence it will dishonor the check. It returns the check to the presenting bank on Tuesday morning. As it turns out, by Tuesday afternoon Frederick has deposited another $1,000 in cash into his account. He argues that had the bank waited until later on Tuesday, there would have been no need for it to dishonor this check and that in addition, had the new funds not come into his account, the bank would still have been able to return the check prior to its midnight deadline at the end of Tuesday. Did Paley wrongfully dishonor the check by returning it on Tuesday morning? See §4-402(c) and Comment 4 to that section.

Frederick writes several other checks on his account with Paley. On a Thursday morning, four checks, in the amounts of $10, $500, $400, and $1,000 are simultaneously presented to the bank. Frederick has $1,234 in his account. Paley determines to honor the $1,000 check and then to dishonor the $500, the $400 and the $10 checks. It returns these three checks with an indication that they have been dishonored because of insufficient funds in the drawer's account. It also charges Frederick a fee (as set forth in the agreement he signed to open his account) of $25 for each of the three checks returned. Frederick argues that it was much more important to him that the three smaller checks be honored than that the $1,000 one be paid. In addition, he points out, by dealing with the four checks as it has, Paley has been able to extract from him $75 in fees for having to return three checks. Had it paid those three checks and dishonored the one larger one, he could have been charged only one $25 fee. Was Paley wrong to deal with the checks as it did? See §4-303(b) and Comment 7 to that section.

Geraldine writes a check to Hal out of her account with Paley National Bank on February 1, 2013, writing that date on the check in the space provided. She immediately mails this check to Hal, who receives it on February 5. This check gets lost among all of the papers, news clippings, photographs, and other junk piled high on Hal's exceptionally messy desk. He comes upon it again around Thanksgiving of that year. He signs the back of the check and deposits it in his own account. The check is presented to Paley on December 1, 2013.

If Paley dishonors the check, would it be guilty of a wrongful dishonor? See §4-404.

If Paley does honor the check, will Geraldine have any argument that it was not a properly payable item and that its amount cannot be charged to her account?

On May 11, Paley National Bank is presented with a check written by one of its customers, Isaac, on his account with the bank. Paley pays the check. As it turns out, Isaac (after a long and fruitful life) has died (peacefully in his sleep) on May 9. When it paid the check in question, Paley had not yet been informed of Isaac's death.

Was Paley within its rights in paying the check? See §4-405(a).

Suppose instead that Paley had become aware of Isaac's death on May 10. Would it then have been under an absolute obligation to dishonor the check? See §4-405(b) and Comment 2 to this section.

Cosmo Graphics runs a small business enterprise that he has incorporated (with himself as president, naturally) under the name of Graphics Surprise, Incorporated. He opens a checking account in the name of the corporation with Paley National Bank. He also signs a lease in the name of the corporation for office space in a building owned and operated by Cubicle

Realty Associates. A monthly rental check, which Cosmo writes out of the corporate account, is sent to Cubicle Realty, which deposits the check in its own bank account. The check is presented to Paley, but Paley, because of a computer error at the branch that handles the Graphics Surprise account, dishonors the check even though there is more than enough money in the corporation's account to cover it.

Would Cubicle Realty, as payee of the check, have any cause of action for wrongful dishonor of the check under §4-402(b)?

Would Cosmo Graphics personally have such a cause of action?

Graphics writes a second check on the corporate account, this one to Woodchip Industries, a major supplier of high-quality paper and other products to the graphics industry. Woodchip has for several years been willing to sell to Graphics Surprise on a credit basis, delivering goods as ordered on the understanding that they would be paid for within 60 days of delivery. The check that Graphics sends to Woodchip is intended to pay for some supplies delivered in the prior month. Again, due to a mix-up at Paley National Bank, this check is wrongfully dishonored and is returned to Woodchip unpaid. A representative of Woodchip calls up Graphics and complains to him about what has happened. She explains that it is her company's policy, once it has received "a bum check" from any of its customers, not to make any further deliveries except in exchange for a certified or cashier's check for the full price of any supplies delivered. An order that Woodchip has just received from Graphics Surprise will not be processed except on that basis. Graphics says that he doesn't know what has gone wrong, but he will look into it. In the meantime, he is under time pressure to get the needed supplies so as to fulfill commitments to his own customers, but he does not have the cash available to pay up-front for all that is needed. He is able to buy on credit from another supplier what he needs, but only at a significantly higher price than he would have had to pay Woodchip for the same stuff.

When it eventually becomes clear what has happened, can Graphics Surprise, Inc. hold the Paley bank liable for the increased cost of supplies due to the bank's wrongful dishonor of the check?

Assume further that, because of the delay caused by the mix-up, Graphics Surprise is slightly late in delivering its own work to a number of its own customers. In an effort to placate these customers and to safeguard good customer relations, Graphics agrees to a 10 percent reduction in what is owed on each of these jobs. Is the amount that Graphics Surprise loses because of this decision also recoverable from Paley?

Arnold Moneybucks is a prominent businessperson in the community. He has a checking account with Paley National Bank. Because of a mix-up at the bank, a number of checks that Arnold wrote in connection with a variety of business matters are all dishonored, even though he has more than enough in his account to cover every one of them. Arnold starts getting a series of phone calls asking him what has happened and suggesting that perhaps his business empire, which has seemed so impressive up to this point, is beginning to collapse. Arnold makes an angry call to his personal account manager at Paley. She quickly discovers the bank's error and apologizes profusely. She offers to and does contact individually each of the persons who have received return of a check written by Arnold and explains the situation to them. She assures each that Arnold's financial situation has never been stronger and that the return of the checks was due solely to a mistake on the bank's part. Each of the checks is redeposited by its recipient and is paid by Paley with no trouble. Arnold contacts you (a licensed lawyer) for advice. He would like to sue Paley for its several instances of wrongful dishonor of his checks. He argues that the whole incident has caused him great mental anguish and that in addition it has been very embarrassing to him, casting doubt within the local business community on his creditworthiness and reputation. He even thinks that punitive damages may be in order. How do you advise Arnold?

Explanations

May Paley honor this check? Yes, under §4-401(a). There is absolutely nothing here to suggest that this is other than a properly payable item. *Must* it do so? Yes again, now under §4-402(a). Were it not to honor the check, Paley would be responsible for its wrongful dishonor. I grant you that the situation given and the questions presented here are about as easy as they come. What is significant—other than the pleasure of getting a real easy question every now and then—is that checks just like this one account for more than 99 percent of all checks presented to any given payor bank. The bank's computerized processing machines read all the necessary information from the MICR line, verify that there are sufficient funds in the account, and make sure that no stop-payment order or other special instruction has been received by the bank with respect to either the account or this particular check. If nothing rings a warning bell, which will be true for the overwhelming majority of checks presented, the check is paid and the customer's account charged its amount without any human intervention. The check collection system (which, remember, processes tens of billions of checks a year in this country) would not be able to operate, or at least not as efficiently and without greatly increased cost to the customer, if this were not so.

Under §4-401(a), Paley may if it so chooses pay the check and charge it to Andrew's account "even though the charge creates an overdraft." So Paley *may* honor the check. See, for example, *McGuire v. Bank One, Louisiana, N.A.*, 744 S.2d 714, 42 U.C.C.2d 804 (La. App. 1999), where the payor bank was held to have done no wrong by paying a properly payable check for $200,000 (and charging a $22 overdraft fee) when its payment created an overdraft of $188,198.79 in Ms. Lottie M. McGuire's personal account. Ms. McGuire had written the check to one Timothy P. Looney who, representing himself as an investment broker, promised he would arrange for the proceeds of the check to be used to purchase a large amount of bonds on McGuire's behalf. McGuire then arranged for the $200,000 to be transferred into her checking account from a second investment account she had with Bank One. When Looney, who unfortunately turned out to be a con man, presented the check to the bank the transfer had not yet been made and there was nowhere near this amount available in the checking account on which it was drawn. Still, the bank paid the check even though it created this large overdraft. Looney, needless to say, absconded with the money. For the record, he was later caught and sentenced to serve time in a federal penitentiary, but McGuire was still out all this money. She tried to recover it from Bank One on the theory that it should not have honored this check when doing so created an overdraft, or at least one this large. As the court concluded, "It is unfortunate that McGuire was the victim of fraud. However, her loss is not one for which Bank One can be found liable under the circumstances of the case."

On the second question of our example, whether the Paley Bank is obligated to pay Andrew's check if doing so would create an overdraft, the answer is clearly no, unless part of its contract with Andrew provides him with overdraft privileges. See the concluding language to §4-402(a).

No. This is not a properly payable item under §4-401(a). It has not been "authorized by the customer." Note the statement in Comment 1 to this section that “[a]n item containing a forged drawer’s signature or forged indorsement is not properly payable.” In this case we have a forged drawer’s signature, and the check therefore is not properly payable.

No. Here we have a forged indorsement, which means that the item is not properly payable. Andrew, in writing out this check, authorized its payment only to Clara or to some other party who later qualifies as a “person entitled to enforce” the check, as defined in §3-301. Because of the forged indorsement, Thelma is not a person entitled to enforce the check, and so the check is not properly payable to her.

> For our present purposes, it is sufficient to see that in both this example and in Example 2, the Paley bank will be required to recredit Andrew’s account for the amount of any check it charged to the account that turns out, because of forgery, to be a not-properly-payable item. This leaves Paley bearing the loss unless it can assert a right on its own account against another party, claiming that the other party should pay Paley all or part of the loss it has suffered. In Part V, we will pick up the story of how losses resulting from forgery and other mischief with respect to checks may be shifted from one party to another under various theories of liability. The conclusion here is only the beginning of the analysis: A check that bears a forged drawer’s signature or a forged indorsement is not properly payable and cannot be charged to the customer’s account.

No. This check is not properly payable, not because of any forgery but because it is not, in the words of §4-401(a), “in accordance with any agreement between the customer and the bank.” Paley’s computers should have been programmed to screen for any check written against the DotCom account for an amount in excess of $50,000 (again, something that can be read from the MICR line and hence dealt with on an automated basis) and to pull that check out of the stream of checks being dealt with in the customary automated fashion. The check would have tobe examined by a real live human, who could then make sure that the two signatures required were present on the check. If the bank had done what it committed itself to do, this check would not have been paid. The check is not properly payable and its amount cannot be charged against the DotCom account.

> Not all special agreements as to what is and what is not a properly payable item necessarily work in the customer’s favor. In *Spear Insurance Co., Ltd. v. Bank of America, N.A.*, 2000 U.S. Dist. LEXIS 961, 40 U.C.C.2d 807 (N.D. Ill. 2000), the corporate customer authorized

the bank to pay out of its account in accordance with a resolution passed by the corporation's board, a certified copy of which was delivered to the bank. The resolution provided in relevant part:

> [T]he bank is authorized and directed to honor checks, drafts or other orders for the payment of money drawn in this Organization's name … when bearing or purporting to bear the facsimile signature(s) of any 1 of the following persons and for amounts over $100,000 require 2 signatures one of which must be manual and of the following: [listing the titles of corporate officers entitled to sign] regardless of by whom or by what means the facsimile signature(s) may have been affixed to such checks, drafts or other orders, if such facsimile signature(s) resemble(s) the facsimile specimens duly filed with the Bank by the Secretary or other officer, agent or partner of this Organization.

The bank had been furnished with the information that Ronald N. Woodward was the Chief Financial Officer and Treasurer of the corporation—one of the officers whose facsimile signature could authorize a check—and with a specimen of his facsimile signature. For reasons that are unclear Woodward was ousted from office, but the bank was never officially informed of that fact. A series of checks, all well under $100,000 and bearing what was undisputedly a facsimile of Woodward's signature closely resembling that on file at the bank, were presented to and paid by the bank. The corporation claimed that the checks in question were counterfeit and hence not properly payable. The court concluded that the bank was within its rights to consider the checks properly payable under the terms of the agreement between the corporate customer and the bank. The resolution was held to be a valid variation of the terms of Article 4 under §4-103(a), because the standard to which it held the bank was not "manifestly unreasonable." Such "facsimile signature agreements" are in fact not uncommon for larger corporate clients, whose smaller checks are signed not manually but through the use of a check writing machine, and (as the court pointed out) such agreements have been accepted as reasonable and enforceable in a number of prior cases. See *Lema v. Bank of America, N.A.*, 375 Md. 625, 826 A.2d 504, 50 U.C.C.2d 955 (2003), and *Donovan v. Bank of America*, 574 F. Supp. 2d 192, 66 U.C.C.2d 853 (D. Me. 2008), for further examples of how terms of the specific Deposit Agreement made applicable to the customer's relationship with the bank will be looked to and enforced, even if their effect is to change the result from what would be true under Articles 3 and 4 unvaried by the parties' private agreement.

Yes. Yolanda may, by her signature alone, authorize the bank to pay on a check. Under §4-401(a), as we know, the bank is allowed to accept the check and charge the account on which it is drawn even if the charge results in an overdraft.

Under §4-401(b), Xavier would not be liable for the amount of the overdraft if he "neither signed the item [which he did not] nor benefited from the proceeds of the item." If the proceeds of the check were used by Yolanda to buy a car that Xavier is not going to be able to use, and if Xavier was under no obligation (under a separation agreement, for example) to provide Yolanda with transportation, he should be able to establish that he did not "benefit" from the proceeds of this check. There will, of course, be more complicated cases in which it is debatable whether a customer who has not signed a check issued from a joint account has or has not "benefited" from the proceeds of the check. This just doesn't seem to be one of them. The example does point out how careful a payor bank must be in deciding when to honor a check that will result in an overdraft of the account, other than when it has contractually committed itself to extend overdraft privileges to the particular customers. If Yolanda cannot be made to come up with the $1,500, Paley will have to bear the loss arising from its decision not to reject the check when it had the right to do so.

Paley was within its rights to honor the postdated check and to charge its amount against Darla's account unless Darla had given the bank the form of notice called for in §4-401(c), which alerts the bank that a postdated check has been issued and that it is not to pay the item until the date written on the check. The notice that Darla is entitled to give under this subsection is, as you can see, treated as a kind of before-the-fact stop-payment order.

> The underlying reason for Article 4's treatment of postdated checks in this fashion, which was introduced in the 1990 revisions, is (as you may have guessed) the simple fact that the date of any check is not something encoded on the MICR line. A payor bank's automated system will have no way of discerning when a postdated check has been presented and is making its way through the system. If, however, the customer gives the bank the type of notice provided for in §4-401(c), "describing the check with reasonable certainty" (a concept we will confront in greater detail in Chapter 15 as it applies to the stop-payment order), the bank will be able to enter into its computer the information necessary to ensure that the check is not paid but is instead culled out for individual treatment from the steady stream of items being automatically processed.
>
> The bank may, of course, charge a fee for dealing with any such

check on this basis, just as it will be entitled to charge a fee for a stop-payment order. As you can see from Comment 3, Article 4 makes no attempt to regulate the fees that banks may charge their customers for this and other types of special services—in fact, the drafters most deliberately avoided doing so, much to the dismay of consumers' rights advocates. The fees banks charge, at least to their consumer customers, have been and continue to be regularly challenged on a variety of different theories. Such challenges have been, almost without exception, unsuccessful. The courts usually defer either to federal authorities that have the power to oversee banking and the structure of the fees banks may charge their customers, at least if the applicable fees are properly disclosed to the customer at the time the account is opened; or to the general power of the marketplace to provide the consumer what he or she needs at a "reasonable" market price. The long and the short of it is that should you as a consumer be unhappy with the service provided by your bank or the fees it charges, go and shop around for another bank which will treat you better. Individual consumers and consumers' rights advocates are, needless to say, not pleased with this answer, but by and large that's the way it is.

Paley did no wrong in dishonoring the check based on its initial determination of what funds were available in Frederick's account. Subsection 4-402(c) and the accompanying comment are perfectly clear on this point.

Paley, which has apparently adopted an internal procedure for dealing with items presented at the same time in descending order of their amount, paying the largest check first, will contend that it has done no wrong. Its argument is fairly straightforward. It is explicity allowed, it will note under the cited portions of Article 4 to establish its own rules for the priority it gives to multiple items presented on the same account.

This practice of dealing with multiple items in descending order of amount (known as "high-to-low" posting), which admittedly may, in situations such as we have here, result in the bank's having to return (and collect fees for) a greater number of checks than would another practice, has been criticized by consumer advocates as just another way for banks to increase the fees they can levy against their hapless customers. Initial attempts to challenge such practices met with little sucess. *Smith v. First Union National Bank*, 958 S.W.2d 113, 35 U.C.C.2d 1309 (Tenn. Ct.

App. 1997), involved an attempt to bring a class action suit against a bank that had adopted this practice for processing items, claiming it to be "unfair, deceptive and unlawful." A motion to dismiss was sustained by the trial court, and the dismissal was affirmed by the Court of Appeals of Tennessee. In *Daniels v. PNC Bank, N.A.*,137 Ohio App. 3d 247, 738 N.E.2d 447 (2000), a similar attempt at a class action was brought, the plaintiff alleging that the defendant bank had engaged in a "check sorting and posting scheme specifically for the purposes of generating additional revenue at the expense of its own 'valued' customers." The plaintiff argued, among other things, that the bank's practice breached a duty of good faith and fair dealing, constituted unconscionable conduct, and was tantamount to the collection of liquidated damages. The trial court had dismissed the complaint, and this dismissal was affirmed by the Court of Appeals of Ohio. The same conclusion was drawn by the courts in *Fetter v. Wells Fargo Bank Texas, N.A.*, 110 S.W.3d 683, 51 U.C.C.2d 201 (Tex. App. 2003), and *Hill v. St. Paul Federal Bank for Savings*, 329 Ill. App.3d 705, 768 N.E.2d 322, 47 U.C.C.2d 26 (Ill. App. 2002). It should be pointed out that the bank's justification for dealing with multiple items in this way—other than that the law gives them the right to do so if they wish—is that it is a reasonable assumption that a customer would want a larger check, which presumably reflects a more significant transaction and for which dishonor could have particularly serious repercussions for the customer, to be honored if at all possible, even if it means having to dishonor some greater number of smaller items to do so.

In just the past few years, the consumer-driven assault on many banks' adoption of high-to-low posting as a regular practice, or norm, has begun to gain traction and achieve some significant victories in the courts. Most notable in this regard is the lengthy class-action litigation culminating in the decision in *Gutierrez v. Wells Fargo Bank, N.A.*, 730 F. Supp. 2d 1080 (N.D. Cal. 2010), *motion to amend denied* 2010 U.S. Dist. LEXIS 113767 (N.D. Cal. 2010). While the opinion is long and addresses many subsidiary issues, the essence of that decision is given by the court early in its opinion:

> This action does not challenge the amount of a single overdraft fee (currently $35). That is accepted as a given. Rather, the essence of this case is that Wells Fargo has devised a bookkeeping device to turn what would ordinarily be *one* overdraft into as many as *ten* overdrafts, thereby dramatically multiplying the number of fees the bank can extract from a single mistake. The draconian impact of this bookkeeping device has then been exacerbated through closely allied practices specifically "engineered"—as the bank put it [in numerous internal memos that were uncovered and entered into

> evidence during the course of the litigation]—to multiply the adverse impact of this bookkeeping device. These neat tricks generated colossal sums per year in additional overdraft fees, just as the internal bank memos had predicted. The bank went to considerable effort to hide these manipulations while constructing a facade of phony disclosure. This order holds that these manipulations were and continue to be unfair and deceptive in violation of Section 17200 of the California Business and Professions Code. For the certified class of California depositors, the bookkeeping device will be enjoined and restitution ordered.

The "tricks" which the court found the bank to have adopted included a variety of changes in procedure other than adopting a high-to-low posting procedure for checks presented to it on the same banking day. In fact, the facts of the case itself deal more with how debit card transactions and ATM withdrawals—neither of which is, of course, initiated by the writing of a check—were handled by the posting process adopted by the bank in ways that seemed designed solely for the purpose of maximizing the amount the bank could collect in overdraft fees. (We will see more about this when we deal with these types of electronic transactions in Chapter 21.) It may also be of some significance that the California legislature had adopted a nonuniform amendment to the comments to §4-403 in 1995 which can be read to disapprove of the high-to-low posting practice and that the court had another bit of California statute, §17200 of the California Business and Professions Code, giving remedy to consumers for, among other misbehavior, "unlawful, unfair or fraudulent" business acts or practices to work with. Still, it seems fair to conclude that the days when a bank could adopt a high-to-low posting policy for all or some of its customers' checking accounts in its unfettered discretion may well be numbered in many, though not necessarily all, states. Compare the decisions in *White v. Wachovia Bank, N.A.*, 563 F. Supp.2d 1358 (N.D. Ga. 2008), denying dismissal of such a suit under Georgia law, with *Hassler v. Sovereign Bank*, 374 Fed. Appx. 341, 2010 U.S. App. 5445 (3d Cir. 2010), in which a panel of the Third Circuit affirming dismissal of a suit based on the law of New Jersey challenging a bank's high-to-low posting practice.

For the latest, at least as of this writing, on this ongoing litigation battle, see *Hughes v. TD Bank, N.A., 2012 U.S. Dist. LEXIS 54765* (D.N.J. 2012). Add to this volatile mix the fact that the Consumer Financial Protection Bureau, a new federal agency created under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and which could potentially put forth significant federal regulation of order-of-posting practices, has signaled (in a press release of February 22, 2012) its interest in this issue in connection with a wide-ranging inquiry into the overdraft policies and practices of the nation's banks, at least as far as consumer accounts are concerned.

No. Under §4-404, "[a] bank is under no obligation to a customer having a checking account to pay a check, other than a certified check, which is presented more than six months after its date." Paley is not obligated to pay this "stale" check.

No, unless Geraldine could show that Paley's acts of paying the check and charging her account were in some way lacking in good faith. For the operative definition of that term, see §3-103(a)(4). Given what facts we have here, there doesn't seem to be anything that would constitute bad faith on Paley's part. Remember that the date of a check is not information carried on the MICR line, and so the automated systems at Paley would not normally have any way of even recognizing a stale check. Such a check registers on the bank's computers as just another check drawn on Geraldine's account, which has been presented for payment.

A tale worth telling in this regard is that of *IBP, Inc. v. Mercantile Bank of Topeka*, 6 F. Supp. 2d 1258, 36 U.C.C.2d 270 (D. Kan. 1998), where a check for $135,234.18 was presented to and paid by the payor bank *nine years* after it was written. On July 15, 1986, the plaintiff, IBP, Inc., issued and delivered to Meyer Land & Cattle Company a check for this amount, written on its account with the Mercantile Bank of Topeka, for the purchase of some cattle. "Incredible as it may seem," in the words of the court, "officials at the closely-held family-run Meyer business apparently misplaced the check." It was found in the fall of 1995 by Tim Meyer, the president of the Meyer Company, behind a desk drawer in his home. The check was then deposited for collection. The Mercantile Bank, its computers showing no outstanding stop-payment order covering the check, withdrew the amount from IBP's account and paid the check. As the court noted,

IBP issues thousands of checks on its Mercantile account every month. In the period of July 1995 through December 1995, IBP drew 73,769 checks on the account. In September 1995 alone, the month in which Mercantile processed the 1986 check to Meyer, IBP drew 14,852 checks. For IBP, a $135,234.18 check is not extraordinary as the company issues numerous checks each month for amounts well in excess of $100,000.

Mercantile had pointed out that if it were to be responsible for recognizing stale checks, it could not rely on automated processing and the MICR line, and would have to conduct manual examinations of each and every check written by its customer, “an extraordinarily expensive and inefficient way of transacting business.” The court concluded,

> it is undisputed that Mercantile had no knowledge that the IBP check it honored in 1995 was more than nine years old. It is similarly uncontested that IBP frequently drafted checks of equal or greater value on its account. Furthermore, IBP was cognizant of Mercantile’s procedures for seeking a stop-payment order, yet it chose not to secure (or at least update) such an order.

The court granted summary judgment to the bank, finding that it was not lacking in good faith in paying the item.

Yes. According to §4-405(a): “Neither death nor incompetence of a customer revokes the authority to accept, pay, collect [an item], or account [for its proceeds] until the bank knows of the fact of death or of an adjudication of incompetence and has reasonable opportunity to act on it.”

No. Under §4-405(b), even with knowledge (as of May 10) of the death on May 9, Paley could have rightfully paid any check presented to it through May 19 written by Isaac before his death, as long as it was not “ordered to stop payment by a person claiming an interest in the account.” The rationale for this rule, allowing “holders of checks drawn and issued shortly before death to cash them without the necessity of filing a claim in probate,” is given in Comment 2. Notice that if “a person claiming an interest in the account” does order the bank to stop paying on such checks, the bank is obligated to obey. It is not authorized or required to make a determination, and to take on the risk of making what may later turn out to be a mistaken conclusion, of whether the person making such an order does actually have a legitimate interest in the account and is entitled to give such an instruction regarding how it is to be dealt with. As Comment 3 states: “The bank has no responsibility to determine the validity of the claim or even whether it is ‘colorable.’”

No. Subsection 4-402(b) makes a payor bank that wrongfully dishonors a check liable only to “its customer.” The term *customer* is defined in §4-104(a)(5). In this case the customer is clearly the corporation, Graphics Surprise, Incorporated. Cubicle Realty is not the bank’s customer and can assert no statutory liability on the part of Paley for the fact that the check was wrongfully dishonored. Cubicle’s relief, if any there be, will be against its tenant, Graphics Surprise, Incorporated.

No. Cosmo Graphics personally is not the customer of the bank; the corporation, a separate legal entity, is. As you can see from Comment 5, the courts in some instances have been willing to blur the line between the business entity that has an account with the bank and the individuals who are running the entity, but this Official Comment at least, and most other commentators as well, look unfavorably on such results. For an interesting discussion of who is and who is not a customer permitted to sue for damages for wrongful dishonor, see *Jana v. Wachovia, N.A.*, 61 U.C.C.2d 583 (Phila. Ct. Com. Pl. 2006).

Yes. Graphics Surprise, Incorporated, is the customer here and can under §4-402(b) hold Paley liable for "damages proximately caused by the wrongful dishonor" of its check to Woodchip Industries. It should easily be able to prove that those damages include the additional cost the corporation incurred to obtain the needed supplies, which cost it would not have had to bear save for the bank's wrongful dishonor of the check.

I would say yes, although it is less clear-cut than the previous part of this example. Subsection 4-402(b) states:

> Liability is limited to actual damages proved and may include damages for an arrest and prosecution of the customer or other consequential damages. Whether any consequential damages are proximately caused by the wrongful dishonor is a question of fact to be determined in each case.

Fortunately, this wrongful dishonor has not resulted in any arrest or prosecution of Graphics for the passing of bad checks, but it has, he will argue, resulted in another form of consequential damages for which the corporation should be compensated. Graphics may not have been contractually bound to give its own customers discounts for late delivery, but it doesn't seem an unreasonable thing for Graphics to have done, and the company should be able to establish the exact dollar figure of the loss and that it followed directly and "proximately" from the bank's wrongful dishonor. As the passage quoted from §4-402(b) indicates, this type of claim for damages has to be evaluated on a case-by-case basis. My own response is that Graphics Surprise, Incorporated, has a good argument here for the award of this amount as actual and proximately caused consequential damages.

I think you would have to advise Arnold, as tactfully as possible, that he would not be able to recover any damages from the bank under this scenario and that his only recourse would be to take his business elsewhere if he thought he could get better service from some other bank. As far as Arnold's mental anguish goes, there is no reason to question how truly disturbing the entire episode may have been for him, but §4-402(b) allows only for the recovery of “actual damages” caused to the customer. Although courts have in some instances awarded an amount for mental anguish for wrongful dishonor, these cases are few and far between and usually involve some particularly egregious behavior on the part of the bank, such as failing to admit that it has wrongfully dishonored or failing to respond to the customer’s complaints in a reasonable and timely fashion, resulting only in its clumsily adding insult to injury. Here Paley seems to have been more than willing to admit its mistake and make amends and did what it could to right the situation as soon as possible.

What of Arnold’s protest that the incident has in some general, if not necessarily quantifiable, way done harm to his reputation within the business community in which he works? Comment 1 makes clear that the drafters don’t believe damages should be awarded on this basis alone, although it has to go into a bit of history to explain why. Prior to promulgation of the Code, there was authority in many states for what was known as the “trader rule,” to the effect that someone in business, a “merchant or trader,” could recover damages for wrongful dishonor even when no direct actual damages had resulted. The idea was that such a party should be able to recover for the injury to his, her, or its reputation and good name that was assumed to flow from a wrongful dishonor of just the type Arnold is arguing he suffered here. The original version of Article 4 was intended by its drafters to do away with the trader rule, but through some problems with its wording (or perhaps because of resistance on the part of some courts to believe that the adoption of Article 4 could really have changed a rule with which they were all familiar and perfectly satisfied), not all courts came to this conclusion. Thus, the revision drafters tried to be even more explicit. As Comment 1 explains, the 1990 revision of this section “precludes any inference that Section 4-402 retains the ‘trader’ rule.”

As to punitive damages, it seems exceptionally unlikely that Arnold will have any chance of collecting here. Comment 1 concludes with the statement that “[w]hether a bank is liable for noncompensatory damages, such as punitive damages, must be decided by Section 1-103 and Section 1-106 [or these sections’ equivalents in §1R-103(b) and §1R-305] (‘by other rule of law’).” The standards by which the various states adjudge whether punitive damages can rightfully be awarded to a plaintiff may vary to some degree, but I think it almost universally true that punitive damages are normally not even considered unless some compensatory damages have arisen from the wrong committed. In this situation, Arnold won't be able to show any "actual" damages, so I can't see how he could possibly be able to collect any punitives. Paley National Bank has apparently angered one of its valued customers by its wrongful dishonor of a number of his checks. Its customer relations department may have to put in a bit of overtime undoing the harm that's been done. The bank, however, will not have any monetary liability to Arnold under §4-402(b).

Confronted by a recent case—one much more sympathetic, I assure you, than Arnold's—the Supreme Court of South Dakota upheld a jury's reward of $250,000 for a livestock dealer's lost income and a separate $200,000 for the "lost value of his business" caused by a wrongful dishonor. It reversed, however, an additional award of $150,000 for "emotional distress" suffered by the plaintiff. It also held that the trial judge had been correct in not even submitting the question of punitive damages to the jury. *Maryott v. First National Bank of Eden*, 2001 S.D. 43, 624 N.W.2d 96, 44 U.C.C.2d 240.

CHAPTER 15

Stopping Payment

INTRODUCTION

The first seven Examples in this chapter deal with the right of a customer who has written a check on his or her account to stop payment of that check. Article 4 covers the topic in §4-403, which you should read through as preparation for those Examples. As Comment 1 to that section states:

> The position taken by this section is that stopping payment … is a service which depositors expect and are entitled to receive from banks notwithstanding its difficulty, inconvenience and expense.

Whether the customer has the right to issue a stop-payment order is not in doubt. Still, questions remain that call for our attention: Who may issue a stop-payment order? What information must the order include to be effective? When will an order be too late to be effective? If a stop-payment order is given to the bank, how long does it remain in effect? If a bank mistakenly pays a check on which a valid stop-payment order has been received, what is its liability? All this and more in the Examples to follow.

The later Examples (8, 9, and 10) deal with a related but distinct set of issues concerning cashier's checks, teller's checks, and certified checks—or, as they are often collectively referred to, *bank checks*. The fundamental distinction between such checks and the typical personal check is that the party taking a bank check is relying on the fact that such checks carry with them the assurance of a bank that they will be paid. Creditors will insist on being paid with a bank check just so they don't have to worry about the customer's not having enough money in his or her account to cover the item. But again questions remain. Can the customer who has arranged for the issuance of a bank check ever effectively order the bank to stop payment on it? Can the bank that issued the check itself decide that the check is not to be paid? If so, under what circumstances? If a bank wrongfully refuses to pay on a cashier's check that it has issued, stops payment of a teller's check that it has drawn on its own account with another bank, or dishonors a personal check that it has certified, what are the consequences? When you get to these later Examples, you will want to look over §3-411 for guidance.

Examples

Angela has a regular checking account with the Paley National Bank. She writes a check for $350 payable to one Bertie. Bertie signs the back of the check and places it in his wallet. Or at least he thinks he does. Later, when he plans to go to his own bank and deposit the check, he cannot find it. He does remember that it was written on the Paley bank. Can Bertie, by notifying that bank and giving it all the pertinent information, effectively stop payment on this check?

For many years, the married couple of Xavier and Yolanda Zendel have had a joint checking account with Paley National Bank, on which either is authorized to sign a check payable from the account on his or her own without the signature of the other. On January 2013, Xavier (having made a New Year's resolution to get in shape) writes a check on this account to pay for a family membership in a local health club. When he informs Yolanda of what he's done, she finds the idea ridiculous. She immediately goes to Paley National and fills out and signs a stop-payment order form covering the check. Is the bank obligated to dishonor the check written to the health club by Xavier?

Angela from Example 1, who has a checking account with Paley National Bank, writes a check to one David Driller, a contractor who has done some household remodeling for her. Immediately after she mails the check off to him, she becomes aware of some problems with the work he has done. She contacts the Paley bank by phone and says that she wants to stop payment of the check. She gives the bank representative with whom she speaks her name and account number and tells him that the check was "written recently to David Driller." The bank representative asks her for the number of the check and for its exact amount, but Angela is unable to recall either. All she can say is that "the check was written recently and was for something like $4,500 or $4,600."

Has Angela made a valid stop-payment order on this check, so that the bank is under an obligation to dishonor it upon presentment?

What if instead Angela, though she had not been able to give the exact number of the check, had told the bank that the check was for $4,515.27? As it turns out, the check was actually written to David Driller in the amount of $4,515.72. Should Angela's attempt to stop payment be deemed effective?

Angela writes a check from her Paley National Bank account to Earl. The check is dated February 12, 2013, and she hand-delivers it to Earl on that day. The next day she telephones the bank and says she wants to stop payment of the check. She accurately gives the bank her account number, the number of the check, and its amount.

Is Paley obligated to dishonor the check based on this oral notice? If so, for how long will this stop-payment order be effective?

Assume that Angela stops by the bank on February 14, 2013, and fills out a form provided by the bank for written stop-payment of checks. She fills in all the information requested by the form and the information she gives is accurate in every detail. For how long will her stop-payment order on this check now be effective?

Assume that Angela does no more regarding this check. Earl deposits it in his bank in November of 2013 and it is duly presented to Paley. If Paley pays the check, will it have the right to charge against Angela's account the amount of the item?

Paley National Bank normally opens for business at 9:00 in the morning. It has established a cutoff time of 11:00 a.m. for receipt of stop-payment orders, the fact of which is made known to its customers as part of the initial agreement opening any account. Marty, another of Paley's checking account customers, writes a check on March 3. On March 6, at around 3:00 in the afternoon, he comes into the bank and fills out a stop-payment order giving all the essential information about the particular check he wants to have stopped. As it turns out, the check in question was presented to Paley on

March 5, and Paley made provisional settlement for the check with the presenting bank on that day. If Paley does not return the check and revoke this provisional settlement by midnight on March 6, thus making final payment of the check, will it be able to charge its amount against Marty's account? See §4-303(a).

Arnold Moneybucks, one of the community's most prominent (and flamboyant) businesspersons, also has a checking account with Paley National Bank. After treating several of his friends to an expensive dinner at the city's newest fashionable restaurant, La Pretense, Arnold pays for the feast with a personal check. The next day Arnold decides that the meal did not live up to his expectations and, in addition, that several of the restaurant staff were insufficiently attentive to him and his guests. He contacts the Paley bank and issues a stop-payment order on the check he wrote the evening before.

Assuming that this stop-payment order is received by the bank well before the bank is presented with the check, is the bank obligated to follow the order and dishonor the check?

A review question: Assume that when the check is presented to Paley, that bank does not pay it, but returns the item with a notice that it has been dishonored due to a stop-payment order given by the drawer. The unpaid check eventually makes its way back into the hands of the owner of the restaurant, Chef Maurice. Does Maurice have any cause of action against Paley National Bank for its refusal to pay the check? Does he have any cause or causes of action against Arnold?

Now suppose that even though the stop-payment order was received by Paley in plenty of time before the check was presented, that bank by mistake pays the check over the valid stop-payment order. It deducts the amount of the check from Arnold's account. When Arnold hears about this, he flies off the handle. He also threatens suit against the Paley bank. If he does sue the bank for its failure to comply with his stop-payment order, what damages would he be entitled to collect? See §4-403(c) and §4-407, paragraph (2).

Cosmo Graphics, president and sole shareholder of Graphic Surprise, Inc., contracts to buy on behalf of the corporation some high-quality paper from one of its suppliers, Woodchip Industries. The contract calls for Graphic Surprise to buy ten crates of a certain kind of paper at a price of $500 per crate. Immediately upon receiving the shipment from Woodchip, Graphics sends that company a check written on the corporation's account with Paley

National Bank for $5,000. The next day, as he is moving the crates of paper into his supply room, Cosmo becomes aware that the shipment he has received contained only nine crates. Cosmo issues a stop-payment order on behalf of the corporation to the Paley bank covering the $5,000 check written to Woodchip. Due to a foul-up at the bank, the check is paid over the valid stop-payment order and the $5,000 is charged to the Graphic Surprise account. Cosmo, when he becomes aware that the check has been paid over its stop-payment order, insists that the bank recredit the corporate account with the $5,000. The bank refuses to do so.

If Graphic Surprise is forced to bring an action against Paley, to what amount will it be entitled?

Suppose instead that the Paley bank, upon becoming aware of its mistake and in order to maintain good relations with its customer, does immediately recredit the Graphic Surprise account with the full $5,000. Paley is now out $5,000. Graphic Surprise is in possession of nine crates of high-quality paper for which it has, as of this point, paid not a penny. And Woodchip has been paid $5,000 for ten crates of paper when it only delivered nine. What can Paley do to deal with its loss? Consult §4-407, paragraphs (2) and (3).

Johanna has been looking to buy a cabin in the mountains that she can use as a summer retreat. When she finally finds one that seems to be just what she is searching for, Caleb, the current owner, tells her that many people have shown an interest in the property. If she wants to make sure that she gets it, he tells her, she should bring him a bank check for $10,000 (10 percent of the asking price) as soon as possible. Johanna writes a check for this amount out of her account at Paley National Bank and goes to the bank, where she has the check certified. Immediately after delivering this check to Caleb, she begins to regret her decision to buy this particular cabin.

Can Johanna issue a stop-payment order covering this check that the bank is obligated to obey? See §4-303(a).

Suppose instead that Johanna had obtained from Paley a cashier's check in the amount of $10,000 payable to Caleb. Would she have the right to stop payment on this check?

Finally, suppose that the check Johanna gave to Caleb was a teller's check made payable to him, which Paley National Bank had drawn on its own account with State Street Bank. Does Johanna have the right to stop payment of this check?

The DotCom Corporation also has a checking account with Paley National

Bank. The treasurer of DotCom, who is authorized to act in all banking matters for the corporation, requests that Paley issue a cashier's check for $45,000 payable to one Edwin Commerce, deducting the cost of the check from DotCom's account. DotCom exchanges the cashier's check for a sealed envelope, which Commerce has promised contains the details of a new computer program that will be of considerable value to DotCom's operations. As soon as the people at DotCom receive this envelope, they go to work testing the new program. By the end of the day it becomes apparent that the "new" program is in fact nothing special, but rather just a clumsy compilation of some well-known programs that are in the public domain. Edwin Commerce, they conclude, has tried to pull a fast one on them. DotCom's treasurer immediately contacts its account manager at Paley, who determines that the cashier's check has not yet been presented to or paid by the bank. The treasurer wishes to stop payment on this check, but she is informed by the account manager that this is not possible. DotCom has no authority to stop payment on the cashier's check. The manager does suggest that, given the importance of keeping up its "valuable relationship" with the ever-growing DotCom Corporation, he will arrange for the bank to refuse payment on the cashier's check upon its presentment to the bank. If the bank does refuse to pay on the cashier's check, what will be the consequences? See §3-411 and Comment 1 to that section.

In December of 2013, a teller at Paley National Bank is presented over the counter with a check for $12,000 payable to "Sally Kahn Valley," purportedly drawn on the account of the DotCom Corporation. The person presenting is able to give the teller several pieces of personal identification showing that she is indeed Ms. Valley and furthermore that she is an employee of DotCom. She explains that the check represents a year-end bonus that she just received from her employer. She asks that the teller accept the check and issue her in return a cashier's check for the same amount. The teller makes inquiries of the bank's computer system and determines that DotCom has more than enough in its account to cover the check, and also that the bank has not received any stop-payment order with respect to it. The signature of DotCom's treasurer on the check looks close enough to the official signature that the bank has on record. The teller accepts the check being presented by Valley and issues her a cashier's check for $12,000. About an hour later, the Paley bank is contacted by DotCom's treasurer. He has just been made aware that one blank check is missing from the company’s checkbook. When he gives the bank the number of the missing check, he is informed that a check bearing that number, made out for $12,000, has already been paid. The treasurer assures the bank manager that he never signed any such check and that any signature on the check that appeared to be hers is certainly a forgery. Valley is nowhere to be found. The certified check that was issued to her is presented to Paley several days later, after Valley apparently used it to open an account at a bank in a distant part of the country.

Would Paley be within its rights in refusing to pay the cashier’s check?

What if Valley had taken the check to a local auto dealership and indorsed it over to that dealership in exchange for a used car in which she fled the scene? The dealership, which you may assume took the cashier’s check as a holder in due course, then deposits the check for collection. Could Paley refuse to pay the cashier’s check under this set of facts?

Explanations

No. Under §4-403(a), only “a customer or a person authorized to draw on the account if there is more than one person” may stop payment. Bertie is the payee of the check, not its drawer. Note the language in Comment 2: “Subsection (a) follows the decisions holding that a payee or indorsee has no right to stop payment.” What is Bertie to do now? He can request of Angela that *she* stop payment of the check and issue him another one for the same amount, but recall (from Comment 4 to §3-310) that Angela is not legally obliged to stop payment or to issue a new check. Bertie may just have to live with the fact that he has either lost or had stolen a bearer instrument worth $350, which can end up being no different than if the same had happened to $350 in cash that he remembers placing in his wallet.

Yolanda is not the customer who wrote the particular check in question, but she is a “person authorized to draw on the account.” In this case, there is more than one person so authorized. So under §4-303(a), Yolanda may stop payment of the item. The Zendels are going to have to work things out between themselves, but the bank is unquestionably under an obligation to follow Yolanda’s stop-payment order.

This would not be, at least according to most authorities, a valid stop-payment order. A stop-payment order may be oral (see subsection (b)), so that is not the problem. Any stop-payment order, however, must, according to subsection (a), "describ[e] the item or account with reasonable certainty." The Code itself does not give any further guidance about what is required to meet this measure, but consider the language that concludes Comment 5:

> In describing the item, the customer, in the absence of a contrary agreement, must meet the standard of what information allows the bank under the technology then existing to identify the item with reasonable certainty.

Think what this means. Most commentators conclude that the bank has to be given the kind of information that could be entered into the bank's computerized system for examining checks and determining whether they are properly payable. This means that, in addition to the number of the account on which the check was written, the customer would have to give the bank either the *exact* amount of the check or the *exact* number of the check and preferably both. Each of these two pieces of information is, as we know, carried on the MICR line and can be read by the bank's automated equipment. The bank should be able to program its system so that when a check written on the particular account is presented for this amount or with this check number, the automated processing procedures will "spit out" the check so that it doesn't get paid in the ordinary course of things. The payee's name, however, is never encoded on the MICR line. If the bank were obligated to stop payment on a check based solely on account number and the payee's name, the only way it could do so would be to have its system initially reject any check written on the account for individualized sight examination of each check. Someone at the bank would have to look at the payee's name on each and every check in order to catch the one check on which the customer has requested that payment be stopped. This would be a timely and expensive procedure. It seems sensible to insist that, if this is all the information the customer can remember about a check he or she has written, the customer can't really expect such costly service from the bank—unless, that is, he or she is willing to enter into a special arrangement and pay an additional fee for the service. As the Seventh Circuit Court of Appeals remarked,

> [The customer] knew that the information she provided [her account representative] for the stop-payment order was incomplete at best, lacking a vital piece of identifying information—the exact check number. One does not need to be a banker or versed in banking law to know that this is a vital piece of information for locating or stopping a check. It is, as the courts below noted, a matter of common sense.

Rovell v. American National Bank, 194 F.3d 867, 39 U.C.C.2d 1147 (7th Cir. 1999).

It is interesting to speculate on what would happen in our example if Paley National Bank's technology allowed an automated search for, say, any item written on an account for between $4,500 and $4,600. Computers certainly can be programmed to do such things. If that were the case, then the bank would presumably have the obligation to enter a stop-payment order based on this information and could be expected to comply with the order. The fact is, however, that the "technology now existing" (to use the language of Comment 5) at all banks of which I am aware, allows searching for checks based only on the precise check number or the exact amount of the check as encoded on the MICR line. Banks have not seen fit to invest the money it would take to upgrade or reinvent their computerized systems to allow for more flexible or intricate searches. Apparently no need has been felt by the average bank to offer more sophisticated service of the type that new technology could provide. The present system, inflexible as it may be, seems to work well enough for the typical bank's and the typical customer's purposes.

If the technology used by the bank to identify a check on which a stop-payment order has been placed is as rigid as it presently is, the fact that the order identifies the check by amount incorrectly—even if that error would seem obvious or trivial to any human looking at it—would be enough to render the stop-payment order ineffective. To a computer, $4,515.27 and $4,515.72 are as unequal as any two unequal numbers can be, and a search for any item that is supposedly written for the first amount would not pick up an item written for the second.

Some courts, faced with the type of "minor" error that Angela has made here, have bent over backward to find that the bank was obligated to stop payment. For example, in the case of *Staff Service Associates, Inc. v. Midlantic National Bank*, 207 N.J. Super. 327, 504 A.2d 148, 42 U.C.C. 968 (1985), the customer issued a stop-payment order giving the amount of the check as $4,117.72, intending to cover a check that was actually for $4,117.12. As a result of this incorrect information being programmed into Midlantic's computers, the check when presented was paid and the amount was charged to Staff Service's account. Staff Service sued the bank for wrongful payment of the check, and the New Jersey Superior Court was asked by the bank to grant summary judgment in its favor. This the court declined to do. After reviewing prior cases, which had gone both ways on the issue, the New Jersey court declined to take a hard-line approach.

> Staff Service's representative did not know that Midlantic utilized a computer to effect stop payment of a check. In addition, Midlantic never informed Staff Services that the exact amount of the check is necessary for the computer to pull the check. It chose a computerized system which searches for stopped checks by amount alone. By electing this system Midlantic assumed the risk that it would not be able to stop payment of a check despite the customer's accurate description of the account number, the payee's name, the number and date of the check and a de minimis error in the check amount.… Midlantic should not be permitted to relieve itself of this risk unless it calls attention to its computerized system and the necessity for the exact check amount to meet computer requirements.

The court held that Midlantic had not met the burden imposed upon it for "relieving itself of this risk," even though the stop-payment form that Staff Service's representative signed included the following statement at the bottom:

> IMPORTANT: The information on this Stop Payment Order must be correct, including the exact amount of the check to the penny, or the Bank will not be able to stop payment and this Stop Payment Order will be void.

Staff Service's representative acknowledged that he had read this language. Assuming that the analysis of the situation and the test given by the court in this case are a good way of handling the problem presented—and I assure you not everyone would be willing to agree on even this—was the court's application of its own test to the facts of the case correct?

Yes. Under §4-403(b), a stop-payment order need not be in writing to be effective. This oral order will, however, lapse and cease to be effective 14 days after it is given to the bank unless it is confirmed in writing within the 14-day period.

Angela has confirmed the stop-payment order in writing only one day after having initially given the order. Her stop-payment order is now effective for six months from February 13, 2013, the date on which the order was originally given.

Yes. By the time the check is presented to Paley, Angela's stop-payment order will have lapsed, and the bank will be within its rights to pay the check and charge it against Angela's account. Recall that, according to §4-404, although a payor bank is not *obligated* to pay a so-called stale check (one that is outstanding more than six months after its date) it *may* do so if it acts in good faith. See the concluding language of Comment 6 to §4-403:

> When a stop-payment order expires it is as though the order had never been given, and the payor bank may pay the item in good faith under §4-404 even though a stop-payment order had once been given.

Consider the story of Mr. Scott D. Leibling, attorney at law. Mr.

Leibling represented one Fredy Winda Ramos in a personal injury action. When a settlement was concluded, he issued a check out of his account with Mellon bank (#1031) in the amount of $8,483.06 to Ramos, representing her proceeds from the settlement. About five days later, he mistakenly issued a second check (#1043) to Ramos for the same amount. Six days later, when he became aware of his mistake, Liebling called Ramos and advised her that the second check had been issued in error. He instructed her to destroy this second check. He called the bank and gave an oral stop-payment order on check #1043. Some 19 months later, Ramos deposited this check in her account and the Mellon bank paid it. Ramos was not easily available for suit, so Liebling brought an action against Mellon arguing that it should not have honored the check. He could not argue that the bank had wrongfully paid over a valid stop-payment order, because the order had long since lapsed. The court found no lack of good faith on the part of the bank in paying the check, even though it carried a date more than a year old, recognizing that the bank's computerized system for processing checks would have had no means of identifying a stale check or one on which a stop-payment order had once been placed after that order ceased to be effective. *Scott D. Leibling, P.C. v. Mellon PSFS (NJ) National Ass'n,* 311 N.J. Super. 651, 710 A.2d 1067, 35 U.C.C.2d 590 (1998).

What could attorney Leibling have done to avoid this result? Under §4-403(b), "[a] stop-payment order may be renewed for additional six-month periods by a writing given to the bank within a period during which a stop-payment order is effective." So Leibling could have repeatedly renewed the stop-payment order every six months to assure himself that check #1043 would never be paid. Doing so would eventually become not just boring but also costly, as each renewal would presumably result in an additional fee. If Ramos were willing to outwait Leibling on this score, she would presumably be able to get paid on the second check eventually. Other than continually renewing his stop-payment order, the only things Leibling could have done to make sure that this second check was never paid and charged to his account would have been to get the check physically returned to him or to close the account altogether. Note that §4-403(a) provides not just for the issuance of stop-payment orders but for a customer or any person authorized to draw on an account to "close the account" by a proper order to the bank.

Of course, what Leibling should have done in the first place to avoid this whole problem was be careful enough with his business to avoid issuing two checks to cover the same debt.

Yes. Subsection 4-303(a)(5) provides that a stop-payment order received by the payor bank comes too late to "terminate, suspend, or modify the bank's duty or right to pay an item or to charge its customer's account for the item" if the stop-payment order comes after "a cutoff hour no earlier than one hour after the opening of the next banking day after the banking day on which the bank received the check and no later than the close of that business day." Paley received the check on March 5. It had established a cutoff hour of 11:00 a.m., which would fit within the timeframe of this provision. Marty's stop-payment order was received by the bank after the cutoff hour on March 6, the day following receipt of the item by Paley, so it comes too late to be effective.

Yes. The bank is obligated to obey an effective stop-payment order. It is not required to determine—indeed, it is not given any right to rule on—whether the customer has a good or a bad reason for wanting to stop payment, nor whether its customer has any right as against the payee to stop payment. The bank's role is to serve its customer and to obey the customer's order.

Maurice has no cause of action against the bank for its refusal to pay the check. This goes back to §3-408 and the elemental proposition that the drawee of an instrument, in this case the bank on which a check has been written, is not liable on the instrument until the drawee accepts it. Arnold has ordered his bank not to accept the item, and the bank has followed through on this order.

Maurice does, of course, have rights against Arnold. Once the check is dishonored, he can hold Arnold, as its drawer, liable on the check under §3-414(b). Or he could assert his rights on the underlying contract that Arnold entered into with the restaurant to pay for the meal. Recall §3-310(b)(1) and Comment 3 to that section. Arnold does have to pay for his meal, and those of his friends, one way or another.

Under §4-403(c),

> The burden of establishing the fact and amount of loss resulting from payment of an item contrary to a stop-payment order … is on the customer. The loss from payment of an item may include damages for dishonor of subsequent items under §4-402.

It is hard to see how Arnold will be able to establish any loss resulting from Paley's mistaken payment of this particular check over a valid stop-payment order. As we saw in the prior part of this example, one way or another it seems fairly clear that Arnold would eventually have to pay Maurice the amount of the check, so Arnold has apparently suffered no loss by the payment of the check, the result of which has been to discharge his obligation to pay Maurice for the fancy meal. For a recent case in which a bank wrongfully made payment over a valid stop payment order, but was found not to be liable to its customer, as the customer had failed to demonstrate any loss on its part because of the bank's mistake, see *NCS Healthcare, Inc. v. Fifth Third Bank*, 2005 Ohio 3125, 2005 Ohio App. LEXIS 2925.

In the hypothetical we are now considering, perhaps Arnold can meet the burden of proving that, had the check been stopped, he would have been able to negotiate with Maurice and end up paying some lesser amount for the meal. Payment of the check will in effect have denied Arnold the opportunity to enter into this negotiation; after all, once Maurice has been paid for the meal, Arnold has little leverage to exert against the chef. If Arnold can prove actual loss on this basis—which I have to admit does strike me as very unlikely—then he would be able to collect this measure of damages from Paley for its mistaken payment of the check.

Note also that Arnold may have suffered loss if, assuming (as he had every right to do) that the check to Maurice would be stopped on his order, he wrote additional checks out of the account that wound up being dishonored because the amount available in Arnold's account had been mistakenly decreased by the amount of the check to the restaurant, leaving too little in the account to cover these other checks. If the account would have been able to cover these other checks had Paley not mistakenly failed to observe the stop-payment order on the check to Maurice, then these other checks have been wrongfully dishonored, and Arnold is entitled to whatever damages he can show resulting from the wrongful dishonor as specified in §4-402(b).

Another way to reach the same result is via §4-407. Suppose that Arnold sues the bank for the amount of the check, relying upon §4-401 and the fact that the bank had deducted from his account the amount of a not-properly-payable item. Under §4-407, paragraph (c), "to prevent unjust enrichment" (of the type we would find if Arnold were allowed to have eaten his meal and never been made to pay for it), Paley would be "subrogated to the rights of the payee or any other holder of the item [here Chef Maurice] against the drawer [Arnold]… either on the item or under the transaction out of which the item arose [the fabulous feast]." Arnold would sue the bank for the amount of the check. Paley would be able to assert on its behalf the right of Maurice to be paid the amount of the check for the meal itself. The two claims would most likely cancel one another out, with the consequence that Paley owes Arnold nothing for its mistaken payment of the check. Maurice, because he has been paid on the check and may not even be aware that Arnold attempted to stop payment on it, has nothing to complain or to worry about. Arnold may, of course, still want to bring to Maurice's attention his displeasure with the meal and the service he received at La Pretense, and that is something that may (or may not) be of concern to Maurice. But this could have happened even if Arnold had not paid by check but had instead just pulled out a large wad of big bills at the end of the meal and paid by cash.

You may find it interesting (and morally instructive) to look at the case of *Seigel v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 745 A.2d 301, 40 U.C.C.2d 819 (D.C. Ct. App. 2000). The plaintiff, Walter Seigel, wrote several checks from a Merrill Lynch account—Merrill Lynch for these purposes serving as a drawee bank—to various Atlantic City casinos. The checks were exchanged for chips that he then proceeded to gamble away. Upon his return from Atlantic City, Seigel stopped payment on the checks. Many of the checks (we are not told for how much) were subsequently dishonored by Merrill Lynch, but the firm accidently paid some others totaling $143,000 even though they were covered by the stop-payment orders. Seigel then brought an action against Merrill Lynch for its failure to observe the valid stop-payment orders. He argued that had these checks not been paid he would have been able to defeat efforts by the casinos to collect on them, claiming among other things that the casinos would have had no right to enforce the checks as he was a "compulsive gambler" protected under New Jersey law. The court concluded that Seigel was not covered by a New Jersey statute designed to protect compulsive gamblers under a specific procedure not applicable to Seigel's case, and that compulsive gambling in and of itself is not a defense to a contract action on a check such as this under the common law of New Jersey. Seigel also claimed that the checks were unenforceable under the District of Columbia's version of the historical

Statute of Anne, which makes it illegal to make a loan to another when the proceeds of the loan are to be used for gambling. The District of Columbia court reasoned that even if this were true—and it had its doubts—the casinos could have pursued Seigel in the courts of New Jersey or his home state of Maryland and eventually obtained a judgment against him. That being so, the court concluded the Seigel had failed to establish that Merrill Lynch's mistaken payment of the checks over stop-payment orders caused him to suffer any actual loss. The trial court's summary judgment in favor of Merrill Lynch was therefore affirmed.

If we assume that the only loss to Graphics is the $500 it paid for a crate of paper that it never received, then under §4-403(c) it would be entitled to only this amount from Paley.

As of this point, both Graphic and Woodchip stand "unjustly enriched," Graphic because it has nine crates of paper for which it has paid nothing, and Woodchip because it has collected on a $5,000 check when it was entitled to only $4,500. Paley can bring an action under §4-407(2) against Graphic, using the fact that it is subrogated to the rights of the payee of the check, Woodchip, either on the item or under the purchase and sale transaction out of which the item arose. Had the check been properly dishonored, Woodchip could have sued on the check for $5,000, in which case it would have been subject to a claim in recoupment for $500 and ended up receiving only $4,500. If Woodchip had sued on the original contract of sale, it would presumably have been able to collect only $4,500 for the nine crates that were delivered. Either way you look at it, §4-407(2) allows Paley in this circumstance to take up any rights that Woodchip would have had to collect $4,500 from Graphic.

In addition, under §4-407(3), Paley could bring an action against Woodchip, arguing that it was subrogated to the rights of the drawer of the check, Graphic Surprise, against the payee, Woodchip, "with respect to the transaction out of which the item arose." Had Graphic not been able to stop the check in time, it would have ended up paying $5,000 for only nine crates of paper, $500 more than it should have had to. So Graphic would have had a claim, based on the law of sales, for $500 against Woodchip. Via paragraph (3) of §4-407, Paley, which has mistakenly paid the check over the stop-payment order, is under the circumstances subrogated to Graphic's rights to payment of this amount from Woodchip.

If all goes well for Paley in these two causes of action, it should end up whole. Paley's decision to immediately recredit Graphic's account for the full $5,000 that Paley paid out mistakenly may well have been a sensible move, considering that it had indeed made a mistake and that it wants to protect its reputation for good customer service. This assumes, of course, that the cost of each of the two lawsuits is zero—which is quite an assumption when you think about it. Paley also runs the risk that when it does try to collect what is rightfully owed by each of the two parties, Graphic and Woodchip, it will find itself right in the middle of a dispute between the two where the facts are muddled. (Is it really undisputed that Graphics received only nine crates of paper? Woodchip may well claim that it had sent out all ten. To which Graphics may respond, upon closer examination, that it was really only eight, and that the paper wasn't of the quality ordered in any event.) The possibility of coming to some dispassionate and amicable settlement of the whole sordid affair may be far from a first priority on either Graphic's or Woodchip's part. Notice how much better off Paley would have been if it could have gotten Graphic's agreement in the first place to recredit its account only with the $500 that its customer then claimed to be in dispute. Paley would then only have had to pursue Woodchip for the $500 that Paley would have been out of pocket. Of course, the best by far would have been for Paley not to have made such a mistake in the first place and to have observed and acted upon Graphic Surprise's stop-payment order. Then the whole controversy would have been left to the actual parties initially involved, the buyer and the seller, and the bank could have stayed out of it entirely. Recall Examples 6a and 6b, and the case of Arnold Moneybucks's disappointing dinner.

No. Johanna has no right to stop payment on a check once it has been certified. Under §4-303(a)(1), a stop-payment order "comes too late" once "the bank accepts or certifies the item."

No. Under §4-403(a), the right to stop payment is available only to "[a] customer or a person authorized to draw on the account." As this is a cashier's check, the drawer of the check is Paley National Bank, not Johanna. She is not in a position to issue a stop-payment order on the check.

Once again the answer is no. Paley has drawn this check on its own account with State Street Bank. Johanna is not a customer of that bank nor herself authorized to draw on that account, so she is not in a position to issue a stop-payment order to State Street, the drawee bank.

This example just makes official what Caleb apparently knew from the start (and which is confirmed by Comment 4 to §4-403). By insisting on a bank check in payment rather than a personal check, he protects himself from the check being stopped by Johanna should she later have a change of heart or find a mountain retreat more to her liking.

Under §3-411(b), if the bank "wrongfully" refuses to pay the cashier's check when the check is presented,

> the person asserting the right to enforce the check is entitled to compensation for expenses and loss of interest resulting from the nonpayment and may recover consequential damages if the obligated bank refuses to pay after receiving notice of particular circumstances giving rise to the damages.

This section, which was added to Article 3 as part of the 1990 revision, does not specifically lay out when a bank that has issued a cashier's check acts "wrongfully" in refusing to pay, but it seems clear from other parts of this section and from the comments that the bank has no right to deny the holder of a cashier's check his or her money based solely on some argument that *the customer*, the purchaser of the bank check, may have against the party to whom the check was initially made payable. In the case before us, this translates into the statement that Paley National Bank, having issued a cashier's check payable to Mr. E. Commerce at the request of DotCom, would have no right to refuse payment on this check based on any defense, argument, or claim that DotCom may have against Commerce. Note the following language from Comment 1:

> [A cashier's check or teller's check] is taken by the creditor as a cash equivalent on the assumption that the bank will pay the check. Sometimes, the debtor wants to retract payment by inducing the obligated bank not to pay. The typical case involves a dispute between the parties to the transaction in which the check is given in payment.… A debtor using any of these types of checks has no right to stop payment [as we saw in the previous example]. Nevertheless, some banks will refuse payment as an accommodation to a customer. Section 3-411 is designed to discourage this practice.

The Paley bank is in no position to determine whether the computer program that Commerce handed over to DotCom is, as the company seems to believe, nothing like what was promised. Perhaps the people at DotCom are just too dense to appreciate the impressive new functionality of what Commerce has delivered to them. In any event, the message of §3-411 to Paley is that it need not, and indeed that it *should not,* get involved in this controversy. Its only role has been to issue a cashier's check at the request of a customer, for which it presumably got fully paid by deducting available funds out of DotCom's account. The bank should pay the check when presented, and leave DotCom to pursue Commerce by other means if the company feels it has been cheated in the underlying transaction. Permitting a bank that has issued a cashier's or a teller's check at the request of a customer, or that has already certified a customer's personal check, later to refuse payment on that check as a favor to its customer is seen as seriously undermining the functionality of bank checks in the commercial world. See, for example, *MidAmerica Bank, FSB v. Charter One Bank, FSB*, 232 Ill.2d 560, 905 N.E.2d 839, 68 U.C.C.2d 289 (2009), and *South Central Bank of Daviess County v. Lynnville National Bank*, 901 N.E.2d 576, 68 U.C.C.2d 232 (Ind. App. 2009).

This example differs dramatically from the previous one, in that here the bank wants to deny payment on the cashier's check not as an accommodation to its customer but to *itself* avoid loss. If it has to pay the $12,000 on the cashier's check it has issued to Ms. Valley, it will not be able to charge this amount to DotCom's account, because the check it took from Valley was not properly payable. The question is when, if ever, a bank that has issued a cashier's or teller's check, or that has certified a personal check, can use a defense *of its own* to justify refusing payment on such a check.

Look first to §3-411(c). The expenses or consequential damages for which a bank refusing to pay on such a bank check may be liable under subsection (b) are not recoverable "if the obligated bank asserts a claim or defense *of the bank* that it has reasonable grounds to believe is available against the person entitled to enforce the instrument." So if Paley refuses to pay the check when Valley is the person attempting to enforce the instrument, it should not have to worry about being made to pay any expenses or consequential damages, under §3-411, that Valley might claim she has suffered.

This still leaves the more important question unanswered: If Paley does refuse to pay on the certified check, even if it will not be held responsible for any expenses, interest, or consequential damages, should it be held liable for the $12,000, the actual amount of the check? This is an issue on which courts and commentators have differed and will presumably continue to differ, because Articles 3 and 4, even in their revised state, fail to address the question directly or impose a set answer.

Under the prerevision version of the Code, the majority of courts took what became referred to as the "cash equivalent" approach to questions involving bank checks. Under this approach to the problem, a bank's issuance of a bank check was considered to be the functional equivalent of its having paid out cash in the amount of the check. Just as there was no way for a bank to "stop" the recipient of cash from using it as he or she saw fit, considering the issuance of a bank check as equivalent to a cash payment meant that the issuing bank would never be in a position to rightfully refuse payment on a cashier's, teller's, or certified check. This would be so even if the bank reasonably believed itself to have, and in fact did have, a defense of its own (such as fraud, lack of consideration, or mistake) that it could assert against the person seeking payment on the check. A passage from an earlier case is often cited to explain the rationale behind this cash-equivalence approach:

> A cashier's check circulates in the commercial world as the equivalent of cash. People accept a cashier's check as a substitute for cash because the bank stands behind it, rather than an individual. In effect, the bank becomes a guarantor of the value of the check and pledges its resources to the payment of the amount represented upon presentation. To allow the bank to stop payment on such an instrument would be inconsistent with the representation it makes in issuing the check. Such a rule would undermine the public confidence in the bank and its checks and thereby deprive the cashier's check of the essential incident that makes it useful.

National Newark & Essex Bank v. Giordano, 111 N.J. Super. 347, 268 A.2d 327, 7 U.C.C. 1153 (1970).

A second, minority approach to the problem has been to consider the bank check as equivalent to a note issued by the bank. If this is the view taken, then the bank, in refusing to pay on a bank check it has issued, would be permitted to introduce any and all defenses of its own that it could muster against payment of the obligation, if it were later sued for the amount of the check. Some cases take a middle ground and hold that the bank can rely upon a defense that it was defrauded into issuing the check, but not on simple lack of consideration for the check or mistake on the bank's part in issuing it.

As the 1990 revisions were being prepared, arguments were made on both sides that either one or the other of these approaches should be formally recognized by the revision, but the revision drafters chose not to incorporate either view into the Code. Thus, the debate will continue. Whether Paley would be within its rights to refuse payment on the cashier's check it issued to Valley will depend on the rule of the jurisdiction, or, if the jurisdiction has yet to address the issue, on which approach it decides to adopt and on how it understands that approach to operate in any particular situation.

Two postrevision cases each provide a good summary discussion of this problem, and both ultimately adopt the "cash equivalent" approach to bank checks. *Gentner & Co., Inc. v. Wells Fargo Bank*, 76 Cal. App. 4th 1165, 90 Cal. Rptr. 2d 904, 40 U.C.C.2d 38 (1999), considers the problem under each of the approaches and concludes that, "[f]ortunately, the … revisions to the Commercial Code allow us to resolve the issue before us without resort to a blanket rule or a rule under which the nature of a cashier's check fluctuates from case to case." The court's holding, given the facts before it, was that:

> [A]s between the bank and a payee who acts in good faith, the Commercial Code clearly requires the bank to suffer the loss occasioned by its error in accepting or paying a check covered by a stop payment order, and that the result is the same whether the check is paid in cash or exchanged for a cashier's check.

See also *Flatiron Linen, Inc. v. First American State Bank*, 23 P.3d 1209, 44 U.C.C.2d 673 (Colo. 2001). But see the more recent decision of the Court of Appeals of Missouri, rejecting the "cash equivalent" approach to bank checks in favor of what it refers to as the "ordinary negotiable instrument" approach as the law of Missouri, basing its holding on prior opinions by the courts of that state as well as the writings of "several noted UCC scholars" contending this to be the preferred approach and furthermore that the revision of Article 3 in 1990 did not alter the law on the subject. *Trancontinental Holding Ltd. v. First Banks, Inc.*, 299 S.W.3d 629, 69 U.C.C.2d 763 (Mo. App. 2009). It seems this is an issue on which the courts—and even, yes, noted Uniform Commercial Code scholars—will continue to differ.

No. Everyone seems to agree, without question, that once a bank check is in the hands of a holder in due course who seeks to collect upon it, the bank has no option but to pay. If you look at this under the cash-equivalent approach, then it doesn't matter who is seeking to enforce the cashier's check. It must be paid. Under the "note approach," the bank would be allowed to assert its own defenses against the person seeking to enforce the check, but because the note has come into the possession of a holder in due course, those defenses the bank might have had against Valley, all being personal defenses, would not be available against the car dealership. If Paley refuses to pay the cashier's check, it will be sued by the dealership and have no legitimate defenses to the claim that it should pay the full amount of the check. Note also that it could be held liable to the dealership, in addition to the $12,000, for expenses, loss of interest, and possibly consequential damages under §3-411. Subsection (c) of that section absolves the bank of any such additional liability only when it can assert a claim or defense of its own "that it has reasonable grounds to believe is available against the person entitled to enforce the instrument." Unless Paley has "reasonable grounds to believe" that the dealership is not a holder in due course, it would have no defense to payment of the cashier's check that it could reasonably believe would be good against that party. Paley had better pay on the cashier's check when the dealership comes calling.

Revision Proposals

Under the 2002 Amendments to Article 4, what would be necessary to extend a stop-payment order beyond 14 days to 6 months and for additional 6-month periods after that is a "record" and not a "writing." See §4R-303. What's the difference? See the last part of the Revision Proposals outlined at the end of Chapter 12. Have you been communicating with your bank, about stopping payment or another matter, by sending it unwritten records lately?

CHAPTER 16

Funds Availability Under Regulation CC

INTRODUCTION

Prior to the passage in 1987 by the federal government of the Expedited Funds Availability Act and the promulgation by the Federal Reserve System of its Regulation CC (designed to implement the Act), individual banks had a great deal of latitude to decide for themselves how long a customer who deposited a check would have to wait until the amount of the check would be available for his or her use.* We have already dealt with one aspect of Regulation CC—Subpart C, calling for expedited return and notice of nonpayment by a payor bank that determines to dishonor an item—in Chapter 13. In this chapter we consider a second major consequence of Regulation CC; indeed, that which is the primary explanation for its existence (as you can see from the title of the Act that it implements, the Expedited Funds Availability Act). Subpart B of Regulation CC makes mandatory, for all banks in the United States, an availability schedule under which the depositing customer will have as a matter of law the right to withdraw in cash or have applied against checks that he or she has written the funds represented by any given deposit. A bank may, if it wishes to do so, make funds available on a shorter timetable than that called for in Regulation CC, Subpart B, either in an individual case or as a matter of general policy designed to attract and hold either all or some particular favored customers.

Many banks do now offer more favorable availability schedules, as competition for checking account business increases. No bank, however, may deny availability beyond the times established in the regulation.*

The funds availability schedule dictated by Regulation CC is set forth in three sections, at which we will be looking in the examples. Section 229.10 (12 C.F.R. §219.10) calls for *next-day availability* of certain types of deposits. The general *availability schedule*, for items that do not deserve next-day availability treatment, is found in §229.12. This section as written basically provides for what we can term *second-day availability* for local checks and *fifth-day availability* for nonlocal checks. Up until very recently it was obviously important for compliance with the mandated availability schedule that a bank be able to distinguish a *local* check from a *nonlocal* one. See the definitions in 12 C.F.R. §229.2(m), (r), and (s). Note furthermore that the check processing region of the payor bank of any check deposited into an account is information that the bank should be able to determine directly through its automated systems, from the MICR line on that check. The situation changed dramatically as of February 27, 2010. On that date the Federal Reserve Board—reacting to the steady increase in the number of checks which were being forwarded for collection by electronic means—completed a program it had initiated to reduce the number of locations at which it provided the processing of physical, still in paper form, checks down to a single center, the Federal Reserve Bank of Cleveland. The result was that as of that date *all domestic checks are "local"* for the purposes of Regulation CC. (The Board made this change not by amendment of the language of Regulation CC itself, but by changing an appendix to the regulation making the entire country one unified "check processing region" as that term is defined in §229.2 (m) and used in §229.2(s). So the term "nonlocal check" remains in the text of the regulation but refers, in effect, to something that cannot now exist. Confusing perhaps, but at least the result makes things that much easier for us—both as students of the subject and as banking customers.)

It will still be important for you to pay attention to Regulation CC's carefully wrought distinction between a *business day* and a *banking day*. See the definitions in §229.2(f) and (g). What counts as a business day is defined without reference to any particular bank's activities; any weekday other than one of a set of predetermined holidays will be a business day for the purposes of Regulation CC. What is and what is not a banking day, in contrast, can differ from bank to bank. For any particular bank,

> “Banking day” means that part of any business day on which an office of a bank is open to the public for carrying on substantially all of its banking functions.

A set of exceptions to the next-day and general availability schedules is set forth in 12 C.F.R.§229.13. I will not attempt, in the following examples, to place before you every twist and turn of these sections, which are, as you can see, not lacking for detail. We can, however, make a quick tour of the highlights.

Examples

> *In all of the following examples, you should assume that the Depot National Bank has adopted an availability schedule that conforms to the requirements of Regulation CC and has not agreed to give any customer availability of funds on a speedier basis.*

Chuck has an account with the Depot National Bank. As of the beginning of business on Monday morning, this account contains only $15. At 10:00 in the morning, Chuck goes into the bank and deposits with a teller $300 in cash. As soon as he walks out of the bank, he spies in the window of a nearby store a small, hand-held computerized personal digital assistant, which he realizes he would very much like to have. The owner of the store tells Chuck that the regular price for the gadget is $375, but he would be willing to let Chuck have it for $300 if Chuck can pay in cash by the end of the day. Chuck immediately returns to Depot National and fills out a withdrawal slip requesting that he be given $300 in cash. He presents this withdrawal slip to the teller. Is the bank obligated to hand over to Chuck $300 in cash? See §229.10(a)(1).

Marisa, another customer of Depot National Bank, has arranged with her employer for her weekly paycheck to be automatically deposited into her account at the bank by electronic means. On Friday, the employer electronically deposits into Marisa’s account $875.60, representing her week’s salary (net, of course, of a whole host of deductions for taxes and the like). Prior to this deposit, the available balance in Marisa’s account was down to $100. Also on Friday, Depot is presented with a check that Marisa has issued to her dentist, in the amount of $135. On Friday evening, Depot dishonors this check and returns it to the presenting bank. Assuming that Depot has not agreed to give Marisa any overdraft privileges, did Depot wrongfully dishonor by not accepting this check? See §229.10(b).

Emily deposits a cashier's check for $2,500, issued by Paley National Bank, into her account with Depot National Bank on a Tuesday morning by personally handing it over to a teller at the bank. As of when will this $2,500 be available in Emily's account as a matter of right? See §229.10(c)(1)(v).

Joel has an account with the North Street branch of the Depot National Bank. On Wednesday he deposits a check that he received from Lenore, which was written by Lenore out of her account with the Southern Avenue branch of Depot National Bank. As of when will the amount of this check be available to Joel in his account? See §229.10(c)(1)(vi).

On Monday Susan deposits three personal check written on domestic banks —in the amounts of $125, $75, and $240—totaling $440 into her account with Depot National Bank, all three of which are written on other banks.

) As of Tuesday, does Susan have available in her account any money represented by these three checks? If so, how much? See §229.10(c)(1)(vii).

What if the three checks Susan deposits on Monday are for only $12, $7.50, and $20, for a total of $39.50? When would Depot have to make this amount available to her?

Richard deposits a single check for $350, drawn on a nearby bank, into his account with Depot National Bank on Monday morning.

\s of when must the full amount of this check be regarded as fully available to him so that he could withdraw this amount in cash? Must it be treated as part of the amount in his account available to cover any check he himself may have drawn? See §229.12(b)(1).

/hat would be your answer to the previous question if instead the $350 check deposited by Richard was written on a bank located a long distance from where Depot National Bank is located?

Andrea deposits a single check for $1,000, into her account at Depot National Bank on a Tuesday. The following Thursday she goes to the bank and requests that it issue to her a cashier's check for $900, authorizing the deduction of this amount from her checking account to pay for the cashier's check.

Assuming that Andrea has no money in her account other than that from this deposit, is the bank obligated to issue the cashier's check as she requests? See

§229.12(d).

What if her request had been for a cashier's check in the amount of $300?

What if her request for the $900 cashier's check had come on the following day, that is, the Friday of the week following her Tuesday deposit?

Julia has just moved into a new city and wants to open a checking account there. She comes into Depot National Bank on a Monday to open an account with that bank. As an initial deposit, she gives the bank a personal check for $12,000, which she has written to herself out of an account she already has with another bank in the distant part of the country that she has just moved from. When will funds be available in her new Depot account as a result of this initial deposit? See §229.13(a).

Amanda deposits a personal check for $50,000 into her existing account with Depot National Bank.

As of when must the bank make this amount available to her? See §229.13(b) and §229.13(h)(2) and (4).

If Depot does decide to apply the large-deposits exception of §229.13(b) to this deposit, what other obligation does it have under Regulation CC? See §229.13(g)(1).

Barbara Lynch received a check from a client for $14,900 written on Citizen's Bank. On March 19, she deposited it into her account with Depot National Bank. A few days later she inquired of her bank whether the funds represented by this check were available to her under the bank's availability policy. The bank's availability policies and procedures, you may assume, were in compliance with the requirements of Regulation CC. Upon being informed that the funds were available, she withdrew $14,200 in cash from her account on March 22. On March 23 her bank was electronically notified by Citizen's Bank that the check Barbara had deposited on March 20 would not be honored. Depot National Bank withdrew the provisional credit it had earlier credited to her account for the amount of the check and gave her proper notice of this charge-back. Barbara wishes to argue that this charge-back was improper. She reasons that, once the funds represented by the check were made available to her, this money was hers and was no longer a provisional credit to her account that was subject to a charge-back by the bank based on the check's return uncollected. Will Barbara's argument succeed?

Explanations

No. Under 12 C.F.R. §229.10(a)(1), a cash deposit made in person to an employee of the depositary bank must be available as of right "not later than the business day *after* the banking day on which the cash is deposited."

So Chuck may withdraw the $15 that has been sitting in his account for some time, but he does not have the right to withdraw the $300 in cash he just deposited earlier in the day. At first this may strike you as strange or inherently unfair to the depositor. The fact is, however, that under Regulation CC there are *no* circumstances under which the depositor is entitled to availability on the actual day of deposit. The earliest that a deposit must be made available to the customer is next-day availability in those instances covered by §229.10. The rationale for this is that the depositary bank has to be given at least one day to deal with the deposit and to take a look (by automated means in the normal course of things) at the status of the customer's account. Later in the day on Monday, Depot National Bank may find that Chuck's account is overdrawn, in which case it would be within its rights to apply the $300 to that overdraft. Or a check drawn by Chuck on his account, say for $240, may have been presented to Depot during the course of the day. Depot would be within its rights to pay this check, leaving only $75 in Chuck's account as of the opening of business on Tuesday. By making next-day availability the earliest that a deposit must, as a matter of law, be afforded to the customer, the regulation allows the depositary bank one processing cycle, at the end of the day of deposit, to assess the status of the depositor's account in light of the deposit and all other factors.

No. The amount deposited into Marisa's account by electronic means will qualify for next-day availability under 12 C.F.R. §229.10(b), so that it will be available to cover any checks written by Marisa on her account as of the opening of business on the following Monday (provided that Monday is a business day under §229.2(g), of course). As of Friday, when Depot determined to bounce the check written to her dentist, Marisa still had only $100, less than the amount of the check, available in her account, so this was not a wrongful dishonor.

Recall that under §4-401 of the Code, Depot was not *required* to dishonor the check. It could have decided to honor it even though this would have resulted in a temporary overdraft. The bank's computers could be programmed to account for funds that have been deposited which are not yet technically available in the customer's account, but which should become so in due time. Or the bank's systems could determine to hold onto the $135 check presented to it until the following Monday. When Marisa's pay becomes available in the account—and provided that no other checks are presented by that time not all of which could be covered by her then-available funds and that Marisa has not withdrawn too much in cash from her account—Depot could then determine whether to honor the item prior to midnight on Monday, which would still be within its midnight deadline. Any of these possibilities will, needless to say, add significantly to Depot's cost and potential risk in dealing with Marisa's account. If Depot were willing to do this for a relatively small-time customer like Marisa, the easier route would probably be for it just to extend to her some measure of overdraft privilege once she has proven herself to be a responsible customer. This privilege limit could easily be programmed into its computer system once and for all.

Under 12 C.F.R. §229.10(c), "certain check deposits" are entitled to next-day availability. We will not look at each of the types of checks that so qualify, but as you can see just by glancing through paragraphs (i) through (iv), this favored treatment is reserved for checks that figure almost certainly to be paid because they are drawn on the credit of the government or a governmental agency. Similarly, under (v), with which we deal here, the credit behind the check is that of a bank, and there should be no doubt that such a check will be paid without question.

Emily's deposit of the cashier's check on Tuesday will result in its amount being available in her account as of the next business day, Wednesday, if her deposit meets the criteria of §229.10(c)(v). We know that she deposited it into an account in her own name and that her deposit was directly in person to an employee of the bank. The only questions remaining are whether her bank calls for such a deposit to be made using a special deposit slip or deposit envelope, as may be required by the bank under §229.10(c), and if so whether she actually did use the special deposit slip or envelope to make the deposit. The rationale for this special method of deposit, which is also found in §229.10(c)(iv) governing checks drawn by a state or unit of local government, is that the depositary bank would not be able to determine simply from reading information off the MICR line whether the type of check deposited was such as would qualify for next-day availability. The bank is authorized to institute a system for such deposits that will call to the teller's attention the nature of the check. Note that if Emily's deposit of a certified check does not, for some reason, qualify for next-day availability under §229.10(c)(v)—if, for example, she had not deposited in person to an employee of the bank or if she had failed to use the special deposit slip or envelope required by the bank in such situations—the availability of the funds represented by the check is governed by the general availability schedule of §229.12. That is, the Depot bank will only be required to determine, as it easily can do from the MICR line, whether the bank on which the check is drawn makes this a local check (in which case second-day availability will apply) or nonlocal check (which would be entitled to fifth-day availability). See §229.12(b)(4) and (c)(1)(ii).

This check qualifies for next-day availability under the cited part of 12 C.F.R. §229.10, so the amount of the check must be added to the available funds in Joel's account as of Thursday.

None of the three checks that Susan deposited on Monday is individually entitled to next-day availability. Under §229.10(c)(vii), however, Susan is entitled to next-day availability of *the lesser of* $100 or "the aggregate amount [which in this case would be $440] deposited on any one banking day … by check or checks not subject to next-day availability." So Susan is entitled to have $100 added to her available funds on Tuesday. The remaining $340 represented by these checks, which was not made available under this provision, will be available in her account on Wednesday since each of these checks, no matter where the bank on which it was drawn is located, will be considered a local check.

Under 12 C.F.R. §229.10(c)(1)(vii), the full $39.50, being less than $100, would be subject to next-day availability and hence available to Susan on Tuesday.

The entire amount of this check, which has to be treated as a local check, must be considered as funds available in Richard's account "not later than the *second* business day following the banking day on which" the check was deposited. So the full $350 will be available in his account on Wednesday, under the requirement of second-day availability for local checks. Note that, depending on what other checks Richard may have deposited on Monday, it is possible that up to $100 of this check was made available to him on Tuesday, under the rule of §220.10(c)(1)(vii), which we looked at in Example 5b. In any event, whatever was not made available to him on Tuesday must be made available on Wednesday, the second business day following deposit.

As of February 27, 2010, the result would be no different from what we concluded in the previous part of this example. All domestic checks, no matter where the bank on which they are written is located, are treated as local checks.

Under 12 C.F.R. §229.12(d), a depositary bank may extend by one business day the normal second-day or fifth-day availability (which now for all practical purposes means second-day availability in all cases) provided for in subsections (b) and (c), setting the time that funds are available "for withdrawal by cash or similar means." Such similar means include the issuance of a cashier's check. So, although Andrea would have available, as of the Thursday following her Tuesday deposit of this check, the full $1,000 for use in covering checks she has written that have been presented to the bank, she will have to wait one more day to withdraw this amount in cash or to use it to purchase a cashier's check. She does not, as of Thursday, have the right to purchase a $900 cashier's check based on her deposit exactly two business days earlier of the $1,000 check.

Notice the last two sentences of 12 C.F.R. §229.12(d):

> A depositary bank shall, however, make $400 of these funds available for withdrawal by cash or similar means not later than 5:00 p.m. on the business day on which the funds are available under paragraphs (b), (c) or (f) of this section. This $400 is in addition to the $100 available under §229.10(c)(1)(vii).

So, if Andrea is willing to wait until 5:00 p.m. to pick up the cashier's check she has requested, she would then have the right to a cashier's check in this amount and would not have to wait until the following day. In fact, because $100 in automatic next-day availability under §229.10(c)(vii) will have been allocated to this particular check, she would be entitled to withdraw in cash or purchase a cashier's check for up to $500 as a matter of right by 5:00 p.m. on Thursday. The remaining amount of the check will have to become available on the next business day.

By this day all of the $1,000 represented by the check deposited three business days earlier must be available to Andrea, either to cover checks written on her account or for "withdrawal by cash or similar means." Even taking into account the one-day extension of 12 C.F.R. §229.12(d), she is entitled to purchase a cashier's check with these funds on this Friday.

Since Julia's deposit into this new account does not fall within either §229.13(a)(1)(i) or (ii), Regulation CC does not impose any mandatory availability schedule on Depot National. Julia is going to have to ask the bank what schedule it uses to make a deposit such as hers into a new account and live with those conditions. Or, of course, she can shop around for another bank in the same locality that has a more favorable availability schedule for deposits made into new accounts by personal checks. She's probably going to have to wait some time. What might she have done in opening her new account to speed things along, or at least to get some help from Regulation CC in seeing that the bank is obligated to *some* mandatory schedule of availability? For one thing she could have brought in a check for $12,000 that was either certified or a cashier's or a teller's check. Had she done this, then under §229.13(a)(1)(ii), she would have been entitled to $5,000 of next-day availability, with the remaining $7,000 available to her no later than nine business days after her deposit, that being Friday of the week following her opening of the account. What could she have done to speed things up even more? For one thing, she could have carried $12,000 in cash into the offices of Depot National Bank, but carrying that amount of cash across the country or even across town is not something that we should be quick to recommend. A safer way would have been for her to have arranged for an electronic transfer of funds from her distant bank directly into her new Depot account, either beforehand or with the aid of the person at Depot who helps her open the new account. In either instance—cash or electronic payment—she would have been entitled to next-day availability under 12 C.F.R. §229.13(a)(1)(i).

Under 12 C.F.R. §229.13(b)(1), the general availability rules regarding checks of any kind do not apply "to the aggregate amount of deposits by one or more checks to the extent that the aggregate amount is in excess of $5,000 on any one banking day." Under §229.13(h)(2), if this exception applies, the depositary bank may extend the time of availability to "a reasonable period after the day the funds would have been required to be made available had the check been subject to … §229.12." Paragraph (h)(4) tells us that,

> For the purposes of this section, a "reasonable period" is an extension of up to one business day for checks described in §229.10(c)(1)(vi), five business days for checks described in §229.12(b)(1) through (4) and six business days for checks described in §229.12(c)(1) and (2) or §229.12(f). A longer extension may be reasonable, but the bank has the burden of so establishing.

So, unless Depot decides to impose an even longer extension and bear the burden of establishing reasonableness, it must make the $50,000 represented by this check available to Amanda no later than seven business days after deposit (two days extended by five) if the check is a local check and eleven business day (five days extended by six) if it is a nonlocal check.

Many banks do not take full advantage of the extensions allowed by this provision, especially when the customer is a business entity that makes deposits of checks for large amounts on a fairly regular basis, but do impose some shorter extensions or allow for availability of at least some portion of the funds at an earlier date.

Depot is required by the cited paragraph to give Amanda written notice informing her of (among other things) the amount of the deposit that is being delayed; the reason for the exception to its normal availability rules, of which she presumably has knowledge and on which she might otherwise believe she could rely; and "the time period within which the funds will be available for withdrawal."

In these examples we have dealt with only two of the exceptions, provided in 12 C.F.R. §229.13, that may extend the time that the depositary bank has to make the funds deposited available to the customer: the new account and the large deposit exceptions. You can see that there are others of which you should be aware, even if it is not necessary to go into them in detail. Extension of the availability schedule is also allowed when the check is a redeposited check (one that has already been deposited once and returned dishonored); when the customer has "repeatedly overdrawn" his, her, or its account in the recent past; when there is other "reasonable cause to doubt collectibility"; and under certain defined emergency conditions.

This example is loosely based on *Lynch v. Bank of America, N.A.*, 493 F. Supp. 2d 265 (D.R.I. 2007). The argument that Barbara is advancing failed in the case, as indeed it really must. The Expedited Funds Availability Act is clear, and courts have been consistent in its application, that nothing in the Act interferes with a depositary bank's right to revoke provisional credits in a customer's account that later are found to represent uncollectible funds—even if those funds have already been made available to the customer under the terms of the Act and Regulation CC. It is important to keep in mind the distinction between the funds a customer has "available" in his or her account, as we have been discussing that notion in this chapter, and what funds have been finally and irreversibly credited to the account under the check collection rules we studied earlier. As the district court judge recognized in the *Lynch* case:

[T]he situation that gave rise to this litigation is perhaps an unintended consequence of the earlier availability of funds mandated under [the Expedited Funds Availability Act]. By making customer deposits available sooner, EFAA increases the possibility that a depositor will have access to those funds before a check clears. Nevertheless, as long as depositary institutions comply with its notice provisions, EFAA does not make banks liable for their customers' checks. Customers of banks, in other words, withdraw money early at their own peril. EFAA requires insitutions to make funds available, but it does not require a bank to effectively become a guarantor of the check in the process.

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* If, because of the order in which you are studying the various payment systems topics, you have not yet looked at Chapter 13, which first introduced the Expedited Funds Availability Act and Regulation CC, you should at this point read the first section of introductory text to that chapter.

* The Regulation also requires that any bank properly disclose its availability policy to the account holder. See C.F.R. §§229.15 and 229.17.

PART V

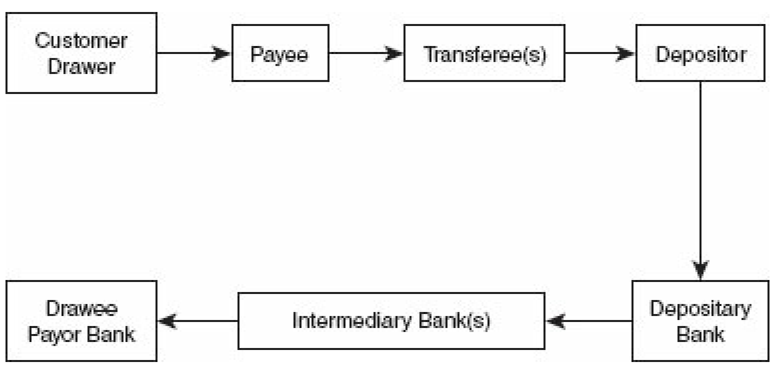
Problems of Theft, Forgery, and Alteration

CHAPTER 17

Who Bears the Risk of Theft, Forgery, and Alteration?

THE WAYS OF THE THIEF

Recall the route that the typical check takes on its way from the customer, who as drawer of a draft is expressing an order, to the payor bank, which, as drawee, is obligated to carry out that order.



The road can be a long one. The customer first issues the check to the payee. The payee may immediately deposit the check himself or herself, but he or she need not necessarily do so. The check may first be transferred to one or a series of holders before it comes into the hands of a party who decides to deposit it into the depositary bank. At that point, the item enters the check collection system, which we have already looked at in the earlier chapters of Part III. We know that the depositary bank may, depending on the circumstances, itself present the check directly to the payor bank, or it may instead forward the check for collection through one or a series of intermediary banks. The last of the intermediary banks takes on the special role of being the presenting bank, which forwards the check without intermediary to the payor bank. One way or another, the check is eventually presented to the payor bank.

It will be important to remember for what follows that every time the check is passed from one party to another as it makes its way around the circuit, other than the initial *issuance* by the drawer and the culminating *presentment* to the payor bank, the event can and should be characterized as a *transfer* of the check. Equally important is to recognize that neither issuance nor presentment of a check is an incident of transfer. Issuance is issuance. Presentment is presentment. Any movement in between is a transfer.

This travel of any individual check—from issuance, through anywhere from none to a large number of transfers, to eventual presentment—is referred to in the jargon of the trade as the *downstream flow* of the instrument. As we saw in Chapter 14, at the end of its flow downstream, when the check is presented to the payor bank, that bank will be under a duty (set forth in §4-401(a)) to its customer to honor the check and release funds in the amount of the check for the benefit of the depositor if and when the check is "properly payable." You will also recall from Comment 1 to that section that a check is *not* properly payable if it contains a forged drawer's signature or a forged indorsement. In the preceding chapters we dealt for the most part only with examples in which there was no forgery of any signature, theft of the instrument from its rightful owner, or alteration of any of the instrument's terms. In this chapter, along with Chapters 18 and 19, we abandon this restriction and deal instead with just those situations where some such skullduggery has taken place. A thief has entered the picture. He or she, by nefariously monkeying with or redirecting the intended downstream flow of a check—by busting into the nice, neat diagram with which we began this chapter—is able to divert the flow of funds away from the rightful claimant and into his or her own pocket.

One thing should be made clear from the outset: If the thief of funds is found out and caught, he or she will be made to pay the price. There should be nothing surprising in this. Theft is theft, and there are laws against that kind of thing. Quite apart from whatever criminal sanctions may apply, the thief will be legally liable to whoever has been wrongfully deprived of funds and must turn over the ill-gotten gains. As a matter of fact, part of what we will see in this chapter is just how, section by section, Articles 3 and 4 of the Uniform Commercial Code give the wronged party the statutory authority to recover the stolen amount from the thief. The more interesting, and troubling, problems we have to explore, however, each go one step beyond this. It will probably not shock you to learn that often the thief of funds, just like any other garden-variety thief, disappears with his or her ill-gotten gains before the fact of the theft is uncovered. Even if the thief does stick around and is caught, he or she often enough does not have the funds still on hand to repay the wronged party. What, we then have to ask, should the result be in such a case? Who among all the various parties, individuals and banks, involved in the scenario should end up bearing the loss when the thief cannot be found or, even if found, is not in a position to make full recompense for what he or she has taken? The thief is not around or is not able to put money back in the pot to ensure that everyone else comes out whole. The government may impose criminal sanctions against the malefactor, but it certainly isn't going to cough up the funds to undo the harm the criminal has done. It is inevitable in such a situation that some *innocent party* is going to be left to suffer the loss and have nowhere to turn for relief.*

Thieves are very ingenious types; let's give them that much. There are any number of stratagems that a person intent on getting his or her hands on funds intended for someone else may use to suit the sinister purpose. Almost all instances of theft by check, however, sort themselves out into one of four paradigm cases, each of which occurs with stunning and saddening regularity:

The thief forges the signature of the customer-drawer to create a check purportedly authorized by the account holder, or what is sometimes referred to as a "forged check."

The thief makes away with a check written to another and then forges that person's indorsement to collect the funds himself or herself.

'he thief steals a check that is a bearer instrument and collects on it.

The thief alters a check either to make it appear to be payable to someone other than the true payee or to inflate the amount for which the check appears to be written.

In the examples of this chapter, we will work our way through each of these paradigm situations in detail.

The tools we will need to grapple with the problems arising from this type of misbehavior are several. We already have available to us the all-important "properly payable" rule of §4-401(a).* Beyond this we will have to make use of warranty theory as it is made part of the law governing negotiable instruments—both the warranties of transfer and the warranties of presentment—and the doctrine of conversion as it applies to checks.

THE TRANSFER WARRANTIES

The transfer warranties allow those who have taken transfer of a check under certain conditions to sue back "upstream" those through whose hands the check previously passed if the earlier party transferred the check in breach of one of the warranties. The Code provisions creating and governing these warranties are §3-416 in Article 3 and §4-207 in Article 4. Section 3-416 states the general rules in terms applicable to all negotiable instruments. Once a check has been deposited and entered into the check collection process, it is §4-207 that technically applies to the transfers that take place within that system. Fortunately for us, the two sections are virtually identical, both in language and certainly in intended effect. As the short Official Comment to §4-207 states:

> Except for subsection (b) [a matter with which we are not going to concern ourselves], this section conforms to Section 3-416 and extends its coverage to items [which include checks once they've entered the check collection system]. The substance of this section is discussed in the Comment to Section 3-416.

Because §3-416 is accompanied by such a rich load of comments, it seems a better place to look to pick out the details of the transfer warranties in general. By way of introduction, I suggest we break the topic down into a series of questions, most of which we can easily answer from the language of §3-416, primarily subsection (a), itself.

Who gives the transfer warranties?

"A person who transfers an instrument for consideration." Note from Comment 1 that "[a]ny consideration sufficient to support a simple contract will support these warranties."

Who receives the transfer warranties?

"[T]he transferee and, if the transfer is by indorsement, … any subsequent transferee."

What does the transferor warrant to be true?

That "the warrantor is a person entitled to enforce the instrument." The end of Comment 2 states that this is "in effect a warranty that there are no unauthorized or missing indorsements that prevent the transferor from making the transferee a person entitled to enforce the instrument."
That "all signatures on the instrument are authentic and authorized."
That "the instrument has not been altered."
That "the instrument is not subject to a defense or claim in recoupment of any party that can be asserted against the warrantor."
That the warrantor has no knowledge of any insolvency proceedings commenced against the drawer of the check.

What are the rights of a transferee against a transferor who has breached one of these warranties?

Look now to subsection (b): Any transferee who took the instrument in good faith "may recover from the warrantor as damages for any breach of warranty an amount equal to the loss suffered as a result of the breach, but not more than the amount of the instrument plus expenses and loss of interest as a result of breach."

May the transfer warranties be disclaimed with respect to checks?

No. See the first sentence of subsection (c).

THE PRESENTMENT WARRANTIES

The presentment warranties allow a payor bank that has paid on a check under certain conditions to sue back “upstream” those through whose hands the check previously passed if the earlier party transferred or presented the check in breach of one of the warranties. The presentment warranties are found, in substantially similar form, in §§3-417 and 4-208. Again, for reasons of practicality I suggest we look to the Article 3 section to pick up the details, at least as they relate to checks, and that we do so by breaking the topic down into a series of questions, most of which we can easily answer from the language of §3-417, primarily subsection (a), itself.

Who gives the presentment warranties?

A person obtaining payment on a check or a previous transferor of the check.

Who receives the presentment warranties?

The drawee-payor bank that pays on a check.

What does the presenter or prior transferor warrant to be true?

That “the warrantor is, or was, at the time the warrantor transferred the [check], a person entitled to … obtain payment … of the [check] or authorized to obtain payment … of the [check] on behalf of a person entitled to enforce it.” Comment 2 states that this is “in effect a warranty that there are no unauthorized or missing indorsements.”

ʾhat the check has not been altered.

That the warrantor “has no knowledge that the signature of the drawer of the [check] is unauthorized.”

What are the rights of a bank that pays a check against a presenter or prior transferor who has breached one of these warranties?

See subsection (b).

May the presentment warranties be disclaimed with respect to checks?

No. See the first sentence of subsection (e) as well as the first two sentences of Comment 7, which give the justification for this rule.

CONVERSION OF AN INSTRUMENT

Conversion is a concept deriving from the basic principles of property law. A person converts the property of another when he or she wrongfully deprives the other of that property or its value. The converter has stolen the property of another and, not surprisingly, is expected to give it back. The application of the conversion notion to negotiable instruments, including checks, goes beyond this elementary example, however, as you can see by a careful reading of §3-420(a).

Who may bring an action in conversion?

Section 3-420 never states, in so many words, who may qualify to assert a claim in conversion. We generally tend to think of the plaintiff in any conversion action as the "rightful owner" of the instrument, which will usually translate into the "person entitled to enforce" the instrument under §3-301 at the time the conversion took place. Notice that the last sentence of §3-420(a) gives some explicit directives about who may *not* bring an action in conversion (as we will examine more fully in Examples 2b and 5).

Against whom may an action in conversion be brought?

The introductory sentence to §3-420(a) states that "[t]he law applicable to conversion of personal property applies to instruments." So any thief who steals a negotiable instrument will be liable in conversion no differently than if he or she had stolen a piece of jewelry, a book, or an amount of cash. Subsection (a) goes on, however, to provide: "An instrument is *also* converted if it is taken by transfer, other than negotiation, from a person not entitled to enforce the instrument *or* a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment." This latter type of conversion—which may be the result of actions by a totally innocent and decent party—will play a large part in many of the following examples. Note for the moment the statement in Comment 1 that "[t]his [sentence] covers cases in which a depositary bank or a payor bank takes an instrument bearing a forged indorsement."

What amount may a wronged party collect from the converter?

See §3-420(b).

PUTTING IT TOGETHER

We now have at least an introduction to all the pieces of the puzzle that we will need to sort out the mess the thief has left in his or her wake. The examples in this chapter give us the chance to work out how these pieces come together in a variety of scenarios to give us the legal analysis on which will turn the thorny question of which party must ultimately bear the burden of the loss to the thief—assuming, of course, that the thief is not available to pay up and come clean. In the Code we are given an array of distinct and highly precise legal concepts, each of which we have to be ready to apply when the time is right: the properly payable rule, the transfer warranties, the presentment warranties, and conversion. These, together with the large number of parties who may be involved in even the simplest of situations, can make the questions of who *can* and who *should* sue whom and *on what grounds* at first (and I stress, only at first) seem fairly daunting, if not downright mystifying. That said, let me suggest a general approach to problems of this type to help you to sort them out and work them through.

First and foremost, I cannot urge too strongly that you first draw out at least a rudimentary diagram that helps you keep track of exactly who each of the parties is, what role each has played, and exactly what has happened to the particular check whose misadventure we are tracking. Feel free to use the format of the diagram I have been using so far in this book (I'll be relying on it myself in the explanations of this and succeeding chapters)—but the exact form of your diagram is, of course, not the important thing. First get the facts straight, and do this by whatever visual means work best for you.

Next thing to do is to stare at your diagram. If, as we will assume, the thief has made off with some money that is not rightfully his or hers, then some other party is as of this moment left holding the bag, so to speak. That party, which could be a private party, a consumer or a business, or one of the banks that figures in your diagram, is *out of pocket* a sum of money equal to the amount that has been stolen. There's no way around it: The sums must always equal out. If the thief has successfully made off with some money, somebody else is, when we first enter the scene to do our analysis, short by the same amount. So the key fact on which we now focus is exactly which party initially stands aggrieved by the loss of funds.

Now the fun begins. Though I do not want to minimize how serious this is to the actual parties involved, from our perspective it may not be unsporting to think of the situation as analogous to one extended game of “hot potato.” Someone must ultimately bear the loss and be left holding the bag, but who will it be? Initially we look at the problem from the point of view of the party we have just identified as being the one left out of pocket the amount of the theft when we first take a look at the scene. That party takes a look around him, her, or it (as on behalf of that party we take a good long look at our diagram). Is there anyone else upstream or downstream of the presently aggrieved party on the route the check has traveled to whom that party can *shift* the loss by one means or another? Recall the tools at hand: A customer can make its bank recredit its account for any amount paid on a not properly payable item; a transferee can, in the appropriate instances, enforce the transfer warranties against upstream parties; the payor bank can assert the presentment warranties; the rightful owner of a check can bring an action for conversion against parties downstream who have done him, her, or it wrong if the facts fit within the confines of §3-420. One way or another, the initially aggrieved party will try to shift the burden of the loss from its shoulders onto those of someone else.

If the initially aggrieved party is able to shift the loss onto another in some way, that is of course not the end of the story. We now have to ask whether *that* party, who is now out of pocket the amount of the theft, can itself shift the loss once again, either upstream or downstream, to get out from under the burden of loss. And so it goes. Our complete analysis may conclude that there is from the very start no chance of the initially aggrieved party shifting the loss to anyone else; that party may be stuck with the loss and have nowhere else to turn. In other situations, we may determine that the loss can legitimately be shifted from one party to another several times until it eventually comes to rest with some party who will have to be the ultimate loss-bearer. The game of hot potato cannot and does not go on forever. Eventually things come to an end, and we will have discovered what party is the ultimate loss-bearer in the situation.

What you will begin to see as you work through the examples is that, although each scenario has its own peculiarities and calls for distinct analysis, the actual events can and will be grouped into a limited number of archetypes or patterns, reflecting those four paradigmatic categories of thievery mentioned early in the first part of this introduction; for each pattern, a general rule will appear. Your task now is to work through each of the examples carefully, so that you can discern those patterns as they emerge and the general rules or results that apply to each of them.

Examples

Andrew, who has a checking account with Payson State Bank, hires one Thad to do some redecorating in Andrew's apartment. When he is left alone in Andrew's den, Thad (who turns out to be not just a decorator but also a thief) finds Andrew's checkbook in a desk drawer. Thad rips out one of the checks from the middle of the book. Later that night, Thad uses the stolen check form to write out a check to himself for $700, forging Andrew's signature on the drawer line. Thad signs his own name on the back of the check and deposits it in his bank, the Depot National Bank. The check is forwarded by Depot National for collection to Payson State via two intermediary banks, First Intermediate and Second Intermediate. Second Intermediate presents the check to Payson, which pays the check out of Andrew's account. The $700 makes its way into Thad's account with Depot. Thad quickly withdraws all his available funds from his Depot account and disappears from the scene. When Andrew gets his next monthly statement from Payson, he carefully looks it over and quickly discovers that this one check for $700 has been paid out of his account based on a check that he never signed or authorized. No wonder the balance in his account is $700 less than he expected it to be!

Does Andrew have a right to insist that Payson recredit his account with the $700?

Assume that Payson does recredit the account as Andrew insists. Now *it* is out that amount of money. May Payson assert a breach of a transfer warranty against any party to make itself whole? Why not?

May Payson assert a breach of a presentment warranty against any party to make itself whole?

How does this particular scenario play itself out? That is, which party ends up "losing" the $700 that Thad the thief has made off with?

The basic pattern of thievery set out in this single, humble example repeats itself all too often in everyday life, with only the details changed. The one consistent element is that the theft is accomplished by the creation of a so-called *forged check*—that is, one on which the signature of the drawer has been forged—that is presented to and paid by the payor bank. Who do you conclude will ultimately be made to bear the loss to the thief in any general case of this type? Does this result depend on any showing that the party bearing the loss acted in bad faith or with a lack of ordinary care in its handling of the particular item? In this regard, take a look at the definitions given in §3-103(a)(4) and (7).

Before his unfortunate disappearance, Thad the decorator was also finishing up a job at the home of one Cara. While doing his last bit of "cleaning up," he comes across a check resting in the top drawer of Cara's bureau. The check, for $1,200, has been written "to the order of Cara" by one Bernie out of his account with the Payson State Bank. Bernie sent this check to Cara to repay a loan she had made to him a few months earlier. Thad puts this check in his pocket on the way out of Cara's home. Thad signs the name "Cara" on the back of the check. Under this he signs his own name and deposits the check in his bank, the Depot National Bank. The check is forwarded by Depot National for collection to Payson State via two intermediary banks, First Intermediate and Second Intermediate. Second Intermediate presents the check to Payson, which pays the check out of Bernie's account. The $1,200 makes its way into Thad's account with Depot. Thad quickly withdraws all his available funds from his Depot account and disappears from the scene. When Cara returns to her home, she is pleased with how the redecorating work has come out and how clean Thad has left the place, but quickly discovers that the check she had received from Bernie is missing. She contacts Bernie, who calls his bank, only to be told that the check has already been paid out of his account.

Cara tells Bernie that he should send her another check for $1,200 so that she can consider the loan repaid. Is Bernie obligated to do as she says? Recall §3-310(b)(1) and consult Comment 4 to that section.

Bernie does write Cara a second check for $1,200, which she quickly deposits in her own bank and which is paid by Payson State. Bernie has now had $2,400 deducted from his account and has the benefit of only satisfying a single debt for $1,200. He quite understandably looks for a means of recovering what he has lost on account of the first, stolen check. Can Bernie bring a conversion action against any of the other players in this story? See the last sentence in §3-420.

Does Bernie have the right to insist that Payson State recredit his account with the $1,200 paid on this first check?

Assume that Payson State does recredit Bernie's account for the $1,200 represented by the first check. Under this set of facts, may Payson assert a breach of a transfer warranty against any party to make itself whole?

May Payson assert a breach of a presentment warranty against any party to make itself whole?

Assume that Payson successfully asserts a breach of a presentment warranty against Second Intermediate Bank. That bank pays Payson $1,200. What route would you now suggest to Second Intermediate to avoid itself having to bear the loss of this amount?

If every party pays careful attention to its rights, which party ends up "losing" and not being able to pass on to any other the $1,200 that Thad the thief made off with when he stole the check belonging to Cara and forged her signature on the back of it?

The fact pattern is the same as in Example 2. Cara, however, decides to take another route to recovering the $1,200 represented by the check Thad has stolen from her bureau, a route that need not involve Bernie at all.

May Cara bring an action claiming the conversion of this stolen check? Against whom may she bring such an action? Look at §3-420(c) and Comment 3 to that section.

Suppose Cara successfully brings a conversion action against Payson State Bank and is paid $1,200 by that bank. Is there any other party against which Payson may proceed to itself recover this loss? If so, on what basis?

How does the end result compare with the result in Example 2?

We look at this same set of facts one last time. If she had wanted to, could Cara have brought a conversion cause of action against Depot National Bank directly?

Danielle owes some money to her friend Edgar. She prepares a check, drawn on her account at Payson State Bank, made out to Edgar for $124. She puts this check in the mail correctly addressed to Edgar, but for some mysterious reason it never arrives. Several weeks later, Edgar calls Danielle asking where his money is. She tells him about the check that she previously mailed to him. He assures her that he never received it. Danielle goes to her bank and is able to find out that the check was cashed (bearing an indorsement of "Edgar" which even Danielle can tell looks nothing at all like Edgar's signature) at some place named The Korner Deli, which had then deposited the check in its account at Depot Bank. The check had been forwarded to Payson, which paid it in the normal course of its operations. Danielle reports all this to Edgar. She says to him, "You are obviously going to have to look into how, if at all, you can get your $124 back." Edgar objects. His position is that he has never been paid the $124 and that Danielle still owes it to him. He insists on immediate payment of this amount, either by another check or in cash. As far as the first check is concerned, he tells Danielle, "That's *your* problem, not mine." The two of them want to remain friends, so they consult you for advice. As of this moment, who bears the loss? How should that party proceed to get the $124 back? Who should eventually bear the loss in this situation if the mysterious stranger who cashed the check while pretending to be Edgar cannot be identified and somehow brought to justice? Be sure, in preparing your explanation to Danielle and Edgar, to consult the last sentence of §3-420(a).

Danielle writes a second check, this one for $300 to Ernesto, out of her Payson account. She mails this check to Ernesto, who receives it. He puts it in his wallet, intending to deposit it in his own account. On his way to the bank, Thelma (a thief) steals his wallet. She finds the check inside. She writes "Pay to Thelma" on the back of the check, under which she signs "Ernesto." Thelma takes this check to Isaac's Liquor Emporium, where she asks Isaac the owner to cash the check for her. After checking Thelma's ID, Isaac asks Thelma to sign the back of the check in her own name, which she does. Isaac takes the check and gives Thelma $100 worth of liquor and $200 cash in return. Isaac deposits this check, along with others that he has taken in during the week, into his account with Depot National Bank. The check is forwarded to Payson State, which pays. By the time Ernesto is able to patch together the story of what has happened to the stolen check, Thelma is, needless to say, nowhere to be found.

Need Ernesto necessarily bear the loss of the $300 represented by the check, along with whatever else of value there might have been in the wallet? How should he proceed to recover at least this $300?

All of the situations, from Example 2 through this one, bear one thing in common: The theft is accomplished by the forgery of an indorsement on the check. Who do you conclude will ultimately be made to bear the theft loss in any general case of this type? Does this result depend on any showing that the party bearing the loss acted in bad faith or with a lack of ordinary care in its handling of the particular item?

Lacky receives a paycheck for $1,000 from his employer, Ms. Boss. This check is written on Boss's account with Payson State Bank. Lacky signs the back of the check with his name only and puts it in his wallet. As he is on the way to his bank to deposit this check, a thief comes up from behind, knocks him down, and makes off with his wallet. The check is later deposited in an account held by one Mugsy Boy at the Depot National Bank. Depot forwards the check to Payson, which pays the check out of the Boss account. Mugsy is eventually apprehended, but by the time he is caught he is penniless. He has no money or other valuables on him, and his account at Depot National Bank is running in the red.

Does Lacky have any legal avenues open to him by which he may recover the loss of the $1,000, which Mugsy stole and apparently has squandered?

As a general rule, who do you conclude bears the risk of loss of a check that is at the time of the theft in bearer form?

Ms. Boss receives a delivery of supplies needed for her business from Sammy's Supplies Store, along with an invoice requesting that she pay $125 for the supplies within 30 days of delivery. She writes a check out of her Payson State Bank account payable to Sammy's Supplies Store for $125, and mails it to the address given on the invoice. When Sammy receives this check, he is in desperate need of ready cash to keep his business afloat. Using a pen similar in color to that which Boss used to write the check, he is able to insert a comma and a zero between the "1" and the "2" where the amount of the check is given in numbers, so that it now reads "$1,025." He also uses an ink eraser and the pen to change the amount of the check where it is given in words to read "One Thousand Twenty-Five and 00/100 Dollars." He deposits this check in his account with Depot National Bank. The bank forwards the check to Payson, which pays it, deducting $1,025 from Boss's account. Because the check is paid, this same amount is soon credited to Sammy's account with Depot. When Boss next receives her monthly bank statement from Payson, she immediately sees what has happened. She complains to Sammy, only to find that by this time he is totally insolvent and not in a position to repay anything to anybody.

Boss contacts Payson and demands that it immediately recredit her account with the full $1,025. Is it obligated to do so? See §3-407(a) and §4-401(d).

To the extent that Payson does have to recredit Boss's account, it is then bearing this amount of loss. How should it proceed in an attempt to make itself whole?

The firm of Magnetic Resonating Services, Incorporated, which uses as its trade name the shorter "M.R.S., Inc." runs a facility where doctors send patients in need of highly sophisticated (and highly expensive) medical testing. The company insists that all patients pay in full at the time of testing for the services being performed, either in cash, with a credit card, or by check. One morning a patient, Martha Kent, comes in for some testing and as she leaves writes out a check to the order of "MRS" for the $1,200 that she has been told the testing will cost her. This check is written on Martha's checking account with Payson State Bank. It is sitting on top of the reception desk when the next patient, Lois Lane, comes up to the desk to check in. At a moment when the receptionist is distracted by some other business, Lois quietly takes Martha's check and slips it into her purse. She quickly makes up some excuse why she cannot have her medical testing done that morning and leaves the company's facilities. Once home, Lois makes some additions to what is written on the payee line on this check, so that it then reads "MRS. LOIS LANE." Lois deposits this check in her account with the Depot National Bank. The bank forwards the check to Payson, which pays the check out of Martha Kent's account. The $1,200 is added to Lois Lane's account with Depot. By the time the facts of what has happened have been sorted out, Lois has withdrawn everything from her Depot account and is nowhere to be found.

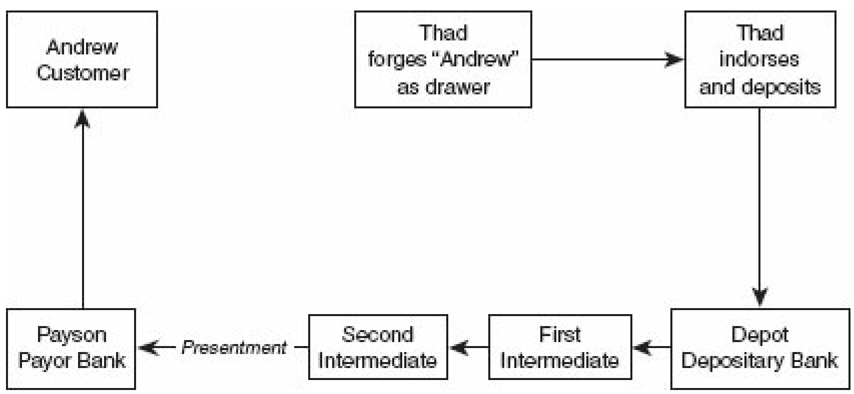
M.R.S., Inc., acknowledges that it was given a check for $1,200 from Martha for the services it provided her, but it has never actually received any of the money represented by the check. How do you suggest it proceed? What party should eventually bear the loss of the $1,200 that Lois Lane has so cleverly made away with?

Looking at this example and the previous one, what do you conclude about who will normally bear the loss occasioned by a thief's alteration of a check?

A company called MediaEdge drew a check made out to CMP Media for $133,026 on its account at Wachovia Bank. Soon thereafter a woman named Choi deposited into her account with Foster Bank a check that to all appearances was this check, with the one crucial difference that the name of the payee was now that of Choi and not CMP Media. Foster Bank forwarded the check to Wachovia, which paid the check. Only later, after Choi had withdrawn the money from her account and vanished, was the fraud, by which she had somehow gotten her name substituted for the true payee's on the check, discovered. By this time Wachovia had destroyed the paper check itself, retaining a computer image. From the image it was not possible to say with any certainty whether the check Choi had deposited was the original check itself, with her name having replaced (by a process known as "chemical washing") that of the true payee, or an entirely different piece of paper, a forged check that had been created using a sophisticated technique to produce a copy that was identical in every respect to the original check (including the authorized signature of MediaEdge's chief financial officer) except that it bore Choi's name as payee and not that of CMP Media. In other words, it is impossible to say with any certainty if Choi's theft was accomplished by her alteration of a check, in which case the loss would under the traditional allocation of loss rules have to be borne by Foster Bank, the depositary bank, or by her presentation of a forged check, in which case Wachovia as the payor bank should bear the loss. The dispute between the two banks is in your court. Which way do you decide?

Explanations

First, let's get a good look at the situation:



Thad forged Andrew's name as drawer on a check written to himself. Thad indorsed the check and deposited it in Depot Bank. Depot sent the check on for collection to Payson, which paid it out of Andrew's account. Thad has made off with the $700, and Andrew is at this point out that amount of money. This is how things would stand, perhaps indefinitely, except that Andrew becomes aware of the problem—if not all the details, at least that his account has been charged $700 that he did not authorize—and so it is up to him to make the first move to rectify the situation.

Andrew does have the right to insist that Payson recredit his account with the $700. We have already seen that, under §4-401(a), the payor bank may not charge the customer's account for anything other than a properly payable item. An item is not properly payable unless it is "authorized" by the customer, which this check certainly was not. Recall the language in Comment 1 to §4-401 that, "An item containing a forged drawer's signature or a forged indorsement is not properly payable." The check bears a forged drawer's signature, so it was not properly payable. Payson must recredit Andrew's account with the $700.

Payson may not assert the transfer warranties against anyone. The transfer warranties accompany any *transfer*, being given by the transferor to "the transferee and to any subsequent collecting bank" (§4-207(a)). Payson is not a transferee. It was *presented* with the item and, as you'll recall, presentment is not a transfer. Nor is Payson a collecting bank; it is the payor bank, and the payor bank is not a collecting bank (§4-105(5)).

Payson did receive the presentment warranties at the time the check was presented to it and it paid on the item. The problem for Payson will be that, except for Thad himself, no party has breached any of the presentment warranties. Look to §4-208(a) and the analogous §3-417 (where the helpful comments are found). The payor bank can rely upon three warranties of presentment. The first of the warranties, that set forth in subsection (a)(1), may at first seem to apply to the situation, but it does not. As Comment 2 to §3-417 makes clear, "Subsection (a)(1) is in effect a warranty that there are no unauthorized or missing *indorsements*." Thad has indorsed the instrument and in his own name. So there is no breach of that warranty. The check has not been altered in any way, so (a)(2) has not been breached by any party.

This leaves us, and Payson, with the warranty set forth in (a)(3): A warranty that "the warrantor has no knowledge that the signature of the drawer of the draft is unauthorized." The simple fact of the matter is that, other than Thad himself, who certainly is aware that his forgery of Andrew's name as drawer of the check was unauthorized, none of the other parties who subsequently handled the check has breached this warranty to Payson. The banks that handled the check for collection—Depot, First Intermediate, and Second Intermediate—had no knowledge that the signature of Andrew on the drawer line was a forgery.

Payson State Bank, the payor bank that paid on a check with a forged drawer's signature, ultimately ends up bearing the $700 loss. There is no other party—other than, of course, Thad if he could ever be found—onto whom it may shift the burden. The buck (or rather the loss of the 700 bucks) stops at Payson's door.

The general rule is as we see it in this example: The loss of any money to a thief who has created a forged check and by that means made off with the amount of the check, rests on the payor bank that paid the check. It is important to note that this is a rule of strict liability, and does *not* depend on any showing in the particular case, nor on any general assumption, that the payor bank must either have been lacking in good faith or acting negligently in paying the item. There is no reason to think that a payor bank, honoring a check such as this in the ordinary course of its automated operations, is not acting in good faith; that is, with "honesty in fact and the observance of reasonable commercial standards of fair dealing" (§3-103(a)(4)). Nor can it be said to have acted without ordinary care, as defined in §3-103(a)(7), especially when you take into account the second sentence of that definition. The payor bank is an innocent party that must bear the loss resulting from this kind of theft because, when you get down to it, that's the way the rules work. Were it able to make itself whole by shifting the loss to another, that other would itself be an innocent party in no better position to bear the loss.

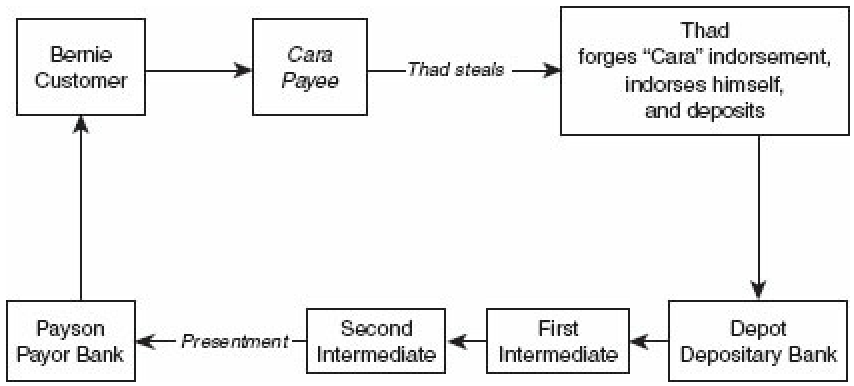
The result here is not an invention of the drafters of the Uniform Commercial Code. It is generally referred to as the "rule of *Price v. Neal*," after the early English case that first set out the principle. Subsequent renditions of the law of negotiable instruments, up to and including the 1990 revisions to Articles 3 and 4 of the U.C.C., have retained the rule. See Comment 3 to §3-417:

> [S]ubsection (a)(3) retains the rule of Price v. Neal, 3 Burr. 1354 (1762), that the drawee takes the risks that the drawer's signature is unauthorized unless the person presenting the draft has knowledge that the drawer's signature is unauthorized.

At the time of its origination in the mid-eighteenth century, the justification for this "rule" would have been that a drawee bank, which would presumably have made a sight inspection and individual determination of whether to pay any check coming to it for payment, would be in the best position to compare the drawer's signature on the check with the sample of the drawer's signature it had on file, and thus to catch the forgery. The rule, as we have seen, has continued unchanged even to this day, when the processing of checks takes place in a very different environment and in very different ways. Whatever rationale there is behind the rule today has to be more than simply persistence of a classic case and a time-honored tradition. It can be argued that the drawee bank, even if it was not lacking in ordinary care in paying this instrument automatically, is still in the best position to determine what level of scrutiny to give to checks presented to it for payment. It cannot and will not sight-examine each and every item; that would simply be too expensive and unwarranted by the level of risk it faces by honoring most checks presented without this kind of special treatment. The drawee bank can, however, set up its computerized systems to sift out for special attention unusually large or otherwise questionable items. Had Thad forged this check to himself for $70,000, let us say, and this is an unusually high amount for a check that passes through Andrew's account, it is unlikely that Payson's computers would have paid it as a matter of course. The bank would have taken more time with the check, comparing the signature on it to the specimen signature of Andrew that it had on file. Even if the forgery was a good one, and the signature looked authentic, someone at Payson might have personally contacted Andrew to inquire whether he had indeed drawn the check in question. Thus the drawee-payor bank is left, by the rule of *Price v. Neal*, to make its own cost-benefit analysis of what level of safeguards it wants to build into its check payment system to reflect the fact that it will have to bear the loss of any forged check it pays.

In this particular example (and in probably the great majority of situations), the thief, having not been overly greedy, the forged check was paid as a matter of course and the loss was left to be borne by the payor bank. Because all banks that carry on this kind of business will end up bearing their share of loss on such forged items, the loss to thieves of Thad's ilk is thought of as roughly balancing out, with each bank taking its share of such losses. The end result is that losses of this type end up being considered as just another cost of doing business for banks like Payson and any other bank that offers checking account services. The cost thus gets spread out among all checking account customers, such as you and I.

My diagram has the situation looking like this:



As to the first question presented, no, Bernie is not obligated to send Cara a second check to repay the loan. Upon Cara's receipt and taking of the first check, Bernie's repayment obligation was suspended under §3-310(b)(1). This suspension continues until the check is dishonored "or until it is paid or certified." This check has not been "paid" under the definition of §3-602(a), because payment was not made to a person entitled to enforce the instrument. Thad was not entitled to enforce the instrument because the supposed indorsement of Cara that it bore was forged. Thad is not a holder of the check. The suspension of Bernie's obligation to Cara thus carries on indefinitely, as Comment 4 to §3-310 makes clear. Bernie is not obligated to send Cara a second check, but he may of course do so if he wishes, and if he trusts Cara sufficiently. (You may want to refer back to the explanation given in connection with Example 5b of Chapter 6.) In this scenario as we first work it through, we will assume that Bernie does.

No, Bernie cannot bring a conversion action against anyone for the wrongful payment of this check. The last sentence of §3-420(a) explicitly states that a conversion action may not be brought by the issuer of the instrument. This language was added to Article 3's section on conversion (previously numbered §3-419) to clarify an issue that had divided the courts. See the second paragraph of Comment 1 to the current §3-420.

As the comment you just read concludes, "The drawer has an adequate remedy against the payor bank for recredit of the drawer's account for unauthorized payment of the check." The first check that was paid by Payson was not a properly payable item. It bore a forged indorsement. Therefore, Payson does have to recredit Bernie's account for the $1,200 it subtracted from his account balance when it wrongfully paid that check.

No. Once again we rely on the basic principle that the payor bank does not receive the transfer warranties from anyone. There was no transfer of the check to Payson, but rather a presentment.

Yes. Payson as the payor bank may assert, under §4-208, the breach of any presentment warranty against the party that presented the check, which would be Second Intermediate, or against any "previous transferor," which would include First Intermediate, Depot Bank and of course Thad. In this situation, unlike the one we explored in the first example, there has in fact been a breach of a presentment warranty. Recall that the warranty set out in subsection (a)(1) is (in the words of Comment 1 to §3-417) "in effect a warranty that there are no unauthorized or missing indorsements." Here the indorsement purporting to be that of Cara is indeed unauthorized; it is an out-and-out forgery. Payson can assert the breach of this (a)(1) warranty against either of the intermediary banks or against Depot Bank. Payson could also try to bring suit against Thad as well on this theory, but we have to assume that its doing so would only be an exercise in frustration. Thad isn't anywhere to be found, much less served with process.

Payson was not obliged to make its claim for retribution against Second; it could have gone against First or Depot instead. But it certainly was free to do as it has done in going against Second, and so we look at the situation as we then find it. Second Intermediate Bank would not be able to assert any claim of a breach of any presentment warranties that ran to it. Second received no presentment warranties as the check passed through its hands. Second did, however, receive the full panoply of *transfer* warranties of §4-207 from the customer (Thad) and the various collecting banks that were upstream of it as the check flowed (that is, First Intermediate and Depot National). Each of these parties could be held responsible to Second Intermediate for a breach of the warranty set forth in (a)(2), as the signature of Cara on the check was most definitely unauthorized. Second could bring a claim for reimbursement directly against Depot. If instead Second brought its claim against First Intermediate, as it would have every right to do, then First would in turn have the right to proceed against Depot on the transfer warranties that First received, along with the check, during the flow downstream.

One way or another, Depot is going to end up having to bear the loss of this money. It retains the right to go against Thad, of course, but, as we have already concluded, this right is at least in this instance more theoretical than real.

Yes. Cara may bring a conversion action against Thad, under the first sentence of §3-420, but that is not likely to get her anywhere. She may also bring an action, based on the second sentence of that section, against either Payson Bank or Depot Bank. Notice that she may *not* assert liability for conversion against either of the two intermediary collecting banks, First Intermediate or Second Intermediate, because of the special rule laid out in subsection (c) of §3-420. These banks just served as mere conduits, for the paper check and the flow of funds through interbank settlements, in the processing of the check. Were Cara to be extended the opportunity to assert conversion against either of these two banks, all it would mean is that those banks in turn would have to move the loss upstream in a separate action or series of actions. Subsection (c) cuts out the middlemen, so to speak, because there is nothing to be gained in allowing the owner of the check to bring an action based on conversion against them other than in instances (which have to be extremely rare) in which the intermediary bank still retains some of the "proceeds [of the item] that it has not paid out."

Cara has decided to go against Payson in conversion and has been successful. Payson may now assert the breach of a presentment warranty—that found in §4-208(a)(1)—against Depot.

The route we and the parties have taken is different, but the result is, as you would hope, the same. Depot, the depositary bank that took the check bearing a forged indorsement from the forger, ends up bearing the loss. Once again, Depot does have any number of ways to go against Thad, but we have to assume that in all reality they add up to one big fat zero.

Yes. Nothing in the text of §3-420 bars Cara from bringing a conversion action against Depot directly. That bank will have to pay up and, as in the two preceding examples, will be the party that ultimately bears the loss of the $1,200 made off with by Thad the thief.

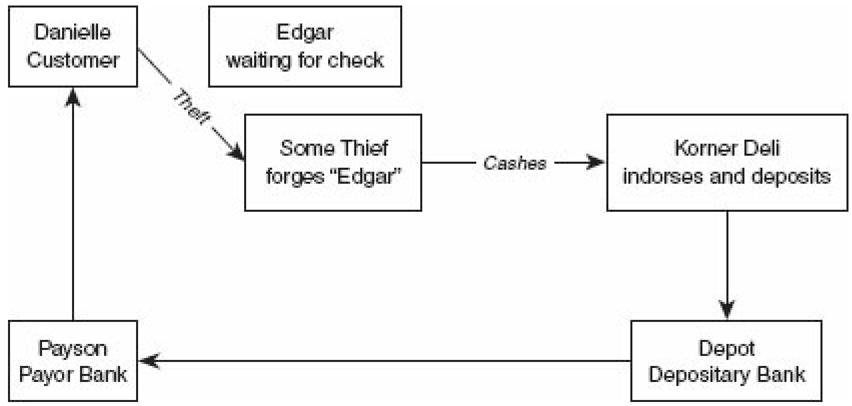
> You might wonder why I set aside a whole example just to ask what turns out to be a particularly easy question. The explanation is that although the question causes no difficulties for us today, with the present revised 1990 version of Article 3, the result would have been otherwise prior to that revision. The section in the prerevision Article 3 dealing with the nature of conversion explicitly extended the defense, which we have already seen in the current §3-420(c), to cover *depositary* banks as well as intermediary banks. The result was that a party in Cara's position would have been forced to bring her conversion action against the drawee-payor bank, which, upon paying up, would have then had to bring a separate

action (based on the breach of a presentment warranty) against the depositary bank.

This situation worked an especially great hardship (and for no apparent benefit that anyone could make out) on a party from whom a large number of checks, and not just a single check, had been stolen. Imagine that Thad had stolen from the top drawer of Cara's bureau, say, a dozen checks that had been issued and sent to Cara by a dozen different drawers on a dozen different drawee banks spread all over the country. Thad then takes all these checks, forges Cara's indorsement on the back of each, and then deposits them together (for a total of, say, $4,568) into Depot National Bank. Thad then makes away with all the money before anyone can stop him. If, as was true under the language of the prerevision Article 3, Cara could not bring a conversion action directly against the Depot bank, it would be necessary for her to bring 12 separate conversion actions, one against each of the 12 distinct drawee banks. Each of these 12 banks would in turn have had to bring a distinct action, based on the check it had wrongfully paid, against Depot. If all worked out as it should, the end result would be Cara retrieving (in 12 chunks) her $4,568 and the Depot bank being liable in 12 different actions for a series of judgments totaling that same amount, $4,568. You can understand why commentators and some courts were so critical of the rule, barring as it did someone in Cara's position from bringing one simple action for recovery on the conversion theory against the depositary for all that had been stolen, no matter the number of checks and the multiple jurisdictions in which each of the several drawee banks was located.

The revised version of Article 3 did away with this whole controversy, and the entire problem, by "adjusting" the language that now appears in §3-420(c) so that it does not offer any immunity from a conversion action to the depositary bank. See Comment 3 to this section.

As you will no doubt have already told Danielle and Edgar, the loss of the money represented by this check is as of this moment on Danielle.

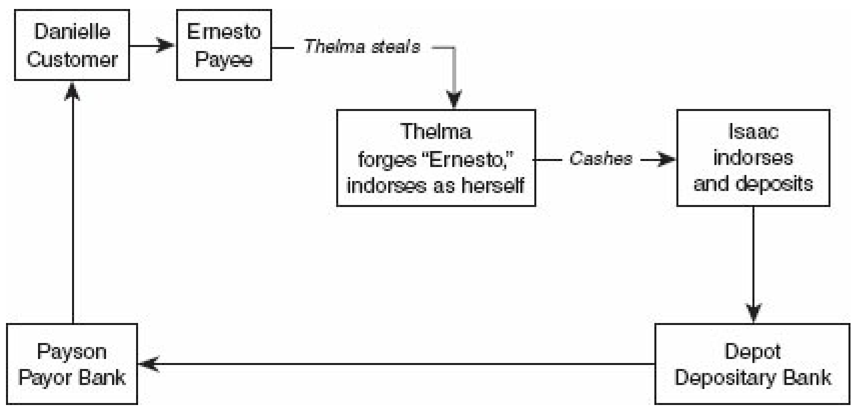


First of all, recall the rule of §3-310(b)(1). Danielle has a preexisting debt to Edgar. She puts a check in the mail to meet that debt, but the check never arrives. Under §3-310(b)(1), her underlying obligation to Edgar, whatever its genesis, would have been suspended only when Edgar "took" the check. Edgar never took this check; he never had a chance to. Therefore, Danielle's underlying obligation to Edgar has not been suspended, much less discharged, by the mailing of the check and its eventual charge against Danielle's account. Danielle must pay Edgar what she owes him and then confront the fact that $124 has been charged against her account by Payson State Bank when it should not have been.

Notice this result also comports with what we find in the last sentence of §3-420. A conversion action may not be brought by "(ii) a payee … who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee." If we were to conclude that, as of this moment, the loss of the $124 is Edgar's to bear, there would be no way for Edgar to move the loss onto anyone else's shoulders. He would end up bearing the loss by the theft of some of his property that he never had possession of in the first place. Placing the loss initially on Danielle may not be a result that particularly delights her, but at least she will have some way of recovering that loss so that she ultimately does not have to bear it.

How should Danielle proceed to make sure she isn't stuck holding the $124 bag? She should contact Payson and convince them that this was not a properly payable item, because it bore a forged indorsement. Payson must then recredit Danielle's account with the amount. Payson can then bring an action based on the breach of a presentment warranty (because the check bore a forged indorsement) against any intermediary bank that passed on the item, against Depot National Bank, against the Korner Deli, or finally against the thief (whatever his or her name may be)—if it can even figure out who that person was. If Payson sues up the chain some party other than the deli, the party onto whom the loss is then temporarily shifted (say, Depot Bank) can then itself sue the Korner Deli on a breach of a warranty of transfer. Ultimately the loss will be borne by the deli unless it can identify, locate, and get its hands on (metaphorically, of course) the thief who cashed the check either pretending to be Edgar or that the signature of "Edgar" on the back of the check was the real thing.

Ernesto, unlike Edgar of the previous example, having actually received the check prior to its being stolen, is in a position to bring a conversion action under §3-420 based on the fact that payment was made to "a person not entitled to enforce the instrument or receive payment."



He could bring such an action against Isaac, who has "taken the check by transfer, other than a negotiation, from a person not entitled to enforce the instrument," or against either the Payson or Depot bank. If he does recover his money from either of the banks, that bank would act to recover the loss from Isaac, calling upon either the presentment warranties (in the case of Payson) or the transfer warranties (for Depot). Ultimately, Isaac will bear the loss of the $300.

The general result when a theft of this kind, involving a forged indorsement, has occurred is that the party who took the instrument directly from the forger —the first party downstream of the villain—should end up as the one ultimately bearing the loss. In many cases, such as we saw in Examples 2 through 4, that party will end up being the depositary bank. In others, such as this and the preceding example, it will be a private party who has taken the check from the thief, usually having cashed it or given goods or services in return.

This result, although it doesn't come with a convenient handle as does "the rule of *Price v. Neal*," which we looked at earlier when a different mode of thievery was involved, does share with that rule an important feature: It is a rule of strict liability. The party who has taken an instrument bearing a forged indorsement directly from the forger should end up bearing the loss even if nothing in the particular situation could bring into question that party's good faith or its exercise of ordinary care. Some innocent party has to bear the loss, and the rule has evolved that the loser should be the one who took directly from the thief, even if that party was undoubtedly acting in good faith and can legitimately claim to have done everything within reason considering his, her, or its situation to avoid taking an instrument with a phony indorsement. What justification there is for this result—other than that some innocent party has to bear the loss and no better candidate obviously comes to mind—lies in the fact that the party who takes from the forger, having actually had some sort of direct contact with the malefactor, is in the best position of any of the parties involved to catch the forgery, or, if that is not possible (forgers can be very good at what they do), at least to make a knowing and reasonable, if not necessarily precise and quantifiable, cost-benefit analysis of how much care to take to bring down to a tolerable level the number of instances when it will be made to bear this form of loss.

We cannot reasonably expect that loss due to forged indorsements can be avoided altogether. There is still money to be made in thievery. To the extent that loss of this type is often (probably most often) borne by a depositary bank, the costs end up being spread—as with the rule of *Price v. Neal*—among all checking account customers. When the loss is borne by another private party, such as the Korner Deli in Example 5 or Isaac's Liquor Store in this example, it ends up being factored into the cost of doing business for that enterprise. The Deli or the Liquor Store could, of course, adopt a rigid policy of never cashing so-called third-party checks (such as we saw in this example) or of never cashing any checks, but it may very sensibly determine that such a stance would hurt more than it would help, by alienating longstanding and trusted customers or by driving away new business. In the present example, if Isaac had refused to take the check from Thelma, she would most likely simply have taken her business elsewhere. In the particular instance, this would have been just fine with Isaac, who now knows that Thelma is a thief and passed to him a check on which he will not be able to collect. We have to remember, however, that the great majority of checks are just fine; they do not bear a forged drawer's signature nor any forged indorsement. For Isaac to refuse to take any checks because of the slight, if foreseeable, risk involved in doing so might just cut into his sales significantly if other liquor stores in the area were not so picky.

You should be careful not to fall into the trap of assuming that anyone who takes a check bearing a forged indorsement must have been negligent in some way, or lacking in "ordinary care" as that term is defined in §3-103(a)(7). There is simply no way that a party taking a check can make an in-depth inquiry of each and every indorsement on the instrument. Even if this were possible, we have to acknowledge that any forger who is willing to put in the time and effort should be able to come up with a reasonable likeness of the necessary signature, and with some reasonably convincing (if phony) supporting identification, which always helps. In some situations, of course, it may be appropriate to charge the party taking the instrument with a lack of ordinary care, because of the too-casual or sloppy way it handled the transaction. But that is another story, which we take up in Chapter 18. For the moment, the general rule —that the loss due to a forged indorsement ends up lying at the doorstep of the party who took the instrument from the forger, irrespective of any lack of ordinary care—is what we need to go with.

I'm sorry to say for Lacky, but this one doesn't even seem to rate a diagram. Lacky has no one from whom he will be able to get relief, Mugsy being for all practical purposes out of the picture as far as potential defendants go. Lacky has no cause of action for conversion against anyone downstream from Mugsy. Payment has been made on the check, but to Mugsy, who for all of his faults is still a holder of the instrument and hence a person entitled to enforce it. Remember the general result, which we saw early on, that the thief or finder of bearer paper does indeed become a holder of that paper. Negotiation of bearer paper requires only the transfer of possession, "whether voluntary or involuntary," of that instrument (§3-201(a) and Comment 1 to that section). Nor will Lacky have any more luck trying to get another check in the same amount from Ms. Boss, arguing that he never received the pay due him. His taking of the check suspended Ms. Boss's obligation to pay her employee for his services, and payment of the check resulted in "discharge of the obligation to the extent of the amount of the check" (§3-310(b)(2)). This check was paid, under §3-602(a), because payment was made to a person, Mugsy, who was entitled to enforce the instrument. Lacky has lost and will not be able to retrieve the money represented by the check he was carrying around in bearer form, as surely as he has lost the wallet it was being carried in and any cash or other valuables that might have been tucked away in that wallet as well.

The general rule applicable to the theft of a check in bearer form should be painfully clear. The party who was holding it at the time of the theft bears the loss, with the only hope of recovery being if the thief can be identified and made to pay back what he or she has stolen. There is a lesson here for all of us: Never carry around more bearer paper than you can afford to lose.

We turn at the end to problems of alteration. Payson is obligated to recredit Boss's account with $900, not the full $1,025 it has charged her account. What Sammy has done is clearly an "alteration" under §3-407(a)(i). Under subsection (c) of §3-407, Payson, as the payor bank that paid the fraudulently altered item, "may enforce rights with respect to the instrument … according to its original terms." Subsection 4-401(d)(1) tells the same story: "A bank that in good faith makes payment to a holder [and Sammy is that] may charge the indicated account according to … the original terms of the altered instrument." So Payson *may* charge Boss's account with the $125 that the check was originally made out for. It may *not* charge her for the $900 that Sammy added on by his alteration.

Payson may assert a breach of the presentment warranty set forth in §4-208(a)(2), resulting in a loss to it of $900, against any bank that handled the check for collection, including Depot National. If Payson were to assert its claim against any intermediary bank, that bank could just pass the loss onto Depot by virtue of the transfer warranty of §4-207(a)(3). So Depot ends up bearing the loss. It can, of course, go against Sammy in an attempt to make itself whole, but we have stipulated that he is penniless, so what good would that do?

Notice that the result we have come to does not depend on any showing that Depot took the check in bad faith or that it failed to take ordinary care. Sammy's alteration might have been clumsy and crude, the kind of work just about anyone with any sense would question, or it might have been done with such skill and artistry that it could have not been caught by even the most careful visual examination. Either way, Depot has to bear the loss of the $900.

M.R.S., Inc., will have to assert a claim of conversion of the instrument. It may assert this claim against either Payson or Depot. Should it go against Payson and receive redress from that bank, then Payson could use the breach of a warranty of presentment against Depot. Thus, Depot ultimately bears the loss occasioned by the alteration. Note also that Martha Kent has the right to have her account fully recredited for the $1,200 that was deducted from her account, because the item was not properly payable. It looks now as if Martha has gotten her medical services from M.R.S., Inc., but has in effect had them paid for by Depot National Bank. Perhaps Depot can recover from Martha on the theory of restitution under §3-418(b) if the common law of restitution of the governing jurisdiction will allow it. Note also the language of §4-208(c):

> If a drawee asserts a claim for breach of warranty under subsection (a) based on an unauthorized indorsement of the draft or an alteration of the draft [which is what Payson will have asserted against Depot to shift the loss to that bank], the warrantor [Depot] may defend by proving that … the drawer [Martha] is precluded under Section 3-406 or 4-406 from asserting against the drawee [Payson] the authorized signature or alteration.

The referenced sections, §3-406 and §4-406, are covered in Chapters 18 and 19, after which you will be able to appreciate how they fit into the grand (and admittedly very complex) scheme of things.

I might point out that this example, though of my own devising, was inspired by a problem that comes up each year around April 15 when payment of federal taxes is due. The instructions accompanying the standard tax forms call for any payment made by way of a check to have the check made out to "United States Treasury." Unscrupulous tax preparers have been known to instruct their clients to make out the necessary check simply to "IRS" and to hand it over to the preparer for delivery to the Internal Revenue Service along with the completed tax form. Changing "IRS" to "MRS." is not apparently all that difficult (if you are of a mind to), and the rest of the plot follows the story we have just seen.

The general rule with respect to theft by alteration ends up the same as that when a forged indorsement is involved. The loss to the thief will normally be borne, regardless of good faith or lack of negligence, by the party who took the instrument directly from the alterer.

The facts of this example are essentially those that faced Judge Richard Posner and his colleagues on the Seventh Circuit in *Wachovia Bank, N.A. v. Foster Bankshares, Inc.*, 457 F.3d 619, 60 U.C.C.2d 1126 (7th Cir. 2006). As Judge Posner summarized the situation:

So the case comes down to whether, in cases of doubt, forgery [that is, the creation and presentation of a forged check] should be assumed or alteration should be assumed. If the former, Foster wins, and if the latter, Wachovia.

So which assumption was it to be? The opinion continues:

It seems to us that the tie should go to the drawer bank, Wachovia. Changing the payee's name is the classical alteration. It can with modern technology be effected by forging a check rather than by altering an original check, but since this *is* a novel method, the presenting bank must do more than merely assert the possibility of it.

This result—what a district judge soon thereafter characterized as the legal equivalent of baseball's "ties go to the runner" rule—was followed in *Bank of North America, N.A. v. Mazon State Bank*, 2007 U.S. Dist. LEXIS 68515, 63 U.C.C.2d 994 (N.D. Ill. 2007), a case in which a $200,000 check originally bearing the name "University of Chicago Law School" ended up being presented to the payor bank bearing the name "George Murdaugh" as the payee. This case differed from *Wachovia Bank* in that the check as presented had not been destroyed but was still in existence and subject to forensic analysis by experts employed by both parties. Unfortunately for Mazon, the depositary bank, its expert was unable to give a definitive opinion as to whether the check was altered or forged. So the factual question of whether this was an alteration or a forged-check case was still very much in doubt. The district court judge, therefore, followed *Wachovia Bank*, the law of his circuit (and, one gathers, his understanding of the rules of baseball) and went with the assumption that this was a case of alteration, not of a forged instrument. The game was won by Bank of America, the payor bank.

As it turns out, however, the game may not be being played under identical rules nationwide. In the same year that Judge Posner issued his ruling for the Seventh Circuit in the *Wachovia Bank* case, a similar case was being decided by the Fourth Circuit. *Chevy Chase Bank, F.S.B. v. Wachovia Bank, N.A.*, 208 Fed. Appx. 232, 61 U.C.C.2d 458 (4th Cir. 2006). A check in the amount of $341,187.45 drawn on an account at Wachovia was deposited in an account at Chevy Chase. While the check had originally been drawn with the payee given as "Hearst Magazines Division," at the time of the deposit the payee was rendered as "Kon Pesicka/CJ International." Wachovia paid the check but then sought repayment from Chevy Chase based on its assertion of a breach of the presentment warranty. Once again the question was whether the check, which had been destroyed and of which only a digital copy was available, had been forged or altered. The trial court had proceeded on the premise that Wachovia could succeed only if it could produce sufficient evidence showing that the check had in fact been altered as opposed to counterfeited. The court concluded that Wachovia had failed to offer up sufficient proof as, working with only the digital image, its forensic expert testified that he could not say with a reasonable degree of scientific certainty that the check had been altered rather than forged. The Fourth Circuit affirmed. As the Court of Appeals concluded,

In these circumstances, Wachovia has failed to offer any evidence from which a reasonable factfinder could conclude that the check was altered as opposed to counterfeited. Accordingly, Wachovia cannot carry its burden of proving that Chevy Chase breached its warranty of presentment, and its claim against Chevy Chase fails.

So in the Fourth Circuit, at least, it would appear that in this type of situation ties go not to the payor bank (arguing that it had been presented with an altered check) but to the depositary bank (arguing that what was presented was a forged or counterfeit check for which the payor bank must take the risk).

The dispute between the two banks is in your court, which is in neither the Seventh or Fourth Circuit. Which way do you decide?

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* It might have struck you at this point that whichever party we eventually find is going to have to bear the loss occasioned by the theft should insure against this type of loss. This, of course, just begs the question. Once we have determined the legal rule as to who must bear the loss in a given situation, then it may make sense for that party to pay for insurance covering the type of loss in question. An appropriate form of insurance may indeed be available. Many homeowner's insurance policies, for instance, provide coverage for losses due to stolen or forged checks, and businesses can purchase similar insurance. In some situations it may turn out that the ultimate risk-bearer will reasonably decide to "self-insure" against such losses; that is, to consider them over time as just another inevitable, recurring, and to some degree predictable cost of doing business. But it makes no sense for a party to insure against a loss that it will not be made to bear. So the answer to the question of who may even have to consider the insurance option depends on what we will conclude, upon investigation, about who will be made to bear the risk of loss as a matter of legal principle.

* When you get to the examples involving alterations made to a check, you will want to consult §4-401(d)(1), which gives the variant of the properly payable rule as it applies to altered items.

CHAPTER 18

Special Rules for Special Situations

CIRCUMSTANCES DESERVING OF SPECIAL ATTENTION

In Chapter 17 we encountered the basic rules of loss allocation when theft by check has occurred. If the theft was accomplished through forgery of the drawer's signature, the loss will fall on the drawee bank that paid the check bearing the forged signature of its customer. That's the rule of *Price v. Neal*. If the thief makes away with his or her ill-gotten gains by virtue of a forged indorsement or an alteration, the loss ultimately comes to rest on the party who took the check directly from the thief. Those are the general results as they have been handed down to us by history and as they are presently generated by application of the Code's sections on proper payment by the drawee bank, warranties of presentment and transfer, and conversion. Although private parties may get caught up in the proceedings, the losses arising from theft most often end up falling on one bank or another, either the payor bank in the case of a forged drawer's signature or the depositary bank that took a check bearing either a forged indorsement or an alteration. Such losses are usually thought of as most appropriately borne by the banking system—a system that should, at least in theory, be in the best position to develop an appropriate level of safeguards against such misbehavior and that can, in effect, spread the inevitable losses deriving from theft by check among all customers who take advantage of the banks' services by making use of checking accounts.

The history of negotiable instruments law has always recognized, however, that there are some special circumstances in which the application of these general rules should not be the end of the story. For one reason or another, in these instances there is a party who, it seems, should much more appropriately bear the loss. Any attempt to generalize about this set of exceptions or to encapsulate them in a single sentence, other than to say that each will make sense in its own context, is, in my experience, doomed to failure. I won't even try. The present version of Article 3 sets them forth in three sections—§§3-404, 3-405, and 3-406—each of which can cover multiple special varieties of thievery. We'll begin with a brief, bare-bones look at each of these sections, and then put the flesh on the bones through the examples and explanations.

IMPOSTORS AND FICTITIOUS PAYEES—SECTION 3-404

Section 3-404 pulls together three separate instances when the nature of the theft may justify the loss being borne by the drawer-customer rather than anyone else who has handled the item.* First of all, in subsection (a), the section deals with the case in which the drawer writes a check but is "induced" or duped into handing it over to an impostor, a thief posing as the payee. Subsection (b) covers two distinct situations. In the first, "the person whose intent determines to whom an instrument is payable … does not intend the person identified as payee to have an interest in the instrument." In the second, "the person identified as payee of an instrument is a fictitious person," that is, someone who does not exist except in the mind and the plans of the thief. If there is anything these three situations have in common (other than the fact that the drafters of the most recent version of Article 3 have put them into the same section), it is that in each instance the drawer has been duped into issuing a check to the wrong party or to a party who plans to use the check for purposes other than what the drawer intended. The dupe, as we will see in the examples, is then made to bear the loss, which at least in theory he or she might have been able to avoid with a little more care. The loss is best thought of not as a loss to be borne by the banking system in general, but as one to be borne by the person or enterprise that issued a check under such circumstances.

FRAUDULENT INDORSEMENT BY A “RESPONSIBLE” EMPLOYEE—SECTION 3-405

Subsection 3-405(a) goes to great lengths, as you can see, to define when an employee can be said to have “responsibility with respect to” a particular instrument. Under subsection (b), if an employer entrusts an employee with responsibility with regard to a particular check, and that employee fraudulently indorses the check, the loss because of the thieving employee will be shifted to the employer. Note that, under §3-405(a)(2), “fraudulent indorsement” comes in two varieties. In the first, the faithless employee indorses the name of the employer on checks that have been issued to the employer and on which the employer is the named payee. The second variety of fraudulent indorsement occurs when the employer has issued a check intended for another named payee and the “responsible” employee forges the indorsement of the named payee. In either situation, Article 3 works to shift the loss onto the employer. This certainly makes sense. If an employee steals from an employer by taking money from the petty cash drawer to which he or she has been given access, or by making off with a valuable piece of office equipment with which he or she has been entrusted, the loss is quite rightly borne by the employer. The same will be true of checks that an employee has been given the responsibility to handle. Losses of this sort are deemed to be part of the cost of doing business and thus should be borne by the employer.

ACTUAL NEGLIGENCE—SECTION 3-406

Up to this point, none of the rules we have looked at regarding loss due to theft have depended on any showing that the party who will be made to bear the loss acted with anything less than “ordinary care” (look again at the definition of §3-103(a)(7)) in the particular instance. The general rules of loss attribution that we discovered in the previous chapters, and the special results generated by §§3-404 and 3-405, nowhere call for a showing that the ultimate loss-bearer did not observe, in the case of a person engaged in a business, "reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged."* In the situation of wrongful indorsement by a responsible employee, covered by §3-405, for example, there is no need for any other party to show that the employer was negligent in hiring this particular person who turned out to be an embezzler or was negligent in its supervision of the miscreant. The result turns only on the facts that the employee was entrusted with responsibility with respect to the instrument and then took advantage of the situation to make off with some money that did not belong to him or her. Even the best people sometimes go wrong. Even the most intricate monitoring systems that an employer might reasonably think of adopting to keep tabs on the day-to-day functioning of its operations can be circumvented by a determined thief. The risk that something like this will occur with even the most carefully vetted and supervised employee is thought properly to rest with the employer. The employer is made to bear the risk not because it acted negligently in the given case, but because it is thought to be in the best position of any party to evaluate the risk and to take the appropriate level of care, balancing the additional cost of doing even more against the foreseeable risks, to keep losses to a tolerable level.

There are situations, however, when one or another of the parties involved with a check *has* actually failed to exercise the level of care we would expect of someone in that party's position. When this is the case, it makes sense to place at least some of the loss on that party, because of its lack of care that either made the theft possible or at least made it easier for the thief to carry through (and perhaps encouraged the thief to give it a try). Under Subsection 3-406(a):

> A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or collection.

We will look at some instances calling for application of this section, which would not be covered by either §3-404 or §3-405, in the examples.

One point that needs to be explored here is that, while both §§3-404(d) and 3-405(b) are worded in a way to allow them to serve as the basis of an affirmative cause of action (note the language “may recover”), §3-406 speaks only of “preclusion.” There follows from this an argument that, unlike §§3-404 and 3-405, this section cannot be the basis for an affirmative cause of action. Comment 1 seems to say as much when it declares, “Section 3-406 does not make the negligent party liable in tort for damages resulting from [in the situation there being discussed] the alteration.” The comments are, however, not controlling law, and some Code authorities and earlier cases were able to argue or conclude that it was possible under some situations, rare though they might be, for a customer to bring an action against the depositary institution based on its argued lack of care under §3-406 directly when all other routes of recovery would be, for one reason or another, unavailing. More recent cases, and in particular the Supreme Court of Virginia in the carefully-considered case of *Halifax Corp. v. Wachovia Bank*, 268 Va. 641, 604 S.E.2d 403, 55 U.C.C.2d 208 (2004), have held that §3-406 does not create an affirmative cause of action. Section 3-406 serves in the proper situations, as the saying goes, as “a shield but not a sword.” It may be invoked to create a legitimate defense, but not an affirmative cause of action. See also, *Continental Casualty Co. v. Compasss Bank*, 2006 U.S. Dist. LEXIS 13001 (S.D. Ala. 2006), in which the United States District court concluded that Alabama courts would adopt the reasoning and result of the *Halifax Corp.* case, and *Burns v. The Neiman Marcus Group, Inc.*, 173 (Cal.App.4th, 93 Cal.Rptr. 3d 130, 68 U.C.C.2d 636 Cal. App. 2009), concluding the same to be the law in California.

ENTER COMPARATIVE NEGLIGENCE

Prior to the revision of Articles 3 and 4, the system of loss allocation dealing with theft by check worked on an all-or-nothing principle. Similar to and no doubt influenced by the doctrine of contributory negligence prevailing in the law of torts prior to the 1960s, earlier versions of Articles 3 and 4 were written so that however the game was played, the loss due to theft would eventually have to be borne in its entirety by one party or the other. There was no mechanism for splitting of the loss even when the situation seemed to suggest that this would be the fair and equitable thing to do. Since the 1960s, as you will recall from your introductory course in torts, the general law of torts has switched to what is referred to as a comparative negligence regime. If two parties were both negligent and the negligence of each contributed to the injury involved, then the two parties will be made to share, on some basis, the monetary damages that ensue.

One of the major changes wrought by the revision of Articles 3 and 4 (effective as of 1990) was incorporation of this comparative negligence principle into the overall scheme for allocation of losses due to theft by check. See, for example, Subsection (b) of §3-406:

> Under subsection (a) [quoted above], if the person asserting the preclusion fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to the loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.

See also the beginning of Comment 4 to this section. So, if party *X* asserts against party *Y* a failure to exercise ordinary care that substantially contributed to the alteration or forgery of a signature on an instrument, *Y* is then free to assert against *X* its own lack of ordinary care that substantially contributed to the loss. If both parties were negligent, the loss will be split, apportioned between the two "according to the extent to which the failure of each to exercise ordinary care contributed to the loss." You will find similar invocations of the comparative negligence principle in the two other U.C.C. sections investigated in this chapter. See Subsection 3-404(d) and the second and last sentence of §3-405(b).

It is important to note that the possibility of actual negligence on the part of any person still does not enter into the picture if we are dealing with the general rules of loss allocation covered in Chapter 17. Those general results are taken as matters of strict liability, and the question of whether there has been actual negligence by anyone in dealing with the particular check involved simply never comes up. However, once a party, in order to get out from under the burden that would normally fall upon it by virtue of those general rules, brings into play any of the special rules of §3-404(a) or (b), §3-405(b), or §3-406(a) to shift the loss onto another, then the party against whom the special loss-shifting rule is being asserted has a right to prove if it can the “lack of ordinary care” of the party invoking that special rule. If it succeeds in its proof, then the concept of comparative negligence comes into play, and the two parties (or maybe more if things have gotten especially complex) end up sharing the loss.

Examples

Arnold Moneybucks has been negotiating over the phone with one Hy Pile, a dealer in oriental rugs, for the purchase of a particular expensive rug that Pile advertised for sale in the local paper. Eventually, Pile offers over the telephone to have the rug in question delivered to Arnold’s office, where Arnold can inspect it and make a final determination of whether he wants to pay Pile’s asking price of $38,000. The rug is delivered to Arnold, who immediately decides that he loves it and that it is well worth the price. The next day a well-dressed gentleman appears at Arnold’s office and introduces himself as Hy Pile. He asks whether Arnold has made a decision on the rug. Arnold tells his visitor that he does indeed want to buy it. He writes a check to the order of Hy Pile for $38,000 payable out of his account at Payson State Bank and hands it over to his visitor. As it turns out, this gentleman is not Hy Pile but is instead one Thad, a drinking buddy of one of Pile’s delivery persons, who has picked up enough information to figure out basically what is going on between Arnold and Pile. Thad takes the check, forges Hy Pile’s signature on the back of it, and then deposits it in his own account with Depot National Bank.

By the time the ruse is discovered a few days later, when the real Hy Pile calls Arnold to ask whether he has made a decision about the rug, Thad has vanished, taking with him the $38,000, which he has withdrawn from his account. Arnold immediately notifies Payson and demands that his account be recredited with this amount because the check that was paid bore a forged indorsement. Does Payson have to accede to Arnold’s demand? See §3-404(a).

Suppose instead that Arnold receives a call from someone purporting to be Pile, requesting that if Arnold wants to keep the rug he send a check made out to “Hy Pile” to a particular address. The caller is (of course) Thad and the address that of Thad himself. Thad gets the check, forges Pile’s name, and again makes away with the money. What is the result here?

Now suppose that Thad does not intrude himself into the situation. When Pile calls Arnold to inquire about the rug, Arnold tells Pile that he definitely wants it. Pile tells Arnold that his assistant, Ms. Knapp, will soon be coming around to Arnold's to pick up a check for the price. Sure enough, later in the day someone introducing herself as Ms. Knapp comes by and asks for the check. Arnold hands over to her the $38,000 check. It turns out that the woman in question is not Ms. Knapp, but one Thelma, a customer in Pile's store who happened to overhear the conversation between Arnold and Pile. Thelma takes the check, forges Pile's signature on it, and deposits it in her account with Downtown National Bank. She later withdraws all the money from this account and makes off for parts unknown. Who bears the loss of the $38,000 that Thelma has taken with her?

Finally, suppose the following: Pile calls Arnold and, upon being informed that Arnold wants the rug, tells Arnold that he will come around within a few days to pick up a check for the price. Later in the day, the real Ms. Knapp comes to Arnold's office. She explains to Arnold that she is Mr. Pile's personal assistant (as indeed she is) and that Mr. Pile has instructed her to come to Arnold's office to pick up a check due him. Arnold gives Ms. Knapp a check made out to Hy Pile for $38,000. Ms. Knapp then forges Pile's signature on the back of the check and deposits it into her own account with Deep River Bank and Trust. Several days later, she withdraws all of her funds from this account, which now includes the $38,000, and goes to the racetrack, where she proceeds to lose everything. When Pile eventually discovers what has happened, he comes to Arnold's office to demand another check for the price of the rug. He tells Arnold, truthfully, that he never authorized Ms. Knapp to pick up the check on his behalf or to deal with it in any way. His voice rising, he asks, "What made you give it to her in the first place? I told you *I* would pick it up!" Assuming that Ms. Knapp is in no position to pay anybody the $38,000 she has made off with and lost on the horses, who must bear the loss of this amount?

Hamilton is the treasurer of the DotCom Corporation. As such, he is authorized to sign, without the co-signature of any other officer, checks for up to $50,000 drawn on the company's account with the Payson State Bank. Hamilton draws a check payable to HAL Systems, a supplier from which DotCom has often bought needed computer components in the past, for $36,724. At present, however, DotCom does not owe any money to HAL. Hamilton takes the check that he has written to HAL and himself indorses it with a signature purporting to be that of HAL. He deposits the check in an account he has himself opened up with Decoy National Bank under the name "HAL Systems, Incorporated." The check is forwarded to Payson, which pays it in the ordinary course of its operations. By the time the theft is discovered, Hamilton is long gone, having moved on to some other Internet start-up.

Who ends up bearing the loss of the $36,724?

How would you analyze the situation if there were no such company as HAL Systems? Hamilton just made up the name, having come up with something that sounds like the kind of entity to which DotCom might owe money. Once again Hamilton signs the name "HAL Systems" on the back of the check and, after depositing it in Decoy to the HAL account he has opened up, makes off with the money.

Jackson, as treasurer of the NewEco Corporation, is authorized to write checks on that company's account with Payson State Bank. One of her primary duties is to authorize the issuance of the weekly paychecks of each of the company's employees. She does so on the basis of information provided to her by one Lincoln, who is head of the payroll department. Lincoln gives Jackson a listing of each employee along with how much is due him or her. Jackson has the checks drawn and returns them to Lincoln for distribution to the employees. Beginning in June, Lincoln begins adding to the list that he gives to Jackson the name of one "Mary Todd," assigning to her a salary in line with that of other newly hired employees of the firm. In fact, no Mary Todd exists. When the payroll checks are handed over to Lincoln, he himself takes the one made out to Mary Todd. He indorses it on the back in the name of the fictitious Ms. Todd, and then deposits it in his own account with Depot National Bank. This continues on a weekly basis until it is discovered—soon after Lincoln has quit, cleaned out his account with Depot, and left the area—that there is in fact no such person working at NewEco by the name of Mary Todd. Who bears the loss generated by Lincoln's scam?

Dr. Tooth runs a thriving dental practice. He employs one Ernie who, in addition to scheduling appointments for patients, is in charge of handling patient accounts, sending out bills as needed, and depositing the checks that Tooth receives for his services into Tooth's business account with Depot National Bank after having presented these incoming checks to Tooth for his indorsement on each. At some point, Ernie begins to set aside for himself some of the checks that come into the office made out to Dr. Tooth. He forges the signature of Tooth on the back of each of these checks and deposits them into his own account at Downtown Bank and Trust. This goes on for some time, until Tooth begins to wonder why his income seems to have dipped in recent months. He confronts Ernie, who admits to the wrongdoing, but informs Tooth that he has by now spent all the money that he siphoned off from the dental practice and is in fact broke. Tooth immediately fires Ernie, but he is now more concerned with getting back the money that was stolen from him. Will Tooth be able to do so?

Dr. Tooth, of the preceding example, replaces Ernie with one Bert, who seems a more trustworthy character. Among the duties Bert takes on is preparing checks for Tooth's signature, so that Tooth can pay the bills that have come into his office for his rent, supplies that he purchased, and other obligations of the dental practice. Among the checks signed by Tooth as drawer are ones written to Oscar's Cleaning Service, a firm that cleans Tooth's office once a week. Bert does not send these checks to Oscar, but instead forges the name of Oscar's Cleaning Service on the back of each and deposits them into Bert's own account with Downtown Bank and Trust. Oscar calls Tooth's office to complain that he has not been getting his checks, but Bert, who initially receives the calls, tells Oscar that there has obviously been some mistake and not to worry. "The check is in the mail." Only after several months of this is Oscar able to get through to Tooth himself and tell him what has been going on. Tooth checks the records while Bert is out to lunch and is able to piece together what has happened. He confronts Bert on his return, and Bert has to admit to what he has been up to. He also has to inform Tooth that the balance of his account with Downtown Bank is just about down to zero and that he has no other funds to repay Tooth what he has stolen. Bert, needless to say, is fired on the spot. Tooth quickly writes a check, which he personally delivers to Oscar, covering all the money owed to Oscar that Oscar has never received. Tooth now concerns himself with how, if at all, he can recover from some other party the money stolen by Bert. Will Tooth have to bear the loss, or can he shift it to some other party?

Return to the basic situation of Example 2: Hamilton, as treasurer of the DotCom Corporation, is authorized to sign, without the co-signature of any other officer, checks for up to $50,000 drawn on the company's account with the Payson State Bank. Hamilton draws a check payable to HAL Systems for $36,724. The check in this instance is written in response to an invoice sent by HAL for some computer equipment actually received by DotCom. At the time he prepares the check, Hamilton fully intends to send it on to HAL. After staring at the check for some time, however, all the while dwelling on the mounting bills that he has been personally running up trying to live the life of a successful Internet executive, he decides to make it his own. He takes the check, forges a signature purporting to be that of an authorized representative of HAL on its back, and deposits the check in his own account with Delwood Bank.

s this situation covered by §3-404?

Vhat about §3-405?

What party ends up bearing the loss of the money should Hamilton, when his misdeed is discovered, be in no position to repay anything like $36,724? He's still up to his ears in debt from other sources.

Franklin, the new treasurer of the DotCom Corporation, writes out a check for $28,456 payable to HiTech Supplies Incorporated to cover a bill for supplies that HiTech has furnished to DotCom. Franklin puts the check in an envelope correctly addressed to HiTech and delivers this envelope, along with other outgoing mail that has piled up during the day, to DotCom's mailroom. Pierce, an employee in the mailroom, takes the envelope for himself. He signs the reverse of the check inside first with the words "HiTech Supplies Incorporated" and under that with his own name. He deposits this check into his own personal account at Delroy Savings and Loan. When the amount of the check has been made available to him by Delroy, he cleans out all that he has in this account and vanishes, never to return to his lowly job at DotCom. DotCom eventually discovers what has happened when HiTech sends a second bill for the amount it is owed.

Does §3-404 cover this situation?

Vhat about §3-405?

Vhat about §3-406?

What party or parties do you believe will end up bearing the loss of the $28,456 Pierce has made off with?

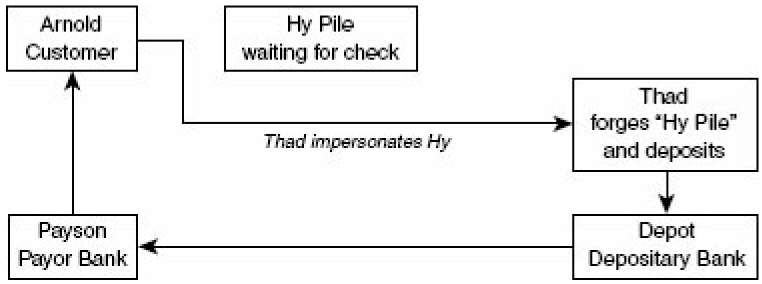
Franklin writes another check, this one for $2,567, to another of DotCom's suppliers, the Ebiz Corporation. He leaves this check on top of his "to-do" pile at the end of work on Thursday, fully intending to mail it to Ebiz on the following day. Polk, one of the members of the staff that cleans the DotCom offices overnight, spots the check on top of Franklin's desk and pockets it. Polk forges the signature of Ebiz on the back of the check. He then takes it to the offices of Main Street Check Cashing, where he signs his own name to the back of the check and receives in exchange $2,361 in cash (having been charged an 8 percent fee by the check cashing firm). Main Street forwards the check for collection and Payson State Bank pays it out of DotCom's account in the ordinary course of affairs. How do you analyze this situation? What party or parties should bear the loss of Polk's theft of this check?

Andrew has a personal checking account with Payson State Bank. He keeps his checkbook on top of the desk in his home office. Thad, a decorator whom Andrew has hired to do some work in the apartment, is able to steal a blank check out of this checkbook when he is alone in the room. He fills this check out for $700, naming himself as payee and forging Andrew's name on the drawer line. He deposits this check in his own account with Depot National Bank and the check is paid by Payson. When Andrew discovers what has happened, he quickly contacts Payson and demands that it recredit his account with the $700, because this check bore a forged drawer's signature and hence was not a properly payable item. Can the bank make an argument based on §3-406(a) that would preclude Andrew from getting the $700 recredited to his account?

Bernie writes a check out of his account with Payson State Bank, payable to one Cara for $1,200, and sends it to Cara at her home. Cara puts the check in the top drawer of her desk intending to deposit it the next time she goes to her bank. Before she can do so, Thelma, a niece of Cara's who is paying her a brief visit, comes across the check while rummaging through the drawers of her aunt's desk. Thelma takes the check and leaves for home, cutting her visit with her aunt even shorter. Once home, Thelma forges Cara's name on the back of the check and deposits it into her own account with Distant Bank and Trust. Distant Bank forwards the check for collection to Payson, which pays it in the ordinary course of its operations. When Cara discovers the loss and finds out what has become of the check, she brings an action of conversion against Distant Bank for its role in obtaining payment on an item that bore a forged signature. Do you think Distant Bank has any response to this claim, by which it could avoid at least part of the loss, based on §3-406(a)?

Explanations

As always, it pays first to get a good look at the situation:



No, Payson does not have to recredit Arnold's account. In the normal course of events, the payor bank would have to recredit the account, because the check it paid bore a forged indorsement. In this case, however, Payson can point to §3-404(a) and what is known as the *impostor rule* or *impostor defense*. Thad was clearly an imposter, impersonating Hy Pile, the payee of the check. That being so, "an indorsement *by any person* in the name of the payee *is effective* as the indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection." So Payson can legitimately argue that the drawer's signature on the check was valid—as Arnold had himself signed it—and that the indorsement of "Hy Pile" was effective as if Pile himself had signed or authorized another to sign for him. This check was properly payable, and hence Payson did no wrong in paying it and charging the amount against Arnold's account.

Arnold, as the party who was duped into personally handing over the check to a thief, will have to bear the loss stemming from the theft. Notice that this all follows from §3-404(a) and does not depend on any showing that Arnold acted negligently in turning the check over to Thad believing him to be Pile. Arnold may have simply taken Thad at his word that he was Pile, or Arnold might have asked for and been shown a super set of phony ID. The result is once again a matter of strict liability; it follows from the basic pattern of the theft.

Arnold may try to shift at least some portion of his $38,000 loss onto another party by bringing into play the concept of comparative actual negligence, in this case by invoking subsection (d) of §3-404:

> With respect to an instrument to which subsection (a) [as here] or (b) applies, if a person paying the instrument or taking it for value or collection fails to exercise ordinary care in paying or taking the instrument and that failure substantially contributes to loss resulting from payment of the instrument, the person bearing the loss [here Arnold] may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.

The problem for Arnold here is that there does not seem to be another party that failed to exercise ordinary care in handling the check.

Recall the definition of §3-103(a)(7). The fact that Payson may have paid the check without individually examining it would not constitute a lack of ordinary care unless that failure to examine violated the bank's prescribed procedures "and the bank's procedures do not vary unreasonably from general banking usage not disapproved of by" either Article 3 or 4. See Comment 5 to §3-103. Apparently many banks today do not set their automated check processing equipment to cull out for individual inspection checks unless they are in the $50,000 or more range. So unless Payson's own procedure called for individual inspection of items with amounts as large as this one, and the bank then failed to follow its own procedure, Payson would not have failed to exercise ordinary care on that score. Even if someone at Payson Bank had individually examined the check, what would he or she have seen? The one thing he or she would be expected to check is the authenticity of its customer's signature, and here Arnold's signature is valid. There is no way reasonably to expect Payson to be able to catch the forgery of Hy Pile's signature, as it does not have a specimen signature on file for everyone in the community.

Perhaps Arnold could argue that Depot National Bank did not act with ordinary care in allowing Thad to deposit into his account a check initially issued to Hy Pile and bearing a forged indorsement of Mr. Pile, but this seems unlikely to succeed. General banking practice in the area in which Depot operates probably does not call for the bank to turn away such third-party checks, or to insist on any verification that the payee's indorsement is genuine, when they are presented for deposit to a customer's account. Unless Depot had some special reason to believe that Thad might be depositing stolen checks into his account (in which case, why are they still doing business with him?), it does not seem a lack of ordinary care for the depositary bank to take for deposit a check under the circumstances we have here. Arnold is going to have to bear the full loss.

For an interesting case involving the impostor rule, including an attempt by the drawer to hold another party partially liable for its loss under the theory of comparative negligence and §3-404(d), see *State Security Check Cashing, Inc. v. American General Financial Services,* 409 Md. 81, 972 A.2d 882, 69 U.C.C. Rep. Serv.2d 683 (Md. App. 2009). The impostor, whose real name of course we will never know, initially contacted a lender, American General Financial Services, by telephone, posing as one Ronald E. Wilder, and inquired about a loan to renovate a property he owned. The lender ran a credit check on Ronald E. Wilder, which indicated his credit to be excellent. The caller was informed that American General would need personal tax returns for the prior two years. Within a couple of days, American General's district manager received the completed loan application along with copies of the requested tax returns (of Ronald E. Wilder, of course), performed a cash-flow analysis, and obtained approval from senior management for an $18,000.00 loan to Mr. Wilder. American General informed the impostor that the loan was approved, and the impostor appeared at noon at American General's Security Boulevard office in Baltimore County. He presented an apparent Maryland driver's license bearing Mr. Wilder's personal information and the impostor's photograph, and the loan was quickly closed. After all the loan documents were signed, American General issued to the impostor a loan check for $18,000.00, drawn on Wachovia Bank, N.A., and payable to Ronald E. Wilder. As the court continues the story,

> Later that afternoon, the imposter presented the check to State Security Check Cashing, Inc. ("State Security"), a check cashing business. At the time the imposter appeared in State Security's office, also on Security Boulevard in Baltimore County, only one employee was on duty, Wanda Decker. Decker considered the same driver's license that the imposter presented to American General, and reviewed the American General loan documents related to the check. She also compared the check to other checks issued by American General which had been cashed previously by State Security. Deeming the amount of the check relatively "large," Decker called Joel Deutsch, State Security's compliance officer, to confirm that she had taken the proper steps in verifying the check. Deutsch directed Decker to verify the date of the check, the name of the payee on the check, the address of the licensee, the supporting loan paperwork, and whether the check matched other checks in State Security's system from the issuer. Decker confirmed the results of all of these steps, and, upon Deutsch's approval, cashed the check, on behalf of State Security, for the imposter for a fee of 3-5% of the face value of the check.

When the real Ronald E. Wilder appeared the next day at the offices of American General, having been notified by the U.S. Secret Service that a person had applied for a loan in his name, American General was able to stop payment on the check before it was paid by Wachovia Bank, the payor bank. State Security seemed to be left holding the bag. It sued American General for the face value of the check, plus interest, arguing that it was a holder in due course of the check and entitled to be paid on the instrument. As you should be able to appreciate, its case depended mainly on its invocation of the impostor rule of §3-404(a). Among American General's arguments in its defense was one based on §3-404(d), contending that State Security should bear the loss, or at least a portion of it, because of its failure to use "ordinary care" in its cashing of the check, a failure that "contributed to the loss" of the whole $18,000 to the imposter. The trial court had ruled in favor of American General on this theory, but the Court of Appeals reversed this ruling. While the opinion on this point is lengthy, perhaps the most telling point made by the Court of Appeals is the simplest. American General was asking the court to find Security General's *cashing* of the check lacking in "ordinary care" when that action was based on an examination of the same driver's license and other papers, including the loan documents American General had itself created and found satisfactory, in *issuing* the check.

The result here should be the same as in 1a. Subsection 3-404(a) comes into play whenever "an imposter, *by use of the mails or otherwise*, induces the issuer of an instrument to issue the instrument … by impersonating the payee of the instrument." Here Thad, posing as Pile, made use of the telephone and the mail to carry out his scheme, but it is still a classic case in which the impostor rule governs. If anything, a situation such as this may be more common than what we saw in 1a. It is, after all, probably easier in most situations for an impostor to get away with an impersonation of someone else when the transaction is carried out at a distance, as here, rather than face-to-face as in 1a.

Again the result remains the same. Arnold bears the loss unless he is able to shift all or some of it onto another party by proving that party to have acted without ordinary care in its handling of the check. Subsection 3-404(a) specifically covers the situation in which an impostor is able to get his or her hands on a check "by impersonating the payee of the check *or a person authorized to act for the payee*." The real Ms. Knapp was authorized to act for Hy in picking up the check. Thelma's impersonation of Ms. Knapp is covered by §3-404(a) and has the same result as Thad's impersonation of the real Hy Pile in the two previous parts of this example.

The risk of loss here will fall on the Deep River bank, as the party who took an instrument bearing a forged indorsement directly from the forger. Deep River may try to invoke the impostor rule of §3-404(a), to argue that the indorsement was "effective" under the circumstances and hence the loss should fall on Arnold, but this attempt, at least if the court follows prior decisions on the question, will fail. Neither that section nor any other part of Article 3 defines exactly what is meant by the word *impostor*, but the courts have generally ruled that the word connotes the impersonation of one person by someone else. Here Ms. Knapp is really Ms. Knapp. True, she has made a serious misrepresentation to Arnold; she has told him that she has the authority to act on behalf of Pile in picking up the check when in fact she has not been given that authority. She has not, however, impersonated anyone else, nor has anyone else impersonated her. A good review of this issue was given by the Kansas Supreme Court in *King v. White*, 265 Kan. 627, 962 P.2d 475, 38 U.C.C.2d 469 (1998). The court concluded:

> It does seem clear from cases both before and after the [1990] revision that someone must still impersonate someone else in order for the imposter defense to apply. There must be impersonation of an actual agent; a misrepresentation of agency authority is generally not sufficient to invoke the defense.

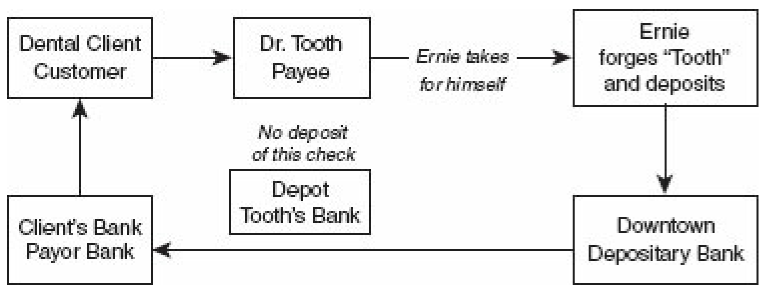
The loss of the $36,724 will probably be borne in its entirety by the DotCom Corporation. Under §3-404(b)(i), if the person whose intent determines to whom an instrument is payable—which would be Hamilton here—"does not intend the person identified as payee to have any interest in the instrument," then "an indorsement by any person in the name of the payee stated in the instrument is effective as the indorsement of the payee in favor of any person who, in good faith, pays the instrument or takes it for value or collection." The drawer's signature on this check is valid, as Hamilton had the authority to sign and issue checks on behalf of DotCom. The indorsement purporting to be that of HAL Systems is effective under the language of §3-404(b). This check was properly payable out of DotCom's account, and thus that corporation will have to bear the loss. One of DotCom's trusted principal officers has turned out to be a thief, and it certainly makes sense that the company should bear the loss stemming from his deviation from the straight and narrow.

DotCom's one chance for recouping at least part of this loss is to argue that Decoy National Bank acted without ordinary care in handling the check, and that under subsection (d) of §3-404 DotCom should be able to recover from Decoy "to the extent that the failure [by Decoy] to exercise ordinary care contributed to the loss." How might Decoy have been lacking in ordinary care? DotCom would have to show that Decoy did not observe "reasonable commercial standards, prevailing in the area in which [Decoy] is located, with respect to the business in which [Decoy] is engaged" (§3-103(a)(7)) by allowing Hamilton to open an account in the name of "HAL Systems, Incorporated" with himself as the authorized signatory for that account. Banks usually demand certain back-up documentation when opening up a corporate account: proof that the corporation actually exists, proof that the corporation's board has authorized the opening of the account, and the identity of the persons it has authorized to act with respect to the account. If Decoy failed to follow this routine and allowed Hamilton to open the HAL account too easily, perhaps it could be shown to have acted with less than the ordinary care required of it. See Comment 4 to §3-405, which deals with just such a possibility, and *K.I.M. Co. Refrigeration Corp. v. CFS Bank*, 2001 N.Y. Misc. LEXIS 371, 45 U.C.C.2d 1138. If, however, Hamilton had done his homework, he no doubt could have produced, without too much effort, the kind of documentation that even the most finicky bank would have found satisfactory. (If nothing else, he could have, at no great expense, considering what he may have planned to gain by the ruse, created a corporation named "HAL Systems Incorporated" under the laws of some state other than the one in which the "true" HAL was incorporated. Then it would just be a matter of creating the standard paperwork to hand over to Decoy.) As will always be the case once the rules of Article 3 steer us into any inquiry about whether a party was "lacking in ordinary care" in its handling of a particular instrument, it will all depend on the facts of the situation and a comparison with what "reasonable commercial standards" would be in such an instance, in the place in question, and given the nature of the business in which that party is engaged.

The result is the same as in 2a, even if the reasoning is slightly different. Here §3-404 governs not because of the rule we looked at in 2a, but because of the so-called *fictitious payee* rule of (b)(ii). Any time a person identified as a payee of an instrument is a "fictitious person," an indorsement by any person in the name of that payee is deemed effective as the indorsement of the payee "in favor of a person who, in good faith, pays the instrument or takes it for value or collection." You will notice that this example is basically the same as that given in Case #1 of Comment 2 to §3-404. For that matter, Example 2a paralleled Case #2 in the same comment.

NewEco bears the loss. This is an example of the classic *padded payroll* scam. Jackson has been conned by Lincoln into issuing a check payable to a fictitious payee. By virtue of §3-404(b)(ii), anyone, including Lincoln, can effectively indorse on "Mary Todd's" behalf. The check is therefore properly payable out of NewEco's account with Payson. Any attempt by NewEco to place some of the responsibility (and some of the loss) on either Payson or Depot Bank via §3-404(d), claiming a lack of ordinary care by either or both banks, seems very unlikely to succeed. Payson just paid the check written on the payroll account automatically; it certainly is under no obligation to check out exactly who is and who is not an employee of NewEco and how much he or she may be owed. Depot accepted for deposit at various times into the account of one of its customers a single third-party check seemingly indorsed over to that customer. It would be exceptionally difficult to prove that in doing so Depot was acting outside the bounds of reasonable, customary practice. The lesson for NewEco is that it ought to set up more rigorous internal controls over its payroll procedures—some system that does not put all the responsibility (and opportunity for mischief) into the hands of a single employee—rather than try to blame others for its misfortunes.

We now turn to the workings of §3-405. The picture with respect to any one of the checks made out to Tooth that Ernie took for himself looks like this:



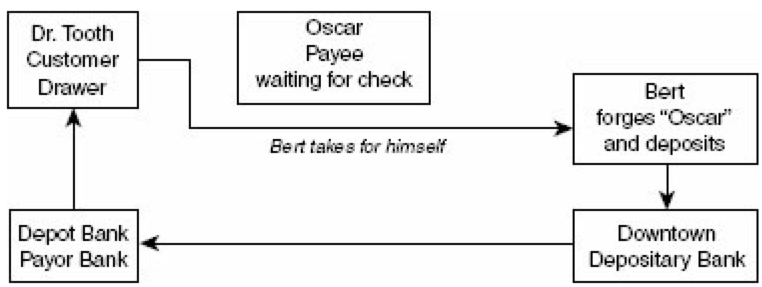
Tooth will most likely have to bear the full loss occasioned by Ernie's theft of this check and all the others. The check would be properly payable out of the client's account with his or her own bank. There is no question that the drawer's signature is valid. Ernie has made a "fraudulent indorsement" under §3-405(a)(2)(i), but the forged signature of Tooth is considered "effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person" under §3-405(b) if the forger is an employee of the named payee "entrusted with responsibility with respect to the instrument." You should read over subsection (a) carefully to see how this section defines who is an *employee* entrusted with such "responsibility," but in our scenario there seems to be no question that Ernie fits right within the mold. As Comment 1 to this section makes clear, §3-405 is based on the belief that the employer is in a far better position to avoid the loss, by taking care in choosing employees, supervising them, and adopting other measures to prevent forged indorsements on instruments payable to the employer or fraud in the issuance of instruments in the name of the employer. For two recent cases examining who is and who is not an employee "with responsibility" for an item, see *Schrier Bros.*, *Lee v. Golub*, 123 Fed. Appx. 484, 56 U.C.C.2d 317 (3d Cir. 2005), and *Dean Classic Cars, L.L.C. v. Fidelity Bank and Trust Co.*, 978 So. 2d 393, 64 U.C.C.2d 925 (La. App. 2007).

The second sentence of §3-405(b) does give Tooth the right to seek contribution from any party that handled the various checks whose lack of ordinary care substantially contributed to the loss, but it is going to be hard for him to make the case against anyone else. Certainly his client's bank did not fail to use ordinary care. All it did was pay a check written by one of its customers to a "Dr. Tooth," which bore what was apparently the indorsement of that doctor. What about Downtown Bank and Trust, where Ernie deposited each of these checks? Perhaps if Ernie had tried to deposit, all at one time, a whole bundle of checks totaling some thousands of dollars, made out to another and supposedly indorsed over to him, a red flag should have gone up at the teller's window. Tooth could at least argue that whoever processed the deposit on behalf of Downtown should at least have inquired how Ernie had gotten all of these checks payable to a third party. What explanation could Ernie then have given that wouldn't in itself have sounded dubious? If, however, Ernie did not overplay his hand, and deposited checks into his own account in this fashion only one at a time and only now and then, it is unlikely that any finder of fact would conclude that the depositary bank had failed to use ordinary care.

A case that fits this pattern of skullduggery that you would do well to read is *Menichini v. Grant*, 995 F.2d 1224, 20 U.C.C.2d 959 (3d Cir. 1993). The employer, Gerald C. Menichini, had established as a sole proprietorship a firm by the name of Best Legal Services to provide various nonprofessional support services to attorneys and law firms. In 1986 Menichini hired as his first full-time employee one Lissa Grant, a law student, to serve as a receptionist. Over time, Grant's role in the firm grew to the point where Menichini left her exclusively responsible for recording all invoices and dealing with payments received. Over a period of about a year and a half, starting in April 1988, Grant intercepted some 150 checks made out to Best Legal Services and totaling $61,431.98, forged Menichini's signature to each, and deposited them in her own account. Menichini was, not surprisingly, held to be the one who should bear the loss because of his employee's embezzlement. See also *Halla v. Norwest Bank Minnesota, N.A.*, 601 N.W.2d 449, 39 U.C.C.2d 1104

(Minn. Ct. App. 1999), in which an agent charged with management of five apartment buildings, over the course of three years, was able to take for herself more than $100,000 from rent checks made payable to the property owner. In this case the owner did make the argument that the bank into which the embezzling employee had deposited the rental checks acted with a lack of ordinary care by taking for deposit, into a personal account, checks originally made payable to a business and by failing to verify the business's indorsements on the checks. The Minnesota Court of Appeals upheld the trial court's grant of summary judgment to the depositary bank. It agreed with the trial court that the owner's assertion (that the depositary bank acted with less than ordinary care) was not supported by any evidence in the record. "Because a party resisting summary judgment must rest on more than mere averments, Hall [the property owner] has not established a fact issue on whether Norwest [the depositary bank] failed to exercise ordinary care."

Dr. Tooth's unfortunate experience with Bert illustrates the second type of theft by a "responsible" employee for which the employer must bear the loss.



Tooth has given Bert responsibility with respect to the checks he draws to his suppliers and others to whom he owes money. Bert has made a "fraudulent indorsement" on the check, now under subpart (ii) of §3-405(a)(2). By virtue of §3-405(b), this fraudulent indorsement is effective as if Oscar himself had signed the check. The check is properly payable out of Tooth's account with Depot National Bank. Tooth may try to show that Downtown Bank and Trust, as the depositary bank that took an instrument bearing a forged indorsement from the forger, should bear at least a portion of the loss under the second sentence of §3-405(b), but to do so Tooth would have to show that Downtown failed to exercise ordinary care in accepting for deposit and sending on for collection this check bearing the forged indorsement of a third party, Oscar. If Bert has only been depositing one such check each month, and if Downtown Bank has not been given any reason to know that there is anything fishy about the situation on any occasion, I think it is highly unlikely that Tooth would be able to demonstrate lack of ordinary care on that bank's part. But, again, it would all depend on the particular facts of the situation. See, for example, the recent case of *Rodrigue v. Olin Employees Credit Union*, 406 F.3d 434, 57 U.C.C.2d 392 (7th Cir. 2005), in which the Seventh Circuit concluded that the customer has demonstrated such a lack of care by the depositary institution to support the trial court's determination that it, the credit union into which the faithless employee had over time deposited some 269 medical reimbursement checks by forging the signature of her doctor employer, had to bear 90 percent of the loss under the comparative fault provision of §3-405(b).

For a good review of the workings of §3-405, seen here in the operations of a couple of faithless employees of a doctor who were not choosey—working in tandem they engaged in the type of misbehavior we have seen in both Ernie in the previous example *and* Bert in this one—see *Lee Newman, M.D., Inc. v. Wells Fargo Bank N.A.*, 87 Cal. App. 4th 73, 104 Cal. Rptr. 2d 310, 43 U.C.C.2d 912 (2001).

No. There are no impostors or fictitious payees. Subsection 3-404(b)(i) does not apply because at the time he wrote up and signed the check payable to HAL Systems, Hamilton fully intended that company to receive and therefore "have an interest" in the instrument.

Yes. Hamilton as treasurer of DotCom was clearly a person with "responsibility" with respect to the item. He made a "fraudulent indorsement" of the payee's name and took the money for himself. See Case #6 in Comment 3 to §3-405.

DotCom will end up bearing the loss of the $36,724 unless it can shift some of the loss, on a comparative negligence basis, onto the Delwood Bank, which took the check for deposit into Hamilton's personal account bearing a forged indorsement of HAL Systems. Look once again at Comment 4 to §3-405, which tries to illustrate the ways in which a depositary bank may be shown to have acted with less than ordinary care in taking a check under circumstances such as this. The example we have before us is not as dramatic as that set forth at the end of the comment: HAL Systems may not be a "well-known national corporation"; Hamilton has not attempted to open an account in HAL's name at Delwood; and as far as we know this check is not the only one being deposited into the account, but is only one of many (some of which may be for amounts in the tens of thousands if Hamilton is really trying to live like an Internet millionaire) that have been moving in and out of Hamilton's personal account. I tend to doubt that DotCom would be able to establish any lack of due care on Delwood's part. We should remember, however, as the comment makes clear, "Failure to exercise ordinary care is to be determined in the context of all the facts relating to the bank's conduct with respect to the bank's collection of the check."

No. There are no impostors or fictitious payees, nor does §3-404(b)(i) apply. Franklin fully intended that HiTech Supplies would receive and therefore "have an interest" in the instrument.

No. Pierce would not be considered an employee with "responsibility" with respect to the instrument just because it passed through the mailroom of the company where he worked. Look at the last sentence of §3-405(a)(3): "'Responsibility' does not include authority that merely allows an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access."

Section 3-406 may come into play here, though with what success is questionable. So far we have found no reason that Pierce's theft and forgery of the payee's name would not result in the loss falling, simply under the standard rules, on the party that took the check from the forger, which here is Delroy Savings and Loan. Delroy may, however, argue under §3-406(a) that DotCom somehow failed to exercise ordinary care in its hiring or supervision of its mailroom employees and that this failure "substantially contributed" to the making of the forged signature on the instrument. If it could show as much, then DotCom would be "precluded" from asserting the forgery when it tried to recover the money it has lost in a conversion action against Delroy, as in its bid to get its account with Payson recredited for the amount of the improperly paid check (which, if it had to recredit, would naturally go against Delroy on a breached warranty of presentment). Under subsection (c), the bank asserting this preclusion would have the burden of proving DotCom's failure to exercise ordinary care. It would have to prove that DotCom's mailroom procedures and safeguards failed to meet "reasonable commercial standards, prevailing in the area in which [DotCom] is located, with respect to the business in which [DotCom] is engaged" (Section 3-103(a)(7) once again). It is possible that the bank could do so, but I think it highly unlikely unless DotCom is running a particularly careless and sloppy mailroom operation.

> The mere fact that an embezzling employee is able to make off with what should rightfully have gone to his or her employer or another party does not in and of itself show the employer-customer's lack of ordinary care. See, for example, the carefully conceived and executed embezzlement scheme carried out by one Landrum as described in *Clean World Engineering, Ltd. v. MidAmerica Bank, FSB*, 341 Ill. App.3d 992, 793 N.E.2d 110, 51 U.C.C.2d 1169 (2003). The Appellate Court of Illinois there upheld the finding of the trial court that no showing had been made of the customer's lack of care, quoting the trial judge for the proposition that "an innocent employer … was simply no match for an experienced, professional scam artist like Mr. Landrum."
>
> Suppose that the bank against which DotCom is proceeding to recapture the stolen money was able to demonstrate a lack of ordinary care on DotCom's part in handling the item, which lack of care substantially contributed to Pierce's ability to get his hands on and forge the payee's signature on this check. This would preclude DotCom from relying on the forgery to avoid payment of the check. DotCom might then, in turn, assert under §3-406(b) that the bank in question had *itself* failed to exercise ordinary care in its handling of the item. If DotCom could prove this, then the two parties, DotCom and the bank, would have to share the loss on a comparative negligence basis. All this, at least in the example we have before us, appears to me to be getting more and more unlikely, but of course it all depends on the facts in context.

If DotCom cannot be proven to have been running its mailroom with a lack of ordinary care, and that this failure substantially contributed to Pierce's opportunity to act as he did, the loss falls on Deloy as the party that took the check directly from the forger.

Under the basic rules of loss allocation, the check cashing firm, as the party that took a check bearing a forged indorsement from the forger, would normally have to bear the risk of this loss. (This is one of the principal reasons why cashing a check at such an establishment is so relatively expensive.) That firm would have no success in calling upon either §3-404 or §3-405 for relief. This may, however, be one of the cases in which §3-406(a) should apply, allowing the check cashing service to establish that DotCom was, because of its failure to use ordinary care in its handling of the check, precluded from relying upon the forgery of Ebiz's name to avoid having the check charged to its account. Franklin does seem to have acted outside of what we would guess to be “reasonable commercial standards” for the treasurer of a major corporation, in that he left the check so casually on the top of his desk overnight and in addition apparently did not notice and immediately act upon its disappearance when he came in the next day. Had Franklin been aware that the check had been stolen, or at least that it was missing, he could have placed a stop-payment order on the check, which would have avoided the loss to DotCom. Franklin’s actions appear to amount to a lack of ordinary care with respect to the item. DotCom should be made to bear the loss. Comment 3 gives as illustration three cases in which a business entity might be found lacking in ordinary care with respect to a check that is later stolen, upon which a forger has worked his or her particular type of transgression, or that has all too easily been altered. The particular hypothetical we are dealing with here does not follow any of these three cases, but taken together they suggest that DotCom’s behavior here was indeed “lacking in ordinary care.”

DotCom may, of course, argue under §3-406(b) that Main Street Check Cashing was itself negligent in the way it handled the check, and that this negligence substantially contributed to the theft by Polk. If that could be proven by DotCom (which I tend to think would be difficult, but then you never know), the two negligent parties, DotCom and Main Street, would be made to bear the loss allocated “between the party precluded [DotCom] and the person asserting the preclusion [Main Street] to the extent to which the failure of each to exercise ordinary care contributed to the loss.”

For a recent case that demonstrates one more way a business customer can fail to exercise ordinary care with respect to its checking account, you may want to look at *Bank of Texas v. VR Electric, Inc.*, 276 S.W.3d 671, 67 U.C.C.2d 713 (2008). The firm of VR Electric had a checking account with the named bank. One day Beverley Pennington, a bookkeeper for VR, placed an unsigned check from this account for $8,276 on the counter in front of the office of Terry Viohl, VR’s president. The bookkeeper, we are told, often placed checks in this location for Viohl’s signature because Viohl’s office was very disorganized, “and there was concern that the check would be lost if placed in his office.” The counter on which the check was placed was next to the front entrance and accessible to anyone who entered VR’s office. As it happened, one Anthony Burlew, an employee of a contractor working with VR, took the check from the counter. He signed Viohl's name to the front of the check as drawer and then indorsed the check on the back over from the named payee to himself. Burlew then took the check to Frank C. Mata, a used car dealer, and indorsed the check over to Mata for a car and some cash. Mata accepted the check and deposited it into his account, into which it was paid in due course. Pennington and Viohl had, in fact, noticed the check was missing but had decided not to place a stop-payment order on it "because they thought the check was lost in Viohl's office." There is much more going on in the case if you are interested, but for present purposes the point of interest—which shouldn't be a difficult one for you to appreciate—is that VR didn't even appeal the jury's finding that it had failed to use ordinary care with regard to the check and that this failure substantially contributed to its loss resulting from Burlew's theft, forgery, and subsequent misuse of it.

The bank can make an argument against Andrew based on §3-406(a)—anybody can argue just about anything—but it is extremely unlikely that the bank would find any takers for a result that would put any of the loss on Andrew. The bank would have to show that Andrew was acting with less than ordinary care as a consumer by keeping his checkbook on top of his desk at home and allowing someone unaccompanied access to his home office so that the theft of one of his blank checks was thereby made possible. But where else is Andrew going to keep his checkbook? Even if he placed it in a drawer, a wily character like Thad would not have been stopped from finding it and taking one of the blank check forms to use later in this way. Does it seem to you reasonable to insist that a regular guy like Andrew keep his personal checkbook under lock and key? Or that he should never leave anyone in his apartment alone in any of his rooms? What is Andrew supposed to do, follow his decorator around from room to room during the entire course of the job?

When you first read this example, you might have been tempted to conclude that Andrew must have been negligent in some way in failing to prevent Thad from making off with the blank check as he did, but I think this is being much too hard on Andrew and asking too much of him. Ask yourself this simple question: As you are reading this, are you *absolutely sure* that every single one of your own personal blank checks is exactly where you assume it to be? The intent of my asking this is not to make you paranoid. It does demonstrate, I think, that it would be unduly harsh and unrealistic to treat Andrew as having been lacking in ordinary care under the circumstances here. Perhaps if for a number of days Andrew had been noticing that some of his valuable smaller items had gone missing from just the room or rooms in which Thad had been working, it would reach a point at which it would be fair to say that Andrew was acting negligently in still allowing Thad to hang around the place unattended. Short of that, however, all we have is that Andrew has put some trust in Thad, and that trust has turned out to be misplaced. This only makes Andrew human, and now perhaps a bit more cynical. It doesn't make him negligent.

If you do happen to be searching for a case in which a consumer banking customer *was* found to have been lacking in ordinary care with respect to her checking account, I suggest you look at *Jurcisin v. Fifth Third Bank*, 2007 Ohio 3000, 63 U.C.C.2d 26 (Ohio App. 2007). The case involved three checks, totaling $9,500, drawn on Nicole Jurcisin's personal checking account by her former roommate Farris Haile. Haile had forged Jurcisin's signature as drawer on each of the three checks. When Jurcisin returned to her home in California from a four-month stay in Mexico, she discovered that her checking account was overdrawn and that her checkbook was missing. Haile eventually confessed to the forgeries and was arrested. Jurcisin sought reimbursement from the bank based on its payment of the three forged checks. The bank refused to reimburse Jurcisin, having concluded that her negligence allowed Haile to perpetuate the forgeries, and Jurcisin sued. As she apparently admitted to an investigator for the bank, she had made it "very easy" for Haile to commit the forgeries. While away in Mexico, she left her personal checks in an unlocked file in an unlocked closet in an unlocked room. She had also handed over to Haile her debit card, which bore her signature on the reverse. "Also of note," according to the appellate court, she

> entirely failed to keep track of her checking account while in Mexico. She did not put a hold on her checking account, receive or review account statements, forward her statements to a trusted friend or family member, or monitor her account online (even though she regularly accessed the internet to send e-mails).

The court of appeals affirmed the trial court's determination that Jurcisin failed to exercise ordinary care under the circumstances.

Unless Distant Bank can come up with some facts that we don't have here (for example if Cara had actually seen Thelma taking things from her desk and had done nothing to stop it, or if Thelma had stolen things from her aunt in the past and Cara had just chosen to turn a blind eye), it is doubtful that it would be able to shift any of the loss onto Cara by arguing that she had somehow failed to use ordinary care in the situation. It certainly is a good rule of thumb that you deposit any check you receive as soon as possible, but we can't expect a consumer like Cara to drop everything and run to her bank every time she gets a check in the mail. And storing a check in a drawer of her desk, even if isn't protected by lock and key, doesn't ring of negligence. Neither does Cara's willingness to let her niece stay in her apartment for a while. When you look at cases of this type, you will find that a disconcerting number of them involve theft by a family member. The courts are not inclined to hold that simply being trusting of and hospitable to one's own kin allows a finding that a party has been lacking in ordinary care.

I feel reassured in my assessment that Andrew, of Example 9, should be able to get his account recredited for the $700 stolen by Thad—but only slightly reassured—by the decision of the Court of Appeals of Arizona in *Mercantile Bank of Arkansas v. Vowell*, 82 Ark. App. 421, 117 S.W.3d 603, 50 U.C.C.2d 631 (2003). The case makes interesting, if awfully disturbing, reading. In June of 1997, Dr. John G. Vowell and his wife allowed their daughter Susan and her boyfriend to move in with them, even though they knew that the two had a history of involvement with "drugs, alcohol, writing bad checks, and stealing." They also were aware that Susan had in the past stolen checks from them and forged both of their signatures to get her hands on some money. The trial court found that the only precaution they took was to hide Mrs. Vowell's purse, which contained their checkbook, under the sink. Mrs. Vowell was seriously ill at the time and mostly bedridden. Yet her husband continued to rely on her to review their bank statements and to balance the checkbook. In addition, it has to be noted, the PIN they used in connection with their ATM card was identical to that which they used for their home security system. Not surprisingly, Susan proceeded to draw two unauthorized checks and make nine unauthorized ATM withdrawls in the aggregate of $12,028.75 over a period of approximately three months. By a vote of 3 to 3 the Appeals Court upheld a ruling of the trial court that the bank could not successfully invoke §3-406(a) against Dr. Vowell as his conduct did not "substantially contribute" to the forgery of the checks and the unauthorized ATM withdrawals. The doctor, who was the sole plaintiff (as by this time his wife had died), did not recover from the bank all that Susan had stolen, however. The reason that he had to bear a good portion of the loss had to do not with anything we have studied in this chapter, but with the so-called Bank Statement Rule of §4-406, the subject of the next chapter. A fourth judge, while concurring with the ultimate disposition of the matter based on the Bank Statement Rule, found himself in serious disagreement with the three judges who saw §3-406(a) as inapplicable.

It is quite understandable that loving parents will try to provide shelter to their prodigal children, even though the children remain unrehabilitated from propensities that are unsavory. Nevertheless, the decision to house a thieving relative does not absolve one of the duty to exercise ordinary sense involving family valuables.… I fear that our refusal to reverse and remand under [§3-406] sends a powerful, and unsound, message. If the facts of this case do not demonstrate failure to exercise ordinary care, under [§3-406] [and remember three judges had found they did not], what set of facts would ever do?

A good point. In any event, I think the facts surrounding Andrew’s loss to the seeming trustworthy Thad are nothing like what the court was faced with in this case, and that Andrew should be able to recover fully from his bank.

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* I sometimes find help in thinking of §3-404 as the “duped drawer” section of Article 3, for reasons that should become obvious. No one likes to be a dupe, and certainly not in these situations.

* Neither Article 3 or 4 explicitly defines what would constitute “ordinary care” or the lack thereof in the case of a consumer. I think we have to assume that the traditional common law standard for negligence, whatever that may be exactly, is to apply.

CHAPTER 19

The Bank Statement Rule

THE BANK SENDS THE STATEMENT

Article 4 itself imposes no duty on a bank to provide its checking account customer with periodic statements of the activity recorded relating to the account and the current status of the account. This is strictly a matter of what is called for in the contract between the customer and the bank. Most account agreements do, however, call for the bank to prepare and mail or otherwise make available statements on a regular basis. Furnishing a statement of the account is considered a service that the bank makes available to its customers, and it would be the rare customer who would agree to opening an account that did not include this feature. The provision of regular statements is, as we will see in this chapter, also in the interest of the bank. *If* the bank does make such statements available, and the customer thereafter does not bring to the bank's attention checks that bear an unauthorized drawer's signature or alteration and therefore are not properly payable, the customer may be foreclosed by his, her, or its failure to give proper and timely notice of the irregularity from insisting that the bank recredit the account. Banks make available periodic statements for the convenience and security of their customers but also for their own protection.

Section 4-406(a) does provide that:

> A bank that sends or makes available to a customer a statement of account showing payment of items for the account shall either return or make available to the customer the items paid or provide information in the statement of account sufficient to allow the customer reasonably to identify the items paid. The statement of account provides sufficient information if the item is described by item number, amount, and date of payment.

Notice that the bank is not obligated by this provision physically to return the canceled checks with the statement. This again is a matter dealt with in the customer's contract with the bank. Some banks agree to and do furnish canceled checks with the statement. Some do not. Many banks now include with the statement an image of any check (front and back) charged to the account, but not the canceled check itself. If the bank does not return the paid items with the statement, subsection (b) of §4-406 sets out what the bank must do by way of retaining the item or a "legible copy" thereof and also how the bank must furnish the customer, upon request, with either the item or the copy.

What §4-406(a) does require is that, one way or another, the bank furnish, along with or as part of the statement of account, information "sufficient to allow the customer reasonably to identify the items paid." Actual return of the canceled checks or inclusion of a legible copy of each will, in and of itself, meet this criterion. If the bank does not include the checks or copies of them, then the last sentence of the section provides what is referred to as a *safe harbor rule* for the bank: "The statement of account provides sufficient information if the item is described by item number, amount and date of payment." You will have noticed that, by virtue of this safe harbor rule, a bank will have provided "sufficient information" about the item even though it does not include either the name of the payee or the date written on the check. These two bits of information, especially the former, would probably be the most helpful to a customer in spotting a check he or she has not authorized but which has been written as part of an embezzlement scheme or theft. The justification for the safe harbor rule as written is given in the concluding paragraph of Comment 1, which I suggest you read at this time. Note particularly the policy decision "that accommodating customers who do not keep adequate records is not as desirable as accommodating customers who keep more careful records." This should be heartening to customers like me—and I have to assume you—who take the time and effort to keep adequate records of the checks we write out of our accounts.

THE CUSTOMER EXAMINES THE STATEMENT

Once a bank sends or makes available to its customer a statement of account that satisfies subsection (a) of §4-406, then under subsection (c) the customer

> must exercise reasonable promptness in examining the statement or the items to determine whether any payment was not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized.

If, based on this examination, the customer should have discovered the unauthorized payment out of his, her, or its account, then the customer "must promptly notify the bank of the relevant facts."

You will sometimes hear this spoken of as the customer's "duty" to examine the statement and recognize unauthorized items, but the important thing to remember is that this "duty" is a duty the customer *owes only to himself, herself, or itself*. The reason we make sure to open our bank statements soon after they arrive and give them a careful and complete examination is not because the bank has any right to insist that we do so. No one is going to come and get you, haul you to jail, or bring suit based on your failure to review your bank statement and any accompanying canceled checks. The duty you owe to yourself to take such care on your own behalf follows from the consequences of your (totally hypothetical) failure to do so. Pursuant to subsections (d)(1) and (2), under certain specified circumstances, as we will explore more fully in the examples, a customer's failure to "comply with the duties imposed … by subsection (c)" will preclude the customer from asserting the bank's wrongful payment of a not-properly-payable item. The customer may forfeit the right to have the account recredited for the amount of an item or items if it fails to promptly notify the bank "of the relevant facts" regarding an irregularity that could have been discovered by reasonably prompt and careful examination of the statement.

Subsection (e) continues the comparative negligence approach that we encountered often in Chapter 18. If the customer is precluded under subsection (d) from asserting the unauthorized signature or any alteration of an item, because of a lack of diligence in dealing with the statement provided, the customer may try to show that the bank also failed to exercise ordinary care in paying the item and that this failure by the bank “substantially contributed” to the loss. If the customer is able to make out a case for the bank’s negligent treatment of the item—and it is probably only the very exceptional case in which this is a realistic possibility—then the customer and the bank share in the loss on a comparative negligence basis. Subsection (e) also states that if the customer can prove that the bank did not act in good faith in paying the item—and such cases have to be rarer still—then “the preclusion of subsection (d) does not apply.” Subsection (e) may offer some limited consolation to the customer who has failed to exercise the care called for in (c), but it is surely no substitute for carefully reviewing the bank statement soon after it arrives and giving prompt notice to the bank of any problems.

THE ONE-YEAR PRECLUSION

The separate rule set out in subsection (f) of §4-406 carries even greater consequences for the careless or lackadaisical customer.

> *Without regard to care or lack of care of either the customer or the bank,* a customer who does not within one year after the statement or items are made available to the customer (subsection (a)) discover and report the customer’s unauthorized signature on or any alteration on the item is precluded from asserting against the bank the unauthorized signature or the alteration.

This subsection means what it says, and there are any number of decided cases in which the payor bank has been able to gain summary judgment, dismissing an action brought against it for wrongful payment of an item, simply by showing that no problem of the type covered by §4-406(f) was brought to the bank’s attention until more than one year after the bank sent a statement from which the customer should have been able to detect the problem. You should be aware that several states, in adopting Article 4, have shortened this absolute preclusion period to less than one year.* A separate question, which we will deal with in the last example of this chapter, is whether the periods set forth in this section—either the vague “reasonable promptness” of (c) or the strict one year of (f)—may be varied or shortened by the account agreement entered into between the bank and its customer.

Examples

Andrew has a personal checking account with Payson State Bank. He keeps his checkbook on top of the desk in his home office. Thad, a decorator Andrew has hired to do some work in the apartment, is able to steal a blank check (#1084) out of this checkbook when he is alone in the room. He fills this check out for $1,500, naming himself as payee and forging Andrew’s name on the drawer line. He deposits this check in his own account with Depot National Bank and the check is paid by Payson on January 13, 2013. By the end of the first week of February, Thad has cleaned out his account with Depot and vanished from the scene. Payson sends Andrew a monthly statement of his account activity for the month and his balance as of the end of January. This statement is mailed off by the bank on February 3 and received by Andrew on February 6. It clearly shows that check #1084, in the amount of $1,500, was paid by the bank on January 13. Andrew reviews this statement on February 9 and immediately notices this entry. He has no recollection or record of drawing any check in this amount. Furthermore, he looks at his checkbook and finds that the blank check numbered 1084 is indeed missing. The next day he goes into his bank and speaks to a bank officer. Together they look at the check itself, which was retained by the bank as are all checks paid out of Andrew’s account, as provided for in the account agreement. Andrew is willing to sign an “Affidavit of Forgery” to the effect that the signature on the drawer’s line of check #1084 is not his. Indeed, as the bank officer herself can see, the signature is nothing like Andrew’s normal signature. Andrew demands that Payson recredit his account with the $1,500, because this check bore a forged drawer’s signature and hence was not a properly payable item.

Would anything in §4-406 give Payson justification for refusing to comply with this demand?

What if instead Andrew had left his January bank statement unopened on his desk for a month or so? He does not notice the questionable item until early March, when he immediately brings it to the attention of the bank. May Payson refuse to recredit Andrew’s account under these facts?

Finally, suppose that Andrew either does not spot the problem or chooses not to do anything about it until he reviews his various financial records in preparation for doing his taxes for the year 2013. He does not go to the bank complaining of the payment of this forged check until March *of 2014.* What result here?

In mid-August of 2013, Andrew (of the previous example) mails a check (#1064) for $12,000 to one Beatrice in payment for some freelance work she did for him. The statement that Payson sends to Andrew covering the month of August indicates that check #1064 for $12,000 was paid by Payson on August 24, 2013. In October Beatrice phones Andrew and asks when she is going to be paid by him for the work she did. Andrew assures her that he long ago sent her a check for her services and that indeed the check has been paid. Beatrice adamantly insists that she never received any such check. Andrew asks for and receives from Payson a copy of his check #1064. When he and Beatrice examine it together, they determine that the check must somehow have been pirated from Beatrice's mail before she even got a chance to see it. The back of the check bears an obviously forged indorsement in the name of "Beatrice" and indicates that the check was then deposited into an account with Decoy Bank and Trust by one Thelma. The two contact the Decoy bank, which tells them that Thelma closed her account with that bank sometime in September and did not leave a forwarding address. Andrew contacts Payson and demands that the bank recredit his account for the $12,000, because the check was not a properly payable item, bearing as it did a forged indorsement of the payee's name. Does §4-406 offer Payson any basis for resisting Andrew's demand? Consult the second point made in Comment 5 to that section.

Cara, who also has a checking account with Payson, invites her nephew Theo to live with her while he attends a local college. In March of 2013, Theo steals a blank check (#2345) from his aunt's checkbook, makes it out to himself for $500, and forges Cara's name as the drawer of the check. The account statement for the month of March, mailed by Payson on April 2 and received by Cara a few days later, indicates that check #2345 for $500 was paid out of her account on March 26. In early May Theo steals another check (#2372) from his aunt's checkbook, makes it out to himself for $600, and forges Cara's name on the check. In late May he repeats the trick, this time with check form #2385 made out for $2,000. Payment of both of these checks is reported to Cara on her May statement of account from Payson. Only then does Cara go into Payson and look at what she now realizes are three questionable checks paid out of her account. She discovers the forgery of her signature on all three (#2345 paid in March and #2372 and #2385 both paid in May). She confronts her nephew with what she has learned, and he is deeply apologetic. He is also totally broke and in no position to repay her what he has admittedly stolen. Cara makes a formal demand that Payson recredit her account for the amount of each of these three checks, as each bore a forged drawer's signature. Under §4-406, is Payson required to recredit her account with any or all of the total of $3,100 that Theo stole from his aunt's account?

Hamilton is the treasurer of the DotCom Corporation. As such he is authorized to draw checks for up to $2,000 out of that company's checking account at Payson State Bank. DotCom's agreement with Payson calls for the signatures of both Hamilton as treasurer and Washington, the president of DotCom, on any checks for amounts greater than $2,000. Beginning in January of 2013, Hamilton writes a number of checks on the DotCom account for amounts in excess of $2,000 and running up to $15,000 payable to a friend of his, one Burr. He signs the checks in his own name and also forges Washington's signature on them. Each month, when the statement of account prepared by Payson bank is received at DotCom, it is directed to the desk of Hamilton, who himself reviews it. Needless to say, he makes no mention to anyone else of the checks he has written to Burr, his confederate, who has been cashing the checks and turning the proceeds over to Hamilton. In March of 2013, after he has embezzled a total of more than $100,000 by this means, Hamilton resigns from his position with DotCom and leaves its employ, stating that for personal reasons he must relocate to another part of the country. In February of 2014, the accounting firm that does DotCom's annual audit begins to look at the company's transactions for the year 2013. They bring to the attention of Washington, still president of DotCom, "questions" about "several checks written during the earlier part of the year," but at this point they are not able to pinpoint which checks, if any, may have been improperly drawn. On February 12, Washington contacts the officer at Payson who handles the DotCom accounts and tells her that he has been given reason to believe that "some improper items may have been paid out of our account during the first months of last year." The auditors eventually give Washington a detailed listing of the checks that Hamilton wrongfully issued —listing them by number, amount, and date paid by Payson—in May of 2014. Washington immediately forwards this list to Payson and demands that the bank recredit the company's account for the full amount of each check. Payson refuses to do so, citing the one-year rule of §4-406.

Can DotCom successfully argue that it never received the statements covering the months in question, as they were delivered to and examined by Hamilton, the perpetrator of the scheme?

Can DotCom successfully argue that the conversation Washington had with the bank officer in February should be considered a sufficient report of the unauthorized signatures on the checks in question, so that the company had in fact given notice within one year of its receiving the statements on which these checks were listed?

Martin opens a checking account with the Payoff Bank of Springfield. The written deposit agreement that Martin signs at the time of opening this account provides that the bank will furnish the customer with monthly statements, which will include copies of each check processed during the month. The agreement also includes the following language:

> Because you are in the best position to discover an unauthorized copy of your signature or a material alteration made to any check, you agree that we will not be liable for paying such items if you have not reported such an unauthorized signature or alteration to us within 60 days of the mailing date of the earliest statement describing these items.

A check (#2317) is stolen from Martin's checkbook in early June 2013. The thief, who writes out the check payable to herself and forges Martin's name on the drawer line, deposits this check into an account at Distrust Savings and Loan. The check is paid by Payoff Bank on June 20. Martin's June statement records payment of this check, a copy of which is made part of the statement. This statement is mailed to Martin on July 3. It is delivered to his home on July 7. Martin is away for an extended vacation during the month of July. When he returns home in mid-August, he sorts through his mail and finds both this statement and his July statement from Payoff, but does not open either. When his August statement arrives, on September 6, Martin decides that it is finally time to look at all these statements. He immediately discovers the problem with check #2317. He reports this to the bank, giving all the proper details, on September 7. Payoff Bank refuses to recredit his account for the amount of this check, citing the language in the deposit agreement as its reason for doing so and pointing out that the statement detailing this item was mailed to Martin on July 3 and that his report of the unauthorized signature on the item was not made to the bank until September 7, more than 60 days later. Is the bank's reliance on the 60-day reporting period provided for in the deposit agreement effective?

Explanations

No. Upon receipt of his January statement, Andrew did all that could be expected of him under §4-406(c). He exercised "reasonable promptness in examining the statement" and "promptly" notified the bank of the relevant facts regarding the improper payment. Payson would have no grounds for claiming that he is precluded, under subsection (d), from asserting against the bank its payment of an item bearing a forged drawer's signature. Because Andrew's report to the bank came well within one year of the bank's mailing of the statement, subsection (f) is also inapplicable.

Payson will probably have to recredit Andrew's account with the $1,500 even though it also is probably fair to say that Andrew did not meet his responsibility to exercise "reasonable promptness" in examining the January statement. Payson would try to assert the right to place the loss on Andrew by virtue of §4-406(d)(1):

> If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by subsection (c), the customer is precluded from asserting against the bank … the customer's unauthorized signature …, if the bank also proves that it suffered a loss by reason of the failure.

The problem for Payson will not be proving that Andrew failed to meet his subsection (c) responsibilities, but in proving in addition that Payson *suffered a loss* by reason of Andrew's failure. Imagine that Andrew *had* immediately looked at his January statement as soon as he received it and then promptly reported the unauthorized signature to Payson. Even assuming this to be so, Payson would have been made aware that it had paid an item bearing a forged drawer's signature no earlier than February 6 or so. Under the rule of *Price v. Neal*, Payson would normally have to bear this loss. The only party against whom it could proceed, asserting a breach of a warranty of presentment, to recover its loss would be Thad, the thief himself. But by this time, Thad has taken the money and run. (Thieves are wont to do just this.) So even if Andrew had promptly discovered and notified the bank of the improper payment, the bank would have had to bear the loss with nowhere else to turn. Thus, as Andrew will argue, Payson did not "suffer a loss by reason of [his] failure" to give prompt notice. It would have suffered that loss even if Andrew had not failed to comply with subsection (c). Only if Payson could prove that, had it been given prompt notice of the unauthorized signature, it would have been able to catch up with Thad before he left town and made him reimburse the bank for what he had stolen (unlikely indeed) would Andrew be precluded by subsection (d)(1) from asserting the unauthorized signature against the bank.

Under subsection (f) of §4-406, Andrew would have to bear the loss and could not make Payson recredit his account for the $1,500, even though it paid a check bearing a forged drawer's signature. Because Andrew did not discover and report to the bank the unauthorized signature until more than one year after the statement on which it appeared was made available to him, he is absolutely precluded from asserting against the bank the unauthorized signature. This is true, as the subsection states, "[w]ithout regard to care or lack of care of either the customer or the bank."

The Supreme Court of Virginia has even held that the preclusion of §4-406(f) applied irrespective of whether or not the bank has paid the contested items in good faith. *Halifax Corp. v. First Union National Bank*, 262 Va. 91, 546 S.E.2d 696, 44 U.C.C.2d 661 (2001). The plaintiff, a corporation, was made to bear the loss of all of the $15,445,230.49 embezzled by its comptroller—via 88 bogus checks she was able to create on her home computer—between August 1995 and January 1997, without even the possibility of getting some contribution from the bank. The corporation did not discover "accounting irregularities" until January 1999. When it sued its bank, which had paid all of the bogus checks out of its account without question, the bank sought and was granted a summary judgment in its favor on the basis of §4-406(f). The corporation argued that it had raised a triable issue of whether the bank had acted in good faith in paying some of the checks, at least some of the very largest ones, but the court held that good faith is simply not relevant as far as the §4-406(f) preclusion is concerned. The court, noting the absence of any reference to good faith in subsection (f) of §4-406, and comparing this to subsections (d) and (e), concluded its state legislature had left it out intentionally. The court stated, "If the General Assembly had intended to limit the preclusion contained in [§4-406(f)] to items paid in good faith, the General Assembly would have done so explicitly." That being so, the court did not believe itself authorized to, in effect, add the phrase to §4-406(f) of its own volition. The reasoning and decision of the Supreme Court of Virginia in *Halifax* have now been adopted by a number of courts. See the cases collected in *Environmental Equipment & Service Co. v. Wachovia Bank, N.A.*, 741 F.Supp.2d 705 (E.D.Pa. 2010).

Section 4-406 does not come into play here at all. Subsection (c) requires that the customer act reasonably promptly to discover or report only when "any payment not authorized because of an alteration of an item or because a purported signature by or on behalf of the customer was not authorized." Similar language appears in subsection (f). As Comment 5 states:

Section 4-406 imposes no duty on the drawer to look for unauthorized indorsements. Section 4-111 sets out a statute of limitations allowing a customer a three-year period to seek a credit to an account improperly charged by payment of an item bearing an unauthorized indorsement.

It is not hard to appreciate why the drafters made the bank statement rule apply only to unauthorized drawer's signatures and alterations; these are the types of transgressions that a diligent customer should be able to catch by a careful examination of his or her bank statement and the canceled checks or copies of those checks that usually accompany the statement. The drawer is normally in no position to detect a forged indorsement of the payee. In our case, Andrew could have spent all the time in the world looking over his statement and canceled check #1064, but all he would have seen was a signature purporting to be that of Beatrice and the fact that it was deposited into Decoy Bank for collection. There is no reason to think that he would be able to spot a forged signature purporting to be that of Beatrice (he may never have seen her signature before under any circumstances) or that Decoy Bank and Trust was not her bank.

Payson may have to recredit Cara's account for the $500 lost to Theo via check #2345 paid in March, but this ultimately will depend on facts we don't have here. The bank can rightfully claim that Cara failed to carry out her duties of reasonably prompt inspection and notification after receipt of the March statement. To preclude Cara from asserting against it the forged signature on that check under subsection (d)(1), however, the bank will also have to prove that Cara's failure to notify it within a reasonable time caused it to suffer a loss of $500 that it would otherwise have not had to bear. This requires a showing by the bank that had Cara reported the forgery to it by sometime early in April, it would have been able to locate the thief (which might not be hard here, as Theo continued to live at Cara's place) and that Theo would have had sufficient financial resources at that time to pay back the $500 he had stolen. This involves questions of fact, evidence of which both Cara and Payson will have to explore.

Payson will definitely not be required to recredit Cara's account for the two later checks, #2372 and #2385, both forged by Theo and paid by Payson in May. This is so even though Cara promptly caught the problem and reported the relevant facts to the bank. Subsection (d)(2) of §4-406 provides:

> If the bank proves that the customer failed, with respect to an item, to comply with the duties imposed on the customer by subsection (c) [as Cara clearly did with respect to check #2345], the customer is precluded from asserting against the bank … the customer's unauthorized signature or alteration *by the same wrongdoer* on any other item paid in good faith by the bank [here payment on both #2372 and #2385] if the payment was made before the bank received notice from the customer of the unauthorized signature or alteration, and after the customer had been afforded a reasonable period of time, not exceeding 30 days, in which to examine the item [#2345 again] or statement of account [here the March statement] and notify the bank.

The justification for this rule seems clear enough. Had Cara diligently examined her March statement and promptly given notice of the first forged check to the bank sometime in early April, it may not have given the bank the chance to retrieve the $500 amount of that check from Theo, but it certainly would have put Cara (as well as the bank) on notice that she had a thief in her house who was not averse to stealing from her and knew where she kept her checkbook. As Comment 2 observes at one point:

> The rule of subsection (d)(2) follows pre-Code case law that payment of an additional item or items bearing an unauthorized signature or alteration by the same wrongdoer is a loss suffered by the bank traceable to the customer's failure to exercise reasonable care … in examining the statement and notifying the bank of objections to it. One of the most serious consequences of failure of the customer to comply with the requirements of subsection (c) is the opportunity presented to the wrongdoer to repeat the misdeeds. Conversely, one of the best ways to keep down losses of this type of situation is for the customer to promptly examine the statement and notify the bank of an unauthorized signature or alteration so that the bank will be alerted to stop paying further items.

Cases in which this "repeater rule" applies—and where the customer's chances of getting most of what has been looted out of his, her, or its account become very slim—tend to come in two basic configurations, neither of which does much to bolster the confidence we would like to feel justified in placing on our fellow men and women. The first pattern that arises with distressing frequency is the relative or trusted companion who takes advantage of the hospitality of another, as was the hypothetical given here. For a good recent example, see *Mercantile Bank of Arkansas v. Vowell*, 82 Ark. App. 421, 117 S.W.3d 603, 50 U.C.C.2d 631 (2003). The second pattern that you'd end up seeing a lot of if you spent more time with the cases is, of course, the embezzling employee. See, for example, *Tatis v. US Bancorp*, 473 F.3d 672, 61 U.C.C.2d 726

(6th Cir. 2007), or *Spacemakers of America, Inc. v. SunTrust Bank*, 271 Ga. App. 335, 609 S.E.2d 683, 55 U.C.C.2d 893 (2005). The last-cited case is a good read, if for no other reason than as fair warning of what to expect if you should later, say in setting up your law practice or another business, hire a twice-convicted embezzler still on probation as a bookkeeper without making any inquiry about her history (criminal or otherwise), and then immediately delegate "the entire responsibility of reviewing and reconciling [your] bank statements to her while failing to provide any oversight on these essential tasks." No wonder the employer in question soon noticed a "precipitous drop" in its cash assets. Even so, as the court notes, the company took on a new line of credit to keep it afloat—but did not investigate the new employee's bookkeeping to see if there had been any unauthorized activity within the account.

No. The customer's responsibilities under subsection (c) are triggered when a bank "sends or makes available" a statement of accounts. Subsection (f), the one-year preclusion provision, is written so that the critical period commences upon the statement or items are "made available" to the customer, but the courts have sensibly read this as being equivalent to the "sends or makes available" of subsection (c). What else could it mean? Now look at the definition in §1-201(38) (or its equivalent in §1R-201(b)(36)(A)), which, coming as it does in Article 1, is applicable to Article 4 as well as any other article of the Code:

> "Send" in connection with any writing or notice means to deposit in the mail or deliver for transmission by any other usual means of communication with postage or cost of transmission provided for and properly addressed.…

In this case, Payson apparently sent each monthly statement to the address given to it by the customer, the DotCom Corporation, in connection with the account. The corporation did in fact receive the statements. There is no argument about that. The problem—for the corporation—is that the wrong person within the corporation, the embezzler himself, was the only one to review the statements as they came in. But this just shows that the corporation did not set up the proper internal safeguards to protect itself against the relatively rudimentary mode of embezzlement perpetrated by its treasurer. A more carefully thought-out procedure would have provided for a person other than one who had authority to issue checks on the account to receive and review the statements as they came in.

The bank, by sending the statements to the proper address with the proper postage, did all that it needed to do to place upon the customer (in this case the DotCom Corporation) the responsibility to review the statements and to report irregularities to avoid the preclusions provided for in (c) and (f) of §4-406. See *Dow City Cemetery Ass'n v. Defiance State Bank*, 596 N.W.2d 77, 38 U.C.C.2d 1267 (Iowa 1999), in which the Supreme Court of Iowa observed, "The fact that the cemetery [the customer] relied on Starla [the crooked employee] to examine the bank statements did not relieve it of its own duty to examine the statement and notify the bank of any unauthorized signatures or alterations," citing a goodly number of cases to back up its statement. More recently, see *Union Planters Bank, N.A. v. Rogers*, 912 So. 2d 116, 57 U.C.C.2d 236 (Miss. 2005), in which the Supreme Court of Mississippi opined that,

> A reasonable person who has not received a monthly statement from the bank would promptly ask the bank for a copy of the statement. Here Rogers [an elderly woman who had been victimized by an embezzling employee, hired to help her take care of her bedridden husband and to do errands around the house] claims that she did not receive numerous statements. We find that she failed to act reasonably when she failed to take any action to replace the missing statements.

In *Lowenstein v. Barnett Bank of South Florida, N.A.*, 720 So. 2d 596, 36 U.C.C.2d 1139 (Fla. Dist. Ct. App. 1998), the customer sought to recover in 1995 against his bank for more than 81 forged checks created and cashed by a family member between 1991 and 1994, totaling some $100,553.20. The court held that he was barred from recovering as to all but the last six of these checks by the one-year rule, despite the fact that statements including information about all the checks had been delivered to his home during a period when the customer "was in federal custody at two different correctional institutions." The evidence indicated that each of the statements had been sent by the bank to the proper address last given it by the customer.

No. Subsection (f) is avoided only if the customer "discover[s] and report[s]" the irregularity within the one-year period. This is usually read as being equivalent to the customer's responsibility to promptly "notify the bank of the relevant facts" under subsection (c). The customer does not meet this obligation by vague statements that something seems to be wrong with some items. The customer meets the responsibilities of (c) and avoids the preclusion of (f) only by giving specifics as to exactly which items it claims were wrongfully paid. See, for example, *First Place Computers, Inc. v. Security National Bank*, 251 Neb. 485, 558 N.W.2d 57, 31 U.C.C.2d 843

(1997) ("general concerns about possible irregularities in the account" did not meet the requirement of the one-year rule), and *Villa Contracting Co. Inc. v. Summit Bancorporation*, 302 N.J. Super. 588, 695 A.2d 762, 33 U.C.C.2d 1177 (1996) (the customer "must deal in specifics rather than generalities" and "must notify the bank of exactly which items bear the forged signatures"). See also the discussion in *Environmental Equipment & Service Co. v. Wachovia Bank, N.A., supra*, 741 F.Supp.2d at 719-722.

The language in the deposit agreement that Martin has signed is based on the provision before the court in the case of *W.J. Miranda Construction Corp., Inc. v. First National Union Bank*, 40 U.C.C.2d 8 (Fla. Cir. Ct. 1999). The court there held that the so-called "cut-down" clause made part of the deposit agreement between the customer and the bank, reducing the time the customer had to report irregularity in any items paid from the one year after the mailing date of a statement provided for in §4-406(f) to 60 days, was enforceable against the customer and hence blocked any recovery when the customer gave notice more than 60 days after receipt of the statement describing the items under dispute. The court first concluded that the one-year notice requirement of §4-406(f) was not in the nature of a statute of limitations; had it been so, the parties would not have been free to shorten it by their personal agreement. Rather, subsection 4-406(f) sets out "a notice requirement, which acts as a condition precedent to [the customer's] right to sue" on the contract with the bank. As a term of the contract entered into between the bank and its customer, this provision is to be judged in light of §4-103(a):

> The effect of provisions of this Article may be varied by agreement, but the parties to the agreement cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure. However, the parties may determine by agreement the standards by which the bank's responsibility is to be measured if those standards are not manifestly unreasonable.

The court then held that the particular cut-down language in the agreement was not a "manifestly unreasonable" alteration of the one-year preclusion provided for, in the absence of other agreement, in §4-406(f), at least when the agreed-upon time limitation was not being asserted in an attempt to absolve the bank of its duty to act in good faith and use due care. No argument was being made by the customer under the circumstances that the bank had failed to do either.

This decision is in keeping with the majority of those that have had to rule on the validity of such cut-down provisions, which are found in many bank-customer deposit agreements and in some instances call for notice by the customer of any irregularities that the statement should have brought to light in as few as 14 days. See, for example, *National Title Insurance Corp. Agency v. First Union National Bank*, 263 Va. 355, 559 S.E.2d 668, 47 U.C.C.2d 318 (2002), and *Peters v. Riggs National Bank, N.A.*, 942 A.2d 1163, 65 U.C.C.2d 340 (D.C. App. 2008). A particularly well-known, and generally well-regarded, opinion on point was rendered by the Minnesota Supreme Court in *Stowell v. Cloquet Co-op Credit Union*, 557 N.W.2d 567, 31 U.C.C.2d 623 (Minn. 1997). The court there read the cut-down provision (to 20 days) before it not as an attempt to vary the terms of subsection (f) of §4-406, but rather as a specification by the parties of what would constitute "reasonable promptness" by the customer in the examination of his or her account statements and notification of the bank of any forged checks as required by subsection (c). Applying §4-103(a), as quoted earlier, the court held that an agreed-to 20-day term for "reasonable promptness" was not "manifestly unreasonable" under the circumstances.

Notice that neither the *W.J. Miranda* case nor *Stowell*, and the slightly different ways they approached such provisions, would allow a bank to shorten to less than the one year statutorily provided for in §4-406(f) the period in which it could assert a preclusion against its customer *without regard* to the bank's possible lack of care. Nor does either decision dictate the result should a bank try getting its customers to agree to an even shorter period for reporting irregularities (say, one week or ten days). I can well imagine a court determining that such an extreme cut-down was in fact "manifestly unreasonable," at least in a consumer context.

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* Alabama and Oregon have shortened the period to 180 days and Georgia to 60 days. Washington has reduced the period to "sixty days" for any customer other than "a natural person whose account is primarily for personal, family, or household use."

PART VI

Electronic Means of Payment: The Consumer Context

CHAPTER 20

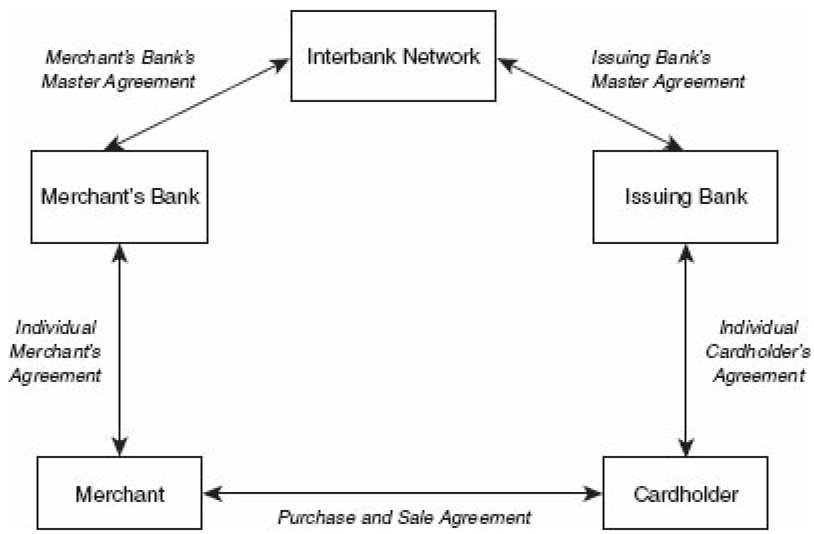
Credit Cards

HOW CREDIT CARDS WORK

Believe it or not, there are those of us who can remember (if only dimly) a time before the availability and widespread use of the universal credit card, such as Visa or MasterCard, of the type we will be considering in this chapter. In the earlier part of the twentieth century, individual retailers might issue to regular customers charge cards, or as they were often called, charge plates (being made of metal!) that the customer could use in making purchases at the store in question. On a periodic basis, the customer would receive a bill for all that had been charged on that customer's account, and the customer was expected to pay the bill in full. If the agreement between the customer and the individual retailer allowed the customer to pay only a portion of what had been charged in any given period, spreading payment of the remainder into the future on established credit terms, the card would then be more properly called a *credit card*, rather than simply a *charge card*. Such restricted-use cards—ones that are accepted by only a particular retailer (for instance Macy's or Wal-Mart), or at gasoline stations selling a particular brand of gas—still exist, of course. You may have one, two, or a whole slew of them in your wallet.

The real boom in the use of credit cards began in the 1960s with the introduction of the so-called *universal use credit card*, a card that was "universal" in that it could be used to charge purchases from a wide variety of retailers and service providers and that incorporated a "credit" agreement allowing the cardholder, in effect, to borrow from the issuer of the card so that not all purchases made within a given billing cycle had to be paid for upon receipt of the bill. This type of card provides the customer with greater flexibility; he or she does not have to open a charge account in advance with each retailer where he or she may end up shopping. It also cuts down on the bulk of the customer's wallet.*

Our first goal is to get a good overview of exactly how the universal credit card works from the point of view of all the parties involved. How do funds eventually get from *A*, the credit card user, to *B*, the merchant taking the card in exchange for goods or services? The basic plan looks like this:



The interbank network placed at the top of this diagram—for example, Visa USA or MasterCard International, the two largest players in this field, which together account for a large majority of all credit cards now in the hands of users in the United States—is not itself directly involved in any individual transaction where the card is used to pay for goods or services. Its function is to provide the technological infrastructure that binds together the various banks and merchants in the system. The network enters into agreements with banks, such as the issuing bank in our diagram, authorizing the bank to enter into the system and to issue cards to end users. An issuing bank is then free to enter into contracts with individuals and businesses under which it issues the type of card in question to these users, agreeing to bill them on a periodic basis, extend them a line of credit up to a specified amount, charge them interest for any outstanding balances, and so on.

The master agreement under which banks become members of an interbank network permits the banks to serve a separate function, as with the merchant's bank of our diagram. Acting in this capacity, a member bank will solicit the participation of and then contract directly with the individual merchants in the system, each of which agrees "to accept" the card, taking it for payment for the goods or services it offers to the public. At the end of each business day, the participating merchant will collect all the charges it has taken in during the day on the card into a bundle—at least metaphorically as a record of each charge having been created electronically by the user's card being "swiped" through a card reader, with the rest of the information regarding the charge input directly to fill out the electronic record. This electronic bundle of all the day's charges is by agreement forwarded to the merchant's bank for processing. Information about each separate charge is sent on by the merchant's bank, via the technological roadways maintained (for a small fee) by the interbank network, to the bank that issued the card used in that particular transaction. That issuing bank periodically compiles a listing of all the charges made on the card, totals the amount due, and sends all this information, in the form of a bill, to the cardholder for payment. This is the one part of the process with which you are most probably familiar.

Fortunately for the merchant, it does not have to wait until each bill is paid and the amount due it on each transaction is fed back into the system to get its hands on the money representing the charges it has collected. Under its agreement with its bank, the amount of the charges it has collected on any given day (minus a small fee, of course) is within a few days made available to the merchant by deposit into an account it holds at the bank. The exact availability schedule, determining how much and when the accumulated charges delivered to the bank will result in money credited to the merchant's account, is set forth in detail in the contract between the merchant and its bank. Under the contract, the merchant must also agree that any charges reported in error, or that are eventually not collected because of a legitimate defense on the part of the cardholder, can be "charged back" or debited from its account.

THE LAW REGULATING CREDIT CARD

The law governing this entire multiparty arrangement is principally the traditional common law of contract. Notice the variety of contractual relationships that serve as background to and make possible any single credit card transaction. The issuing bank has entered into a contract with the interbank network, as has the merchant's bank. The issuing bank has also entered into a contract with the cardholder upon issuance of the card. The merchant's bank has a contract with the merchant. Each of these contracts is in place before the cardholder ever enters the merchant's shop or (as is increasingly true) makes contact with the merchant over the phone or via the Internet. When the cardholder and the merchant do make contact and come to some agreement about the sale or lease of goods or services, this is itself a distinct contract. Only this last contract, the one between the cardholder and the merchant, is even potentially governed by the Uniform Commercial Code; if the contract is for the sale of goods, it is subject to Article 2 of the Code; if for a lease of goods, to Article 2A. (If the cardholder-merchant contract is for the provision of services by the merchant, then of course it falls outside of the U.C.C. and is governed by the common law as it is applicable to service contracts.) Other than this, the various contracts that figure in our diagram are not dealt with at all by the Uniform Commercial Code. Nor, for the most part, does any federal law pertain to them. They are contracts entered into between supposedly savvy business parties (banks and the like), and the rules of the game will be the terms of the agreements entered into. The one exception to this statement is that federal statutory and regulatory law does affect the possible terms and enforcement of the issuing bank's contract with the individual cardholder, at least when the cardholder is a consumer. As we will see, the underlying purpose of this limited regulatory regime is consumer protection.*

In the early 1970s, Congress passed the federal Truth-in-Lending Act (TILA), which has been codified as Title I of the comprehensive Consumer Credit Protection Act (15 U.S.C. §1601 *et seq.*).† Acting pursuant to its authority under the TILA, the Federal Reserve promulgated *Regulation Z* (12 C.F.R. Part 226) to enforce the Act's provisions. Federal regulation of the credit card industry took a major step forward in 2009 with the passage of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the

“CARD Act”). This legislation introduced into the TILA (and to a lesser extent some other federal statutes) what has been referred to as the Credit Cardholder’s Bill of Rights. While it does not limit or control the exact amounts of any fees or rates of interest which could be charged in the underlying credit card agreement entered into by a consumer customer and an issuing bank, it does mandate provisions curtailing or regulating a whole series of *practices* which issuers had employed in ways Congress believed to be unfair or misleading to typical credit card users. As just one example, issuers would now be required to print, on any periodic statement showing a “minimum amount” the customer could pay to not be in default, information about how long it would take for the customer to fully retire his or her total debt owed to the issuer if the customer continued to make only the minimum payment, no further debt having accrued, and, further, how much the customer would pay in interest under this scenario. We will not be considering the various provisions of the CARD Act in this chapter, as they relate to the *credit* facet of a credit card and not to its use as a *payment* mechanism. That being true, however, it would do you no harm—either as a potential lawyer or merely as a credit card user—to take a look at a general summary, several of which can easily be found online, of that act’s provisions and safeguards.

One year after the enactment of the CARD Act, Congress passed and the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), one result of which was the creation of a new federal administrative agency, the Consumer Financial Protection Bureau (the “CFPB”). Under the Dodd-Frank Act, this new agency would assume principal responsibility for administering the TILA as of July 21, 2011. Acting under this authority, the CFPB promulgated its own version of Regulation Z, varying only in minor respects from the Federal Reserve’s version, as 12 C.F.R. Part 1026. In what follows, I will cite you to the CFPB’s version of Regulation Z (e.g., “Reg. Z §1026.12”), but you should not be surprised if you find in other sources citations to the Federal Reserve’s version (e.g., “Reg. Z §226.12”), which still remains on the books. The operative language of the two versions is, at least as far as we are concerned, essentially the same.*

The first thing to notice about the provisions of the TILA is that, with only rare exceptions, they apply only to consumer users of credit cards.† TILA §104(1) [15 U.S.C. §1603(1)] and Reg. Z §1026.3(a) specifically provide that the Act does not apply to

> Credit transactions involving extensions of credit primarily for business, commercial, or agricultural purposes, or to government or governmental agencies or instrumentalities, or to organizations.

Note also that under subsection (3) of the same section, the TILA does not apply to even a consumer transaction (except of one unique type) “in which the total amount financed exceeds $25,000.” It will be handy to remember that for definitions of just about all of the terms used here or elsewhere in the TILA, you can look to TILA §103 [15 U.S.C. §1602] and Reg. Z §1026.2(a).

A large part of the TILA and Regulation Z are taken up with making sure that the card issuer makes certain prescribed *disclosures* to the cardholder every step along the way. Disclosure of certain key aspects of the relationship is required in any advertisement or direct solicitation of potential cardholders by the issuer or accompanying any application that the prospective cardholder is asked to fill out. It is also required upon initial issuance of the card, when a renewal card is sent, and on each bill. The type of information that is the subject of mandatory disclosure includes what rights the cardholder has to dispute any charge reported to him or her on a bill, the method for handling such a dispute, whether there is any annual fee for use of the card, and the extent of the cardholder’s potential liability for unauthorized use of the card. Because the cardholder may also be carrying a balance over from one month to the next, and thereby taking advantage of the issuer’s offer of credit, disclosure has to be made of the terms of the loan, using the TILA’s detailed definitions and Regulation Z’s further explication of the “finance charge” and the “Annual Percentage Rate” that the issuing bank intends to extract.

In the following examples we consider three other aspects of the TILA’s regulation of credit card use. First we deal with issues involving the *unauthorized use* of a credit card by one other than the cardholder. What constitutes an unauthorized use?* To what extent may the cardholder be held liable for any or all of the charges made by the unauthorized party? Second, we take up the method of *error resolution* provided for by the statute. If the cardholder discovers a charge on his or her statement that he or she believes to be in error, what must be done to contest the charge? What must the issuing bank do once a charge is put in dispute? How, if at all, does the dispute get peacefully resolved by this mechanism? Finally, we consider under what conditions the cardholder may assert *against the credit card issuer* any claims or defenses that it would have against the merchant, when the issuer continues to insist that the charge be paid after an attempt at error resolution has failed to wipe the charge off the cardholder's account.

Examples

Angela, who is a very handy type, is personally remodeling and repainting her bedroom, with the help of her friend Bella. At one point Angela asks Bella to go to the local hardware store to purchase some paint for the next phase of the job. Saying, "You'll need this," she hands over to Bella a MajorCard card that was issued to her by Shelbyville Bank. Bella goes to Cogland's Hardware, where she purchases a quantity of paint. She hands Angela's card over to Cogland, who rings up the purchase by charging the card. Bella signs her own name on the charge slip. Bella returns with the paint to Angela's. After it is applied to the walls, Angela decides that the color is not at all to her liking. She is going to have to repaint the whole room. When Angela's next MajorCard bill arrives from Shelbyville Bank, it contains the charge from Cogland's Hardware for the paint Bella purchased. Does Angela have any argument that she is not responsible for this purchase because it was an "unauthorized use" of her card? See TILA §103(o) [15 U.S.C. §1602(o)] or Reg. Z §1026.12(b)(1).

Angela, of the previous example, has to go away for a weekend. Bella offers to come over to her house on Sunday and continue work on the remodeling of the bedroom. Angela gives Bella the key to her house. When Bella arrives on Sunday, she finds a note from Angela thanking her for all her help. Next to the note is Angela's MajorCard card. During the course of her work, Bella determines that she needs a taller stepladder to do work on the ceiling. She takes Angela's MajorCard card to Cogland's, where she purchases a ladder, again using the card for payment but this time signing Angela's name to the charge slip, creating a fairly good likeness of Angela's signature as it appears on the back of the card.

Would this constitute an unauthorized use of the card?

) Suppose that in addition to buying the stepladder for Angela's home remodeling project, Bella also charged to the card a bread-making machine that she happened to see on sale at the hardware store and that she determined she simply must have for her own use. Would *this* charge, for the appliance, be an unauthorized use of the card?

Vould your answer to part (b) remain the same if instead Bella had signed her own name to the charge slip handed to her by Cogland?

Darrel applies for a MajorCard card from Shelbyville Bank. The bank puts a card issued in Darrel's name into the mail, sending it to the address given the bank by Darrel on his application. This card is apparently stolen from Darrel's mailbox by some unscrupulous character. The first mail Darrel actually receives from the bank relating to the card is a first month's statement indicating that more than $3,500 in purchases have been charged to the card. Is Darrel responsible for paying any of this? For this and the example to follow, see TILA §133(a)(1) [15 U.S.C. §1643(a)(1)] or Reg. Z §1026.12(b)(2)(i).

Emily applied for, received, and accepted a MajorCard card issued by the Shelbyville Bank. At one point some crooked character comes into Emily's office while she is not there, rifles through her wallet, and extracts the MajorCard card. When Emily finally becomes aware that the card is missing, she checks with her bank and finds that more than $10,000 in charges have been made on the card by whoever took it.

s Emily responsible for any of these charges?

What if Emily had immediately noticed that her wallet had been tampered with and, upon carefully checking, found that the MajorCard card was missing? She quickly calls the telephone number provided by the bank to report the stolen card. All of these hefty charges on the card are made by the thief after Emily has notified the bank of the theft of the card. Does Emily bear any of the loss under these circumstances?

Frederick has a MajorCard card issued to him by the Shelbyville Bank on which he is billed monthly. On his statement for September 2013, which the bank mails on October 3 and Frederick receives on October 5, 2013, there is a charge of $123.57 from a “Metro Diner” of Shelbyville, the date of the transaction being September 15, 2013. Frederick is sure this is some sort of mistake. He has never been to the Metro Diner, and certainly not on the date in question.

Would this charge constitute a “billing error”? See TILA §161(b) [15 U.S.C. §1666(b)] or Reg. Z §1026.13(a).

What should Frederick do to officially register his dispute of this item? See TILA §161(a) [15 U.S.C. §1666(a)] or Reg. Z §1026.13(b).

What must Shelbyville Bank do upon being made aware that Frederick considers this item to be in error? See TILA §161(a) and (c) [15 U.S.C. §1666(a) and (c)] or Reg. Z §1026.13(c), (d), and (f).

Suppose that upon inquiry to the Metro Diner, the bank is informed by the manager of the diner that its report of a charge in this amount on Frederick's card was indeed an error. The meal was eaten and the charge incurred by someone else whose card number was mistakenly read as that of Frederick's. What is the bank obligated to do now? See TILA §161(a) [15 U.S.C. §1666(a)] or Reg. Z §1026.13(e).

Suppose instead that the manager of the diner, upon checking her records, insists that the charge was not made in error. She forwards to the bank a copy of a charge slip, bearing the date and amount in question, which does indeed carry the imprint of Frederick's card and a signature that appears to be that of Frederick. The bank concludes that its inclusion of the charge on Frederick's September bill was not in error. What may and must it do then? See TILA §161(a) [15 U.S.C. §1666(a)] or Reg. Z §1026.13(f) and (g).

Gabriella, a resident of Baltimore, has a MajorCard issued to her by Maryland Bank and Trust. She uses the card to purchase, for $1,200, from Hopkins Fine Jewelry of Baltimore what she is assured by Hopkins is a unique antique watch made sometime in the late 1800s. She begins to wear the watch immediately and receives many compliments on it. One friend, however, tells Gabriella that she almost bought "the exact same thing" at a jewelry store other than Hopkins. Gabriella goes to this other store and does see a watch there that appears to be identical to hers. The owner of the shop looks at her watch and tells her that although it is a fine watch (as is the identical watch he has on display), it is not an antique but a recent reproduction. He is asking $800 for that particular model. When Gabriella gets home that day, she finds her most recent MajorCard bill, which includes the $1,200 charge she made at the Hopkins jewelry store. She goes to Hopkins's store the next day and demands that he take back the watch and credit her MajorCard with $1,200. Hopkins insists that whatever anyone else may have told her, this particular watch is indeed an antique and worth every penny she paid for it. Gabriella notifies Maryland Bank and Trust that she is disputing the $1,200 on her bill, and the bank investigates, but ultimately it decides (in light of her admission that she made the charge for $1,200 on the date in question and Hopkins's insistence that there was nothing faulty or questionable about what she purchased that day) that there was no billing error and that Gabriella should pay the $1,200 as part of what she owes on her MajorCard account.

If Gabriella refuses to pay this part of her MajorCard bill and is eventually sued for the amount by Maryland Bank and Trust, can she use as a defense against that bank the breach of warranty she claims she was given by Hopkins? That is, could she defeat or lower the bank's claim by proving, by whatever means, that the watch is not a genuine antique made in the late 1800s but rather a cheaper reproduction? Remember, no one at the bank ever gave her any assurances about the nature of the watch. See TILA §170(a) [15 U.S.C. §1666i(a)] or Reg. Z §1026.12(c).

Would your answer be the same if Gabriella had purchased the watch not at a jewelry store located in her hometown of Baltimore but rather at a store in Los Angeles when she happened to be visiting that fair city?

What if Gabriella had not immediately become aware of the questionable nature of her purchase from Hopkins? She pays the MajorCard bill, including the $1,200. Only later does she have reason to believe that Hopkins breached a warranty in the sale of the watch to her. She tries to get relief from Hopkins, but to no avail. Can she sue the bank for return of the $1,200 or for $400 in damages, asserting against the bank the breach of warranty by the merchant? See TILA §170(b) [15 U.S.C. §1666i(b)] or Reg. Z §1026.12(c).

Explanations

No. Angela must pay for this purchase with her card, as this was clearly an *authorized* use. As you see in either the TILA or the Reg. Z cite, the term *unauthorized use* means

> a use of a credit card by a person other than the cardholder who does not have actual, implied, or apparent authority for such use and from which the cardholder receives no benefit.

This was a use by a person other than the cardholder, so the question comes down to whether, under the common law of agency, Bella had the authority to make the charge. In this instance it seems undeniable that Bella was given actual authority by Angela to use Angela's card to purchase the paint.

No. This should also be considered an authorized use of the card. Cogland and the issuing bank could argue that Angela, by leaving her card next to the note as she did, and in light of Angela's past practice of giving Bella actual authority to use the card to buy supplies for the remodeling projects, had given Bella the implied authority to use the card to buy the stepladder. The fact that Bella signed Angela's name rather than her own does not change things. Angela, it could be argued, has impliedly authorized Bella not only to use the card in connection with the work being done, but also to sign Angela's name in connection with the use of the card. This is not a forgery or an unauthorized signature. It is an example of an agent, here Bella, having the authority to sign the name of her principal, Angela, under the circumstances.

Bella was authorized to use the card at Cogland's, but she went overboard and charged an item that she had no reason to think Angela would have authorized her to buy and that she plans on keeping for her own use. The courts have generally held that in a situation such as this, the *misuse* of a card voluntarily made available to another does not constitute an unauthorized use. A well-known case addressing the problem is *Stieger v. Chevy Chase Savings Bank*, 666 A.2d 479 (D.C. App. 1995). Stieger, the cardholder, voluntarily gave his card to one Ms. Garrett for the limited purpose of renting a car and for a stay in a hotel during a business trip being made on Stieger's behalf. Garrett made a number of other charges not specifically authorized by Stieger, in most cases signing "P. Stieger." Stieger contended that these additional charges were unauthorized, but the court ruled that, at least with respect to the charges for which Garrett signed Stieger's name, the doctrine of apparent authority applied and the charges were authorized.

> Our cases reveal that apparent authority arises when a principal places an agent in a position which causes a third person to reasonably believe the principal had consented to the exercise of authority the agent purports to hold.… [A]pparent authority of an agent arises when the principal places the agent in such a position as to *mislead* third persons into believing that the agent is clothed with authority which in fact he does not possess.

The court noted that this was not a case in which the acquisition of the card by the user was without the cardholder's consent, such as when the card has been stolen, lost, or obtained from the cardholder by fraud. In such situations, the mere possession of the card by the user does not support a finding of apparent authority in the user; the cardholder has himself or herself done nothing to give the third party the impression that the use is authorized. As the *Stieger* court concluded, however, the situation is different if the cardholder has voluntarily made the card available to the user, even if for a limited purpose.

> Nearly every jurisdiction that has addressed a factual situation where a cardholder voluntarily and knowingly allows another to use his card and that person subsequently misuses the card has determined that the agent has apparent authority, and therefore was not an "unauthorized" user under [the TILA].

So Bella's purchase of the bread-making machine would likely be considered an authorized use of the card, because Angela voluntarily and knowingly allowed Bella to use the card. The fact that Bella misused it, going beyond what she could have reasonably believed Angela intended her to use the card for, does not render this an unauthorized use.

At least according to the *Stieger* case, this would make a difference and Bella's misuse of the card to obtain the bread-making machine for herself would constitute an unauthorized use.

> To a merchant, voluntary relinquishment combined with the match of a signature is generally reasonable identification of apparent authority to utilize the credit card.… [T]he same cannot be said of the two charges where Ms. Garrett signed her own name rather than "P. Stieger." It is an unreasonable extension of the apparent authority provided to Ms. Garrett for a merchant to accept charges, where the signatures do not match, without any additional factors to mislead the merchant into believing that the person presenting the card is the agent of the cardholder.…

The prospect of employee misconduct involving his or her employer's credit card and leaving the employer to bear the loss (well beyond $50) due to the notion of apparent authority is forcefully brought home in cases such as *Minskoff v. American Express Travel Related Services Co., Inc.*, 98 F.3d 703, 30 U.C.C.2d 999 (2d Cir. 1996). Mr. Minskoff was the President and Chief Executive Officer of his own real estate holding and management firm. In 1988, the firm opened an American Express corporate card account, for which one credit card was issued in his name. Three years later he hired Susan Schrader Blumenfeld to serve as his assistant, giving her responsibility for handling both his personal and business affairs. Among other things, all credit card statements and other communications were forwarded directly to her and dealt with only by her. After hiring Ms. Blumenfeld, Mr. Minskoff no longer reviewed any of this material. Within a few months, this new employee had applied, in response to a mailing sent by American Express, for an additional card to be issued with respect to the corporate account in her own name. Later, when American Express sent an unsolicited invitation to upgrade the corporate account to a "platinum card," Ms. Blumenfeld accepted the offer—again making sure that one card was issued in Minskoff's name and one in hers. Blumenfeld eventually ran up charges totaling over $412,000 on the cards she had obtained in this manner. When monthly statements would come in from American Express, listing the charges made by both Minskoff and herself on each card, she would dutifully (if that's the word) pay American Express the full amount owed out of Minskoff's checking account. When her theft was finally discovered, Blumenfeld agreed to repay $250,000 to Minskoff in return for his promise not to institute legal action against her. Minskoff instead brought an action for the additional loss he had suffered against American Express, claiming that all charges made by Blumenfeld were unauthorized and consequently subject to the $50 limitation on liability.

The Second Circuit found no merit in this argument. It noted that, "while we accept the proposition that the acquisition of a credit card through fraud or theft cannot be said to occur under the apparent authority of the cardholder," the same could not necessarily be said for "the subsequent use of a credit card so obtained." Analogizing the situation to that covered by §4-406 of the U.C.C. with respect to bank checking accounts (see Chapter 19), the court held that "a cardholder's failure to examine credit card statements that would reveal fraudulent use of the card constitutes a negligent omission that creates apparent authority for charges that would otherwise be considered unauthorized under the TILA." Minskoff, therefore, would have to bear the loss of all charges made by his faithless employee from the time he first received the first credit card statement reflecting fraudulent charges made by Blumenfeld "plus a reasonable time to examine that statement. After that time [the cardholder is] liable for the remaining fraudulent charges."

In a later case dealing with a distressingly similar situation, *DBI Architects, P.C. v. American Express Travel-Related Services Co., Inc.*, 363 U.S. App. D.C., 388 F.3d 886 (D.C. Cir. 2004), the Court of Appeals for the District of Columbia Circuit, came to basically the same conclusion, although by a slightly different route. The employer argued that under the law of agency its mere receipt of monthly statements could not by itself create any apparent authority in its employee to continue to use the card. Apparent authority, under traditional doctrine, can be found to exist only when the principal acts in such a way, known to the third party, which reasonably gives the third party reason to believe that the "apparent" agent has been given actual authority by the principal to act as he or she does. Apparent authority cannot be created by "mere silence" of the principal, here the employer. The court concluded therefore, in agreement with the defrauded employer, that "[its] silence without payment would be insufficient to lead AMEX reasonably to believe that [the faithless employee] had authority to use [the employer's] corporate account, as such silence would be equally consistent with [the employer's] never having received the statements." American Express was ultimately to win the day, however. It's argument, and that adopted by the Circuit Court was based not on the reasoning of the earlier *Minskoff* case, even if the lower court had found for it following that case's reasoning. Apparent authority was to be found, not in the cardholder's mere receipt of a statement or statements indicating the unauthorized use of the card or in its failure to examine those statements, but in the cardholder's "repeated payments in full" of all charges of which it had notice via these monthly statements. Such payment was in effect held to be communication to AMEX which could thereafter reasonably believe that all charges listed on those statements, including those made by the faithless employee, were authorized by the cardholder. More recently, courts have cited with approval both the *Minskoff* and *DBI Architects* cases and found for the card issuer in *Carrier v. Citibank (South Dakota), N.A.*, 180 Fed. Appx. 296 (2d Cir. 2006), and *New Century Financial Services, Inc. v. Dennegar*, 394 N.J. Super. 595, 928 A.2d 48 (N.J. Super. 2007).

Whether you prefer the reasoning of the *Minskoff* or the *DBI Architects* case—and I must admit to a preference for the latter, with its thoughtful discussion of the apparent agency doctrine—the lesson remains the same. What we have seen with respect to bank account statements is no less true for statements issued in connection with credit cards. Be sure you get and see *for yourself* those statements. Check them. Check them carefully.

Darrel is not responsible for any of the unauthorized charges made with this card, not a penny. Liability of a cardholder for unauthorized use of the card is predicated (under TILA §133(a)(1)(A) [15 U.S.C. §1643(a)(1)(A)] and Reg. Z §1026.12(b)(2)(i)) on the card having been "accepted." The term *accepted credit card* (which you should be able to find for yourself in either the statute or the regulation),

> means any credit card which the cardholder has requested and received or has signed and used, or authorized another to use, for the purpose of obtaining money, property, labor, or services on credit.

Darrel requested but never received the card, so he is not at all liable for any charges made on it. Up until fairly recently, a large percentage of the losses merchants or issuers suffered from the unauthorized use of cards could be traced to situations like this one, when an initial or replacement card is sent to the cardholder but is stolen before it ever reaches the intended recipient. That is why, as you may have yourself experienced, most issuers now require that the card, once received, be “activated” by the cardholder through a call from his or her home phone and the giving of personal information (such as a Social Security number or mother’s maiden name) that a thief would presumably not have readily available. This practice has apparently cut down on at least this one type of credit card fraud considerably.

The crook’s charges against the card were clearly unauthorized and hence Emily is responsible for only $50 of these unauthorized charges, but no more. See TILA §133(a)(1)(B) [15 U.S.C. §1643(a)(1)(B)] and Reg. Z §226.12(b)(1). The policy decision behind this important aspect of TILA is to have the principal brunt of loss due to unauthorized use (amounting to something like $1.5 billion in 1995) borne by the credit card industry rather than individual users. This of course, is all the more reason why the question of whether a particular charge will be deemed authorized or unauthorized is so important to the cardholder. The cardholder is fully liable for any authorized charges, but can be held responsible for no more than $50 of unauthorized charges, even if he or she fails to report the loss of the card in a timely fashion.

No. Now Emily does not even have to bear $50 worth of the loss. A cardholder can be liable for unauthorized use only if the use occurs “before the card issuer has been notified that an unauthorized use of the credit card has occurred or may occur as the result of loss, theft, or otherwise” (TILA §133(a)(1)(E) [15 U.S.C. §1643(a)(1)(E)] and Reg. Z §1026.12(b)(1)). Emily’s timely reporting of the loss has saved her $50. The $50 amount may not seem like more than a token, but it is something. More important from Emily’s point of view is that the sooner she discovers and reports the loss, the sooner she can put a stop to unauthorized charges on the card. Although she will not be responsible for more than $50 of these charges, anything she can do to minimize the hassle she will have to go through because of unauthorized charges is more than worth the time and effort expended in reporting the loss as soon as she can.

Yes. As of this point, Frederick believes this item on his bill reflects “an extension of credit [by his bank to pay a bill at the Metro Diner] that was never made” to him or to someone authorized to use the card. As you can see, not all “billing errors” that require both the cardholder and the issuing bank to comply with the billing resolution procedures of the TILA are of this type.

The cardholder may be disputing only the amount of a particular item, rather than claiming that he or she never used the card at the merchant's place of business on the date in question. The cardholder himself or herself may not in fact be sure what the listed item stands for and may not know whether it is legitimate, in which case he or she may request "additional clarification, including documentary evidence," about the particular item.

> Notice, however, that the term "billing error" does not include a dispute relating to the quality of property or services that the cardholder has accepted or to which they have been delivered. See *Beaumont v. Citibank (South Dakota) N.A.*, 2002 U.S. Dist. LEXIS 5276 (S.D.N.Y. 2002). That is, if the cardholder acknowledges making the charge and getting the goods or services but is dissatisfied with them, even if rightfully so, he or she cannot claim that a billing error has been made. So, for example, if Frederick does remember eating at the Metro Diner on that day, and using his MajorCard to pay for the meal, he can't initiate the billing error procedure, even if his memory of the meal is particularly vivid because he later had reason to believe he was served tainted food. If he believes that for this reason he should not have to pay any or all of the $123.57, his remedy lies in a different part of the TILA and Regulation Z. See Example 6. For another recent case reflecting the limited nature of disputes that can be said to involve a "billing error" under the TILA, see *Moynihan v. Providian Financial Corp.*, 2003 U.S. Dist. LEXIS 13732 (D. Md. 2003).

Frederick must send the Shelbyville Bank a written notice that is received by the bank within 60 days of October 3. This notice should contain information sufficient to allow the bank to identify Frederick and his account number, and to make the bank aware of which item on his September bill he believes to be in error, as well as the reasons for his belief that the item is in error.

> As a practical matter, many issuers now provide on the monthly statement a telephone number for cardholders to call if they believe a billing error has occurred. The issuer usually immediately puts the amount "in dispute," meaning, as we will see, that the cardholder does not have to pay it as part of that month's bill. The issuer then itself sends the cardholder a form to fill out, sign, and return which acts as the written notice required by the TILA asserting the existence of a billing error.

The bank has to send a written acknowledgment of receipt of the billing error notice sent by Frederick within 30 days after receipt of that notice. The bank may not, during the time the dispute is still pending, require payment of the amount in dispute, make any efforts to collect the disputed amount, or directly or indirectly make or threaten to make an adverse credit report about Frederick's credit status because he has failed to pay the disputed charge. Within two complete billing cycles (two months in this case), the bank must do one of two things. It may resolve the dispute in Frederick's favor and make the appropriate correction to his account, notifying Frederick of the fact. Or it may "send a written explanation or clarification" to Frederick "after having conducted an investigation, setting forth to the extent applicable the reasons why [it] believes [Frederick's] account was correctly shown in the statement," and upon request provide copies of documentary evidence of his indebtedness. I am quoting here from the TILA itself. Regulation Z adds the not unreasonable requirement that the bank's investigation be a "reasonable investigation" (Reg. Z §1026.13(f), n.31).

> It is important to recognize that the role of the issuing bank in this dispute resolution process is that of impartial arbiter. For a cardholder, disputing an item is not the same as having it wiped off the books. How could it be? The issuer's investigation may indeed cause the merchant to realize that a mistake has been made and that the charge was submitted in error. But that will not invariably be the case. Should the merchant insist that the charge was valid, and give the bank evidence appropriate to the situation to back up its claim, then the bank is well within its rights, and may be under an obligation, to conclude that the cardholder's claim of a billing error cannot be sustained. The charge goes back on the bill. Were any individual issuer to consistently rule in favor of its own cardholders when disputes arise, we have to assume that merchants would soon learn not to accept cards issued by that bank.

Shelbyville Bank should correct the billing error and credit Frederick's account with the disputed amount and any related finance charges. It must further mail a correction notice to him.

The bank should then mail to Frederick an explanation of why it has determined that no billing error occurred, and must also furnish copies of documentary evidence (in this case the signed credit card slip) of Frederick's indebtedness to him if he so requests. The bank can then add back to the amount due on Frederick's account the disputed $123.57, notifying him of the time when this payment is due and of the amount, including any relevant finance charges, that he now owes. As TILA §161(a) concludes:

> After complying with the provisions of this subsection with respect to any alleged billing error, a creditor [the issuing back] has no further responsibility under this section if the obligor [the cardholder] continues to make substantially the same allegation with respect to such error.

I think it is important to recognize that a finding against Frederick in such a situation is *not* necessarily equivalent to a clear-cut determination that he must have been lying all along about not having gone to the Metro Diner, and that he is just trying to get out of paying for a meal that he did in fact agree to pay for. Even if the dispute resolution process ends up finding that no billing error occurred, the further information Frederick may have obtained may by now have cleared up the mystery. Sometimes the process just jogs the (perfectly honest) cardholder's memory about a charge that he or she had really forgotten. Perhaps the restaurant that was still officially listed as "Metro Diner" on the MajorCard merchant's directory, and hence showed up on the bill by that name, had by the time in question been operating under another name, say, "International Villa." Or perhaps Frederick, when he gets a chance to see a copy of the charge slip itself and the signature on it, comes to the unhappy realization that the charge occurred during a period when he lent his son the card in order to gas up the car—and his son misused the card to get a meal for himself and some friends at a local diner while he was at it. This would make the charge, as we have already determined, an authorized charge on the card and one for which Frederick really is responsible. How Frederick sorts out the affair with his son is his business. It does not come within the scope of any federal statute or regulation, as far as I am aware.

Yes. Subject to certain limitations, none of which apply here, the TILA provides that the issuer "shall be subject to all claims (other than tort claims) and defenses arising out of any transaction in which the credit card is used as a method of payment." The TILA provides that one of the preconditions to Gabriella's being able to assert the defense against the bank is that she have made "a good faith attempt to obtain satisfactory resolution of a disagreement or problem relative to the transaction from the person honoring the credit card." Similar language is found in Reg. Z §1026.12(c).

If, as here, Gabriella's use of the card was in another state or more than 100 miles from the billing address that she has given the bank in connection with her card, then Gabriella would *not* be able to assert against the bank any breach of warranty arising out of her transaction with the Los Angeles jeweler. What justification there is for the "100 mile rule," as this limitation is sometimes called, is not altogether clear. It is usually asserted that the effect of the limitation is to make credit cards more easily used (that is, more acceptable to merchants) when the cardholder is far away from home. Whether this is indeed the case, and if so exactly why, is subject to dispute. The need, if any, for the 100-mile rule has become even more questionable in recent years, as more and more credit card transactions take place over the telephone or via the Internet. Where exactly is the location of the transaction when the card is used in this way? The few cases that have had to deal even tangentially with such metaphysical questions give no clear or consistent answer. As for Gabriella in our example, the answer is not in dispute. She has no defense based on any alleged breach of warranty if she is sued by Maryland Bank. She is going to have to pay the bank the charge resulting from the purchase of the watch. Any relief she may hope to gain will have to be had by her going against the California seller on a breach of warranty action under Article 2.

No. The cited provisions grant the cardholder no right to institute a suit against the issuer under any circumstances. They provide only for the cardholder's assertion of certain claims and defenses should he or she be sued by the issuer.

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* At least that is the idea. It is, of course, fairly easy nowadays for a person to end up acquiring and carrying around any number of credit cards—and all too easy for that person to run the charges on each of those cards up to the maximum credit limit provided. Such scenarios are more properly dealt with in another course, namely, bankruptcy. For our purposes, we will assume that the credit card holder has been judicious, at least with respect to how many cards he or she has been using and how much debt has been piling up.

* Many states also have passed legislation that supplements but does not replace the federal law and rules discussed in this chapter. Again, these state statutes focus on the issuing bank-cardholder relationship in attempting to protect the consumer from what might be considered unfair or predatory aspects of the relationship.

† Some of the casebooks and other books in this area rely on the section numbers of the TILA directly (as in TILA §103). Others cite to the same section as codified in the United States Code (so TILA §103 is also 15 U.S.C. §1602). For your convenience, I have decided to include both citations, giving the TILA section first followed by the U.S.C. citation in brackets. So, for example, "TILA §103 [15 U.S.C. §1602]."

* Just to make life that much more interesting, it has been my experience that not all of the selected commercial statute books, of the type you have available to you reproducing the Uniform Commercial Code and other related materials, include copies of both the TILA and Regulation Z. Some contain both, some one, and some the other. In truth, the text of the TILA and Regulation Z are almost identical, and I can appreciate why the editors of these volumes may have decided not to reproduce both just to make these statutory supplements even bulkier than they already are. For our purposes, I will cite both the statutory section *and* the parallel provision in Regulation Z. So, for instance, I might refer you to "TILA §132 [15 U.S.C. §1642] or Reg. Z §1026.12." If you can track down and carefully read just *one* of these references in the materials you have available to you—and that you certainly should be able to do—it should be sufficient to analyze the examples I will place before you.

† The exceptions, in which other than consumer users may rely upon TILA, are set out in TILA §135 [15 U.S.C. §1645]. A nonconsumer cardholder is protected from the issuance to it of a credit card for which it has not applied and from liability for unauthorized use of its card, a significant part of TILA that we will take up in the examples. The nonconsumer is also subject to TILA's provision dealing with the fraudulent use of credit cards.

* As you will discover when you look at the definition of unauthorized use in either the TILA or Regulation Z, the key question will be whether a user of the card other than the cardholder himself or herself had the "actual, implied, or apparent authority" to use the card. If you are not familiar with these terms—and how the concepts they represent play out under the common law of agency to which the statute and the regulation refer—you should look at the brief discussion of the basic rules of agency law given in the introduction to Chapter 4, where actual, implied, and apparent authority came up in a different context.

CHAPTER 21

Debit Cards and ATM Transactions

INTRODUCTION TO DEBIT AND ATM CARDS

A *debit card* differs from a credit card in one fundamental respect from which a whole series of consequences flows. Debit cards (or, as some banks have taken to calling them, “check cards”) are necessarily linked to an account that the cardholder has with the issuing bank. As we have spent no small amount of time investigating in prior parts of this book, one way in which a bank’s customer can pay for something using money in his or her account is by the issuance of a paper check. Another way is for the customer to make use of a debit card issued in connection with the account. When the customer makes a purchase at a merchant that is equipped to accept payment by this method, having available what is referred to as a point-of-sale (POS) terminal, the customer first swipes the debit card through the terminal. The customer then enters on a numeric pad adjacent to the terminal his or her own personal identification number (PIN), which he or she was initially given by the bank or later chose to be associated with the card.* The terminal is connected to a network that allows it to transmit information regarding the attempted use of the card to the bank at which the account is held. The terminal should receive, within seconds, a confirmation that the account with which the card is linked is still active, that it has sufficient funds to cover the charge, and that the card has not been reported lost or stolen. Once the use of the debit card is “authorized” in this way, the merchant is free to let the user take the goods he or she has purchased out of the store, just as if he or she had paid cash. The amount of the purchase is instantaneously deducted from the customer’s bank account. The merchant’s own account with its bank is credited, either immediately or (in some systems) at the end of the business day, with the amount of the purchase. Using a credit card, a consumer buys now but pays later, when the bill comes in. Even then, he or she may use the credit feature of the card to spread out payments over a longer period of time. When a customer uses a debit card to pay for goods or services, he or she pays on the spot. The cost is immediately deducted from his or her checking account.*

An *ATM card* is like the debit card (and in fact many banks issue a single card that can function as both a debit card and an ATM card) in that it is issued and functions only in connection with an account or accounts the customer has with the issuing bank. The ATM card, inserted into the slot of an automated teller machine (an ATM) which is then “given” the customer’s PIN number previously associated with the card, allows the customer to check his or her balance and make transfers between accounts. And, oh yes, to withdraw cash from the account, which cash is presented to the customer right then and there.

The debit card and the ATM card, along with other even more recently invented ways for the customer to make use of funds in his or her account (such as automated telephone bill payment service, direct deposit of the customer’s paycheck or preauthorized payment of his or her recurrent bills, and payment of bills and transfers between accounts that the customer initiates through a bank-by-computer system) all are part of a growing phenomenon. The customer carries out his or her banking without ever having come into contact with any human representative of the bank, either face-to-face or by a conventional phone call. This can be very convenient and efficient. It also opens up whole new avenues for possible fraud and error in the transaction.

THE LAW GOVERNING CONSUMER ELECTRONIC FUND TRANSFERS

In 1978 Congress passed the Electronic Fund Transfer Act (EFTA), which was codified as Title IX to the comprehensive Consumer Credit Protection Act (15 U.S.C. §1601 *et seq.*). As authorized and directed by the EFTA, the Federal Reserve then issued *Regulation E* (12 C.F.R. Part 205) to further explicate the workings of the Act. In 2010, Congress passed and the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), one result of which was the creation of a new federal administrative agency, the Consumer Financial Protection Bureau (the “CFPB”). Under the Dodd-Frank Act, this new agency would assume principal responsibility for administering core provisions of the EFTA as of July 21, 2011. Acting under this authority, the CFPB promulgated its own version of Regulation E, varying only in minor respects from the Federal Reserve’s version, as 12 C.F.R. Part 1005. In what follows, I will cite you to the CFPB’s version of Regulation E (e.g., “Reg. E §1005.6”), but you should not be surprised if you find in other sources citations to the Federal Reserve’s version (e.g., “Reg. E §226.6”), which, for reasons that need not concern us here, still remains on the books. The operative language of the two versions is, at least as far as we are concerned, essentially the same. The CFPB in effect “inherited,” as that agency put it, the Federal Reserve’s Regulation E and, as of this writing, has not made any substantive changes to that which it inherited.* Key to understanding the workings of the Act and its scope is its definition of electronic fund transfer in §903(6) [15 C.F.R. §1693a(6)], as elaborated upon in Reg. E §1005.3. The core of the statutory definition reads as follows:

> [T]he term “electronic fund transfer” means any transfer of funds, other than a transfer originated by a check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution to debit or credit an account. Such term includes, but is not limited to, point-of-sale transfers, automated teller machine transactions, direct deposits or withdrawals of funds, and transfers initiated by telephone.†

Although this definition does not appear to limit the scope of the act to individual consumers and their transactions, look at the definition given in EFTA §903(2) [15 U.S.C. §1693a(2)] and Reg. E §1005.2(b)(1) for the word *account.* Reading from the Act, “[T]he term ‘account’ means a demand deposit, savings deposit, or other asset account …, established primarily for personal, family, or household purposes.” Just so that there is no doubt, the

Act also defines *consumer* as meaning “a natural person” (EFTA §903(5) [15 U.S.C. §1693a(5)] and Reg. E §1005.2(e)).

A large part of the EFTA is taken up with the *disclosure requirements* imposed upon any bank that agrees to process electronic fund transfers on behalf of its customers. Specified disclosure is initially required at the time the consumer contracts for an electronic fund transfer service or before the first electronic transfer is made through the service. The bank is also obligated to make disclosure of any change in the terms of the service, as well as, at least once a year, to furnish the customer details of the error resolution process available to the customer in connection with the service. The EFTA also requires that for any transfer initiated at an electronic terminal (such as a POS terminal or an ATM machine), the system shall provide at the time of the transaction written documentation of the transfer (being the debit card receipt or the ATM record, which, in theory at least, should come out of the ATM at the end of your session with the machine). The Act also requires that the bank provide the consumer with a periodic statement, usually on a monthly basis, for each account that can be accessed by means of an electronic fund transfer mechanism. In most instances this requirement is met by the bank’s including information about any electronic fund transfers on the monthly statement of account that it produces and mails in connection with the typical checking account.

One other concept that is crucial to an understanding of the workings of the EFTA is that of the *access device*. The Act itself does not define this term. Regulation E §1005.2(a)(1) does contain a definition: “‘Access device’ means a card, code, or other means of access to a consumer’s account, or any combination thereof, that may be used by the consumer to initiate electronic fund transfers.” Not all electronic fund transfers make use of an access device. Direct deposit of a paycheck or preauthorized payment out of the account of recurring bills, for example, do not. The debit card and the ATM card are, of course, the prime examples of the access device. As you can see, the actual definition of *access device* does not require any special means of verification, such as the PIN we are most familiar with, to be issued along with the card itself. The Act does, however, condition the customer’s potential liability for any unauthorized transfers out of the account on the card issuer’s having provided along with the access device, “a means whereby the user of such card, code, or other means of access can be identified as the person authorized to use it, such as by signature, photograph, or fingerprint or by electronic or mechanical confirmation” (EFTA §909(a) [15 U.S.C. §1693g(a)]). Or see Reg. E §1006.(a).*

In the following examples, we consider a series of issues. First of all, what constitutes an *unauthorized use* of the access device? Second, if there is an unauthorized use of the card, to what extent, if any, may the customer be liable for the amount transferred out of his or her account without his or her permission? Third, what mechanism is required by the EFTA for *dispute resolution* when the customer believes that an amount reported as electronically transferred out of his or her account is in error? Finally, we consider the question of when, if ever, the customer can *stop payment* of or *reverse* an authorized transfer.

Examples

Cesar is in need of some cash, but finds he does not have time during the day to make it to his bank. He gives his niece Nina his ATM card and tells her his PIN number. He asks her to go to the bank and withdraw $300 from his account. Nina does as she is asked, and returns the card to Cesar along with the $300 she has withdrawn from the bank’s ATM machine.

Is this an unauthorized electronic fund transfer? For this and the next three examples, see EFTA §903(11) [15 U.S.C. §1693a(11)] or Reg. E §1005.2(m). What would be your answer if Nina had in fact withdrawn $500 from Cesar’s account at the ATM, keeping $200 for herself?

Ralph has received an ATM card from his bank. Fearing that he will forget the PIN number he has been given, he writes the number on a piece of paper, which he keeps “safely” in his wallet along with the card. Ralph has his pocket picked by one Thelma. Thelma immediately goes to a branch of the bank by which the card was issued and tries using the card at an ATM in conjunction with the number written on the scrap of paper that she finds in the wallet. It works! Thelma withdraws $1,000 in cash from the ATM.

s Thelma’s transaction an unauthorized transaction?

Suppose that Thelma then goes to a local electronics store, which has a sticker on the door indicating that it takes this brand of debit card. She uses the card and the PIN to purchase more than $1,400 worth of high-quality stereo equipment. Is this an unauthorized transaction?

What if Ralph had written his PIN number on the card itself? Would this change your view of either of the prior questions?

Late one night, as she enters the ATM lobby at her bank, Sarah is confronted by a masked figure who claims to be carrying a gun in his pocket. He tells Sarah that she will not be hurt if she just hands over to him her ATM card and tells him her true PIN. Sarah does so. The masked figure uses the card to withdraw $1,000 from Sarah's account before vanishing into the darkness.

s this an unauthorized use of the card?

Vhat if instead the masked man had held the gun to Sarah's back as she, at his insistence, inserted her card into the ATM and punched in her PIN, then calling on the machine to release $1,000 in cash? The thief takes the money and runs.

Joel takes his 16-year-old son, Junior, shopping with him. Before they hit the stores, Joel goes to his bank and uses the ATM to withdraw some cash. Junior looks over his shoulder and is able to make out the PIN as Joel enters it into the machine. Several days later, while Joel is in bed with a high fever, under doctor's orders to rest as much as possible, Junior takes his father's ATM card from Joel's wallet. He goes to the bank and withdraws $300 in cash, which he quickly spends on computer games, heavy metal CDs, and so on.

s Junior's use of the card an unauthorized use?

Suppose instead that the reason Junior makes the withdrawal is otherwise: A plumbing emergency has come up at the house and the only plumber who is willing even to come and look at the problem demands that she be paid $300 in cash upon arrival. Rather than bother his sick father with the problem, Junior goes to the bank, gets the $300 in cash, and uses it to pay the plumber. Would Junior's use of the card be deemed unauthorized under this very different set of facts?

Lenore has been issued and has accepted a combination ATM and debit card for use in conjunction with her checking account at Shelbyville Bank and Trust. On Monday, May 2, while he is visiting in her home, her son-in-law Thad surreptitiously sneaks Lenore's card from her wallet. Later that day, Thad goes to a Shelbyville Trust ATM and, guessing correctly that Lenore has picked the last four digits of her telephone number as her PIN, withdraws $450 from the account. He again uses the card to withdraw $200 from Lenore's account on the following Monday, May 9, and $400 on Wednesday, May 11. Lenore does not discover the loss of her card until May 12. She immediately calls the telephone number she has been given by the bank to report the loss of her card.

When Lenore becomes aware of the total of $1,050 that Thad has transferred out of her account, she demands that the bank recredit the account with this amount. Is the bank obligated to do so? For this and Example 6, consult EFTA §909(a) [15 U.S.C. §1693g(a)] or Reg. E §1005.6.

What if Lenore had discovered the loss of her card soon after Thad's visit, on May 3, but failed to notify the bank until May 12?

Homer has been issued and has accepted a combination ATM and debit card for use in conjunction with a checking account he maintains at Shelbyville Bank and Trust. On his September 2013 statement of account, mailed to him by the bank on October 3 and received by Homer on October 6, there is recorded an $80 ATM withdrawal on September 23. Homer cannot remember making this withdrawal. In fact, he finds it curious as he very rarely uses the ATM card associated with this account. (Homer lives in Springfield and also has an account with Springfield State Bank, from which he normally makes his ATM withdrawals.) Homer gives no notice of this questionable $80 withdrawal to the Shelbyville Bank, nor does he check to see that he still has the card. It turns out that the withdrawal was made by Homer's friend, one Barney, who stole the card from Homer's wallet while the two were together at a local bar, just after Homer bragged about his cleverness in picking "1234" as his PIN. Several months later, Barney begins to use the card again, first withdrawing $600 from the account at an ATM on December 22 and then running up bills totaling more than $500 at the local mall on December 23, using the card as a debit card. When these transactions are reported to Homer on his December 2013 statement, which he receives in early January 2014, Homer is sure that they are in error and finally discovers that his card is missing. He quickly reports the loss of the card and the unauthorized transactions to the bank. Is Shelbyville Bank and Trust required to recredit Homer's account with any of the amounts transferred out of it by Barney?

Flanders has a checking account with Springfield State Bank. He has been issued and has accepted a combination ATM and debit card in connection with this account. When he receives his September 2013 statement of account, he carefully examines each entry. He quickly focuses on a debit in the amount of $246.79 reported to be for use of the debit card on September 4 at a store identified as "Wiggum's Gun Shop." Flanders knows he never made any such purchase.

What should Flanders do to get this debit wiped off his account? See EFTA §908 [15 U.S.C. §1693f] or Reg. E §1005.11.

Is the bank under an obligation to immediately recredit Flanders's account with the disputed amount pending the results of its investigation?

Suppose that the bank does determine, within a couple of days of its receipt of Flanders's notice of the claimed billing error, that this debit was indeed an error. What must it do then?

Suppose instead that the bank determines it will need more than ten business days to investigate the situation. What must it do?

Two weeks later, after completing its investigation, the bank determines that no error occurred. As far as it can determine, Flanders's card was used to make a purchase at Wiggum's on the date and in the amount as indicated, and there is no reason to believe this was other than an authorized use of the card. What may and must the bank do now?

Moe also has a checking account with Springfield State Bank, in connection with which he has been issued and has accepted a combination ATM and debit card. Moe goes to Selma's Appliance City and purchases a wide-screen TV, paying the $1,699.99 price with his debit card. As soon as he gets home, he sets up the TV and turns it on. Nothing happens. As he fiddles with the set, trying to get it to work, it begins to heat up noticeably and the faint smell of burning metal begins to fill the air. Moe unplugs the TV and rushes to his phone. He calls Springfield State Bank to find out how he can "stop payment" of the price to Selma on the purchase he made just hours ago. What will the bank tell him?

Explanations

Obviously not. This is an authorized transaction. An *unauthorized transaction* is defined (basically the same way in both the EFTA and Regulation E) as

> an electronic fund transfer from a consumer's account initiated by a person other than the consumer without actual authority to initiate the transfer and from which the consumer receives no benefit, but the term does not include any electronic transfer … initiated by a person other than the consumer who has been furnished with the card, code or other means of access to such consumer's account by such consumer, unless the consumer has notified the financial institution involved that transfers by such other person are no longer authorized.…

Here Nina was given the *actual authority* by her uncle to use the card as she did. Hence this does not come within the definition of an unauthorized transfer, even though it is made by a person other than the customer whose account is affected.

This also would not be an unauthorized transfer, even though Nina went beyond the bounds of her actual authority in withdrawing the additional $200. Nina has still been "furnished" the access device, the card, directly by her uncle. The latter part of the definition of *unauthorized transfer* quoted above in discussing Example 1a covers the situation.

Yes, this is an unauthorized transfer. Thelma has certainly not been invested with any actual authority by Ralph to use the card. Nor would we say that he has "furnished" her the card. She stole it from him. The fact that he may have made actual *use* of the card that much easier by writing the PIN down as he has does not turn this into an authorized transaction—a point we'll return to in Example 2c.

Yes, this use of the card as a debit card is also an unauthorized transfer, and for just the reasons given in the explanation of Example 2a. This question is intended to remind you that for the purposes of the EFTA and Regulation E use of a card as an ATM card or as a debit card is treated identically. The customer or someone whom he or she has authorized can use the card to get cash or merchandise. It is all one and the same as far as the Act goes. Similarly, an unauthorized transfer can take place at an ATM or at the debit card terminal of a merchant.

Ralph's actually writing his PIN directly on the card might change your opinion of exactly how bright he is, but it does not render either use of the card an authorized use. Ralph has still neither given Thelma the actual authority to use the card nor furnished her with the card itself. The Federal Reserve has issued a series of interpretations concerning the liability of consumers for unauthorized use in the form of a supplement to Regulation E. Included in these interpretations is the following:

> *Question:* Consumer negligence. A consumer writes the PIN on the ATM card or on a piece of paper kept with the card—actions that may constitute negligence under state law. Do such actions affect the liability for unauthorized transfers that may be imposed on the consumer? *Answer:* No. The extent of the consumer's liability is determined by the promptness in reporting loss or theft of an access device or unauthorized transfers appearing on a periodic statement [as we will see in Examples 5 and 6]. Negligence on the consumer's part cannot be taken into account to impose greater liability than is permissible under the act and Regulation E. (§205.6(b)).

Even if the ill-advised way in which Ralph has chosen to keep track of his PIN does not render Thelma's use of the card an authorized transaction, that is of course no reason for any of us to follow his lead. The prudent cardholder will do whatever he or she reasonably can to keep his or her PIN as secret and as hard to guess as possible. For one thing, as we will deal with in later examples, the cardholder will bear up to at least a token $50 of any loss due to unauthorized use, and can bear liability beyond this amount if he or she doesn't deal with the loss of the card or any reported unauthorized use in the correct way. Beyond this, of course, having to deal with any unauthorized use (reporting the theft of the card, convincing the issuer of the card as to which uses were unauthorized, simply waiting for the whole unhappy matter to be cleared up and the money recredited to the account) is enough of a hassle that the advisability of closely guarding one's card and keeping one's PIN separate and secret cannot be stressed too strongly.

Yes, of course this is an unauthorized use. Sarah has certainly not given the masked figure the actual authority to use her card, nor does it make any sense to say she has "furnished" him with the card. That word, as used in the definition of an unauthorized transfer, is taken to mean that the cardholder turned the card over to another voluntarily. Had the robber accosted Sarah on the street outside the ATM and demanded that she turn over her purse, we would not say that she had "furnished" him with her card simply because it was in the purse at the time of the robbery.

I would say that this is an unauthorized transfer even though the card-holder herself did plug the card into the machine and enter her PIN. True, the definition of *unauthorized transfer* contemplates that the transfer be "initiated by a person other than" the cardholder, but I would argue that this transfer was really "initiated" by the masked man and not Sarah. I know of no case in which an issuer has even tried to argue that the transfer was authorized in a situation such as this.

Yes, this is an unauthorized use. Junior did not have any actual authority from his father to use the card as he did, nor did Joel furnish him with it. Joel may have been careless in letting someone else, even his own flesh and blood, discover his PIN as Junior has, but as we have already discovered such carelessness does not turn this into an authorized transaction.

Under these facts, Junior's use of the card would not be deemed an unauthorized transfer. The definition of the term requires both that the transfer be initiated by someone without the actual authority to use the card and that "the consumer receive[] no benefit" from the use. Here Joel has gotten the benefit from the card's use, even if Junior was never given actual authority to use the card as he did.

We deal here and in Example 6 with the question of what liability the cardholder has for unauthorized use of the card. (The cardholder is naturally fully liable for any *authorized* use.) The EFTA establishes a three-tiered system of liability in §909(a) [15 U.S.C. §1693(a)], even if it is not immediately apparent from the awkward way in which the subsection is written. Regulation E, in §1005.6(b)(1) through (3), sets out the same matter and is a much easier read. The first level of liability is that of the cardholder for any unauthorized use when the loss of the card is reported to the issuer within two business days after the cardholder learns of the theft or loss of the card. In such a case the cardholder is liable for *the lesser of* the amount of the unauthorized transfers made that occurred before notice to the issuer or $50. In this part of the example, Lenore gave notice to the bank promptly after she became aware of the loss of her card. (Note that the two-business-day period begins to run not when the card is lost or stolen but when the cardholder "learns of the loss or theft.") Lenore is liable for $50 of the unauthorized transfers made by Thad, but no more. Having given timely notice, she is protected by the $50 cap on the cardholder's potential liability for unauthorized use. The bank will have to recredit her account with all but $50 of the transfers made out of her account by Thad. As a practical matter, many issuers will waive the $50 they are entitled to in situations such as this, as a matter of good customer relations.

By failing to give notice to the bank within two business days after having learned of the disappearance of her card, Lenore has lost the protection of the $50 cap on her potential liability. She can be held liable by the bank for the lesser of (i)$500 or (ii)up to $50 in unauthorized use in the first two days after the cardholder becomes aware of the loss plus "[t]he amount of unauthorized transfers that occur after the close of two business days and before notice to the [issuing] institution, provided the institution establishes that these transfers would not have occurred had the consumer notified the institution within that two-day period." Here the bank would argue that, had Lenore given notice to it by the close of business on May 5, it would have deactivated the card and Thad would not have been able to use it as he did on May 9 or May 11 (for a total of $600). So Lenore is potentially liable for the lesser of $500 or the sum of $50 (for the use on May 2) and $600 (for the uses after May 5). The lesser of $500 and $650 is of course $500. Lenore will be able to insist on her account being recredited for all but $500 of the various transfers Thad made with her card. This is an example of the second tier of cardholder liability established by the EFTA; the cap on the loss that the cardholder may be made to bear is raised to $500 if the cardholder is not prompt in reporting the loss or theft of the card. As to what constitutes notice for the purposes of this rule, and for the possibility that the period in which notice must be given may be extended “due to extenuating circumstances,” you can check out paragraphs (4) and (5) of Regulation E §1005.6(b).

The bank is obligated to recredit Homer’s account with only $30. Homer is protected by the $50 cap with regard to the first unauthorized transfer made by Barney (the $80 taken on September 23). With respect to Barney’s later uses of the card in December, Homer will be fully liable. This unlimited liability—based on Homer’s failure to report the unauthorized transfer appearing on his bank statement within 60 days of the bank’s transmittal of the statement on October 3—is the third tier of responsibility, which the cardholder has to be aware of and particularly careful to avoid. Quoting from Regulation E §1005.6(b)(3):

> A consumer must report an unauthorized electronic fund transfer that appears on a periodic statement within 60 days of the financial institution’s transmittal of the statement to avoid liability for subsequent transfers. If the consumer fails to do so, the consumer’s liability shall not exceed the amount of the unauthorized transfers that occur after the close of the 60 days and before notice to the institution, and that the institution establishes would not have occurred had the consumer notified the institution within the 60-day period. When an access device is involved in the unauthorized transfer, the consumer may be liable for other amounts set forth in paragraphs (b)(1) [the $50 token liability for any unauthorized use] or (b)(2) [the liability of up to $500 for the cardholder’s failure to promptly report loss or theft of the card] of this section, as applicable.

Here the bank should be able to establish that had Homer given it notice within 60 days of the unauthorized transfer reported to him on his September statement, it would have deactivated the card in time to prevent Barney’s use of it in late December. So Homer is liable under (b)(1) for $50 based on the unauthorized use of the card in September and under (b)(3) for the total of $1,100 on use of the card in late December.

Flanders should, within 60 days of the date on which the September statement was mailed to him, give notice to the bank that he believes this particular entry to be in error. His initial notice may be oral or written, as long as it enables the bank to identify him and his account; gives the date, type, and amount of the supposed transaction; and indicates why he believes the entry is in error. The bank may, however, require Flanders to give a written confirmation of all this information within ten days of his giving any oral notice.

No. The bank is under no obligation to immediately recredit the account with the amount of the claimed error. Rather, it is under an obligation to promptly investigate the alleged error and is required to determine whether an error has indeed occurred. The bank must make this determination within ten business days after it receives notice from Flanders.

If the bank determines the claim of error to be valid within the ten-day period, it must correct the error, in this case by recrediting Flanders's account with the $246.79, within one day after it determines that an error has occurred. It must also report the result of its investigation to Flanders within three business days after completing its investigation.

The bank is normally given only ten business days to investigate without recrediting the account with the disputed amount. (This period is extended to 20 days if the transfer was into or out of an account within 30 days of the first deposit being made to the account. Reg. E §1005.11(c)(3)(i).) If the bank is not ready to conclude its investigation within the ten business days, it is required to provisionally recredit the account with the amount in dispute, withholding a maximum of $50 from the account if it has a "reasonable basis" for believing that an unauthorized transfer may have occurred. The bank must inform Flanders, within two business days of the provisional crediting, of the amount and date of the credit, and must give him full use of the provisionally credited funds during the continuation of the investigation. The bank will normally then have up to 45 days from the date of receipt of the notice it got from Flanders to complete its investigation. This 45 days is extended to 90 days in §1005.11(c)(3)(ii) of the Regulation in some situations, including one such as this when the electronic fund transfer "resulted from a point-of-sale debit card transaction." Within this period, be it 45 or 90 days depending on the circumstances, the bank must conclude its investigation. Should it at any time within this period determine that the debit card charge posted at Wiggum's was indeed in error, it must correct the error within one day after making that determination and so inform Flanders within three days. Flanders will be informed that the provisional credit of funds made pending the extended investigation has been made final.

The bank, having determined that no error has occurred, must give Flanders a written explanation of its findings and note his right to request any documents on which the bank relied in making its determination. Should Flanders so request, the bank must promptly provide him with copies of any such documents. The bank may also then debit his account the amount of the provisional credit that it added during the course of the extended investigation. The bank must give Flanders notice of the date and the amount of this debit and must also give him what amounts to overdraft privileges equal in amount to the debit for a period of five business days following the notice. See Reg. E §1005.11(d).

What can Flanders do now if he is still sure that the bank made an error that is costing him money? He is going to have to take the bank to court. The EFTA and Regulation E set out a dispute resolution process that both the customer and the bank have to follow in an attempt to resolve any asserted billing error; neither mandates that the bank must always find in favor of the customer. As set forth in §1005.11(e) of the Regulation:

> A financial institution that has fully complied with the error resolution requirements has no further responsibilities under this section should the consumer later reassert the same error.

If Flanders does take the bank to court, and *if* he is able to establish that the bank "knowingly and willingly concluded that [his] account was not in error when such conclusion could not reasonably have been drawn from the evidence available to [the bank] at the time of the investigation"—a tall order indeed—Flanders would be entitled to treble damages. EFTA §908(e)(2) [15 U.S.C. §1693f(e)(2)].

The bank will have to tell him that there is no way for him to "stop" payment made by use of a debit card once the payment has been made. The transaction, including the payment for the goods, is conceived of as completed at the moment the debit card's use was authorized at the point of sale, Selma's Appliance City. It is the same as if he had paid in cash. He's going to have to take up his problem with the TV with Selma.

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* In recent years the Visa and MasterCard networks have begun to market through their member banks debit cards that don't depend on the use of a PIN to complete a transaction. Use of such "PIN-less" debit cards relies only on the signature, or sometimes a picture, of the cardholder as a means of identification and theft-protection device.

* Just to make things more interesting, some banks have taken to issuing cards that can serve as either a credit or a debit card. If that is the case, the customer will have to determine at the time of purchase in what way the card is being used. Whenever the card is functioning as a credit card, its use is governed by the Truth-in-Lending Act and Regulation Z, which we discussed in Chapter 20. When the card is put to use as a debit card, the governing law is the EFTA and Regulation E, which we are about to look into.

* Some of the statutory supplements and other books covering this topic reproduce or cite only the language of Regulation E. Some contain or cite to the EFTA itself, sometimes to the section number of the EFTA and sometimes to the parallel section number of the United States Code. The exact language of the Regulation is, of course, not precisely the same as that of the Act. Its purpose is, after all, to clarify and make the EFTA more coherent. Still, for our purposes, looking at either the Regulation or the Act should serve equally well. I will try to cover all bases by directing you when I can to the rule

we seek in all three ways. So, for example, we are just about to look at the definition of *electronic fund transfer*, which can be found in EFTA §903(6) [15 U.S.C. §1693a(6)] and Reg. E §1005.3.

† Notice that, under the exclusion listed as (E) following this language, an instruction given for a one-time transaction in the course of a telephone conversation between the consumer and an officer or employee of the bank is not covered by the Act. Once a real live person at the bank is involved in taking the instruction from the customer, the transaction is not truly “electronic” and is not within the scope of the Act.

* Notice that nothing in the Act or the Regulation requires that a debit or ATM card be usable only with a PIN. In recent years both MasterCard and Visa have introduced their own form of debit card, which normally requires verification by the merchant only through comparison of the signature of the user with the signature on the reverse of the card. Such PIN-less systems impose, of course, a higher risk of loss on the issuer, but these networks obviously believe that the additional risk is justified by the greater convenience offered to the user, making it just that much easier to spend, spend, and spend.

PART VII

Electronic Means of Payment: The Commercial Context

CHAPTER 22

Introduction to Commercial Electronic Funds Transfers and Article 4A

THE COMMERCIAL ELECTRONIC FUNDS TRANSFER

Although the use of cash, checks, or consumer credit or debit cards still accounts for the large majority of payment transactions that take place every day in the United States, when measured by the total *dollar volume* of transactions, all these means pale in comparison to the so-called *wholesale wire transfer* used by businesses and financial institutions to move money around from one party to another. Greater than 85 percent of all payment transactions, measured by the total amount of money involved, are carried out through the wire transfer system. Recent estimates have it that payments totaling almost $4 trillion are carried by this system every day in the United States alone. Taking into account international wire transfers would raise this number considerably. A typical commercial wire transfer can easily be for an amount in the millions of dollars, which is certainly something we couldn't say for payment by cash, check, credit card, or debit card.

Commercial wire transfers are characterized not only by their size but also by the high speed and efficiency with which they are carried out. A wire transfer of funds is usually completed within one day, and often in only an hour or two at the outside. Equally important from the point of view of the recipient, funds received by wire become final and available for use with practically the same speed. Compare this to the check, which (as we have seen) has to be deposited and then forwarded for collection, and may in some instances *never* turn into available funds if it is not accepted for payment by the payor bank. Furthermore, the cost of carrying out a wire transfer, especially considering the amounts involved, is amazingly low. Wire transfer of funds as a means of payment is said to be particularly appropriate to the modern, large-scale business operation because it is, as the saying goes, cheap, fast, and final.

Given the amounts involved and the obvious importance of this means of making payment to the economy as a whole, it is disconcerting to find that prior to the last decade of the past century there was no comprehensive body of law—common law, statute, or regulation—governing the electronic wire transfer. The technological developments that made large-scale electronic transfer of funds possible had leapt ahead of what the law was prepared to deal with. This situation was rectified in 1989 by the addition to the Uniform Commercial Code of an Article 4A, Funds Transfers, which has by now been adopted by all the states. You should at this time read the Official Comment to §4A-102. It gives a good summary of the reasons for and the underlying philosophy behind the creation of Article 4A. As that Comment says,

> In the drafting of Article 4A, a deliberate decision was made to write on a clean slate and to treat a funds transfer as a unique method of payment to be governed by unique rules that address the particular issues raised by this method of payment.

It is our task in this and the next two chapters to see what has been written on this clean slate and the "unique rules" that apply to this rather remarkable means of moving money from one party to another.*

THE SCOPE OF ARTICLE 4A

First look to §4A-102: "Except as otherwise provided in Section 4A-108, this Article applies to *funds transfers* defined in Section 4A-104." So it is to that section we next turn. In subsection (a) we find that

> "Funds transfer" means the series of transactions, beginning with the originator's payment order, made for the purpose of making payment to the beneficiary of the order.

We are obviously dealing here with a whole different set of terms than those we encountered in the checking context. (That's the "clean slate" the drafters of Article 4A referred to.) We start with the simple observation that the *originator* (§4A-104(c)) of any particular funds transfer is the party who is initiating the transfer for the purpose of making payment to another, the *beneficiary* (§4A-103(a)(2)) of the transfer. The originator starts the whole process rolling by issuing a payment order to its bank, the *originator's bank* (§4A-104(d)), instructing it to wire a certain amount of money to a specified account held by the beneficiary in the *beneficiary's bank* (§4A-103(a)(3)). How all this actually gets accomplished, the steps along the way, is something we will explore in detail in this chapter. For now, just look at the big picture and note the concluding sentence of §4A-104(a): "A funds transfer is completed by acceptance by the beneficiary's bank of a payment order for the benefit of the beneficiary of the originator's payment order." We will have to consider in more detail exactly what constitutes "acceptance" of a payment order, but the basic idea should not be that hard to grasp. An individual funds transfer commences with the originator instructing its bank to send some money into the beneficiary's account held at the beneficiary's bank. The funds transfer is successfully completed when the money has made its way into that account and is available for the beneficiary's use.

A single funds transfer is, as you could see in the quoted definition, a *series* of transactions. Each one of these will be what the article defines as a *payment order* in §4A-103(a)(1):

> "Payment order" means an instruction of a sender to a receiving bank, transmitted orally, electronically, or in writing to pay, or to cause another to pay, a fixed amount of money to a beneficiary, if …

three conditions (which you should read) are met. Any given funds transfer may consist of one, two, three, or more payment orders, each one following from the one before, starting with the payment order given by the originator to its bank and culminating with a final payment order sent to the beneficiary's bank.*

We will leave the detailed mechanics of Article 4A for the moment, but it is important to point out two types of transactions that do not fall within its scope. Under §4A-108, the article does not apply to “a funds transfer any part of which is governed by the Electronic Fund Transfer Act of 1978.” We looked at the EFTA in Chapter 21. It covers electronic transfers made into or out of bank accounts held by consumers. Such transactions are governed by the EFTA and not Article 4A. Article 4A is intended to cover only the wholesale wire transfer initiated by a business or financial institution for large-scale commercial purposes. The originator or the beneficiary of an Article 4A funds transfer may, of course, be an individual, but if so he or she will be involved not in a consumer transaction but in a commercial one. Secondly, Article 4A does not cover even large commercial wire transfers that are “debit” rather than “credit” transfers. Suppose, for example, that a large corporation has authorized its insurance company to withdraw, by electronic means, its monthly insurance premiums from a specified account the corporation has with a particular bank. Once a month the insurance company sends a directive to the bank to pay it the appropriate amount. The bank complies because it has been preauthorized to do so by its customer, the insured corporation. Such a transaction does not fall within the §4A-104(a) definition of *funds transfer*, which delineates the scope of Article 4A, because it is not set in motion by an initial payment order made by a *debtor* for the purpose of making payment owed by it to its *creditor*. A transfer such as we have here, initiated by an instruction given by a creditor, is referred to as a “debit transfer” and is not covered by Article 4A. See the first paragraph of Comment 4 to that section.

THE MAJOR FUNDS TRANSFER SYSTEMS

As you can see in the definition of *payment order*, such an order may be transmitted by its sender “directly to the receiving bank or to an agent, a funds-transfer system, or communication system for the transmittal to the receiving bank.” A definition of *funds-transfer system* is found in §4A-105(a)(5). Although banks communicate with other banks in a variety of ways, two major funds-transfer systems now operate in the United States and take up the lion’s share of the wire transfer business. The first of these systems is called *CHIPS* (for Clearing House Interbank Payments System). It is a privately owned and operated system maintained by the Clearing House (an organization formerly known as the New York Clearing House Association), conducted through a single “node” or computer located in New York City. CHIPS is set up to accept messages from and can send messages to about 52 affiliated entities, primarily major banks, both foreign and domestic. At last count (at least that I could find) CHIPS was said to handle more than 375,000 transfers, totalling over $1.46 trillion, each day. CHIPS is also the principal facility through which international transfers heading in or out of the United States make their way.*

Fedwire is a telecommunications network owned and operated by the 12 Federal Reserve Banks around the country. Each bank is a “node” in the system. It allows each of the Federal Reserve Banks to communicate with and transfer funds to all the others. In addition, an individual private bank can arrange to make use of Fedwire by becoming affiliated with the Federal Reserve Bank covering the territory in which it is located and by establishing its own account with that Federal Reserve Bank, in which it must keep a given level of money on deposit. Overall, something like 7,300 financial institutions are served by the Fedwire system, which carries more than $2.7 trillion a day of funds-transfer orders, the average being something like $5.23 million or more.

It will be important to remember for the purposes of all that follows that Fedwire as a telecommunications system is never a party to an Article 4A funds transfer. It is merely a means of communications that one bank may use to send a payment order to another. Individual Federal Reserve Banks, in contrast, can be and regularly are banks acting as parties as the orders and the money move from the originator’s bank to the beneficiary’s bank.

MEANS OF SETTLEMENT

So far all that we have been speaking about is how messages—orders of one sort or another to transfer money—are carried out in series to accomplish a funds transfer. Words are cheap. How does the actual money flow from the originator to the beneficiary? Any individual bank in the chain of messages is not likely to follow an order to send money to another bank or, in the case of the beneficiary’s bank, to make money available to its customer—especially when you think of the sums involved—unless that bank has itself already received that amount of money from the one doing the ordering (or is virtually certain that it will do so in a short time). This is where the notion of settlement comes in. A bank receiving a payment order is only likely, simply as a matter of common sense, to carry out that order (or, as we will use the Article 4A term, "accept" the order) if it has already received funds equivalent to the amount it is being ordered to pay out.

There are various ways in which the sender of a payment order can settle with the receiving bank to ensure that the sender's order will be accepted. At the very start, we know, the originator sends a payment order to its bank. The originator and the originator's bank will have signed an agreement (typically termed a Funds Transfer Agreement) under which the bank will agree to carry out such instructions provided the originator has enough in its account to cover the order. Assume first that the beneficiary happens to have an account with the originator's bank, and that it is this account into which the bank is being ordered to transfer the money. The originator's bank will simply debit the originator's account for the amount indicated and credit the beneficiary's account for that same amount (taking for itself perhaps only a very small fee). That's easy enough. Suppose next that the beneficiary's account is held with another bank, but that this is a bank with which the originator's bank normally carries on a large volume of transactions. The originator's bank may then itself actually maintain an account with the beneficiary's bank. The originator's bank will then debit the amount of the order from the originator's account at the same time as it sends a payment order directly to the beneficiary's bank. This order will authorize the beneficiary's bank to debit the originator's bank's account held at the beneficiary's bank for the amount of the transfer. The beneficiary's bank will do so, at the same time crediting this amount to the beneficiary's account. Once again, the money has moved out of the originator's account and into the beneficiary's account without either bank having to worry that it will not get paid. The money is already there and at hand.

Things get decidedly more complicated if the account into which the originator wants money to be transferred is not in the same bank or is not in a bank with which the originator's bank itself has an account. This is where CHIPS and Fedwire come into play, not merely as ways of sending messages, but as means of settling accounts by the actual transfer of funds. A payment order sent by one CHIPS-participating bank to another is not necessarily settled by the simultaneous transfer of funds equivalent to the individual order from the sending bank to the receiving one. Up until just a few years ago, in fact, settlement of *all* payment orders executed through CHIPS on any given day was done by an end-of-the-day settlement procedure referred to as "multilateral netting," which took into account all payment orders processed during the course of that day by all of the participating banks. At day's end, all activity for each participating bank—both the payment orders it has sent and those it has received—was summed up to arrive at a net figure. If a particular bank had sent in total, say, payment orders totaling $70 million and received payment orders totaling $65 million, it would have to transfer $5 million into the CHIPS pool. If another bank had received more in payment orders (say $102 million) than it had initiated (say $98 million), then CHIPS would make sure that the net of $4 million was credited to that bank's account. By the end of the day, and barring some catastrophic failure of one of the participating banks, the total of all of these net debits and credits would balance out. Settlement for each of the thousands of payment orders carried over the CHIPS system (currently around 375,000 a day) during the course of the day would have been completed.*

Starting in 2001, CHIPS introduced a new method for faster settlement of most of the orders its executes, what it refers to as "CHIPS Finality." As stated in its promotional literature

> Our patented algorithm for multi-lateral netting continually offsets and settles payments throughout the day. Payments are matched, netted, and settled usually in a matter of seconds—85% are cleared before 12:30 p.m. This allows payments to flow faster and maximizes liquidity.

As you might guess, the smaller payments are settled the most quickly. The larger payments may still take some time to settle, but in no event later than the end of the day. One important reason for the implementation by CHIPS of this new and more complex system was to make its services more competitive with those offered by Fedwire, where settlement is instantaneous in all cases.

Settlement of payment orders sent via Fedwire is always simultaneous with receipt of the order. Any bank that has arranged for direct access to the Fedwire system is required to have an account with the Federal Reserve Bank through which it will be sending payment orders. When the Federal Reserve Bank receives a payment order from the participating bank, it then sends a payment order of its own to the next bank in the chain, and immediately transfers the amount of the order out of the sending bank's account. Simultaneously with its sending of a payment order to the next bank in the chain (either a bank in its own territory which will necessarily have an account at the same Federal Reserve or another Federal Reserve Bank in another part of the country), the bank will credit the same amount to the account of the bank to which it is sending the payment order. As the saying goes, with Fedwire, "the message is the money."

THE ARTICLE 4A FUNDS TRANSFER

It is time now to look at the basic mechanism by which a funds transfer is carried out. By the very definition of a funds transfer, the process starts out with a payment order made by the originator to its bank, referred to naturally enough as the *originator's bank*. This payment order may be transmitted "orally, electronically or in writing" (§4A-103(a)(1)), as may indeed any payment order. Large-scale users of the system are by now usually linked up to their banks via computerized systems, but others still initiate payment orders by personally appearing at the bank or through a phone message.* The payment order must identify the intended beneficiary and specify into what account at what bank the money is eventually to be transferred.

The originator's bank will then check to make sure the originator has enough in its account or in borrowing privileges to cover the amount of the order. The originator's bank makes the decision on whether to accept the order. *Acceptance* of a payment order is a key concept in Article 4A. Look at §4A-209. The two crucial subsections are (a) and (b). Subsection (a) covers the case when the receiving bank is other than the beneficiary's bank. Subsection (b) deals with the question of when acceptance has occurred when the bank receiving a payment order is the beneficiary's bank. If the originator's bank does not happen also to be the beneficiary's bank, then it will accept the order issued to it by the originator by "executing the order." As to what it takes for a bank to *execute* a payment order it has received, see §4A-301(a): "A payment order is 'executed' by the receiving bank when it issues a payment order intended to carry out the payment order received by the bank."

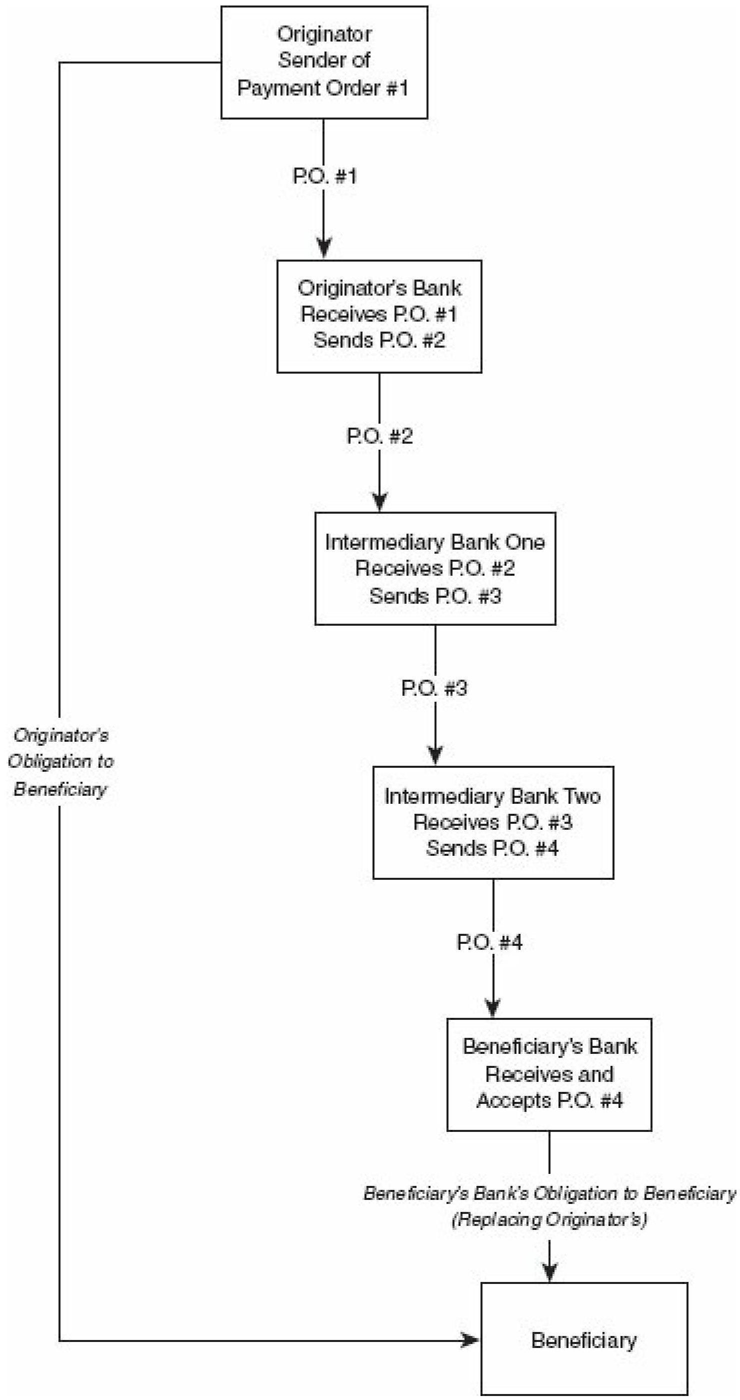
If the originator's bank is in a position to send a payment order directly to the beneficiary's bank, either directly or through a systems such as CHIPS or Fedwire, it will accept by doing so. If not, it will issue a payment order to an *intermediary bank* (§4A-104(b)), which will itself then accept (if it determines it is right to do so) by executing the order. It will execute the order either by sending its own payment order to the beneficiary's bank, if it is in a position to do so, or to another intermediary bank that it has reason to believe is in a better position to get the message (and the money) to the beneficiary's bank.

A given funds transfer may occur using no intermediary banks or several. Eventually, one receiving bank will be in a position to communicate and settle directly with the beneficiary's bank. It will send a final payment order to the beneficiary's bank directing that the given amount be credited to the beneficiary's account with that bank. The beneficiary's bank will then either accept or reject this order (acceptance to be judged by §4A-209(b)), its main concern being whether it has any reason to doubt that it will receive settlement for this amount prior to having to make the funds available to the beneficiary. If all goes according to plan, as is true with the overwhelming majority of funds transfers, the beneficiary's account with its bank will be credited with the amount of the transfer. Even if several intermediary banks are involved, this entire process will typically have taken no more than an hour or two.

The important thing to remember is that a single funds transfer will consist of a *series* of payment orders, each of which has to be separately identified. If all goes well, as it normally does, dissection of the exact route the funds transfer took soon becomes no more interesting than the exact route a valid check takes in being forwarded from the depositary bank to the payor bank, which pays as a matter of course when sufficient funds are available in the customer's account. Should issues arise, however, each and every step along the way could become relevant and enter into the dispute.

Let us look at the diagram on the following page of a funds transfer involving two intermediary banks and hence four payment orders. Here the Originator owes the Beneficiary some amount of money. It has been agreed between the two that the Originator will pay by wiring the money into the Beneficiary's account with the Beneficiary's bank. The Originator initiates the payment by making Payment Order #1, its order to the Originator's Bank, which has presumably agreed to handle this type of transaction for the

Originator. The Originator's Bank is the receiving bank of Payment Order #1. It accepts this order by execution, sending Payment Order #2 to Intermediary Bank One. That bank is the receiving bank of Payment Order #2, which it accepts by sending Payment Order #3 to Intermediary Bank Two. That bank in turns accepts by sending Payment Order #4 to the Beneficiary's Bank. Once the Beneficiary's Bank accepts Payment Order #4, the amount of the payment is credited to the Beneficiary's account with that bank.



And that's the story. As the last sentence of §4A-104(a) states: "A funds transfer is completed by acceptance by the beneficiary's bank of a payment order for the benefit of the beneficiary of the originator's payment order." And the result? Look first to §4A-404(a). Setting aside certain rare exceptions that need not concern us here, "if a beneficiary's bank accepts a payment order, the bank is obligated to pay the amount of the order to the beneficiary of the order." The beneficiary may not immediately withdraw all the money, but these funds are as secure as any other money that the beneficiary has parked in this account at that particular bank (and remember, the beneficiary was the one to pick where it wanted to do its banking and have this payment sent). Furthermore, under §4A-406(a),

> [T]he originator of a funds transfer payment pays the beneficiary of the originator's payment order (i) at the time a payment order for the benefit of the beneficiary is accepted by the beneficiary's bank in the funds transfer, and (ii) in an amount equal to the amount of the order accepted by the beneficiary's bank, but not more than the amount of the originator's order.

The originator's initial obligation to pay the beneficiary under some underlying contract, perhaps for goods or services rendered or something of the sort, is extinguished. Payment has been made. In place of the right of the beneficiary under this underlying contract, the beneficiary now has its right against the beneficiary's bank for the amount of the payment order accepted by that bank and credited to its account.

Examples

Under an agreement between the Big Apple Manufacturing Company, located in the suburbs of New York, and Gotham Bank, a major New York bank in which Big Apple has an account, the treasurer of Big Apple is authorized to initiate funds transfers out of the company's Gotham account. In late April, Big Apple enters into a purchase and sale agreement with San Francisco Sheet Metal, one of its principal suppliers, under which the sheet metal firm will ship a large quantity of product to Big Apple, delivery to be completed by Tuesday, May 31. Big Apple agrees to pay by a transfer of $765,000 into a specified account the supplier has at Golden Gate Bank of San Francisco. On May 10, Big Apple's treasurer sends a written instruction to Gotham Bank calling for it to transfer $765,000 to the designated Golden Gate account "upon the delivery to Big Apple of merchandise to be provided by San Francisco Sheet Metal under contract with our firm."

Is this instruction a valid payment order under Article 4A? Review §4A-103(a)(1).

What if instead the instruction had said that the transfer of funds was to be made on May 31, with no other condition attached?

What if the instruction in part (b) had been made orally, over the telephone, and not in writing?

Big Apple, of the preceding example, also arranges to buy a large quantity of component parts to be specially manufactured to its specifications by Brooklyn Cogs and Widgets (BC&W). The purchase and sale agreement calls for Big Apple to pay $1 million into a specified account that BC&W has with Dodger National Bank of Brooklyn. On October 1, Big Apple's treasurer sends an instruction via computer to Gotham Bank telling it to immediately transfer $1 million into BC&W's account with Dodger National Bank.

Is Gotham legally obligated to comply with this instruction, simply by virtue of having received it from Big Apple? Why might it not want to do so? Should it decide not to comply with this order, what must it do? See Comment 3 to §4A-209 and §4A-210.

Suppose the person at Gotham in charge of receiving and processing computer instructions such as that sent by Big Apple replies to the message with one of his or her own. The message sent to Big Apple reads, in effect, "Will do as you have instructed." Has Gotham "accepted" the payment order as that term is used in Article 4A? Look to §§4A-209(a) and 4A-301(a).

Suppose that Big Apple's computer instruction is received by Gotham at 10:30 a.m. At 10:45 a.m., Gotham, having determined that Dodger National Bank participates in the CHIPS system, sends a computerized message via CHIPS to the Dodger National Bank instructing it to credit BC&W's specified account with that bank with $1 million. Has Gotham now accepted the payment order sent to it by Big Apple? If so, as of what time?

Dodger National Bank receives the computer message sent to it by Gotham at 10:46 a.m. By its receipt of this message, has Dodger accepted the payment order? See §4A-209(b).

Is Dodger National Bank obligated to immediately credit BC&W's account with the $1 million? Is it obligated to get into contact immediately with BC&W and inform BC&W that it has received payment of $1 million from Big Apple? See Comment 5 to §4A-209.

Assume that Dodger neither credits the money to BC&W's account nor gets in touch with that firm on October 1. As of when will it be deemed to have accepted the payment order sent to it by Gotham? What obligations does Dodger National Bank then have to its customer, Brooklyn Cogs and Widgets? See §§4A-404(a) and 4A-405(a) and (b).

Upon acceptance by Dodger National Bank, what is the effect on Big Apple's obligation to pay $1 million to BC&W under the terms of their purchase and sale agreement? See §4A-406(a) and (b).

To complete a major expansion of its plant in 2013, Big Apple Manufacturing Company negotiated a loan of $100 million (secured of course by a mortgage on its property) from a major mortgage lender, The Moneymen Group, with headquarters in New England. Big Apple is to make payments of $2 million into a specified account held by Moneymen with Patriot National Bank of Boston by the end of each month over a period of years. On March 25, 2014, the treasurer of Big Apple sends a computer message to Gotham Bank instructing it to transfer $2 million into the specified account at Patriot National Bank on March 30, which is the last business day of the month. At 10:30 a.m. local time on March 30, Gotham sends a Fedwire to the Federal Reserve Bank of New York, instructing it to pay or cause to be paid $2 million into this account at Patriot National Bank of Boston. This message is received by the New York Fed at 10:31 a.m. At 10:45, the New York Fed sends a message by Fedwire to the Federal Reserve Bank of Boston, carrying along the instruction, which message is received by the Boston Fed at 10:46. At 11:00 a.m. the Boston Fed sends a Fedwire to Patriot National Bank instructing it to credit $2 million to the designated account. At noon, the account representative at Moneymen who is responsible for the loan to Big Apple calls Patriot National Bank. She inquires whether a payment of $2 million has been received from Big Apple by that bank and credited to her company's account. She is told that, yes, this has occurred. Carefully outline the course of this particular funds transfer. Who is the originator and who is the beneficiary? Describe each payment order: Who was the sender, which was the receiving bank, and how and when was the order accepted by the receiving bank? What is the end result of the entire process?

Big Apple carries a worker's compensation insurance policy with Big Orange Insurance Company of California. During the first week of each month, Big Apple receives a statement from Big Orange giving it the amount of premium it owes for the month. Payment is owed by the 20th of the month, or on the first business day following the 20th if the 20th falls on a weekend or a holiday. On September 8, having received and reviewed the premium statement for that month, the treasurer of Big Apple sends an instruction to Gotham Bank to transfer the billed amount into an account held by Big Orange Insurance with the Sunshine Bank of Los Angeles, "payment to be credited to that account Tuesday, September 20."

What is the "payment date" of Big Apple's payment order to Gotham Bank? See §4A-401.

What is the "execution date" of that payment order? See §4A-301(b).

Suppose that on September 8, immediately upon receiving the payment order from Big Apple, an authorized representative of Gotham Bank had sent a payment order intended to carry out Big Apple's instructions to the New York Federal Reserve. Would it be correct to say that Gotham had executed Big Apple's order on September 8? What are the consequences for Gotham of its representative's having jumped the gun in this way? See §4A-209(d) and §4A-402(c).

Jules Moneybucks owns and operates a fashionable jewelry store, dealing in both new and antique jewelry, in the heart of New York City. He is contacted by one Ellie Diamond, a broker in jewelry and gems known to Jules, who tells him that she has just made arrangements to purchase a particularly fine piece, a diamond tiara once owned by the Queen of Romania, which she would be willing to sell to Jules for $250,000. Jules is aware of the piece (news of its availability has been circulating in the jewelry business over the past few weeks) and agrees to buy it for that price. It is agreed that Ellie will have the piece delivered by special courier to Jules's shop and that he will then wire the price into a specified account at Ellie's bank, Golden State Bank of Los Angeles. The tiara is delivered to Jules's place of business by (heavily armed) couriers around noon the next day. Jules opens the package and gives the piece a quick look over to determine that it is indeed what he has been promised. He then makes a call to his bank, Gotham National Bank, instructing it to arrange for the immediate transfer of $250,000 into Ellie's account at Golden State Bank. This call is made by Jules at 12:15 p.m. Jules then goes back to bask in the glory of his new acquisition and to arrange for its display. It is only then, upon giving the piece more attention, that he becomes concerned that one of the largest diamonds in it appears to be a replacement and not part of the original piece as it has always been described in the literature. At 12:45 p.m., he places a second urgent call to Gotham Bank and orders it not to go through with the wire transfer that he ordered only half an hour earlier. As it turns out, Gotham Bank had itself already sent a payment order to the Federal Reserve Bank of New York, following up on its instruction from Jules at 12:30 p.m.

Does Jules's countermand of his original order come too late to stop payment to Ellie? See §4A-211.

Can Jules, upon being told that this order has already been accepted by Gotham's sending of a payment order to the New York Fed, try to call that bank and cancel the order sent in furtherance of his originating instruction?

Suppose that when Jules makes his second call at 12:45 p.m., Gotham Bank has yet to issue a payment order of its own carrying out the instruction it received from Jules at 12:15 p.m. What is the result?

Arnold Moneybucks owns and operates a venture capital firm, the Moneybucks Money Fund, which specializes in buying interests in start-up Internet companies. For several months, Andrea Hotshot has been trying to convince Arnold to put some money into her new firm, Horseshoes.com. Eventually Arnold decides to make an investment in Andrea's firm if the right terms can be negotiated. Lawyers for Arnold and Andrea enter into negotiations and eventually arrive at an agreement they think will be suitable to the two parties. A closing is arranged to take place in Chicago, at the principal offices of the Moneybucks firm. Arnold and Andrea are in attendance, along with their various advisors and lawyers. As the closing progresses, the parties make minor changes to the terms of the agreement under which Arnold's firm will buy a stated number of shares for a given price. The exact amount that Arnold is to pay for the shares has to be adjusted to take into account these last-minute changes, as well as the most current information regarding Andrea's firm. After all the various calculations are performed and the paperwork is signed, the last thing necessary to close the deal is for Arnold to pay the sum of $5,230,000 to Horseshoes.com. Arnold goes into the office of the treasurer of his firm and instructs her to have this amount immediately wired into an account that Horseshoes.com has with Palo Alto Bank for Entrepreneurs, located in California. Arnold returns to the conference room where the closing is being held. The participants sit around chatting (and perhaps trying to accomplish other business) for about an hour. At that time a call comes in for Andrea. It is from an officer of the Palo Alto bank, who tells Andrea that a wire transfer for $5,230,000 has just come into the bank via Fedwire and has been credited to her company's account.

Is the attorney in charge of the closing now free to release to Arnold the share certificates in Horseshoes.com which represent his firm's interest in that company? What happens next?

Suppose that the officer of the Palo Alto bank informs Andrea that it has received and credited to her company's account only $5,229,980. It seems that the various banks that have handled the wire transfer have each taken a small fee for their services, and the end result is that $20 less has been credited to Horseshoes.com's account than had been deducted from the Moneybucks' account at the initiation of the transfer. Is Andrea free to consider Arnold in breach of their agreement and call the deal off? See §4A-406(c) and Comment 5 to that section.

Explanations

No. This written instruction to Gotham Bank does not constitute an Article 4A payment order, because it "state[s] a condition to payment to the beneficiary [the San Francisco firm] other than time of payment." As the drafters of 4A point out in Comment 3 to §4A-104,

> The function of banks in a funds transfer under Article 4A is comparable to the role of banks in the collection of checks in that it is essentially mechanical in nature. The low price and high speed that characterize funds transfers reflect this fact.

This would be a payment order under Article 4A. The only "condition" attached to the instruction given by Big Apple was the time of payment.

Under §4A-103(a)(1), a payment order may be "transmitted [to a receiving bank] orally, electronically, or in writing." So the fact that the instruction was made orally would not prevent it from being a valid payment order initiating a funds transfer governed by Article 4A.

Gotham is not obligated to comply with Big Apple's instruction under any rule of Article 4A. As the cited comment says,

> A receiving bank has no duty to accept a payment order unless the bank makes an agreement, either before or after issuance of the payment order, to accept it, or acceptance is required by a funds transfer system rule. If the bank makes such an agreement it incurs a contractual obligation based on the agreement and may be held liable for breach of contract if a failure to execute violates the agreement.

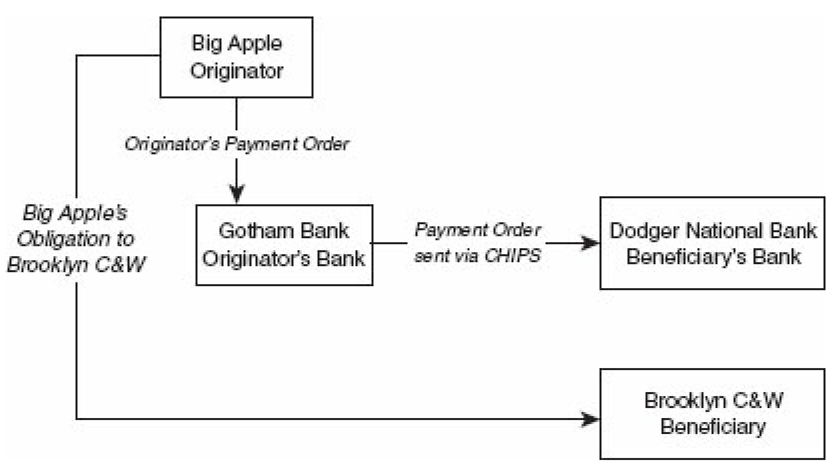
Assuming as we are that Big Apple does have an account with Gotham, and furthermore that the bank has entered into an agreement to comply with payment orders issued to it by the appropriate party at Big Apple, the principal reason why the bank might not want to comply with the order given it would be that Big Apple might not at the moment have $1 million in its account to cover the order. Just as a bank will usually not honor a check written on an account of one of its customers for which there are insufficient funds in the account, it would usually not want to execute an Article 4A payment order that would put it at risk of itself incurring liability when its customer could not "cover" the transfer of funds. The amounts involved in funds transfers are typically much greater than with your average, or even above average, check, so the bank has to be that much more careful.

Unless Gotham has by agreement agreed to execute orders, at least up to a certain predetermined amount, for which there are not currently sufficient funds in Big Apple's account, it is not obligated to accept the order and most likely will not do so. The means Gotham may use to *reject* the payment order it has received are set out in §4A-210(a). Comment 1 to this section, which you should be sure to read in full, states that notice of rejection, when the receiving bank is other than the beneficiary's bank, is not necessary to prevent acceptance of the payment order. "Acceptance can occur only if the receiving bank executes the order." Notice of rejection, however, "will routinely be given by such a bank in cases in which the bank cannot or is not willing to execute the order for some reason." The bank, after all, wants to keep up its good relationship with its customer and not just ignore communications from it.

No. This message back to the sender of the payment order, here the party intending to originate the funds transfer, does not constitute acceptance of the payment order. That can happen, under §4A-209(a), only upon the receiving bank's *execution* of the order. Under §4A-301(a), "[a] payment order is 'executed' by the receiving bank when it issues a payment order intended to carry out the payment order received by the bank."

Yes. Gotham now has accepted the payment order by its execution of that order. It accepted at 10:45 a.m., the time when it initiated its own payment order.

As the funds transfer we are investigating has now gotten going in earnest, it is time for a diagram.



> The originator's payment order was followed up by a second payment order, sent through the CHIPS system, from Gotham to Dodger National Bank, which in this case happens to be the beneficiary's bank.

No. Subsection (b) of §4A-209 governs when a payment order sent to the beneficiary's bank is accepted. Acceptance does not occur simply because that bank has received the payment order directed to it. Acceptance occurs upon the earliest of three possible events. Here the Dodger bank has not yet paid Brooklyn Cogs and Widgets (which would require either that it inform that firm that the money is available in its account, or that it actually apply the $1 million to meet some obligation of BC&W, such as covering BC&W's own transfers out of its account). So an event meeting subsection (b)(1) criteria has not yet occurred. Because this transfer used the CHIPS system, the Dodger bank may not have received settlement at the same time. So (b)(2) can be used to set a moment of acceptance only if we know exactly when Dodger does receive settlement through CHIPS, which might, in fact, be after the cutoff hour the Dodger bank has established as the end of its "funds-transfer business day." See §4A-106. The workings of (b)(3) are explored in Example 2f.

No. Dodger is not obligated to credit BC&W's account with the $1 million immediately. It will not have to do so until it has accepted the payment order that it received from Gotham, and as we've seen it has not necessarily done so yet. Nor is Dodger required immediately to notify BC&W that the order has been received. In fact, it will want to be careful not to do so until it is sure the money has arrived. Should it notify BC&W that the payment order has been received on October 1, it will then have accepted the order and be itself obligated to BC&W for the $1 million as of that moment, under §4A-209(b)(ii), "unless the notice indicates that the bank is rejecting the order [unlikely] or that funds with respect to the order may not be withdrawn or used until receipt of payment from the sender of the order." The concluding part of Comment 5 to this section—beginning with "If the beneficiary's bank wants to defer incurring liability to this beneficiary until the beneficiary's bank receives payment, it can do so."—deals with this crucial matter of timing.

Under §4A-209(b)(3), Dodger will have accepted the payment order sent to it on October 1 as of the opening of its next funds-transfer business day following that date, "if, at that time, the amount of the sender's order is fully covered by a withdrawable credit balance in an authorized account of the sender or the bank has otherwise received payment from the sender." If

CHIPS effected settlement by the end of October 1, (even to imagine otherwise is to assume the occurrence of the "doomsday scenario" of the CHIPS system failing on a given day, an event we are assured in Comment 4 to §4A-405 "should never occur"), then the order to Dodger is automatically accepted as of the opening of business on October 2 if that is a funds-transfer business day as defined in §4A-105(a)(5).

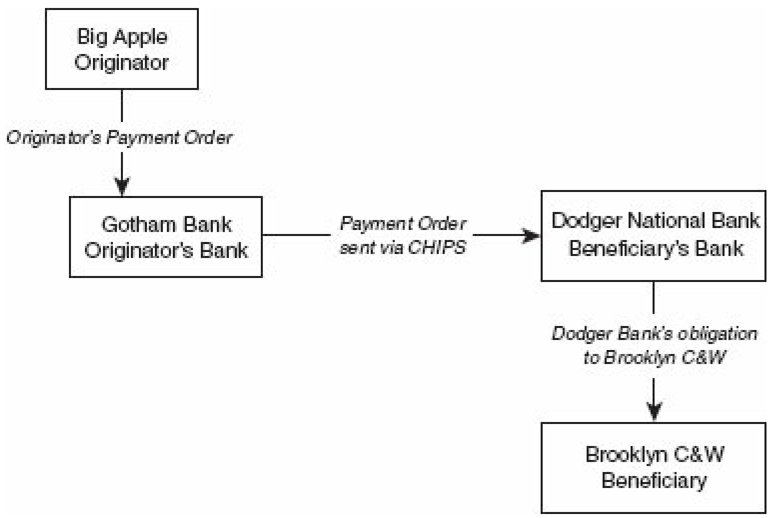
Note in general that if a beneficiary's bank has not already accepted via subsections (b)(1) or (b)(2) of §4A-209, and if for some reason it has not been paid the amount of the transfer as of the beginning of the next funds-transfer business day but "the amount of the sender's order is fully covered by a withdrawable credit balance in an authorized account of the sender," then it can still be held to have accepted the order by the passage of time, unless the order is rejected (under §4A-210) "before that time [the opening of its next funds-transfer business day] or is rejected (i) within one hour of that time, or (ii) one hour after the opening of the next business day of the sender following the payment date if that time is later." Many payment orders to a beneficiary's bank are probably accepted in this way, by that bank's doing nothing to reject the order within the time-frame allowed, just as most checks are accepted by a payor bank by that bank's failure to dishonor and return the item within the time limits laid out in Article 4. You should read over Comments 7 and 8 to §4A-209.

Under §4A-404(a), with only some minor exceptions with which we need not concern ourselves, "if a beneficiary's bank accepts a payment order, the bank is obligated to pay the amount of the order to the beneficiary of the order." As that subsection goes on to detail, the beneficiary's bank can and will be held liable for damages, including in some instances consequential damages, for its failure to pay what *it* now owes the beneficiary. You should recognize your old friend, the rule of *Hadley v. Baxendale*, as it has made its way into that subsection. What it means for the beneficiary's bank to "pay" the beneficiary is set forth in §4A-405(a). Under §4A-404(b), the beneficiary's bank is also responsible for giving notice to the beneficiary "before midnight of the next funds-transfer day following the payment date" when the order has been accepted. If the beneficiary's bank fails to give this notice, it will be liable to the beneficiary for interest on the amount of the payment for any delay in the beneficiary's learning of the payment.

Under §4A-406(a),

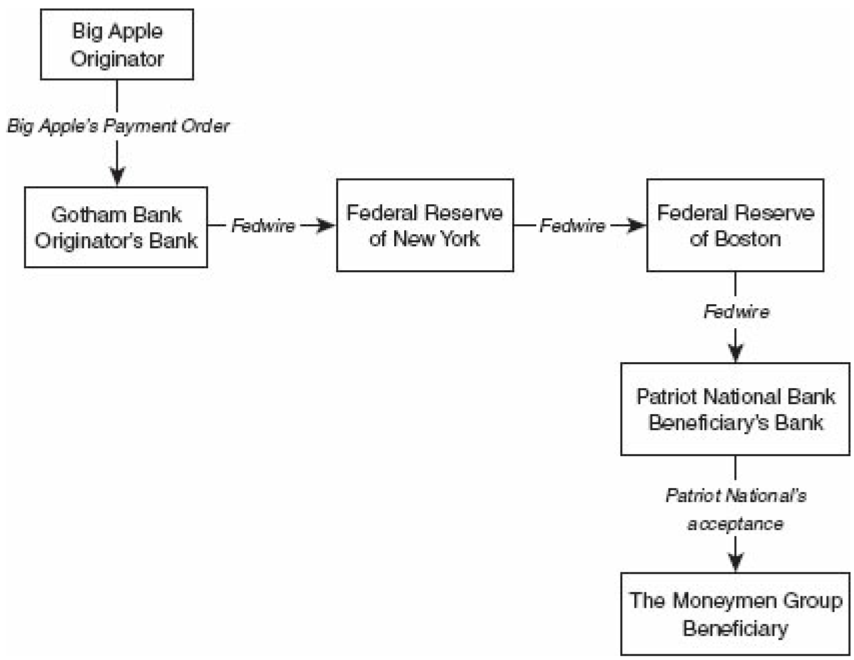
the originator of a funds transfer [Big Apple] pays the beneficiary of the originator's payment order [BC&W] (i) at the time a payment order for the benefit of the beneficiary is accepted by the beneficiary's bank [Dodger], and (ii) in an amount equal to the amount of the order accepted by the beneficiary's bank, but not more than the amount of the originator's order.

Under subsection (b), this discharges the obligation Big Apple had to BC&W under the purchase and sale agreement the two entered into. See Comments 1 and 2 to this section. With Dodger National Bank's having accepted the payment order received by it, thus concluding the funds transfer, our earlier diagram is transformed to the following:



Once again, a diagram will be worth, if not exactly a thousand words, a goodly number of them. See the bottom of this page.

The first payment order was sent on March 25 by Big Apple, the originator, to Gotham, the originator's bank. This payment order was accepted by Gotham at 10:30 a.m. on March 30, by Gotham's execution of the order. It did so by sending a second payment order at that time via Fedwire to the Federal Reserve Bank of New York, which is the receiving bank of this order. This order is accepted by the New York Fed at 10:45 when it sends, via Fedwire, a third payment order to the Federal Reserve Bank of Boston. This order is in turn accepted by the Federal Reserve of Boston when it sends a fourth payment order, again via Fedwire, to Patriot National Bank at 11:00 a.m. This last payment order is accepted by the bank when it receives payment of the amount indicated in the Fedwire message, which will presumably come to it (that is, be credited to its account with the Boston Fed) virtually simultaneously with the message sent to it by that bank at 11:00 a.m. Thus, when the representative of Moneymen calls Patriot at noon, the payment order sent to its bank has almost assuredly already been accepted by full payment to the bank, sometime within minutes of 11:00 a.m. If for some reason it has not, it is then accepted at the moment the person at Patriot tells the person at Moneymen at noon that the $2 million has arrived and has been credited to the Moneymen account. The end result? Patriot National Bank owes Moneymen $2 million and Big Apple's obligation to pay $2 million on its mortgage to Moneymen by the end of March has been discharged. All is well.



The payment date has in this instance been determined, by the instruction sent by Big Apple, to be Tuesday, September 20.

The execution date of a payment order

> means the day on which the receiving bank [here Gotham] may properly issue a payment order in execution of the sender's order.… If the sender's instruction indicates a payment date, the execution date is the payment date or an earlier date on which execution is reasonably necessary to allow payment to the beneficiary on the payment date.

So here the execution date would also be Tuesday, September 20, unless for some reason the Gotham bank thought and was reasonable in thinking that execution on a prior day was necessary to ensure that payment would be made into Sunshine Bank of Los Angeles for the benefit of Big Orange Insurance on time. It is hard to think of a reason why execution even one day ahead of September 20 would be reasonably necessary in this instance, especially when the funds are traveling east to west and into a part of the country where the days end three hours later.

Gotham has not accepted Big Apple's payment order by sending out an order of its own on September 8. Under §4A-209(d), "[a] payment order issued to the originator's bank cannot be accepted until the … execution date if the bank is not the beneficiary's bank." One risk that Gotham faces here is that Big Apple, as the originator, will cancel the order prior to the execution date of September 20 and Gotham will be left holding the bag. Its order will have been carried out almost two weeks earlier and the money will be in the beneficiary's account. Gotham will have no right to payment from Big Apple, because Big Apple has effectively canceled its order. Gotham is left with the right to "recover from the beneficiary any payment received to the extent allowed by the law governing mistake and restitution." Granted, the chances that Big Apple will want to cancel payment of an insurance premium are small, but in other circumstances this could be a greater possibility, and Gotham has incurred a significant risk by acting before the execution date. In addition, under §4A-402(c), "[p]ayment by the sender [Big Apple] is not due until the execution date of the sender's order," so Gotham will have no right to debit Big Apple's account with the amount of the order until September 20. It takes the risk that on that date Big Apple's account will not have enough in it to cover the payment already made by Gotham earlier in the month. At the least, because money in the bank in the amounts typically involved in wholesale wire transfers is money earning interest, Gotham will have to bear the loss of whatever interest would have been attributable to the amount of the transfer because it paid this large amount of money on September 8, and will not be entitled to payment from its customer, Big Apple, until the 20th. See Comment 9 to §4A-209.

Yes, Jules is too late. Here, because no different payment date was specified by Jules, the execution date was, under §4A-301(b), the day the order was received. Gotham executed and by doing so accepted the order at 12:30 p.m. Pursuant to §4A-211(c), "[a]fter a payment order has been accepted, cancellation or amendment of the order is not effective," unless the receiving bank agrees or a funds-transfer system rule allows for cancellation or amendment without the agreement of the bank. This last condition would not be applicable to any order sent via Fedwire. And it is awfully hard to imagine why Gotham would agree to Jules's cancellation of his already accepted payment order unless Gotham itself could be sure that *its* payment order to the New York Fed could in turn be canceled, relieving Gotham of any obligation to pay that bank $250,000. See the concluding paragraph of Comment 3 to this section.

Jules can place the call, but it will have no effect, even if he can find someone at the Fed willing to talk to him and even if the New York Fed has not yet accepted Gotham's order. Looking at §4A-211, we note that a communication attempting to cancel or amend a payment order may be made only by the *sender* of that order. Jules has no authority to cancel an order sent by Gotham, which is what he would be attempting to do.

Under §4A-211(b), Jules's cancellation would be effective "if notice of [his] communication is received at a time and in a manner affording the receiving bank a reasonable opportunity to act on the communication before the bank accepts the payment order."

Yes. If all other aspects of the closing have been taken care of, this payment by wire is the final step in the transaction and the closing can be completed by the attorney's release to Arnold of the share certificates. What happens next? Well, everybody can go home or back to work, unless they want to go out for a meal together to celebrate the closing of the deal. As to what the future will bring for Horseshoes.com and Arnold's investment in that firm, only time will tell.

> This example is meant to illustrate one of the principal ways in which the present ability to wire large sums of money from one party's account into another's greatly facilitates modern business practices. Imagine what this closing would have been like if wholesale wire transfer of funds in amounts as large as this were not feasible, or if they took days to accomplish. Andrea and her attorneys certainly could not agree to close the deal with a personal check from Arnold or his firm. Also, because the exact amount that Arnold is going to have to come up with is typically not determined until the time of the closing, it would be impossible for him to have brought a bank check for the exact amount to the table. The participants in this closing may have had to waste an hour or so just chatting while they waited for the $5,230,000 to be paid, and we acknowledge of course that they are busy people, but this really is an amazingly effective way for the exact amount that ultimately must change hands to be paid—quickly, efficiently, and cheaply.

No. Subsection 4A-406(c) provides that "if the beneficiary's bank accepts a payment order in an amount equal to the amount of the originator's payment order less charges of one or more receiving banks in the funds transfer," payment to the beneficiary and hence discharge of Arnold's obligation to pay $5,230,000 to close the deal "is deemed to be in the amount of the originator's payment order unless upon demand by the beneficiary the originator does not pay the beneficiary the amount of the deducted charges." So Andrea does have the right, if she wishes to insist upon it, to demand that Arnold's firm come up with and pay to her firm the $20 in fees. Arnold can settle it then and there by giving Andrea a $20 bill (if he happens to be carrying around any such small bills).

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* A continuing controversy surrounding Article 4A in the courts is whether its provisions are the sole law applicable to issues arising out of the use of wire transfers. You can see, in the concluding sentence to the Official Comment to §4A-102, that the drafters thought that their work should essentially cover the field and in effect preempt any claims based on law extrinsic to 4A. "[R]esort to principles of law and equity outside of Article 4A is not appropriate to create rights, duties and liabilities inconsistent with those stated in this Article." Most courts have followed the intention of the drafters and have ruled that any arguments based on principles not found in Article 4A itself were "displaced" (see the general principle set forth in §1-103 or §1R-103(b)) by the enactment of 4A and hence are no longer relevant to a controversy governed by that article. A few courts, however, have found room for claims based on common law principles that the courts determined were not "inconsistent with" but rather still valid and supplemental to the rules of 4A. See, e.g., *Sheerbonnet, Ltd. v. American Express Bank, Ltd.*, 951 F. Supp. 403, 28 U.C.C.2d 330 (S.D.N.Y. 1995). Such decisions are, it seems fair to say, in the minority and can perhaps best be thought of as limited to their very distinctive facts. Most Code commentators would argue that Article 4A is exactly what its drafters intended it to be: the sole comprehensive source of law relating to conflicts arising out of wire transfers. Thus, any common law claims are necessarily "inconsistent" with Article 4A as statutory law. Most courts do indeed seem to view the question in the same way and find cases such as *Sheerbonnet* distinguishable if not downright questionable. See, e.g., *Grain Traders, Inc. v. Citibank, N.A.*, 160 F.3d 97, 36 U.C.C.2d 1141 (2d Cir. 1998); *National Council of Churches of Christ v. First Union National Bank*, 153 F.3d 721 (4th Cir. 1993); *Zengen, Inc. v. Comerica Bank*, 41 Cal. 4th 239, 158 P.3d 800, 62 U.C.C.2d 911 (2007).

* It is interesting to note that Article 4A speaks only in terms of a "funds transfer" and not of an electronic or wire transfer. That is deliberate on the drafters' part. As you can see, nothing in the definition of payment order requires that the order be made electronically, whatever we take that word to mean. It is entirely possible, in a given funds transfer, for all the payment orders to be transmitted orally or in writing. Practically, of course, it is the fact that most funds transfers are carried out at least partially through electronic means that makes them suit their intended purpose—and makes them as interesting as they are.

* CHIPS transfers are always denominated in U.S. dollars, no matter where they are heading or from whence they have come. Another communications system, SWIFT (Society for Worldwide Interbank Financial Telecommunications), is an automated system set up to send international funds-transfer messages not denominated in dollars. SWIFT, unlike CHIPS and Fedwire (which we will soon encounter), serves as a message transmittal service only. It does not itself provide a means of settlement between the sender and the recipient of the message, as CHIPS and Fedwire are able to do.

* The actual mechanism for transfer of funds into and out of what I have referred to as the CHIPS pool is in fact Fedwire. In the end-of-day settlement procedure, for example, late in the afternoon CHIPS

informs banks that have a net debit for the day of the amount they owe, and the banks are expected to send this amount to CHIPS through a Fedwire transfer of funds. Early in the evening, CHIPS then sends via Fedwire the amount owed to all those banks with a net credit for the day.

* The communication between the originator and its bank must be carried out using previously designated security procedures; we will deal with what those procedures may be, and how they affect potential liability for fraudulent transactions, in Chapter 23.

CHAPTER 23

Security Procedures and the Risk of Theft

INTRODUCTION TO SECURITY PROCEDURES

With all that money whizzing around the world via wholesale wire transfers and in such large amounts, it is perfectly understandable that thieves would try to get their hands on some of it. The major wire transfer systems, such as Fedwire and CHIPS, are (as you can imagine) quite well aware of the risks involved in carrying on this business, and have in place their own procedures, both in terms of personnel management and the highest level of computer security, for protecting themselves and those that use their services. Banks that regularly carry out payment orders will do likewise. The weakest link in the chain by far is the initial payment order made by the originator to its bank that starts the funds transfer on its way. Article 4A establishes the rules of loss allocation should a thief break into this weakest link and make off with some money that is not rightfully his or hers.

Central to Article 4A's handling of this problem is the concept of the *security procedure* agreed to by the originator and its bank at the time the customer and the bank enter into an agreement under which the bank will accept and execute payment orders received from the customer. Under §4A-201,

> "Security procedure" means a procedure established by agreement of a customer and a receiving bank for the purpose of (i) verifying that a payment order or communication amending or canceling a payment order is that of the customer, or (ii) detecting error in the transmission of the content of the payment order or communication. A security procedure may require the use of algorithms or other codes, identifying words or numbers, encryption, callback procedures, or similar security devices. Comparison of a signature on a payment order or communication with an authorized specimen signature of the customer is not by itself a security procedure.

Something more than signature comparison is required to constitute an Article 4A security procedure. The procedures actually in use vary widely, usually reflecting the size of the customer and the number and typical amount of wire transfers it expects to initiate over time. The largest customers, who regularly transmit many large payment orders a day, will probably have on their premises dedicated computer terminals connecting them directly with their bank; access to such a terminal is normally heavily restricted and the connection is made using a high level of encryption technology. A medium-sized user might have been supplied by the bank with a computer program, which can run on one or more of the user's desktop computers, but which requires both an identification code and a special password to enter and activate. Again, communication with the bank will presumably be by a secure Internet connection. The customer who intends to initiate payment orders infrequently may agree with its bank to rely solely on oral means to communicate with its bank with respect to wire transfers. (Remember that a payment order may be "transmitted orally" under §4A-103(a)(1).) In such a case the security mechanism agreed upon typically requires that the person representing the originator in making the telephone call use a previously agreed-upon keyword or phrase. Either the person at the bank who receives this call or another person at the bank will then call back the originator at a previously specified telephone number. The originator's representative, or a second person working at the originator's business, will then be asked to verify (perhaps by another, different keyword) that the order actually came from the originator. Requiring that two separate people at the originator's place of business, or two separate people at the originator's bank, be involved in the process does, of course, add to the complexity and time it takes to complete the transaction. It may well be justified, however, in that it makes it just that much harder for a single individual working either for the originator or for the originator's bank to pull off a scam.

Notice in the definition of *security procedure* that such a procedure may be set in place not only to make sure that the payment order or other communication has truly been initiated by an authorized representative of the originator, but also to "detect error" in the transmission. The agreement between the customer and the bank, for example, may contain a provision that any payment order for, say, more than $500,000 must be initiated by a second keyword in addition to the one which the customer normally uses. If the customer makes a mistake, and enters the amount $4,000,000 in a payment order that is supposed to be for only $400,000, this type of security procedure should be able to catch the mistake before the originator's bank accepts the order.

BEARING THE RISK OF THEFT

Article 4A allocates the risk of loss due to unauthorized payment orders in three sections, §§4A-202 through 4A-204. Under §4A-202(a), "[a] payment order received by the receiving bank is the authorized order of the person identified as sender if that person authorized the order or is otherwise bound by it under the law of agency." Therefore, an originator's order will be deemed to be authorized by the originator, whether or not it complies with the security procedure agreed to by the originator and the bank, if the order was actually *authorized* by the originator as that term is used in the law of agency.

The originator's bank, however, is usually not in a position to know for sure whether an order it receives by phone or computer is in fact the authorized act of the originator, nor does it want to take the time or incur the risk of trying to make that determination. For most funds transfers, the originator's bank will be entitled to treat the communication as coming from the originator, to debit the originator's account for the amount of the order and to execute the order, by itself sending an order to the next bank in the chain, because the order can legitimately be considered a *verified payment order* under the terms of §4A-202(b): "If a bank and its customer have agreed that the authenticity of payment orders issued to the bank in the name of the customer as sender will be verified pursuant to a security procedure, a payment order received by the receiving bank is effective as the order of the customer, whether or not authorized," as long as certain conditions are met. For a verified order to be effective as an order of the originator, it is necessary that the security procedure agreed to between the customer and the bank be a "commercially reasonable" security procedure, on which see subsection (c). It is also necessary that "the bank prove[] that it accepted the payment order in good faith [as to which see §4A-105(a)(6)] and in compliance with the security procedure and any written agreement or instruction of the customer restricting acceptance of a payment order issued in the name of the customer."*

Thus, the originator's bank is generally entitled to treat as coming from the originator any payment order that is actually authorized *or* that is verified according to the security procedure previously agreed to by the originator-customer. The bank may accept such orders by executing them and may deduct from the account of the originator the amount of the order. In certain limited circumstances, set out in §4A-203, the bank may be barred from enforcing even a verified payment order. We will consider these situations in the following examples. We will also look at the provisions of §4A-204, which sets out the liability of a receiving bank for executing what turns out to be an unauthorized and ineffective payment order.

Examples

The DotCom Corporation and Payson State Bank have entered into a written agreement under which the bank will execute wire transfer payment orders on behalf of the corporation. The agreement provides that all such orders will be transmitted to the bank via a computer program provided to the corporation by the bank. The program, which calls for any payment order to be accompanied by an identification number given by the bank to DotCom as well as by a password chosen by the corporation, is installed on the desktop computer that sits in the office of Hamilton, who is the treasurer of the corporation. The identification number and password are known only to Hamilton and to Washington, who is the president of DotCom. Only Hamilton and Washington are authorized to use the system to send payment orders or other communications to Payson in this way. One day while he is away from his office, Hamilton realizes that he was supposed to have sent a payment order to Payson on the previous day to pay one of DotCom's principal suppliers the money it is owed. Hamilton sends the bank a fax ordering it to send a certain amount of money to the supplier at a given account in a named bank.

s Payson obligated to execute this order?

f Payson does execute the order it has received by fax, is it within its rights to withdraw the amount of the order from DotCom's account with the bank?

The basic set-up is the same as in Example 1. Suppose that one day Hamilton is about to send a payment order to Payson when he finds he can't recall the exact identification number and password he will have to use. He goes to the door of Washington's office and asks her to remind him. Washington shouts out the information to Hamilton. Benedict Arnold, Washington's secretary, hears the conversation loud and clear. Soon after, Arnold goes into Hamilton's office when Hamilton is not there but the computer is on. He sits down at the computer and quickly figures out how to initiate a payment order to Payson, which directs the bank to wire $250,000 into a certain account that Arnold has with Distrust National Bank. Payson does as this order instructs. By the time Hamilton, as treasurer of the company, becomes aware of this transfer out of the corporation's account, when he is reviewing the company's monthly statement, Benedict Arnold has left the employ of DotCom and vanished from the scene.

Vho bears the loss of this $250,000?

Suppose instead that Arnold had only been able to catch the identification number used by the company when Washington reminded Hamilton of the relevant information. Arnold, however, is a good enough computer hacker that he is able, using just that information, to find a way to get the password out of the system and to send a computer message from his own home computer that perfectly mimics an authorized message sent from the computer in Hamilton's office using the correct identification number and password. Once again he orders $250,000 to be sent to his own account, takes the money, and runs. Who would be responsible for taking the quarter-million-dollar loss under this set of circumstances?

Finally, suppose that after $250,000 is mysteriously wired out of DotCom's account with Payson, diligent investigation discloses that the payment order received by the bank and bearing all the indicia of an authentic payment order from the company was actually sent by one Thad Codemaster, a sophisticated computer user. Given some time and effort, Thad has been able to hack into the computer that Payson uses for receipt of payment orders and to capture the identification numbers and passwords used by a number of Payson's customers, including DotCom. Thad has then been able to send from his own computer an instruction that is read by Payson's computer as an authorized message from DotCom, instructing it to wire $250,000 into an account that Thad has with a bank in the Cayman Islands. Who bears this loss? See §4A-203(a)(2).

Brooklyn Cogs and Widgets (BC&W) is one of the largest manufacturers in the New York metropolitan area. Because of the volume of its business, it regularly has to pay a large variety of suppliers, often in amounts ranging up to the millions. BC&W enters into an agreement with one of its banks, Dodger Bank, under which that bank will execute wire transfers out of BC&W's account. The agreement calls for a security procedure under which payment orders can be made over the telephone by the treasurer of BC&W, currently Mr. P. W. Reese, identifying himself and using an agreed-upon password. The bank will then call the treasurer back at his office telephone number and ask him to verify the order by using a second password. Bummer, an employee of BC&W who works in an office near Reese's, is able to overhear Reese initiating and verifying a payment order to the Dodger bank using this system. When next he finds Reese's office empty, Bummer sneaks in and, pretending to be Reese, calls in a payment order instructing the bank to transfer $100,000 into an account Bummer has at Yankee Pinstripe Bank. Within a minute, a call comes into Reese's telephone line asking for Reese to verify the payment order. Bummer is there to pick up the phone and give the needed verifying password. Bummer slips out of Reese's office. Later in the day, when he checks his balance at Yankee Pinstripe, he finds that the account has indeed been credited with $100,000. He goes out to the Aqueduct racetrack that weekend and loses the entire amount and whatever other meager savings he had. When the unauthorized transfer by Bummer is discovered, there is no way he can repay even a fraction of the $100,000.

Does Brooklyn Cogs and Widgets have to bear this loss? What argument might the firm make that it should not?

Suppose further that when BC&W entered into a written funds transfer agreement with Dodger Bank, the bank had suggested and in fact urged the firm to incorporate a security procedure involving a dedicated computer terminal at BC&W's offices, or at the very least a highly secure computer program that could be installed on Reese's desktop computer. Reese insisted that he is an old-fashioned sort, uncomfortable with anything having to do with computers and preferring to do business face-to-face or over the telephone, "where I at least know who I'm talking to." Dodger Bank then wrote into the agreement the "call-back" telephone security procedure that

BC&W was to use in placing payment orders. How does this affect your answer to the previous question? Look at the last sentence of §4A-202(c).

The Yankee Pinstripe Bank inserts into all funds transfer agreements that it asks its customers to sign a clause that reads:

> By its signing this Agreement Customer hereby agrees that in no event shall Yankee Pinstripe Bank be liable for more than $100,000 in loss resulting from the Bank's unauthorized execution of a payment order on behalf of Customer without regard to whether the Bank has complied with its obligations under the Security Procedure set forth elsewhere in this Agreement or whether such Security Procedure is later found to be a commercially reasonable procedure in regard to use by Customer.

Is this an enforceable provision? See §4A-202(f).

Steinbrenner, an employee of Yankee Pinstripe Bank who has access to the Fedwire terminal at the bank and is knowledgeable about its use, issues a payment order to the Federal Reserve Bank of New York purporting to execute a payment order that Yankee Pinstripe received from one of its customers, Uptown Fashions. In fact, Uptown Fashions has issued no such payment order. The order sent to the New York Fed instructs that bank to wire $135,000 into an account Steinbrenner has with the New Dodgers Bank of California. This funds transfer is completed by the New York Fed's sending a payment order to the San Francisco Fed, which in turn sends a payment order to the New Dodgers Bank. That bank accepts the order it receives and credits $135,000 to Steinbrenner's account. Meanwhile, Steinbrenner has caused the same amount to be deducted from Uptown Fashion's account with Yankee Pinstripe. Uptown Fashion soon becomes aware of the amount that has been taken out of its account without its permission and immediately contacts the bank.

Vhich party should bear the loss to Steinbrenner, the thief?

Iow much will Yankee Pinstripe have to credit to Uptown Fashion's account? See §4A-204.

) Suppose instead that Uptown Fashion does not become aware of the unauthorized withdrawal soon after it happens. The $135,000 debit, which was wrongfully deducted from Uptown Fashions's account on May 6, 2013, is reported on the May statement of account, which Uptown Fashion receives from the bank on June 4. No one from Uptown Fashion contacts the bank about this unauthorized withdrawal until July 28. How does this affect your answer to Example 5b? What if Uptown Fashion does not come upon the problem until the time it conducts its annual audit and contacts the bank only in February of 2014?

Finally, what if Uptown Fashion does not complain about the unauthorized deduction from its account until June of 2015? See §4A-505.

Explanations

No. Recall that a receiving bank "has no duty to accept a payment order unless the bank makes an agreement, either before or after issuance of the payment order, to accept it" (Comment 3 to §4A-209). Payson State Bank certainly would have made sure that the funds transfer agreement it entered into with DotCom explicitly provides that the bank is under no duty to accept any payment order other than the one sent to it and verified through the security procedure DotCom has agreed to use. See also the language in §4A-202(b) to the effect that "[t]he bank is not required to follow an instruction that violates a written agreement with the customer.…"

If Payson does execute this order, even though it is under no duty to do so, it will be entitled to withdraw the amount of the order from DotCom's account. This would be an order actually *authorized* by the customer and hence one that the bank is entitled to treat as valid. Payson, of course, took a great risk in executing an order that did not come to it via the agreed-upon secured method. In this instance, at least it did not lose by taking that risk, but it certainly isn't something you would expect the bank to do often—not if it wanted to stay in business.

DotCom will bear the loss of funds. The payment order sent by Arnold was not an authorized order. It does, however, appear to be a *verified* payment order and hence, under §4A-202(b), one that is "effective as the order of the customer."

For Payson to take advantage of the rule of §4A-202(b), of course, it will have to prove a number of things should DotCom want to contest the issue. First of all, was the security procedure under which Payson verified the order a "commercially reasonable method of providing [DotCom] security against unauthorized payment orders"? The first sentence of subsection (c) tells us that the commercial reasonableness of a selected security procedure is a matter of law and that it is to be determined by considering a number of variables. For a case in which the court concluded that a security procedure selected unilaterally by the bank pursuant to the customer's agreement was, as a matter of law, commercially reasonable, see *Braga Filho v. Interaudi Bank*, 2008 U.S. Dist. LEXIS 31443, 65 U.C.C.2d 1038 (S.D.N.Y. 2008), *aff'd.* 334 Fed. Appx.381 (2nd Cir. 2009). For comparison you might want to look at *Patco Construction Company, Inc. v. People's United Bank*, 2012 U.S. App. LEXIS (1st Cir. 2012), in which the First Circuit held that the security procedure used by a bank in dealing with a particular customer's account was not commercially reasonable, in part because a revision in the procedure rendered more likely a compromise of the procedure by a so-called "keylogger," which the court explained "is a form of computer malware, or malicious code, capable of infecting a user's system, secretly monitoring the user's Internet activity, recognizing when the user has browsed to the website of a financial institution, and recording the user's key strokes on that website. In this way, the keylogger is able to capture a user's authentication credentials, which the keylogger then transmits to a cyber thief."

In the hypothetical before us, involving DotCom and Payson Bank, let us assume for the purposes of discussion that the customer and bank have agreed on a security procedure that does meet the test of commercial reasonableness given the circumstances. That being the case, Payson must still establish if called into question that it "accepted the payment order in good faith and in compliance with the security procedure" as well as with any other written agreement or instruction given to it by DotCom that would limit Payson's right to accept a payment order. Given the facts we have here, there seems no reason to doubt that Payson will be able to meet these criteria as well. DotCom has been given a security procedure to use in initiating funds transfers through Payson, and its own officers have compromised the security of the procedure by their casual way of dealing with it. DotCom should and will bear the loss occasioned by its employee's theft.

DotCom will still bear the loss. You can check for yourself that all the criteria established in §4A-202(b) for a verified payment order have been met. As we will see in the next part of this example, §4A-203 provides for some limited instances in which a verified payment order will not be enforceable against the customer, but that section does not apply to this case. The security procedure was overcome by a computer hacker, but it was an inside job, and so DotCom must still take the loss.

Under §4A-203(b)(2), the Payson bank will not be allowed to consider the message initiated by Thad an effective order from DotCom, although from all appearances the order will have seemed to be so as far as the bank's personnel and computers were concerned. Payson will have to bear the loss. This is all assuming, of course, that Thad did not receive any information helping him to break into Payson's system "from a source controlled by the customer [DotCom]… regardless of how the information was obtained or whether the customer was at fault." See Comment 5 to this section.

What if Thad, the thief, had been able to make his way into the "secure" method DotCom had agreed to use in making payment orders to Payson only because he, Thad, *had* received necessary information, "regardless of how it was obtained," from a source within DotCom? Then, of course, the customer would be made to bear the loss, at least if Payson could show it had made the illegitimate payments in good faith. In this regard you may want to follow the story told in two gripping installments in *Experi-Metal, Inc. v. Comerica Bank*, 2010 U.S. Dist. LEXIS 68149, 72 U.C.C.2d 666 (E.D.Mich. 2010), and 2011 U.S. Dist. LEXIS 62677, 74 U.C.C.2d 899 (E.D.Mich. 2011). The bank had provided Experi-Metal, Inc., the customer, with what was found to be a reasonable security method, the details of which were known to only a few people at the firm and which included "a confidential secure token identification, Treasury Management Web ID, and login information" particular to the individual. On the morning of January 20, 2009, an enterprising computer hacker conducted a successful "phishing" expedition from which he or she was able to obtain the necessary information from one Keith Maslowski, the controller of the firm and a person authorized to initiate payment transfers. The phishing e-mail was initially sent to the firm's Vice President of Manufacturing who forwarded it to Mr. Maslowski at 6:48 a.m. on January 22, 2009. As the Court explained

The e-mail instructed the recipient to click on an attached link to complete a "Comerica Business Connect Customer Form." At approximately 7:35 a.m., Mr. Maslowski clicked on the link and was directed to a website where he responded to a request for his confidential secure token identification, Treasury Management Web ID, and login information. By doing so, Mr. Maslowski provided a third-party with immediate online access to Experi-Metal's Comerica bank accounts from which the individual began initiating wire transfer payment orders from Experi-Metal's Sweep Account—one of only two accounts from which online wire transfer orders were authorized. Between 7:30 a.m. and 2:02 p.m., ninety-three fraudulent payment orders totaling $1,901,269.00 were executed using Mr. Maslowski's user information. The majority of these payment orders were directed to accounts at banks in destinations where most cyber-crime has been traced (i.e. Russia and Estonia).

The fact of the malefactor's intrusion into the system was eventually discovered and transfers out of the account stopped, but only after approximately six and a half hours. Of the wire transfers totaling $1,901,269.00 executed by him or her over that period, Comerica recovered all but $561,399. The issue, therefore, became who was to bear the risk of the loss of this amount, the customer or the bank. Fortunately for Experi-Metal, District Judge Patrick J. Duggan found that the burden fell on the bank to demonstrate that it had accepted all of these fraudulent payment orders in "good faith" where that term was correctly understood as requiring, under §4A-105(a)(6) not only "honesty in fact" but also "the observance of reasonable commercial standards of fair dealing," and that Comerica had failed to meet that standard. Both parties offered up expert witness testimony, but Judge Duggan deemed neither expert sufficiently experienced in the specific problems of "online wire transfers and 'phishing' issues." Left to his own devices, the judge concluded the bank had failed to meet its burden of showing its good faith under the circumstances.

There are a number of considerations relevant to whether Comerica acted in good faith with respect to this incident: the volume and frequency of the payment orders and the book transfers that enabled the criminal to fund those orders; the $5 million overdraft created by those book transfers in what is regularly a zero balance account; Experi-Metal's limited prior wire activity; the destinations and beneficiaries of the funds; and Comerica's knowledge of prior and the current phishing attempts. This trier of fact is inclined to find that a bank dealing fairly with its customer, under these circumstances, would have detected and/or stopped the fraudulent wire activity earlier. Comerica fails to present evidence from which this Court could find otherwise.

Although I did not include an example calling for reference to paragraph (1) of §4A-203(a), you should look it over, along with Comment 6. At first it might seem puzzling: Why would a bank agree to take on *greater* risk for verified but unauthorized payments than Article 4A requires? Banks usually try to cut their losses, not the other way around. You have to remember, however, that the customers who are most likely to contract for wholesale wire transfers service are often the largest and hence most powerful commercial entities around—the

> General Motorses and Time Warners of this world. Major banks will understandably compete to get the business of customers such as these. The negotiation between such a customer and its bank that leads to the final funds transfer agreement by which both are bound will not be a simple matter. The bank is in no position to insist that a mega-customer sign the bank's standard form agreement on a take-it-or-leave-it basis. Under such circumstances, it may turn out to be a prudent business decision on the part of a bank to agree in writing to "limit the extent to which it is entitled to enforce or retain payment of [an unauthorized but verified] payment order," so as to get or keep a major customer.

BC&W does not necessarily have to bear the loss. The argument it would make—and it seems a good one under the circumstances—is that the security procedure was not a commercially reasonable one given the size and nature of the customer. Recall that under §4A-202(b), the customer will be responsible for the consequences of the unauthorized but verified payment order only if "the security procedure is a commercially reasonable method of providing security against unauthorized payment orders." The commercial reasonableness of the security procedure is to be considered, under subsection (c),

> by considering the wishes of the customer expressed to the bank, the circumstances of the customer known to the bank, including the size, type and frequency of payment orders normally issued by the customer to the bank, alternative security procedures offered to the customer, and security procedures in general use by customers and receiving banks similarly situated.

> If this minimal procedure of oral confirmation was the only security procedure offered to BC&W, a court might well conclude that the procedure was not commercially reasonable given the particular circumstances.

If BC&W was offered a commercially reasonable security procedure, but then the firm chose a riskier procedure and agreed to it in writing, then under the cited part of §4A-203(c) the bank would be protected by the security procedure and BC&W would have to bear the loss. You should read Comment 5 to §4A-203, which gives a good overview of both the working of and the policy justifications for the "commercially reasonable" security procedure aspect of §4A-202(b).

No, such a provision would not be enforceable. Subsection (f) of §4A-202 makes this clear.

Yankee Pinstripe Bank, should bear the loss. It never received an authorized or verified payment order from Uptown Fashions to transfer any funds out of that firm's account, so it had no right to withdraw any money from that account. The bank has to bear the risk that one of its employees will, as has happened in this case, carry on a fraudulent transaction. Steinbrenner has stolen $135,000 from Yankee Pinstripe Bank, not from Uptown Fashions.

Yankee Pinstripe is going to have to recredit Uptown Fashions's account with the full $135,000, because this "payment" purportedly received from that customer was made on the basis of a payment order that the bank was clearly "not entitled to enforce." In addition, the bank will have to pay Uptown Fashions "interest on the refundable amount calculated from the date the bank received payment to the date of the refund."

Uptown Fashions will still be entitled to refund of the $135,000, but it may have lost the right to interest on this amount by its failure to exercise ordinary care under the circumstances and to "notify the bank of the relevant facts within a reasonable time not exceeding 90 days after the date the customer received notification from the bank that the order was accepted or that the customer's account was debited with respect to the order." If Uptown Fashions does notify the bank on July 28, this is within 90 days, but a question remains as to whether this delay of almost two months was outside a "reasonable time" for the customer to report the totally unauthorized transfer out of its account of this amount of money. As Comment 2 to this section (which you should read at this time) states, "Reasonable time is not defined and it may depend on the facts of the particular case." Many banks will make sure that the written funds transfer agreements they enter into with their customers set forth a specific number of days less than 90 that will constitute "reasonable time" for the purposes of §4A-204, just so that this issue doesn't later have to be litigated. Note that under (b), "[r]easonable time under subsection (a) may be fixed by agreement."

If Uptown Fashions does not notify the bank until February 2014, well beyond 90 days after it received notice of the unauthorized and unverified payment order, then it will definitely lose the right to any interest on the $135,000. It will still, of course, have the right to refund of the base amount. Nothing in §4A-204 puts in jeopardy Uptown's right to refund of money wrongfully taken out of its account. Subsection (b) of §4A-204 explicitly states, "the obligation of the receiving bank to refund payment as stated in subsection (a) may not otherwise be varied by agreement."

Under the cited section, if Uptown Fashion does wait to object until more than a year has passed after its having received notice that this order was executed, it will be "precluded from asserting that the bank is not entitled to retain the payment." It will lose not only the right to interest on the $135,000, but the base amount as well. As the comment to this section remarks, "This section is in the nature of a statute of repose for objecting to debits made out of the customer's account." In this respect, it may put you in mind of the similar (if not identical in detail) §4-406(f), which we looked at as part of the "bank statement rule" covering a bank's mistaken or wrongful payment of a check out of a customer's account. The California Supreme Court recently had the opportunity to consider what the customer must do to "object" for the purposes of this provision.

We must decide exactly what the italicized words mean. Specifically, we must decide whether (1) it suffices for the customer to notify the bank that the payment orders were unauthorized or fraudulent (Zengen's position), or (2) the customer must object to the bank's action in debiting the customer's account or otherwise receiving payment from the customer (the Bank's position).… We conclude that, properly understood, the Bank's legal position is correct. The customer need not precisely state in so many words that it objects to the debiting of its account, but it must inform the bank in some fashion it believes the bank should not have accepted the payment order or otherwise is liable for the loss. Under the California Uniform Commercial Code, a bank is not necessarily liable for accepting an unauthorized, or even fraudulent, payment order. Accordingly, merely informing the bank the payment order was fraudulent does not inform it that the customer considers it liable for the loss.

Zengen, Inc. v. Comerica Bank, 41 Cal.4th 239, 158 P.3d 8000, 62 U.C.C.2d 911 (2007).

A question about §4A-505 that remains to some degree unresolved is whether the statutory one-year period specified in that section may be shortened to something less by agreement of the parties. We saw the analogous question with respect to §4-406(f) in Example 6 of Chapter 19. The courts have typically found nothing inherently wrong with such contractually shortened "cut-off" periods, as long as the time allowed for the customer to become aware of and report problems discernible from his or her account statement is still "commercial reasonable" in the Article 4 context. The answer might not be the same when the problem to be reported is with a funds transfer governed by Article 4A. In 2005, the Court of Appeals of New York determined, in response to a question certified to it by the United States Court of Appeals for the Second Circuit, that "the one-year period of repose period in [§4A-505], governing the customer's time in which to notify the bank of the unauthorized transfer, may not be modified by contract," to a period of less than one year. *Regatos v. North Fork Bank*, 5 N.Y.3d 395, 804 N.Y.S.2d 713, 57 U.C.C.2d 791 (2005). This decision by the highest court in New York has drawn considerable attention and comment, not all of it favorable, as you may imagine. The decision itself acknowledges that "the issue is close." As of this writing, it should be pointed out, no court has differed with *Regatos*. Still, whether other jurisdictions will adopt its ultimate conclusion is, it seems, far from certain, and a matter on which only time will tell the full story.

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* As an example of the type of separate written instruction that the customer may give to its bank "restricting acceptance of payment orders issued in the name of the customer," consider the following. A customer may on a regular basis supply the bank with a list of authorized beneficiaries; that is, of parties and account numbers to which it anticipates it will be transferring funds under its agreement with the bank. The bank is entitled to accept orders only if they instruct payment to these listed beneficiaries. If a crooked employee of the customer were to get his or her hands on the means normally used to transmit payment orders to the customer's bank and try to use this to funnel money into an account of his or her own, the bank would not be entitled to accept this order for payment into an unlisted account.

CHAPTER 24

Errors in Execution

INTRODUCTION

Mistakes will happen. In this chapter we consider which party must bear the risk of a mistake being made somewhere along the line in the execution of a funds transfer governed by Article 4A. We also have to consider what damages a party who fails to fulfill its obligations under the article may be liable to pay for its mistake, to whom and for what amount. Finally we take on a particularly interesting question: If an error in the processing of a funds transfer results in a sum of money (and these being wholesale wire transfers, the sums involved can often be quite great) being accidentally credited to the account of someone, usually just some random person, who was not meant to be the beneficiary of the transfer, what recourse does the party who bears the loss of the mistake have to get the money back from the recipient?

The general principle under which Article 4A operates is, not surprisingly, that the party who made the mistake should be made to bear the risk of that mistake. This general principle is carried out in a number of individual sections that attempt to take into account all the various types of errors that can occur in the funds transfer context. When you think about it—and the drafters of Article 4A did think about it a great deal—there are plenty of ways things can go awry in the wire transfer system. We have to anticipate that an error could be made by the originator itself, by the originator's bank, by any intermediary bank, or by the beneficiary's bank. Also, the error could result in a payment order being for more than was intended or for less, it could be executed in duplicate, or it could be "addressed" to the wrong recipient entirely. For each of the various possibilities that might crop up, Article 4A should provide a definitive answer about which party takes the loss occasioned by its mistake.

Having determined which party was at fault in the course of events, the article also sets out the consequences for that party. In some instances it will be enough to say that the party initially bears the loss of the amount of the transfer involved and the difficulty of trying to recover this amount from whoever is now in possession of the funds. In other situations the party making the mistake may also be liable in damages to another to whom it has failed in its obligation to execute and respond to payment orders without mistake.

Before moving into the examples, there are two particularly important parts of the Article 4A scheme worth noting at the outset. First of all, look at §4A-402. Under subsection (c), as we have already seen, the originator who sends a payment order to its bank is obligated to pay that bank upon the execution of its order. But look at the last sentence:

> The obligation of that sender [here the originator] to pay its payment order is excused if the funds transfer is not completed by acceptance by the beneficiary's bank of a payment order instructing payment to the beneficiary of that sender's payment order.

Under subsection (d), if the originator has already paid its bank on a payment order that does not eventually result in a conforming payment order being received and accepted by the beneficiary's bank effectively discharging the originator's obligation to the beneficiary under §4A-406, the originator's bank is obliged to "refund payment to the extent the [originator] was not obliged to pay" and indeed to credit the originator with interest from the date of its payment until the time of the refund. This is the so-called *money-back guarantee* provision of Article 4A. As Comment 2 to this section quite rightly points out,

> This "money-back guarantee" is an important protection of [the] Originator. Originator is assured that it will not lose its money if something goes wrong in the transfer.

To this we would add only the obvious caveat that the originator can take comfort from this protection only if *it* is not the one responsible for something going wrong.

A second noteworthy aspect worthy of the Article 4 scheme for allocating risks due to errors is that the party making the mistake and having to bear the loss is often given the right to recover from the person into whose account the funds were mistakenly delivered, "to the extent allowed by the law governing mistake and restitution." (See, for example, §4A-303(c).) Article 4A itself does not cover the law of mistaken payment and restitution; these are common law concepts, and the article invokes the common law of the state under whose laws any dispute is being considered to determine whether and to what extent the party who has received a mistaken payment is legally obligated to restore it to the party who made the mistake. In most cases there will be no question that restitution is due. If the account into which a mistaken payment has been credited is held by just some random person who is owed nothing by the originator, it should be clear under the common law of restitution that the money must be restored to its rightful owner. There do turn out to be cases, however, in which the error is such that the party receiving the mistaken payment is not an entire stranger to the originator, and may in fact be owed some money by that entity. Under the common law of restitution, a doctrine referred to as the *discharge for value rule* may come into play. Even if there was no intention on the originator's part to pay its debt to the party mistakenly receiving payment, may that party hold onto the money as long as it credits the payment to what it is in fact owed by the originator? We will look at this common law wrinkle on the right to restitution, and how the courts have dealt with it, in the last example.

Examples

The DotCom Corporation and Payson State Bank have entered into a written funds transfer agreement under which the bank will execute wire transfer payment orders on behalf of the corporation. The agreement sets up a security procedure that takes advantage of a computerized means for DotCom to communicate with the bank. One day Hamilton, the treasurer of DotCom, determines to pay the $800,000 his company owes one of its principal suppliers, the Wireless Corporation located in Palo Alto, California. The purchase and sale agreement between DotCom and the Wireless firm calls for a payment to be made via wire transfer into Wireless's account (#80368046) at the Sunshine Bank of Palo Alto. Using the desktop computer in his office, and following the security procedure provided for in his company's agreement with Payson, Hamilton sends a payment order to that bank. By mistake Hamilton's order directs the transfer of $8 million into Wireless's account with the Palo Alto bank. Hamilton does give the correct name, bank, and account number of Wireless. Within a few minutes of its receiving this order, Payson has deducted $8 million from DotCom's account and sent its own payment order via Fedwire to the New York Federal Reserve Bank, intending to execute this order. A couple of hours later, a payment order is received via Fedwire at the Sunshine Bank of Palo Alto from the Federal Reserve Bank of San Francisco ordering it to credit $8 million to Wireless's account #80368046. Sunshine Bank accepts the order and informs the Wireless Corporation that its account has been credited with $8 million sent to it by the DotCom Corporation.

Can DotCom insist that its bank, Payson State, recredit its account with the excess $7,200,000 that was mistakenly sent to Sunshine and credited to Wireless's account? If not, what can it do to recover this money sent in error?

Suppose that the security procedure set forth in the funds transfer agreement entered into between DotCom and Payson provided not only a means for the bank to verify that the order was truly sent by an authorized person at DotCom, but also a means of detecting certain errors. In particular, it provided that any payment order sent by DotCom for an amount in excess of $1 million would include the prefix "XXX" prior to the amount in the order. The order as sent by Hamilton indicated the amount of the order as "8,000,000 U.S. Dollars" and did not include the "XXX" prefix. As before, the Payson bank executed the order by sending its own payment order to the New York Fed, instructing payment of $8 million into the designated Wireless account. How would this affect your analysis of the situation? See §4A-205.

Hamilton, the treasurer of DotCom, also decides to pay the $500,000 that DotCom owes its advertising agency, MadAve Associates. Hamilton issues a payment order, following the agreed-to security procedures, to Payson State Bank calling for $500,000 to be paid into the account of MadAve Associates at Gotham Bank. Unfortunately, Hamilton enters the number of MadAve's account as #123465 when the correct number is #123456. Payson Bank deducts $500,000 from the DotCom account and executes the order as received. When Gotham Bank receives a payment order instructing it to credit $500,000 into account #123465, its computers report that there is no account at the bank bearing that number.

What should Gotham do in this situation? See §4A-207(a). What will be the end result?

Suppose instead that there is a customer, one Larry Luckowski, who does happen to have an account #123465 at Gotham Bank. Gotham Bank credits Larry's account with the $500,000. Was Gotham wrong to do so? Would it make any difference to your answer if the payment order received by Gotham had included the name of the intended beneficiary ("MadAve Associates") as well as the (mistaken) account number? See §4A-207(b)(1).

Has DotCom paid what it owes to its advertising agency, MadAve Associates? Recall §4A-406.

Against whom is DotCom going to have to proceed to get return of the $500,000 that has gone astray? See the remainder of §4A-207.

The DotCom Corporation also owes $4 million to one of its principal suppliers, Brooklyn Cogs and Widgets (BC&W). Hamilton uses the desktop computer in his office and the security procedure provided for in his firm's agreement with Payson State Bank to place a payment order to Payson, instructing it to wire $4 million into a designated account that BC&W has at Dodger National Bank. Through a foul-up at Payson, the payment order it sends intending to execute DotCom's order is for $6 million. That amount is deducted from DotCom's account at Payson, and that amount is eventually credited to BC&W's account with Dodger National Bank.

Is DotCom entitled to return of the extra $2 million? From whom? See §4A-303(a).

Suppose instead that Payson did at first send a payment order intending to execute the order it received from DotCom in the correct amount, $4 million. Then, later in the day, Payson sent a duplicate order for $4 million, acting on the mistaken belief that it had not yet executed its customer's order. By the end of the day, BC&W's account with the Dodger bank has been credited with each of these orders, for a total of $8 million. How do you analyze this situation?

Finally, suppose that Payson's error was to send an order instructing that only $400,000 be credited to BC&W's account. That firm's account at Dodger is indeed credited with that amount but no more. What then? See §4A-303(b).

After a period of tough negotiations, the president of DotCom has entered into an agreement for her firm to buy all of the outstanding stock of another Internet company, the NetNet Corporation, from its current owner, one Arnold Moneybucks. She has received the approval of DotCom's board of directors to go ahead with the deal. Her agreement with Arnold calls for her to seal the deal by having $5 million wired into a designated account (#789864) held by Arnold in the Palo Alto Bank for Entrepreneurs by the end of business on Friday, November 13. Hamilton, the treasurer of DotCom, is directed to arrange for the transfer of the funds. Late in the afternoon of Thursday, November 12, Hamilton sends a payment order to Payson State Bank, ordering it to have $5 million transferred into Arnold's account as soon as possible. This order is given by Hamilton using the prescribed security procedures called for in DotCom's agreement with Payson and correctly identifies the account into which the funds are to be transferred, both by the name of the beneficiary and the bank account number. Payson deducts $5 million from the DotCom account and attempts to execute the order. Unfortunately, through a foul-up at Payson, the payment order it itself sends, intending to execute DotCom's order gives the beneficiary's account number as #864789. This happens to be the number of an account at the bank, held by Winona Windfall. The Palo Alto bank credits the $5 million it receives to Ms. Windfall's account.

Is DotCom entitled to have its account at Payson recredited for this amount? See §§4A-303(c) and 4A-402(c) and (d).

Assume that Arnold, having not received his payment of $5 million from DotCom by the agreed time, pulls out of the deal. By the end of the next week the aggregate value of all of the NetNet stock has shot up to more than $9 million, because that firm has come upon a method for making its product work just that much faster. Can DotCom hold Payson liable for its mistake to the tune of the $4 million lost profit it can demonstrate it has suffered due to the bank's mistake? See §4A-305(b) and (c).

Winona Windfall comes to you for advice. She wants to know if she is entitled to hold onto the $5 million that has suddenly and mysteriously appeared in her account? What do you tell her?

The recently organized firm of Horseshoes Incorporated (which has just set up a Website called "Horseshoes.com") enters into a funds transfer agreement with the Palo Alto Bank for Entrepreneurs under which that bank agrees to execute wire transfers on behalf of the corporation under a prescribed security procedure. Money is tight for the start-up firm and it begins to experience cash-flow problems. The president and chief executive officer of the firm, one Smithy, has to make calculated decisions about which of its creditors to pay when, and which can be held off for a time. Smithy sees that his firm has just over $160,000 in available funds in its account with the Palo Alto bank. He decides that he can wait no longer to pay a bill for $75,000, which he owes to one of his firm's principal suppliers, the Ironbars Corporation. If he does not pay Ironbars soon, that firm has threatened to discontinue making deliveries to Horseshoes, and if this were to happen Smithy would have to discontinue critical operations. Using the required security procedure, Smithy sends a payment order to the Palo Alto bank, instructing that $75,000 be wired to Ironbars's account, which he gives as #10001 at San Francisco Federal Bank. Unfortunately, Smithy has made a mistake in referring to his list of creditors and their bank account information and in transferring the needed information onto the payment order that he sends to his company's bank. Account number #10001 at San Francisco Federal happens to be the account of the landlord who owns the building out of which Horseshoes operates—and to which Smithy's firm owes a considerable amount (more than $120,000) in back rent. Upon receiving the payment order sent by Smithy, the Palo Alto bank deducts $75,000 from the Horseshoes account. It then sends a payment order of its own instructing the recipient to transfer $75,000 into the account (given as #10001) of Ironbars at San Francisco Federal. By the end of the day, San Francisco Federal has received a payment order instructing it to accept this amount for credit to Ironbars and its account #10001. San Francisco Federal credits the $75,000 to account #10001, which is, as we know, an account held by Horseshoes's landlord, not by Ironbars.

Did San Francisco Federal act in error? Recall §4A-207.

Can Horseshoes demand a refund from the Palo Alto Bank for Entrepreneurs of the $75,000 previously withdrawn from its account held with that bank?

Given the circumstances, does Horseshoes have a right to restitution of the $75,000 it has mistakenly put into the hands of its landlord?

Explanations

No. Payson has executed DotCom's order as it was received according to the agreed-upon security procedure. There has been no error on Payson's part. The error was obviously on the part of Hamilton, representing DotCom, and that company is initially going to have to bear the consequences and see what can be done to recover the money it overpaid by mistake from the Wireless Corporation. DotCom's present predicament is not one governed by Article 4A; the situation is no different than if it had paid by check and made the check out for the wrong higher figure (or if it had paid in cash and just happened to leave off a moneybag full of $8,000,000 instead of $800,000 at Wireless's reception desk). DotCom will first seek recovery of the extra $7,200,000, one would think, simply by contacting Wireless, explaining the mistake, and asking for return of the amount paid in error. In most cases this should probably be enough to get the mistaken payment back. What justification can Wireless have for holding onto $7,200,000 of DotCom's money to which it has no right? If Wireless balks at returning the funds, then DotCom will have to resort to the law, in this case the common law of restitution. Under the common law of restitution, a party that has been mistakenly paid an amount to which it has no right and for which it has not thereafter given value, and that has not relied upon the mistaken payment, is legally bound to return the mistaken payment to the party from whom it came. Barring some unusual circumstances, none of which appear to be present here, Wireless would be legally obligated to return the $7,200,000 to DotCom.

Section 4A-205 deals with the problem of erroneous payments when the payment order was transmitted "pursuant to a security procedure for the detection of error" as was the case here. Under (a)(1), if the sender proves that it complied with the security procedure but that the receiving bank did not, and furthermore that "the error would have been detected had the receiving bank also complied, the sender [here DotCom] is not obliged to pay the order to the extent stated in paragraphs (2) and (3)." Here Payson did fail to observe the security procedure for detection of error, made part of the funds transfer agreement it entered into with DotCom. Had it correctly observed the procedure, the mistaken overpayment would have been detected and the extra $7,200,000 would not have ended up in Wireless's account. This case is covered by paragraph (3). DotCom is obligated to pay Payson $800,000 but no more. Payson will have to recredit DotCom's account for the $7,200,000 wrongfully charged through Payson's mistake. Payson is "entitled to recover from the beneficiary the excess amount received to the extent allowed by the law governing mistake and restitution." So in this instance it will be Payson that will have to resort to the common law of restitution to recover the excess $7,200,000 from Wireless.

Because the payment order received by the beneficiary bank refers to a "nonexistent or unidentifiable person or account, no person has rights as a beneficiary of the order and acceptance of the order cannot occur." Gotham Bank should reject this order, acting pursuant to §4A-210. A communication stating that the order has been rejected should soon be received by Payson, which should then notify DotCom. Under the money-back guarantee of §4A-402(c) and the rule of §4A-402(d), Payson will also have to recredit DotCom's account with the $500,000 it previously deducted from that account. Hamilton will have to try again to make the payment due MadAve, and this time we hope he'll get all the details right.

Gotham was not wrong to credit the $500,000 into account #123465, even if the communication it received did also identify MadAve Associates and not Mr. Luckowski as the intended beneficiary, unless Gotham Bank *actually knew* that the name and number on the payment order it received referred to different persons. Typically, a bank will be operating on an automated system that is programmed to accept payment orders based on the given account number, which is of course more easily dealt with by computer than the name of the account holder. The bank will not even check for any possible discrepancy, and as you can see from the last sentence of §4A-207(b)(1), it is not required to do so. The justification for this rule is given in Comment 2 to this section, which is well worth your time to read.

> What the receiving bank actually knew at the time of its acceptance is a question of fact, and it is not sufficient for the customer to prove that the bank "could have known" or even "should have known" of the different name and number. See *First Security Bank of New Mexico, N.A. v. Pan American Bank*, 215 F.3d 1147, 42 U.C.C.2d 206 (10th Cir. 2000), or *TME Enterprises, Inc. v. Norwest Corp.*, 124 Cal. App. 4th 1021, 55 U.C.C.2d 385 (2004), either of which serves as a good example of how difficult it can be for a customer to prove the bank's actual knowledge of the mix-up, even when its system is not entirely automated but involves genuine human beings retrieving and acting upon incoming information.

No. DotCom has not paid what it owes to MadAve, even though it has attempted to do so. Payment to another is made by wire transfer under §4A-406(a) only when "a payment order for the benefit of the beneficiary is accepted by the beneficiary's bank in the funds transfer." Here Gotham did accept a payment order, but it was not a payment order for the benefit of

MadAve. No money has come into MadAve's account. MadAve remains unpaid.

Hamilton, acting on behalf of DotCom, is the one who made the mistake here, so we would expect that his firm would initially have to bear the loss of the money that was mistakenly transferred into Luckowski's account. In general that will be true. Under §4A-207(c)(2),

> If the originator is not a bank and proves that the person identified by number was not entitled to receive payment from the originator, the originator is not obliged to pay its order *unless* the originator's bank proves that the originator, before acceptance of the originator's order, had notice that payment of a payment order issued by the originator might be made by the beneficiary's bank on the basis of an identifying or bank account number even if it identifies a person different from the named beneficiary.

At first this might seem to give DotCom a good argument that it deserves a refund from Payson of the amount deducted from DotCom's account in regard to the misdirected payment order, but that is highly unlikely. Unless the lawyers who advise Payson have done a particularly poor job, we can be sure that the funds transfer agreement entered into by it and DotCom *did* include notice to DotCom that payment of a payment order issued by DotCom might be made based solely on the account number given to Payson in any payment order, "even if [the number] identifies a person different from the named beneficiary." This provision in Article 4A is meant to make sure that anyone contracting with a bank for wire transfer services is well aware that banks generally deal with these transfers on the basis of the numbers given and not the names, and thus how exceptionally important it is for the originator to get the numbers right. Once the originator is given this notice, it will bear the risk if it specifies an incorrect account number in any payment order it communicates to its bank.

Under §4A-207(d)(2), because the beneficiary's bank rightfully paid the person identified by the number of the payment order it received, and "that person is not entitled to payment from the originator, the amount paid may be recovered from that person to the extent allowed by the law governing mistake and restitution" by DotCom, the originator. DotCom should be able to recover the full amount from Luckowski under restitutionary theory. Luckowski may understandably consider himself lucky suddenly to find $500,000 showing up in his bank account, but luck is itself no reason for him to claim a right to the mistaken payment. He has given no value for this amount. And let us hope for his sake that he has not "relied" on his all of a sudden being that much richer simply because his account balance reads as it does. It would be hard for him to argue that he had *reasonably* relied upon receipt of the $500,000 to, say, withdraw large amounts and spend it on fine dinners and extensive travel, when he had no basis for believing that the money was truly his in the first place.

DotCom is entitled to return of the extra $2 million from Payson, under §4A-303(a). Payson *is* entitled to the amount of DotCom's payment order ($4 million) under §4A-402(c), but no more. Payson will have to recredit DotCom's account with the $2 million that it mistakenly added to the amount of the funds transfer. Payson would then have to recover the $2 million that its mistake has cost it by going against BC&W, once again "to the extent allowed by the law governing mistake and restitution."

Here the mistake is again on Payson's part. It issued a duplicate payment order following one that properly executed the payment order received by Payson from DotCom. Under §4A-303(a), the situation is treated like one in which the originator's bank mistakenly issues a payment order in an amount greater than the originator instructed. Payson can retain payment from DotCom only for the first payment order it sent out. It will have to seek from BC&W directly restitution of the second $4 million, which it has itself paid out of its own funds and which has been credited to BC&W's account.

Under the cited subsection, if a receiving bank (here the originator's bank) mistakenly executes a payment order it has received (here from the originator) for an amount less than the amount of the sender's order, it is entitled to the amount of the sender's order ($4 million) if it "corrects its mistake by issuing an additional payment order [here for $3,600,000] for the benefit of the beneficiary of the sender's order." If Payson does not correct its error, then it is entitled to payment of only $400,000 from DotCom's account. In that case BC&W will, of course, have been paid only one-tenth of what it is owed by DotCom. It will, we have to assume, complain. At this point DotCom presumably issues another payment order for the remainder to be sure that it has paid its supplier what it is owed. Under §4A-305(b), Payson could be held liable to DotCom for any expenses incurred in this second corrective payment order and also for any "incidental expenses" (for example, any late fee it might have paid to BC&W for not having its payment on time because of the bank's initial improper execution). We look at §4A-305 in more detail in Example 4.

Yes. The mistake was on the bank's part. Under §4A-303(c), DotCom, the customer and the originator, does not have to pay a thing for the improperly executed order and is entitled to recredit of its account for the full amount. This is another example of the much-needed security the customer receives from Article 4A's money-back guarantee of §4A-402.

Under §4A-305(b), because Payson's error resulted in noncompletion of the funds transfer, the bank is liable to DotCom

> for its expenses in the funds transfer and for incidental expenses and interest losses … resulting from the improper execution. Except as provided in subsection (c), additional damages are not recoverable.

So DotCom could gets its fees back and recover any incidental damages it has incurred, but would normally not be able to recover any consequential damages from the bank for the improper execution. Under subsection (c),

> In addition to the amounts payable under subsections (a) and (b), damages, including consequential damages, are recoverable to the extent provided in an express written agreement of the receiving bank.

So, unless the initial funds transfer agreement entered into between DotCom and Payson, or some other written agreement entered into later between these parties, specifically obliges Payson to pay for consequential damages in the event it makes an improper execution, DotCom will have no right to insist on payment of any such damages. As you can well imagine, it would be the rare instance in which a bank would agree to pay consequential damages even for its most blatant mistakes. The pre-Article 4A history of this issue and the Article 4A drafters' justification for dealing with the problem as they have is given in Comment 2. As you will read, the position taken by the banks in the negotiation leading up to the final version of Article 4A—that protection for them from the obligation to pay consequential damages was essential to keep wire transfers not only "fast and final" but also "cheap"—was respectfully deferred to by the drafters.

It is your obligation to tell Winona Windfall that the money is not hers to keep. Payson State Bank will have a right to recover it from her in restitution.

No. Under the rule of §4A-207(b)(1), San Francisco Federal was entitled to accept the payment order it received and credit the $75,000 to the landlord's account unless it actually was aware that the name and number of the payment order it received referred to different parties. Here it was presumably not aware of the discrepancy; had it been so, it would not have accepted the confusing order and would have asked for clarification from the party sending it the order. As matters stand, San Francisco was perfectly within its rights to credit the amount to the landlord's account.

No. The Palo Alto bank has made no mistake. It executed the order as received from its customer, Horseshoes. Unless a security procedure was in place that should have detected Smithy's error (and it is hard to imagine what that might be) and the Palo Alto bank failed to carry out its part in observance of this procedure, the bank has no liability for executing as it did the payment order received from Smithy.

Your first reaction to this question might have been to say that Horseshoes is entitled to restitution of the $75,000 mistakenly paid into the account on the theory of restitution, just as earlier we saw that Larry Luckowski and Winona Windfall would have had to return the money mistakenly wired into their accounts. There is a crucial difference here, however. In this instance, the party into whose account the money was wired was in fact owed something by the originator. Can the landlord argue that it is entitled to keep the $75,000 in return for discharging Horseshoes to that extent from Horseshoes' obligation to pay the rent that is in arrears? The issue is not addressed directly by Article 4A. That article defers to "the law governing mistake and restitution" of the jurisdiction, the common law of which applies to the transaction. Comment 2 to §4A-303 does seem to acknowledge that "in unusual cases" the law might allow the actual beneficiary of the last payment order, in this case the landlord, to keep all or part of the amount mistakenly paid into its account. Is this such a case?

> The law of restitution has had to deal with this question of when the recipient of a mistaken payment may actually retain all or part of that payment since long before the wholesale wire transfer came on the scene. Mistaken payments can and have been made by check or cash for just about as long as those means of payment have been in use. Different jurisdictions have adopted slightly different rules to handle the situation. In some, the recipient of the mistaken payment may retain the amount that has come into its possession only to the extent that it has relied to its detriment on the receipt of the funds. The *Restatement of Restitution* sets out a different rule, which has come to be known as the "discharge for value" doctrine (even if the term isn't the best one could think of to explain the situation).

This defense [to an action for restitution] arises where there is a preexisting liquidated debt … owed to the beneficiary by the originator of the payment. If the originator or some third party erroneously gives the beneficiary funds at the originator's request, and the beneficiary in good faith believes the funds have been submitted in full or partial payment of that preexisting debt … and is unaware of the originator's or third party's mistake, the originator or third party will not be entitled to seek repayment from the beneficiary of the erroneously submitted funds [citing to a treatise on contracts].

Bank of America National Trust & Savings Ass'n v. Sanati, 11 Cal. App. 4th 1079, 14 Cal. Rptr. 2d 615, 19 U.C.C.2d 531 (1992). The California appellate court, which also took note of the treatment of the issue in the *Restatement of Restitution*, held the discharge-for-value rule to be applicable under California law, even if in the instant case it did not bar recovery in restitution (because the recipient of the mistaken payment had not established that the originator owed her a preexisting liquidated debt). In the oft-cited case of *Banque Worms v. BankAmerica International*, 77 N.Y.2d 362, 570 N.E.2d 189, 568 N.Y.S.2d 541 (1991), the Court of Appeals of the State of New York held that the discharge-for-value rule applied to suits for restitution of mistaken payments, at least in cases involving "the unique problems presented by electronics funds transfer technology." More recently, the Mississippi Supreme Court applied the discharge-for-value rule to a case involving a mistaken funds transfer that ended up putting money into the hands of a legitimate creditor of the originator's in *Credit Lyonnais New York Branch v. Koval*, 745 So. 2d 837, 39 U.C.C.2d 205 (Miss. 1999).

In the case before us, the landlord would have to establish that Horseshoes did owe it a liquidated debt, but that should not be hard if the struggling firm was behind in the rent. It would also have to show that it took the $75,000 in good faith believing the money to have been sent it by the tenant in at least partial fulfillment of what the landlord was owed. Why would it think otherwise? All that it would know, or that the bank's records would reveal to it if it cared to inquire, is that the Horseshoes firm had wired the amount of $75,000 directly into the account where Horsehoes was suppose to wire rental payments. Would not the landlord be reasonable in believing that its tenant was intentionally sending it this money to get caught up, at least to some partial extent, on the overdue rent? That being so, the discharge-for-value rule, if applied to the situation by the court in the jurisdiction whose common law governs this aspect of the transaction, would bar Horseshoes from recovering any of the money from its landlord. True, Horseshoes will be that much less behind on what it owes in back rent, but how is it going to make payment of the $75,000 Ironbars is still insisting upon if it is to continue to deliver Horseshoes' much-needed raw material. We leave that question for

Smithy and his colleagues at Horseshoes Incorporated to worry over. Nothing in the law of payment systems gives a ready answer to the question of how to come up with the money to pay an obligation when you don’t have it readily on hand.

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